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Interim Report of  
The Bankruptcy Law Reform Committee

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February 2015

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# 1. INTRODUCTION

## 1.1. MANDATE

The Bankruptcy Law Reform Committee (“**BLRC**” or the “**Committee**”) was set up by the Department of Economic Affairs, Ministry of Finance, under the Chairmanship of Mr. T.K. Vishwanathan (former Secretary General, Lok Sabha and former Union Law Secretary) by an office order dated August 22, 2014 to study the “corporate bankruptcy legal framework in India” and submit a report to the Government for reforming the system.<sup>1</sup> During the course of its deliberations, the Committee decided to divide the project into two parts: (i) to examine the present legal framework for corporate insolvency and suggest immediate reforms, and (ii) to develop an ‘Insolvency Code’ for India covering all aspects of personal and business insolvency. Given the multiplicity of laws and adjudicatory forums governing insolvency matters in India, the BLRC is of the opinion that developing an Insolvency Code and its operationalisation will require more time. However, there are several measures for insolvency resolution of *companies* under financial distress that can be implemented sooner without undermining the long-term project of developing and implementing the Insolvency Code. Although one of the main purposes of this interim report (“**Interim Report**” or “**Report**”) is to suggest certain immediate reforms for improving the corporate insolvency regime in India, given that the provisions of the new Companies Act, 2013 (“**CA 2013**”) on rescue and liquidation of companies (or at least the principles therein) may be subsumed into the Insolvency Code with suitable modifications, the issues related to CA 2013 covered in this Report will be relevant for framing the Insolvency Code as well.<sup>2</sup> To that extent, this Interim Report is also intended to serve as an ‘Approach Paper’ for the Insolvency Code.

During the course of its deliberations, the BLRC also realised that since most Micro, Small and Medium enterprises in India (“**MSMEs**”) are established as sole proprietorships whose legal status is inseparable from that of the individuals who own them, issues relating to their insolvency resolution cannot be addressed completely by introducing changes to the corporate insolvency regime alone. While the Insolvency Code will cover all forms of businesses (irrespective of the nature of the entity), given that developing and implementing such a code will require more time, it was decided to include a separate section for MSMEs in this Report and suggest some measures for addressing their immediate concerns.

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<sup>1</sup> Other members of the Committee include Mr. Ajay Tyagi, Additional Secretary (Investment), Department of Economic Affairs, Mr. Ajai Mehrotra (Representative of the Ministry of Corporate Affairs), Dr. Shashank Saksena (Representative of the Department of Financial Services), Dr. M.Vijaywargiya (Representative of the Ministry of Law, Legislative Department), Mr. Sudarshan Sen (Representative of the Reserve Bank of India), Mr. Amit Pradhan (Representative of the Securities and Exchange Board of India), Dr. Ajay Shah (National Institute of Public Finance and Policy), Prof. Susan Thomas (Indira Gandhi Institute of Development Research), Mr. M.R.Umarji (Alliance Corporate Lawyers), Mr. Bahram Vakil (AZB & Partners), Mr. P. Ravi Prasad (Tempus Law Associates), Mr. B.S. Saluja (The International Centre for Alternative Dispute Resolution), Ms. Aparna Ravi (Centre for Law and Policy Research) and permanent invitee, Mr. Malay Mukherjee (CEO & MD, Industrial Finance Corporation of India).

<sup>2</sup> It may be noted that the Ministry of Corporate Affairs representative on the Committee was of the view that given that the provisions relating to winding up of a company as envisaged in Chapter XX of CA 2013 also apply to liquidation of companies on grounds other than insolvency, such provisions may be retained in CA 2013 (and not subsumed in the Insolvency Code). Although the BLRC has not taken a final decision on this issue yet, it notes that in order to prevent the development of a fragmented regime on the law of liquidation, the Insolvency Code can contain provisions on liquidation of solvent companies as well. It may be noted that the Insolvency Act, 1986, the comprehensive insolvency code of the United Kingdom provides for liquidation on non-insolvency related grounds as well.

We also wish to clarify that this Report does not address issues relating to insolvency resolution of banks and other financial institutions. Recent experience and research have shown that financial institutions require a special insolvency regime that is faster than any traditional insolvency procedure, where rights of the creditors and the shareholders can be overridden in the interest of the financial system and the economy. The Financial Sector Legislative Reforms Commission (“**FSLRC**”) constituted by the Government of India has already recommended a separate resolution mechanism for financial institutions. However, in view of a specific proposal made by the Securities and Exchange Board of India (“**SEBI**”) for urgent consideration of the BLRC that proposes exemptions for certain financial contracts from several crucial features of general insolvency law in the interest of efficient functioning of the capital markets, we have examined that proposal in a separate section and made use of the opportunity to raise some questions about the nature and content of such ‘safe harbor provisions’ for the purpose of the Insolvency Code.

Given the increase in foreign investments into India in the recent past, the impact of Indian laws that affect businesses ought to be viewed in conjunction with the laws of other jurisdictions. In this context, the BLRC realises the importance of developing an efficient system for addressing cross-border insolvencies in India. In this regard, some of the previous law reform committees have recommended that the UNCITRAL Model Law on Cross-Border Insolvency should be adopted in India. The UNCITRAL Model Law provides a legal framework to coordinate cross-border insolvency proceedings so as to protect the interests of all stakeholders. The Model Law achieves this object by first, mandating judicial cooperation, secondly, by conferring on a foreign insolvency administrator (or a similar representative) standing in local proceedings and finally, by ensuring equal treatment to foreign and local claims. The Model Law is applicable in cases where the foreign creditor seeks to initiate insolvency proceedings before a local court or when a local court seeks the assistance of a foreign court or foreign representative and finally, in situations where there are parallel insolvency proceedings of the same debtor company in different jurisdictions. The BLRC is of the opinion that further thought and consideration is required before implementing the UNCITRAL Model Law.<sup>3</sup> Such adoption should ideally take place only after the adoption of the Insolvency Code. This is because the effectiveness of a cross-border insolvency system is predicated on the effectiveness of the domestic insolvency regime. The issues relating to cross-border insolvency shall be addressed as part of the final report of the BLRC (“**Final Report**”).

Lastly, this Interim Report does not cover issues relating to debt recovery legislations. It may be noted that the commencement of corporate insolvency procedures may entail significant costs. For *solvent* debtor companies, it will usually be far less costly to provide mechanisms *outside corporate insolvency law* for the resolution of disputes over debts and for the enforcement of undisputed debts on default. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (“**SARFAESI Act**”) and the Debt Recovery Tribunals under the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (“**RDDBI Act**”) were designed to perform this function. Although the former has been fairly successful, several challenges remain to be addressed for both the legislations. We intend to cover issues relating to those legislations in the Final Report.

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<sup>3</sup> It may be noted that in addition to the UNCITRAL Model Law on Cross-Border Insolvency, other international approaches may also need to be considered. Such approaches include the EC Regulation on Insolvency Proceedings (Council regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings), American Law Institute’s NAFTA Transnational Insolvency Project and the International Bar Association Cross-Border Insolvency Concordat.

## 1.2. WORKING PROCESS OF THE COMMITTEE

The BLRC had its first meeting on September 4, 2014. The Committee had five subsequent meetings between September 26, 2014 and January 28, 2015. The Committee received and deliberated on research papers submitted by ‘Finance Research Group, Indira Gandhi Institute of Development Research, Mumbai’ and the Vidhi Centre for Legal Policy, New Delhi. The Committee also received written submissions from its members, the Securities and Exchange Board of India, the Ministry of Corporate Affairs (“MCA”), and the Ministry of Micro Small and Medium Enterprises on various issues relating to its mandate. The Committee also invited and received comments from members of the public through a notification dated October 20, 2014. It is expected that this Interim Report will serve as a catalyst for a wider and more extensive consultation with all the stakeholders.

The Committee is thankful to Dr. Raghuram Rajan, the Governor of the Reserve Bank of India (“RBI”) who addressed the BLRC on September 26, 2014 and underscored the outcomes that need to be considered for a project of this nature.

Vidhi Centre for Legal Policy, New Delhi assisted the Committee with legal research and drafting of this Report.<sup>4</sup>

## 1.3. STRUCTURE OF THE REPORT

This Report is divided into eight parts. ‘Section 3’ of the Report attempts to spell out the broad policy objectives for a well-functioning corporate insolvency system and outlines the minimum requirements for the system to be effective. ‘Section 4’ discusses the law applicable to corporate rescue in India and makes recommendations for reforms. In addition to providing an overview of the law on the books, this Section also examines the law in practice, underscoring the failures of the system. The last part of this Section identifies key issues relating to the law on corporate rescue as proposed in CA 2013 and suggests reforms for making the system more effective. ‘Section 5’ of the Report carries out a similar analysis for the law on liquidation of companies. In ‘Section 6’, we examine issues relevant for both rescue and liquidation of companies. This section covers issues relating to (i) the operationalisation of National Company Law Tribunal (“NCLT”), (ii) practice and procedure in rescue and liquidation proceedings and (iii) regulation of insolvency practitioners. ‘Section 7’ discusses the concept of safe harbours that exempt certain financial contracts from several features of general insolvency law. Lastly, in ‘Section 8’, we examine issues relating to insolvency resolution of MSMEs. ‘Section 2’ provides an overview of the legal landscape and contains an executive summary of all the issues and recommendations discussed in this Report.

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<sup>4</sup> The Vidhi team that assisted the Committee included Debanshu Mukherjee, Arghya Sengupta, Alok Prasanna Kumar, Subramanian Natarajan, Anjali Anchayil, Shreya Garg, Krishnaprasad K.V., Yashaswini Mittal, Jeet Shroff, Faiza Rahman, Chintan Chandrachud and Shubhangi Bhadada. Dr. Kristin van Zwieten, Associate Professor of Law and Finance at the University of Oxford acted as a consultant to the Vidhi team.

## 2. EXECUTIVE SUMMARY

### 2.1. THE LEGAL LANDSCAPE

#### A. LEGISLATIVE COMPETENCE

The Parliament has the power to make laws with respect to any of the matters listed in List I (Union List) and List III (Concurrent List) of the Seventh Schedule to the Constitution of India, 1950 (“**Constitution**”). States also have the power to enact laws on matters listed in List III, besides List II (State List). In case of repugnancy, or conflict between laws made by the Parliament and State Legislature on a matter relatable to List III, the parliamentary law prevails.<sup>5</sup> This is unless the State has sought presidential assent for its law, in which case it prevails in that state only.<sup>6</sup> ‘*Bankruptcy and Insolvency*’ is an item specified in Entry 9 of List III. Entry 43 of List I deals with ‘incorporation, *regulation and winding up* of trading corporations, including banking, insurance and financial corporations, but *not including co-operative societies*’ whereas Entry 44 of List I deals with ‘incorporation, *regulation and winding up* of corporations, whether trading or not, with objects not confined to one State, but not including universities.’ Further, Entry 32 of List II deals with ‘incorporation, *regulation and winding up* of corporations, other than those specified in List I...’ While the entries in List I do not raise any issues regarding the Parliament’s competence to pass a law on such entries, the power of the State Legislatures to enact a law on a matter under Entry 32 of List II does not, in any matter whatsoever, affect the Parliament’s power to enact a law under Entry 9 of list III.

#### B. REVIVAL AND REHABILITATION OF SICK COMPANIES

The Sick Industrial Companies (Special Provisions) Act, 1985 (“**SICA**”) remains to date the only central corporate rescue law in force (although, it applies to industrial companies only). This is because other legislative attempts to overhaul the corporate rescue regime in India have not been made operational yet. Chapter XIX of CA 2013 which provides for a broader and more balanced corporate rescue procedure, applicable to all companies, has not been notified for commencement. The changes made in the older companies legislation, the Companies Act, 1956 (“**CA 1956**”) have also not entered into force: Chapter VIA of the CA 1956, inserted by the Companies (Second Amendment) Act, 2002, which provided for the National Company Law Tribunal (“**NCLT**”) to exercise powers in relation to sick industrial companies could not be notified for commencement because the operationalization of the NCLT remained entangled in litigation. Consequently, the accompanying repealing legislation, the Sick Industrial Companies (Special Provisions) Repeal Act, 2003 could also not be notified. Therefore, as of today, all aspects of rehabilitation of sick/potentially sick industrial companies continue to be governed by SICA and there is no similar statutory rescue mechanism for other categories of companies (other than mechanisms under certain statutes applicable to banking companies and some State Relief Undertaking Acts).

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<sup>5</sup> Article 254(1), Constitution of India 1950.

<sup>6</sup> Article 254(2), Constitution of India 1950.



### C. DEBT RESTRUCTURING UNDER SCHEMES OF ARRANGEMENT

Chapter V of the CA 1956 (or Chapter XV of CA 2013) provides for a mechanism by which corporate revival and rehabilitation may be undertaken (at least in theory). Section 391 of CA 1956 provides for a court-supervised process by which a company can enter into a scheme of arrangement or a compromise with its creditors and/or members. The nature of the scheme or compromise that can be proposed under this provision is very wide: it includes schemes or compromises that may be proposed to restore the company to profitability. Further, such a scheme may be proposed at any stage, including during the pendency of insolvency proceedings against the company. There is no requirement of proof of insolvency or impending insolvency. Thus, the company's management can act at the early signs of financial distress and collaborate with the creditors to rescue the company. Further, unlike the SICA, all companies, and not just industrial companies, are covered within the ambit of Section 391. However, unlike SICA, provisions for debt restructuring under Chapter V of CA 1956 or Chapter XV of CA 2013 do not provide for an automatic moratorium (see Section 4.3 (K) of this Report for an overview of the mechanism envisaged under CA 2013). It may be noted that schemes of arrangement for companies governed under certain special Acts (like the Banking Regulation Act, 1949 for banking companies) are governed by such Acts.

### D. LIQUIDATION/WINDING-UP OF COMPANIES

The current legal framework governing the winding-up of companies is contained in the CA 1956. The provisions contained in Chapter XX of the CA 2013 relating to winding up of companies have not been notified yet. The winding up proceedings under the CA 1956 are carried out voluntarily (members' voluntary liquidation, which is a liquidation procedure for solvent companies, and creditors' voluntary liquidation), or compulsorily by the High Court. It may be noted that insolvency of a company is only one of the grounds for compulsory winding up a company.<sup>7</sup>

### E. INSOLVENCY RESOLUTION OF INDIVIDUALS AND PARTNERSHIPS

(i) Personal insolvency is primarily governed under two Acts in India: the Presidency Towns Insolvency Act, 1909 (for the erstwhile Presidency towns, i.e. Kolkata, Mumbai and Chennai) and the Provincial Insolvency Act, 1920 (for the rest of India). Though these are central laws, it should be noted that both these Acts have a number of state specific amendments. The substantive provisions under the two Acts are largely similar. There have not been any substantial changes to this regime over the years and it has proved to be largely ineffective in practice. (ii) The Limited Liability Partnership Act, 2008 ("LLP Act") includes provisions not only related to winding up and dissolution of a limited liability partnership<sup>8</sup> ("LLP") but also for compromise, arrangement or reconstruction of an LLP<sup>9</sup>. These provisions are similar to the ones in the CA 2013. In addition, the Limited Liability Partnership (Winding up and Dissolution) Rules, 2012 contain detailed provisions regarding the procedure of winding up and dissolution of an LLP in various circumstances, including insolvency.<sup>10</sup> However, unlike the CA 2013, there are no provisions for the rehabilitation

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<sup>7</sup> It may be noted that winding of certain statutory corporations are governed as per the provisions of the special acts applicable to such corporations.

<sup>8</sup> See Sections 63-65, LLP Act, 2008.

<sup>9</sup> See Sections 60-62, LLP Act, 2008.

<sup>10</sup> Please note that there is also a 'Notification regarding Certain Provisions of the Companies Act, 1956 which shall be Applicable to a Limited Liability Partnership', dated 6 January 2010 that has made a number of provisions of the Companies Act 1956 relating to winding up of companies applicable to limited liability partnerships.

or revival of sick LLPs. Most aspects of insolvency resolution of other partnerships (established under the Indian Partnership Act, 1932) are governed under the personal insolvency law.

#### F. INSOLVENCY RESOLUTION OF CO-OPERATIVE SOCIETIES

Co-operative societies fall under the State List in the Constitution and there are State specific legislations for co-operative societies which often include provisions relating to winding up. In addition, the Co-operative Societies Act, 1912<sup>11</sup> and the Multi-State Co-operative Societies Act, 2002<sup>12</sup>, which are both central acts, also include provisions for the dissolution and winding up of co-operative societies registered under them. However, these Acts do not provide for the rehabilitation or revival of sick co-operative societies.

#### G. ASSET RECONSTRUCTION UNDER THE SARFAESI ACT

The SARFAESI Act envisages specialised resolution agencies in the form of Asset Reconstruction Companies (“**ARCs**”) to resolve Non-performing Assets (“**NPA**s”)<sup>13</sup> and other specified bank loans under distress. ARCs are seen as vehicles to increase the liquidity of banks which can divest themselves of bad loans by transferring them to the ARCs. But given their powers to resort to several measures (which includes taking over the management and conversion of debt into equity among others) for recovering the value underlying those loans, ARCs can (at least in theory) also help in insolvency resolution of a company. The banks are required to hold exposure in the sold loans through subscription to security receipts issued by the special purpose vehicle holding the assets under consideration. Such offloaded assets are generally held in trusts that issue security receipts and are managed by the ARCs in their capacity as trustees. It may be noted that an ARC can takeover the management of the borrower only for the purpose of ‘realization of dues’. The management of the company has to be restored back to the borrower after realisation of the dues. Therefore, this mechanism is largely seen as a debt recovery tool and not an insolvency resolution tool (i.e., it does not facilitate rescue in practice).

#### H. DEBT ENFORCEMENT/ RECOVERY

- a. The RDDBI Act set up the framework for the establishment of Debt Recovery Tribunals (“**DRTs**”) and the Debt Recovery Appellate Tribunals (“**DRATs**”) in India. The primary objective of RDDBFI Act was to ensure speedy adjudication of cases concerning recovery of debts due to banks and notified financial institutions. Cases pending before the civil courts where the debt amount exceeded Rs 10,00,000 were automatically transferred to DRTs. There are some key differences between DRTs and ordinary civil courts. First, differences in procedure: ordinary civil courts are bound to follow the procedural rules set out in the Code of Civil Procedure, 1908 (“**CPC**”), whereas DRTs adopt a summary procedure based on the rules of natural justice.<sup>14</sup> Second, in DRTs, there is a more restricted scope for hearing arguments

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<sup>11</sup> See Sections 39-42, Co-operative Societies Act, 1912.

<sup>12</sup> See Sections 86-93, Multi-State Co-operative Societies Act, 2002.

<sup>13</sup> Among other grounds, a loan account is classified as a NPA if “interest and/ or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan” on the basis of guidelines and conditions prescribed by the RBI.

<sup>14</sup> Section 22(1), RDDBFI Act.

over the procedural lapses of the creditor.<sup>15</sup> Third, DRTs fall within the purview of the Ministry of Finance, unlike civil courts, which are part of the judicial hierarchy under the supervision of the respective High Court. Appeals from orders of the DRT lie to the relevant DRAT.

- b. In terms of Section 13 of the SARFAESI Act, after a secured debt has been classified as an NPA and the borrower fails to repay the amount within sixty days of being called upon to do so, the secured creditors can enforce their security interests without the intervention of any court or tribunal. Such enforcement proceedings can also be initiated by the ARCs where the debt has been assigned to them. Section 17 of the SARFAESI Act allows borrowers to file an appeal against such enforcement actions before the DRT (provided certain conditions are satisfied).
- c. Both secured and unsecured creditors can also initiate recovery proceedings by filing a civil suit before a civil court of competent jurisdiction.
- d. Certain State financial institutions can also initiate recovery proceedings under the State Financial Corporation Act, 1951.

#### I. THE NON-STATUTORY FRAMEWORK PRESCRIBED BY THE RBI

- a. Corporate Debt Restructuring (“**CDR**”) Mechanism: The Corporate Debt Restructuring mechanism, as envisaged in the RBI circulars on the subject, aims to provide a forum for corporate debt restructuring for viable businesses in financial distress outside the court/tribunal driven legal processes. Whereas the court-supervised scheme of arrangement procedure provides a formal route to the restructuring of any or all of a company’s debts through a court, the CDR tool aims to facilitate the restructuring of debts owed to a class of creditors (institutional creditors) using essentially contractual means. Only debtors availing credit facilities from more than one bank with an outstanding total debt of INR 10 crore or more are eligible for such restructuring.
- b. Joint Lender’s Forum: The RBI has recently laid down guidelines for early recognition of financial distress, taking prompt steps for resolution, and ensuring fair recovery for lending institutions. Before a loan account turns into a NPA, banks are required to identify incipient stress in the account by creating three sub-categories under the Special Mention Account (“**SMA**”) category. Banks are also required to report certain credit information pertaining to a class of borrowers to the ‘Central Repository of Information on Large Credits’ (“**CRILC**”). These guidelines envisage the mandatory setting up of a Joint Lenders’ Forum (“**JLF**”) by the lending institutions if the principal or interest payment on the loan account is overdue for more than 60 days and the aggregate exposure of lenders in that account is INR 1000 million and above (see Section 4.3 (A) of this Report for an overview of other features of this mechanism). The JLF mechanism allows lenders to explore various options to resolve the stress in the account with the intention of arriving at an early and feasible solution to preserve the economic value of the underlying assets as well as the lenders’ loans. Such options include restructuring of the account if it is *prima facie* viable and the borrower is not a wilful defaulter, and recovery if the restructuring procedure does not appear feasible to the participating lenders.

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<sup>15</sup> H Jayesh, Fraser M Alexander, Rashmi Grover, Ashish Banga, ‘Multi-Jurisdictional Survey: India: Enforcement of Security Interests in Banking Transactions’.

- c. RBI Guidelines for Rehabilitation of Sick Micro and Small Enterprises (“MSEs”): The RBI issued new Guidelines for Rehabilitation of Sick Micro and Small Enterprises in 2012, which provides for the process of identification of a sick unit, early detection of incipient sickness, and lays down a procedure to be adopted by banks for resolution of distress (see Section 8.2 of this Report for an overview of other features).

## J. STATE RELIEF UNDERTAKING ACTS

Several State governments have their own Relief Undertaking legislations that seek to provide for rehabilitation of sick undertakings established or funded by the government. Many such legislations were specifically enacted for the purpose of preventing unemployment (and thus allowed many unviable businesses to continue operating even at the cost of creditors).

## K. THE INDUSTRIES DEVELOPMENT AND REGULATION ACT, 1951

It may be noted that the Central Government is authorised to take-over the management of a scheduled industrial company under the Industries Development and Regulation Act, 1951 several grounds and provide relief similar to those available under insolvency laws (suspension of claims etc.)

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\*It may be noted that this Interim Report focuses on suggesting immediate reforms to the legal regimes discussed in items B., C. and D. above.

## 2.2. POLICY OBJECTIVES AND INGREDIENTS OF AN EFFECTIVE SYSTEM

The incidence of corporate failure has adverse implications for various stakeholders including the shareholders, creditors, employees, suppliers and customers. Corporate failure can also have a ripple effect on the economy, affecting the solvency of many other businesses. Therefore, it is necessary that there be a *highly efficient* corporate insolvency regime that (i) separates viable companies from the unviable ones, and (ii) reorganises the former to the extent feasible and liquidates the latter (before any significant depletion in the value of the business), minimising losses for all stakeholders in the process. A well-designed insolvency system must address the following policy objectives: (i) the protection of creditor interests by maximising returns to creditors; (ii) the promotion of economic growth through efficient reallocation of resources; (iii) the development of credit markets; (iv) the protection of other stakeholders such as employees and shareholders; and (iv) enhancement of investor confidence. An ideal insolvency regime needs to strike the right balance between the interests of all the stakeholders by a reasonable allocation of risks among them. However, the law on the statute book cannot be the sole basis for an effective corporate insolvency regime. For any law to be effective, the institutional context within which it operates plays as significant a role as the substantive law itself. This Report makes a case for reforming the corporate insolvency regime in India through a combination of substantive and institutional changes.

## 2.3. FAILURE OF THE INDIAN CORPORATE INSOLVENCY REGIME

The *Doing Business* reports, a joint project of the World Bank and the International Finance Corporation, attempt to shed light on how easy or difficult it is for a local entrepreneur to open and run a small to medium-size business while complying with relevant regulations in a given economy. The project aims to track changes in regulations in 11 areas in the life cycle of a business. One among these

is the ease of resolving insolvencies. The most recent *Doing Business* Report ranks India 137 out of the 189 economies for resolving insolvencies. It notes, “According to data collected by *Doing Business*, resolving insolvency takes 4.3 years on average and costs 9.0% of the debtor’s estate, with the most likely outcome being that the company will be sold as piecemeal sale. The average recovery rate is 25.7 cents on the dollar”.<sup>16</sup> In spite of being structurally similar to some efficiently functioning insolvency regimes of the world (especially for winding up or liquidation), the Indian regime has not proved to be very effective in practice.

It is seen that delays both at level of the insolvency officials or at the courts/tribunals are primarily responsible for the failure of the Indian corporate insolvency regime. The delays in the proceedings are attributable to several factors including : (i) managerial delaying tactics (which may be at least in part a function of how the existing laws operate), (ii) requirement of court approvals and the discretion available with the courts to intervene at every stage, (iii) lack of institutional capacity (in terms of resources, number of judges and well-trained officials) (iv) complicated priority regime for distribution (in liquidation), (v) abuse by the debtors of the moratorium on debt enforcement (during rescue); (vi) pro-rehabilitation approach of the courts and adjudicatory bodies (even in case of unviable businesses), which appears to have led to practice and procedural rules that result in delays, (vii) holdouts by certain creditors in rescue through schemes of arrangement and compromises with creditors (which again may be a function at least in part of how the existing procedures operate, (viii) delayed decision-making by state-owned creditors (arguably attributable to their institutional structure) and (ix) multiple forums spread across different legislations leading to multiplicity of legal actions on the same cause of action and related conflicts. Recent research indicates that several procedure and practice related issues have contributed to the failure of the corporate insolvency regime in India, indicating that unless such issues are also countered effectively, there may be no substantial improvement in the actual outcomes (see Sections 4.1 (B) and 5.1 (B) of the Report for a discussion on the recent findings).

The inefficiency of the corporate rescue and winding up/liquidation regime in India has led to a situation where most creditors prefer to initiate separate recovery proceedings (often involving the same assets) irrespective of the viability of the company. This leads to conflicts, disorderly distribution, delays and depletion in value of the company, which could have otherwise been rescued. Although the debt enforcement legislations are meant to provide a crucial support function for the corporate insolvency regime, creditors should not be resorting to piecemeal debt enforcement for *insolvent/distressed but viable* companies. Such companies should be referred to a ‘court/tribunal driven’ or ‘out-of-court’ collective rescue process to maximise the value for all the stakeholders. However, in the absence of an efficient corporate rescue and liquidation regime in India, it is difficult to prevent creditors from initiating separate debt enforcement actions even for viable businesses. This problem is compounded further where the creditors are over collateralized (where the value of collateral is higher than the debt). These issues underscore the importance of having a well-functioning, collective corporate rescue and liquidation regime in India that creates the right incentives for all the stakeholders to be involved in the process.

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<sup>16</sup> It may be noted that the *Doing Business* “data for the resolving insolvency indicators are derived from questionnaire responses by local insolvency practitioners and verified through a study of laws and regulations as well as public information on bankruptcy systems”. Further, it may also be noted that the *Doing Business* data is based on information collected from two cities only (Delhi and Mumbai). Therefore this data may not necessarily be representative of the actual situation in India. Anecdotal accounts suggest that the time taken to resolve insolvencies through the formal procedures in India may be much longer in many cases.

## 2.4. SUMMARY OF ISSUES AND RECOMMENDATIONS

Although the rescue and liquidation related provisions of the new CA 2013 make several improvements over the old regime, there are many areas where its provisions need further changes to ensure that the new regime works efficiently and produces the desired outcomes. This not only requires some substantive changes to CA 2013, but also certain institutional and practice related changes. It may be noted that this Report also identifies the amendments required to comply with the judgments of the Supreme Court in relation to the NCLT. The BLRC is hopeful that most of the changes proposed in this Report will help in development of an effective corporate insolvency regime in India and may also help in improving India's ranking in the 'Resolving Insolvency' indicator of the *Doing Business* reports. Moreover, since many of the CA 2013 concepts on rescue and liquidation are also relevant for the proposed Insolvency Code, the issues raised in this Report and the rationale provided for the proposed amendments will be useful for initiating a wider public consultation on all such concepts.

### A. CORPORATE RESCUE

#### a. DETERMINING WHEN CORPORATE REVIVAL AND REHABILITATION IS TO BE INITIATED BY SECURED CREDITORS OR THE DEBTOR COMPANY:

- Section 253(1) of CA 2013 should be amended to specify that any secured creditor may initiate rescue proceedings if the debtor company fails to pay a single undisputed debt owed to such secured creditor exceeding a prescribed value within thirty days of the service of the notice of demand or fails to secure or compound such debt to the reasonable satisfaction of such creditor.
- Section 253(4) should be amended to specify that the debtor company itself may initiate rescue proceedings on the ground of inability or likely inability to pay any undisputed debt of a prescribed value owed to any creditor whether secured or unsecured.
- The prescribed value for making a reference can be provided by rules and may be amended from time to time.
- The NCLT should be empowered to impose sanctions/costs/damages on a petitioner and disallow re-applications on the same grounds if it finds that a petition has been filed to abuse the process of law.

Reasons: CA 2013 permits a secured creditor or a debtor company to make a reference to the NCLT for declaring the company to be a 'sick company' if it is unable to pay/secure/compound the debt when a demand for payment has been made by secured creditors representing 50% or more of the outstanding amount of debt within thirty days of the service of notice of demand. The BLRC is of the opinion that the present criteria for initiating rescue proceedings by creditors and the debtor company may not facilitate early intervention and timely rescue. If a company has already defaulted on 50% of its outstanding debt, it is very likely that it has reached a stage where it would be very difficult to rescue it effectively. Secured creditors or the management of the debtor company with superior information about the company's financial status and prospects should be able to file an application for rescue of the company at a sufficiently early stage so as to allow early intervention for resolving financial distress on the basis of a simple test. Early recognition of financial distress and timely intervention are recognised as key features of efficient rescue regimes. As per the present wording of the relevant provisions on rescue and winding up, while any creditor may file a winding up petition if the company is unable to repay a single undisputed debt exceeding one lakh rupees on a demand having been made, an application for rescue can be made by a secured creditor or the

concerned company only after the company has defaulted on majority of its debt. This appears to be counterintuitive.

(i) Secured creditors: The chances of abusive filing by secured creditors are minimal as they would prefer individual enforcement over the collective rescue procedure. Moreover, the costs and the time taken in rescue are likely to make it less attractive to such creditors in comparison to other means of debt enforcement. Nevertheless, the NCLT should be able to impose sanctions/costs/damages on a petitioning creditor and disallow reapplications on the same grounds if a petition has been filed to abuse the process of law. The BLRC has also proposed that CA 2013 should lay down the criteria for determining whether a debt is disputed or not – please see the recommendations under point B. (a) below. (ii) Debtor company: the debtor company should be able to initiate rescue proceedings even before a default takes place (i.e., on the ground of ‘likelihood of inability to pay debt’). It is important to note that CA 2013 provides for takeover of the management of a debtor company as part of the rescue process (after it has been declared sick), which can even be permanent if the creditors decide to remove the management permanently under a scheme of revival, subject to approval of the NCLT . Given the possibility of such permanent displacement of management, it is unlikely that debtor companies will initiate the rescue proceedings too early in order to abuse the process for extraneous considerations. However, if creditors are allowed to initiate the rescue process on the ground of likelihood of insolvency (as is allowed in some other jurisdictions), it could in certain situations aggravate the financial position of the company. Given the public nature of the rescue proceedings contemplated under CA 2013, further consultation with the stakeholders is required before permitting creditors to initiate rescue proceedings on the ground of likelihood of insolvency.

b. ALLOWING UNSECURED CREDITORS TO INITIATE RESCUE PROCEEDINGS

- Section 253 of CA 2013 should be amended to allow unsecured creditors representing 25% of the value of the debt owed by the debtor company to all its unsecured creditors to initiate rescue proceedings if the debtor company fails to pay a single undisputed debt owed to any such unsecured creditor exceeding a prescribed value within 30 days of the service of the notice of demand or fails to secure or compound it to the reasonable satisfaction of such unsecured creditor.
- The prescribed value for making a reference can be provided by rules and may be amended from time to time.
- Further, the NCLT should be able to impose sanctions/costs/damages on a petitioning creditor and disallow reapplications on the same grounds if it finds that a petition has been filed to abuse the process of law.

Reasons: Unsecured creditors are not permitted to initiate rescue proceedings under the CA 2013. This may reduce their incentives to provide credit. The recent Global Financial Crisis has shown that a market for secured credit may not be available at all times and alternative sources of finance need to be put in place to prevent widespread liquidity crunch when banks are under distress. A right to initiate rescue proceedings is particularly important for unsecured bond investors, who expose themselves to a high risk in such investments. Moreover, there may be companies which have unsecured creditors only. In order to prevent any frivolous applications which may cause damage to the goodwill of the company, the eligibility criteria for making such reference should have value related threshold. It may be noted that Section 262 of CA 2013 requires the consent of 25% of the unsecured creditors by value for a scheme of revival to be sanctioned. Therefore, it is only fair that such percentage of unsecured creditors should be able to initiate rescue proceedings.

c. RELEVANCE OF VIABILITY AND REDUCTION OF TIME-LINES FOR DETERMINING WHETHER TO RESCUE OR LIQUIDATE:

- Sections 253 to 258 of CA 2013 should be redrafted to ensure that the viability of a company is taken into account while determining its sickness and enabling the creditors to have a say in such determination. If an interim administrator is appointed by the NCLT sooner (within seven days of the first application for rescue being filed)<sup>17</sup> for the limited purpose of convening a meeting of a committee of creditors (that will include representatives of all classes of creditors) and submitting a report to the NCLT on the viability of the business, the NCLT will be able to use such report to examine the viability of the business at the time of determining whether a company is sick or not. This allows creditors to have a say in determining the viability of a company at an early stage and significantly reduces the time-period for arriving at a final decision on whether to rescue a company or initiate liquidation proceedings. By way of such an amendment, a decision on whether the sick company should be rescued or whether winding up proceedings should be initiated can be taken within two months of filing of the initial application as against the presently contemplated five months or longer (in case of an appeal against the first order) - up to sixty days for determination of sickness and another ninety days or longer for a final decision on whether to go for rescue or liquidation.
- The terms and conditions of the appointment of the interim administrator and its powers shall be determined by the NCLT at the time of his or her appointment (as is currently envisaged).
- A decision of the committee of creditors on whether the company should be rescued or liquidated should be supported by 75 % secured creditors by value (or 75% of all the creditors by value, if there is no secured debt in the company). As 75% of the secured creditors by value can initiate action under the SARFAESI Act (under the proviso to Section 254 of CA 2013) and defeat the rescue proceedings at any stage, giving them a larger say in assessing the viability of the company will incentivise them to actively participate in the rescue proceedings and not initiate separate security enforcement action.

Reasons: The CA 2013 uses ‘sickness’ as the preliminary criterion for determining whether a company should be rescued or not. However, it does not prescribe any statutory test for determining ‘sickness’ and leaves much to the discretion of the NCLT. The BLRC notes that if some of the procedural steps envisaged in Chapter XIX are collapsed, the viability of a business can be considered at the time of determination of sickness at a very early stage of the proceedings, which will also make the process of making that determination objective. The NCLT is required to decide whether a company is sick or not within sixty days of the receipt of the initial application under Section 253. Such an order can also be subjected to an appeal before the National Company Law Appellate Tribunal (“NCLAT”). The viability of the business can be considered by a committee of creditors (in a meeting convened by an interim administrator) *only after* a company has been declared sick. A decision on the initial question of whether a company should be rescued or liquidated on the basis of such assessment (of the creditors and the interim administrator) can be taken at a hearing, which is to be held as late as five months from the date of the initial application (or longer in case of an appeal on the order declaring that a company is sick) – it is important to

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<sup>17</sup> It may be noted that the time-lines indicated in the recommendations for completion of different processes are indicative and may be streamlined at the time of drafting the amendment bill.



*note that the Doing Business report suggests that some of the better functioning insolvency regimes of the world are able to resolve insolvencies within such period.* The BLRC is of the opinion that viability should be the most important (if not the only) consideration for allowing a company to be rescued. Unviable insolvent companies should not be allowed to continue functioning for extraneous considerations. Liquidation should not be seen as a measure of last resort for unviable businesses that have become insolvent – they should be liquidated as soon as possible to minimize the losses for all the stakeholders.

- d. MORATORIUM: The NCLT's discretion to grant, refuse or lift a moratorium under Section 253 (2) should be guided by a non-exhaustive list of grounds specified in a separate statutory provision. Such grounds may include:
- The moratorium may ordinarily be granted if the business seems *prima facie* viable (and needs to be protected from piecemeal sale or liquidation).
  - The moratorium may not be granted if 75% of the secured creditors by value (or 75% of all the creditors by value where there is no secured debt in the company) dissent to the grant of a moratorium.
  - The moratorium may not be granted where there is any evidence of fraud, diversion of funds, etc.
  - Once a moratorium has been granted, the NCLT may terminate or modify the same or impose terms on the application of the moratorium, for cause.
  - The NCLT may terminate/modify or impose terms on the application of the moratorium on the following grounds: (a) if the creditor applying to the NCLT for leave to take debt enforcement action is able to prove that the grant of leave is unlikely to hinder the purpose of the rescue proceedings from being achieved; (b) on the application of the creditor applying for the same if the debtor company has not 'adequately protected' the interests of the such creditor; (c) if the creditor is able to show that the property in question is not necessary for the effective reorganization of the debtor company.
  - In exercising its discretion on whether to grant leave to a creditor to take enforcement action, the NCLT may balance the legitimate interests of such creditor against the legitimate interests of other creditors of the debtor company. If significant loss (financial or non-financial, direct or indirect) will be caused to the creditor applying for leave to take enforcement action if such leave is refused, the NCLT may normally grant leave. However, if the loss caused to the other creditors in granting such leave is greater, then the NCLT may not grant leave. In conducting the balancing exercise, the NCLT may consider factors such as the financial position of the debtor company, its ability to pay arrears due to the creditor as well as continuing payments, the proposals put forth by the interim administrator or the company administrator, the time for which the rescue proceedings has already been in place and the time for which such proceedings will continue, the effect on the rescue proceedings if the NCLT were to grant leave, the effect of refusal of leave on the creditor applying for leave, the end result to be achieved by the rescue proceeding, the prospects of such a result being achieved. In considering the various factors listed above, if loss to the creditor applying for leave is certain if leave is refused, but loss to the others only a remote possibility if leave is granted, then the NCLT may grant such leave to the creditor.
  - Lastly, the moratorium shall automatically stand revoked if the NCLT makes determination under Section 253 (7) that the company cannot be rescued.

In order to prevent a precipitous break-up of a viable company before the NCLT decides on an application for a moratorium, there should be an automatic interim moratorium in place till such determination (or for a maximum/non-extendable period of thirty days, whichever is earlier).

Reasons: The CA 2013 provides for a moratorium on enforcement proceedings to be granted on an application to the NCLT, and for a fixed duration of 120 days. The purpose of a moratorium is to (a) keep a debtor company's assets together during the rescue proceedings by providing relief from debt enforcement in certain circumstances and (b) avoid multiple legal actions without undermining the interest of the creditors. However, the provision on the grant of moratorium in CA 2013 suffers from the following problems: (i) wide discretion to the NCLT to determine whether a moratorium should be granted or not; (ii) no provision for lifting the moratorium or modifying its terms once it has been granted; (iii) no consideration of creditor interests in granting the moratorium; (iv) no express requirement for consideration by the NCLT of creditor interests in making the decision to granting the moratorium. In relation to the interim moratorium, given the possibility of takeover of management (which can even be permanent) under the rescue mechanism under CA 2013, it is unlikely that debtor companies will initiate rescue proceedings only with the intention of taking advantage of such limited and interim automatic moratorium.

e. DIRECT APPOINTMENT OF THE COMPANY ADMINISTRATOR BY THE SECURED CREDITORS:

- 75% of the secured creditors in value (or 75% of all creditors by value, if there is no secured debt in the company) should be able to appoint a company administrator directly (after a company has been declared sick) and determine the terms and conditions for such appointment (including the fee), subject to *post facto* confirmation by the NCLT. Such creditors may appoint the interim administrator as the company administrator.
- The CA 2013 should be amended to empower the Government to issue separate rules to prescribe standard terms and conditions for such appointment.
- The NCLT may confirm such appointment in the absence of a manifest violation of the prescribed terms and conditions or a challenge by the company or the other creditors. The process for appointment of the company administrator should be completed within fifteen days from the date of the order of the NCLT determining that the debtor company can be rescued.
- The company and/or other creditors should be permitted to petition the NCLT for the removal or replacement of the company administrator on grounds as may be prescribed by rules. Further, a provision similar to the UK's provision for "unfair harm" (which entitles a creditor to petition the court for relief where the administrator is acting so as to harm the interests of the applicant, with the available relief including the removal of the administrator) may be appropriate.<sup>18</sup> The NCLT should be able to impose sanctions/costs/damages on a petitioner if it finds that a petition challenging such appointment has been filed to abuse the process of law.
- The NCLT shall dispose of any application for removal or replacement of the company administrator within thirty days of the application.

Reasons: The current scheme of the CA 2013 does not provide for the participation of creditors in the appointment of the company administrator (who is appointed at a later stage for the purpose of preparing/implementing a scheme of revival and/or taking over the management or assets). He is to be appointed by the NCLT. There is a strong case to be made for creditor involvement in the process of appointment of the company administrator. Creditors are likely to be most incentivised to select

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<sup>18</sup> Schedule B1 para. 74 of the Insolvency Act 1986.

the person who is best suited for the task - as the fees payable to the company administrator may be taken out of the company's assets, the creditors will often choose a person who is familiar with the company's business, its activities or assets or has skills, knowledge or experience in handling the particular circumstances of the case. Permitting such direct appointment of company administrators may also help in the development of a market for turnaround specialists in India. The possibility of abuse can be minimised by incorporating safeguards and allowing such a right to a large majority of secured creditors. Giving such right to the secured creditors will incentivise such creditors to participate in the rescue process and not initiate separate recovery proceedings which may lead to breaking up of viable businesses. Further, the debtor company and other creditors may be given the right to file a petition before the NCLT to remove or replace the administrator on specified grounds. Such a measure, when combined with the administrators ability to takeover the management of a company (discussed below) could also help in overcoming the limitations of SARFAESI Act for using this tool of 'management acquisition' for resolution of insolvency. The SARFAESI Act (read along with the RBI guidelines) permits takeover of management only for the purpose of recovery, and does not help in the revival process. Providing appropriate level of protection for directors nominated by an administrator is important for incentivising suitable experts to come forward and offer their services for turning viable companies around.

f. TAKEOVER OF MANAGEMENT OR ASSETS BY THE ADMINISTRATOR: Chapter XIX of CA 2013 should have a separate provision on takeover of management or assets by the company administrator, which should provide for the following:

- The NCLT may direct the company administrator to takeover the management or assets of the debtor company *suo motu* (on its own motion) or on an application made by 75% of the secured creditors in value (or 75% of all the creditors by value if there is no secured debt in the company). Such an application may be made within seven days of confirmation of the administrator's appointment.
- The NCLT shall decide on such application of the secured creditors within thirty days. The *suo motu* order may be made during any stage of the rescue proceedings.
- There should be a separate provision to guide the NCLT's discretion for directing takeover of management or assets by the company administrator and the scope of such order.
- Such provision should provide for a non-exhaustive list of grounds to guide the NCLT's discretion in determining whether such takeover should be ordered or not. It may be noted that the NCLT will be required to allow the debtor company to be heard before such an order is passed. Such grounds may include:
  - Fraud or impropriety;
  - Mismanagement of the affairs of the company;
  - The debtor company has defaulted in meeting its undisputed payment or repayment obligations to any creditor who is eligible to make a reference under Chapter XIX *and* where any of the following conditions are satisfied: (a) where the debtor company has defaulted on such obligations despite having the capacity to honour them; or (b) where the debtor company has not utilised the finance from the creditors for the specific purposes for which finance was availed of but has diverted the funds for other purposes; or (c) where the debtor company has siphoned off the funds such that the funds have not been utilised for the specific purpose for which finance was availed of, nor are the funds available with the debtor company in the form of other assets; or (d) where the debtor company has disposed off or removed the movable fixed assets or immovable property given by it for the purpose of securing a loan from any creditor without the knowledge of such creditor; provided

that a solitary or isolated instance should not form the basis for such takeover unless the NCLT is of the view that such an intervention is required for protecting the interest of the business and the stakeholders.

- The debtor company does not engage constructively with the creditors by defaulting in timely repayment of undisputed dues while having ability to pay, thwarting the creditors' efforts for recovery of such dues by not providing necessary information sought, denying access to assets financed or collateral securities, obstructing sale of such securities and in effect, deliberately obstructing the legitimate efforts of the creditors to recover their undisputed dues; provided that a solitary or isolated instance should not form the basis for such takeover unless the NCLT is of the view that such an intervention is required for protecting the interest of the business and the stakeholders.
  - Unauthorized transfers of the debtor company's cash or assets during the course of rescue proceedings or anytime before the commencement of the proceedings if the NCLT is satisfied that such transfers were carried out for the purpose of putting such cash or assets beyond the reach of the creditors who have a claim on such cash or assets;
  - Where an application for rescue has been filed by the debtor company without a draft scheme for revival or rehabilitation and there is a declaration to that effect by its board of directors (as presently envisaged under the proviso to Section 256(b)).
- The NCLT's order for takeover of the management may also provide for the following:
    - Empower the administrator to appoint or dismiss managerial personnel (subject to applicable labour laws) including directors as part of taking over the management; any directors nominated on the board of the company by the administrator as part of an attempt to rescue a company shall have similar level of protections as envisaged for directors appointed in terms of Section 35A of the State Bank of India Act, 1955 and hold office for such period as directed by the administrator or the NCLT (as the order may prescribe). Such a director will not incur any liability 'by reason of only being a director or for anything done or omitted to be done in good faith in the discharge of his duties as a director or anything in relation thereto.'
    - Further, in cases where the financial distress of the company is not attributable to managerial actions and where the presence of such management (or senior employees) is in the opinion of the administrator crucial for a successful turnaround of the business, the administrator should be allowed to enter into agreements (on behalf of the company) with such managerial personnel that incentivise them to stay on for turning the company around.
    - Require the other directors or employees to (a) extend all assistance and co-operation to the company administrator and (b) not carry out any act that materially affects the business or property of the company without the prior permission of the administrator.
    - Such an order may also specify the powers of shareholders after the administrator takes over the management and define the rights of the administrator vis-à-vis the shareholders.
    - The NCLT may also be guided by Section 15 of the SARFAESI Act to determine the manner and effect of such takeover of management.

Reasons: One of the main drawbacks of the SICA regime was that it allowed the existing management of the debtor company to remain in control of the company during the course of rescue proceedings (which facilitated practices involving siphoning of assets, etc.). In order to address this

concern, the CA 2013 provides that an interim administrator or the company administrator can take-over the management of the debtor company, but only on being directed to do so by the NCLT. Once again, it leaves too much to the discretion of the NCLT without providing any criteria to guide the exercise of such discretion. Given that an NCLT order for takeover of management can be appealed before the NCLAT (and subsequently before the Supreme Court), the law should specify a non-exhaustive list of grounds on which the NCLT may direct that the management may or may not be taken over to avoid the possibility of protracted disputes on the question of takeover of management. It may be noted that Section 420 of CA 2013 requires that the NCLT give the concerned parties a reasonable opportunity of being heard before passing any order. In the absence of clear grounds on which such orders may be passed, matters can easily get entangled in long-drawn-out litigation. Further, unlike SARFAESI Act that includes a detailed provision on the manner and effect of such takeover, CA 2013 is silent on these aspects (including the question of the interrelationship between the company administrator and the existing directors/management), which is also problematic.

- g. POWERS AND FUNCTIONS OF THE COMPANY ADMINISTRATOR: Section 260 should be amended to provide the following powers to the company administrator:

General powers in relation to takeover of management (which will include takeover of the company's assets):

- Without prejudice to the powers of the NCLT to direct the company administrator to perform any function, the company administrator shall have the following powers after he has been directed by the NCLT to take over the management of the company:
  - do anything necessary or expedient for the management of the affairs, business and property of the company;
  - enforce, modify or terminate any contract or agreement entered into by the company depending on whether such contract is beneficial or detrimental for effectively rescuing the company;
  - take possession of and collect the property of the company;
  - appoint a lawyer or accountant or other professionally qualified person or expert to assist him in the performance of his functions;
  - bring or defend any action or other legal proceedings in the name and on behalf of the company;
  - power to raise or borrow money and grant security therefor over the property of the company as part of a scheme of revival, subject to the terms of the scheme;
  - use the company's seal;
  - do all acts and to execute in the name and on behalf of the company any deed, receipt or other document;
  - effect and maintain insurances in respect of the business and property of the company;
  - do all such things as may be necessary for the realisation of the company's property;
  - carry on the company's business;
  - make any payment which is necessary or incidental to the performance of his functions;
  - do all things incidental to the exercise of the above powers.

General powers in relation to takeover of assets (the management need not be displaced in cases where an administrator is directed to take over a particular asset or assets):

- Without prejudice to the powers of the NCLT to direct the company administrator to perform any function, the company administrator shall have the following powers after he has been directed by the NCLT to take over any asset or assets of the company:
  - take possession of such assets;
  - do anything necessary or expedient for the management of such assets;
  - enforce, modify or terminate any contract or agreement entered into by the company in relation to such assets depending on whether such contract is beneficial or detrimental for the protection of such assets;
  - appoint a lawyer or accountant or other professionally qualified person or expert to assist him in the performance of his functions in relation to such assets;
  - bring or defend any action or other legal proceedings in the name and on behalf of the company in relation to such assets;
  - do all acts and to execute in the name and on behalf of the company any deed, receipt or other document in relation to such assets;
  - effect and maintain insurances in respect of such assets;
  - make any payment which is necessary or incidental to the performance of his functions in relation to such assets;
  - do all things incidental to the exercise of the above powers.

Common principles applicable to the above powers:

- Any action of the company administrator that may adversely affect the rights of the existing creditors or the shareholders will require prior authorisation from the NCLT.
- Any action of the company administrator relating to transfer of assets or property of the company other than in the ordinary course of business will also require prior authorisation from the NCLT.
- The company administrator should also have the power to apply to the NCLT for seeking directions and clarifications in relation to the above functions.
- The NCLT shall have the power to modify any of the powers of the company administrator at the time of directing such administrator to takeover the management or assets.
- After a scheme of revival has been sanctioned by the NCLT, the company administrator shall have such powers and perform such functions as may be specified in the scheme or as directed by the NCLT for the proper implementation of the scheme.

Reasons: Chapter XIX of CA 2013 envisages an important role for the company administrator (who can be selected from a panel of specified professionals) in the revival and rehabilitation of financially distressed companies. However, despite having such a prominent role in the rescue proceedings, the CA 2013 does not specifically set out the powers and functions of the administrator in detail. Section 260 (1), CA 2013 states that the company administrator shall perform “*such functions as the Tribunal may direct*”, thereby leaving much to the discretion of the NCLT. Unless the statute specifies some basic powers of the administrator in line with international best practices after it has been directed to takeover the management or the assets, there will be a lot of uncertainty on this issue which may lead to delays and undermine the very purpose of involving independent insolvency practitioners in the rescue process. There may be a considerable time gap between an administrator’s taking over the management or assets and the final order of the NCLT sanctioning the scheme. The proposed powers will ensure that company administrator is able to preserve the value of the company and protect its business and/or assets till the scheme is sanctioned. This is important for addressing issues faced under the SICA regime wherein the management often engaged in practices like siphoning of assets, etc after filing a reference for rehabilitation. Appropriate safeguards have also been proposed to prevent any unilateral action of the company administrator that could harm the interest of the stakeholders.

h. SCHEME OF REHABILITATION:

- Section 262 should be amended to provide for the following principles to be applicable at the time of sanctioning a scheme of revival: (i) the creditors within the same class should be treated equally; (ii) dissenting creditors should get as much in scheme as they would in liquidation; (iii) consent of creditors who are not affected by a scheme should not be required (for instance, secured creditors who have realised their security interests outside the rescue proceedings); (iv) related parties should be excluded from the unsecured creditors entitled to vote on a scheme.
- Identifying ‘creditors who are unaffected by a scheme’ and ‘unsecured creditors who are related parties of the company’ should be a specified function of the company administrator under Section 260. The process of identification should be completed before the scheme is put to vote.
- Section 261 (2) should be amended to specify that a scheme of revival may include ‘measures imposing obligations on the debtor company to provide periodic reports to the company administrator, creditors and the NCLT on cash flow status of the company including utilisation statements’. The NCLT will be able to monitor this under its general powers to monitor the implementation of the scheme under Section 264 and order corrective action if required.

Reasons: In order for the scheme for the rehabilitation of the company to be sanctioned, CA 2013 requires such scheme to be approved by (i) secured creditors representing 75% in value of the debts owed by the company to such creditors and (ii) unsecured creditors representing 25% in value of the amount of debt owed to such creditors. While allowing unsecured creditors to vote on a plan of rehabilitation allows them to be part of the process, their involvement is also in the interests of the debtor in the long run. However, the BLRC is of the view that this provision needs further thought and consideration to prevent hold-outs by non-consenting creditors. Accordingly, appropriate level of thresholds will be devised at a later stage (during the formulation of the Insolvency Code). However, the CA 2013 provision on creditor consent for a scheme of revival seems underdeveloped in several other aspects, which need to be addressed now. The above recommendations are designed to (a) provide for a predictable and fair mechanism for sanctioning of a scheme of revival, (b) avoid hold-outs by debtor companies through their related parties and (c) prevent diversion of cash flow generated by the business after approval of a scheme of revival.

i. RESCUE FINANCING AND GRANT OF SUPER-PRIORITY:

- Section 261 should be amended to include ‘raising secured and unsecured loans from any creditor (whether existing or external) as part of a scheme of revival’. The scheme may also provide for ‘super priority’ being granted to creditors who provide such finance – i.e., the rescue finance providers will rank ahead of all existing creditors subject to such safeguards for the existing creditors as may be provided in the scheme. Given that a scheme of revival will have to be approved by the requisite majority of creditors as specified in Section 262, the terms of such rescue finance (including super-priority rights, if any) will also be subject to approval by such creditors.
- Section 290 (1) (e) should also be amended to allow company liquidators the power to raise both secured and unsecured loan during liquidation proceedings (presently, they are empowered to raise secured loans only).

Reasons: If a financially distressed company is to be able to successfully pull itself out of rescue proceedings, continued trading during the course of rescue proceedings is to be facilitated. For this purpose, such a company often needs access to external finance. However, once a company enters the rescue proceedings, it would find it extremely difficult to obtain credit, as few lenders would be willing to lend to a troubled company. One of the primary issues which lead to the breakup of economically valuable businesses in financial distress is the debt overhang problem which entails that any fresh capital (which is needed to bolster the working capital needs of the distressed company and kick start its recovery) is not forthcoming as it will almost entirely be siphoned off in debt payments to the existing creditors. In order to address this issue, the laws of certain countries provide “super priority” to creditors who provide finance to companies in distress. The US Bankruptcy Code provides for this through a court driven process known as debtor-in-possession financing (discussed in detail in Section 4.3 (I) of this Report). The BLRC is of the opinion that rescue financing can be a very effective way of preserving going-concern value for viable companies under financial distress and the law should provide for an enabling provisions for the company administrator and the creditors to provide for such financing as part of a scheme of revival.

- j. INTERACTION WITH DEBT ENFORCEMENT UNDER THE SARFAESI ACT: CA 2013 allows secured creditors representing 75% of the value of the debt to not only escape the application of the moratorium but also cause the abatement of rescue proceedings altogether (if such secured creditors initiate the debt enforcement process under the SARFAESI Act). This escape route was initially provided by an amendment to SICA, which might perhaps be best understood as a reaction to the widespread opinion that SICA was dysfunctional and not being used for legitimate rescue purposes. But the same carve-outs for secured creditors have been reproduced in the corporate rescue provisions of the CA 2013. However, in stark contrast to SICA which has proved to be dysfunctional in practice, the SARFAESI Act has been fairly successful in enabling secured creditors to enforce their debt against defaulting debtors. Moreover, as discussed above, a scheme of revival needs to be approved by 75% of the secured creditors for it to be approved. If 75% of secured creditors intend to initiate debt recovery proceedings, it is unlikely that they will subsequently approve a rehabilitation plan for the debtor company. Therefore, the BLRC is of the opinion that until there is some evidence to suggest that the rescue proceedings under CA 2013 cannot function effectively (i.e., save viable businesses from piece-meal sale or liquidation) in the face of the secured creditors’ enforcement rights under the SARFAESI Act, such rights should not be disturbed at this stage. This issue will be re-examined at the time of framing the Insolvency Code.
- k. DEBT RESTRUCTURING UNDER SCHEMES OF ARRANGEMENT: The BLRC notes that schemes of arrangements for debt restructuring (under the CA 1956) have not had many takers in India. This may be partially attributable to the perception that court driven processes necessarily involve delays and significant costs. Additionally, there have been problems of holdouts by creditors. Notwithstanding these factors, the BLRC notes that schemes of arrangement in India have been relatively successful for schemes between shareholders (especially those involving mergers and acquisitions). Such schemes are typically driven by the advisors of the parties, and involve minimal intervention from the courts (other than when there is evidence of abuse of the process for achieving extraneous objectives). The BLRC is of the opinion that schemes of arrangement can become a very effective tool for debt restructuring, acknowledging however that such restructurings can also be achieved less formally (and often less expensively) through a workout outside the court. Given that the proceedings for schemes of arrangement can be initiated without any proof of default or insolvency, they can facilitate early intervention and finality. Schemes of arrangement can also facilitate the use of hybrid-rescue mechanisms like ‘pre-packaged rescues’. Pre-packaged rescue is a practice evolved in the UK and the US by which the debtor company and its creditors conclude an agreement for the sale of the company’s business prior to the initiation of formal insolvency



proceedings. The actual sale is then executed on the date of commencement of the proceedings/date of appointment of insolvency practitioner, or shortly thereafter (and the proceeds distributed among the stakeholders in the order of priority). Until the Indian market for insolvency practitioners becomes sufficiently developed and sophisticated, it may not be advisable to allow such sales without the involvement of the court or the 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 (see Section 4.3 (K) of this Report).

## B. LIQUIDATION OF COMPANIES ON THE GROUND OF INSOLVENCY

### a. DEVELOPING APPROPRIATE CRITERIA FOR DETERMINING WHEN A COMPANY IS 'UNABLE TO PAY DEBTS' FOR THE PURPOSES OF WINDING UP:

- In order to re-instate the debt enforcement function of the statutory demand test for winding up, if a company fails to pay an undisputed debt of a prescribed value as per Section 271(2) (a), the creditor should be entitled to a winding up order irrespective of whether it is insolvent (in commercial or balance sheet terms) or not. Further, the NCLT should have the discretion to refer the company for rehabilitation under Chapter XIX before making a winding up order on such ground, if the company appears to be *prima facie* viable. Further, in order to prevent abuse of the provision by creditors and ensure that it is not used to force debtor companies to settle *disputed* debts, the provision should specify the factors that the NCLT may take into account to determine whether the debt under consideration is disputed or not. As laid down by the courts, a petition may be dismissed if the debt in question is *bona fide* disputed, i.e., where the following conditions are satisfied: (i) the defence of the debtor company is genuine, substantial and in good faith; (ii) the defence is likely to succeed on a point of law; and (iii) the debtor company adduces *prima facie* proof of the facts on which the defence depends. Further, as with initiation of rescue proceedings, the NCLT should also have the power to impose sanctions/costs/damages on a petitioning creditor and disallow reapplications on the same grounds if it finds that a petition has been filed to abuse the process of law.
- The Government may also consider revising the present value for triggering the statutory demand test under Section 271 (2) (a) from 'one lakh rupees' to a higher amount or revise the provision to state 'one lakh rupees or such amount as may be prescribed'.
- 'Balance sheet insolvency' and 'commercial insolvency' should be identified as separate grounds indicating a company's 'inability to pay debt' in order to avoid conflicts/confusion with the statutory demand test (as is the case of the UK Insolvency Act, 1986 or "IA 1986" where the statutory demand test, the commercial insolvency test and the balance sheet insolvency test are alternate grounds for determining a company's inability to pay debts under Sections 123(1) (a) ,123 (1) (e) and 123(2), respectively).

Reasons: These amendments are required to prevent recalcitrant solvent debtors from abusing the process of law for avoiding repayment of debt. The process of winding up / liquidation of a company may be initiated on a number of grounds as prescribed in the CA 2013 (previously under the CA 1956). One of the common grounds for filing a winding up petition is "if the company is unable to pay its debts". Although, the law prescribes that a company would be deemed to be "unable to pay its debts" if it fails to repay a single undisputed debt on demand (known as the 'statutory demand test'), Indian courts have been inclined to view non-payment of such debt as an insufficient basis to prove a company's 'inability to pay debts'. Courts require the evidence of such non-payment (even on formal demand) to be supplemented with additional evidence demonstrating the company's omission to pay without reasonable excuse and the

existence of insolvency in the commercial sense. Section 5.2 (A) of this Report contains a detailed analysis of such cases and compares the position with UK law. For the creditor to be able to use the threat of winding up procedures – with their attendant costs for debtors – to encourage repayment, there must also be a real possibility of the imminent commencement of such proceedings, and attendant publicity. However, the judicial practice (in many cases) of requiring the non-payment of a single undisputed debt to be supplemented with evidence of the company's commercial insolvency has meant that the threat of imminent liquidation is not necessarily – at least in the present state of the law – a credible one. Debtors are not compelled to negotiate with the creditors to restructure their debt or take other measures to resolve their financial distress. The potential for misuse can be minimised by providing safeguards mentioned above.

b. PRIORITY OF PAYMENTS:

(i) Priority rights of secured creditors:

- Subject to the *pari passu* charge in favour of the workmen as envisaged in Section 325 of CA 2013 or rights of the employees under employee welfare legislation like the Employee Provident Funds and Miscellaneous Provisions Act, 1952<sup>19</sup>, there should be a separate declaratory provision that upholds the priority rights of secured creditors on their security interests notwithstanding anything to the contrary contained in any state or central law that imposes a tax or revenue payable to the Government by virtue of a specific statutory provision made as a first charge on the assets of the assessee; provided that such first charge may be allowed for claims that existed on the date when such security interest was created.<sup>20</sup>

Reasons: This amendment is required for protecting the interest of secured creditors. While in general, dues of the Government get priority over debts owed to unsecured creditors only, where the tax or revenue payable to the Government is by virtue of a specific statutory provision made as a first charge on the assets of the assessee, such tax or revenue gets priority over secured creditors as well. There are several judgments which strike at the preferential status of the security creditors (See Section 5.2 (B)(a) for a discussion on such judgments). The dues payable to the Government in such circumstances are unlikely to be significant when compared to total government receipts, whereas the impact of non-payment on commercial creditors (including public sector banks) is likely to be substantial and may even lead to their insolvency and systemic issues for the economy.

(ii) Priority for Crown Debt over Unsecured Creditors:

The origins of the preference for Crown debt can be traced back to UK, where the Crown was entitled to an absolute priority for revenue-related debts in the event of the insolvency of a subject. This common law doctrine was later exported to other countries, including India, to

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<sup>19</sup> In *Employees Provident Fund Commissioner v. O.L. of Esskay Pharmaceuticals Limited* (AIR 2012 SC 11) where there was a conflict between two central legislations (the Employee Provident Funds and Miscellaneous Provisions Act, 1952 and the CA1956), the Supreme Court observed that the EPF Act being a social legislation formulated for the welfare of employees will prevail over the inconsistent provisions on priority of claims in CA 1956, a subsequent legislation.

<sup>20</sup> The statute for Goods and Service Tax that will replace state specific sales tax statutes could also provide for this in line with Section 11E of the Central Excise Act, 1944 with appropriate modifications. For avoidance of doubt, it is clarified that the exception for claims existing on the date of creation of the security interest will not disturb the priority rights of the secured creditors under statutes that recognise such rights of secured creditors without any such exception.

grant preferential status over other debts to the government in the absence of a monarch. In the UK, after the enactment of the Enterprise Act 2002, Crown preference has been abolished- the Crown debt is now ranked at par with ordinary unsecured creditors. This doctrine has been abolished in several other jurisdictions as well (See Section 5.2 (B)(b) of this Report). Having said that, the BLRC also notes that if the preferential status of the Crown over unsecured creditors is removed without qualifications, the possibility of misuse of such a benefit cannot be ruled out. Consequently, further consultations with the stakeholders will be required before introducing such a change.

c. STRENGTHENING PROVISIONS ON AVOIDANCE OF CERTAIN TRANSACTIONS IN WINDING UP:

- Section 329, CA 2013 should be suitably amended in line with Section 238 of IA 1986 to lay down clear criteria for challenging undervalue transactions in the lead-up to the insolvency.
- A provision invalidating transactions defrauding creditors similar to Section 423 of the IA 1986 should be inserted in CA 2013. Such provision would apply without any time limits and should be available in and outside formal insolvency proceedings.
- The avoidance provisions under the CA 2013 (Sections 328 and 329) should be strengthened by providing for a longer vulnerability period (up to two years) for avoiding transactions entered into with related parties of the company.

Reasons: The law on avoidance of transactions seeks to invalidate certain transactions which result in dispositions of the company's property in the lead up to insolvency other than for full value, or payments that unduly benefit certain creditors at the expense of others. The CA 2013 contains several provisions which invalidate transactions entered into within specific periods prior to the company's insolvency, such as provisions invalidating fraudulent preferences, late floating charges other than for new value and provisions preventing transfers prior to and during the winding up process. These provisions contain very few departures from the provisions under the CA 1956. In spite of their potential to strike at transactions aimed at siphoning of assets and defrauding the creditors, such provisions have been very ineffective in practice. Moreover, these provisions suffer from several substantive limitations and are not in consonance with international best practices - there is no provision that (i) defines the scope of undervalue transactions specifically; or (ii) strikes at transactions intended to put the debtor's assets beyond the reach of creditors (which can be resorted to even before a winding up petition is initiated); or (iii) provides for longer time periods for applying such provisions to transactions with related parties. The BLRC notes that provisions relating to avoidance of transactions can be a very effective tool against 'wilful defaulters' engaging in siphoning of assets to defraud the creditors. Accordingly, these provisions must be brought in line with international best practices.

d. STRENGTHENING MANAGERIAL ACCOUNTABILITY PROVISIONS IN INSOLVENCY:

- All efforts must be made to ensure that the liquidators and their counsels are sufficiently equipped and have all necessary resources to: (a) discharge their duties efficiently; (b) bring cases against the management for committing offences contemplated in the law during the course of liquidation; and (c) effectively manage the costs associated with achieving these functions. Further, appropriate institutional capacity needs to be built to address issues relating to informational and financial constraints faced by the liquidators in bringing cases against the delinquent management. The 'advisory committee' consisting of creditors (as envisaged under Section 287 of CA 2013) should be utilised for bridging this gap.

- CA 2013 should be amended to introduce a provision for a civil remedy for ‘wrongful trading’ similar to Section 214, IA 1986 with appropriate carve-outs for independent and non-executive directors in line with Section 149 (12) of CA 2013.

Reasons: The CA 2013 contains a number of provisions which provide for the initiation of criminal proceedings against delinquent officers of the company or the imposition of personal liability on such officers to contribute to the company’s assets. However, there are a number of issues which need to be resolved if the CA 2013 is to provide an effective regime for deterrence of managerial misconduct and punishment of offenders. Anecdotal evidence concerning the corresponding provisions on managerial liability under the CA 1956 suggests that the provisions have not been very effective in practice. The provisions relating to the prosecution of directors have been rendered ineffective due to funding constraints and lack of institutional capacity. The BLRC notes that the Official Liquidators face several informational constraints in bringing cases against managerial misconduct - the financial information relating to the company is often unreliable or incomplete. The Registrars of Companies, on whom the Official Liquidators have to rely for obtaining data relating to the company are overburdened, and consequently unable to provide the required assistance efficiently. Therefore, a large number of cases seeking to impose liability on the delinquent directors of the insolvent company are dismissed on account of lack of sufficient supporting evidence in the form of financial data. This indicates that unless issues relating to institutional capacity and informational constraints are addressed, CA 2013 provisions on managerial accountability in the run up to insolvency will not achieve the desired outcomes. Moreover, CA 2013 does not contain any provision similar to the ‘wrongful trading’ provision under the UK Insolvency law that imposes personal liability on the directors if they fail to take reasonable steps to minimize the potential loss to the creditors when there is no possibility of avoiding insolvent liquidation (see Section 5.3 (D)(a) of this Report for a detailed overview). The BLRC recommends that a civil remedy for wrongful trading should be introduced under Indian law as well – this would prevent directors from taking a gamble on the company’s fortunes at the creditors’ expense.

### C. ISSUES RELEVANT FOR BOTH RESCUE AND LIQUIDATION

- FORUM: The BLRC notes that in spite of having been first proposed more than twelve years ago, the NCLT has not been operationalised yet on account of multiple challenges before courts. Although, the Supreme Court in *Union of India v Madras Bar Association*<sup>21</sup> (“the **NCLT case**”) had held certain provisions of CA 1956 relating to the NCLT and the NCLAT to be unconstitutional, the NCLT and NCLAT (as envisaged under CA 1956) were themselves held to be constitutional. However, CA 2013 does not comply with all the observations of the Supreme Court in the NCLT case. Moreover, in light of a recent ruling by a Constitution Bench of the Supreme Court on the 25th of September, 2014, in *Madras Bar Association v. Union of India*<sup>22</sup> (the “**NTT case**”) which struck down the National Tax Tribunals Act, 2005, several other amendments may be required to the CA 2013 provisions to ensure compliance with the Constitution. Although most cases before the NCLT will be between private parties, there are

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<sup>21</sup> (2010) 11 SCC 1.

<sup>22</sup> Writ Petition 150 of 2006 reported in 2014 SCC Online SC 771.

several provisions under CA 2013 in relation to which the Government will be the primary litigant before the NCLT. Section 6.1 (A) of this Report analyses the impact of these judgments on the NCLT and the NCLAT and identifies the CA 2013 provisions that need to be amended to comply with the two decisions. Given that a writ petition challenging the operationalisation of the NCLT and the NCLAT is presently pending before the Supreme Court, the Government may consider making an appropriate representation to the court stating that it will carry out amendments to CA 2013 in line with the rulings of the Supreme Court in the two cases. The following amendments are required:

- Section 419(2) should be amended to provide for at least one bench of the NCLT in every State with a High Court.
  - Section 410 should be amended to provide for setting up a bench of the NCLAT in every State with an NCLT bench.
  - A new clause should be inserted giving the President of the NCLT exclusive power to determine the constitution of benches of the NCLT and the jurisdiction of such benches.
  - A new clause should be inserted giving the Chairman of the NCLAT exclusive power to determine the constitution of benches of the NCLAT and the jurisdiction of such benches.
  - The words “who has been a judge for five years” should be deleted from Section 409.
  - Section 409 should be amended to make it clear that only officers who have held a post at Additional Secretary level or higher will be eligible for appointment.
  - A separate clause should be inserted, in *pari materia* with Section 419 indicating that at least one member of each NCLAT bench will be a judicial member.
  - A clause should be introduced to indicate that in all appeals not involving technical issues, the NCLAT bench hearing such appeals should only comprise judicial members or technical members with legal training, as may be prescribed.
  - The Ministry of Corporate Affairs cannot have representation on the committee to appoint members to the NCLT or the NCLAT. The clauses should be replaced with a provision which gives the Chief Justice of India the final say in the appointment of members to the NCLT and NCLAT, with the relevant inputs being obtained from the concerned ministry.
  - The nodal ministry for the administration of CA 2013 should be different from the Ministry of Corporate Affairs.
- b. PRACTICE AND PROCEDURE: Recent research indicates that several practice and procedure related innovations may have contributed to the failure of the corporate insolvency regime in India (See sections 4.1 (B) and 5.1(B) of this Report) for a detailed discussion on the new findings). Such practices include (i) the judicial practice of hearing a matter on merits of the case even before admission of a winding up petition – which allowed recalcitrant debtor companies to cause delays even before admission; (ii) judicial practice of affording a corporate debtor time to repay all or part of the debt owed to a petitioning creditor (including by instalments) over a potentially long period of time, prior to the admission of a winding up petition or its advertisement – and the debtor company not repaying in spite of such time having been given (in most cases);(iii) a change in the interpretation of the SICA that diluted the power of the Board of Industrial and Financial Reconstruction (“**BIFR**”) to direct companies found incapable of rescue into liquidation, and expanded the power of the High Courts to reconsider a company’s rescue prospects on the merits even after the BIFR had issued a liquidation opinion; and (iv) relatedly, the development of a judicial practice in the High Courts of permitting the SICA companies to explore rehabilitation after the issuance of a liquidation

opinion by the BIFR. CA 2013 contains several provisions, which may cause similar procedural problems and attendant delays (see Section 6.2 of this Report). The rules for operationalization of the NCLT should specify that (i) whenever a company is given an opportunity to file a reply before admission of a petition, the NCLT should not hear the matter on merits at that stage, (ii) whenever a company has been given the opportunity to repay the debts before admission, such repayment should be as per a prescribed schedule (as specified in the order), which shall not be extendable under any circumstances and such a repayment related order should take into account the interests of all (or substantially all) the creditors and not just the petitioning creditor and (iii) an order that stays a winding up order should only be made in exceptional situations (for instance, where there is evidence to suggest that creditors have abused the process of law to obtain a winding up order) – unviable companies should not be allowed to take the benefit of such stays for extraneous considerations. It would be extremely important to develop a system for on-going training of the NCLT members and insolvency practitioners to ensure that they have complete understanding of (i) the reasons for the failure of the present system and (ii) technical issues in liquidation and rescue cases. Further, the relationship between the NCLT and the superior courts should be closely monitored and subject to ongoing review. The judiciary should be sensitised about (i) the economic costs of delays in liquidation and rescue proceedings, (ii) benefits of insulating the NCLT and the NCLAT from a review on merits. Lastly, the NCLT and the NCLAT should be required to record annual statistical data on matters such as the number of pending cases, the number of cases disposed, and the time taken for disposal of cases. This data may be passed on to the Government and the Supreme Court on a regular basis, who can evaluate the data based on standard efficiency parameters and recommend corrective action for tightening of procedural rules as and when required.

- c. REGULATION OF INSOLVENCY PRACTITIONERS: CA 2013 provides for appointment of liquidators and administrator from a Government approved pool of private professionals. Although CA 2013 provides for a fairly comprehensive regime for the liquidators, some issues relating to the appointment, qualification and regulation remain to be addressed. Moreover, CA 2013 provisions in relation to regulation of administrators seem fairly underdeveloped and leave much to the discretion of the NCLT. The MCA informed the BLRC that it is already in the process of developing rules that will provide for a detailed criteria for qualification (including experience in insolvency matters), disqualification and regulation of insolvency practitioners. In view of that representation, a specific amendment may not be required at this stage. However, the BLRC recommends that such rules should also provide for a code of ethics and address issues relating to conflict of interests (for liquidators, administrators, including any directors nominated by the administrators and experts/professionals engaged by such liquidators or administrators). Further, Section 259 (1) should be amended to include ‘turn-around specialists’ or ‘business consultants’ specialising in insolvency matters as professionals who may be appointed as ‘interim administrators’ or ‘company administrators’, subject to any additional qualification criteria that may be laid down by the Government. Lastly, firms or bodies corporate consisting of professionals envisaged in Section 259 (1) should also be eligible to be appointed as ‘interim administrators’ or ‘company administrators. Sections 275 should be amended to specify that the remuneration payable to the company liquidator shall be determined by the creditors as per the rules prescribed by the Central Government (see 6.3(D) of this Report for a discussion on factors which may be taken into consideration for fixing such fee).

## D. SAFE HARBOURS

‘Safe Harbour’ provisions (such as provisions on settlement and netting of transactions in stock exchanges and clearing corporations) exist in the laws of several jurisdictions which exempt certain financial contracts from the normal operation of insolvency laws. Safe Harbour provisions provide exemption from several crucial features of general insolvency law to financial contracts within their scope including exemption from:(i) the mandatory stays on enforcement upon the contractual counterparty’s entry into formal insolvency proceedings (for instance, the provision for moratorium under Section 253 (2) of CA 2013 or stay of suits on a winding up order under Section 279 of CA 2013); (ii) the prohibition on the exercise of termination provisions exercisable upon the entry of the contractual counterparty into formal insolvency proceedings; and (iii) liquidator or other relevant office holder’s rights to challenge and avoid transactions entered into at an undervalue or prefer select classes of creditors (Sections 328, 329 of CA 2013 ). Section 7 of this Report contains a detailed analysis of Safe Harbour provisions in response to a submission received from SEBI. The BLRC agrees with the SEBI proposal to amend the Securities Contracts Regulation Act, 1956 (“SCRA”) to provide for such safe harbours for clearing corporations and stock exchanges in the event of the insolvency of the clearing members and trading members in the interest of settlement finality in the markets. The proposed amendment is also in line with Section 23 (4) of the Payment and Settlement Systems Act, 2007 that provides similar protection for settlement finality in the payment and settlement systems.

## E. INSOLVENCY RESOLUTION OF MSMEs

The BLRC notes that sole proprietorship is the most commonly adopted ownership structure for MSMEs in India. The legal personality of a sole proprietorship is inseparable from the individual who owns the proprietorship. Consequently, the insolvency resolution of most MSMEs is largely dependent on personal insolvency laws (which have proved to be very ineffective in practice). Although the RBI has also issued separate instructions to banks for revival of sick *micro and small enterprises* or MSEs, the said guidelines do not apply to medium enterprises. In order to effectively address issues relating to insolvency of all MSMEs, the personal insolvency regime needs to be substantively reformed. The proposed Insolvency Code will be a comprehensive law that will not only cover companies and other forms of business enterprises, but also provide a detailed and modern framework (and institutions) for resolution of personal insolvencies. However, it is important to note that rescue mechanisms involving courts/tribunals or administrators and liquidators can be very costly. Most MSMEs typically have very few assets (especially the service enterprises). In many cases involving small businesses, the cost of such court/tribunal driven proceedings can be disproportionate to the size of the assets under consideration. The BLRC notes that a key concern among MSMEs under financial distress is that the banks are too quick to initiate recovery proceedings against MSMEs in the event of a default (irrespective of the viability of the entity). In view thereof, the BLRC proposes an administrative mechanism for rehabilitation of viable MSMEs under financial distress and recommends that it be given statutory status. The proposed mechanism, if implemented effectively, will provide much needed relief to viable MSMEs under financial distress without involving the crippling costs associated with formal rescue mechanisms involving administrators and courts/tribunals. Such administrative framework will be useful even after the Insolvency Code is operationalised.

### 3. POLICY OBJECTIVES AND INGREDIENTS OF AN EFFICIENT SYSTEM

#### 3.1. POLICY OBJECTIVES

An essential feature of the market economy is the birth and death of firms. While some firms will be economically viable: they will generate more cash than is required to pay the liabilities incurred to run the enterprise, some firms will fail.<sup>23</sup> In the aftermath of the Global Financial Crisis, business failure is becoming increasingly common in India (as in other parts of the world). The earnings of several Indian businesses have been adversely affected in many sectors. Moreover, financial distress faced by the parent companies of multinational groups in other parts of the world can quickly spread to their affiliates in India. Many prominent Indian and foreign businesses ‘went under’ during the crisis and several others could still be facing the risk of insolvency.

When a business fails, it has adverse implications for various stakeholders including the shareholders, creditors, employees, suppliers and customers. Insolvency of large businesses could also have a ripple effect on the economy, affecting the solvency of many other businesses. It is widely believed that in order to address such extensive financial distress, the economy requires a *highly efficient* corporate insolvency regime that (i) separates viable companies from the unviable ones, and (ii) reorganises the former to the extent feasible and liquidates the latter (before any significant depletion in the value of the business), minimising losses for all stakeholders in the process. A well designed insolvency framework will give certainty to the company and all the economic actors that enter into contractual relationships with it regarding the outcomes that can be reasonably expected in case of failure.

Insolvency of a company may be defined in terms of economic distress or financial distress. While the former relates to its ability to efficiently produce and sell goods and services, the latter signifies its capacity to service debts. It is widely recognized that as long as a failing company remains economically viable it should be first subject to a reorganization or rescue process (and not liquidation). Unlike liquidation, where the company is closed down, reorganisation is a process of “organizational rebirth” where the “debts are renegotiated, costs are cut and the firm may be shrunk, in order to return to profitable operations”.<sup>24</sup> Such reorganisation could also involve change of owners or management. It is important to point out that although a company’s economic viability differs from its financial health (which is primarily related to its level of indebtedness), there could be a strong link between the two, i.e. a company’s financial health could be a strong indicator of its economic viability. It may be noted that reorganization is not the only efficient rescue mechanism for saving a financially distressed company. The business could also be sold on a going concern basis (and proceeds distributed to the creditors) followed by liquidation of the residual entity (especially, when there is a ready market for that business). Some scholars argue that such approaches afford the possibility of avoiding protracted negotiations with various stakeholders and other costs associated with the reorganization process.<sup>25</sup>

Resolving insolvencies efficiently can help in meeting several policy objectives. Some such objectives are analysed below:

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<sup>23</sup> Finance Research Group, Indira Gandhi Institute of Development Research, “Economic thinking for bankruptcy reform” (hereinafter referred to as “IGIDR”)

<sup>24</sup> Bruce G. Carruthers and Jeong-Chul Kim, *The Sociology of Finance*, The Annual Review of Sociology (2011)

<sup>25</sup> Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, Stanford Law Review (2002-2003)



## A. CREDITOR PROTECTION

Protection of creditors is widely recognized as one of the main goals of corporate insolvency law. Such protection is required for efficient functioning of capital markets and availability of capital for investment.<sup>26</sup> In the absence of a collective procedure in the form of a corporate insolvency regime, the creditors may have incentives to run on the company's assets in the event of insolvency or even a doubt thereof. In other words, each creditor may want to initiate separate recovery proceedings for the same assets, leading to conflicts, disorderly distribution, delays and depletion in value of the company. According to a commonly held view, the main purpose of corporate insolvency law is to support the collection efforts of the creditors (who have property rights in the assets of the firm outside of the insolvency regime) by providing a mandatory and collective procedure where the assets are distributed among the stakeholders in an orderly manner.

Most insolvency regimes allow creditors some degree of control over such collective procedure. By providing adequate protection to creditors in insolvency, the law incentivizes them to continue providing capital to the businesses and lowers the cost of debt capital for the companies in general. Further, by promising secured creditors some control in the process (for initiation, etc.), they may be incentivized to monitor the company better, which could in turn encourage managers "to follow more conservative investment policies that reduce the chance of bankruptcy".<sup>27</sup>

## B. PROMOTING ECONOMIC GROWTH

Allocative efficiency requires that the resources in an economy be put to their most efficient use. The economic goal of allocative efficiency is maximization of social welfare.<sup>28</sup> An effective corporate insolvency law can help this process by enabling reallocation of 'inefficiently utilized resources' and 'ousting of inefficient participants' from the market.<sup>29</sup> A robust corporate insolvency regime can help foster growth and innovation by enabling efficient allocation of resources (from failing or failed companies to efficient companies). Empirical research on this issue has shown that this continuous process of reallocation of resources (which is enabled by insolvency law) plays an important role for aggregate productivity and output growth in an economy.<sup>30</sup>

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<sup>26</sup> World Bank, *Resolution of Financial Distress : An International Perspective on the Design of Bankruptcy Laws* (2001) "*Bankruptcy Laws: Basic Economic Principles*", Joseph E. Stiglitz (hereinafter referred to as "Stiglitz")

<sup>27</sup> Sefa Franken, *Creditor- and Debtor-Oriented Corporate Bankruptcy Regimes Revisited*, *European Business Organization Law Review* (2005) (hereinafter referred to as "Franken").

<sup>28</sup> A Ogus, *Regulation: Legal Form and Economic Theory* (1994).

<sup>29</sup> A.V. Pavlova, *The Organizational and Legal Mechanism of Control of the Insolvency and Bankruptcy Institution as an Economic Growth Factor*, *Studies on Russian Economic Development*, Pleiades Publishing Ltd. (2008) (hereinafter referred to as "Pavlova").

<sup>30</sup> Elena Cirmizi, Leora Klapper & Mahesh Uttamchandani, *The Challenges of Bankruptcy Reform*, The World Bank Research Observer, Oxford University Press (2011) (hereinafter referred to as "Cirmizi, Klapper & Uttamchandani").

### C. PROMOTING CORPORATE BOND MARKETS

Corporate bonds (transferable debt instruments) are seen as a reliable and efficient source of raising finance in many countries. Studies show that bonds can lower the cost of raising finance for companies by competing with other sources of finance like bank loans, equity finance, etc. The recent Global Financial Crisis has shown that a market for bank loans may not be available at all times and alternative sources of finance need to be put in place to prevent widespread liquidity crunch when the banks are under distress. Moreover, since bonds have a fixed term of maturity, companies issuing bonds have more time (and associated flexibility) to repay. Nevertheless, bonds are generally perceived as risky instruments by the investors in India, given India's weak creditor protection infrastructure (which includes an ineffective corporate insolvency regime). At present, in India, bond investors plan for near-zero recovery on default. This drives up the required rate of return in the eyes of the bond holder to the point where very few companies find it practical to issue bonds.<sup>31</sup>

Theory predicts that improved creditor rights could assist with the development of bond markets.<sup>32</sup> There is also some empirical evidence to support that better enforcement of creditor rights helps in the development of bond markets.<sup>33</sup> Burger and Warnock, in their analysis of bond markets in 49 countries, find that for those countries that have also issued foreign currency bonds, the size of local debt markets are larger when countries have better rule of law and better creditor rights.<sup>34</sup> Although the corporate insolvency system is only one part of the credit infrastructure, it may be argued that if the rights of the creditors (bond holders) are better protected in the event of insolvency, it could go a long way in developing a robust bond market in India.

### D. PROMOTING CREDIT MARKETS IN GENERAL<sup>35</sup>

The patterns of firm financing over the last two decades (as indicated by the data in the table below) shows that: (i) Indian firms use equity financing more than debt financing; (ii) banks are still the largest source of credit, even though bank-led credit has remained stagnant; (iii) there has always been much more secured than unsecured credit; and (iv) borrowings from bond markets have become even smaller. All these features are symptomatic of under-developed credit markets, and many of these features derive from the lack of an effective bankruptcy process.

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<sup>31</sup> IGIDR.

<sup>32</sup> Rafael La Porta et al, *Legal Determinants of External Finance*, The Journal of Finance (1997). The theory predicts: (a) in general, improvements in creditor protection (particularly protection in insolvency) should facilitate the availability of external finance: "Rules and regulations that protect creditors and are properly and efficiently enforced lead to larger credit market and lower interest margins. This idea has been formalized by Townsend (1979), Aghion and Bolton (1992), and Hart and Moore (1994, 1998)" (A Galindo and A Micco, "Creditor Protection and Credit Volatility" (Working Paper), summarising some of this theory); and (b) the availability of capital in the form of securities (bonds, stock) rather than in the form of bank debt will also be sensitive to the quality of investor protection: see for example F Modigliani and E Perotti, "Security Markets versus Bank Finance: Legal Enforcement and Investors' Protection".

<sup>33</sup> Narjess Boubakri & Hatem Ghouma, *Control/ownership structure, creditor rights protection, and the cost of debt financing: International evidence*, Journal of Banking & Finance (2010); JD Burger & FE Warnock, *Local Currency Bond Markets*, IMF Staff Papers (2006) as cited in IGIDR (hereinafter referred to as "Burger & Warnock")

<sup>34</sup> IGIDR.

<sup>35</sup> IGIDR.

Table 1: Sources of funds for non-financial firms

	<i>Three year averages around</i>	
	<i>1991-1992</i>	<i>2009-2010</i>
<b>Equity</b>	22.60	34.87
Retained Earning	10.56	21.05
Fresh Issuance	12.04	13.82
<b>Depreciation</b>	17.64	9.69
<b>Borrowing</b>	35.32	29.48
Banks	17.14	17.83
Bonds	7.87	3.94
Inter-corporate	1.28	2.28
Foreign	5.51	3.22
<b>Current Liabilities</b>	24.42	24.19
<b>Structure of Borrowing</b>		
Secured	25.40	19.31
Unsecured	19.50	12.69

**Source: CMIE Prowess**

While the reforms process of the 1990s transformed the equity markets of India, there has been little change in the debt markets. The role of debt in firm financing has dropped significantly: the debt to equity ratio of Indian firms dropped from more than 2 in the pre-reforms period to under 0.5 in the decade after the reforms. This may not be a problem if equity and debt are substitutes, but this may not be so since the nature of each varies and would suit different project characteristics differently. For a certain class of projects, it is optimal for firm financing using debt as it more readily solves problems of adverse selection and information asymmetry that is particularly prevalent in developing economies.<sup>36</sup> One reason for this is the lack of clarity on bankruptcy processes and outcomes in India.

Further, where debt financing has been utilised, secured lending exceeds unsecured lending. Despite most lending being collateral-based, banks<sup>37</sup> have been vulnerable to poor recovery against loans in case of firm failure. Between 2002 and 2013, non-performing and restructured loans in the banking sector accumulated from INR 0.7 trillion to INR 5.3 trillion. This was the period following the enactment of the SARFAESI Act, but recovery rates remained between 23% and 24%.

Poor recovery rates, coupled with pressure on asset quality can lead to decreased lending by banks. The Reserve Bank of India's Financial Stability Report (December 2014) reports that the consolidated balance sheets of scheduled commercial banks for 2013-14 show a decline in the growth of credit for the fourth consecutive year. The Report cites "persistent pressure on asset quality leading to increased risk aversion among banks" as one of the factors for the decline in growth of credit.

<sup>36</sup> S. Banerji et al, *New thinking on corporate bond market in India*, Paper produced under the NIPFP-DEA Research Program (2012) as cited in IGIDR.

<sup>37</sup> Banks constitute the largest source of credit in India. Out of total borrowing of 29.48% in 2009-2010, banks are the source for 17.83%.

A properly functioning insolvency system could resolve these issues to a large extent by facilitating the rehabilitation of companies where viable, thereby relieving the pressure on assets held by lenders. Where corporate rehabilitation proves to be unviable, by providing for swift liquidation of unviable companies, an effective insolvency system will maximise returns to lenders. This shall, in turn, contribute to the development of a robust market for credit.

## E. PROTECTING OTHER STAKEHOLDERS

Creditors are not the only stakeholders in a company. Its shareholders (promoters and other investors), employees, suppliers and customers also have significant economic interests in the company and need to be adequately protected in the event of insolvency. The protection of shareholders and employees assumes special importance in this regard.

### a. PROMOTERS/SHAREHOLDERS

While it is widely believed that shareholders are residual claimants and do not need to be protected in an insolvency, the importance of protecting their interests has been recognized in certain situations – particularly in a reorganization. Insolvency defines the risk that the promoters and investors subject themselves to when they decide to promote a business. A robust corporate insolvency regime promotes entrepreneurship by providing a reasonably certain indication of the maximum downside risks and costs that the promoters and investors expose themselves to at the time of starting a venture.<sup>38</sup> The costs of insolvency proceedings (which are directly proportional to the time required for resolving insolvencies) also assume importance in this regard. It has been observed that “firms are more likely to enter and receive start-up financing if bankruptcy proceedings are less costly...”<sup>39</sup> Further, the reorganization or rescue provisions of an insolvency regime are often designed to limit losses for all the stakeholders. In a reorganization or rescue procedure, making payouts to the promoters or the shareholders, or giving them some control over the process, may incentivize them to initiate the process in time and co-operate with the other stakeholders.

### b. EMPLOYEES

Suppliers of labour also need to be adequately protected in insolvency. This is particularly true for businesses deriving their value from the goodwill created by the skills and services of employees. Moreover, most employees are not in a position to ask for higher wages at the time of entering into their employment contracts in exchange for the risk of not being paid in the event of insolvency. Job losses associated with insolvency, if not dealt with adequately, can have many adverse implications for the economy. Protecting employees effectively should thus be one of the objectives of any corporate insolvency regime, at least in relation to accrued wage claims. However, it is important to point out that the interests of employees are arguably better addressed through labour laws and social security measures and that companies should not be allowed to remain alive for the only purpose of preventing unemployment.

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<sup>38</sup> Cirmizi, Klapper & Uttamchandani.

<sup>39</sup> Leora Klapper, Luc Laeven & Raghuram Rajan, *Entry regulation as a barrier to entrepreneurship*, Journal of Financial Economics (2006).

## F. ENHANCING INVESTOR CONFIDENCE

Reforming the insolvency system will have some benefits for liquidation of solvent companies as well. Many shareholder-agreements for investment transactions (involving foreign and domestic investors) in Indian companies provide for voluntary liquidation of the company as one of the exit alternatives for the investors or as a consequence of a termination event (termination events are grounds on the basis of which a shareholder agreement can be terminated by all or any of the parties). The ability of shareholders to cause the liquidation of a company in the event of breach of obligations by the other shareholders can serve as a disciplining mechanism for all the shareholders (and the management). However, the effectiveness of such a remedy depends on the efficacy of the liquidation regime. If the liquidation regime is efficient, it can go a long way in promoting investor confidence by giving strength to such liquidation provisions in shareholder-agreements. Such efficiency could also help commercial certainty on the occurrence of a liquidation event (by enabling parties to weigh legal risks in advance and price them into contracts accordingly).

### 3.2. INGREDIENTS OF AN EFFECTIVE SYSTEM

The corporate insolvency laws of most legal systems are widely categorized as either debtor-friendly or creditor-friendly. The regimes of United States (“US”), France and Italy are perceived as benefiting the debtors more than the creditors, whereas those of United Kingdom (“UK”), Sweden and Germany are seen as favouring the creditors.<sup>40</sup> Reorganization or rescue provisions of an insolvency regime are generally considered to favour the debtors. Liquidation on the other hand is largely assumed to be a process that primarily protects the creditors. Nevertheless, studies have shown that the success or failure of an insolvency regime is not a function of which side of the ‘friendliness spectrum’ a given systems falls in, but is rather dependent on the legal institutions within which the system operates, as well as the nature of the firms that the law services and their capital structure. The Indian reorganization and liquidation regime, as proposed in Chapters XIX and XX of CA 2013 subscribes to the philosophy of giving primacy (at least in the law ‘on the books’) to the interests of the creditors over that of the shareholders and other stakeholders.

A regime that provides excessive protection to the creditors reduces their incentives to conduct proper screening of the debtors, encourages predatory lending and insufficient monitoring.<sup>41</sup> Undue protection for the debtors on the other hand could encourage them to take excessive risks and avoid paying debts, thereby harming the creditors and affecting the availability of credit in the market. An ideal insolvency regime needs to strike the right balance between the interests of all the stakeholders by a reasonable allocation of risks among them. An efficient corporate insolvency system should (i) have clear hierarchy of payments upon insolvency, (ii) have an efficient system for transferring failed reorganizations to liquidation, and (iii) allow sufficient control to the creditors without giving them the leeway to manipulate.<sup>42</sup> The hierarchy of payments should be specific so as to enable a swift disposal of cases. If a company cannot be reorganized or the business rescued (by a sale) within a stipulated period, the company should be transferred to a liquidation process swiftly. Further, in order to incentivize creditors to participate in the reorganization/liquidation process, the insolvency system should allow the creditors

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<sup>40</sup> Pavlova.

<sup>41</sup> Stiglitz.

<sup>42</sup> Cirmizi, Klapper & Uttamchandani.

sufficient control over the process. The court or the administrator should be required only to oversee the proceedings to ensure that there is no manipulation by the creditors. It should be acknowledged that (as noted above), allowing too much protection for creditors may have some trade-offs with pre-filing efficiencies by enticing firms to delay their bankruptcy filings.<sup>43</sup>

The law on the statute book cannot be the sole basis for an effective corporate insolvency regime. It also requires an effective institutional structure for it to be successful. In spite of being similar (in substance) to the corporate insolvency laws of certain western countries, Indian law does not compare well with those countries on the effectiveness scale. This indicates that a well-designed system in itself may not lead to the desired outcomes. The decision-making institutions of an insolvency system (courts, liquidators and administrators) play a vital role in the success or failure of a system.<sup>44</sup>

Moreover, for the insolvency law to be useful, it must be applied in tandem with other laws such as the debt recovery laws, tax laws and labour law. The debt recovery laws, if effective, can discourage solvent debtors from abusing the reorganization process. Threat of seizure (for both forms of debt) may encourage debtors to pay their debts in time and not file for insolvency when they are not facing any serious financial distress. Tax incentives for outside buyers can be used as an effective tool for saving businesses and facilitating reorganizations. Labour law can enable entrepreneurs to efficiently restructure viable businesses while providing due protection for employees.

Lastly, an effective insolvency regime promotes early initiation of proceedings so that the viable businesses can be separated from the unviable ones at the earliest opportunity and the maximum value of a given business can be preserved.

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<sup>43</sup> Franken.

<sup>44</sup> World Bank, *Resolution of Financial Distress : An International Perspective on the Design of Bankruptcy Laws* (2001) “*Systemic Corporate Distress: A Legal Perspective*”, Jay Lawrence Westbrook.

## 4. CORPORATE RESCUE

### 4.1. SICK INDUSTRIAL COMPANIES (SPECIAL PROVISIONS) ACT, 1985

#### A. THE FAILURE OF THE SICA REGIME

The SICA provisions were meant to provide a timely rescue mechanism for reviving sick industrial companies. This was to be achieved through the establishment of a separate statutory body, the BIFR, which administered the provisions under the SICA, and through the limitation of judicial interference in the rehabilitation process. The BIFR, a body required to be staffed with members having experience in a variety of areas had discretionary powers to take measures relating to a sick industrial company. Further, judicial oversight over the proceedings before the BIFR was limited by giving appellate jurisdiction to the Appellate Authority for Industrial and Financial Reconstruction (“AAIFR”). Under the SICA, the formal involvement of the Courts has been limited to two specific circumstances - (i) judicial review of the decisions of the BIFR or AAIFR by the High Courts and the Supreme Court;<sup>45</sup> and (ii) issuance of winding up orders by the High Court on the basis of a liquidation opinion from the BIFR.<sup>46</sup> In the first circumstance, the power of the Courts was circumscribed by the limited scope of enquiry in a judicial review process. In the second instance, the literal import of the SICA provision on issuance of winding up orders was that the decision to wind up was primarily to be made by the BIFR.<sup>47</sup>

However, previous committee reports and studies which have examined the operation of the SICA provisions have almost unanimously condemned the SICA as failing in its mandate to provide a timely rescue mechanism for sick industrial companies. It has been suggested that delays were a routine matter with BIFR proceedings. It has been estimated that it takes about 5-7 years for a sick industrial company to be revived after BIFR proceedings.<sup>48</sup> These delays are augmented by the routine challenges to BIFR decisions before the AAIFR and High Courts. Consequently, although the SICA was originally meant to limit judicial oversight to the minimum required, there has been a significant degree of court involvement in the rescue process.<sup>49</sup> Other criticisms relate to the involuntary nature of SICA rehabilitation packages, the inability of the BIFR to distinguish between cases suitable for rehabilitation and for winding up, the pro-debtor and anti-creditor nature of BIFR proceedings, the provision of an automatic moratorium on enforcement proceedings and the debtor-in-possession regime.<sup>50</sup>

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<sup>45</sup> This refers to the exercise of the writ jurisdiction of the High Court under Article 226 of the Constitution of India and the jurisdiction of the Supreme Court under Article 136.

<sup>46</sup> Section 20, SICA 1985; see also K van Zwieten, ‘Corporate Rescue in India: The Influence of the Courts’, forthcoming 2015(1) *Journal of Corporate Law Studies* (hereinafter referred to as “van Zwieten”).

<sup>47</sup> van Zwieten.

<sup>48</sup> van Zwieten citing Nimrit Kang and Nitin Nayar, ‘The Evolution of Corporate Bankruptcy Law in India’ (2003-2004) *Money and Finance* 37, 44 (hereinafter referred to as “Kang & Nayar”) - “In 2004, Kang and Nayar reported that it took the BIFR an average of 6.5 years to recommend liquidation, and an average of 7 years to sanction a rehabilitation scheme.”

<sup>49</sup> van Zwieten.

<sup>50</sup> Kang & Nayar; Omkar Goswami, ‘Corporate Governance in India’ in *Taking Action Against Corruption in Asia and the Pacific* (ADB 2002) 94.

*The Committee on Industrial Sickness and Corporate Restructuring* (“**Goswami Committee**”), headed by Omkar Goswami, an economist, looked at several issues in corporate insolvency, including the issue of corporate revival and rehabilitation as applicable to industrial companies as part of a broader study on industrial sickness. The Goswami Committee Report was one of the earliest critiques of the SICA. One of the prominent criticisms levelled against the SICA provisions in the Report related to its debtor-in-possession regime. The Report stated that the debtor-in-possession regime under the SICA would give incentives to the management to propose and implement risky rescue measures, as the costs of failure (leading to liquidation) would largely be borne by creditors<sup>51</sup>. It was argued that the informational advantage that managers possessed, coupled with control over the rescue process would enable them to carry out such measures. In addition, they could resort to delay tactics to get concessions from creditors. This finding of the Goswami Committee Report was also mentioned in *The Report of the High Level committee on Law relating to insolvency of Companies 2000* (“**Eradi Committee Report**”), submitted seven years later.

Another drawback of the SICA regime pointed out by the Goswami Committee was that the definition of sickness under the SICA only covered companies in the final stages of corporate distress. *The Goswami Committee Report* alleged a pro-rehabilitation bias on the part of the BIFR: the BIFR did not adequately distinguish between cases suitable for rehabilitation and for winding up, leading ultimately to the failure of schemes sanctioned by it. The Report also stated that BIFR proceedings had been beset with delays from the early years of its working. An allegation of creditor coercion to consent to SICA rehabilitation packages was also put forth- it was said that creditors were pressured to give their consent to schemes for rehabilitation even in cases where the rescue of the company was not a viable option.<sup>52</sup> However, at the same time, the Goswami Committee Report criticised the power of creditor veto under the SICA as enabling every dissenting institutional creditor to delay the sanctioning of the scheme.<sup>53</sup>

The *Eradi Committee Report* reached similar conclusions as the earlier Goswami Committee Report. Thus, the Eradi Committee Report placed emphasis on the debtor-in-possession regime under the SICA, and the rehabilitation bias of the BIFR as adversely affecting corporate rescue under the SICA. The Report went to the extent of recommending the replacement of SICA with a system akin to administration procedure in the UK.<sup>54</sup> Subsequently, the *Advisory Group on Bankruptcy Laws*, appointed by the RBI, was tasked with reviewing the status of various bankruptcy laws and formulating the framework for a national bankruptcy policy and drafting legislation, incorporating international best practices in this area. The report, submitted in 2001 (“**RBI Report**”), also noted that the provisions in the SICA on renegotiation of debt and corporate restructuring were ‘seriously flawed’ and recommended its repeal. In particular, the RBI Report drew attention to the definition of sickness

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<sup>51</sup> van Zwieten.

<sup>52</sup> van Zwieten.

<sup>53</sup> van Zwieten.

<sup>54</sup> “The main drawback of the SICA scheme is that it leaves the debtor company in possession of the assets which creates an asymmetry and imbalance between the debtor company and its creditors conferring on the inefficient or inept management an unmerited advantage...

The debtor in possession allows the promoters to leverage informational advantages and to create tailor made delays in the proceedings by taking recourse to [the moratorium]...” (Eradi Committee Report as cited in van Zwieten).



provided in the SICA, and the ‘command approach’<sup>55</sup> taken by the BIFR towards corporate restructuring. According to the Report, the definition of sickness (in particular, the trigger for initiating proceedings under Section 3(1)(ga), SICA) under the SICA did not facilitate early detection and intervention in case of corporate distress- a company was identified to be a sick company only at the final stage of sickness, at which point there was effectively no scope for restructuring of the company. In relation to the command approach adopted by the BIFR, the RBI Report opined that the restructuring did not provide the scope for voluntary renegotiation by creditors, ultimately hampering financial prudence or suitable intervention by creditors.

The RBI Report also criticised the proceedings at the BIFR as being ‘notoriously dilatory.’ It was suggested that debtor companies abused the SICA provisions to avoid repayment of debts owed to creditors, and to siphon away whatever value remained in the company during the pendency of such proceedings. This was aggravated by the fact that promoter/management responsible for instituting BIFR proceedings in relation to the company remained in possession, thereby affording them an opportunity to extract value from the company’s assets during the proceedings. The RBI Report blamed the command approach adopted by the BIFR for this. It was also suggested that such an approach did not give adequate protection to creditors in such a situation: in some cases, the BIFR even ignored the views of institutional creditors in the rehabilitation process.

*The Expert Committee on Company Law*, headed by J.J. Irani, was constituted by the Government of India in 2004 as part of the exercise of an exhaustive review and revision of the company law regime in India. The *Irani Committee Report*, like previous Committee Reports, criticised the proceedings under SICA and BIFR as beset with delays. Further, it was opined that the SICA did not provide a balanced framework for all interested parties in corporate insolvency. It was suggested that the SICA favoured debtors the interest of other parties. The Irani Committee recommended that the insolvency regime should be equally accessible to both debtors and creditors.

The *Irani Committee Report* also pointed out that the non-representation of unsecured creditors in the restructuring process led to legal proceedings being initiated during the rehabilitation proceedings, ultimately hampering the efficiency of the litigation process. It was also noted that the SICA regime did not effectively utilise the experience and knowledge of professionals and experts in the insolvency process.

“A Hundred Small Steps”, the Report of the Committee on Financial Sector Reforms (“**Committee on Financial Sector Reforms Report**”), headed by Dr. Raghuram Rajan, also examined the legal framework in India relating to insolvency and creditor reforms. The *Committee on Financial Sector Reforms Report* stated that an effective insolvency regime should permit rescue in suitable cases, and provide for a legal framework that supports informal workouts as an alternative to (costly) formal proceedings. The *Committee on Financial Sector Reforms Report* concluded that in the current setup, the BIFR and AAIFR have become defunct bodies. The Report specifically noted that the moratorium on enforcement proceedings under the SICA was abused by debtors. The Report proposed a number of modifications to the legal regime on rehabilitation of insolvent companies.

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<sup>55</sup> This refers to the approach of the BIFR where the BIFR decides what measures are to be taken to rescue the company without the agreement of stakeholders.

## B. NEW EVIDENCE ON FAILURE

In a four year doctoral research project,<sup>56</sup> Kristin van Zwieten (now Clifford Chance Associate Professor of Law and Finance at the University of Oxford) conducted a comprehensive study of the development of corporate insolvency law in India, starting with the transplant of UK insolvency law during the colonial period to the operation of the law on liquidation and corporate rescue in the present day. In particular, the project considered the influence of the courts in the failure of the liquidation and corporate rescue procedures under the companies legislation and related laws.

The second part of van Zwieten's doctoral research project<sup>57</sup> conducts an exhaustive study of the background to the enactment of the SICA and the operation of the SICA. The author considers the influence of the courts on the functioning of the corporate rescue procedure under the SICA in practice. She argues that while the existing literature on the SICA has largely linked the failure of the corporate rescue procedure under the SICA to the formal features of the legislation, an equally or more convincing explanation for the SICA's failure lies in the interpretation and application of SICA provisions by courts.

van Zwieten finds that judicial practice in interpreting and applying the SICA provisions has been biased towards rescue, even of commercially unviable companies. Such a bias can be traced to the policy rationale behind the enactment of the SICA, i.e., that of finding a solution to the problem of sickness in the industrial sector. She argues that official policy during the years subsequent to the enactment of the SICA was motivated by the protection of industries from closure and concerns of employee welfare in such industries. Further, such policy was supported by two significant measures in the financial sector- (i) the extension of easy credit facilities for rescue through the establishment of non-deposit taking development financial institutions; and (ii) the earlier policy of the RBI which mandated extension of rescue finance by development financial institutions and commercial banks to even 'potentially viable' companies. Non-compliance with the latter policy of the RBI was seen as 'defeat[ing] the national policy of revival of viable sick units.'<sup>58</sup> There occurred a shift in official policy following economic liberalisation and the consequent reform of the banking system in the 1990s which gave institutional creditors autonomy in credit decision-making; however, judicial practice continued to be influenced by these considerations.<sup>59</sup>

van Zwieten's study analysed a set of 1066 judgments given by various courts and tribunals between 1987 and 2010 relating to SICA proceedings. The author points towards three crucial judicial 'innovations' which had the effect of delaying the process under SICA and improving the position of certain stakeholders vis-à-vis others:-

- i. *The development of the judicial practice in the High Courts of permitting companies to explore rehabilitation options even after the issuance of a liquidation opinion by the BIFR-* This has

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<sup>56</sup> van Zwieten *The Demise of Corporate Insolvency Law in India* (2012, doctoral thesis in law, University of Oxford) (also hereinafter referred to as "van Zwieten").

<sup>57</sup> van Zwieten.

<sup>58</sup> Circular D.O.IECD.No.IRD.26/IR-A/89-90 'Rehabilitation of sick/weak industrial units' (April 9 1990), in Circulars relating to the Industrial and Export Credit Department, June 1989-June 1994, vol 2 (RBI) para 2, as cited in van Zwieten.

<sup>59</sup> van Zwieten.

been usually done through the provision of relief from liquidation on an interim basis. Such relief, van Zwieten notes, has not been based on a finding of error on the part of the BIFR. A variety of measures have been used for the provision of relief from liquidation, such as: (i) the stay of BIFR proceedings; (ii) the stay of BIFR liquidation opinions; (iii) adjournment of hearing of the BIFR liquidation opinion; (iv) use of the provisions of the CA 1956, especially those relating to schemes of arrangement, causing delays in winding up of the company; (v) remittance of cases back to the BIFR for reconsidering rehabilitation of the company etc. van Zwieten also points towards cases in which the courts have exercised their discretion to formulate innovative remedies such as ordering repayment of debts owed to secured creditors in instalments (*Board Opinion v Hathising Mfg Co Ltd*<sup>60</sup>).

- ii. *The interpretation of SICA provisions so as to dilute BIFR's power relating to liquidation of the company*- Section 20(2) of the SICA empowers the High Court to order winding up of the company on the basis of the liquidation opinion issued by the BIFR. The literal import of this provision was to restrict the High Court's discretion in this regard by simply basing the order of winding up by the High Court on the liquidation opinion issued by the BIFR. Such a construction of the provision was advocated by initial judicial decisions on the point and contemporaneous academic commentary. However, this intent was not given effect to by the courts, which permitted companies to consider rehabilitation even after issuance of liquidation opinions by the BIFR.<sup>61</sup> Further, the decision of the Supreme Court in *Ramaraju v Union of India*<sup>62</sup> construed the provision as requiring the High Court to merely consider the liquidation opinion of the BIFR. The Supreme Court held that the High Court had to determine the correctness of the liquidation opinion and determine whether the company was to be wound up. This, van Zwieten argues, envisaged an increased role for the High Court in the proceedings under SICA and significantly diminished BIFR's powers in relation to liquidation.
- iii. *Differential treatment of various stakeholders resulting from differential application of the moratorium under Section 22*- van Zwieten finds that while institutional creditors were prohibited from initiating proceedings for the enforcement of their debts, certain other creditors escaped the stay on enforcement action during the BIFR proceedings. This has been the pattern in relation to debts incurred before the registration of the company under SICA (pre-commencement debts) and debts incurred thereafter (post-commencement debts). van Zwieten finds that certain classes of creditors perceived of as in some way vulnerable (e.g. retail investors, workers) have been permitted to escape the operation of the moratorium in some cases and recover in full, while others (e.g. institutional creditors) have not, compounding the losses that the latter classes of creditors suffer in delayed proceedings.

van Zwieten argues that the effect of these three judicial developments has been to introduce significant delays in the process under the SICA. Consequently, it has enabled the SICA to be abused by the debtor companies to delay repayment to creditors, and in many cases, by the managers to siphon away corporate assets while the company is in BIFR proceedings. This, in turn, leads to increased costs for certain creditor groups under the SICA and an erosion in the company's asset value.

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<sup>60</sup> [2004] 119 CompCas 25 (Gujarat).

<sup>61</sup> van Zwieten.

<sup>62</sup> [1997] 89 CompCas 609, 610.

## 4.2. SCHEMES OF ARRANGEMENT FOR DEBT RESTRUCTURING UNDER THE COMPANIES ACT, 1956

Chapter V of the CA 1956 provides for a mechanism by which corporate revival and rehabilitation may be undertaken. Section 391, CA 1956 provides for a court-supervised<sup>63</sup> process by which a company can enter into a scheme of arrangement or a compromise with its creditors and members. The broad procedure under Section 391 is this: a scheme of arrangement or a compromise may be proposed between the company and its creditors or a class of creditors. Once the scheme is proposed, the company or any creditor or the liquidator of a company being wound up has to make an application to the court for holding a meeting of the creditors or a class of creditors. The scheme/compromise shall be binding on the company and all its creditors, and in the case of a company being wound up, on its liquidator and all contributories if: (i) it gains the approval of a majority in number, representing three-fourths in value of the creditors or class of creditors, present and voting at the meeting;<sup>64</sup> (ii) it is sanctioned by the court; (iii) a certified copy of such order of sanction has been filed with the Registrar of Companies.<sup>65</sup> It may be noted that when separate meetings are held for the approval of a single composite scheme, the approval of three-fourths majority in value of each meeting of creditors / class of creditors is required for the scheme to have been considered approved for the purposes of Section 391.<sup>66</sup> The company can apply to the court for a stay on the initiation or continuation of any suit or proceedings against the company, so as to prevent enforcement action by creditors while the scheme is being finalised.<sup>67</sup>

The nature of the scheme or compromise that can be proposed under this provision is very wide: it includes schemes or compromises that may be proposed to restore the company to profitability. Further, unlike the SICA, *all* companies, and not just industrial companies, are covered within the ambit of Section 391.

The procedure under Section 391 ought to have been used by companies often as a method for reorganisation of debts. Since there is no requirement of proof of insolvency or impending insolvency to have recourse to Section 391, the company's management can act at the early signs of financial distress and collaborate with the creditors to rescue the company. Such timely action can also avoid defaults in debts to creditors, loss of goodwill, and can realise higher value for all stakeholders involved. Further, unlike the SICA where a single institutional creditor can veto a scheme for rescue, the requirement of obtaining only (special) majority creditor approval for the scheme ought to have rendered the procedure more attractive to debtor companies. However, unlike the UK which has

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<sup>63</sup> The word 'court' has been substituted for the 'National Company Law Tribunal' by the Companies (Second Amendment) Act 2002. However, as mentioned before, this provision has not been notified for commencement yet.

<sup>64</sup> In person or by proxy.

<sup>65</sup> Section 391(2), (3), CA 1956.

<sup>66</sup> *Komal Plastic Industries v. Roxy Enterprises Pvt. Ltd.*, [1991] 72 CompCas 61 (Delhi) wherein the Delhi High Court held that when two meetings – one for secured creditors and another for unsecured creditors is required to be called, and the secured creditors (in this case, there was only one secured creditor, the State Bank of India) oppose the scheme, it is futile to convene a meeting of the unsecured creditors, as 100 % of secured creditors rejected the scheme. Also cited *In re. Auto Steering India Pvt. Ltd.*, Vol 47 Company Cases 257 (Del).

<sup>67</sup> Section 391(6), CA 1956.

successfully employed schemes of arrangement for corporate restructuring and reorganisations, schemes of arrangement have not proved to be of much use in India.

Various Committee reports which studied the procedure under Sections 391- 395, CA 1956 found that this procedure failed to meet the crucial requirements of a rescue mechanism- it was a protracted procedure, too expensive and complicated to be effective where speed and urgency were required.<sup>68</sup>

One of the reasons cited for the low uptake of schemes of arrangement has been the requirement of obtaining court approvals at every stage, which results in delays in the process. Firstly, court approval has to be sought for holding a meeting of creditors or class of creditors at which the scheme/compromise is considered.<sup>69</sup>

Secondly, the scheme or compromise can be made binding on the creditors only after it receives the sanction of the court. The court can, in exercising its inherent power of monitoring the scheme proceeding give a deadline by which a final decision has to be made by the creditors/ class of creditors in relation to the scheme.<sup>70</sup>

The sanction of the court shall be granted after the court has been informed of all material facts in relation to the company, including its latest financial position and auditor's reports on the company's accounts.<sup>71</sup> Further, the scheme shall be granted only if the court is satisfied that: (i) the requisite statutory procedure for such a scheme has been complied with and the requisite meetings have been held; (ii) the scheme is supported by the requisite majority vote; (iii) at the creditors' meetings, the creditors had the relevant material to reach an informed decision and the majority decision is just and fair as a whole to legitimately bind even the dissenting creditors; (iv) the scheme is not in violation of any provision of law and is not contrary to public policy;<sup>72</sup>(v) the class was fairly represented by those who attended the meeting; (vi) the statutory majority was acting bona fide and not in an oppressive manner so as to coerce the minority; and (vii) the scheme of arrangement is just and reasonable from the point of view of prudent business persons who take commercial decisions for the benefit of the class represented by them.<sup>73</sup> The court also has the jurisdiction to consider whether the creditors have been divided into separate classes correctly, and within each class, whether creditors have been treated on an equal footing.<sup>74</sup> The court can exercise its discretion to modify the scheme before sanctioning to ensure

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<sup>68</sup> The Report of the Committee to Examine the Legal and Other Difficulties Faced by Banks in the Rehabilitation of Sick Industrial Undertakings and Suggest Remedial Changes Including Changes in the Law ("Tiwari Committee Report") as cited in van Zwieten; RBI Report.

<sup>69</sup> According to the CA 2013, such meetings can be dispensed with by the NCLT if such creditors or classes of creditors having 90% or more of the value agree and confirm, through an affidavit, to the scheme of compromise/arrangement (Section 230(9), CA 2013).

<sup>70</sup> *The Peerless General Finance and Investment Co. Ltd. V. Essar Oil Limited*, [2006] 129 CompCas 353 (Guj).

<sup>71</sup> Proviso to Section 391(2), CA 1956.

<sup>72</sup> Please note that for determining the real purpose of the scheme, the courts can pierce the veil of apparent corporate purpose.

<sup>73</sup> *Miheer H. Mafatlal v. Mafatlal Industries Ltd.*, AIR 1997 SC 506.

<sup>74</sup> *In Re: Spartek Ceramics India Ltd.*, [2007] 7SCL 548 (AP).

parity to a dissenting minority creditor.<sup>75</sup> The court can also use its discretion to thwart the attempt of dissenting minority creditor from stalling a just and reasonable scheme.<sup>76</sup> However, the court will not, while sanctioning a scheme, adjudicate upon the correct amount of debt owed to the creditor,<sup>77</sup> or advise upon the outcome of creditors' meetings.

Thirdly, where the High Court makes an order sanctioning a scheme/compromise under Section 391, it has supervisory powers with regard to the implementation of the scheme/compromise and can give directions or make modifications as necessary to ensure its proper implementation. Such power even extends to the issuance of an order for the winding up of the company if the court feels that the scheme cannot be implemented in a satisfactory manner, with or without modifications. The court also has additional powers to make provisions for the facilitation of reconstruction or amalgamation of companies as part of the scheme.<sup>78</sup>

Another problem that has been pointed out in literature is that of holdouts by certain creditors during the negotiations (*Irani Committee Report*). Such behaviour may result in them obtaining more concessions at the expense of other creditors. This may act as an incentive for holdout behaviour, which can add delay to the negotiation process and cost the company more. Even if holdout behaviour may not be present, delayed decision-making by creditors, particularly state-owned entities, regarding the scheme/compromise can affect the scheme adversely. It has also been suggested that a lack of clarity about priority of debts in liquidation may result in various classes of creditors claiming a higher amount than they are entitled to during the negotiations.<sup>79</sup> This may ultimately prolong the negotiation process.<sup>80</sup>

#### 4.3. COMPANIES ACT, 2013 - RECOMMENDATIONS FOR REFORM AND QUESTIONS FOR CONSIDERATION

The CA 2013 provides for a new comprehensive regime for revival and rehabilitation of companies under Chapter XIX: unlike SICA which applied to specified industrial companies only, the CA 2013 for corporate rescue is applicable to *all* companies. The procedure under the CA 2013 in relation to corporate rescue shall be administered by the NCLT, a quasi-judicial body. The NCLT shall consist of both judicial and non-judicial members. The following features of Chapter XIX CA 2013 make it significantly better than SICA: (i) greater involvement of the creditors in the rehabilitation process, (ii) reference criteria based on a liquidity test (instead of erosion of net worth), (iii) no automatic moratorium (the moratorium under the CA 2013 will be available only on application to the NCLT, and is available only for a fixed duration of 120 days), (iv) provision for a committee of creditors (with representatives from every class of creditors) that will have a say in determining whether a company should be liquidated or rescued, (v) requirement of creditor consent for approving a scheme of rescue (that gives rights to both secured and unsecured creditors), (vi) provision for appointment of

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<sup>75</sup>*In re Siel Limited*, [2004] 122 CompCas 536 (Delhi).

<sup>76</sup> *Unit Trust of India and Anr. V. Garware Polyester Ltd*, AIR 2005 SC 2520.

<sup>77</sup> *In Re: Imp Powers Ltd.*, 2008 142 CompCas 481 Bom.

<sup>78</sup> Section 394, CA 1956.

<sup>79</sup> N Sharma, *Restructuring and Insolvency*, 43(1) Chartered Secretary 19 (2013).

<sup>80</sup> *Ibid.*

administrators (as against operating agency under the SICA) - appointed from a databank of authorised practitioners (company secretaries, chartered accountants, cost accountants and such other professionals) maintained by the government – who can even take-over the management of the debtor company under the NCLT’s directions, (vii) provision for a ‘Rehabilitation and Insolvency Fund’ for the purpose of liquidation and rescue of sick companies. Additionally, as under the SICA, it is possible for SARFAESI Act action to defeat the commencement of rescue proceedings altogether (see the provisos to Section 254 of CA 2013).

Although the rescue related provisions of new CA 2013 make several improvements over the old regime, there are several areas where its provisions need further changes to ensure that the new regime works efficiently and produces the desired outcomes. This not only requires few substantive changes to the CA 2013, but also some institutional changes (to ensure proper implementation).

#### A. DETERMINING WHEN CORPORATE REVIVAL AND REHABILITATION IS TO BE INITIATED BY THE SECURED CREDITORS OR THE DEBTOR COMPANY

In order to facilitate early detection and intervention in case of corporate distress, it is crucial to devise an appropriate test for identifying when measures for corporate rescue are to be taken in relation to a company in financial trouble. Under the SICA, the ‘erosion of net worth’ test was used to determine whether an industrial company had become sick and rehabilitation proceedings were to be initiated in relation to it. This test was criticized by the *Goswami Committee* and the *RBI Advisory Group on Bankruptcy Laws* as failing to provide an appropriate trigger for taking measures for rehabilitation: the test determined a company to be sick only when it was in the final stage of sickness, at which point there was effectively no scope for rescuing the company.

The CA 2013 permits a secured creditor or the company to make a reference to the NCLT for declaring the company to be a sick company if it is unable to pay/secure/compound the debt when a demand for payment has been made by secured creditors representing 50% or more of the outstanding amount of debt within thirty days of the service of notice of demand.<sup>81</sup> A reference may also be made by the Central or State Governments, the RBI, a public financial institution, a State level institution or a scheduled bank if it has sufficient reasons to believe that a company has become sick.<sup>82</sup> Thus, typically, the triggers for making a reference to the NCLT for determination of ‘sickness’ of the company are: (i) non-payment of 50% or more of the outstanding amount of debt when a statutory demand has been made; or (ii) belief that the company has become sick. As per the draft NCLT rules, a ‘sick company’ is defined to mean and include “a company, which has failed to pay the debt of its secured creditors within 30 days of the notice of demand or to secure or compound it to the reasonable satisfaction of the secured creditors as per section 253 of the Act”.

##### a. INTERNATIONAL PRACTICES

At this juncture, it is pertinent to examine the practice in other jurisdictions for some guidance in developing such a test. The US does not require proof of insolvency in order for a company to undergo rescue procedures under Chapter 11 of the Bankruptcy Code. On the contrary, the UK uses the

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<sup>81</sup>Section 253(1), (4), CA 2013.

<sup>82</sup>Section 253(5), CA 2013.

insolvency or likelihood of insolvency of a company as a trigger to invoke administration (the formal process for revival and rehabilitation of companies under financial distress). Since doubtful solvency is often an indicator of impending financial troubles, such a test is best suited for determining whether steps for rehabilitating the company are to be taken.

In the UK, an administration order is made by the court only if it is satisfied that the company (a) ‘is unable to pay its debts’ or ‘is likely to become unable to pay its debts’ and (b) that the administration order is reasonably likely to achieve the purpose of administration.<sup>83</sup>The term “likely” has not been defined anywhere in IA 1986) or the rules, and therefore it becomes relevant to look at the judicial development on this aspect.

The analysis of this term in the context of the first ground came up specifically in issue in the case of *In the matter of Highberry Limited v Colt Telecom Group plc*<sup>84</sup>. A company called Highberry claimed in a petition for administration order that Colt Telecom (“**Colt**”) is or is likely to become insolvent due to the dramatic fall in its share price since the year 2000, and also due to its substantial operating losses and negative cash-flows and also on the basis of the report of an auditing firm. The noteholders of Highberry who were keen on forcing Colt into administration argued that though there was no risk of cash flow insolvency till 2006, however post 2006, Colt would be unable to repay a substantial amount of the capital due on the notes when it becomes payable (which was 4 years later from the date of the petition) as it was not clear it will be generating enough cash flow from its assets or anyone would be willing to re-finance the company in 2006. The issue framed was “must a petitioner prove that the company is “likely to be unable to pay its debts” on a balance of probabilities or is it sufficient for it to prove that that there is a real prospect of that being so” and therefore, Jacob J. considered it necessary to examine the meaning of the term “likely” as it appeared in the IA 1986.

A reference was made to the judgment of *Re Primlaks (UK) Ltd*<sup>85</sup> wherein it has been observed that the plain grammatical meaning of the word “likely” is not always used to convey the speaker's belief that it will probably happen, and such a meaning is not what is intended to be attributed to the word “likely” under the IA 1986. Jacob J. further observed – “*To put a company into administration is a serious matter. Creditors, as well as the company itself, can apply. To expose the company to all the expense, danger, and problems associated with administration is a serious matter. It is most unlikely that Parliament intended this when there was only a real prospect of insolvency rather than where insolvency was more probable than not. The experience of this case fortifies my view that it is not enough merely to show a ‘real prospect’ of insolvency as opposed to insolvency being more likely than not. I cannot think Parliament intended that companies should be exposed to this kind of hostile proceeding where it is more likely than not that the company is not insolvent.*”

#### b. CRITERIA USED IN THE JOINT LENDER’S FORUM FRAMEWORK OF THE RBI

The RBI has recently laid down guidelines for early recognition of financial distress, taking prompt steps for resolution, and ensuring fair recovery for lending institutions. Before a loan account turns into

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<sup>83</sup> Schedule B1, para 11, IA 1986 - Conditions for making order - The court may make an administration order in relation to a company only if satisfied— (a) that the company is or is likely to become unable to pay its debts, and (b) that the administration order is reasonably likely to achieve the purpose of administration.

<sup>84</sup> [2002] EWHC 2815 (Ch).

<sup>85</sup>(1989) 5 B.C.C. 710.



an NPA, banks are required to identify incipient stress in the account by creating three sub-categories under the SMA category. Banks are also required to report certain credit information pertaining to a class of borrowers to the 'Central Repository of Information on Large Credits'. These guidelines envisage the mandatory setting up of a JLF by lending banks if the principal or interest payment on the loan account is overdue for more than 60 days and the aggregate exposure ("AE") of lenders in that account is INR 1000 million and above ("SMA-2"). More importantly, lenders can also form a JLF even when the AE in an account is less than INR 1000 million and/or when the account is reported as SMA-0 (when principal or interest payment is not overdue for more than 30 days but account shows signs of incipient stress) or SMA-1 (when principal or interest payment is overdue for 31-60 days). For classifying an account as SMA-0, banks are required to consider several aspects relating to the borrower and its business which show signs of financial distress even before a default has taken place. Such factors include bouncing of cheques, evidence of diversion of funds, etc. A borrower may also request the lenders to form a JLF on account of imminent stress. The JLF process also requires banks to conduct viability studies before initiating a restructuring.

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The BLRC is of the opinion that the present criteria for initiating rescue proceedings as laid down in Section 253(1) of the CA 2013 may not facilitate early intervention. If a company has already defaulted on 50% of its outstanding debt, it is very likely that it has reached a stage where it would be very difficult to rescue it effectively. Further, it may be noted that while a winding up petition can be filed even if a company was unable to repay a single undisputed debt on demand, an application for rescue can be made only at a much later stage. It may be desirable to permit secured creditors with superior information about the company's financial status and prospects to file an application for rescue of the company at a sufficiently early stage so as to allow for early intervention in case of financial distress. The chances of abusive filing by secured creditors are minimal as they would prefer individual enforcement over the collective rescue procedure. Moreover, the costs and the time taken in rescue are likely to make it less attractive to such creditors in comparison to other means of debt enforcement. Secured creditors are likely to have recourse to the collective rescue procedure under Chapter XIX, CA 2013 only in certain limited circumstances: where the secured creditors would like the management of the company to be replaced by an administrator (for instance, where the secured creditor feels that the company is being badly run by the existing management and may fail as a consequence); where the secured creditor would like to use the collective process so as to obtain the benefit of the moratorium on enforcement (for instance, where the secured creditor is of the opinion that operation of the moratorium is necessary in order to prevent breakup of the company and to realise maximum value by keeping the assets together). Therefore, the secured creditor is likely to prefer individual enforcement of debt rather than a collective rescue procedure. Having said that, if creditors are allowed to initiate public rescue proceedings too early, it may cause damage to the goodwill of the company and worsen its financial condition.

The BLRC recommends that any secured creditor should be able to initiate rescue proceedings if the debtor company fails to pay a single undisputed debt of such creditor above a prescribed value within thirty days of a notice of demand. Further, the debtor company should be able to initiate rescue proceedings even before such a default takes place (i.e., on the ground of likelihood of inability to pay debt). It is important to note that CA 2013 provides for takeover of the management of a debtor company as part of the rescue process. Given the possibility of such displacement of management, it is unlikely that debtor companies will initiate the rescue proceedings too early in order to abuse the process for extraneous considerations. Nevertheless, if creditors are also allowed to initiate the rescue process on

the ground of likelihood of insolvency (as is allowed in the UK), it may in certain situations aggravate the financial position of the company. Given the public nature of the rescue proceedings contemplated under CA 2013, further consultation with the stakeholders is required before permitting creditors to initiate rescue proceedings on the ground of likelihood of insolvency.

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***Recommendations:***

- *Section 253(1) of CA 2013 should be amended to specify that any secured creditor may initiate rescue proceedings if the debtor company fails to pay a single undisputed debt owed to such secured creditor exceeding a prescribed value within thirty days of the service of the notice of demand or fails to secure or compound such debt to the reasonable satisfaction of such creditor.*
- *Section 253(4) should be amended to specify that the debtor company itself may initiate rescue proceedings on the ground of inability or likely inability to pay any undisputed debt of a prescribed value owed to any creditor whether secured or unsecured.*
- *The prescribed value for making a reference can be provided by rules and may be amended from time to time.*
- *The NCLT should be empowered to impose sanctions/costs/damages on a petitioner and disallow re-applications on the same grounds if it finds that a petition has been filed to abuse the process of law.*

***Question for Consideration for the Insolvency Code:***

- i. Should secured creditors be allowed to initiate formal rescue proceedings on the ground of likelihood of insolvency?*

## **B. ALLOWING UNSECURED CREDITORS TO INITIATE RESCUE PROCEEDINGS**

Currently, the CA 2013 permits the following parties to file an application before the NCLT for a declaration that the company is sick- (a) the company, (b) any secured creditor, (c) the Central Government, (d) the Reserve Bank of India, (e) State Government, (f) public financial institution, (g) a State level institution, (h) a scheduled bank.

Unsecured creditors are not permitted to initiate rescue proceedings under the CA 2013. This may reduce the incentives of unsecured creditors to provide credit. The recent global financial crisis has shown that a market for bank loans may not be available at all times and alternative sources of finance need to be put in place to prevent widespread liquidity crunch when the banks are under distress. A right to initiate rescue proceedings is particularly important for unsecured bond investors, who expose themselves to a high risk in such investments. Moreover, there may be companies which only have unsecured creditors. It may also be noted that in the UK, any creditor can apply to the court for an administration order in relation to the company. In the US, a Chapter 11 proceeding may be commenced on the filing of a petition under Chapter 11 by three or more entities, each of which is either a holder of a claim against the company that is not contingent as to liability or the subject of a bona fide dispute, or an indenture trustee representing such a holder, if such non-contingent, undisputed claims aggregate at least \$10,000 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims. Thus, international practice is in favour of permitting even unsecured creditors to file for the initiation of rescue proceedings in relation to the company.

In view of the above the BLRC is of the view that unsecured creditors should also have the right to initiate rescue proceedings. It may be noted that as per Section 262 (2) of CA 2013 a scheme of rehabilitation has to be approved by 25% of the unsecured creditors in value (in addition to 75% of the secured creditors in value). In order to prevent any frivolous applications which may cause damage to the public image of the company, a similar value related threshold can be provided for unsecured creditors for initiating the rescue proceedings.

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**Recommendations:**

- *Section 253 of CA 2013 should be amended to allow unsecured creditors representing 25% of the value of the debt owed by the debtor company to all its unsecured creditors to initiate rescue proceedings if the debtor company fails to pay a single undisputed debt owed to any such unsecured creditor exceeding a prescribed value within 30 days of the service of the notice of demand or fails to secure or compound it to the reasonable satisfaction of such unsecured creditor.*
- *The prescribed value for making a reference can be provided by rules and may be amended from time to time.*
- *Further, the NCLT should be able to impose sanctions/costs/damages on a petitioning creditor and disallow reapplications on the same grounds if it finds that a petition has been filed to abuse the process of law.*

**Question for Consideration for the Insolvency Code:**

- Should unsecured creditors be allowed to initiate formal rescue proceedings on the ground of likelihood of insolvency?*

**C. RELEVANCE OF VIABILITY AND REDUCTION OF TIME-LINES FOR DETERMINING WHETHER TO RESCUE OR LIQUIDATE**

CA 2013 uses ‘sickness’ as the preliminary criterion for determining whether a company should be rescued. However, it does not prescribe any statutory test for determining whether a company referred to the NCLT is sick or not. This limitation was also highlighted in the report of the *Standing Committee on Finance (dated August 2012) on the Companies Bill 2011*. As mentioned above, as per the draft NCLT rules, a ‘sick company’ “means and includes a company, which has failed to pay the debt of its secured creditors within 30 days of the notice of demand or to secure or compound it to the reasonable satisfaction of the secured creditors as per section 253 of the Act”. This definition leaves much to the discretion of the NCLT, with no requirement to consider the viability of the business. Even if the NCLT does evolve criteria for determination of ‘sickness’, it is possible that such criteria may get influenced by the SICA test for ‘sickness’ and jurisprudence on the same, which has been considered to be very problematic. Further, such criteria may be subject to modifications over time and lead to a lot of uncertainty. Therefore, it is absolutely essential that the NCLT’s discretion in determining whether a company has become sick and is eligible for being rescued should be based on an objective assessment of its viability. This can be achieved by collapsing some of the procedural steps envisaged in Chapter XIX as discussed below:

It may be noted that the NCLT is required to decide whether a company is sick or not within sixty days of the receipt of the initial application under Section 253 (“Application 1”). It may also be noted that after a company has been declared a sick company, the company itself or a secured creditor can make an application to the Tribunal for determination of measures that may be adopted for rescuing the company (“**Application 2**”). Since Application 2 can be filed only after an outcome of Application 1, a time period of upto sixty days must pass before Application 2 can be filed.

After **Application 2** has been filed, Section 256 (1) (b) of CA 2013 requires the NCLT to appoint an interim administrator who is in turn required to convene a meeting of a committee of creditors to consider if it is possible to revive and rehabilitate the sick company and file a report with the NCLT within sixty days of such appointment, based on which a final decision on whether a company should be revived or liquidated is required to be taken at a hearing, which can be held as late as ninety days from the date of **Application 2** (S 256 (1) (a)). It is also important to note that all orders of the NCLT can be subjected to appeals before the NCLAT (with the possibility of a further appeal to the Supreme Court. Therefore, if a decision on Application 1 is subjected to an appeal, the outcome of Application 2 may take even longer.

**In other words, (a) an interim administrator and the creditors can examine the viability of the company only after it has been declared sick and (b) creditors can object to rescue and recommend liquidation on the basis of unviability at a hearing that takes place much later.** It may be noted that as per the JLF framework of the RBI, within 30 days of an account being reported as SMA -2 (see point b. under Section A. above) or receipt of request from the borrower to form a JLF (with substantiated grounds), the JLF is required to arrive at an agreement on the option to be adopted for a ‘Corrective Action Plan’ (i.e., rectification of the account on the basis of commitments made by the borrower, exploring restructuring alternatives or initiating recovery proceedings).The JLF is required to sign off the detailed final Corrective Action Plan within the next 30 days from the date of arriving at such an agreement. **In other words, the JLF framework requires finality on the corrective action to be pursued within sixty days of a reference being made.**

If an interim administrator is appointed earlier (within seven days of Application 1) for the limited purpose of convening a meeting of the committee of creditors and submitting a report to the NCLT on the viability of the business, the NCLT will be able to use the report of the interim administrator to determine the viability of the business at the time of determining sickness of the company. **By way of such an amendment, a decision on whether the company should be rescued or whether winding up proceedings should be initiated can be taken within two months of filing of the initial application (as against five months as is presently contemplated - up to sixty days for determination of sickness and another ninety days for a final decision on whether to go for rescue or liquidation).**

The BLRC is of the opinion that viability should be the most important (if not the only) consideration for allowing a company to be rescued. Unviable insolvent companies should not be allowed to continue functioning for extraneous considerations. Liquidation should not be seen as a measure of last resort for unviable businesses that have become insolvent – they should be liquidated as soon as possible to minimize the losses for all parties.

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### **Recommendations:**

- *Sections 253 to 258 of CA 2013 should be redrafted to ensure that the viability of a company is taken into account while determining its sickness and enabling the creditors to have a say in such determination. If an interim administrator is appointed by the NCLT sooner (within seven days of the first application for rescue being filed) for the limited purpose of convening a meeting of a committee of creditors (that will include representatives of all classes of creditors) and submitting a report to the NCLT on the viability of the business, the NCLT will be able to use such report to examine the viability of the business at the time of determining whether a company is sick or not. This allows creditors to have a say in determining the viability of a company at an early stage and significantly reduces the time-period for arriving at a final decision on whether to rescue a company or initiate liquidation proceedings. By way of such an amendment, a decision on whether the sick company should be rescued or whether winding up proceedings should be initiated can be taken within two months of filing of the initial application as against the presently contemplated five months or longer (in case of an appeal against the first order) - up to sixty days for determination of sickness and another ninety days or longer for a final decision on whether to go for rescue or liquidation.*
- *The terms and conditions of the appointment of the interim administrator and its powers shall be determined by the NCLT at the time of his or her appointment (as is currently envisaged).*
- *A decision of the committee of creditors on whether the company should be rescued or liquidated should be supported by 75 % secured creditors by value (or 75% of all the creditors by value, if there is no secured debt in the company). As 75% of the secured creditors by value can initiate action under the SARFAESI Act (under the proviso to Section 254 of CA 2013) and defeat the rescue proceedings at any stage, giving them a larger say in assessing the viability of the company will incentivise them to actively participate in the rescue proceedings and not initiate separate security enforcement action.*

### **D. MORATORIUM**

The CA 2013 provides for a moratorium on enforcement proceedings to be granted on an application to the NCLT, and for a fixed duration of 120 days.<sup>86</sup> The provisions on the moratorium suffer from the following problems: (i) wide discretion to the NCLT to determine whether a moratorium should be granted or not; (ii) no provision for lifting or modifying the terms of the moratorium once it has been granted; (iii) no express requirement for consideration by the NCLT of creditor interests in making the decision to grant the moratorium; (iv) no provision for an interim moratorium while the NCLT is hearing an application for grant of the moratorium.

Many countries provide for an automatic moratorium on other proceedings once the company enters formal insolvency proceedings. The possibility of abuse of the moratorium by the debtor company arising in such a case is prevented through the incorporation of suitable safeguards for secured creditors. For example, Section 362 of the US Bankruptcy Code provides for an automatic moratorium on the

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<sup>86</sup> Sections 253(2)-(3), CA 2013.

enforcement of claims against the company and its property upon the filing of a Chapter 11 petition. The moratorium covers judicial and administrative proceedings, enforcement of judgments against the company or its estate, acts to obtain possession/control of estate property, acts to create, perfect or enforce liens, acts to collect claims, exercise of right of set off, tax court proceedings etc.<sup>87</sup> However, secured creditors can apply to the court to lift the stay under certain circumstances. The moratorium may be lifted for appropriate cause, including if, in the opinion of the court, the debtor company has not ‘adequately protected’ the property interests of the creditor during the period of the moratorium.<sup>88</sup> Similarly, the moratorium may also be lifted with respect to an action against property of the debtor’s estate, if the debtor does not have any equity in the property and such property is not required for the effective reorganisation of the debtor.<sup>89</sup>

Schedule B1 of the IA 1986 (UK) provides for an interim moratorium applicable during the period between the filing of an application to appoint an administrator or giving of notice of intention to appoint an administrator and the actual appointment of such administrator. Further, the IA 1986 provides for an automatic moratorium on insolvency proceedings. The moratorium on insolvency proceedings is broad in nature.<sup>90</sup> Further, there is an automatic moratorium on enforcement of security over the company’s property, repossession of goods in the company’s possession under a hire-purchase agreement (defined to include retention of title arrangements), exercise of a right of forfeiture by a landlord by peaceable re-entry and institution of legal proceedings against the company. The moratorium in these cases can be lifted with the approval of the administrator or the consent of the court.<sup>91</sup>

It is evident that in these jurisdictions, an automatic moratorium (coupled with an interim moratorium in the case of the UK) has been used to prevent a race to collect by the creditors, precipitating the liquidation of the company. Specific safeguards for protection of the interests of secured creditors and others with a proprietary interest in the assets in the possession of the firm (e.g. under hire purchase and retention of title arrangements) have been incorporated through express stipulation of circumstances under which a moratorium may be lifted in the US, and in the case of the UK, through provision for lifting of moratorium with the approval of the administrator or the consent of the court.

### Principles governing the moratorium

As discussed above, the US provides for an automatic stay on the enforcement of claims against the company and its property upon the filing of a Chapter 11 petition. The court may grant relief from a moratorium under Section 362(a) of the US Bankruptcy Code by terminating, annulling, modifying or imposing conditions on such moratorium.<sup>92</sup> Such relief may be granted for cause, including where the debtor has not adequately protected the interests of the concerned secured creditor in the property.

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<sup>87</sup> Rodrigo Olivares-Caminal et al, *Debt Restructuring*, (1<sup>st</sup> edn, Oxford University Press 2011) (hereinafter referred to as “Olivares- Caminal et al”)

<sup>88</sup> Finch.

<sup>89</sup> Olivares- Caminal et al

<sup>90</sup> Olivares- Caminal et al.

<sup>91</sup> Schedule B1, para 43, IA 1986.

<sup>92</sup>Section 362(d), US Bankruptcy Code.

Similarly, with respect to a moratorium on an act against property, if the debtor does not have equity in the property and the property is not necessary for the effective reorganisation of the debtor company, the court may grant relief from the moratorium. Relief may be granted from the moratorium on an application by a creditor having an interest in the real property of the company if the court finds that the filing of the petition was part of a scheme to hinder, delay or defraud creditors that involved multiple bankruptcy filings affecting the property or transfer of ownership (either in part or whole) or other interest in the property without the consent of the secured creditor or approval of the court. The court may also grant relief from the stay, with or without a hearing if such relief is necessary to prevent irreparable damage to the interest of an entity in the property of the company and if such interest will suffer such damage before a notice and hearing can be held.

In the UK, case law on the moratorium provisions under the IA 1986 provides useful guidance as to the exercise of the discretion by the administrator/court in lifting the moratorium. In *Re Atlantic Computer Systems plc*,<sup>93</sup> the court laid down some guidance for the cases where leave is sought to exercise proprietary rights (including security rights) against a company in administration. The court held that if the grant of leave is unlikely to hinder the achievement of the purpose for which the administration order was made, then the creditor should be given leave to take enforcement action. In other cases, the court has to conduct a balancing exercise between the legitimate interests of the particular creditor and the legitimate interests of other creditors. Such a balancing exercise attaches great significance to the proprietary interests of the creditor:

*“...The underlying principle here is that an administration for the benefit of unsecured creditors should not be conducted at the expense of those who have proprietary rights which they are seeking to exercise, save to the extent that this may be unavoidable and even then this will usually be acceptable only to a strictly limited extent...”*

Thus, the court will have to take into account the loss (any kind of financial or non-financial loss, whether direct or indirect) caused to the creditor on account of a refusal of leave, and weigh it against the loss caused to others due to the grant of leave. In conducting this exercise, the court will have to consider circumstances such as the financial position of the company, its ability to pay rental arrears as well as continuing rentals, the proposals put forth by the administrator, the time for which the administration order has been in force and the time period for which it will remain in force, the effect on the administration if the court were to grant leave, the effect of refusal of leave on the creditor applying for leave, the end result to be achieved by the administration, the prospects of such a result being achieved and the history of the administration till date. It must be noted that other considerations may also apply, depending on the circumstances of each case. Thus, in *Bristol Airport v Powdrill*,<sup>94</sup> the court considered the conduct of the parties as an important factor in not granting leave- the creditors had in this case obtained the benefit of the administrator’s actions through most of the administration period and were subsequently seeking to exercise their security interests.

The court in *Re Atlantic Computer Systems* also noted that in considering various circumstances, if loss to the creditor applying for leave is certain if leave is refused, but loss to the others only a remote possibility if leave is granted, then that may be a significant factor in favour of granting leave. These

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<sup>93</sup> [1990] BCC 859.

<sup>94</sup> [1990] Ch 744.

considerations were also held to be relevant to a decision on whether to impose terms where leave is granted.

While many countries provide for an automatic moratorium, given the past experience under the SICA wherein the automatic moratorium was widely abused by debtor companies, the present provision in the CA 2013 may be retained. However, the law must at minimum lay down clear principles to guide the exercise of discretion by the NCLT on whether the moratorium should be granted or not, and it does not seem optimal to leave this fundamental question to be developed on a case by case basis in the NCLT. Further, a provision may be made for an interim moratorium applicable automatically till the NCLT decides on the application for grant of moratorium or for a maximum period of 30 days, whichever is earlier. Given the possibility of the displacement of management under the rescue mechanism under CA 2013, it seems unlikely that debtor companies will initiate rescue proceedings only with the intention of taking advantage of the interim automatic moratorium.

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### **Recommendations:**

- i. *The NCLT's discretion to grant, refuse or lift a moratorium under Section 253 (2) should be guided by a non-exhaustive list of grounds specified in a separate statutory provision. Such grounds may include:*
- *The moratorium may ordinarily be granted if the business seems prima facie viable (and needs to be protected from piecemeal sale or liquidation).*
  - *The moratorium may not be granted if 75% of the secured creditors by value (or 75% of all the creditors by value where there is no secured debt in the company) dissent to the grant of a moratorium.*
  - *The moratorium may not be granted where there is any evidence of fraud, diversion of funds, etc.*
  - *Once a moratorium has been granted, the NCLT may terminate or modify the same or impose terms on the application of the moratorium, for cause.*
  - *The NCLT may terminate/modify or impose terms on the application of the moratorium on the following grounds: (a) if the creditor applying to the NCLT for leave to take debt enforcement action is able to prove that the grant of leave is unlikely to hinder the purpose of the rescue proceedings from being achieved; (b) on the application of the creditor applying for the same if the debtor company has not 'adequately protected' the interests of the such creditor; (c) if the creditor is able to show that the property in question is not necessary for the effective reorganization of the debtor company.*
  - *In exercising its discretion on whether to grant leave to a creditor to take enforcement action, the NCLT may balance the legitimate interests of such creditor against the legitimate interests of other creditors of the debtor company. If significant loss (financial or non-financial, direct or indirect) will be caused to the creditor applying for leave to take enforcement action if such leave is refused, the NCLT may normally grant leave. However, if the loss caused to the other creditors in granting such leave is greater, then the NCLT may not grant leave. In conducting the balancing exercise, the NCLT may consider factors such as the financial position of the debtor company, its ability to pay arrears due to the creditor as well as continuing payments, the proposals put forth by the interim administrator or the company administrator, the time for which the rescue proceedings has already been in place and the time for which such proceedings will continue, the effect on*



*the rescue proceedings if the NCLT were to grant leave, the effect of refusal of leave on the creditor applying for leave, the end result to be achieved by the rescue proceeding, the prospects of such a result being achieved. In considering the various factors listed above, if loss to the creditor applying for leave is certain if leave is refused, but loss to the others only a remote possibility if leave is granted, then the NCLT may grant such leave to the creditor.*

- *Lastly, the moratorium shall automatically stand revoked if the NCLT makes determination under Section 253 (7) that the company cannot be rescued.*
- ii. *In order to prevent a precipitous break-up of a viable company before the NCLT decides on an application for a moratorium, there should be an automatic interim moratorium in place till such determination (or for a maximum/non-extendable period of thirty days, whichever is earlier).*

#### E. DIRECT APPOINTMENT OF THE COMPANY ADMINISTRATOR BY SECURED CREDITORS

The current scheme of the CA 2013 does not provide for the participation of creditors in the appointment of the interim administrator (who is appointed initially for the purpose of convening a meeting of the committee of creditors) or the company administrator (who is appointed at a later stage for the purpose of preparing and implementing the scheme). Both the interim administrator and the company administrator can take-over the management of the company under directions from the NCLT. As discussed before, any secured creditor who wishes to initiate rescue proceedings has to apply to the NCLT for declaring the company to be sick<sup>95</sup> and for taking measures for the revival and rehabilitation of the company once it has been determined to be sick.<sup>96</sup> However, it is the NCLT who appoints the interim administrator and the company administrator. While vesting the power to appoint the interim administrator/ company administrator in the NCLT may be seen as ensuring fairness and impartiality towards all parties, such a measure may not always ensure the appointment of the person who is most suited for conducting rescue proceedings for the particular company involved. Moreover, there is a strong case to be made for creditor involvement in the process of appointment of the company administrator (if not the interim administrator). Creditors are likely to be most incentivised to select the person who is best suited for the task- as the fees payable to the company administrator may be taken out of the company's assets,<sup>97</sup> the creditors will often choose a person who is familiar with the company's business, its activities or assets or has skills, knowledge or experience in handling the particular circumstances of the case.

Under Section 13(4)(b) of the SARFAESI Act, the secured creditor has a right to take-over the 'management of the business of defaulting borrower' for the *express purpose* of realisation of the secured debt. The taking over of the management of the borrower is operationally difficult for the creditor as it may not have the expertise for management of the assets (albeit, Section 13(4)(c) does permit the secured creditor to appoint any person for the management of the secured assets). Further, if the borrower is a running unit, the management of the secured assets may have legal implications and

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<sup>95</sup> Upon meeting the relevant criteria prescribed in Section 253(1), CA 2013.

<sup>96</sup>Section 254(1), CA 2013.

<sup>97</sup> Please note that the CA 2013 does not have a specific provision on the remuneration of the company administrator. Section 259(2) merely states that the terms and conditions of the administrator's appointment shall be fixed by the NCLT. This is an important question that should be closely considered and addressed with reference to administrator's duties.

may render the secured creditor liable to the borrower for the losses which may be sustained on account of the creditor running operations of the borrower.<sup>98</sup> Hence, the purport of the section is effectively limited to *management of the assets* unlike Section 9 of the SARFAESI Act which deals with asset reconstruction and allows for the ARC to take over the *management of the business* of the borrower whilst taking into consideration RBI guidelines prescribed in this regard. The RBI guidelines specify that ARCs can takeover the management only for the purpose of realization of its dues. The SARFAESI Act requires that the management of the company has to be restored back to the borrower after realisation of the dues. In other words, the provisions relating to acquisition of management in the SARFAESI Act are designed to facilitate debt recovery and not insolvency resolution or rescue.<sup>99</sup> An administrator appointed by the creditors (whose rights and obligations are specified in CA 2013 or the NCLT's order) to take-over the management of a viable sick company under an NCLT order may offer a solution to the limitations of the management acquisition provisions of the SARFAESI Act regime. The possibility of abuse of the power of appointment of administrator may be minimised by incorporating safeguards in the CA 2013. For instance, the company/ other creditors may be given the right to file a petition before the NCLT to remove or replace the administrator.

In the UK, the holder of a qualifying floating charge<sup>100</sup> may appoint an administrator out of court at any point. This enables a qualifying floating charge holder who has a substantial stake in the company's fortunes and receives early warning signals about impending financial trouble to act at the earliest and initiate proceedings for turning the company around. In order to appoint the administrator, the qualifying floating charge holder only has to file with the court the following documents:

- a. a notice of appointment- the notice must include a statutory declaration by or on behalf of the person that he/she is a QFCH, that each floating charge relied on is/was enforceable on the date of the appointment and that the appointment was in accordance with Schedule B1. Further, the notice must identify the administrator.
- b. the statement by the administrator that he consents to the appointment and that in his opinion, the purpose of the administration is likely to be achieved, and giving any other information and opinions as may be prescribed.
- c. such other documents as may be prescribed.

Such right may only be given to secured creditors who may otherwise initiate SARFAESI action under the provisos to Section 254. This will incentivise such creditors to participate in the rescue process and not initiate separate recovery proceedings which may lead to breaking up of viable businesses. A process that facilitates direct appointment of insolvency professionals outside the NCLT can also help in the development of a market for turnaround specialists. Turnaround specialists have become

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<sup>98</sup> H.P.S. Pahwa, *Law & Practice of Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest*, 604 (New Delhi: Modern Law Publications, 2006).

<sup>99</sup> It may be noted that the limitations of the SARFAESI Act for achieving insolvency resolution through ARCs may also be attributable to factors such as valuation/pricing, lack of proper incentives to turn around a venture, etc.

<sup>100</sup> A QFC is a floating charge created by an instrument which:

- a. states that para 14 (on appointment of administrator by QFCH) applies to such charge, or
- b. purports to empower the holder of such floating charge to appoint an administrator of the company, or
- c. purports to empower the holder to make an appointment which would be the appointment of an administrative receiver under earlier law (Para 14(2), Schedule B1).

increasingly popular in international restructuring and recovery processes. They are essentially professionals skilled in the mechanics of turning around a struggling business. The key for the success of a turnaround specialist is that they are brought in early enough in the process such that their efforts can salvage the economic value in the company. Turnaround specialists are particularly useful in the context of companies suffering from idiosyncratic rather than systemic issues. Since they are essentially generalists adept at dealing with companies in distress, they may not have the level of in depth knowledge of the distressed company's particular area of operation. In this context, it is crucial to note that turnaround specialists are generally more successful when they operate with the advice and guidance of the incumbent management. Since they are external parties, they are able to bring in a fresh perspective to the issues faced by the distressed company. As they operate across sectors, they also have the benefit of being able to look at broader "macro" issues and trends which often entrenched incumbent management fails to perceive. If certain creditors are allowed to directly appoint a company administrator and determine the terms and conditions of such appointment (including the fee), it may help in the development of a market for turnaround specialists in India (as a market driven process will encourage such service providers to work as company administrators or advisors to company administrators) .

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**Recommendations:**

- *75% of the secured creditors in value (or 75% of all creditors by value, if there is no secured debt in the company) should be able to appoint a company administrator directly (after a company has been declared sick) and determine the terms and conditions for such appointment (including the fee), subject to post facto confirmation by the NCLT. Such creditors may appoint the interim administrator as the company administrator.*
- *The CA 2013 should be amended to empower the Government to issue separate rules to prescribe standard terms and conditions for such appointment.*
- *The NCLT may confirm such appointment in the absence of a manifest violation of the prescribed terms and conditions or a challenge by the company or the other creditors. The process for appointment of the company administrator should be completed within fifteen days from the date of the order of the NCLT determining that the debtor company can be rescued.*
- *The company and/or other creditors should be permitted to petition the NCLT for the removal or replacement of the company administrator on grounds as may be prescribed by rules. Further, a provision similar to the UK's provision for "unfair harm" (which entitles a creditor to petition the court for relief where the administrator is acting so as to harm the interests of the applicant, with the available relief including the removal of the administrator) may be appropriate.<sup>101</sup> The NCLT should be able to impose sanctions/costs/damages on a petitioner if it finds that a petition challenging such appointment has been filed to abuse the process of law.*
- *The NCLT shall dispose of any application for removal or replacement of the company administrator within thirty days of the application.*

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<sup>101</sup> Schedule B1 para. 74 of the Insolvency Act 1986.

## F. TAKEOVER OF MANAGEMENT OR ASSETS BY THE ADMINISTRATOR

As indicated earlier in the Report, “*The main drawback of the SICA scheme*” was that it left “*the debtor company in possession of the assets which creates an asymmetry and imbalance between the debtor company and its creditors conferring on the inefficient or inept management an unmerited advantage...The debtor in possession allows the promoters to leverage informational advantages and to create tailor made delays in the proceedings by taking recourse to [the moratorium]...*” (Eradi Committee Report as cited in van Zwieten). In order to address this concern, the CA 2013 provides that an interim administrator or the company administrator appointed as part of the rescue process can take over the management of the debtor company. However, like most other powers envisaged in CA 2013, such takeover of management can take place only after the NCLT directs the administrator to take over the management (under Section 256 (1) or Section 258 (3)). In all other cases, the incumbent management continues to be in possession of the company. Moreover, CA 2013 does not provide any guidance on the circumstances in which the management or assets may be taken over. Even where the administrator has been directed to take over the management, CA 2013 provides no clarity on what role the existing management will play after such takeover of management. The provision relating to takeover of management by the interim administrator provides that when such interim administrator has been directed to take over the management, the directors and the existing management shall extend all reasonable co-operation to him manage the affairs of the company (S 256(2)). However, the provision relating to the takeover of management by the company administrator (who is appointed only after the NCLT has ruled that the company should be rescued) is silent on the role of the existing directors and management. Contrast this to Section 15 of the SARFAESI Act that includes detailed provisions on the manner and effect of the takeover of management for the purpose of debt recovery.

### International practices

In the UK, the administrator, **once appointed, takes over the management of the company**. The administrator plays a central role in the rescue process and has the power to do anything ‘necessary or expedient for the management of the affairs, business and property of the company.’ The administrator has the power to carry on the business of the company.<sup>102</sup> Most significantly, it may be noted that a company in administration or an officer of a company in administration may not exercise a management power without the administrator’s consent.<sup>103</sup> Once appointed, the administrator *shall* manage the company’s affairs, business and property.<sup>104</sup> The power of the court to give directions to the administrator is limited to those instances where none of the administrator’s proposals have been approved by the creditors’ meeting, or where its directions are consistent with such proposals/revisions, or if the court thinks the directions are required in order to reflect a change in circumstances since the approval of proposals/revisions.<sup>105</sup> Further, an administrator has the power to remove a director of the company or to appoint a director of the company.<sup>106</sup> Most significantly, a company in administration or

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<sup>102</sup> Para 14, Schedule 1, IA 1986.

<sup>103</sup> Para 64(1), Schedule B1, IA 1986.

<sup>104</sup> Para 68, Schedule B1, IA 1986.

<sup>105</sup> Para 68(3), Schedule B1, IA 1986.

<sup>106</sup> Para 61, Sch B1.

an officer of a company in administration may not exercise a management power without the administrator's consent.

However, this does not mean that the entry into administration terminates board appointment *ipso facto*. But the board's power to exercise managerial powers is limited- if the administrator is of the opinion that the board is competent, he/she may permit them to remain in office and exercise managerial powers. In order to ensure that the board cooperates with the administrator, Section 235 of the IA 1986 imposes an obligation on the management of the company (including officers of the company) to give the administrator such information concerning the company and its promotion, formation, business, dealings, affairs or property that the administrator may at any time after the entry into administration reasonably require, and to attend on the administrator at such times as the latter may reasonably require. This requirement is similar to the obligation under Section 256(2) on the directors to cooperate with the interim administrator.

In contrast, the US follows a debtor-in-possession regime wherein the management remains in control of the debtor company even after Chapter-11 proceedings have been initiated.<sup>107</sup> It has been suggested that in the case of a debtor-in-possession regime as under Chapter 11 of the US Bankruptcy Code, the management would be encouraged to make a timely reference for early resolution of financial distress as they would not fear the loss of control in the event of entry into insolvency proceedings.<sup>108</sup> However, such a system has been criticized because it leaves the management (which may be responsible for the company's failure) in charge of managing the rescue proceedings.<sup>109</sup> It could also increase risks of fraudulent activity by the management, including the siphoning away of the company's assets. However, the US bankruptcy law provides an important safeguard against the abuse of the debtor-in-possession regime by permitting the appointment of a trustee in certain circumstances. Section 1104(a) of the Bankruptcy Code permits the appointment of a trustee to take over the management of the debtor company on two grounds. A trustee shall be appointed for cause, *including* fraud, dishonesty, incompetence or gross mismanagement of the debtor company's affairs by the present management, either before or after the commencement of the Chapter 11 case, or for a similar cause.<sup>110</sup> It must be noted that the grounds mentioned in Section 1104(a)(1) are not exhaustive.<sup>111</sup> Further, a trustee shall also be appointed if such appointment is necessary in the interests of the debtor company's creditors, any equity shareholders, and other interests of the estate. The trustee may be appointed by the court on the request of an interested party or the trustee at any point of time after the commencement of Chapter 11 proceedings but before a plan has been confirmed. Once the trustee is appointed, unless the court orders otherwise, the trustee takes control of the assets and business operations of the debtor.<sup>112</sup> The trustee steps into the shoes of the debtor and has fiduciary obligations to all the parties. The trustee's

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<sup>107</sup> Although in practice the scope of management power in Chapter 11 may be severely limited by the control that some creditors have over the company's cash flow *inter alia* (Ayotte and Morrison).

<sup>108</sup> Franken.

<sup>109</sup> John Armour, *The Rise of the 'Pre-Pack': Corporate Restructuring in the UK and Proposals for Reform*, RP Austin and Fady JG Aoun (eds.), *Restructuring Companies in Troubled Times: Director and Creditor Perspectives*, 43-78. (Sydney: Ross Parsons Centre of Commercial, Corporate and Taxation Law, 2012).

<sup>110</sup> Section 1104(a)(1), US Bankruptcy Code.

<sup>111</sup> *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 109 S.Ct. 1026, 1030, 103 L.Ed.2d 290 (1989).

<sup>112</sup> Section 1108, US Bankruptcy Code.

duties are set out in Sections 1106 and Section 704. They include: (i) investigating the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the viability of continuing the business, any other matter relevant to the case or to the formulation of a plan; (ii) file a plan under Section 1121 or recommend conversion of the case to a case under chapter 7, 12, or 13 of this title or dismissal of the case; and (iii) post-confirmation of the plan, file such reports as are necessary or in accordance with the court orders, etc.

An examination of the jurisprudence of the US courts on Section 1104(a) shows that this remedy for creditors and other interested parties has been considered to be an extraordinary one.<sup>113</sup> This is based on the strong presumption that the debtor is to be left in possession even after Chapter 11 proceedings have commenced.<sup>114</sup> In *In re Lifeguard Industries, Inc.*,<sup>115</sup> the court noted that the shareholders (management) of a debtor company continued to have the right to manage the company once Chapter 11 proceedings were initiated and the same could not be lightly interfered with. However, the court held that it had an obligation to 'scrutinize the actions of the corporation' upon the request of an interested party so as to "protect creditors' interests from the actions of inexperienced, incapable, or a foolhardy management." The appointment of a trustee must "better serve creditors, shareholders, and the public interest by promoting efficiency, effectiveness and transparency..."<sup>116</sup> Further, in line with this reasoning, a very high standard of proof has been required by courts in cases under Section 1104(a). The interested party petitioning the court for the appointment of a trustee must show that there is 'clear and convincing' evidence that makes the appointment of the trustee necessary.<sup>117</sup>

The power of the court under Section 1104(a)(1) and Section 1104(a)(2) differ in as much as under the former, the court has no discretion once it has been found that sufficient cause for the appointment of a trustee exists.<sup>118</sup> However, under the latter sub-section, the court can exercise some degree of discretion in whether to appoint a bankruptcy trustee.

US courts have appointed a trustee under Section 1104(a)(1) where the evidence pointed towards fraud, dishonesty, mismanagement, unauthorized post-petition transfers of the debtor's property etc. In *Celeritas Technologies*, the discord between the debtor and creditor which hindered reorganisation attempts was held to be sufficient cause to appoint a trustee under Section 1104(a)(1). It was found that the debtors were abusing the bankruptcy process to keep their assets and avoid repayment of a debt to a creditor. In another case, the failure of the debtor company to include relevant financial information in its original and amended schedules of assets and liabilities filed with the bankruptcy court in accordance with the Bankruptcy Code and Rules was held to raise issues of dishonest conduct,

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<sup>113</sup> *Tradex Corp. v. Morse*, 339 B.R. 823 (2006); *In re Celeritas Technologies, LLC*, 446 B.R. 514 (2011).

<sup>114</sup> *In re St. Louis Globe-Democrat*, 63 B.R. 131, 138 (Bankr.E.D.Mo.1985).

<sup>115</sup> 37 B.R. 3 (Bankr. S.D. Ohio 1983).

<sup>116</sup> *In re Celeritas Technologies, LLC*, 446 B.R. 514 (2011).

<sup>117</sup> *In re Celeritas Technologies, LLC*, 446 B.R. 514 (2011). It may be noted that while *Tradex Corp. v. Morse*, 339 B.R. 823 (2006) held that a lower standard of preponderance of evidence was sufficient, a majority of cases have favoured using the standard of 'clear and convincing' evidence.

<sup>118</sup> *In re Oklahoma Refining Company*, 838 F.2d 1133, 1136 (10th Cir.1988); *In re St. Louis Globe-Democrat, Inc.*, 63 B.R. 131, 138 (Bankr.E.D.Mo.1985); *In re Ford*, 36 B.R. 501, 504 (Bankr.W.D.Ky.1983).

necessitating the appointment of a trustee.<sup>119</sup> A bankruptcy trustee was also appointed for cause by the court where the debtor company had transferred certain assets, stocks etc, made loans to a corporation solely owned by the debtor company without the court's permission or disclosing the same to the court, and had not disclosed these transactions in the monthly financial reports.<sup>120</sup> It was also held that the same also constituted grounds for appointment under Section 1104(a)(2). The pre-petition conduct of the debtor in placing its retail fuel operations beyond the reach of creditors, and post-petition conduct in not disclosing material and relevant information and making misrepresentations to the court and creditors was also held to necessitate the appointment of a trustee under Section 1104(a)(1).<sup>121</sup> A trustee was also appointed under Section 1104(a)(1) where the person performing the role of debtor-in-possession had an interest which was adverse to the debtor's estate.<sup>122</sup> This was held to be necessary in the best interests of creditors under Section 1104(a)(2).

While appointing a trustee under Section 1104(a)(2) in the best interests of the creditors, the court has held that the debtor's ability to fulfil its duty of care to protect the assets, the debtor's duty of loyalty and duty of impartiality are relevant.<sup>123</sup> Dishonest conduct or the withholding of information on the part of the debtor would work in favour of the appointment of a trustee. Other factors that the court would consider include: (i) the overall management of the debtor, in the past and present; (ii) the trustworthiness of the debtor company's management; (iii) the (no) confidence of the business community and creditors in the incumbent management; (iv) practical considerations including a balancing of the benefits from the appointment of a trustee against the costs of such appointment.<sup>124</sup> The court takes into account equitable considerations in exercising its power to appoint a trustee under Section 1104(a)(2).<sup>125</sup> Relevant cases where courts have appointed trustees in the best interests of the creditors include where there was a history of transactions which the debtor company carried out with affiliated companies at the cost of creditors;<sup>126</sup> where there were inaccuracies and inconsistencies in the statements made by the debtor company's principal to the bankruptcy court leading the court to believe that the creditors cannot place trust in the debtor company to carry out its obligations to the creditors

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<sup>119</sup> *In re Deena Packaging Industries, Inc.*, 29 B.R. 705 (1983)- "Because Deena has failed to provide a full and truthful statement of its financial condition, it is necessary to appoint a trustee so that the court and Deena's creditors are fully informed." Such a line was also taken in cases such as *In re Horn & Hardart case*, 22 B.R. 668, 7 C.B.C.2d 65 (Bkrcty.E.D.Pa.1982) (where one of the factors was the failure of the debtor company to file operating statements as required by the bankruptcy rules) and *In re Philadelphia Athletic Club, Inc.*, 15 B.R. 60 (Bkrcty.S.D.N.Y.1981) (where there were allegations of gross mismanagement coupled with a failure on the part of the debtor to keep adequate books and records).

<sup>120</sup> *In re Ford*, 36 B.R. 501 (1983). Please note that in this case, the debtor was an individual.

<sup>121</sup> *In re V. Savino Oil & Heating Co., Inc.*, 99 B.R. 518 (1989).

<sup>122</sup> *Matter of Embrace Systems Corp.*, 178 B.R. 112 (1995).

<sup>123</sup> *In re Celeritas Technologies, LLC*, 446 B.R. 514 (2011).

<sup>124</sup> *In re Celeritas Technologies, LLC*, 446 B.R. 514 (2011).

<sup>125</sup> *In re Hotel Associates, Inc.*, 3 B.R. 343, 6 B.C.D. 160 (E.D.Pa.1980), *aff'd*, No. 80-4444 (E.D.Pa. January 30, 1981).

<sup>126</sup> *In the Matter of State Capital Corp.*, 51 B.R. 400 (Bankr.M.D.Fla.1985); *In re Humphreys Pest Control Franchises, Inc.*, 40 B.R. 174(Bankr.E.D.Pa.1984).

properly,<sup>127</sup> where the debtor-in-possession made transfers aimed at placing the company's assets beyond the reach of its creditors etc.<sup>128</sup>

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Given the experience under the SICA regime, a debtor-in-possession approach may be problematic in the Indian context. Although CA 2013 does provide for takeover of management or assets by the administrator, it does not provide much guidance on the grounds on which such takeover may be ordered or the manner and effect of such takeover. The provisions relating to takeover of management by the administrator under CA 2013 need several changes to make the system more predictable and less prone to litigation. Given that an NCLT order for takeover of management can be appealed before the NCLAT (and subsequently before the Supreme Court), the law should specify a non-exhaustive list of grounds on which the NCLT may direct that the management or assets may or may not be taken over to avoid the possibility of protracted disputes on the question of such takeover. It may be noted that Section 420 of CA 2013 requires that the NCLT give the concerned parties a reasonable opportunity of being heard before passing any order. In the absence of clear grounds on which such orders may be passed, matters can easily get entangled in long-drawn-out litigation. Further, unlike SARFAESI Act that includes a detailed provision on the manner and effect of such takeover, CA 2013 is silent on these aspects (including the question of the interrelationship between the company administrator and the existing directors/management and the shareholders), which is also problematic. The following recommendations are intended to address these concerns.

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**Recommendations:**

- i. *Chapter XIX of CA 2013 should have a separate provision on takeover of management or assets by the company administrator, which should provide for the following:*
  - *The NCLT may direct the company administrator to takeover the management or assets of the debtor company suo motu (on its own motion) or on an application made by 75% of the secured creditors in value (or 75% of all the creditors by value if there is no secured debt in the company). Such an application may be made within seven days of confirmation of the administrator's appointment.*
  - *The NCLT shall decide on such application of the secured creditors within thirty days. The suo motu order may be made during any stage of the rescue proceedings.*
  - *There should be a separate provision to guide the NCLT's discretion for directing takeover of management or assets by the company administrator and the scope of such order.*
  - *Such provision should provide for a non-exhaustive list of grounds to guide the NCLT's discretion in determining whether such takeover should be ordered or not. It may be noted that the NCLT will be required to allow the debtor company to be heard before such an order is passed. Such grounds may include:*
    - *Fraud or impropriety;*
    - *Mismanagement of the affairs of the company;*
    - *The debtor company has defaulted in meeting its undisputed payment or repayment obligations to any creditor who is eligible to make a reference under Chapter XIX*

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<sup>127</sup> *Tradex Corp. v. Morse*, 339 B.R. 823 (2006).

<sup>128</sup> *In re Ford*, 36 B.R. 501 (1983).



*and where any of the following conditions are satisfied: (a) where the debtor company has defaulted on such obligations despite having the capacity to honour them; or (b) where the debtor company has not utilised the finance from the creditors for the specific purposes for which finance was availed of but has diverted the funds for other purposes; or (c) where the debtor company has siphoned off the funds such that the funds have not been utilised for the specific purpose for which finance was availed of, nor are the funds available with the debtor company in the form of other assets; or (d) where the debtor company has disposed off or removed the movable fixed assets or immovable property given by it for the purpose of securing a loan from any creditor without the knowledge of such creditor; provided that a solitary or isolated instance should not form the basis for such takeover unless the NCLT is of the view that such an intervention is required for protecting the interest of the business and the stakeholders.*

- *The debtor company does not engage constructively with the creditors by defaulting in timely repayment of undisputed dues while having ability to pay, thwarting the creditors' efforts for recovery of such dues by not providing necessary information sought, denying access to assets financed or collateral securities, obstructing sale of such securities and in effect, deliberately obstructing the legitimate efforts of the creditors to recover their undisputed dues; provided that a solitary or isolated instance should not form the basis for such takeover unless the NCLT is of the view that such an intervention is required for protecting the interest of the business and the stakeholders.*
- *Unauthorized transfers of the debtor company's cash or assets during the course of rescue proceedings or anytime before the commencement of the proceedings if the NCLT is satisfied that such transfers were carried out for the purpose of putting such cash or assets beyond the reach of the creditors who have a claim on such cash or assets;*
- *Where an application for rescue has been filed by the debtor company without a draft scheme for revival or rehabilitation and there is a declaration to that effect by its board of directors (as presently envisaged under the proviso to Section 256(b)).*

ii. *The NCLT's order for takeover of the management may also provide for the following:*

- *Empower the administrator to appoint or dismiss managerial personnel (subject to applicable labour laws) including directors as part of taking over the management; any directors nominated on the board of the company by the administrator as part of an attempt to rescue a company shall have similar level of protections as envisaged for directors appointed in terms of Section 35A of the State Bank of India Act, 1955 and hold office for such period as directed by the administrator or the NCLT (as the order may prescribe). Such a director will not incur any liability 'by reason of only being a director or for anything done or omitted to be done in good faith in the discharge of his duties as a director or anything in relation thereto.'*
- *Further, in cases where the financial distress of the company is not attributable to managerial actions and where the presence of such management (or senior employees) is in the opinion of the administrator crucial for a successful turnaround of the business, the administrator should be allowed to enter into agreements (on behalf of the company) with such managerial personnel that incentivise them to stay on for turning the company around.*
- *Require the other directors or employees to (a) extend all assistance and co-operation to the company administrator and (b) not carry out any act that materially affects the business or property of the company without the prior permission of the administrator.*

- *Such an order may also specify the powers of shareholders after the administrator takes over the management and define the rights of the administrator vis-à-vis the shareholders.*
- *The NCLT may also be guided by Section 15 of the SARFAESI Act to determine the manner and effect of such takeover of management.*

## G. POWERS AND FUNCTIONS OF THE COMPANY ADMINISTRATOR

Chapter XIX, CA 2013 envisages an important role for the company administrator in the revival and rehabilitation of financially distressed companies. However, despite having such a prominent role in the rescue proceedings, the CA 2013 does not specifically set out the powers and functions of the administrator in detail. Section 260 (1), CA 2013 only states that the company administrator shall perform “*such functions as the Tribunal may direct*”, thereby leaving much to the discretion of the NCLT. This provision may be contrasted with the corresponding provision on the powers and duties of company liquidators as set out in Section 290, CA 2013. The latter provision contains a non-exhaustive list of powers and duties of the company liquidator, unlike Section 260(1) which provides a basic outline.

In the UK, the functions of the administrator are set out expressly in Schedule B1, IA 1986. Paragraph 59 (1) of Schedule B1 vests a wide discretion in the administrator by empowering him/her to do anything ‘necessary or expedient for the management of the affairs, business and property of the company.’ Paragraph 60 states that the powers of the administrator are as specified in Schedule 1, IA 1986, which contains a list of 23 powers of the administrator.<sup>129</sup> It may be noted that a UK administrator takes over the management of the debtor on its appointment unlike CA 2013 which envisages takeover of the management or assets by the company administrator **only under directions of the NCLT.** Therefore, most powers of administrator under IA 1986 are relevant in the Indian context only after the administrator has been directed to takeover the management or the assets.

The BLRC anticipates that the current wording of Section 260(1) may not facilitate the effective functioning of the administrator after it has been directed to takeover the management or the assets of the debtor company. According to the current scheme of the CA 2013, the administrator does not enjoy any general powers and may have to constantly rely on directions issued by the NCLT. Unless the statute specifies some basic powers of the administrator in line with international best practices after it has been directed to takeover the management or the assets, there will be a lot of uncertainty on this issue which may lead to delays and undermine the very purpose of involving independent insolvency practitioners in the rescue process. There may be a considerable time gap between an administrator’s taking over the management or assets and the final order of the NCLT sanctioning the scheme. The proposed powers will ensure that company administrator is able to preserve the value of the company and protect its business till the scheme is sanctioned. This is important for addressing problems faced under the SICA regime where the management engaged in siphoning of assets, etc after filing a reference for rehabilitation. Appropriate safeguards can also be provided to prevent any unilateral action of the company administrator that could harm the interest of the stakeholders.

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<sup>129</sup> Para 64(1), Sch B1.

**Recommendations:**

i. Section 260 should be amended to provide the following powers to the company administrator:

General powers in relation to takeover of management (which will include takeover of the company's assets):

- Without prejudice to the powers of the NCLT to direct the company administrator to perform any function, the company administrator shall have the following powers after he has been directed by the NCLT to take over the management of the company:
  - do anything necessary or expedient for the management of the affairs, business and property of the company;
  - enforce, modify or terminate any contract or agreement entered into by the company depending on whether such contract is beneficial or detrimental for effectively rescuing the company;
  - take possession of and collect the property of the company;
  - appoint a lawyer or accountant or other professionally qualified person or expert to assist him in the performance of his functions;
  - bring or defend any action or other legal proceedings in the name and on behalf of the company;
  - power to raise or borrow money and grant security therefor over the property of the company as part of a scheme of revival, subject to the terms of the scheme;
  - use the company's seal;
  - do all acts and to execute in the name and on behalf of the company any deed, receipt or other document;
  - effect and maintain insurances in respect of the business and property of the company;
  - do all such things as may be necessary for the realisation of the company's property;
  - carry on the company's business;
  - make any payment which is necessary or incidental to the performance of his functions;
  - do all things incidental to the exercise of the above powers.

General powers in relation to takeover of assets (the management need not be displaced in cases where an administrator is directed to take over a particular asset or assets):

- Without prejudice to the powers of the NCLT to direct the company administrator to perform any function, the company administrator shall have the following powers after he has been directed by the NCLT to take over any asset or assets of the company:
  - take possession of such assets;
  - do anything necessary or expedient for the management of such assets;
  - enforce, modify or terminate any contract or agreement entered into by the company in relation to such assets depending on whether such contract is beneficial or detrimental for the protection of such assets;
  - appoint a lawyer or accountant or other professionally qualified person or expert to assist him in the performance of his functions in relation to such assets;
  - bring or defend any action or other legal proceedings in the name and on behalf of the company in relation to such assets;

- *do all acts and to execute in the name and on behalf of the company any deed, receipt or other document in relation to such assets;*
- *effect and maintain insurances in respect of such assets;*
- *make any payment which is necessary or incidental to the performance of his functions in relation to such assets;*
- *do all things incidental to the exercise of the above powers.*

Common principles applicable to the above powers:

- *Any action of the company administrator that may adversely affect the rights of the existing creditors or the shareholders will require prior authorisation from the NCLT.*
- *Any action of the company administrator relating to transfer of assets or property of the company other than in the ordinary course of business will also require prior authorisation from the NCLT.*
- *The company administrator should also have the power to apply to the NCLT for seeking directions and clarifications in relation to the above functions.*
- *The NCLT shall have the power to modify any of the powers of the company administrator at the time of directing such administrator to takeover the management or assets.*
- *After a scheme of revival has been sanctioned by the NCLT, the company administrator shall have such powers and perform such functions as may be specified in the scheme or as directed by the NCLT for the proper implementation of the scheme.*

## H. SCHEME OF REHABILITATION

In order for the scheme for the rehabilitation of the company to be sanctioned, Section 262 (2) of CA 2013 requires that it has to be approved by (a) secured creditors representing 75% in value of the debts owed by the company to such creditors and (b) unsecured creditors representing 25% in value of the amount of debt owed to them. This provision requiring consent from both secured and unsecured creditors for approval of a scheme of revival seems well founded. In relation to industrial units, such unsecured creditors will typically consist of suppliers of raw materials and other services such as maintenance of the plant and machinery. Other unsecured creditors may include bond holders and trade creditors. If the scheme is approved with the consent of all such stakeholders, it reduces the possibility separate legal actions by such creditors for recovery of their dues.

The BLRC notes that as per the JLF framework of the RBI, decisions approved by a minimum of 75% of creditors by value and 60% of creditors in number bind all others. The JLF framework does not distinguish between secured and unsecured creditors. However, since the JLF circular is applicable to banks and financial institutions, the second leg of the JLF requirement for sanctioning a scheme (i.e., approval from 60% of the creditors by volume) although workable within the JLF framework, may not be workable in relation to a scheme of rehabilitation under CA 2013 where the number and nature of creditors may be significantly different (for instance unsecured creditors like trade creditors and suppliers). It is useful to see how this issue is addressed in some other jurisdictions:

- *US:* In Chapter 11 proceedings in the US as each class of creditors that are impaired by the plan need to consent to it through a vote of two-thirds of that class in volume and half the allowed claims of that class. Any class of creditors that are not impaired by the plan are automatically deemed to have accepted the plan and any class that does not receive any property or claims

under the plan are deemed to have rejected the plan. The US Bankruptcy Code provides for “cram down” of dissenting creditors as long as certain conditions are satisfied.

- *UK:* In a UK administration proceedings, acceptance of the proposal requires a simple majority in value of the creditors present and voting.
- *Germany:* The plan needs to be approved by each class of creditors. For each class, approval requires majority vote in number of creditors voting on the plan, provided that this represents the majority of claims by aggregate amount. The plan may be “crammed down” on any non-approving class of creditors if (i) the plan does not make that class any worse than they would be in the event of liquidation, (ii) the plan provides that the creditors of such class will participate fairly in the economic value to be distributed to creditors and (iii) the plan has been approved by the majority of classes.
- *France:* In French *sauvegarde* proceedings, two committees of creditors plus a bond holders’ committee are established. One committee consists of all institutions that have a claim against the debtor (financial institutions creditors’ committee) and the second committee consists of all the major suppliers of the debtor (trade creditors’ committee). Consent must be given by each committee and requires approval of two-thirds in value of those creditors who exercise their voting rights. Creditors of each committee and bondholders vote as a single class regardless of the security interest they may hold against the debtor.

While allowing unsecured creditors to vote on a plan of rehabilitation allows them to be part of the process, their involvement as presently envisaged under Section 262 is also in the interests of the debtor in the long run. However, the BLRC is of the view that this provision needs further thought and consideration to prevent hold-outs by non-consenting creditors. Accordingly, appropriate level of thresholds will be devised at a later stage (during the formulation of the Insolvency Code).

However, Section 262 (2) seems underdeveloped in several other aspects, which need to be addressed now. For instance, while Section 262(2) provides that the administrator shall convene separate meetings of the secured and unsecured creditors for the purpose of approving the scheme of rehabilitation, it does not clarify if the creditors within each such class are to be treated equally. Further, given that 75% of secured creditors and 25% of unsecured creditors can ‘cram-down’ a scheme of revival on 25% of secured creditors and 75% of unsecured creditors, respectively, international best practices indicate that such non-consenting creditors should at least get as much in scheme as they would in liquidation. It may be noted that determining whether dissenting creditors are no worse off usually requires valuation evidence, which may be prepared using a number of different valuation methodologies - so there will need to be expert evidence prepared and presented, and there will need to be judicial expertise sufficient to evaluate this. Further, consent of creditors who will not be affected by a scheme (for instance, creditors who will get paid in full regardless of the scheme) should not be required. Lastly, in order to prevent a scheme from being blocked by related parties of the debtor company, who may also be unsecured creditors of the company, such related parties should be excluded from the unsecured creditors entitled to vote on a scheme.

Another problem that is currently not addressed by the provisions relating the scheme of revival relates to diversion of cash flow generated by the debtor company after a scheme has been

sanctioned. In order to prevent such diversion, Section 261 should include a specific sub-clause that provides for measures which may be included in a scheme to prevent such diversion.

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**Recommendations:**

- *Section 262 should be amended to provide for the following principles to be applicable at the time of sanctioning a scheme of revival: (i) the creditors within the same class should be treated equally; (ii) dissenting creditors should get as much in scheme as they would in liquidation; (iii) consent of creditors who are not affected by a scheme should not be required (for instance, secured creditors who have realised their security interests outside the rescue proceedings); (iv) related parties should be excluded from the unsecured creditors entitled to vote on a scheme.*
- *Identifying ‘creditors who are unaffected by a scheme’ and ‘unsecured creditors who are related parties of the company’ should be a specified function of the company administrator under Section 260. The process of identification should be completed before the scheme is put to vote.*
- *Section 261 (2) should be amended to specify that a scheme of revival may include ‘measures imposing obligations on the debtor company to provide periodic reports to the company administrator, creditors and the NCLT on cash flow status of the company including utilisation statements’. The NCLT will be able to monitor this under its general powers to monitor the implementation of the scheme under Section 264 and order corrective action if required.*

**Question for Consideration for the Insolvency Code:**

- i. *What should be the appropriate thresholds for the different classes of creditors for approving a scheme of revival?*

**I. RESCUE FINANCING AND GRANT OF SUPER-PRIORITY**

If a financially distressed company is to be able to successfully pull itself out of rescue proceedings, continued trading during the course of rescue proceedings is to be facilitated. For this purpose, a financially distressed company often needs access to external finance. However, once a company enters the rescue proceedings, it would find it extremely difficult to obtain credit as few lenders would be willing to lend to a troubled company. Therefore, lenders need to be encouraged to come forward to lend through measures such as giving super-priority to such finance, increased governance rights, safeguards for protection of creditor interests etc.

The CA 2013 does not contain provisions which encourage lenders to extend credit to a financially troubled company. While a proposal for provision of super-priority for rescue financing was considered by the *Committee on Financial Sector Reforms*, the Committee ultimately favoured a position where the debtor would work towards a consensual solution with its largest secured creditor so that, in most cases, that creditor would be the one providing the additional financing in restructuring.

The experience in other jurisdictions points towards the grant of super-priority for rescue financing, either through specific legislative provisions or judicial interpretation. For example, in the US, bankruptcy courts give several benefits, including super priority to a lender who agrees to provide finance to the company under reorganization, a process known as Debtor-in-Possession financing (see

the discussion below on how such finance works in practice). One of the primary issues which lead to the breakup of economically valuable businesses is the debt overhang problem which entails that any fresh capital (which is needed to bolster the working capital needs of the distressed company and kick start its recovery) is not forthcoming as it will almost entirely be siphoned off in debt payments to the existing creditors. In order to address this issue, the Bankruptcy Code of US contains provisions which provides (subject to various safeguards) for the possibility of “super priority” being granted to creditors who provide finance to companies in distress (in the US, context, companies which have filed for Chapter 11 protection) – i.e., the rescue finance providers will rank ahead of all existing creditors. Any free cash flows generated as a result of the injection of fresh capital will first go toward the Debtor-in-Possession financiers and not the existing creditors thereby avoiding the debt overhang problem. The buy-in of the existing creditors is achieved by allowing them to participate in the Debtor-in-Possession financing or with equity positions in the distressed companies. This regime has proven to be reasonably robust in practice in the US (although several lessons need to be learnt from the US experience) and some of the biggest bankruptcies in the recent past including those of Chrysler and General Motors included portions of Debtor-in-Possession financing in their structures.

In the UK where the idea of super-priority funding was considered in great detail, the Enterprise Act 2002 (which made significant amendments to the IA 1986) did not provide for such priority. The Government was of the opinion that the decision to lend to a company in financial trouble was to be left to the commercial judgment of the market. However, a reading of Section 19(5) and Schedule B1, para 99, IA 1986 indicate that there is a possibility that super-priority for rescue funding may be permitted—under these provisions, super-priority (over the administrator’s statutory charge for his remuneration and expenses) is given for debts incurred under contracts entered into by the administrator in the carrying out of his functions. This has been expansively interpreted in *Bibby Trade Finance Ltd v McKay*,<sup>130</sup> where the High Court permitted the administrator’s liability to a lender who had advanced funds during administration to be characterized as a legitimate administration expense (and therefore enjoying super priority). This indicates that English courts are willing to permit super-priority funding even in the absence of a specific legislative provision in this regard. Note however that expenses are payable only out of the company’s unsecured assets and, to the extent these are insufficient, those subject to a floating charge. Assets subject to fixed security interests are not, to the extent of the security interest, available for discharging expenses. The result of this is that one can’t grant ‘super priority’ above the holders of fixed security interests, and these secured creditors may have fixed security over much of the company’s assets.

Provision for super-priority financing has now been recognised as an integral part of insolvency law reform. The European Bank for Reconstruction and Development's 10 Core Principles for an Insolvency Law Regime states that super-priority new financing should be permitted in cases of corporate restructuring (Core Principle 8). Similarly, the UNCITRAL Legislative Guide on Insolvency Law 2004 also recognizes that giving priority for post-commencement finance is essential for continued trading and consequently, for a successful rescue. Thus, it is evident that internationally, there is recognition that provision of super-priority for rescue finance is crucial for a successful rescue. Having said that, the crucial issue is whether such financier can get priority over existing secured creditors, given that the company may have no unencumbered assets. This is possible under the US regime (whereas in the UK, fixed charge holders cannot be subjected to such a super priority result without their consent), but the US rules are subject to significant safeguards for existing secured creditors. The application of these

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<sup>130</sup>[2006] EWHC 2836 (Ch).

safeguards requires significant judicial expertise, including in the adjudication of complex valuation disputes.

#### a. US PRACTICE ON DIP FINANCING

##### Background and context:

For a corporate borrower, Chapter 11 of the Bankruptcy code allows for a reorganisation process involving different steps including, *inter alia*, a voluntary filing by the debtor, automatic stay on all payments to pre-petition creditors and allowing the incumbent management to maintain operating control of the debtor's assets.<sup>131</sup> Once the firm has filed for bankruptcy, it is allowed to formulate the plan of re-organisation while operating the day to day business. Therefore, while the debtor remains in possession of the company, there are various restrictions on how they are allowed to use, sell and lease the estate's assets, even the ordinary use of "cash collateral" is prohibited without permission from the court. Given the insufficiency of these mechanisms in operating the firm, several financing options are provided under Chapter 11 ("**DIP Financing**").<sup>132</sup> Usually, the debtor-in-possession ("**DIP**") tries to arrange for credit before the formal filing of Chapter 11 petition and provided that the credit is arranged, the petition is accompanied by a request for DIP financing approval.

##### How does DIP financing work?

The process for approval of a financing mechanism involves two steps. First, in terms of the Federal Bankruptcy Rule 4001 (c) (1), the debtor makes a motion for authorization to obtain credit. Whilst the motion has a fifteen day period wherein other existing creditors are allowed to respond to the motion, the court is authorized to approve immediate borrowing of a limited amount, which is necessary to avoid "immediate and irreparable harm". Second, after taking into account the objections of the existing creditors, the court approves a permanent financing order that authorizes borrowing of the full amount.<sup>133</sup>

In terms of Section 364 of the Bankruptcy Code, four DIP mechanisms have been provided. First mechanism does not require any court approval and allows the debtor to obtain unsecured credit in the ordinary course of business, however, the credit must be eligible for treatment as an administrative expense. Second mechanism allows for financing for purposes other than ordinary course of business, but it must be approved by the bankruptcy court after a due notice and hearing, however this credit is also unsecured. Third mechanism allows that the court may authorize DIP credit with a super-priority status, where DIP loans are given priority over administrative expenses and a lien on unencumbered assets, a junior lien on encumbered assets or both. Fourth mechanism allows for the highest level of security for DIP financing, where it is secured by a senior or equal lien on the assets that are already subject to a lien. However, despite an enhanced security, there are still risks of loss in cases, including,

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<sup>131</sup> Sandeep Dahiya, "A Theoretical Framework for Evaluating Debtor-in-Possession Financing", available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2447868](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2447868).

<sup>132</sup> In few cases, the commencement of Chapter 11 is initiated by an involuntary petition by the creditors; *ibid*.

<sup>133</sup> Sandeep Dahiya (et al.), "Debtor-in-possession financing and bankruptcy resolution: Empirical evidence" *Journal of Financial Economics* 69 (2003) 259–280. (hereinafter referred to as "Dahiya").



*inter alia*, the value of liquidation being less than DIP loans and primacy being given to secured creditors in the event of liquidation.<sup>134</sup>

Whilst order approving DIP financing have rarely been appealed against, in order to provide protection to the DIP lenders, the Bankruptcy Code provides that the reversal or modification of the DIP order does not affect the validity of the debt, any priority or lien, unless the effect of the DIP order was stayed pending appeal. Further, given that the bankruptcy courts have jurisdiction over the debtor's property, DIP orders usually have a provision stating that the liens are perfected without any further action under state law. To give an additional protection however, DIP lenders also undertake customary collateral documentation and complete necessary filings.<sup>135</sup>

#### How has US experience in DIP Financing evolved?

Whilst the DIP financing mechanism has been in place since the Bankruptcy Reform Act of 1978, it started to gain importance and significance only during the "wave of bankruptcies" that occurred in early 90's.<sup>136</sup> From being a mechanism to facilitate the rehabilitation of distressed companies, DIP financing is increasingly used as a mechanism by creditors to exert significant control over the bankruptcy reorganisation process.<sup>137</sup> This has led to concerns that whilst Chapter 11 was originally intended to be a tool that helps restructure the capital arrangements of businesses and balance the needs of the debtors with creditor rights and interest of the business owners, it has gradually evolved in a system where the degree of control exercised by DIP lenders "arguably upsets this balance" and hampers effort to save and rehabilitate businesses.<sup>138</sup>

In the case of *In re Tenney Village Co, Inc* (1989), a proposed DIP financing arrangement was rejected on the grounds that it would have given the DIP lenders substantial control over the debtor through several arrangements, including, requirement of the lenders' approval for any planned improvements, their direct supervision and hiring of chief executive, granting highest administrative expense priority to the bank's claims, and waiver of the debtor's potential claims and defenses. In effect, the proposed DIP arrangement would amount to the DIP lenders operating the business, which is only permitted to be done by the debtor or the trustee.

However, the aforesaid financing arrangements are increasingly becoming more acceptable by the courts. In the case of *In re Yellowstone Mountain Club* (2008)<sup>139</sup>, a DIP financing arrangement that gave the lender substantial control over the bankruptcy process by providing that certain restructuring benchmarks (filing a plan, for instance), if not complied with in due course, would trigger a sale of

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<sup>134</sup> D. Moore, "How to finance a debtor-in-possession" *Commercial Lending Review* 5 (1990) 3–12.

<sup>135</sup> Marshall S. Huebner, "Debtor-in-Possession Financing", available at [www.davispolk.com/sites/.../huebner.dip.article.2005.revised.pdf](http://www.davispolk.com/sites/.../huebner.dip.article.2005.revised.pdf).

<sup>136</sup> Dahiya

<sup>137</sup> Robin Phelan, "The use of DIP financing as a mechanism to control the US corporate restructuring process", available at [http://commission.abi.org/sites/default/files/DIP\\_Financing\\_Phelan-Tama.pdf](http://commission.abi.org/sites/default/files/DIP_Financing_Phelan-Tama.pdf).

<sup>138</sup> *Ibid.*

<sup>139</sup> Case No 08- 61570-112008, Bankr LEXIS 4062 (Bankr D Mont 17 December 2008).

assets by the debtor, was approved by the court. Similarly, in the cases of *In re Lyondell Chemical Co*<sup>140</sup> and *In re The Reader's Digest Association*<sup>141</sup>, the DIP financing agreements provided for stringent timelines for delivering, filing and confirming draft reorganisation plans, and obtaining approval of the aforesaid plans respectively. Therefore, as evident from the above, DIP financing has transformed into a “lever to gain control of the bankruptcy process”, by taking control of aspects in managing distressed companies, that was earlier within the ambit of either the debtor-in-possession or the bankruptcy courts.<sup>142</sup>

### Safeguards for existing creditors

In order to protect the debtor's business against power grabbing creditors and to protect the interests of all creditors<sup>143</sup> including existing creditors who do not enjoy the special rights a DIP lender does, courts have developed a set of safeguards.

First, courts are reluctant to attach super-priority rights to post-petition credit unless the DIP furnishes proof under Section 364 of the Bankruptcy Code that the debtor was unable to obtain credit on another basis. Although the DIP is not required to seek financing from every possible lender, it must show a good faith effort to obtain finance otherwise than on a super-priority basis.<sup>144</sup> On the other hand, if it is established that the DIP failed to make any effort whatsoever, courts can reject the DIP lender's proposed financing terms.<sup>145</sup> Second, courts have prohibited cross-collateralization and roll-ups. Cross-collateralization involves the use of unencumbered property to secure not only post-petition extensions of credit but also pre-petition claims. Roll-ups involve the using of the proceeds of DIP financing to pay the pre-petition obligations owed to the DIP lender. Both practices were regarded as self-serving, beneficial to the DIP lender but often to the detriment of ordinary creditors. Ever since the Seventh Circuit court first rejected the use of cross collateralization<sup>146</sup> a number of districts have adopted rules or guidelines discouraging cross-collateralization and roll-ups.<sup>147</sup> Third, in the *AMF Bowling Worldwide* case the court held that the DIP owed a fiduciary duty to its stakeholders to maximize the value for the estate. Such a finding militated against the argument that the DIP could ignore its fiduciary duties if its agreement with the DIP lender allowed it to do so.<sup>148</sup> Fourth, courts have eliminated the requirement

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<sup>140</sup> Case No 09-10023 (Bankr SDNY 11 January 2009).

<sup>141</sup> Case No 09- 23529 (Bankr SDNY 24 August 2009).

<sup>142</sup> Richard M. Kohn, Alan P. Solow and Douglas P. Taber, “Pure-Debtor-in possession financing”, available at [http://www.goldbergekohn.com/media/publication/51\\_kohn\\_DebtorinPossession.pdf](http://www.goldbergekohn.com/media/publication/51_kohn_DebtorinPossession.pdf).

<sup>143</sup> The mandate under Chapter 11 is also to protect the interests of all creditors. See *In re Applied Paging Techs, Inc.*, 1999 WL 672098 where the court held that the Bankruptcy Code aimed to provide “a fresh start to the debtor and to maximize the bankruptcy estate for the benefit of all creditors.”

<sup>144</sup> See *In re Snowshoe Co.*, 789 F.2d 1085, 1088 (4th Cir. 1986); *Suntrust Bank v. Den-Mark Constr., Inc.*, 406 B.R. 683 (E.D.N.C. 2009).

<sup>145</sup> See *In re Tamarack Resort, LLC*, 2010 Bankr. LEXIS 3680, at 35 (Bankr. D. Idaho Oct. 19, 2010).

<sup>146</sup> *Shapiro v. Saybrook Manufacturing Co.*, 963 F.2d 1490 (11th Cir. 1992).

<sup>147</sup> See for instance, the Local Rules For the United States Bankruptcy Court District of Delaware, Rule 4001-2; Guidelines for Cash Collateral & Financing Motions and Stipulations, United States Bankruptcy Court Northern District of California.

<sup>148</sup> *AMF Bowling Worldwide, Inc., et al.*, Case Number: 12-36495, available at <http://www.kccllc.net/amf>.

that a DIP must pay its existing creditors in full in cash. In *Toibb v. Radloff*<sup>149</sup> for instance, it was held that Chapter 11 embodied the general policy of maximizing the value of the bankruptcy estate. By extension, this applies to case where the senior class of creditors could not be paid in full.<sup>150</sup> Fifth, courts have held that inter-creditor agreements that do not adequately protect junior lenders' rights in the collateral are contrary to the intentment of the Bankruptcy Code and hence unenforceable.<sup>151</sup>

### Current Reforms

It is important to note that the US Bankruptcy Code and DIP financing itself are currently under review in the US<sup>152</sup>. However, the extant provisions on the point provide useful guidance for a similar mechanism to be included under Indian law.

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The BLRC is of the opinion that rescue financing can be a very effective way of preserving going-concern value for viable companies under financial distress. Therefore the law should provide for an enabling provisions for the company administrator and the creditors to provide for such financing (by existing or external creditors) as part of a scheme of revival. In the event the existing creditors refuse to allow super-priority for rescue finance provided by external creditors even at the cost of failure of the rescue exercise (of a company which is otherwise viable), the NCLT could arguably require the existing creditors to agree to such super-priority for such external financiers as part of its general powers to modify a scheme under Section 262 (6). However, the US experience suggests that granting super-priority for rescue financiers by courts provide for several safeguards for the existing creditors. In view thereof, if the NCLT does require modification a scheme to grant such super-priority, it should do so subject to providing appropriate safeguards for existing creditors as available in the UK and the US.

### ***Recommendations:***

- *Section 261 should be amended to include 'raising secured and unsecured loans from any creditor (whether existing or external) as part of a scheme of revival'. The scheme may also provide for 'super priority' being granted to creditors who provide such finance – i.e., the rescue finance providers will rank ahead of all existing creditors subject to such safeguards for the existing creditors as may be provided in the scheme. Given that a scheme of revival will have to be approved by the requisite majority of creditors as specified in Section 262, the terms of such rescue finance (including super-priority rights, if any) will also be subject to approval by such creditors.*

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<sup>149</sup> 501 U.S. 157, 163 (1991).

<sup>150</sup> Jennifer Taylor (on behalf of O'Melveny & Myers LLP), "Hot Topics in DIP Financing: DIP Financing as a Means of Gaining Control" at the American Bankruptcy Institute's Southwestern Conference held on 23 August 2013, available at <http://materials.abi.org/sites/default/files/2013/Aug/InsAndOutsOfDIPFinancing.pdf>.

<sup>151</sup> See *Beatrice Foods Co. v. Hart Ski Mfg. Co., Inc.* (In re Hart Ski Mfg. Co.), 5 B. R. 734 (Bankr. D. Minn. 1980) where the court refused to enforce the junior lender's waiver of its adequate protection rights. Similarly in *In re Hinderliter Indus., Inc.*, 228 B.R. 848 (Bankr. E.D. Tex. 1999) the court refused to enforce pre-bankruptcy waivers by creditors of other statutory rights.

<sup>152</sup> <https://abiworld.app.box.com/s/7rzks7fa7h01grihurx8>

- *Section 290 (1) (e) should also be amended to allow company liquidators the power to raise both secured and unsecured loan during liquidation proceedings (presently, they are empowered to raise secured loans only).*

## J. INTERACTION WITH DEBT ENFORCEMENT UNDER THE SARFAESI ACT

Corporate insolvency law may have a crucial role in supporting the operation of debt enforcement law, but it also has a role in *relieving* debtors from debt enforcement in certain circumstances. Where a debtor is distressed but its underlying business is sound, corporate insolvency law may provide a forum in which the debtor's assets can be kept together. This may enable the sale of the business on a going concern basis, or facilitate the restructuring of the underlying debt such that the debtor company can itself survive: in either case, the loss of value associated with the piecemeal dismemberment of the debtor's assets in individual enforcement actions by creditors can be ameliorated. Corporate insolvency procedures achieve this through the imposition of a moratorium that bars the exercise of individual enforcement remedies. This will only be effective if the moratorium bars (at least temporarily) enforcement by secured creditors as well as unsecured creditors: otherwise, the enforcement of security interests may result in the same precipitous break-up of the debtor's assets, and the associated loss in value.<sup>153</sup> In its current form, the law permits secured creditors to not only escape the application of the moratorium in corporate rescue procedures but also cause the abatement of rescue proceedings altogether. This escape route was initially provided by an amendment to SICA, which might perhaps be best understood as a reaction to the widespread opinion that SICA was dysfunctional and not being used for legitimate rescue purposes. But the same carve-outs for secured creditors have been reproduced in the corporate rescue provisions of the CA 2013.<sup>154</sup> However, given that the current rescue regime under the CA 2013 has been predicted to resolve the problems with the SICA regime, *inter alia*, through greater creditor involvement in the rescue process, the inclusion of such a provision may adversely affect the effectiveness of the rescue regime under the CA 2013. In other words, giving power to secured creditors to effectively 'veto' recourse to the corporate rescue procedure may mean that viable businesses are unnecessarily dismembered, where – at least in principle<sup>155</sup> – they could have been rescued under a collective insolvency procedure. In a given case it is possible for NCLT to pass an order approving the revival scheme which compels secured and other creditors to accept repayment of their outstanding loans in the manner provided in the revival scheme. Such an order would by implication mean that the rights of enforcement of securities of secured creditors shall be suspended during the period the scheme of revival is in operation. This may be a difficult proposition in the Indian context where banks have a practice of obtaining mortgage of land and building, hypothecation of plant and machinery and all other movables coupled with personal guarantees of the promoter directors. Since the entire undertaking would be mortgaged and charged to the secured creditors it would not be possible to enforce the scheme of revival unless the secured creditors give their consent to the scheme. However, in stark contrast to SICA which has proved to be dysfunctional in practice, the SARFAESI Act has been fairly successful in enabling secured creditors to enforce their debt against defaulting debtors. Moreover, as discussed above, in terms of Section 262 of CA 2013, a scheme of revival needs to be

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<sup>153</sup> IMF, *Orderly and Effective Insolvency Procedures* (1999), "Treatment of Encumbered Assets and Secured Creditors", explaining also that secured creditors' interests will need to be adequately protected whilst they are subject to the stay.

<sup>154</sup> See the provisos to Section 254 CA 2013.

<sup>155</sup> In practice, of course, this will depend on whether the corporate rescue law operates efficiently – otherwise it may be no better at preserving value in distress.

approved by 75% of the secured creditors for it to be approved. If 75% of secured creditors intend to initiate debt recovery proceedings<sup>156</sup>, it is unlikely that they will subsequently approve a rehabilitation plan for the debtor. Therefore, the BLRC is of the opinion that until there is some evidence to suggest that the rescue proceedings under CA 2013 cannot function effectively (i.e., save viable businesses from piece-meal liquidation) in the face of the secured creditors' enforcement rights under the SARFAESI Act, such rights should not be disturbed at this stage. This issue can be re-examined at the time of framing the Insolvency Code.

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***Question for Consideration for the Insolvency Code:***

- i. In what circumstances should debt enforcement by secured creditors be allowed while a company is undergoing a rescue? More specifically, where a reference for rescue has been made and (a) the court/tribunal has made a determination that revival or rehabilitation of the company is feasible based on an independent viability study, and (b) the scheme has been sanctioned by the requisite majority of creditors, should secured creditors be permitted to stop the rescue proceedings by enforcing their security interests under the SARFAESI Act?*

#### **K. DEBT RESTRUCTURING UNDER SCHEMES OF ARRANGEMENT**

Debt restructuring under a scheme of arrangement was possible under Section 391 of CA 1956. Section 230, CA 2013, the corresponding provision on schemes of arrangement has undergone a few changes. This section will examine the significant changes to the provision from an insolvency resolution perspective.

Firstly, the company or any other person making an application for a compromise or arrangement under Section 230(1) is required to disclose to the NCLT (in addition to earlier disclosure requirements contained in the proviso to Section 391(2), CA 1956) the following: (a) a reduction of share capital of the company, if any, included in the compromise or arrangement; (b) any scheme of corporate debt restructuring having the consent of not less than seventy-five per cent of the secured creditors in value, including— (i) a creditor's responsibility statement in the prescribed form; (ii) safeguards for the protection of other secured and unsecured creditors; (iii) auditor's report stating that the fund requirements of the company after the corporate debt restructuring as approved shall conform to the liquidity test based upon the estimates provided to them by the board; (iv) where the company proposes to adopt the corporate debt restructuring guidelines specified by the RBI, a statement to that effect; and (v) a valuation report by a registered valuer in respect of the company's shares, its property and all assets (tangible and intangible, movable and immovable). The requirement of disclosure of a scheme of corporate debt restructuring was probably made taking into consideration the Irani Committee's recommendation for the quick sanctioning of schemes of corporate debt restructuring under the CDR mechanism of the RBI. The *Irani Committee* had recommended that if the petitioning creditors or the company is *prima facie* able to prove that seventy five percent of secured creditors have consented to the scheme, the scheme should be sanctioned upon filing. However, while Section 230(2) provides for disclosure of such schemes consented to by seventy five percent or more of the creditors at the time of making the application, it does not provide for sanctioning upon filing. The approval of a scheme of arrangement still requires the consent of three-fourths majority of each class of creditors, including secured and unsecured creditors, thereby defeating the purpose of making such a disclosure.

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<sup>156</sup> Albeit, it must be noted that the SARFAESI Act threshold has now been reduced to 60%

Secondly, the proviso to Section 230(4) stipulates that objections to be made to any compromise or arrangement can be made only by persons holding not less than 10% of the shareholding or having not less than 5% of the total outstanding debt as per the latest audited financial statements. This ensures that creditors having only a small amount of debt due to them, most likely unsecured creditors, cannot delay or otherwise obstruct the process.

Thirdly, it may be noted that the NCLT has the discretion to dispense with the calling of a meeting of creditors or a class of creditors where such creditors or class of creditors, having at least ninety percent value, agree and confirm by affidavit to the scheme.<sup>157</sup> This amendment might speed up the procedure to some extent.

Fourthly, the order made by the NCLT sanctioning the scheme has to, inter alia, provide for protection of any class of creditors and for the abatement of BIFR proceedings, if any, where the scheme or compromise is agreed to by any of the creditors.<sup>158</sup>

It may also be noted that while Section 391(3), CA 1956 stipulates that the order of the court sanctioning the scheme will not take effect till a certified copy of the order has been filed with the Registrar of Companies, Section 230(8), CA 2013 merely stipulates that the order of the NCLT shall be filed by the company with the Registrar of Companies within thirty days of receipt of the order. While Section 230(8) does not specify what the effect of non-compliance with the provision is, the wording in Section 230(6) suggests that the NCLT's order is binding on the company and the creditors or class of creditors or members or class of members, as the case may be, and in the case of a company being wound up, on the liquidator and the contributories of the company.<sup>159</sup>

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The BLRC notes that schemes of arrangements (under the CA 1956) for debt restructuring have not had many takers in India. This may be partially attributable to the perception that court driven processes necessarily involve delays and significant costs. Additionally, there have been problems of holdouts by creditors. Notwithstanding these factors, the BLRC notes that schemes of arrangement in India have been relatively successful for schemes between shareholders (especially those involving mergers and acquisitions). Such schemes are typically driven by the advisors of the parties and involve minimal intervention from the courts (other than when there is evidence of abuse of the process). The BLRC is of the opinion that schemes of arrangement can become a very effective tool for debt restructuring, acknowledging however that such restructurings can also be achieved less formally (and often less expensively) through a workout outside the court. Given that the proceedings for schemes of arrangement can be initiated without any proof of default or insolvency, they can facilitate early intervention and finality.

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<sup>157</sup>Section 230(9), CA 2013.

<sup>158</sup>Section 230(7), CA 2013.

<sup>159</sup>Section 230(6) Where, at a meeting held in pursuance of sub-section (1), majority of persons representing three-fourths in value of the creditors, or class of creditors or members or class of members, as the case may be, voting in person or by proxy or by postal ballot, agree to any compromise or arrangement and if such compromise or arrangement is sanctioned by the Tribunal by an order, the same shall be binding on the company, all the creditors, or class of creditors or members or class of members, as the case may be, or, in case of a company being wound up, on the liquidator and the contributories of the company.

Schemes of arrangement can also facilitate the use of hybrid-rescue mechanisms like ‘pre-packaged rescues’. Pre-packaged rescue is a practice evolved in the UK and the US by which the debtor company and its creditors conclude an agreement for the sale of the company’s business prior to the initiation of formal insolvency proceedings. The actual sale is then executed on the date of commencement of the proceedings/date of appointment of insolvency practitioner, or shortly thereafter (and the proceeds distributed among the stakeholders in the order of priority). Until the Indian market for insolvency practitioners becomes sufficiently developed and sophisticated, it may not be advisable to allow such sales without the involvement of the NCLT. However, such sales can be allowed as part of a NCLT supervised scheme of arrangement. Subject to prior approval of the different classes of creditors, shareholders and government authorities as may be prescribed, such pre-packed schemes may be approved by the NCLT within thirty days of filing (without requiring any separate meetings or hearings) as long as the scheme satisfies the basic requirements as may be prescribed. However, pre-packaged rescues in the UK have also been criticised for failing to take into account the interests of all the stakeholders (specially the unsecured creditors). In view thereof, before any such measure is introduced in India, separate rules will have to be developed to operationalise such pre-packed schemes to protect the interests of all the stakeholders. Accordingly, the BLRC is of the view that further consultation may be required with the stakeholders before allowing such pre-packed sales as part of the schemes of arrangement without involving all the requirements relating to creditor meetings, etc.

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***Questions for Consideration:***

- i. Should pre-packaged schemes of rescue (with minimal involvement of the NCLT and no separate requirements for creditor meetings) be allowed as part of a scheme of debt restructuring under Section 230 of CA 2013?*

## 5. LIQUIDATION OF COMPANIES ON THE GROUND OF INSOLVENCY

### 5.1. COMPANIES ACT, 1956

#### A. THE LAW IN PRACTICE

During the initial period following the commencement of the CA 1956, the application of law on liquidation was guided by governmental policy on the resolution of industrial sickness. It was perceived that the healthy functioning of the industrial sector was vital to the economic growth of the country.<sup>160</sup> Thus, this period was characterised by government interventions in cases of industrial indebtedness, such as management take-overs and provision of rescue finance by the financial sector. In this framework, liquidation of an insolvent company was only seen as a measure of last resort. Consequently, this is likely to have diminished creditor recourse to liquidation as a mechanism for enforcement of debt.

Following economic liberalisation and the concomitant reform of the banking sector in the 1990s, the interventionist policy of the government underwent a change. This ought to have increased creditor recourse to liquidation and winding up proceedings against insolvent companies. However, the liquidation provisions under the CA 1956 have been widely seen as being ineffective in protecting stakeholder interests and facilitating an easy exit for companies in financial trouble. Various committee reports and studies have analysed the limitations of India's liquidation law and proposed substantive changes to the provisions in the CA 1956.

The *Goswami Committee Report*, submitted in 1993, broadly condemned the liquidation procedure prescribed by the CA 1956 as unworkable.<sup>161</sup> The Report pointed out that the liquidation process under the CA 1956 was beset with delays. The official liquidator of an insolvent company faced an uphill task as he was subject to delays at various stages of the process: delay tactics employed by the management, delays at the level of the courts in obtaining and enforcing decrees in favour of the company, in making asset sales etc.<sup>162</sup> This allegation of delay made in the Goswami Committee Report has been a recurring complaint in other Committee reports that undertook a review of the law on liquidation.

The *Eradi Committee Report* drew attention to the administrative aspects of the liquidation regime as being responsible for delays in the winding up proceedings, particularly after the making of the winding up order<sup>163</sup>. The Report echoed the findings of the *Goswami Committee Report* regarding the vulnerability of the official liquidator to delays at various stages. Additionally, it pointed out that further delays were caused due to the requirement of court approvals at several stages of the liquidation process. The Eradi Committee also noted that the liquidators also faced significant resource constraints- there was a lack of well-trained staff to assist the liquidator, and often enough, the liquidator did not have

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<sup>160</sup> See for example, Tiwari Committee Report 1984 as cited in van Zwieten.

<sup>161</sup> van Zwieten.

<sup>162</sup> An earlier report on the working of the CA 1956, the Report of the High-Powered Expert Committee on the Companies and MRTP Acts 1978 ("Sachar Committee Report") had also made an observation regarding delays in the liquidation process, especially after the making of the winding up order (van Zwieten).

<sup>163</sup> van Zwieten.



enough funds to cover the expenses of liquidation, costs of litigation etc. *The Eradi Report* also noted that there were constraints in court capacity due to a dearth of judges dealing with company matters at the High Courts.<sup>164</sup> Very significantly, it also pointed towards the involvement of courts in the failure of the law on liquidation: it noted that in some cases, delays were *caused* by the courts which insisted on pursuing recovery proceedings even for very small claims or on carrying on the business of the company for many years or delayed the making of a winding up order against the company.

The *RBI Report*, submitted in 2001, indicated some of the main problems with the bankruptcy regime as being: (i) significant delays in insolvency proceedings; (ii) institutional constraints, such as lack of official liquidators with specialised knowledge and training, resource limitations; (iii) lack of timely implementation of restructuring and winding up.

The *Irani Committee* criticised the Indian insolvency regime for failing to provide an easy exit for insolvent companies. It noted that the liquidation procedure in India is “*costly, inordinately lengthy and results in almost complete erosion of asset value.*” The Committee added that the insolvency framework did not balance competing stakeholder interests adequately. The Report proposed a number of changes to the liquidation regime, including changes for increased protection of creditor rights, maximisation of asset value and better management of the company in liquidation.

The *Committee on Financial Sector Reforms* drew a link between the availability of credit to the protection of creditor rights and effective enforcement of debt claims. Therefore, it emphasised that an effective insolvency framework should provide: (i) adequate protection of creditor rights; and (ii) a mechanism for quick and efficient liquidation in cases where corporate rescue is not viable. The *Committee on Financial Sector Reforms Report* stated the key challenges to the efficient operation of insolvency laws in India are: (i) the fragmented nature of the bankruptcy regime, resulting in increased costs for creditors in lending; and (iii) delays, hampering the efficient reallocation of assets and results in erosion of asset value. The Report also pointed towards resource constraints such as lack of properly trained judges as a cause for delays in the bankruptcy process.

## B. NEW EVIDENCE ON FAILURE

As discussed in Section 4.1 (B) above, a recent research on the law and practice of corporate insolvency (conducted by van Zwieten over a period of four years) throws more light on the reasons for the failure of the liquidation regime. In the first part of her research project, van Zwieten examined the development of the law on liquidation and considered the reasons why India’s liquidation procedure, although very similar to that of the UK, has worked very differently in practice. The data compiled by van Zwieten from the ‘*Annual Reports on the Working and Administration of the Companies Act 1956*’ for the period between 2005 and 2010 reveals that there were only a total of 1138 compulsory winding up orders, and an additional 10 cases of creditors’ voluntary liquidations, given during that period as against 303, 239 company registrations. Compared to this, there were 13, 460 compulsory liquidations and creditors voluntary liquidations as against 429, 700 company registrations during 2006- 2007 alone in the UK.<sup>165</sup> Thus, assuming the reliability of the reported data, the insolvency procedures under the

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<sup>164</sup> This observation was also made by the Sachar Committee Report in 1978 (van Zwieten).

<sup>165</sup> The corresponding statistics for India are- 249 liquidations and 51, 708 new company registrations (van Zwieten).

CA 1956 (India) appear not just *dysfunctional* but ‘*near defunct*’.<sup>166</sup> It is important to note that these figures relate to the period after the enactment of the SARFAESI Act and indicate that most secured creditors now prefer enforcing their security interests under the SARFAESI Act instead of initiating liquidation proceedings under CA 1956. This goes against the main objectives of corporate insolvency law – preservation of going concern value by preventing piece-meal liquidation. In other words, a dysfunctional liquidation regime encourages creditors to initiate separate recovery proceedings for the same assets, leading to conflicts, disorderly distribution, delays and depletion in value of the company.

van Zwieten’s work looks at the existing literature on liquidation law in India, and concludes that the failure of liquidation law in the initial phases post-Independence is likely to be linked, at least in part, to the government’s earlier policy bias towards revival and rehabilitation of industrial companies. Specifically, she observes that the literature refers to two factors that could be predicted to have decreased creditor recourse to insolvency law procedures: (i) development of a liberal policy towards rescue of insolvent industrial debtors, supported by the provision of rescue finance from banks and other financial institutions; (ii) encouragement of such lending to certain categories of borrowers by the central and state governments.

In the period following economic liberalisation, despite a policy shift on the part of the government, liquidation proceedings continued to be unattractive to creditors as a means of debt enforcement. It is in this context that van Zwieten’s research offers an alternate (or more likely complementary) explanation for the failure of the liquidation regime. While existing literature has focussed on the administrative aspects of the liquidation regime, including the substantial role played by courts in the liquidation process, delays at the court level caused by overburdening / lack of judicial and registry resources, resource constraints faced by liquidators and managerial delay tactics, van Zwieten’s research draws attention to the role of judicial practice and procedure in the failure of the liquidation regime. For this purpose, she compiled a hand-collected dataset of 454 judgments handed down by the High Courts on insolvent liquidation<sup>167</sup> between the commencement of the CA 1956 and 31 December 2011. Specifically, the study looked at judgments on creditors’ petitions to wind up the company.

The author reports that there had been a series of judicial innovations during the entire liquidation process (from the presentation and admission of petitions to the making of the final winding up order), and in deciding when an order of inability to pay debts was to be made against the debtor. The author draws attention to three sets of judicial developments:

- i. *The development of a special pre-admission procedure in the initial stage of presentation and admission of the petition for winding up.* The Supreme Court decision in *National Conduits (P) Ltd v SS Arora*<sup>168</sup> had added the requirement of the issuance of a show-cause notice to the company prior to the admission of a petition for winding up, leading to an opportunity for the company to be heard at the admissions stage. Although an opportunity to be heard is not problematic *per se*, this decision, coupled with the later decision in *Pradeshya Industrial & Investment Corporation of U.P. v North India Petrochemical Ltd*<sup>169</sup> which

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<sup>166</sup> van Zwieten.

<sup>167</sup> Section 433(e), CA 1956.

<sup>168</sup> AIR 1968 SC 279.

<sup>169</sup> [1994] 79 CompCas 835 (SC).

necessitates an enquiry into the validity of the claim of the petitioning creditor at the admissions stage, has led to significant delays at this stage. The author notes that such delays are caused, in particular, due to the judicial practices of permitting adjournments to enable the debtor company to file objections and to be heard, of requiring the petitioner to satisfy the court that there is a case for winding up at the admissions stage itself. These delays are aggravated by subsequent appeals from decisions to admit such petitions, which have to be heard on merits<sup>170</sup>.

- ii. *The development of the judicial practice of giving the debtor company time to settle the debt owed to the petitioning creditor at various stages between the presentation of a petition and the making of an order for winding up.* The author notes that this has extended even to a stay of the winding up in order to enable the debtor company to pay the petitioning creditors - the debtor companies have often used such orders only to delay the proceedings to avoid a winding up order.
- iii. *The exercise of judicial discretion in determining when the company is 'unable to pay debts' and in making a winding up order when the creditor has proved an inability to pay debts.* According to van Zwieten, the available evidence shows that courts in India have taken a strict view on the first issue- the non-payment of a single undisputed debt has been held to be insufficient to prove an inability to pay debts in the absence of a formal statutory demand.<sup>171</sup> Further, the author notes that there have been cases where such non- payment (even on formal demand) has been held to merely give rise to a rebuttable 'presumption' about the company's financial position- "...it must be further be shown that the company omitted to pay without reasonable excuse and the condition of insolvency in the commercial sense exists."<sup>172</sup> In the case of disputed debts, courts have applied an even more rigorous standard of inability to pay debts, considering even the question of factual insolvency of the debtor company.

Once the petitioning creditor has proved the inability of the debtor company to pay debts, van Zwieten states that courts in India have recognised a wide discretion that enabled it to give time to the debtor to make payment or even dismiss the petition. This is in stark contrast with the position in the UK (from where the law was transplanted) where once the company's inability to pay debts has been proven, the petitioning creditor is ordinarily held to be entitled to a winding up order (although it should be noted that there is an alternative corporate rescue procedure, 'administration', which a debtor may be entitled to enter).

The effect of these abovementioned judicial developments has been to add significant delays in the liquidation process under CA 1956 and to add uncertainty regarding the rights of the creditors in the event of the company's insolvency. Consequently, this has made creditor recourse to the liquidation procedure as a means of debt enforcement rather difficult, and secondly, rendered the liquidation procedure ineffective as a disciplinary mechanism for creditors against insolvent debtors.

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<sup>170</sup> *Golcha Investment P Ltd v Shanti Chandra Barna* AIR 1970 SC 1350.

<sup>171</sup> Section 433 (e) read with Section 434(1), CA 1956.

<sup>172</sup> *Kanchanaganga Chemical Industries v Mysore Chipboards Ltd* [1998] 91 CompCas 646 (Karnataka), as cited in van Zwieten.

## 5.2. COMPANIES ACT, 2013 - RECOMMENDATIONS FOR REFORM AND QUESTIONS FOR CONSIDERATION

CA 2013 incorporates several features of CA 1956 in relation to winding up of companies. However, there are many marked differences between the two, which include – (i) additional grounds for winding up of a company including failure to ‘restructure the debt’ to the creditor’s reasonable satisfaction after a statutory demand for repayment; (ii) defined timelines for the winding process (for example, unlike the CA 1956, the NCLT has to make an order upon receipt of the petition for winding up within ninety days from the date of presentation of such petition); (iii) more comprehensive framework for the appointment of official liquidators (now termed as company liquidators, who are to be appointed from a panel of prescribed professionals including lawyers, chartered accountants, company secretaries and cost accountants); (iv) expanded powers of the liquidator including the power to conduct a going concern sale of the company, obtain professional assistance, appoint a professional for the protection of the company’s assets and appoint an agent to do any business that he may not be able to do himself; (v) new provisions relating to increased oversight of the liquidator by the NCLT in terms of the requirement of submission of reports and the contents thereof, fixing the time limit for the completion of the winding-up proceedings by the liquidator, monitoring the proceedings through an advisory committee constituted by the NCLT; (vi) provision for constitution of a winding up committee to monitor the progress of liquidation proceedings; (vii) provision requiring promoters, directors, officer and employees etc. to cooperate with the company liquidator in the discharge of his functions and duties (and non-compliance with this provision leads to penalties, including imprisonment for a term upto six months);(viii) power the of the NCLT to stay the winding up of the company (even after a winding up order has been made) if it is satisfied that it is just and fair to give an opportunity for rehabilitation of the company; and lastly (ix) a summary liquidation procedure for prescribed class/classes companies.

Although CA 2013 provisions on winding up of companies includes several improvements over the CA 1956, there are several unresolved issues which have not been appropriately addressed. The said issues have been discussed below. In order to develop an effective legal regime for winding up under the CA 2013, it is suggested that these issues be resolved statutorily, as per the recommendations underscored in this Section.

### A. DEVELOPING APPROPRIATE CRITERIA FOR DETERMINING WHEN A COMPANY IS ‘UNABLE TO PAY DEBTS’ FOR THE PURPOSES OF WINDING UP

The process of winding up / liquidation of a company may be initiated on a number of grounds as prescribed in the CA 2013<sup>173</sup> (previously under the CA 1956). One of the common grounds for filing a winding up petition is “if the company is unable to pay its debts”. The phrase, “unable to pay its debts” is not specifically defined in CA 2013 and its contours are determined by the judicial precedents delivered by the Indian courts. However, Section 271(2) of CA 2013 lays down three situations wherein a company is deemed to be unable to pay its debts – (i) if a creditor makes a statutory demand upon the company for repayment of debt (owed by the company to the creditor) for an amount exceeding INR 1,00,000/- and the company fails to pay the sum within 21 days of the demand or to provide adequate security or re-structure or compound the debt to the reasonable satisfaction of the creditor; or (ii) if any execution / other process issued on a decree or order of any court or tribunal in favour of a creditor of

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<sup>173</sup>Section 271(1), CA 2013.

the company is returned unsatisfied; or (iii) if it is proved<sup>174</sup> to the satisfaction of the NCLT that the company is unable to pay its debts, and, in determining whether a company is unable to pay its debts, the NCLT shall take into account the contingent and prospective liabilities of the company.

On a plain reading of the law above, it is abundantly clear that the deeming provision treats the mere inability to pay a single undisputed debt (for an amount exceeding INR 1,00,000/-) as proof of inability of a company to pay its debt for the purposes of Section 271 of the CA 2013, thereby being a clear ground for winding up of a company. Thus, on the face of it, under this ground, the creditor is relieved from proving that a company is unable to pay all its debts, or in other words, establish insolvency of the company in a wider or more comprehensive sense. However, over the years, the courts seem to have interpreted this provision very liberally (for the debtor) by reading into it various additional requirements to be proved by the creditor.<sup>175</sup>

An early judgment on this issue was in the case of *State of Andhra Pradesh v. Hyderabad Vegetable Products Co. Ltd., Hyderabad*<sup>176</sup> wherein the judge proceeded on the premise that consequence of failure to pay debt upon a statutory demand (as envisaged under Section 434 of CA 1956) leads to the *presumption of insolvency* and the basis of a winding-up order on the ground of a company's inability to pay its debts is always *insolvency*. The judge further clarified that by *insolvency*, he meant commercial insolvency and the meaning of “commercial insolvency” was routed to Sir William James, V. C.’s definition of the same, in *European Life Assurance Society*<sup>177</sup>, to mean: “*Not in any technical sense but, plainly and commercially insolvent -- that is to say, that its assets are such, and its existing liabilities are such, as to make it reasonably certain -- as to make the Court feel satisfied -- that the existing probable assets would be insufficient to meet the existing liabilities.*” In another judgment<sup>178</sup>, the division bench of the Calcutta high court observed that “*before a company could be sent to liquidation, it must be "unable to pay its debts." This presupposes that there exists a debt and the company is unable to pay it. Prima facie this must relate to the solvency of the company. The word used is "unable" and not "unwilling."*” Therefore, the judicial interpretation as emergent from these cases inclines towards the interpretation that in the event a company defaults in the payment of a debt upon a statutory demand, the court will only *presume* the company to be insolvent in the commercial sense (rather than find this insolvency ‘deemed’), and the creditor will be required to not just prove the inability to pay the demanded undisputed debt, but insolvency of the company in the commercial sense. It becomes pertinent to analyse cases which decipher Section 433 and 434 of CA 1956 from a different perspective. In an earlier case of *In the Matter of Advent Corporation Pvt. Ltd.*<sup>179</sup>, a petition for winding

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<sup>174</sup> It may be noted here that despite the heading of the section, this sub-section is not a deeming provision and inability to pay debt has to be proved.

<sup>175</sup> van Zwieten.

<sup>176</sup>[1962] 32 CompCas 64 (Andhra Pradesh).

<sup>177</sup>In re (1869) 9 Eq. 122 at p. 128.

<sup>178</sup>*Bangasri Ice and Cold Storage Ltd. v. Kali Charan Banerjee*, AIR1962 613 (Cal).

<sup>179</sup>[1969] 39 CompCas 463 (Bom). Followed in *Destinations of the World (Subcontinent) Pvt. Ltd. v. Raj Travels and Tours Ltd.*, 2013 (7) BomCR 320 (In this case, it was held that the dispute in relation to the debt was not bona fide (commercial insolvency was not looked into), and following In re Advent case for the ratio that once there is noncompliance with a statutory notice and the court comes to the conclusion that there is no bona fide dispute with regard to the petitioner's debt, the creditor is entitled to a winding up order *ex debito justitiae*, and hence, the company petition for winding up was admitted).

up was filed on the basis of an unpaid debt upon a statutory demand under Section 434(1)(a) of the CA 1956. The counsel for the respondent argued no winding-up order should be made unless the company is shown to be commercially insolvent, even though it may have neglected to comply with a statutory notice under section 434(1)(a). The judge outrightly rejected the counsel's argument stating that that if that were to be the construction to be placed upon section 434(1)(a), it would be a logical absurdity and there would be no reason why section 434(1)(a) should have been enacted by the legislature. It was also held that courts do not have a discretion of not winding up a company under Section 433 and 434. Following this principle, it was held that the dispute in relation to the debt was not bona fide, and therefore the company is deemed to be unable to pay its debt. The petition for winding up was admitted to the court and a direction for advertisement to invite claims to be published was given.

In 2007<sup>180</sup>, a single judge of the Bombay High Court appears to have extended the line of reasoning propounded in *In re Advent* (supra), while ordering winding-up of a solvent company on the non-payment of a demanded debt. It was held that the fact that the company was solvent was not an extenuating circumstance but rather is further proof of the company's neglect to pay. The judge observed the following : (i) Omission to pay under Section 434(1)(a) except on account of bona fide dispute<sup>181</sup> therefore is sufficient in law and commercial solvency of respondent company does not appear to be relevant at all; (ii) Relying on *In re Advent* (supra), the judge reiterated that Section 434(1)(a) does not merely lay down a presumption which can be rebutted but uses the word "shall" and enacts a deeming provision which must come into play once the company neglects to pay the sum demanded by the statutory notice to which it refers; (iii) A person can be said to be neglecting to pay only when though he possesses that capacity, payment is not made for no valid reason. Legislature appears to have deliberately treated such culpable withholding of amount due to another by company as its inability to pay for the purposes of section 433(e) and that intention needs to be honoured. The Supreme Court has also held that if a company refuses to pay a debt on statutory demand for no valid reason, it should not be able to avoid paying the debt on the grounds that it is a solvent company.<sup>182</sup> Although these cases lay down the correct law in this regard<sup>183</sup>, due to other conflicting judgments on this issue, it becomes important that the position of law is clarified under the statute.

The discussion above relates to cases relating to the statutory demand test. The discussion suggested that there have been some cases where courts have doubted whether a debtor should be 'deemed' insolvent on the basis of its failure to pay such a debt, while others have applied the deeming provision. A further problem that emerges from the case law relates to when a debt is to be treated as *bona fide* disputed. On an analysis of various judgments regarding bona-fide disputed debt wherein the petitioner seeks winding up of the company on the ground of its inability to pay debt, the judicial trend that emerges is that the courts tend to look into and attribute weightage to the factual solvency of the company.<sup>184</sup> For

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<sup>180</sup>*Karpara Project Engineering, Surat v. Ballarpur Industries Ltd.*, Company Petition No. 8 of 2006, Decided On: 28.02.2007 (Bombay) (in this case, it was held that the dispute in relation to the debt was not bona fide, and therefore the company is deemed to be unable to pay its debt).

<sup>181</sup>The judicial interpretation in respect of the term 'bona fide' has been discussed later in this report.

<sup>182</sup>*IBA Health (I) Pvt. Ltd. V. Info-Drive Systems Sdn. Bhd.*, [2010]159CompCas369(SC).

<sup>183</sup>For several reasons i.e. a third party creditor may find it extremely difficult to establish insolvency of the defaulting company in a global sense (being unaware of the affairs of the company and not having access to the relevant documentation) and also, a defaulting company may have the ability to pay debt (i.e. it may not be insolvent in the global sense) but may be plainly unwilling to satisfy the debt.

<sup>184</sup>van Zwieten.

instance, while dismissing a winding up petition on the basis of a bona-fide disputed debt (as the agreement under which the debt was due had been cancelled) the court attributed its decision to dismiss to some extent to the financial soundness and profitability of the company.<sup>185</sup> In another case<sup>186</sup> though there was a bonafide dispute as to the liability of the respondent to pay the debt as it was based on the determination whether the debt demanded had crystallized or not, the court also emphasized that since no case for proving the commercial insolvency of the respondent was made out and the respondent company was in fact profit making and solvent (as per the evidence adduced), the respondent will not be wound up. The rationale as to why the courts would require to take upon the exercise of looking into the solvency of a company wherein the debt owed by the company is itself bona-fide in dispute has been to some extent explained by the Supreme Court in the case of IBA Health (I) Pvt. Ltd. V. Info-Drive Systems Sdn. Bhd.<sup>187</sup>. The Court stated that – “An examination of the company's solvency may be a useful aid in determining whether the refusal to pay debt is a result of a bona fide dispute as to the liability or whether it reflects an inability to pay. Of course, if there is no dispute as to the company's liability, it is difficult to hold that the company should be able to pay the debt merely by proving that it is able to pay the debts. If the debt is an undisputedly owing, then it should be paid. If the company refuses to pay, without good reason, it should not be able to avoid the statutory demand by proving, at the statutory demand stage, that it is solvent. In other words, commercial solvency can be seen as relevant as to whether there was a dispute as to the debt, not as a ground in itself, that means it cannot be characterized as a standalone ground.” Therefore, what the court attempted to lay down was that if the court has to determine whether the reason for non-payment of the debt is a bona fide dispute or insolvency, if it is shown that the company is solvent, it strengthens the stand that there exists a bona fide dispute. The problem with the approach laid down by the Supreme Court is that upon the evidence of solvency of a company the courts may be too quick to hold the debt as disputed without a rigorous inquiry into the validity of the dispute, and thus deprive the creditors of the benefit of the deeming provision.<sup>188</sup>

It is settled law that if there exists a “bona fide dispute” in relation to liability of payment of the debt, then a winding up order will not be made, unless such dispute relating to the debt is settled (or another creditor is substituted for the original petitioning creditor), as the courts have held that a winding up petition is not a legitimate means of seeking to enforce payment of a bona-fide disputed debt. Further, as long there exists a bona fide dispute, the petitioner cannot be regarded as a creditor per se, and the so called debtor cannot be said to have neglected / failed to make the payment of the debt. The yardstick on which a disputed debt may be termed as bona-fide disputed is three pronged<sup>189</sup> - (i) that the defence of the company is in good faith and one of substance; (ii) the defence is likely to succeed in point of law; and (iii) the company adduces prima facie proof of the facts on which the defence depends. The Indian courts have further expounded that the defence of the debtor should not be moonshine and the court is entitled to investigate whether a dispute has been manufactured in order to delay and defeat the

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<sup>185</sup>*Pradeshiya Industrial & Investment Corporation of U.P. v. North India Petrochemical Ltd. and Anr.*, [1994]7 9 CompCas 835 (SC).

<sup>186</sup>*Alpha Packaging Ltd. v. Som Distilleries Ltd.*, Company Petition No. 15/1999, Decided On: 12.11.2014

<sup>187</sup>[2010] 159 Comp Cas 369 (SC).

<sup>188</sup> van Zwieten.

<sup>189</sup>*Madhusudan Gordhandas & Co. v. Madhu Woollen Industries Pvt. Ltd.*, AIR 1971 SC 2600.

realisation of the dues of the petitioning creditor and is merely a cloak for the inability of the company to pay its just debts.<sup>190</sup>

The corollary to this should be that if the debt is undisputed, or if it is proved that that the dispute in relation to the debt is not bona fide, then the courts should not have a wide discretion in whether to wind up the company or not and should generally incline towards winding up of the company (without looking into other factors such as commercial insolvency etc.) under the companies legislation, specifically in cases where the statutory demand for debt is not honoured, as it is reflective of the defaulter's admission of debt on the one hand and non-payment for no reasonable cause on the other hand. This approach has been affirmed in the case of *In re Advent* (supra) and *Karpara v Bullarpur* (supra). To this effect, the Supreme Court<sup>191</sup> has held that “Where the debt is undisputed, the court will not act upon a defence that the company has the ability to pay the debt but the company chooses not to pay that particular debt.” However, the more recent judicial reality does not seem to be in line with these decisions and is rather quite complex due to the court's discretion in exercising its power to wind up being fraught with the consideration of various factors. It has been observed in some cases that the court moves on the premise that the creditors are not entitled to winding up orders as a matter of right. Some of the factors as culled out of the judicial precedents are as follows – **(i) impact on the employment of numerous persons; (ii) loss of revenue of the state by way of collection of tax from the operating company; (iii) scarcity of goods and diminishing employment opportunities; (iv) public interest; (v) entire status and position of the company in the market; (vi) interest of justice; (vii) alternative remedy etc.** The Gujarat High Court<sup>192</sup> held that winding up “is the last thing that the Court would do and not the first thing that the Court would do having regard to its impact and consequences” and suggested that it should not be done as long as the company can be resurrected (by a scheme or arrangement). *Tata and Iron Steel Co v. Micro Forge (India) Ltd.*<sup>193</sup>, widens the discretion of the court in winding up to a great extent, observing that the winding up is akin to ‘commercial death of a company’ and lays down numerous guidance notes for the exercise of discretion of the court, most of which indicate that the court should exercise a very wide discretion in relation to winding up orders and incline towards not granting a winding up order. The court has gone to the extent of holding that an order admitting a winding up petition and the resultant advertisement published for invitation of claims is, from the commercial point of view, the business point of view, from the marketability point of view, no less injurious than winding up.<sup>194</sup> A creditor's winding up petition in certain instances implies insolvency and financial difficulty and may damage the creditworthiness or financial standing of the company.<sup>195</sup> Therefore, an order admitting a winding up petition or a winding up order itself has been cast in a negative light and as something which should be avoided by the courts as much as possible. Though Section 271 (1) reads that a company “may” be wound up on the grounds mentioned therein, which includes inability to pay debt, indicative of the court's discretion in winding up the company, however, such an interpretation if applied to Section 271(2) of the CA 2013 would result in defeating the very purpose of the deeming

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<sup>190</sup>*Bangasri Ice and Cold Storage Ltd. v. Kali Charan Banerjee*, AIR 1962 613 (Cal).

<sup>191</sup>*Madhusudan Gordhandas & Co. v. Madhu Woollen Industries Pvt. Ltd.*, AIR 1971 SC 2600; *Excel Embroideries and Ors. v. Trend Designs Limited and Ors.*, AIR 1997 Ker 329.

<sup>192</sup>*Registrar of Companies v. Navjeevan Trading Finance Private Limited*, (1978) 48 Comp Cas 402 (Guj).

<sup>193</sup>[2001] 104 Comp Cas 533 (Guj).

<sup>194</sup>*Tata Iron Steel and Co. v. Micro Forge (India) Ltd.*, [2001] 104 Comp Cas 533 (Guj).

<sup>195</sup>*IBA Health (I) Pvt. Ltd. V. Info-Drive Systems Sdn. Bhd.*, [2010] 159 CompCas 369 (SC).



provisions as present therein. Hence a statutory clarification in this regard is necessary. Also, the courts may look into the judicial development in this regard in the UK, wherein a creditor who establishes the company's inability to pay debts (even a single undisputed debt) can ordinarily expect the court to exercise its discretion to admit / make a winding up order.<sup>196</sup>

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Such broad interpretation by courts of when a company is determined to be unable to pay debts under the Indian law has rendered liquidation ineffective as a disciplinary mechanism against insolvent debtors. For the creditor to be able to use the threat of winding up procedures – with their attendant costs for debtors – to encourage repayment, there must also be a real possibility of the imminent commencement of liquidation proceedings, and attendant publicity. However, the judicial practice of requiring the non-payment of a single undisputed debt to be supplemented with evidence of the company's commercial insolvency has meant that the threat of imminent liquidation is not necessarily – at least in the present state of the law – a credible one. Debtors are not compelled to negotiate with the creditors to restructure their debt or take other measures to resolve their financial distress. The creditor should ordinarily be entitled to a winding up order upon proof of non-payment of a single undisputed debt after a formal statutory demand for payment has been made.<sup>197</sup>

Moreover, the test for determination of insolvency under the Indian law appears to be, as has been cited in various judicial precedents<sup>198</sup>, the “commercial insolvency test” as laid down by James VC in 1869 in *In Re European Life Assurance Society* (*supra*). The definition by James VC was given at the time when there was no rigid distinction between the commercial insolvency test and balance sheet insolvency test. However, in the Supreme Court case of *Mediquip Systems (P) Ltd. v. Proximo Medical System*<sup>199</sup> the Apex Court observed (approving the view of the Bombay High Court in *In Re: Softsule(P) Ltd.*<sup>200</sup>) “that one of the considerations in order to determine whether the Company is able to pay its debts or not is whether the Company is able to meet its liabilities as and when they accrue due. Whether it is commercially solvent means that the Company should be in a position to meet its liabilities as and when they arise.” However, the interpretation of the term “as and when they arise” is not clear, particularly in relation to how far ahead should one look for the inclusion of the unpaid liabilities / debts.<sup>201</sup> Further, there has been extensive judicial development with regard to the meaning and interpretation of “commercial insolvency” in the UK post the *In Re European Life Assurance Society* which does not seem to have been taken into consideration by the Indian courts.

### The position of law in the UK

In the UK, the concept of insolvency can be located in Section 123 of IA 1986. The said section lays down a number of tests for determining whether a company is “deemed” to be unable to pay its debts.

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<sup>196</sup>van Zwieten.

<sup>197</sup>The law may provide for exceptions if the petition has been filed for a collateral purpose to abuse the process of law and to allow the possibility of a corporate rescue in appropriate cases.

<sup>198</sup> *Pradeshia Industrial & Investment Corporation of U.P. v. North India Petrochemical Ltd. and Anr.*, [1994] 79 CompCas 835 (SC); *Dallah Albaraka (Ireland) Ltd. v. Pentasoft Technologies Ltd.*, [2011] 101 CLA 177 (Mad.)

<sup>199</sup> AIR 2005 SC 4175.

<sup>200</sup> (1977) 47 Com. Cases 438 (Bom).

<sup>201</sup> Please see Cheyne judgement.

In general parlance, the tests are divided into two groups – (i) specific tests which refer to the statutory demand test and the jurisdiction specific tests as encapsulated in Section 123(1)(a) and Section 123(b) to (d) respectively; and (ii) general tests which refer to cash flow insolvency or commercial insolvency test and balance sheet insolvency test as encapsulated in Section 123(1)(e) and Section 123(2) respectively.

The statutory demand test under IA 1986 is similar to the test as under Section 434(1)(a) of the CA 1956 or Section 272 (2)(a). **As discussed above, the Indian courts have read cash flow / commercial insolvency into the statutory demand test, as opposed to in the UK, where statutory demand test and cash flow / commercial insolvency test form separate grounds for the purposes of the deeming provisions under Section 123 of IA 1986.** The statutory demand test presumes the fact that the company is unable to pay its debt and it may be rebutted by the company, however, a detailed analysis of the financial condition of the company is not required.<sup>202</sup> Further, the courts have generally been amenable to accepting the inability of a company to pay its debt on failure to pay a single undisputed debt.<sup>203</sup> To this effect, the observations of Lord Walker in the Supreme Court judgment of *BNY Corporate Trustee Services Limited and others v Eurosail-UK 2007-3BL PLC*<sup>204</sup> (“**Eurosail**”) are relevant – “*A company’s non-compliance with a statutory demand, or non-satisfaction of execution of a judgment debt, is a matter that can be proved quite simply, usually by a single short witness statement. If proved, it establishes the court’s jurisdiction to make a winding up order, even if the company is in fact well able to pay its debts.*” On the other hand, the cash flow / commercial insolvency test and the balance sheet test require a more detailed examination of the financial status of the company to conclude the existence of any one kind of insolvency.

Cash flow / commercial insolvency test – Before the IA 1986, there was no rigid statutory and judicial distinction between the said two tests as is evident from Section 518(1)(e) of the Companies Act 1985 which read - “... if it is proved to the satisfaction of the court that the company is unable to pay its debts (and, in determining that question, the court shall take into account the company's contingent and prospective liabilities).” The split rendering the two tests as distinct grounds was statutorily recognized only in the IA 1986. In place of the requirement to take into account the company's contingent and prospective liabilities, the phrase “as they fall due” was added after “debts”. The requirement to take into account the company's contingent and prospective liabilities now only appears in Section 123(2). So, Section 123(1)(e) reads: “... if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due.”

Commercial insolvency basically means that a company cannot pay its way in the conduct of the business, and the fact that its assets exceed its liabilities is irrelevant. In this regard, the creditor has to adduce evidence that demonstrates a persistent failure on the part of the company to pay its debts as they fall due.<sup>205</sup> In the *In re European Assurance Society* case (supra), though James VC ostensibly laid down the test for commercial insolvency, however, as the Supreme Court of UK in the *Eurosail* judgment (as mentioned later in the report) observed that in *European Life Assurance Society* case, the

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<sup>202</sup> Olivares- Caminal et al.

<sup>203</sup> van Zwieten.

<sup>204</sup> [2013] UKSC 28.

<sup>205</sup> Olivares- Caminal et al.

judge seems to have applied the ‘balance sheet test’ to existing liabilities. The original interpretation of this kind of insolvency was that it made a reference to the inability of the company to pay its debts immediately / presently due and did not include any debt falling due in the future.<sup>206</sup> However, in the case of *Re Cheyne Finance Plc (No.2)*<sup>207</sup> (“**Cheyne**”) the judge changed the law by giving a different interpretation to this aspect in the following words – “In my judgment, the effect of the alterations to the insolvency test made in 1985 and now found in section 123 of the 1986 Act was to replace in the commercial solvency test now in section 123(1)(e), one futurity requirement, namely to include contingent and prospective liabilities, with another more flexible and fact sensitive requirement encapsulated in the new phrase ‘as they fall due.’” **The said interpretation was affirmed by the Supreme Court of UK in the Eurosail judgment in 2013, where the court observed that the commercial insolvency test is concerned with presently due debts and also those falling due from time to time in the “reasonably near future”.** The Supreme Court of UK has however given only a skeletal guidance on what constitutes reasonably near future – “it will depend on all the circumstances, but especially on the nature of the company’s business.”<sup>208</sup> The question which arose post the Cheyne judgment was that with both the cash flow / commercial insolvency test and balance sheet insolvency test having a futurity element to them, and as they stood side by side in the same section of the IA 1986, how could one understand the interaction between the two tests? This question was put to rest to some extent in the Eurosail judgment, wherein the Supreme court held that “*moving beyond the reasonably near future (the length of which would depend on the circumstances of the case), any attempt to apply a cash-flow test will become completely speculative, and a comparison of present assets with present and future liabilities (discounted for contingencies and deferment) becomes the only sensible test.*” In the subsequent case of *Bucci v Carman (Liquidator of Casa Estates (UK) Ltd)*<sup>209</sup>, it was further laid down that (i) significance has also to be attached as to how the debts are being satisfied and (ii) the two tests of cash-flow and balance sheet feature as part of a single exercise to determine whether a company was unable to pay its debts, and that the balance sheet test in IA 1986 was not excluded merely because a company was for the time being paying its debts as they fell due.

**Balance Sheet test** – A company is deemed to be unable to pay its debts if it is proved to the satisfaction of the court that the value of the company’s assets<sup>210</sup> is less than the amount of its liabilities, taking into account its contingent and prospective liabilities. The rationale for this test is that even if a debtor company is able to meet its current obligations, its solvency cannot be established if it is already clear that its assets will be inadequate to satisfy its liabilities going forward.<sup>211</sup> This test is an important warning mechanism for the board of a debtor company to know of the troubled times ahead, if any.<sup>212</sup> The land mark case which attempts to throw some light on the ‘balance sheet test’ as it exists under the

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<sup>206</sup>*Highberry Limited v Colt Telecom Group Plc* [2002] EWHC 2815.

<sup>207</sup> [2008] Bus LR 1562.

<sup>208</sup> Another Australian judicial decision (*Lewis v Doran*, [2005] N.S.W.C.A. 243.) cited in the Cheyne judgment held –“it is a fact sensitive question depending upon the nature of the company's business and, if known, of its future liabilities”.

<sup>209</sup>[2014] EWCA Civ 383.

<sup>210</sup>These assets include the present assets of the company valued at their present value, and contingent and prospective assets will not be considered.

<sup>211</sup> Roy Goode, *Principles of Corporate Insolvency Law* (4th edn, Thomson Sweet & Maxwell 2011).

<sup>212</sup> Olivares- Caminal et al.

UK law is the Eurosail judgment. The Supreme Court of UK elucidated the following factors for the determination of balance sheet insolvency – (i) The balance sheet test doesn't have to be interpreted literally (in the sense of an examination of what appears on the company's balance sheet only) because there is no statutory provision linking section 123(2) of the IA 1986 to the detailed provisions of the Companies Act 2006 as to the form and contents of a company's financial statements. Therefore it is far from an exact test and will depend on all the circumstances of the company's business; (ii) the “point of no return” test goes beyond the need for a petitioner to satisfy the court that, on the balance of probabilities, a company has insufficient assets to be able to meet all of its liabilities, including prospective and contingent liabilities. The Supreme Court accepted that the test was good in so far as it elucidated the purpose of Section 123(2) but should not be read to be a paraphrase of Section 123(2) of IA 1986 or as setting a higher standard of proof to be met by the petitioners; (iii) The court must be satisfied that, on the balance of probabilities: a company has insufficient assets to be able to meet all of its liabilities, including prospective and contingent liabilities, if and when they eventually fall due; and that there will therefore “*eventually be a deficiency*”.

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The BLRC is of the opinion that in order to re-instate the debt enforcement function of the statutory demand test, cash flow / commercial insolvency tests should not be read into that test. In other words, if a company fails to pay an undisputed debt of prescribed value, the creditor should be entitled to a winding up order irrespective of whether it is insolvent (in commercial or balance sheet terms) or not. It is important to note that although a creditor should be entitled to a winding up order on failure to pay such debt, the NCLT should have the discretion to refer the company for rehabilitation under Chapter XIX (before making a winding up order), if the company appears to be *prima facie* viable. Such power of the NCLT will prevent liquidation of viable companies on failure to pay single undisputed debt.

Further, in order to avoid any overlap with the statutory demand test, the tests of commercial insolvency and balance sheet insolvency should be recognised as separate grounds on which a company shall be deemed to be unable to pay its debts. These tests should be defined in the statute itself but unlike the statutory demand test, will require a more detailed examination of the financial status of the company to conclude the existence of insolvency.

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### **Recommendations:**

- *In order to re-instate the debt enforcement function of the statutory demand test for winding up, if a company fails to pay an undisputed debt of a prescribed value as per Section 271(2) (a), the creditor should be entitled to a winding up order irrespective of whether it is insolvent (in commercial or balance sheet terms) or not. Further, the NCLT should have the discretion to refer the company for rehabilitation under Chapter XIX before making a winding up order on such ground, if the company appears to be *prima facie* viable. Further, in order to prevent abuse of the provision by creditors and ensure that it is not used to force debtor companies to settle disputed debts, the provision should specify the factors that the NCLT may take into account to determine whether the debt under consideration is disputed or not. As laid down by the courts, a petition may be dismissed if the debt in question is *bona fide* disputed, i.e., where the following conditions are satisfied: (i) the defence of the debtor company is genuine, substantial and in good faith; (ii) the defence is likely to succeed on a point of law; and (iii) the debtor company adduces *prima facie* proof of the facts on which the defence depends. Further, as with initiation of rescue proceedings, the*

*NCLT should also have the power to impose sanctions/costs/damages on a petitioning creditor and disallow reapplications on the same grounds if it finds that a petition has been filed to abuse the process of law.*

- *The Government may also consider revising the present value for triggering the statutory demand test under Section 271 (2) (a) from ‘one lakh rupees’ to a higher amount or revise the provision to state ‘one lakh rupees or such amount as may be prescribed’.*
- *‘Balance sheet insolvency’ and ‘commercial insolvency’ should be identified as separate grounds indicating a company’s ‘inability to pay debt’ in order to avoid conflicts/confusion with the statutory demand test (as is the case of the IA 1986 where the statutory demand test, the commercial insolvency test and the balance sheet insolvency test are alternate grounds for determining a company’s inability to pay debts under Sections 123(1) (a) ,123 (1) (e) and 123(2), respectively).*

## B. PRIORITY OF PAYMENTS

The provisions of the CA 2013 lay down a very complicated system for payments to be made in a winding up.<sup>213</sup> Such a complicated system increases uncertainty, costs and leads to delays as the ascertainment of claims, sums payable under those claims as well as the distribution of assets in winding up becomes a very difficult exercise. Therefore, the provisions relating to priority of payments and preferential payments need to be simplified and made more transparent in line with international best practices. Specifically, two issues need to be addressed- rights of secured creditors in the event of an insolvency and the status of the government as a preferred creditor.

### a. PRIORITY RIGHTS OF SECURED CREDITORS

The secured creditor has the option to relinquish his security and prove his debt in the winding-up proceedings or independently enforce the security outside the winding up proceedings by way of an action for debt enforcement. However, the preferential status of the secured creditor is subject to certain exceptions.

In terms of Section 529 of the CA 1956 (or Section 325 of CA 2013), the security of every secured creditor is deemed to be subject to a *pari passu* charge in favour of the ‘workmen’<sup>214</sup> to the extent of the workmen’s portion therein. The workmen’s ‘portion’ in relation to a security for any secured creditor is equal to such percentage of the value of the security that is equal to the percentage that the workmen’s dues constitute of the sum of (a) the total amount of the debts due to all the secured creditors and (b) the workmen’s dues. In other words, if the value of the security for a secured creditor is INR 1,00,000, the workmen’s dues are INR 1,00,000, and the amounts dues to all the secured creditors is INR 3,00,000, then the workmen’s portion of the security in question is INR 25,000 (i.e., 25% of the value of the security, as the workmen’s dues also amount to 25% of the sum of total debt owed to secured creditors - INR 3,00,000 – and the workmen’s dues - INR 1,00,000). Therefore, if a secured creditor decides to enforce his security interest outside the winding up proceedings, such proceeds will be subject to a charge in favour of the workmen as per the above formula. However, such unrealised portion of the debt of the secured creditors that could not be recovered completely because of the

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<sup>213</sup> Section 325-327, CA 2013.

<sup>214</sup> As defined in the Industrial Disputes Act 1947.

operation of Section 529 is required to be paid to them in priority over all other debts in the winding up of a company. As per Section 529A of CA 1956 (or Section 326 of CA 2013), (a) workmen's dues and (b) the dues of the secured creditors that could not be recovered completely (outside the winding up proceedings) because of the operation of Section 529 of CA 1956 (or Section 325 of CA 2013) are to be paid before any other debt, out of the proceeds realised from the other assets of the company (during the course of winding up). The Supreme Court in *Jitendra Nath Singh v. Official Liquidator*<sup>215</sup> has clarified that, "... only such debts due to the secured creditor which rank *pari passu* with dues of the workmen under Clause (c) of the proviso to Sub-section (1) of Section 529 have to be paid in priority over all other debts of the company. The High Court has clearly fallen in error by holding that all debts due to secured creditors will rank *pari passu* with the workmen's dues and have to be paid along with the workmen's dues in priority to all other debts of the company." The effect of these provisions is that while a secured creditor may be able to realise his security outside the winding up proceedings, the proceeds of such sale will remain subject to a charge in favour of the workmen in accordance with Sections 529 and 529A of CA 1956 (or Sections 325 and 326 of CA 2013), i.e., such creditor may retain the sale proceeds of his secured assets after depositing the specified portion of the workmen's dues.

Further, while in general, dues of the Government get priority over debts owed to unsecured creditors only, where the tax or revenue payable to the Government is by virtue of a specific statutory provision made as a first charge on the assets of the assessee, such tax or revenue gets priority over secured creditors as well.<sup>216</sup> There are various judicial precedents also which affect the preferential status of the secured creditors. For instance, in *Employees Provident Fund Commissioner v. O.L. of Esskay Pharmaceuticals Limited*<sup>217</sup>, where there was a conflict between two central legislations (the Employee Provident Funds and Miscellaneous Provisions Act, 1952 ("EPF Act") and the CA, 1956), the Supreme Court observed that the EPF Act being a social legislation formulated for the welfare of employees will prevail over the inconsistent provisions of CA 1956, a subsequent legislation<sup>218</sup> (the inconsistency was that the EPF Act gave priority to the employees' contribution over all other debts whereas the CA 1956 placed the dues of the secured creditors and the workmen at par in a specific situation).

Furthermore, the basic principle applied by the Supreme Court, when pronouncing judgments in relation to the priority to be given to government debts vis-a-vis secured debts appears to be that firstly, the common law doctrine (i.e. absolute priority to government debts) existing on the date of coming into force of the Constitution must yield to a statutory provision enacted by the central or the state legislature, and secondly, that the state legislation should not be inconsistent with any central legislation occupying the same field (or there should be no ostensible overlap between a state and central legislation occupying different fields).<sup>219</sup> However, this has given rise to several conflicting judicial precedents on this aspect.

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<sup>215</sup> (2013)1 SCC 462.

<sup>216</sup> M.R.Umarji, *Law & Practice relating to Securitization & Reconstruction of Financial Assets & Enforcement of Security Interest* (6<sup>th</sup> edn., Taxmann Publications Private Limited 2014).

<sup>217</sup> AIR 2012 SC 11.

<sup>218</sup> Especially in view of *A.P. State Financial Corporation v. Official Liquidator* ((2000) 7 SCC 291) wherein the Supreme Court held that the relevant provisions under the CA 1956 (Section 529, 529A) would prevail over the State Financial Corporation Act, 1951 in view of the settled position of law that a legislation later in point of time prevails over an earlier legislation by virtue of the non-obstante clause.

<sup>219</sup> *Central Bank of India v State of Kerala*, [2010] 153 CompCas 497 (SC).

On the one hand, there are judgments<sup>220</sup> which uphold the statutory priority in state legislations which give absolute priority to government debts over all other debts (including debts of secured creditors), whereas on the other hand there are more recent judgments which uphold state legislations<sup>221</sup> / stock exchange rules approved by the central government<sup>222</sup> which have express provisions giving absolute priority to secured debts over all debts including government debts.

This position is in stark contrast to the position in many jurisdictions where the rights of secured creditors are given a great degree of protection.<sup>223</sup> In the UK, fixed charge holders are entitled to claim first, even over liquidator's fees and expenses, whereas there are certain carve-outs made from the assets available for distribution to floating charge holders (but this no longer includes debts owed to the Crown, like taxes).<sup>224</sup> In the US, secured creditors are entitled to claim first, even over the liquidator's fees and expenses.

Although subjecting the priority rights of secured creditors to the workmen's dues and dues under certain employee welfare laws like the EPF Act may be reasonable, there is a strong case to be made for not subjecting such rights to crown debt. 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*.

Moreover, the dues payable to the Government in such circumstances are unlikely to be significant when compared to total government receipts, whereas the impact of non-payment on commercial creditors (including public sector banks) is likely to be substantial and may even lead to their insolvency<sup>225</sup> and systemic issues for the economy. As noted by the *Committee on Financial Sector Reforms*, "The government, which has substantial powers to recover arrears to it prior to bankruptcy, should not stand ahead of secured creditors."

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<sup>220</sup> *Dena Bank v. Bhikhabhai Prabhudas Parekh & Co. & Ors*, AIR 2000 SC 3654; *State Bank of Bikaner & Jaipur v. National Iron & Steel Rolling Corporation and Ors.*, (1995) 2 SCC 19; *State of Madhya Pradesh and Anr. v. State Bank of Indore and Ors.*, (2002) 10 SCC 441; *Orissa State Financial Corporation v. Commnr. Of Commercial Taxes and Ors.*, (2013) 14 SCC 619.

<sup>221</sup> *Union of India (UOI) and Ors. V. SICOM Ltd. and Anr.*, (2009) 2 SCC 121; *Rana Girders v UOI* (AIR 2013 SC 3422).

<sup>222</sup> *The Stock Exchange v. V.S. Kandalgaonkar*, [2014] 187 CompCas 143 (SC).

<sup>223</sup> Section 59, 60, 61, IA 1986; Chapter V, VII, US Bankruptcy Code.

<sup>224</sup> *Ibid.*

<sup>225</sup> Morgan.

## b. PRIORITY FOR GOVERNMENT DEBTS (CROWN DEBTS) OVER UNSECURED CREDITORS

The preferential status given to dues of the Government/Crown has been a controversial issue in many jurisdictions. The origins of the preference for Crown debt can be traced back to UK, where the Crown was entitled to an absolute priority for revenue-related debts in the event of the insolvency of a subject.<sup>226</sup> This common law doctrine was later exported to other countries, including India, to grant preferential status over other debts to the government in the absence of a monarch.<sup>227</sup> However, under the Indian law, two significant qualifications to this doctrine were laid down by the Supreme Court<sup>228</sup> - (i) the preferential status of the government debt is largely confined only to unsecured creditors (with the exception of the circumstances discussed in the previous section) and such preferential right is not available over debts of a mortgagee or pledgee of goods or a secured creditor, as the rights of the latter are complete and perfect before that of the crown; and (ii) the doctrine may not be applicable when the welfare state enters into commercial fields which cannot be regarded as an essential and integral part of the basic government functions of the State.

The main reasons behind giving preferential status to the Crown are: (i) unlike the claims of private creditors, revenue-related claims of the Government are for the benefit of the community- granting priority usually prevents the costs of insolvency from being borne by taxpayers; (ii) the Crown is a non-adjusting creditor in that it cannot choose the debtor or obtain security for its dues; (iii) in cases where the debtor collects taxes on behalf of the Crown (sales tax, value added tax etc.), if no priority is given to the Crown, the moneys so collected will result in a windfall for other unsecured creditors; (iii) if the Crown is not given some security through preferential status, the Crown may not negotiate repayments with debtors, thus precipitating unnecessary business failures.<sup>229</sup> However, these arguments have been countered by critics of the Crown preference. The Crown is often able to adjust tax levels in a manner that anticipates the risk of default. Further, as discussed earlier, the dues payable to the Crown are unlikely to be significant when compared to total government receipts, whereas the impact of non-payment on private commercial creditors is likely to be substantial and may even lead to their insolvency.<sup>230</sup> It has also been argued that the Crown has other means of enforcing its debts, which private creditors do not have recourse to, such as imposition of penalties, higher interest rates, statutory liens and levies.<sup>231</sup> Thus, it seems clear that the arguments for granting Crown preference are tenuous.

Taking these arguments into consideration, many jurisdictions have moved towards abolishing or limiting the status of the Crown as a preferential creditor.<sup>232</sup> In the UK, after the enactment of the Enterprise Act 2002, Crown preference has been abolished- the Crown now takes in *pari passu* with ordinary unsecured creditors. In Germany, a flat priority system is followed with the Crown being

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<sup>226</sup> Barbara Morgan, *Should the Sovereign be Paid First? A Comparative International Analysis of the Priority for Tax Claims in Bankruptcy*, 74 Am. Bankr. L.J. 461, Fall 2000.

<sup>227</sup> Morgan.

<sup>228</sup> *Dena Bank v. Bhikhabhai Prabhudas Parekh & Co. & Ors*, AIR 2000 SC 3654

<sup>229</sup> Morgan.

<sup>230</sup> Morgan.

<sup>231</sup> Morgan.

<sup>232</sup>For example, the UK, Germany and Australia.



treated on par with other unsecured creditors.<sup>233</sup> Australia has also abolished priority for tax claims, while strengthening the powers of taxing authorities through statutory liens, personal liability of directors etc.<sup>234</sup> It is pertinent to note that though the common law doctrine was exported into the Indian legal regime from England and applied and adopted by the Indian courts, we have failed to take cognizance of the later developments in terms of the abolition of this doctrine.

Thus, it is evident that the preferential status given to the Crown in winding up stands on a shaky ground. Having said that, the BLRC notes that if the preferential status of the Crown over unsecured creditors is removed without qualifications, the possibility of misuse cannot be ruled out (for instance, related parties being used in the garb of unsecured creditors to misuse the benefit). Consequently, further consultations with the stakeholders is required before introducing any such change.

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**Recommendations:**

- *Subject to the pari passu charge in favour of the workmen as envisaged in Section 325 of CA 2013 or rights of the employees under employee welfare legislation like the EPF Act, there should be a separate declaratory provision that upholds the priority rights of secured creditors on their security interests notwithstanding anything to the contrary contained in any state or central law that imposes a tax or revenue payable to the Government by virtue of a specific statutory provision made as a first charge on the assets of the assessee; provided that such first charge may be allowed for claims that existed on the date when such security interest was created.*<sup>235</sup>

**Question for Consideration for the Insolvency Code:**

- i. *Should the preferential status of the Crown over unsecured creditors under insolvency law be abolished? If so, what safeguards should be provided to mitigate the possibility of misuse of such benefit?*

### C. STRENGTHENING PROVISIONS ON AVOIDANCE OF CERTAIN TRANSACTIONS IN WINDING UP

If liquidation proceedings are to be fair to all creditors, insolvency law must provide for protection of the collective nature of the insolvency process, and promote adherence to the principle of *pari passu* distribution of assets.<sup>236</sup> For this reason, the law on avoidance of transactions seeks to invalidate certain

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<sup>233</sup> Morgan.

<sup>234</sup> Morgan.

<sup>235</sup> The statute for Goods and Service Tax that will replace state specific sales tax statutes could also provide for this in line with Section 11E of the Central Excise Act, 1944 with appropriate modifications. For avoidance of doubt, it is clarified that the exception for claims existing on the date of creation of the security interest will not disturb the priority rights of the secured creditors under statutes that recognise such rights of secured creditors without any such exception.

<sup>236</sup> Finch.

transactions which result in dispositions of the company's property in the lead up to insolvency other than for full value, or payments that unduly benefit certain creditors at the expense of others.

The CA 2013 contains several provisions which invalidate transactions entered into within specific periods prior to the company's insolvency, such as provisions invalidating fraudulent preferences, late floating charges other than for new value and provisions preventing transfers prior to and during the winding up process. These provisions contain very few departures from the provisions under the CA 1956.

While the law on avoidance in the UK has evolved through legislative intervention and case law developments, the law on avoidance in India has become outmoded. Specifically, the scope of certain provisions need to be clarified, while other provisions need to be reinforced to provide for specific scrutiny of transactions involving related parties.

#### a. AVOIDANCE OF TRANSFERS NOT IN GOOD FAITH

Section 329 of the CA 2013 voids any transfer of property or delivery of goods made by a company within the period of one year before the presentation of a petition for winding up by the Court or the passing of a resolution for voluntary winding up, if such transfer/delivery is not made in the ordinary course of its business or in favour of a purchaser or encumbrancer in good faith and for valuable consideration. This provision is in *pari materia* with Section 531A of the CA 1956. There has been some indication from the courts that this provision strikes at undervalued transactions (similar to the provision avoiding transactions at undervalue contained in the IA 1986),<sup>237</sup> however, in practice it is not clear if the same sort of rigorous enquiry in the determination of undervalue transactions as done in the UK, is also followed in India.<sup>238</sup> Certainly the modern formulation of the undervalue transaction rule in the UK is different in its terms and scope to Section 531A, despite their common heritage. Therefore, there is a need to clarify the scope of Section 329, CA 2013 by laying down clear criteria for determination of whether the transaction is at undervalue.

#### b. INCLUSION OF A PROVISION VOIDING TRANSACTIONS DEFRAUDING CREDITORS

In the UK, Section 423 of the IA 1986 voids transactions at undervalue if such transactions have been entered into with the intention of putting the assets beyond the reach of, or otherwise prejudicing the interests of a person who is making or may make a claim against the company. While the scope of this provision is similar to that of the provision avoiding transactions at undervalue (Section 238, IA 1986), Section 423 actions differ in that they do not have any time limit for the challenged transactions, and is available in and outside formal insolvency proceedings. The inclusion of such a provision in the CA 2013 would reinforce the protection given to creditors under avoidance law by permitting the liquidator to set aside transactions entered into prior to the one year period ending in the company's insolvency. This is necessary to guard against the siphoning away of corporate assets by managers who have knowledge of the company's financial affairs in cases where a long period of financial trouble, extending over a year, ends in insolvency.

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<sup>237</sup> See Section 238, IA 1986.

<sup>238</sup> See *Monark Enterprises v Kishan Tulpule* [1992] 74 CompCas 89 (Bombay); *Hawa Controls v Official Liquidator of Tirupati Foundry Private Ltd.* [2008]172 CompCas 528 (Gujarat).

### c. TRANSACTIONS WITH RELATED PARTIES

The law on avoidance in the UK provides for close scrutiny of transactions entered into with persons connected with the company (other than employees) by incorporating longer time periods in relation to which such transactions can be challenged. Thus, while the relevant time period for avoiding preferences is six months prior to the onset of insolvency, the time period is increased to two years in the case of persons connected with the company.<sup>239</sup> Similarly, for late floating charges other than for new value, the vulnerability period for non-connected persons is twelve months while it is two years in the case of connected persons.<sup>240</sup> The avoidance provisions under the CA 2013 does not provide for longer time periods in case the transactions are with connected persons. It is submitted that providing for longer time periods for vulnerability would be significant in improving the efficacy of these provisions. This is because a wider range of transactions diminishing creditor wealth entered into with insiders occur not in the 'zone of insolvency' but as soon as early signals of trouble are visible. Such insiders have superior information of the company's deteriorating financial position and may raid corporate assets knowing that the company may become insolvent. These provisions are of special significance in the Indian context where even the larger corporates are often promoter/family controlled with such insiders often enjoying significant informational advantages over even well advised secured lenders.

### d. IMPROVING THE EFFECTIVENESS OF THE AVOIDANCE PROVISIONS

Anecdotal evidence on the working of the avoidance provisions under the CA 1956 indicate that these provisions have been a failure in protecting creditor interests. The Official Liquidator was faced with severe resource constraints in prosecuting these cases. The Official Liquidator also did not have access to reliable information regarding the financial affairs of the company. Moreover, funding constraints (see section E, below) have acted as a deterrent to pursuing such actions. Therefore, it is evident that the law on the books has to be supplemented with the provision of adequate support to liquidators to pursue such actions.

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#### **Recommendations:**

- *Section 329, CA 2013 should be suitably amended in line with Section 238 of IA 1986 to lay down clear criteria for challenging undervalue transactions in the lead-up to the insolvency.*
- *A provision invalidating transactions defrauding creditors similar to Section 423 of the IA 1986 should be inserted in CA 2013. Such provision would apply without any time limits and should be available in and outside formal insolvency proceedings.*
- *The avoidance provisions under the CA 2013 (Sections 328 and 329) should be strengthened by providing for a longer vulnerability period (up to two years) for avoiding transactions entered into with related parties of the company.*

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<sup>239</sup> Section 240, IA 1986.

<sup>240</sup> Section 245(2), IA 1986.

#### D. STRENGTHENING MANAGERIAL ACCOUNTABILITY PROVISIONS IN WINDING UP

The management of a company enjoys wide powers in the running of the company and its business. While such powers to make business decisions are often exercised for the benefit of the company and its shareholders, unscrupulous managers may misuse such powers and put the interest of the company and its creditors at risk. In the lead up to insolvency, the managers may be incentivized to take more risks to save the business (knowing that the upside to such risks would be enjoyed by them but the downsides will be borne by the creditors). There may also be a heightened risk of fraudulent activity, for example, the transfer of assets to persons connected with the company. The need to limit managerial discretion, particularly when the company is in dire financial straits and is set to be wound up thus becomes necessary for protection of its creditors.

The CA 2013 contains a number of provisions which provide for the initiation of criminal proceedings against delinquent officers of the company or the imposition of personal liability on such officers to contribute to the company's assets. However, there are a number of issues which need to be resolved if the CA 2013 is to provide an effective regime for deterrence of managerial misconduct and punishment of offenders.

Anecdotal evidence concerning the corresponding provisions on managerial liability under the CA 1956 suggests that the provisions have not succeeded in holding directors responsible. Interestingly, the evidence points to the existence of a practice whereby promoters resign from directorships and key managerial positions by the time the winding up order is made, installing employees (who act as proxies for such promoters) as directors in their place. Such 'employee-directors' then act as directors of the company which has already been stripped off valuable assets throughout the duration of insolvency proceedings. In such cases, it has been difficult to hold the promoters who are responsible for the company's failure accountable as they would have long ceased holding key managerial positions. While the managers can theoretically be held liable for transactions entered into while they were in office, prosecution in such cases has been found to be extremely difficult in practice.

The evidence also suggests that provisions relating to the prosecution of directors have been rendered ineffective due to funding constraints and lack of institutional capacity. The total number of Official Liquidators is grossly inadequate in comparison to the number of liquidations being initiated. As a consequence, Official Liquidators are currently overburdened, and are forced to give less priority to prosecutions under provisions imposing liability on directors. Further, Official Liquidators do not get adequate support in the form of legal assistance as the standing counsel assigned to him/her prosecutes cases relating to 60-70 companies (even 200 companies in some cases). Therefore, they are often forced to seek multiple adjournments, delaying such prosecutions even further.

It is also suggested that Official Liquidators faced informational constraints in that the financial information relating to the company was often unreliable or incomplete. The Registrars of Companies, on whom the Official Liquidators have to rely for obtaining data relating to the company are overburdened, and consequently not able to provide the required assistance efficiently. Therefore, a large number of cases seeking to impose liability on the directors of the insolvent company are dismissed on account of lack of sufficient supporting evidence in the form of financial data. This evidence indicates that there is a need to build institutional capacity and address issues relating to informational and financial constraints to ensure that the provisions in the CA 2013 deter managerial misconduct, particularly in the run up to insolvency. It may be noted that Section 287 of CA 2013 envisages an 'advisory committee' (which can include creditors) to assist the company liquidator, which

can be constituted by the NCLT at the time of making a winding up order. Such advisory committee is specifically empowered to examine the books and accounts of the company.

Further, the provisions under the CA 2013 do not recognise the existence of a duty on the directors to consider creditor interests when the company is in financial distress. Conventional corporate law jurisprudence says that the directors are primarily responsible to the company and its shareholders. However, given the societal losses associated with creditor losses and the risk of a creditor contagion, it has been argued that the directors of companies in financial distress should also be liable to the creditors in certain situations. The wrongful trading provision of the IA 1986 subjects directors to personal liability if they fail to take reasonable steps to minimize the potential loss to the creditors when there is no possibility of avoiding insolvent liquidation. Such directors may be liable to make contributions to the assets of the insolvent company, which could then be distributed to the creditors.

It may also be noted that US courts have observed that creditors cannot bring cases against the directors for breach of fiduciary duties whether before or after insolvency (*North American Catholic Educational Programming Foundation Inc. v Gheewalla*<sup>241</sup>), i.e. the directors do not owe any direct duty to the creditors. Courts in the UK have also recognized that directors owe no direct duties to the creditors. However, some courts in the US (and the UK) have held that the duties of directors to the company should be adjusted to reflect the fact that when the company is insolvent or in the ‘zone of insolvency’, the residual claimants are the creditors and not the shareholders (*Credit Lyonnais, N.V v Path Communications Corp.*<sup>242</sup> in the US and *West Mercia Safety wear v Dodd*<sup>243</sup> in the UK)<sup>244</sup>. Such shift of duty appears to have been recognised in certain situations by Indian courts as well.<sup>245</sup> Recent incidents of corporate collapses in India show us that the directors and management may underestimate the risks of their actions and overestimate their own ability to save a failing business. At such instances, the law should step in to protect other stakeholders before a company goes beyond redemption. When a company is in financial distress, such shift of duty in favour of creditors should be recognized under Indian law as well. The introduction of a wrongful trading remedy under Indian law could be considered in this regard as it would prevent directors from taking a gamble on the company’s fortunes at creditors’ risk. An overview of the law on the wrongful trading remedy is as follows:

#### a. INTRODUCING THE WRONGFUL TRADING PROVISION

The first attempt to include a provision on wrongful trading and mismanagement under company law in the UK was made by the Greene Committee on Company Law Reforms.<sup>246</sup> The said recommendation

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<sup>241</sup>930 A.2d 92 (Del. 2007).

<sup>242</sup>Civ. A. No. 12150, 1991 WL 277613, (Del. Ch. Dec. 30, 1991).

<sup>243</sup>[1988] BCLC 250.

<sup>244</sup> The shift under Delaware law occurs on ‘insolvency’, and not in the ‘zone of insolvency’ (while the UK shift does occur in the zone): see *North American Catholic Educational Programming v Gheewalla*.

<sup>245</sup> See for example the Karnataka High Court decision in *Chamundi Chemicals and Fertilisers Ltd (in liquidation) v M C Cherian [1993] 77 CompCas 1* and the Supreme Court decision in *Bakemans Industries Pvt Ltd v New Cawnpore Flour Mills AIR 2008 SC 2699*.

<sup>246</sup> Andrew Keaya, and Michael Murray, ‘Making Company Directors Liable: A Comparative Analysis of Wrongful Trading in the United Kingdom and Insolvent Trading in Australia’, *Int. Insolv. Rev.*, Vol. 14 (2005) 27-55 (hereinafter referred to as “Keaya & Murray”)

envisaged criminal liability for the responsible directors through proof of intent.<sup>247</sup> However, on account of various inadequacies noted by the UK Insolvency Law Review Committee (“**Cork Committee**”) in its report in 1982, a form of civil liability was recommended by the Cork Committee to deal with the issues surrounding fraudulent trading and mismanagement of the company’s affairs.<sup>248</sup> It may be noted that although there did exist a provision on fraudulent trading, the committee was concerned about the narrowness of the provision (since it required proof of the carrying on of business with intent to defraud): hence the committee’s recommendation of parallel civil liability for wrongful trading, which would not require proof of intent to defraud. This recommendation was accepted and Section 214 was subsequently included into the Insolvency Act of 1986.<sup>249</sup> The main purpose of the provision is to minimise losses for the creditors and not to penalise the directors, after it has been discerned that a company is inevitably going into an insolvent liquidation.<sup>250</sup>

Under Section 214 of IA 1986, the director of the company can be made liable to make contributions to the company’s assets in an insolvent liquidation, if at some point before liquidation, the director knew or had reason to conclude that there was no reasonable prospect of the company avoiding going into insolvent liquidation.<sup>251</sup> In this context, insolvent liquidation implies a form of liquidation of a company wherein its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up (i.e, this provision relates to balance-sheet insolvency and not a cash-flow insolvency).<sup>252</sup> The directors for the purposes of this provision, include shadow directors of the company as well.<sup>253</sup>

The operation of the provision is dependent upon three conditions namely, (i) a company going into (balance-sheet) insolvent liquidation, (ii) the director’s knowledge (or where he ought to have known) that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and (iii) the director holding his position as the director in the company at the time of his knowledge.<sup>254</sup> The Court is however not to make any order for contribution by the director where it is satisfied that the director, after learning that there was no reasonable prospect of saving the company from liquidation (or the time when she or he ought to have concluded this), took every step that he ought to have taken to minimise the potential loss to the company’s creditors.<sup>255</sup> In instances where the company lacks proper accounting records, the liability of the director is assessed through quantification of the aggregate

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<sup>247</sup> *Ibid.*

<sup>248</sup> Edward Bailey & Hugo Groves, *Corporate Insolvency: Law and Practice*, Third Edition (LexisNexis Butterworths, 2007) p. 698. (hereinafter referred to as “Edward Bailey & Hugo Groves”).

<sup>249</sup> Keaya & Murray.

<sup>250</sup> Edward Bailey & Hugo Groves.

<sup>251</sup> Section 214 (1), IA 1986. It may be noted that the starting point for liability under Section 214 is the increase in net deficiency, i.e., increase in deficiency of funds owed to the creditors in the relevant period.

<sup>252</sup> Section 214 (6), IA 1986.

<sup>253</sup> Section 214 (7), IA 1986.

<sup>254</sup> Section 214 (2), IA 1986.

<sup>255</sup> Section 214 (3), IA 1986.

debts incurred after wrongful trading began.<sup>256</sup> It is pertinent to note that in determining the knowledge of the director, the Court not only looks at the available financial and accountancy records of the company but also at the time when the proper accounts should have been laid and filed (even if they were not prepared by that time). In the case of *Re Produce Marketing Consortium Ltd (No. 2)*<sup>257</sup>, this was followed as the Court ruled that the directors had knowledge about the company's affairs in spite of absence of records.

The level of awareness and skill expected of a director, under the impugned section, is that which is known or ascertained, or reached by a reasonably diligent person having both (i) the general knowledge, skill and experience reasonably expected of a director of a company, and (ii) the general knowledge, skill and experience that the director actually possesses.<sup>258</sup> Further, the functions carried out in relation to a company by the director of the company include functions which he does not carry out but which are entrusted to him.<sup>259</sup>

In establishing knowledge of a director, the objective component of general knowledge, skill and experience required of a director a company along with the subjective component of general knowledge, skill and experience that a particular director actually has, needs to be satisfied.<sup>260</sup> The size and complexity of the company and its business are crucial elements for establishing knowledge, since in a more complex business operation the level of skill and care required is higher in comparison to a smaller and simpler operation.<sup>261</sup> An examination of the qualifications of the director also assist the Court in assessing the level of actual or presumed knowledge.<sup>262</sup> The hurdle of proving the requisite knowledge of there being 'no reasonable prospect of avoiding an insolvent liquidation' rests on the liquidator making the application.<sup>263</sup>

The main defence that a director can resort to in action for wrongful trading is that on becoming aware of no reasonable prospect of avoiding insolvent liquidation, the director took every step that a reasonably diligent person would take in order to minimise the potential loss to the creditors.<sup>264</sup> Some of the matters that have been suggested to be considered by directors, on becoming aware of the company's uncertain affairs are:-

- a. Calling a meeting of the creditors to inform them of the financial state of the company;
- b. Considering liquidation of the company or inviting a lender to appoint a receiver;

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<sup>256</sup> *Re Purpoint Ltd.*, [1991] B.C.C. 121.

<sup>257</sup> (1989) 5 B.C.C. 569

<sup>258</sup> Section 214 (4), IA 1986.

<sup>259</sup> Edward Bailey & Hugo Groves at p. 700.

<sup>260</sup> Edward Bailey & Hugo Groves at p. 702.

<sup>261</sup> *Ibid.*

<sup>262</sup> *Ibid.*

<sup>263</sup> *Ibid.*

<sup>264</sup> Edward Bailey & Hugo Groves at p. 704.

- c. Taking a call on discontinuing trade, as in certain instances that could lead to aggravation of losses rather than improvement;
- d. Consulting professional advisors about the financial viability of the company;
- e. Holding regular directors' meeting to review the situation with up-to-date financial information, as feasible and possible;
- f. Keeping minutes of directors' and creditors' meetings and considering rationalisation programmes, such as reducing employees or cutting back on the company's perks;
- g. Considering resignation, as even though it may not free the director from liability, it may be the only option available to the director in instances where the board ignores his/her warnings.<sup>265</sup>

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**Recommendations:**

- *All efforts must be made to ensure that the liquidators and their counsels are sufficiently equipped and have all necessary resources to: (a) discharge their duties efficiently; (b) bring cases against the management for committing offences contemplated in the law during the course of liquidation; and (c) effectively manage the costs associated with achieving these functions. Further, appropriate institutional capacity needs to be built to address issues relating to informational and financial constraints faced by the liquidators in bringing cases against the delinquent management. The 'advisory committee' consisting of creditors (as envisaged under Section 287 of CA 2013) should be utilised for bridging this gap.*
- *CA 2013 should be amended to introduce a provision for a civil remedy for 'wrongful trading' similar to Section 214, IA 1986 with appropriate carve-outs for independent and non-executive directors in line with Section 149 (12) of CA 2013.*

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<sup>265</sup> *Ibid.*



## 6. ISSUES RELEVANT FOR BOTH RESCUE AND LIQUIDATION

### 6.1. FORUM

#### A. IMPACT OF THE SUPREME COURT RULINGS ON THE NATIONAL COMPANY LAW TRIBUNAL AND THE NATIONAL TAX TRIBUNAL

As discussed before, the CA 2013 provides for the establishment of the NCLT to deal with, *inter alia*, the revival and rehabilitation of sick companies and the winding up of companies. The establishment of the NCLT was originally proposed by way of an amendment to CA 1956 in 2002. However, the NCLT was never established under CA 1956, as the relevant provisions of the Companies (Second Amendment) Act, 2002 could not be notified for commencement. The NCLT proposed under the CA 2013 has also not been established yet. The BLRC notes that in spite of having been first proposed more than twelve years ago, the NCLT has not been operationalised on account of multiple challenges before courts. Although, the Supreme Court in the NCLT case had held certain provisions of CA 1956 relating to the NCLT and the NCLAT to be unconstitutional, the NCLT and NCLAT were themselves held to be constitutional.

However, the BLRC notes that the CA 2013 does not comply with all the observations of the Supreme Court in the NCLT case. Moreover, in light of a recent ruling by a Constitution Bench of the Supreme Court on the 25th of September, 2014 in the NTT case which struck down the National Tax Tribunals Act, 2005 (“**NTT Act**”), several other amendments may be required to the CA 2013 to prevent further challenges. The National Tax Tribunal (“**NTT**”) was set up to take over the existing jurisdiction of High Courts in India to hear and decide appeals pertaining to ‘questions of law’ relating to Income Tax, Customs, Central Excise and Service Tax matters, arising from the Income Tax Appellate Tribunal and the Customs, Excise and Service Tax Appellate Tribunal. While the power of the legislature under Article 323B of the Constitution to create by law, any tribunal and vest any jurisdiction upon such tribunal as the legislature so chooses was upheld, the Supreme Court has laid down that Tribunals which are vested with the jurisdiction of Courts should enjoy the same constitutional protections and features as Courts whose jurisdictions they are replacing. The NTT was struck down as being unconstitutional, since it was a tribunal which had been vested with the extant subject matter jurisdiction of a High Court<sup>266</sup>, but did not enjoy at least as much of the Constitutional protection that the High Court enjoyed in respect of its independence from the Executive.<sup>267</sup> Moreover, the Court also struck down provisions of the NTT Act on the ground that they were responsible for the NTT being a less efficacious remedy than the High Courts it was supposed to replace.<sup>268</sup> Thus, Sections 5, 6, 7, 8 and 13 of the NTT Act were held to be unconstitutional. Since these were the principal provisions of the NTT Act, the entire Act was held unconstitutional.

The NCLT is designed to replace the jurisdiction of the existing Company Law Board (CLB), the BIFR and **the High Court in the exercise of its jurisdiction as a Company Court**. Although most cases before the NCLT will be between private parties, there are several provisions under CA 2013 as per

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<sup>266</sup> See Section 15 of the NTT Act.

<sup>267</sup> NTT case, p. 225, para 89 (majority judgment) and p. 270 para 43 (concurring opinion of J Nariman).

<sup>268</sup> NTT case, p. 215, para 80.

which the Government will be the primary litigant before the NCLT. A non-exhaustive list of such provisions include:

- i. Presentation of a winding up petition of a company to the NCLT by the Registrar of Companies or by any person authorised by the Central Government in that behalf or by the Central Government or State Government (in circumstances as specified in Section 272) - one such ground being the company having acted against the interests of the sovereignty and integrity of India, the security of the State, friendly relations with other States, public order, decency and morality; It is important to mention that the jurisdiction for winding up of companies under CA 1956 presently lies with the designated Company Courts at the High Courts.
- ii. Appeal to the NCLT against orders of the Registrar of Companies or the Central Government under several provisions of CA 2013;
- iii. A reference may be made by the Central Government under Section 221 to the NCLT for freezing of assets of a company for a specified period of time during the investigation into the affairs of a company;
- iv. The Central Government may file an application before the NCLT for passing orders (relating to disgorgement of assets etc. or holding directors etc. personally liable) in cases of detection of fraud in a company under Section 224(5);
- v. The Central Government may make an application to the NCLT for relief in cases where it is of the opinion that the affairs of the company are being conducted in a manner prejudicial to public interest under Section 241.

The NCLAT on the other hand is empowered to hear appeals from the orders of the NCLT (and the Central Government too, in certain cases) in exercise of its jurisdiction under CA 2013. It replaces the jurisdiction of the High Court under Section 10F (appeals against the orders of the CLB) of CA 1956 and the AAIFR under Section 25 of the SICA. In view of the above, the provisions of CA 2013 relating to NCLT and NCLAT need to be analysed on certain specific parameters as laid out by the Supreme Court in the NTT case as well.

#### ANALYSIS AND IMPLICATIONS

Some of the parameters laid down by the Supreme Court in the *NTT case* were already discussed in the *NCLT case*. However, NTT case lays down some additional parameters, which also need to be considered. The following section identifies the key parameters that need to be considered for complying with the decisions of the Supreme Court in relation to the constitutional validity of a tribunal:

- (1) WHETHER THE TRIBUNAL TAKING OVER THE FUNCTION OF THE COURT IS AT LEAST AS GEOGRAPHICALLY WIDESPREAD AND ACCESSIBLE AS THE COURT IT SEEKS TO REPLACE?

The NCLT, replacing the jurisdiction of High Courts is required to have a presence in at least those States where the seat of High Court is located. However, sub-section (2) of Section 419 of CA 2013 creates only the principal bench of the Tribunal in New Delhi and leaves it up to the Central Government to decide the number of benches under sub-section (1). While this is not identical to sub-section (2) of Section 5 of the NTT Act, it does however leave it up to the discretion of the Central Government to set up the benches of the Tribunals where it deems fit. The fact that there is no positive mandate upon the Central Government to do so in the legislation is likely to affect the efficacy of the NCLT as a forum replacing the High Court. In the context of the NCLAT, which is also replacing the function of the High

Court insofar as appeals are concerned, there is no provision akin to Section 419 which prescribes where the seat of the Appellate Tribunal shall be. Consequently, we are of the view therefore that:

- a. *Sub-section (2) of Section 419 of CA 2013 may not withstand judicial scrutiny as it does not provide for at least one bench of the NCLT in each State where there exists a High Court.*
- b. *Section 410 of CA 2013, by not providing for a seat or even giving the Central Government powers to set up more benches of the NCLAT may not withstand judicial scrutiny, since there is no provision to create a principal bench or grant powers to the Chairperson of the NCLAT to constitute additional benches.*

(2) WHERE THE CENTRAL GOVERNMENT IS A PARTY IN EVERY CASE BEFORE THE TRIBUNAL OR WHERE THE TRIBUNAL'S JURISDICTION WAS VESTED EARLIER WITH THE HIGH COURT, WHETHER THE TRIBUNAL'S FUNCTIONING WITH RESPECT TO COMPOSITION AND JURISDICTION OF BENCHES OF THE TRIBUNAL AND TRANSFER OF MEMBERS IS VESTED WITH THE PRESIDENT OF THE TRIBUNAL?

This test will be applicable in the present case since both the NCLT and the NCLAT's jurisdiction, to some extent, was previously vested with the High Court. At present, there are no provisions which prescribe the manner in which benches will be constituted or the jurisdiction to be vested in such benches. It is unclear if the power will be exercised by the Central Government or by the President of the NCLT or the Chairperson of the NCLAT.

We are therefore of the view that:

- a. *There is an omission of a clause empowering the President of the NCLT to determine constitution of benches and the jurisdiction to be exercised by such benches and such omission may hamper the functioning of the NCLT.*
- b. *There is an omission of a clause empowering the Chairman of the NCLAT to determine constitution of benches of the NCLAT and the jurisdiction to be exercised by such benches and such omission may hamper the functioning of the NCLAT.*

(3) WHETHER THE PRESCRIBED QUALIFICATIONS OF THE MEMBERS OF THE TRIBUNAL ARE ADEQUATE TO ENABLE THE TRIBUNAL TO EXERCISE ITS JURISDICTION?

In order to be eligible to be the President of the NCLT, a person should have been a High Court judge for a period of five years. In order to be a "Judicial Member" a person should have been a judge of a High Court, a District Judge for at least five years or an advocate of a court for at least ten years.<sup>269</sup> In order to be eligible to be a "Technical Member", the person should have been

- a. A member of the Indian Corporate Law Service or the Indian legal service out of which at least three years' of service should be at Joint Secretary level
- b. A chartered accountant for at least fifteen years
- c. A company secretary for at least fifteen years

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<sup>269</sup> Section 409 CA 2013.

The Chairperson of the NCLAT is required to have been a judge of the Supreme Court of India or a Chief Justice of a High Court.<sup>270</sup> A judicial member should have been a judge of a High Court or a judicial member of the tribunal for five years.<sup>271</sup> A technical member is required to have “special knowledge and experience” in law, industrial finance, et al or has been a presiding officer of a Labour Court or National Tribunal constituted under the Industrial Disputes Act, 1947.<sup>272</sup>

In so far as the Supreme Court’s finding in the *NCLT case* in respect of the rank of the members being appointed as “technical members” is concerned, we find that Section 409 and Section 411 would be contrary to the finding of the Supreme Court that at least Additional Secretary level officers should be appointed to the NCLT and the NCLAT given the fact that the High Court jurisdiction is being vested with the Tribunals in question. As such the clauses which permit the appointment of Joint Secretary level officers may be struck down since it is not keeping in mind the requirement of independence of the judiciary as has been discussed in the *NTT* and *NCLAT* cases. Although Section 411 of CA 2013 does not per se prescribe the eligibility of serving Government officers to be appointed as Technical Members, the fact that some may be qualified by virtue of the expertise would mean that they would also have to meet the requirements of the test laid down by the Supreme Court in the *NCLT* case when it comes to the question of their rank.

Further, the requirement under Section 409 that a person has to be a High Court judge for a period of five years to be eligible to be appointed to the NCLT President is unlikely to pass the test of non-discrimination under Article 14 of the Constitution. While Article 14 of the Constitution permits classification in a law based on rational and intelligible criteria linked to the purposes of the law, it does not permit classification on bases that have no relation to the legislation itself.<sup>273</sup> As such the category of High Court judges being created by the Constitution, there cannot be a distinction between the eligibility of a High Court judge for a post-retirement post in a Tribunal on the basis of the time period for which they have been High Court judges.

For these reasons we are of the view that:

- a. *The requirement of five years of service as a High Court judge for appointment as President of the NCLT may be struck down on the ground being unconstitutional.*
- b. *The eligibility requirement for the members of the Indian Legal Service and Indian Corporate Law Service is not in accordance with the Supreme Court’s judgment in the NCLT Case and is likely to be struck down.*

(4) WHETHER THERE IS SUFFICIENT REPRESENTATION FOR LEGALLY TRAINED MEMBERS OF THE TRIBUNAL TO HELP PERFORM ADJUDICATORY FUNCTIONS?

Both the NCLT and the NCLAT are composed of judicial and “technical members” though CA 2013 does not give a break-up of the number of judicial and technical members required to be appointed, leaving it to the discretion of the Central Government. Section 419(3) provides that the powers of the

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<sup>270</sup> Section 411(1) CA 2013.

<sup>271</sup> Section 411(2) CA 2013.

<sup>272</sup> Section 411(3) CA 2013.

<sup>273</sup> *State of West Bengal v Anwar Ali Sarkar* 1952 SCR 284.

Tribunals shall be exercisable by benches consisting of two members, one judicial and one technical member. This ensures that there is adequate representation of the judicial members in the NCLT benches charged with hearing cases. In addition, the proviso to sub-section (3) also permits the single judicial member to exercise the functions of the bench. Moreover, sub-section (4) mandates that the special benches of the NCLT consisting of more than two members are to necessarily have a majority of judicial members. However, no similar clauses can be found in the context of the NCLAT. There is no clarity on the manner in which benches will be constituted and whether there will be a majority of judicial members on such benches. Read with the absence of a clause delegating powers of management of the NCLAT to the Chairperson, there is a serious constitutional defect in CA 2013 insofar as guarantees of independence of the Tribunal are concerned, especially when it has been vested with the functions hitherto carried out by the High Courts.

For these reasons we are of the view that:

*In the absence of a separate section in pari materia with Section 419 of the CA 2013 dealing with the manner of constitution of the Benches of the NCLAT indicating that at least one member per Bench should be a judicial member, the NCLAT's constitution may be constitutionally invalid.*

(5) WHETHER ONLY LEGALLY TRAINED MEMBERS ARE APPOINTED TO THE TRIBUNAL IF SUCH TRIBUNAL IS TAKING OVER THE JURISDICTION OF THE COURT?

Since the NCLT has such a wide jurisdiction which are likely to involve issues of fact, the inclusion of technical members with expertise in chartered accountancy and company secretary work is not problematic. However, the inclusion of such technical members in the NCLAT, which is supposed to exercise a purely appellate function, militates against the judgment of the Supreme Court in the *NTT* case. Therefore, we are of the view that:

*Where the appeal from an order of the NCLT is in any matter that does not relate to technical matters, the bench hearing such matter has to be composed only of judicial members or technical members who have legal training as may be specified, else such clause will not withstand judicial scrutiny.*

(6) WHETHER THE APPOINTMENT, AND TERMS AND CONDITIONS OF SERVICE OF CHAIRPERSON AND MEMBERS OF A TRIBUNAL ARE ON PAR WITH THE COURT WHOSE JURISDICTION IS BEING REPLACED BY THE TRIBUNAL?

The appointment procedure for the Chairperson of the NCLAT, the President of the NCLT and the judicial members of the NCLAT is akin to that of the judges of the High Court<sup>274</sup> in that the appointment is made by the Central Government with due consultation by the Chief Justice of India.<sup>275</sup> Given that the NCLT and the NCLAT both exercise the jurisdiction of a High Court to a certain extent, this is entirely justified. However, technical members of the NCLT and the NCLAT and the judicial members

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<sup>274</sup> See Article 217(1) of the Constitution of India.

<sup>275</sup> Section 412(1) CA 2013. However, since the Chief Justice of the High Court and the State Government are not involved in the running of or functioning of tribunals, consultation with them would not be relevant in this context.

of the NCLT are appointed through a selection procedure where their names are recommended by a selection committee composed of the Chief Justice of India, a judge of the Supreme Court or a Chief Justice of the High Court, the Secretary of the Ministry of Corporate Affairs, the Secretary of the Ministry of Law and Justice and the Secretary of the Department of Financial Services, Ministry of Finance as members.<sup>276</sup>

While it is understandable that the President or Chairperson of a Tribunal, by virtue of being vested with powers to run the tribunal should be selected in a different manner from the members of the tribunal, it is not clear on what basis the distinction between judicial and technical members of the NCLAT is being made when it comes to the appointment procedure. Such a provision would be, *prima facie*, a violation of Article 14 of the Constitution of India. When viewed in light of the fact that in case of the NCLAT, no distinction is made between the judicial and technical members insofar as their powers are concerned, Section 412 inasmuch as it relates to the NCLAT members does not seem constitutionally sustainable. Sub-section (2) of Section 412 is moreover, almost identical to the provisions of sub-sections (1) and (2) of Section 7 of the National Tax Tribunals Act, 2005 which was struck down by the Supreme Court. Since the NTT was replacing the High Court, the Court held that unless the procedure for appointment was identical to that of the High Court, i.e., consultation with the Chief Justice and not by way of recommendation by a Selection Committee, the provision in question would amount to an infringement of the independence of the judiciary. Similarly, since the NCLT and the NCLAT are both replacing the High Court's jurisdiction on various matters, the appointment of NCLT and NCLAT members must follow the same procedure.

In view thereof:

- a. *Sub-section (2) of Section 412 may not be constitutionally valid.*
- b. *Sub-section (1) of Section 412 may not be constitutionally valid.*

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At present, the nodal ministry for the administration of CA 2013 is the Ministry of Corporate Affairs, including for matters related to the appointment to NCLT and the NCLAT. As pointed out, the NCLT and the NCLAT are required to review certain decisions of the Central Government, specifically that of the Ministry of Corporate Affairs. In such a situation, it would be preferable, to ensure the independence of the tribunal, that the nodal Ministry be different from the one which is also the litigant before the tribunal. The Supreme Court had pointed this out as a “defect” in the context of the provisions of the CA 1956 dealing with the NCLT and NCLAT in the *NCLT case*.<sup>277</sup>

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***Recommendations:***

- i. *Since a writ petition against the operationalisation of the NCLT and the NCLAT is presently pending before the Supreme Court, the Government may consider making an appropriate representation before the Court stating that it is agreeable to carrying out changes to CA*

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<sup>276</sup> Section 412(2) of CA 2013.

<sup>277</sup> NCLT case, p 66, para 120.

2013 in line with the rulings of the Supreme Court discussed above. The following amendments are required:

- Section 419(2) should be amended to provide for at least one bench of the NCLT in every State with a High Court.
- Section 410 should be amended to provide for setting up a bench of the NCLAT in every State with an NCLT bench.
- A new clause should be inserted giving the President of the NCLT exclusive power to determine the constitution of benches of the NCLT and the jurisdiction of such benches.
- A new clause should be inserted giving the Chairman of the NCLAT exclusive power to determine the constitution of benches of the NCLAT and the jurisdiction of such benches.
- The words “who has been a judge for five years” should be deleted from Section 409.
- Section 409 should be amended to make it clear that only officers who have held a post at Additional Secretary level or higher will be eligible for appointment.
- A separate clause should be inserted, in pari materia with Section 419 indicating that at least one member of each NCLAT bench will be a judicial member.
- A clause should be introduced to indicate that in all appeals not involving technical issues, the NCLAT bench hearing such appeals should only comprise judicial members or technical members with legal training, as may be prescribed.
- The Ministry of Corporate Affairs cannot have representation on the committee to appoint members to the NCLT or the NCLAT. The clauses should be replaced with a provision which gives the Chief Justice of India the final say in the appointment of members to the NCLT and NCLAT, with the relevant inputs being obtained from the concerned ministry.
- The nodal ministry for the administration of CA 2013 should be different from the Ministry of Corporate Affairs.

## 6.2. PRACTICE AND PROCEDURE

As mentioned earlier in the Report, Dr. van Zwieten in her recent research findings had concluded that several practice related innovations may have contributed to the failure of the corporate insolvency regime in India. These innovations have had a significant impact on how the corporate insolvency procedures functioned in practice, including by adding significant delay (and a range of associated costs) to the disposal of proceedings.

For *company liquidation*, for example, she revealed how changes in practice and procedure in the early stages of the treatment of a creditor’s petition to compulsorily wind-up a company significantly slowed the process of obtaining a winding-up order. The author emphasised two such changes in particular:

- the development of the judicial practice of issuing a show-cause notice to a debtor company **prior to the admission** of a winding-up petition, leading to a hearing on the question of admission (typically on merits) and attendant delays;
- the development of the judicial practice of affording a corporate debtor time to repay all or part of the debt owed to a petitioning creditor (including by instalments) over a potentially long period of time, prior to the admission of the petition or its advertisement.

She contrasted the position under English law, and suggested that the emergence of these practices in India was one plausible source of explanation for the difference in time required to obtain a winding-up order under English law (which as noted above remains similar to India's law on the books, but functions very differently in practice).

For *corporate rescue* under the SICA, she revealed a series of innovations that influenced its operation in practice. Two of the developments that she highlighted were:

- a change in the interpretation of the SICA that diluted the BIFR's power to direct companies found incapable of rescue into liquidation, and expanded the power of the High Courts to reconsider a company's rescue prospects on the merits. This change was contrary to the intention of SICA's drafters, who envisaged an autonomous BIFR insulated (subject only to judicial review) from the civil courts;
- relatedly, the development of a judicial practice in the High Courts of permitting the SICA companies to explore rehabilitation after the issuance of a liquidation opinion by the BIFR.

She concluded that these developments added significantly to the delays associated with the disposal of proceedings under the SICA, especially for companies found to be incapable of rescue (that is, companies that should have been re-directed into liquidation far more swiftly if value maximisation was the goal).

The BLRC notes that CA 2013 includes certain provisions which may seem reasonable in theory, but may facilitate delays in practice (for both rescue and liquidation proceedings). For instance, in relation to rescue proceedings, after a reference has been made, Section 253 (7) requires that before determining whether a company has become sick, the company should be given a reasonable opportunity to reply. A similar opportunity to reply is also provided in relation to a winding up petition under Section 274 (1) of CA 2013. Although giving such opportunity to reply seems reasonable, this should not lead to a situation where the NCLT starts hearing the matter on merits even before admission of a case. Another significant change in the CA 2013 relates to the power of the NCLT to stay the winding up of the company. Section 466 of the CA 1956 permits the Court to stay the winding up of a company, even after the making of a winding up order, without specifying any ground on which such stay can be permitted. Further, the stay can be of an either of an indefinite duration or for a limited time. However, Section 289 of CA 2013 permits the stay of winding up, *after an order of winding up has been made, only if it is satisfied that it is just and fair to give an opportunity for rehabilitation of the company.* Further, the stay order can also be granted when it is accompanied with a scheme for rehabilitation and can operate only for a duration of 180 days. However, there is evidence that the judicial practice of stay of the winding up order to pursue corporate rescue has only added to the delays in the winding up process.<sup>278</sup> While such power of the NCLT is important for preventing liquidation of *viable* companies at the behest of the creditors, caution must be exercised to ensure that *unviable* companies do not use this provision for shielding themselves against a winding up order and abusing the process of law.

Further, in relation to rescue proceedings, Section 253 (8) provides that if the NCLT is of the opinion that the debtor company can repay its debts within a reasonable time, it may allow the company such time as it may deem fit to make the repayment. As discussed above, in the context of liquidation of

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<sup>278</sup> van Zwieten.



companies, research shows that practices that provide for settlement before admission are widely misused. Debtor companies often request for additional time for repayment and the courts seem to have allowed such extensions in many cases, leaving creditors extremely disadvantaged. Any provision that allows the debtor company to exit the proceedings by repaying the debt should be subject to strict-timelines with no possibility of extension and should also take into account the interests of the non-petitioning creditors as well.

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**Recommendations:**

- i. The rules for operationalization of the NCLT should specify that (i) whenever a company is given an opportunity to file a reply before admission of a petition, the NCLT should not hear the matter on merits at that stage, (ii) whenever a company has been given the opportunity to repay the debts before admission, such repayment should be as per a prescribed schedule (as specified in the order), which shall not be extendable under any circumstances and such a repayment related order should take into account the interests of all (or substantially all) the creditors and not just the petitioning creditor and (iii) an order that stays a winding up order should only be made in exceptional situations (for instance where there is evidence to suggest that creditors have abused the process of law to obtain a winding up order)– unviable companies should not be allowed to take the benefit of such stays for extraneous considerations. It would be extremely important to develop a system for on-going training for the NCLT members and insolvency practitioners to ensure that they have complete understanding of (i) the reasons for the failure of the present system and (ii) technical issues in liquidation and rescue cases. Further, the relationship between the NCLT and the superior courts should be closely monitored and subject to ongoing review. The judiciary should be sensitised about (i) the economic costs of delays in liquidation and rescue proceedings, (ii) benefits of insulating the NCLT and the NCLAT from a review on merits. Lastly, the NCLT and the NCLAT should be required to record annual statistical data on matters such as the number of pending cases, the number of cases disposed, and the time taken for disposal of cases. This data may be passed on to the Government and the Supreme Court on a regular basis, who can evaluate the data based on standard efficiency parameters and recommend corrective action for tightening of procedural rules as and when required.*
- ii. The NCLT members and insolvency practitioners should receive sufficient training in banking, finance, accounting and legal matters. The training component should be continuous, requiring such officers to participate in stated minimum training requirements annually. The training programs for NCLT members should include a component on the nature of cases that warrant adjournments and stay orders. Members of the higher judiciary, senior lawyers and chartered accountants, the Indian Institutes of Management, the Indian Institute of Corporate Affairs and the National Institute of Public Finance and Policy may be requested to design and implement such training programs through an institutional set up.*

### 6.3. REGULATION OF INSOLVENCY PRACTITIONERS

Insolvency officials play an integral role in an effective insolvency regime- they are responsible for operationalising the different insolvency procedure so as to derive the best outcomes for the stakeholders involved. Insolvency officials are often influenced by the cultural, institutional, disciplinary and professional backgrounds as well as economic, career and other incentives.<sup>279</sup> Therefore, in order for the efficient functioning of the insolvency regime, significant work needs to be done to develop a framework for the licensing and/or regulation of such professionals in order to ensure that they have the necessary competence, skill and integrity required for the performance of their functions.

‘Inefficient and overburdened official liquidators’ are counted as being one among the primary reasons for the administrative delays that plague winding up proceedings under that legislation.<sup>280</sup> Notably, under the CA 1956, private, professional liquidators could only be appointed for voluntary winding up proceedings. That possibility was entirely foreclosed in the winding-up of companies by the court.<sup>281</sup> Consequently, to many, the solution (or at least a part of it) to the administrative inefficiency was to open up a larger section of winding up proceedings to private liquidators.<sup>282</sup> This proposal finally came to fruition in the CA 2013.

While the CA 2013 provides for a fairly comprehensive regime on liquidators, some issues relating to the appointment, qualification and regulation of private insolvency practitioners as liquidators do remain. However, CA 2013 provisions in relation to administrators seem fairly underdeveloped.

#### A. SAFEGUARDS AS REGARDS QUALIFICATION

Under the CA 2013, a ‘company liquidator’<sup>283</sup> may be appointed from a Central Government panel consisting of chartered accountants, advocates, company secretaries, cost accountants or firms or, bodies corporate consisting of such professionals. The sole criterion for the membership of this panel is that its candidates must possess ‘at least ten years’ experience in company matters.’<sup>284</sup> In relation to administrators, Section 259 provides for the appointment of the interim administrator or the company administrator by the NCLT from a Central Government database consisting of the names of company secretaries, chartered accountants, cost accountants and such other professionals as may be specified by the Central Government. The provision does not provide any additional qualification criteria. It also does not cover firms or bodies corporate consisting of such professionals (as provided in case of company liquidators).

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<sup>279</sup> Finch

<sup>280</sup> van Zwieten; TCA Anant and Omkar Goswami, ‘Getting Everything Wrong: India’s Policies Regarding “Sick” Firms’ in Dilip Mookherjee (ed), *Indian Industry: Policies and Performance* (OUP 1995) 283.

<sup>281</sup>Section 448, CA 1956.

<sup>282</sup>PL Sanjeev Reddy, ‘Good Corporate Governance — the Road Ahead’ in *Public Governance and Decentralisation: Essays in Honour of TN Chaturvedi* (New Delhi, 2003 Mittal Publications) 881.

<sup>283</sup>Section 2(23), 275(2), CA 2013.

<sup>284</sup>Section 275(2), CA 2013.

Bodies such as the Indian Institute of Corporate Affairs have therefore recommended that safeguards for the appointment of candidates to the panel of company liquidators must be augmented: “*merely listing the professions from which company Liquidators should be appointed will not suffice and a set of minimum qualification should be prescribed before the professionals can be enlisted in the panel so as to ensure the quality of professionals entering the profession as Company Liquidators [sic].*”<sup>285</sup>

We believe that this suggestion is well-founded (not only for company liquidators, but also for administrators). It is also buttressed by the experience from other legal systems. In the UK for example, the opening up the liquidation proceedings to private ‘insolvency practitioners’ was accompanied by several safeguards. For example, under the IA 1986, anyone who wishes to practice as an insolvency practitioner needs to pass examinations on Liquidations, Administrations, Company Voluntary Arrangements, Receiverships and Personal Insolvency. These examinations are regulated by the Joint Insolvency Examination Board and meet the authorising body’s insolvency experience requirements. However, the BLRC notes that developing an examination based system may take time and may not be implementable in the short term. This issue can be revisited at the time of framing the Insolvency Code.

## B. REGULATION OF CONFLICT OF INTERESTS

The possibility that the company liquidator may put herself in a position that results in a conflict of interests is currently regulated by Section 275(6) of the CA 2013. This provision offers no guidance on what exactly triggers the ‘conflict of interests’ threshold. As far as administrators are concerned, the terms of their appointment are entirely left to the discretion of the NCLT (S 259 (2)).

Interestingly, an analogous regulatory scheme may be found in the CA 2013 as far as appointment of auditors are concerned. Thus, Section 141 (6) lists nine circumstances under which candidates are prohibited from being appointed as auditors of a company on account of their conflict of interests. Many of these concerns are equally relevant to company liquidators. Section 141(6) prohibits: (i) an officer or employee of the company; or (ii) a person who is a partner, or who is in the employment, of an officer or employee of the company; (iii) a person who, or his relative or partner— (a) is holding any security of or interest in the company or its subsidiary or (b) is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of such amount as may be prescribed; or (c) a person or a firm who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company, among others, from acting as auditors.

## C. CODE OF CONDUCT/ETHICS

The Company Liquidator’s conduct while in office, and the consequences of misconduct for his/her continuance as a member of the Central Government panel, are currently governed by S275(4) of the CA 2013. Section 275(4) provides for the removal of the name of any person or firm or body corporate from the panel by the Central Government on the grounds of misconduct, fraud, misfeasance, breach of duties or professional incompetence.

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<sup>285</sup> Indian Institute of Corporate Affairs, *Need to Regulate & Outline the Qualification of Company Liquidators*, available at <http://www.iica.in/images/1st%20Papers.pdf>.

The exceedingly varied nature of potential for misconduct and the difficulty of anticipatory regulation in this regard make it impossible to lay down precise rules. Besides, the company liquidator will act under the broad supervision of the NCLT. The broad and suggestive wording of Section 275(4) is therefore, in our view, appropriate. However, this provision may be usefully supplemented with a model Code of Conduct and/or a Code of Ethics for company liquidators. Such a model Code will not only prove to be a useful guide for company liquidators but will also assist the Central Government in operationalising Section 275(4). The barebones of a model Code of Conduct including a tentative list of fundamental principles have been suggested by the Indian Institute of Corporate Affairs.<sup>286</sup> This may provide a useful starting point.

In so far as administrators are concerned, as mentioned above, all terms and conditions of their appointment will be as per the discretion of the NCLT. The BLRC notes that leaving all matters relating to the appointment of the administrator to the discretion of the NCLT (on a case by case basis) may create a lot of uncertainty.

#### D. REMUNERATION

Remuneration of company liquidators is governed by Section 275(5), CA 2013. The provision provides for the fixation of fee payable to the company liquidator by the NCLT on the basis of the task required to be performed by such liquidator, his/her/its experience and qualification and the size of the company. The remuneration of administrators on the other hand is entirely left to the discretion of the NCLT.

Such provisions are in contrast to the practice followed in jurisdictions such as the UK where insolvency practitioners' remuneration is fixed by creditors' committees. That methodology has the benefit that it fosters a competitive market for the services offered by insolvency practitioners. However, it may be noted that a recent report in the UK reviewing the remuneration of insolvency practitioners has recommended either regulatory or independent oversight over the fees charged by insolvency practitioners.<sup>287</sup> The BLRC is of the opinion that the remuneration of the insolvency practitioners in India should also be determined by the creditors (with appropriate supervision by the NCLT). In relation to liquidators, such remuneration may be a combination of: (a) payment dependent on the number of hours employed; (b) fixed fee; (c) payment based on the percentage of realisations. In relation to administrators, such remuneration may be a combination of (a) payment dependent on the number of hours employed; (b) fixed fee; (c) payment based on the turn-around of a business or percentage of realisations for the creditors. Such an approach will ensure that, while some part of the insolvency practitioner's fee is pre-determined, some share of it depends on the assets realised or turn-around of business (in case of an administrator). This can be expected in turn to incentivise efficient realisation of the company's assets and genuine efforts towards turnaround of viable companies.

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#### **Recommendations:**

- *The Ministry of Corporate Affairs informed the BLRC that it is already in the process of developing rules that will provide for a detailed criteria for qualification (including*

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<sup>286</sup> *Ibid.*

<sup>287</sup> E Kempson, *Review of Insolvency Practitioner Fees: Report to the Insolvency Service*, <<https://www.gov.uk/government/publications/insolvency-practitioner-fees-a-review>> (accessed 30th October, 2014).

*experience in insolvency matters), disqualification and regulation of insolvency practitioners. In view of that representation, a specific amendment may not be required at this stage. Such rules should also provide for a code of ethics and address issues relating to conflict of interests (for liquidators, administrators, including any directors nominated by the administrators and experts/professionals engaged by such liquidators or administrators).*

- *Section 259 (1) should be amended to include ‘turn-around specialists’ or ‘business consultants’ specialising in insolvency matters as professionals who may be appointed as ‘interim administrators’ or ‘company administrators’, subject to any additional qualification criteria that may be laid down by the Government. Lastly, firms or bodies corporate consisting of professionals envisaged in Section 259 (1) should also be eligible to be appointed as ‘interim administrators’ or ‘company administrators’.*
- *Sections 275 should be amended to specify that the remuneration payable to the company liquidator shall be determined by the creditors as per the rules prescribed by the Central Government.*

## 7. SAFE HARBOURS IN INSOLVENCY

### 7.1. INTRODUCTION

Safe harbour provisions exist in the laws of several international which exempt financial contracts (including contracts in securities, derivatives in various asset classes, *repo* transactions, contracts entered into on recognized securities exchanges etc.) from the normal operation of insolvency laws. Safe Harbour provisions provide exemption from several crucial features of general insolvency law to financial contracts within their scope including exemption from:(i) the mandatory stays on enforcement upon the contractual counterparty's entry into formal insolvency proceedings (for instance, the provision for moratorium under Section 253 (2) or stay of suits on a winding up order under Section 279 of CA 2013); (ii) the prohibition on the exercise of termination provisions exercisable upon the entry of the contractual counterparty into formal insolvency proceedings; and (iii) liquidator or other relevant office holder's rights to challenge and avoid transactions entered into at an undervalue or prefer select classes of creditors (Sections 328, 329 of CA 2013) .

These provisions are referred to as “**Safe Harbour**” provisions since they are seen as providing safe harbours to financial contracts from the normal operation of insolvency legislation.

The nature and types of financial contracts covered by such Safe Harbour provisions and the content of the insolvency law provisions exempted or suspended vary from jurisdiction to jurisdiction. Safe Harbour provisions in the US are contained in the Bankruptcy Code and in Europe, were introduced through a number of Directives including the Settlement Finality Directive and the Financial Collateral Directive at the European Union level. The underlying rationale provided for the various types of Safe Harbour provisions is broadly similar across jurisdictions. It is argued that Safe Harbour provisions provide certainty and predictability for market participants, ensure stability of financial markets and avoid contagion effects by allowing counterparties to terminate contracts with insolvent/near-insolvent entities and limiting the extent of losses suffered by such counterparties.

### 7.2. RATIONALE AND CRITIQUES OF SAFE HARBOUR PROVISIONS

The arguments in favour of Safe Harbour provisions highlight the utility of such provisions in limiting the “contagion” or “domino” effects which may potentially arise as a result of the insolvency or failure of a financial market participant. Such spillover risks could arise in the event that other market participants who are exposed to the failing institution themselves fall into financial risk if they are not allowed to exercise their contractual enforcement rights and rights to collateral. In addition, proponents of Safe Harbour provisions also point to the fact that such provisions permit credit to be extended to institutions in difficulty by alleviating some effects of the debt overhang problem.<sup>288</sup>

Another positive effect often alluded to is that (especially in the context of the *repo* market), in the absence of Safe Harbour provisions, valuable, liquid financial collateral will be tied up in the insolvency proceedings of a failed market participant and reduce systemic liquidity should counterparties not be

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<sup>288</sup> Board of Governors of the Federal Reserve System, “*Study on the Resolution of Financial Companies under the Bankruptcy Code*” (2011) citing Harold S. Novikoff and Sandeep C. Ramesh, “*Special Bankruptcy Code Protections for Derivatives and other Financial Market Transactions*” (2009) (hereinafter referred to as “Novikoff & Ramesh”).

allowed to liquidate such collateral in the enforcement of their claims. As a corollary, Safe Harbour provisions in benign market conditions increase liquidity and reduce financing costs for borrowers. Since creditors who lend money on the back of financial contracts can rely on Safe Harbour provisions to enforce in the event of insolvency, they do not have to charge interest rates commensurate with the level of risk associated with the borrower in the absence of such provisions (which are presumed to be higher). Safe Harbour provisions are also claimed to alleviate market risk. In the absence of such provisions, it is argued that market makers such as banks would be faced with unhedgeable uncertainties associated with the stay on enforcement associated with insolvency law and would thus be disincentivised from providing these hedging services.<sup>289</sup>

In summary, the most often cited benefits of Safe Harbour provisions are (a) reduction in systemic risks and spillover/domino effects and (b) reduction in uncertainty and financing costs and increase in liquidity.

However recently, several academics have questioned these traditional justifications for the Safe Harbour provisions. It has been argued that Safe Harbour provisions, far from ameliorating systemic risks actually exacerbate them and any potential benefits in the form of reduced financing costs increased liquidity are more than offset by increased costs arising as a result of the increase in systemic risks and the increased likelihood of firm failure caused by such Safe Harbour provisions.

Certain academics<sup>290</sup> argue that Safe Harbour provisions have a negative impact on systemic risk in the financial system. Interconnectedness in the financial system, especially in derivatives industry is often cited in order to support Safe Harbour provisions - with high levels of concentration in the financial industry, failure of one market participant greatly increases the likelihood of systemic collapse. However, Safe Harbour provisions also make it more likely that the troubled systemically important financial institution does fail by allowing its financial counterparties to enforce their contractual and collateral rights without being subject to stay - which is what appears to have happened in the case of Lehman Brothers and AIG in 2008.<sup>291</sup> Additionally, Safe Harbour provisions in fact aid market concentration and interconnectedness by making financial contracts which fall within the Safe Harbour artificially attractive. Permitting contractual and close-out netting allows counterparties to increase their exposures to other financial counterparties beyond what would have been permissible absent such exemptions which in turn result in greater concentration.<sup>292</sup>

Unrestricted close-out netting and collateral rights in insolvency also dry up liquidity for the troubled firm when it needs it the most. Given such rights under the Safe Harbour provisions, financial counterparties rush to close out their existing positions and liquidate their collateral at 'fire sale' prices. Absent such rights, these counterparties, it could be argued, would have been persuaded, along with other creditors of the firm to inject additional capital in the struggling firm in order to achieve a turn

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<sup>289</sup> Novikoff & Ramesh.

<sup>290</sup> Steven L Schwarz, "Derivatives and Collateral: Balancing Remedies and Systemic Risk" (2014), Charles W. Mooney Jr., "The Bankruptcy Code's Safe Harbours for Settlement Payments and Security Contracts: When is safe too safe?" (2014) and Mark J Roe, "The Derivatives Market Payment Priorities as Financial Crisis Accelerators" (2011) (hereinafter referred to as "Roe")

<sup>291</sup> Roe.

<sup>292</sup> Roe; Morrison et al, "Rolling back the Repo Safe Harbours" (2014) (hereinafter referred to as "Morrison").

around. In other words, Safe Harbour provisions impact one of the primary objectives of bankruptcy legislation – the rescue of economically viable businesses. This, academics generally agree is what happened during the 2008 crisis – manifesting in the form of accelerated collateral calls on the Repo markets against troubled financial institutions- the “run on the repo markets”.<sup>293</sup>

There is an additional issue involved with permitting unrestricted close out netting and collateral liquidation. A counterparty which has in its possession collateral of a troubled company is often tempted to liquidate such collateral at fire sale prices in the market. While, from a firm stand point such behavior may be rational in that the selling firm earns more by liquidation than by holding off from liquidating, rapid reduction of asset prices cause a negative externality in the market - especially where market participants are obliged to adopt mark-to-market accounting principles and re-value the assets on their books on a periodic basis. In conditions of market stress with depressed asset prices, fire sales of financial collateral, further reduces the value of these assets and calls into question the solvency of all institutions holding these assets on their balance sheet – again, a lesson painfully learnt in the financial crisis.<sup>294</sup>

Safe Harbour provisions also distort the incentives of contractual counterparties by reducing incentives of counterparties to monitor the financial health of the debtor closely. As a corollary poorly managed debtors also have an incentive to grow quickly relying on the short term financing provided by financial counterparties (in the repo markets etc.) who are not incentivized to monitor the debtor. Given unrestricted close out netting and right to liquidate collateral in the event of insolvency, contractual counterparties of a failing debtor are looking to the value of the collateral and their exposures in making credit decisions rather than looking at the underlying financial health of the debtor. This induces increased risk taking by debtors, increase in the size of poorly monitored and highly leveraged debtors and increased systemic risk in the financial system.<sup>295</sup>

In spite of the above arguments, academics who are critical of the Safe Harbour provisions do not advocate their wholesale repeal.<sup>296</sup> In particular, many critics recognize the key function Safe Harbour provisions play in ensuring the liquidity of cash and cash-like collateral (such government securities). However, many question the unthinking extension of the Safe Harbour provisions to a wide variety of financial contracts (at the extreme, extremely illiquid sub-prime mortgages backed securities) and call for a principled debate on the scope and extent of such provisions especially given their path dependent history.<sup>297</sup>

### 7.3. POST-2008 RESPONSES TO SAFE HARBOUR PROVISIONS

The legal and regulatory response to the Global Financial Crisis acknowledged the crisis accelerating effects induced by the Safe Harbour provisions in the run up to the insolvency of Lehman Brothers and the bail out of AIG. However, no jurisdiction has yet taken the step of enacting a wholesale repeal of

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<sup>293</sup> Gorton and Metrick, “*Securitized Banking and the Run on the Repo*” (2009).

<sup>294</sup> Roe.

<sup>295</sup> *Ibid.*

<sup>296</sup> David A Skeel and Thomas H Jackson, “*Transaction Consistency and the New Finance in Bankruptcy*” (2011).

<sup>297</sup> Morrison.



the Safe Harbour provisions. Wide ranging proposals to amend the Safe Harbour provisions of the US Bankruptcy Code have been made by some lawmakers in the US and the effect of such a repeal is being studied by the US Bankruptcy Institute.<sup>298</sup> However no wholesale repeal has been successful in any jurisdiction yet. Instead, steps have been taken with the aim of making certain limited inroads into the scope and extent of Safe Harbour provisions and targeting the most deleterious effects of Safe Harbour provisions.

The Financial Stability Board, as part of its “Key Attributes of Effective Resolution Regimes for Financial Institutions” has set out certain limited changes which are required to be made to Safe Harbour provisions in the interests of efficient and speedy resolution of financial institutions. The FSB recognizes that:

*“In the case of a SIFI, the termination of large volumes of financial contracts upon entry into resolution could result in a disorderly rush for the exits that creates further market instability and frustrates the implementation of resolution measures aimed at achieving continuity. The Key Attributes (see Key Attribute 4.3) stipulate that, subject to adequate safeguards, entry into resolution and the exercise of any resolution powers should not constitute an event that entitles the counterparty of the firm in resolution to exercise early termination rights provided the substantive obligations under the contract, including payment and delivery obligations, and provision of collateral, continue to be performed. Should early termination rights nevertheless be exercisable, the resolution authority should have the power to stay temporarily such rights where they arise by reason only of entry into resolution or in connection with the use of resolution powers and provided that the substantive obligations under the contract, including payment and delivery obligations, and provision of collateral, continue to be performed.”<sup>299</sup>*

The FSB has also set out the scope and content of such “temporary stay” power of the resolution authority and the safeguards which must be exercised by the resolution authority. Such a temporary stay, although only applying in respect of a financial institution constitutes a significant departure from the principles underpinning the Safe Harbour provisions. In recommending this approach, the FSB appears to have been clearly led by the experience of the Lehman insolvency and the AIG bailout during the 2008 crisis.

#### 7.4. THE SEBI PROPOSAL

SEBI submitted a proposal to the BLRC (the “**SEBI Proposal**”) which require amendments to be made to the SCRA with the aim of (a) ensuring priority rights for Clearing Corporations in the collateral posted with them by Clearing Participants and (b) ensuring Settlement Finality in the capital markets. This section will consider both elements of the SEBI proposal in the international regulatory context and discuss the legislative changes proposed by SEBI in order to implement the proposal. A copy of the proposal is enclosed as **Annexure - 1** to this Report.

The necessity to ensure the priority of the rights of clearing corporations and other financial market infrastructure providers (“**FMI**s”) has been recognized in their international regulatory response to the

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<sup>298</sup> Financial Times, “Plans afoot to narrow US Safe Harbour Statutes” (2013).

<sup>299</sup> Financial Stability Board, “Key Attributes of Effective Resolution Regimes for Financial Institutions” (2014).

2008 financial crisis. In fact, the requirement to have OTC derivatives contracts mandatorily traded on exchange and centrally cleared was one of the essential articulated tenets of the G20 summit at Pittsburgh which set out the internationally coordinated response to the 2008 financial crisis.

The Principles of Financial Market Infrastructures published by CPSS-IOSCO<sup>300</sup> contain several crucial principles which are considered to be essential in order to establish and operate efficient FMIs whilst minimizing systemic risks in the financial system. FMIs include the systems that clear, settle and record financial transactions in the financial system and thus include clearing corporations, settlement systems and trade repositories. The CPSS-IOSCO Principles highlight “Legal Risks” as one of the key risks faced by FMIs and require a very high level of legal certainty to be established in the operations of FMIs.

In the particular context of priority over clearing member collateral, the CPSS-IOSCO Principles state:

*“In addition, the legal basis should provide certainty, where applicable, with respect to an FMI’s interests in, and rights to use and dispose of, collateral; an FMI’s authority to transfer ownership rights or property interests; and an FMI’s rights to make and receive payments, in all cases, notwithstanding the bankruptcy or insolvency of its participants, participants’ customers, or custodian bank. Also, the FMI should structure its operations so that its claims against collateral provided to it by a participant should have priority over all other claims, and the claims of the participant to that same collateral should have priority over the claims of third-party creditors.”*

*“If an FMI relies on a title transfer, including transfer of full ownership, it should have a high degree of certainty that the transfer is validly created in the relevant jurisdiction and will be enforced as agreed and not recharacterised, for example, as an invalid or unperfected pledge or some other unintended category of transaction. An FMI should also have a high degree of certainty that the transfer itself is not voidable as an unlawful preference under insolvency law.”*

*“Netting arrangements should be designed to be explicitly recognised and supported under the law and enforceable against an FMI and an FMI’s failed participants in bankruptcy. Without such legal underpinnings, net obligations may be challenged in judicial or administrative insolvency proceedings. If these challenges are successful, the FMI and its participants could be liable for gross settlement amounts that could drastically increase obligations because gross obligations could be many multiples of net obligations.”*

*“The rules, procedures, and contracts related to an FMI’s operation should be enforceable in all relevant jurisdictions. In particular, the legal basis should support the enforceability of the participant-default rules and procedures that an FMI uses to handle a defaulting or insolvent participant, especially any transfers and close-outs of a direct or indirect participant’s assets or positions (see also Principle 13 on participant-default rules and procedures). An FMI should have a high degree of certainty that such actions taken under such rules and procedures will not be voided, reversed, or subject to stays, including with respect to the resolution regimes applicable to its participants. Ambiguity about the enforceability of procedures could delay and possibly prevent an FMI from taking actions to fulfil its obligations to non-defaulting participants or to minimise its potential losses. Insolvency law should support isolating risk and retaining and using collateral and cash payments previously paid into an*

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<sup>300</sup> The Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO)

*FMI, notwithstanding a participant default or the commencement of an insolvency proceeding against a participant.”*

All the above requirements are clearly intended at extending a version of the Safe Harbour provisions discussed earlier to the operation of FMIs. The international regulatory consensus being, that given that FMIs are clearly systemically important institutions by definition and given the concentration of financial exposures in such FMIs, the costs of introducing such Safe Harbour provisions in respect of FMIs (if any) are far outweighed by the benefits of ensuring legal and operational certainty in the functioning of FMIs.

The statement in the CPSS-IOSCO Principles extracted above which states: “*An FMI should have a high degree of certainty that such actions taken under such rules and procedures will not be voided, reversed, or subject to stays, including with respect to the resolution regimes applicable to its participants*” may appear to be contradictory with the FSB Key attributes discussed earlier. However, both the CPSS-IOSCO Principles and the FSB key Attributes address this apparent contradiction by clarifying that the temporary stay under the FSB Key Attributes will only apply to termination rights or other actions taken by contractual counterparties “based solely upon the entry into resolution or the exercise of resolution powers”. If the financial institution in resolution fail to meet any payment or delivery obligation, the FSB Key Attributes clearly envisage a situation where the FMI is permitted to enforce its termination or other rights against a clearing member.

Another aspect of the issue is worth highlighting. In order for the priority rights of FMIs and the FMI related Safe Harbour provisions to work robustly, it may be necessary that the Safe Harbour provisions applying to other market participants be restricted. As discussed, negative externalities such as depreciation of asset prices as result of fire sales in the context of all market participants exercising their rights to liquidate collateral actually diminish the capacity of FMIs to deal with the insolvency of a clearing member in an orderly manner. Similar arguments can be made in respect of each of the other rights afforded by the Safe Harbour provisions to non FMI market participants. This is an issue that is worth considering in the context of amending the laws in order to provide for legal certainty for FMI operation.

In respect of Settlement Finality, the CPSS-IOSCO Principles state as follows:

*“Settlement finality*

*3.1.6. There should be a clear legal basis regarding when settlement finality occurs in an FMI in order to define when key financial risks are transferred in the system, including the point at which transactions are irrevocable. Settlement finality is an important building block for risk-management systems (see also Principle 8). An FMI should consider, in particular, the actions that would need to be taken in the event of a participant’s insolvency. A key question is whether transactions of an insolvent participant would be honoured as final, or could be considered void or voidable by liquidators and relevant authorities. In some countries, for example, so-called “zero-hour rules” in insolvency law can have the effect of reversing a payment that appears to have been settled in a payment system.<sup>26</sup> Because this possibility can lead to credit and liquidity risks, zero-hour rules that undermine settlement finality should be eliminated. An FMI also should consider the legal basis for the external settlement mechanisms it uses, such as funds transfer or securities transfer systems. The laws of the relevant jurisdictions should support the provisions of the FMI’s legal agreements with its participants and settlement banks relating to finality.”*

In view of the above, the BLRC agrees with the SEBI proposal to amend the SCRA as specified in **Annexure -1**. The Government may also consider if similar protections should be available for other FMIs as well. Given the systemic issues linked to such provisions (as discussed in Section 7.3 above), the law on insolvency resolution of banks and financial institutions may provide for the interplay between such settlement and netting provisions and the resolution rules applicable to such banks and financial institutions. In particular, such law may clarify, in line with the FSB Key Attributes that any rights which are vested in the FMIs and which purport to take effect solely as a result of a financial institution entering into resolution will not be exempted from the temporary stay.

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***Recommendations:***

- i.* The BLRC agrees with the SEBI proposal to amend the Securities Contracts Regulation Act, 1956 (“**SCRA**”) to provide for certain safe harbours (provisions on settlement and netting) for certain financial contracts, which provide exemptions from the normal operation of insolvency law as specified in **Annexure 1**.

***Questions for Consideration:***

- ii.* *What should be nature and scope of Safe Harbour provisions for the proposed Insolvency Code?*

## 8. INSOLVENCY RESOLUTION OF MSMEs

As per a report of the International Finance Corporation of the World Bank Group<sup>301</sup>, “*Proprietorship is the most commonly adopted ownership structure (94.5 percent of all MSMEs)*” among MSMEs. The report goes on to state that other ownership structures include partnerships and cooperatives (1.2%), and companies (0.8%). These figures seem to be corroborated by the Damodaran Committee Report for Reforming the Regulatory Environment for Doing Business in India (appointed in response to the ‘Doing Business Report, 2012’ of the World Bank), which notes that “*97% of MSMEs are proprietorship firms or partnerships and do not have an adequate recourse for winding up the business under the Companies Act. Similarly, there are no bankruptcy laws akin to those prevailing in developed countries to facilitate the winding up of uneconomic units in an orderly fashion*”<sup>302</sup> These figures are further corroborated by a representation received by the BLRC from the ‘Chamber of Small Industry Associations’. Given that most MSMEs in India operate in the form of sole proprietorships, their insolvency resolution is largely dependent on personal insolvency laws (which have proved to be very ineffective in practice). Although the RBI has issued instructions to banks on revival of sick micro and small enterprises or MSEs, the said guidelines do not apply to medium enterprises. In order to effectively address issues relating to insolvency of MSMEs, the personal insolvency regime needs to be substantively reformed. Although issues relating to personal insolvency shall be covered in detail in the final report of the BLRC, it would be useful to provide a brief overview of the personal insolvency regime here to highlight some of the key areas of concern.

### 8.1. PERSONAL INSOLVENCY LAWS

Personal insolvency is primarily governed under the Presidency Towns Insolvency Act, 1909 and the Provincial Insolvency Act, 1920. Though these are central laws, it should be noted that both these Acts have a number of state amendments. The substantive provisions under the two Acts are largely similar. There have not been any substantial changes to this regime over the years and it has proved to be largely ineffective practice, being costly and time consuming.<sup>303</sup>

Under both the Acts, an individual must be determined to be insolvent before the substantive provisions become applicable.<sup>304</sup> In order to be declared an insolvent, the individual must be a debtor, a category that includes judgement debtors.<sup>305</sup> A creditor or debtor can petition to have a debtor declared insolvent if he owes at least 500 rupees.<sup>306</sup> Further, in case of a petition by a creditor, the insolvent should have

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<sup>301</sup> Micro, Small and Medium Enterprise Finance in India, A Research Study on Needs, Gaps and Way Forward (November 2012).

<sup>302</sup> Ministry of Corporate Affairs, Report of the Committee for Reforming the Regulatory Environment for Doing Business in India (2013).

<sup>303</sup> See D E Solan, ‘How Consumer Bankruptcy Reforms can Help Save Microfinance in India’ (2011) 13 *Oregon Review of International Law* 317; A Feibelman, ‘Consumer Finance and Insolvency Law in India: A Case Study’, (2010) 36 *Brooklyn Journal of International Law* 75 (hereinafter referred to as “Feibelman”).

<sup>304</sup> Feibelman.

<sup>305</sup> Section 2(b), Presidency Towns Insolvency Act 1909; Section 2(a), Provincial Insolvency Act 1920; Feibelman.

<sup>306</sup> See Sections 12, 14, Presidency Towns Insolvency Act 1909; Sections 9-10, Provincial Insolvency Act 1920; Feibelman.

committed an ‘act of insolvency’ within three months before the presentation of the petition.<sup>307</sup> An ‘act of insolvency’ includes transferring all or most of one’s assets, taking action to defeat or delay one’s creditors, filing a petition of insolvency, giving notice to creditors that one is not going to pay an obligation, having property sold in execution of a court decree, or failing to respond to a creditor’s notice of insolvency.<sup>308</sup>

The courts are given considerable powers under these Acts. A petition for declaring insolvency cannot be withdrawn without permission of the court.<sup>309</sup> The court has the authority to dismiss petitions filed by debtors or creditors that do not conform to the statutory requirements, if it determines that the debtor has the capacity to pay his obligation or if it finds that the petition has been filed to harass or intimidate the debtor.<sup>310</sup> Usually after the debtor has been adjudged an insolvent, the courts have the power to stay other proceedings affecting an insolvent’s property and efforts to collect obligations of the insolvent or allow them to continue.<sup>311</sup>

The creditors submit claims against the debtor to the court, and the presiding court is given broad authority to determine the assets of the debtor that are available to creditors, subject to the property that is exempt from recovery.<sup>312</sup> The unsecured property of the insolvent vests in the court or an official receiver/ assignee appointed by the court.<sup>313</sup> The debtor is given an opportunity to make a proposal of composition to his creditors, which must be accepted by the creditors and then approved by the receiver or court.<sup>314</sup> Priority is given to government claims, certain administrative costs, and obligations owed to landlords.<sup>315</sup>

Where the debtor’s assets cannot satisfy his obligations, he can apply within a certain period after being adjudged an insolvent for the discharge of debts under certain circumstances.<sup>316</sup> The court makes the determination and discharges are subject to considerable judicial discretion, including the grant of conditional discharge.<sup>317</sup> A discharge would be granted only if the debtor fully satisfies the requirements

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<sup>307</sup> See Sections 12 Presidency Towns Insolvency Act 1909; Sections 9-10, Provincial Insolvency Act 1920; Feibelman.

<sup>308</sup> See Section 9, Presidency Towns Insolvency Act 1909; Section 6, Provincial Insolvency Act 1920; Feibelman.

<sup>309</sup> Sections 13(8), 15(2), Presidency Towns Insolvency Act 1909; Section 14, Provincial Insolvency Act 1920.

<sup>310</sup> Section 13(4), Presidency Towns Insolvency Act 1909; Section 25, Provincial Insolvency Act 1920; Feibelman.

<sup>311</sup> Section 18, Presidency Towns Insolvency Act 1909; Section 29, Provincial Insolvency Act 1920; Feibelman.

<sup>312</sup> Sections 26, 36, 46, 52, Presidency Towns Insolvency Act 1909; Sections 28(5), 33, 34, Provincial Insolvency Act 1920; Feibelman.

<sup>313</sup> Section 17, Presidency Towns Insolvency Act 1909; Section 28 Provincial Insolvency Act 1920; Feibelman.

<sup>314</sup> Sections 28-30, Presidency Towns Insolvency Act 1909; Sections 38-39 Provincial Insolvency Act 1920; Feibelman.

<sup>315</sup> Section 49, Presidency Towns Insolvency Act 1909; Section 61, Provincial Insolvency Act 1920.

<sup>316</sup> Section 38, Presidency Towns Insolvency Act 1909; Section 41, Provincial Insolvency Act 1920; Feibelman.

<sup>317</sup> Section 38, Presidency Towns Insolvency Act 1909; Section 41, Provincial Insolvency Act 1920; Feibelman.

set by the court and/or official receiver.<sup>318</sup> In addition, the court has the power to refuse discharge in a number of cases, such as when a debtor has previously received a discharge or if the court determines that the debtor has brought on or contributed to his insolvency due to a number of reasons.<sup>319</sup> Finally, certain obligations are non-dischargeable, such as government obligations, debts as a consequence of fraud or arising from criminal penalties.<sup>320</sup>

The personal insolvency regime in India has not seen many substantive changes over the years and has proved to be very ineffective in practice. Studies indicate that the Indian system is prone to delays, and does not provide sufficient incentives for the debtors or the creditors to initiate proceedings. Moreover, the system remains inaccessible for a large section of the society due the costs associated with initiating proceedings and does not facilitate rehabilitation of the insolvent individual. The present law on personal insolvency provides considerable powers to the courts on various matters, which require detailed adjudication at several stages. For instance, the moratorium (that suspends individual enforcement rights) can only be imposed after a court ‘declares’ that the concerned person is insolvent. If the assets of a bankrupt individual are not sufficient to discharge his obligations, the law permits discharge of the outstanding obligations in certain circumstances that are again subject to the discretion of the courts. Such provisions requiring adjudication at the early stages of the proceedings subject the system to considerable delays. Further, the jurisdiction for most insolvency petitions in the country lies with the district courts or sub-ordinate courts under such district courts (under the Provincial Insolvency Act 1920), which are already overburdened.

## 8.2. THE RBI’S EXISTING FRAMEWORK

A Working Group on Rehabilitation of Sick SMEs was set up by the RBI in 2008 that looked at issues related to rehabilitation of sick micro and small enterprises and suggested remedial measures for the rehabilitation of such enterprises<sup>321</sup>. The report of the RBI Working Group looked at the available data on sick MSEs as well as the causes for such sickness. It concluded that market issues, management issues, diversion of funds, technical obsolescence, delayed or inadequate working capital, wilful default or diversion of funds and delayed realisation of receivables were the major causes of sickness among MSEs. It noted that depending on the viability of the entity, there was a need to have an efficient and swift exit mechanism providing for recovery of dues for lenders for terminally ill entities, and timely and effective rehabilitation for viable entities. The report envisaged that such rehabilitation could be by way of renegotiation of loans, induction of fresh funds, business restructuring, change of management, etc.

The RBI has issued new guidelines for revival and rehabilitation on sick micro and small enterprises (it does not cover medium enterprises) that incorporate several recommendations of the Working Group Report.<sup>322</sup> The RBI guidelines require bank branches to intervene and take remedial action when early

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<sup>318</sup> Feibelman.

<sup>319</sup> Sections 38-9, Presidency Towns Insolvency Act 1909; Sections 41-2 of Provincial Insolvency Act 1920.

<sup>320</sup> Section 45, Presidency Towns Insolvency Act 1909; Section 44, Provincial Insolvency Act 1920; Feibelman.

<sup>321</sup> Report of Working Group on Rehabilitation of Sick SMEs (2008).

<sup>322</sup> RBI Guidelines for Rehabilitation of Sick Micro and Small Enterprises, RBI/2012-13/273, 1 November 2012.

signs of sickness are detected. The said guidelines also require a viability study to be conducted on concerned units and allow only such units to be rehabilitated that are viable or at least potentially viable. The guidelines exclude units that have become sick on account of wilful mismanagement and wilful default. However, the RBI guidelines still use the outdated concept of net worth erosion as one of the criteria for determination of sickness. In addition to this, the RBI has also advised banks to put in place a ‘one-time settlement scheme’ for recovery of non-performing loans to MSEs.<sup>323</sup>

### 8.3. A STATUTORY ADMINISTRATIVE MECHANISM FOR RESTRUCTURING OF MSME DEBTS

As mentioned above, effective insolvency resolution of MSMEs requires large scale reforms to the personal insolvency regime. The proposed Insolvency Code will be a comprehensive law that will not only cover companies and other forms of business enterprises, but also provide a detailed and modern framework (and institutions) for resolution of personal insolvencies. It is expected that an efficient mechanism for resolving personal insolvencies will not only benefit insolvent sole proprietorships and individuals but also the lenders by providing a predictable system of collective recovery. However, developing such a comprehensive code and its operationalization through appropriate institutions will require time. The BLRC is of the opinion that in the given circumstances, it will be appropriate to suggest a measure that alleviates the situation of MSMEs under financial distress, but does not undermine the long term reform of introducing an Insolvency Code. The BLRC notes that a key concern among MSMEs under financial distress is that the banks are too quick to initiate recovery proceedings against MSMEs in the event of a default (irrespective of the viability of the entity). Although the RBI guidelines discussed above require banks to address this concern by exploring different restructuring alternatives after conducting a viability study, anecdotal evidence suggests that many banks continue to initiate recovery proceedings notwithstanding whether the unit is viable or not. Further, such RBI guidelines are not applicable to medium enterprises. Moreover, RBI’s CDR framework only applies for accounts involving multiple banks with an outstanding total debt of INR 10 crore or more. Consequently, a medium enterprise under financial distress that has availed of credit facilities under INR 10 crore is left with no recourse for out-of-court debt restructuring.

Notwithstanding the above discussion, rescue mechanisms involving courts/tribunals or administrators and liquidators can be very costly. Most MSMEs typically have very few assets (especially the service enterprises). In many cases involving small businesses, the cost of such court/tribunal driven proceedings can be disproportionate to the size of the assets under consideration. In view thereof, the BLRC is proposing the following administrative mechanism for restructuring of MSME debts and recommending that it be given statutory status. The proposed mechanism, if implemented effectively, will provide much needed relief to viable MSMEs under financial distress without involving the crippling costs associated with formal rescue mechanisms involving administrators and courts/tribunals. Moreover, the proposed mechanism will require banks to explore such restructuring for viable businesses only, and is not intended to allow unviable MSMEs to continue operating for extraneous considerations. The MSME community must also realise that an insolvency mechanism that allows unviable businesses to continue operating at the cost creditors will only harm their own interests. The rational reaction of the creditors to an insolvency law that facilitates unviable businesses to continue operating will be to either stop or reduce lending or increase the cost of lending. Therefore, a pro-debtor rescue regime that does not protect the interests of creditors adequately may significantly increase the

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<sup>323</sup> RBI Guidelines for Credit delivery to the Micro and Small Enterprises Sector, RBI/2008-09/467, May 4, 2009.



cost of capital for MSMEs. Given that other modes of raising finance (like public issuances in capital markets) are not easily accessible for them, MSMEs with limited assets will find it extremely difficult to raise any finance in such a situation.

### The Proposal

The BLRC proposes an administrative mechanism for resolving financial distress of viable MSMEs. Such mechanism can be operationalized through bodies called ‘Committees for Distressed Micro, Small and Medium Enterprises’ to be established by the banks at such centres as may be considered necessary by the board of directors of the banks to ensure reasonable access to its eligible MSME customers. The composition of the Committee, the terms of appointment of its members, the manner of filling vacancies, and the procedure to be followed in the discharge of the Committee’s functions can be as prescribed by the Central Government, in consultation with the RBI. The eligibility criteria and the grounds for filing an application and the time limits for filing such application will be in accordance with the norms prescribed by the RBI. Any eligible MSMEs under financial distress or a concerned bank will be able to initiate proceedings before such Committees for the formulation of a ‘Corrective Action Plan’. A Corrective Action Plan or CAP shall mean a plan to resolve financial distress in a micro, small or medium enterprise to arrive at an early and feasible solution to preserve the economic value of the underlying assets as well as the loans under consideration in such manner as may be prescribed by the RBI (a CAP could also include an action for recovery). At the time of making an application, or at the time of submitting its first representation to the Committee (whichever is earlier) the MSME will be required to disclose all its liabilities as on the date of such application or response (as the case may be), including the liabilities owed to the Government and other unsecured creditors. This will enable the Committee to take the interests of such other creditors into account while formulating a scheme of revival.

As per a report on Financing of MSMEs prepared by the International Finance Corporation in 2012, “Microenterprises are found to have a finance relationship with a single bank, while small and medium enterprises are found to have finance relationships with more than one bank (average of two financial institutions per enterprise)”. In case of an application involving multiple banks, the Committee of the lead bank will decide the matter. In such cases, the Committee will also have representatives from other banks in accordance with norms prescribed by the RBI. The rules governing the interrelation among banks in such cases will also be prescribed by the RBI. Until the Committee decides on an application or the implementation of a CAP, (a) the concerned bank/banks and the MSMEs shall not initiate any legal proceedings against each other and (b) all legal proceedings relating to the recovery of debt shall be stayed (in a manner as may be specified). A decision of the Committee to initiate recovery action could also be subject to a review process on limited grounds.

The above mechanism can be given statutory status by introducing an amendment to the Micro Small and Medium Enterprises Development Act, 2006 (“**MSMED Act**”). The amendment will also empower the RBI to issue regulations for smooth operation of the mechanism.

## 8.4. VOLUNTARY AUCTIONS FOR SMALL BUSINESSES

A small business seeking rescue protection could be subjected to voluntary auction of the entire business. The proceeds of the auction could be distributed among the different stakeholders in the same order of priority as provided for in the liquidation/personal insolvency regime. Auctions, either as pre-

packs or in bankruptcy, have been utilized under the Swedish bankruptcy system with success- they have been found to be a speedy, low-cost bankruptcy procedure.<sup>324</sup> Under the Swedish system, firms filing for bankruptcy are mandatorily auctioned off under the supervision of a court-appointed trustee, either as a going concern or piecemeal. With sufficient regulatory oversight, a bankruptcy auction process could be considered as rescue tool for small businesses in India (especially where the businesses are closely held or run by families and have a limited number of creditors). In this regard, it would be crucial to establish a framework which facilitates the development of a market for the sale of businesses, through measures for safeguarding stakeholder interests, promoting accurate financial reporting and valuation of businesses. Developing such a framework will also require time and can be addressed as part of the Insolvency Code.

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***Recommendation:***

- i. The Ministry of Small Medium and Micro Enterprises should consider implementing the proposal discussed in 8.3 above by introducing an amendment to the MSMED Act.*

***Questions for Consideration:***

- i. What outcomes should be considered for reforming the personal insolvency regime in India?*
- ii. Should the proposed Insolvency Code provide for a separate insolvency processes for small businesses like voluntary auctions?*

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<sup>324</sup> Karin Thorburn, *Bankruptcy auctions: costs, debt recovery and firm survival*, Journal of Financial Economics 58 (2000) 337-368

## ANNEXURE 1

### SEBI PROPOSAL FOR AN AMENDMENT IN THE SECURITIES CONTRACT REGULATION ACT

#### PRIORITY RIGHT FOR CLEARING CORPORATIONS AND SETTLEMENT FINALITY

In case of bankruptcy of clearing members, the collaterals/assets they have kept with the clearing corporations as mandated under the securities laws shall not be subject to any other claim.

#### RATIONALE

1. The clearing corporations provide novation and counterparty guarantee. Therefore, their rights need to get precedence over rights of others in the collateral of clearing members. Priority rights for clearing corporations to the collaterals, deposits and the assets of clearing member in case of winding up or insolvency of a clearing member, therefore become essential.
2. The Committee on Payment and Settlement Systems (CPSS) and the International Organisation of Securities Commissions (IOSCO) principles for Financial Market Infrastructures (FMI) including clearing corporations require that there should be a sound legal basis for all material aspects of an FMI's activities. Two such aspects are the determination of point of settlement finality and right of FMI on collateral in case of participant default. The participant in case of clearing corporations are clearing members.
3. Principle 1 of Principles for FMI requires that there should be a sound legal basis for the rights and interests of an FMI to use and dispose of collateral deposited by its participants even in case of bankruptcy of the participants. As per the principle –

*"the legal basis should provide certainty, where applicable, with respect to an FMI's interests in, and rights to use and dispose of, collateral; an FMI's authority to transfer ownership rights or property interests; and an FMI's rights to make and receive payments, in all cases, notwithstanding the bankruptcy or insolvency of its participants, participants' customers, or custodian bank"*

4. Principle 8 of Principles for FMI requires Central Counterparties (CCPs) to define the point of settlement finality. The requirements of the principle are as follows:

*"1. An FMI's rules and procedures should clearly define the point at which settlement is final.  
2. An FMI should complete final settlement no later than the end of the value date, and preferably intraday or in real time, to reduce settlement risk. An LVPS or SSS should consider adopting RTGS or multiple-batch processing during the settlement day.  
3. An FMI should clearly define the point after which unsettled payments, transfer instructions, or other obligations may not be revoked by a participant."*

5. In this regard, RBI has enshrined legal basis for the above two aspects for its payment and settlement systems in the Payment and Settlement Systems Act, 2007 (PSS Act). Section 23(4) of the Act states the following:-

*“(4) Where a system participant is declared by a court of competent jurisdiction as insolvent or is dissolved or wound up, then notwithstanding anything contained in the Companies Act, 1956 or the Banking Regulation Act, 1949 or any other law for the time being in force, the order of adjudication or dissolution or winding up, as the case may be, shall not affect any settlement that has become final and irrevocable and the right of the system provider to appropriate any collaterals contributed by the system participant towards its settlement or other obligations in accordance with the rules, regulations or bye-laws of such system provider.*

*Explanation- For the removal of doubts, it is hereby declared that the settlement, whether gross or net, referred to in this section is final and irrevocable as soon as the money, securities, foreign exchange or derivatives or other transactions payable as a result of such settlement is determined, whether or not such money, securities or foreign exchange or derivatives or other transactions is actually paid.”*

6. The following aspects are desirable to protect the clearing and settlement system in securities market from legal risks associated with bankruptcy.-
  - Settlements in accordance with the Rules, Bye-laws and Regulations of a clearing corporation/stock exchange before any bankruptcy order (declaring any client or stock broker or clearing member or the clearing corporation itself as bankrupt) should be final, and any bankruptcy order should not have the effect of reversing such settlements, unwinding of netting and recalculation of net positions.
  - Settlement of trades which are executed in order to terminate or close out/square off open positions, post the order of bankruptcy, should also be final and irrevocable.
  - Payment and settlement obligations in the event of bankruptcy should be determined by clearing corporation by way of netting only, so that only a net claim be demanded or a net obligation be owed.
  - A recognised clearing corporation should have the first right over the collaterals, deposits and other monies in whatever form contributed (and not over all assets) by a client or trading member or clearing member towards its settlement or other obligations and any order of bankruptcy should not affect such right of clearing corporation. However, any excess collateral left after defraying the settlement or other obligations should be returned to the defaulter or official liquidator, as the case may be.
7. The above treatment to the liabilities of failing brokers etc., may possibly be achieved by proposing an amendment to the Securities Contracts (Regulation) Act, 1956 and which will be in line with PSS Act. This is necessary to ensure settlement finality with respect to transactions in stock exchanges and priority of rights of clearing corporations/clearing houses in settlements in order to rule out all other claims such as court orders, execution petitions, claims by creditors, claims by stock brokers etc. which would vitiate the settlement process. Draft text of the proposed amendment under consideration of Government is enclosed. This Committee may kindly consider recommending such an amendment on priority.
8. Proposed Amendment to the Securities (Contract) Regulation Act, 1956
  1. (1) This Act may be called the Securities Contracts (Regulation) (Amendment) Act, 2015.
  - (2) It shall be come into force on the date of its publication in the Official Gazette.

2. In the Securities Contracts (Regulation) Act, 1956, -

(i) in section 2, after clause (c) the following clause shall be inserted, namely,-

“(ca) “netting” means the determination by clearing corporation of net payment or delivery obligations of the clearing members of a recognised clearing corporation by setting off or adjustment of the inter se obligations or claims arising out of buying and selling of securities including the claims and obligations arising out of the determination by the clearing corporation or stock exchange, on the insolvency or dissolution or winding up of any clearing member or trading member or client or such other circumstances as the clearing corporation may specify in its bye-laws, of the transactions admitted for settlement at a future date so that only a net claim be demanded, or a net obligation be owned.”

(ii) after section 20, the following sections shall be inserted, namely-

**“Right of Clearing Corporation.**

**20A.** Notwithstanding anything contained in any other law for the time being in force, the right of clearing corporation to recover their dues from clearing members, incurred in discharge of their clearing and settlement functions, from the collaterals, deposits and the assets of clearing members, in case of winding-up or insolvency, as the case may be, of such clearing member, shall take precedence over the rights of other persons in such insolvency or winding-up proceedings.”

**“Settlement and Netting.**

**20B.** (1) The payment and settlement in respect of transactions in recognized stock exchange and recognized clearing corporation shall be determined in accordance with the netting (or gross) procedure as per the bye-laws of a recognized stock exchange or recognized clearing corporation, as the case may be, with the prior approval of the Securities and Exchange Board of India.

(2) Notwithstanding anything contained in any other law for the time being in force, a payment and settlement referred to in sub-section (1), between the parties thereto, effected as per the bye-laws of a recognized stock exchange or recognized clearing corporation, as the case may be, shall be final, irrevocable and binding on such parties.

(3) Where a trading member or a clearing member or an investor client is declared by a court of competent jurisdiction as insolvent or is dissolved or wound up, or a liquidator, receiver or assignee (by whatever name called), whether provisional or otherwise, is appointed in a proceeding relating to insolvency or dissolution or winding up of a system participant, then such order of adjudication or dissolution or winding-up, as the case may be, shall not affect any settlement that has become final and irrevocable and the right of the recognized clearing corporation or recognized stock exchange, as the case may be, to appropriate any collaterals or deposits or margins contributed by the said trading member or clearing member or client towards its settlement or other obligations in accordance with the bye-laws of such recognized stock exchange or recognized clearing corporation, as the case may be.

**Explanation.**— For removal of doubts, it is hereby declared that the settlement, whether gross or net, referred to in this section is final and irrevocable as soon as the money, securities or other transactions payable as a result of such settlement is determined, whether or not such money, securities or other transactions is actually paid."

(4) Where an order referred to in sub-section (3) is made with respect to a clearing corporation or stock exchange, then, notwithstanding such order or anything contained in any other law for the time being in force, the payment obligations and settlement instructions between the clearing corporation and the clearing members including those arising from transactions admitted for settlement at a future date, shall be determined forthwith by the clearing corporation, in accordance with the gross or netting procedure, as the case may be, in accordance with the bye-laws of such clearing corporation, , and such determination shall be final and irrevocable.

(5) Notwithstanding anything contained in any other law for the time being in force, the liquidator, receiver or assignee (by whatever name called) of the clearing corporation, whether appointed as provisional or otherwise, shall –

- a) not re-open any determination that has become final and irrevocable;
- b) after appropriating in accordance with the bye-laws of the clearing corporation, the collaterals provided by the clearing members towards their settlement or other obligations, return the collaterals held in excess to the clearing members concerned.