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THE CORPORATE INSOLVENCY REGIME IN INDIA

A CASE FOR REFORM

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1. INTRODUCTORY NOTE

"There is no question that bankruptcy is the most critical indicator of the culture of a legal system in its business law."

-Philip R Wood in DEBT RESTRUCTURING (Olivares-Caminal, Douglas, Guynn, Kornberg, Peterson, Singh, Stonefrost, eds., 2011, OUP) [Hereinafter Singh et al].

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 121 out of the 189 countries for resolving insolvencies. It notes, "according to the data collected by *Doing Business*, resolving insolvencies takes 4.3 years on average" in India (which is greater than the time taken for resolving insolvencies in Pakistan and Bangladesh). In spite of being structurally similar to some efficiently functioning insolvency regimes of the world, the Indian regime has not proved to be very effective in practice. A series of Government appointed committees underscored the failings of the system and made several recommendations for reform. We submit that for any law to be effective, the institutional context within which it operates plays as significant a role as the substantive law itself. This concept note attempts to make a case for reforming the corporate insolvency regime in India through a combination of substantive and institutional changes.

In Section 2 of this note, we attempt to spell out the broad policy objectives for a well-functioning corporate insolvency system and outline the minimum requirements for the system to be effective. In Section 3, we examine the interaction of corporate insolvency law with debt recovery laws. In Section 4, we look at some of the international practices and proposals that could be suitably adapted to the Indian context to make the system more robust. Given the increase in foreign investments into India in the recent past, the impact of Indian laws that affect businesses can no longer be seen in isolation. In this context, in Section 5 we attempt to make a case for developing an efficient system for addressing cross-border insolvencies in India. In Section 6, we examine the failures of the corporate insolvency regime in India and evaluate explanations for the same. In the concluding section (Section 7), we assimilate the recommendations of certain key committees and make broad recommendations for making the system useful and effective.

It ought to be noted that the purpose of this note is not to spell out the specific reforms that are necessary for a robust corporate insolvency regime in India. On the contrary, it is intended to provide a conceptual understanding of the key issues that must be considered before embarking on such a project and why such a project is necessary. In this sense, it is intended to serve as the catalyst for a more detailed study delving into details of specific proposals for law reform.*

*We also wish to clarify that this note does not address insolvency resolution of 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 also recommended that financial institutions should be subject to a special resolution mechanism, the defining feature of which should be "speed of action". Please see the FSLRC Report (Volume 1, Chapter 7), dated March 22, 2013 for further details.

2. THE GOALS OF CORPORATE INSOLVENCY LAW: THE INDIAN CONTEXT

2.1. Policy Objectives

The recent global economic crisis has had a significant impact on the Indian economy. In the aftermath of the crisis, the earnings of several Indian companies have been adversely affected in many sectors and the cost of raising finance has also gone up. With the demand for many goods and services having decreased, corporate failure is becoming increasingly common in India (as in other parts of the world). Moreover, "multinational enterprise leads necessarily to multinational default" (Westbrook). 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 the face of such extensive financial distress, the economy requires a *highly efficient* corporate insolvency regime that (a) separates viable companies from the unviable ones, (b) reorganizes the former to extent feasible and liquidates the latter (before any significant depletion in the value of the business), minimizing losses for all stakeholders in the process.

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, reorganization 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" (Carruthers & Kim). Such reorganization 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 (Baird).[1]

Resolving insolvencies can be said to have several policy objectives. Some of the key goals of corporate insolvency law in the Indian context are analyzed below:

[1] Please see the Section 4.1 (B) below for a discussion on Pre-packaged Administrations and Auctions.

(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 (J. Stiglitz). 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 (Jackson). 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.[2]

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"(Franken). The Indian reorganization and liquidation regime, as enshrined in Chapters XIX and XX of the Companies Act, 2013 subscribes to this 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. However, whether the law succeeds in giving effect to this philosophy in practice is a separate question.

(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 (Regus). An effective corporate insolvency law can help this process by enabling reallocation of 'inefficiently utilized resources' and 'ousting of inefficient participants' from the market (Pavlova). 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 (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

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[2] Please refer to Section 3 of this note for a detailed discussion on the interaction between debt recovery laws and corporate insolvency law.

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). Theory predicts that improved creditor rights could assist with the development of bond markets (La Porta).[3] There is also some empirical evidence to support that better enforcement of creditor rights helps in the development of bond markets (e.g. Boubakri and Ghouma). 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) 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. 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..." (Klapper, Laeven, Rajan). 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 giving them some control over the process may incentivize them to initiate the process in time and co-operate with the other stakeholders.

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[3] 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".

(a) 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 (Jackson) and that companies should not be allowed to remain alive for the only purpose of preventing unemployment.

(E) Enhancing Investor Confidence:

While the focus of this concept note is corporate insolvency, reforming the 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).

For reasons to be discussed in subsequent sections of this note, the Indian corporate insolvency regime does not seem to address these objectives effectively.

2.2. Ingredients of an Ideal System

The corporate insolvency laws of most legal systems are widely categorized as either debtor-friendly or creditor-friendly. The regimes of United States, France and Italy are perceived as benefiting the debtors more than the creditors, whereas those of United Kingdom, Sweden and Germany are seen as favouring the creditors (Pavlova). 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. It is believed that the management decisions of smaller companies (with concentrated ownership and one main lender) may be better monitored by the lender if the regime is creditor-friendly (Franken). On the other hand, in large publically held companies (with dispersed ownership and capital structure), a creditor-

friendly regime does not help such monitoring but incentivizes the management to delay the initiation. A debtor-friendly regime that allows managers of such companies to remain in control post insolvency filing has 'information forcing qualities' that facilitates timely initiation by the managers (Franken).

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 (Stiglitz). 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 (a) have clear hierarchy of payments upon insolvency, (b) have an efficient system for transferring failed reorganizations to liquidation, and (c) allow sufficient control to the creditors without giving them the leeway to manipulate (Cirmizi, Klapper, Uttamchandani). 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 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 (Franken).

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. It has been argued that when reformers in the developing world look at the laws of industrial economies for guidance, they often fail to realize that those laws operate within an efficient institutional structure. The decision-making institutions of an insolvency system (courts, liquidators and administrators) play a vital role in the success or failure of a system (Westbrook).

Moreover, for the insolvency law to be useful, it must be applied in tandem with other laws such as the debt recovery laws (see further below, Section 3), tax laws (Westbrook) and labour law. The debt recovery laws, if effective, can discourage solvent debtors from abusing the reorganization process. Such recovery laws should provide for the enforcement of both secured and unsecured debts. 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.[4] 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. Debtors often lack the incentives to initiate proceedings

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[4] Please refer to Section 3 for a detailed discussion on the interaction with debt recovery laws.

in time for the fear of loss of control, loss of value and admission of failure (Westbrook). Consequently, businesses, which could otherwise have been saved through reorganization, end up in liquidation. An effective insolvency system must provide for incentives and/or sanctions to encourage early initiation of proceedings.

3. INTERACTION WITH DEBT RECOVERY LAWS

Corporate insolvency law (the focus of this concept note) can be understood as distinct from, but closely related to, debt enforcement law.

3.1. The functions of corporate insolvency law and debt enforcement law distinguished

Debt enforcement law is concerned with the rights of individual creditors to enforce a debt on a borrower's default (the failure to pay the debt as and when it falls due). The debt may be unsecured, such that any enforcement rights may only be exercised against the available (unsecured) assets of the debtor. Alternatively, a debt may be wholly or partly secured, with the result that enforcement rights may be able to be exercised (to the exclusion of others, except the holders of superior security interests) against secured assets. In either case, the exercise of debt enforcement rights can result in the forcible sale of some of the debtor's assets to discharge the debt, which may in turn imperil the viability of the debtor (as in circumstances where the assets sold are complementary to other assets of the debtor, or otherwise essential to the conduct of its business).

While debt enforcement law provides individual creditors with a remedy on default, corporate insolvency law provides a *collective* mechanism to deal with a distressed debtor's overall position. Once triggered, corporate insolvency laws typically suspend (through the imposition of some form of moratorium) the exercise of individual enforcement rights,[5] replacing them with a single process for the preservation, realisation and sale of the debtor's assets and the distribution of proceeds to creditors, and/or the restructuring of debts. This process is buttressed with statutory tools to set aside transactions executed in the lead-up to the proceedings that diminished the debtor's assets[6] or gave one creditor an advantage over others (as in the case of a fraudulent preference),[7] as well as tools to sanction managerial misbehaviour in that period (for example, through imposing personal liability for fraudulent trading).[8] These tools may enhance the pool of assets available for distribution to creditors in a company's insolvency, but (where effective) can also have broader effects in promoting commercial morality *ex ante*.[9]

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[5] Although the moratorium does not always extend to prohibit the exercise of enforcement rights by secured creditors, as to which see further Section 3.2 (B) below.

[6] See for example s 329 of the Companies Act 2013 (not yet notified for commencement).

[7] See for example s 328 of the Companies Act 2013 (not yet notified for commencement).

[8] See for example ss 213 and 447 of the Companies Act 2013 (not yet notified for commencement).

[9] *Report of the Review Committee on Insolvency Law and Practice* (the 'Cork Report') (Her Majesty's Stationery Office, London, 1982), para [235](a).

While recourse to debt enforcement procedures tends to result in the piecemeal sale of the debtor's assets, the collective nature of corporate insolvency procedures means that they are in principle capable of preserving the debtor's business, at least temporarily. This means that such procedures can be used, for example, to achieve a sale of the debtor's business on a going concern basis, thus avoiding the loss of value that results when assets worth more together are sold on a break-up or piecemeal basis. Even where the business cannot be saved and the debtor's assets will be worth most if sold on a break-up basis,[10] it can be value maximising to have recourse to a single collective insolvency procedure: it can avoid the need for duplication of debt enforcement efforts by individual creditors, and (perhaps even more significantly) may help to reduce the need for duplication of monitoring efforts by creditors *ex ante*.[11] Recourse to corporate insolvency procedures can, however, also be a source of significant costs. These costs are both direct (for example, the costs associated with the work of an insolvency practitioner such as a liquidator) and indirect (for example, the loss of customers or trading partners once proceedings are publicised, and investment opportunities lost during the pendency of proceedings).[12] Managing the costs of corporate insolvency procedures is crucial to realising their potential to maximise value (relative to individual recourse to debt enforcement remedies) in a particular case.

3.2. The interrelationship between corporate insolvency law and debt enforcement law

Although they serve different functions, corporate insolvency law and debt enforcement law interrelate in at least two important respects:

(A) For solvent but recalcitrant debtors, corporate insolvency law can support debt enforcement law by performing a disciplinary function

As explained above, the commencement of corporate insolvency procedures may entail significant costs. These costs mean that - assuming that value maximisation is the goal - corporate insolvency procedures should not be used as a primary tool for debt enforcement. For solvent debtors, 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. In India, the establishment of debt recovery tribunals[13] was a step in this direction, but these tribunals were made available only to institutional creditors (banks and financial institutions), with other classes of creditors left to their ordinary remedies in the notoriously delayed civil courts. More could be done to ensure the availability of inexpensive and effective debt enforcement remedies for use against solvent but recalcitrant corporate debtors. Such efforts would help to guard against the future unnecessary use of costly collective insolvency procedures in such circumstances.

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[10] i.e. the firm is economically, rather than financially distressed: D Baird, 'Bankruptcy's Uncontested Axioms' (1998) 108(3) *Yale Law Journal* 573, 580-581.

[11] See Michelle White, 'The Corporate Bankruptcy Decision' (1989) 3(2) *Journal of Economic Perspectives* 129, 130.

[12] Ibid, 146.

[13] Under the Recovery of Debts Due to Banks and Financial Institutions Act 1993.

Whilst corporate insolvency law should not be a primary tool for debt enforcement, the law may however play an important supporting role where a corporate debtor is solvent but refuses to meet its repayment obligations. In such circumstances, the creditor may be able to use the threat of corporate insolvency procedures – with their attendant costs for debtors – to encourage repayment.[14] For this to be effective, however, the threat must be a credible one. This may mean that creditors have to be given some control over the initiation of corporate insolvency procedures, for example by giving them the right (as is the case under existing Indian law) to petition for the winding up of a debtor. More fundamentally, there must also be a real possibility of the imminent commencement of proceedings, and attendant publicity. If the debtor company is able to delay the process and the publicising of the creditor's petition, then the threat is no longer a credible one. In the Indian context, it appears strongly arguable that lengthy delays in the initial treatment of creditors' petitions to wind up companies on insolvency grounds[15] mean that the threat of imminent liquidation is not necessarily – at least on the present state of the law – a credible one. If this is so, then the law is not currently performing this supportive, disciplinary function for debt enforcement.[16]

(B) For distressed debtors, corporate insolvency law may also relieve against the operation of debt enforcement law

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.

As explained above, 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.[17] In its current form, Indian corporate insolvency law appears unusual in permitting secured (institutional) creditors to wholly escape the application of the moratorium in corporate rescue procedures in certain circumstances. This escape route was initially provided by an amendment to the Sick Industrial Companies (Special Provisions)

[14] Cork Report n x [235](b).

[15] As to which, see further Section 6.4 below (regarding the van Zwieten research findings).

[16] As explicitly noted in MR Umarji, 'Trends and Developments in Insolvency Systems and Risk Management: The Experience of India' in MR Umarji, *Thoughts on Banking Sector Reforms* (Indian Banks' Association 2008) 159.

[17] 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.

Act 1985[18] (hereinafter, SICA), which might perhaps be best understood as a reaction to the widespread perception that the Act was dysfunctional and not being used for legitimate rescue purposes.[19] But the same carve-outs for secured (institutional) creditors have been reproduced in the corporate rescue provisions of the Companies Act 2013.[20] The ability of secured creditors to prevent the commencement of a corporate rescue procedure or to close a pending rescue procedure will necessarily limit the extent to which this procedure can be used to ameliorate the potential inefficiencies of piecemeal asset sales. 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[21] – they could have been rescued under a collective insolvency procedure.

Historically, proposals for reform to Indian corporate insolvency law have often been presented without reference to the interactions between corporate insolvency law and debt enforcement law. It is suggested that these interactions should be better understood and analysed, if reforms to either branch of law are to be effective in achieving the underlying goals of policymakers.

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[18] Effected by the enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (amending s 15 of SICA).

[19] See for example Report of the Committee on Financial Sector Reforms, *A Hundred Small Steps* (Sage Publications 2009) 173.

[20] See the provisos to s 254.

[21] 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.

4. INTERNATIONAL APPROACHES

4.1. Useful Practices and Developments

In this Section, we look at a selection some recent (and some well-established) approaches to insolvency law and practice which have been adopted in different international jurisdictions and briefly assess their suitability to the Indian context.

(A) Insolvency and Corporate Governance:

Many corporate insolvency regimes impose several duties on the directors when the company becomes distressed to prevent them from disposing of the assets of the company, with the intention of keeping the assets beyond the reach of the creditors in a mandatory insolvency procedure. Literature on the subject suggests that the directors of a failing company should be liable to the creditors even before the event of insolvency in certain circumstances. When faced with the prospect of financial distress, the shareholders and 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). According to this view, when a company is in financial distress, the law should impose certain duties on the directors to ensure that they take all reasonable measures to preserve the remaining value. 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 British Insolvency Act, 1986 (Section 214) subjects directors to personal liability if they fail to take reasonable steps to minimize the potential loss to the creditors when they knew or ought to have concluded that there is no reasonable prospect of avoiding the company going into 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 (Davies).

It may 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), 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 United States and the UK, and Australian courts, have held that the duties of directors to the company should be adjusted to reflect the fact that when the company is in the 'zone of insolvency', the residual claimants are the creditors and not the shareholders (Credit Lyonnais, N.V v. Path Communications Corp. in the US and West Mercia Safety wear v Dodd in the UK). Corporate collapses like that of a major airline company in India in the recent past 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.

Further, the directors and the management of failing or failed businesses often act on advice of external advisors like accountants. The law should also impose duties on such advisors to enable early initiation of insolvency proceedings. In the Indian context, such a duty can be imposed on the statutory auditors. Penalties could be imposed on the accountants, if it can be established that they provided negligent advice on the solvency of the company or were complicit in any fraud perpetrated by the management that led to or could have led to 'deepening of insolvency' (Colasacco). Having said that, further research and evaluation may be required before any such measures are introduced in the Indian context.

(B) Out-of- Court Restructuring:

a) Pre-Packaged Administration:

Pre-packaged administration is a practice evolved in the UK and the US where a sale of the all or part of the company's business and/or assets is arranged before formal entry into a corporate insolvency procedure. The actual sale is then executed on the date of the commencement of proceedings or shortly thereafter (*Singh et al*). *Armour* describes how the process works in practice in the UK: "the putative administrator is introduced to the firm's directors in advance of his appointment, and works with them to market the business on a confidential basis to potentially interested parties. A sale is negotiated, due diligence completed, and a price agreed. All the documents are prepared and put in escrow. Then at a pre-arranged time, the administrator is formally appointed, and executes the sale immediately." Many insolvencies in the UK have been resolved under this approach. Since, the pre-packaged administration only requires the consent of the secured creditors, it has been argued that the system is biased in favour of the secured creditors. However, it does have the advantage (as Armour explains) of avoiding the losses that are typically associated with the publicity of the commencement of insolvency proceedings. As long as issues like sales to related parties are addressed, it is submitted that pre-packaged administration could be a very efficient way of resolving insolvencies in India (especially where the businesses are closely held or run by families and have a limited number of creditors). Again, this is an issue which warrants further research and analysis.

b) Voluntary Auctions:

It has been proposed that a company seeking rescue protection could be subjected to a voluntary auction (Baird). The proceeds of the auction could be distributed among the different stakeholders in the same order of priority as provided for in the liquidation regime. Such auction could be for the business or for some or all of the company's assets or the interests in the company (equity or debt). The court or the administrator may only act as a referee in the auction process.

c) Debt - exchange Offers:

Debt - exchange offers have emerged as an effective restructuring tool for many companies in the US. A typical offer involves an offer document (designed specifically for the holders of existing debt securities) and provides a combination of options for exchange (including modification of existing covenants, modification of collateral, etc.). It may be noted that such a restructuring exercise may have implications under the capital markets regulatory regime, which need to be considered.

d) Other Alternatives:

Companies in financial distress can also resort to measures like ‘down-round’ financing, ‘washout financing’ and ‘debt conversion deals’ (Singh et al). Down-round financing involves issuance of securities at a price lower than their actual value. Both existing and new investors can finance the company under this mode. As part of washout financing, existing equity is washed out completely and new investors get significant equity interests in the company. Debt-conversion deals can enable creditors to get equity interests in the company in exchange of complete or partial satisfaction of the debt.

While out-of-court restructuring exercises can serve as a very useful tool for resolving insolvencies, they may require some regulatory oversight to ensure that the interests of various stakeholders are not undermined in any way.

(C) Chapter 11 Reforms in the US:

The Chapter 11 bankruptcy process (that allows managers to propose a reorganization plan and continue operating the business) was considered to be extremely flawed in the early years of its operation. It protected the debtors from action by the creditors and facilitated long delays. However, over the years, the Chapter 11 process has become very effective in spite of remaining largely debtor-friendly in orientation ‘on the books’. It has been suggested that the success of the Chapter 11 process can be attributed to measures like ‘debtor-in-possession financing’ (DIP Financing) or ‘post-petition financing’, ‘management incentives for efficient reorganization’ and ‘creditor control of the board of directors’ (Skeel) and ‘363 sales’ (similar to pre-packaged sales, discussed above).

(a) DIP Financing involves the bankruptcy court giving several benefits to a lender who agrees to provide finance to the company under reorganization (benefits including super priority, i.e., superiority over existing secured creditors, provided their interests are adequately protected). The said DIP Financing lender also gets many governance rights under the DIP Financing agreement to ensure that its interests are adequately protected. The DIP Financing agreements have become the basis for reorganization of several companies under the Chapter 11 proceedings. (b) It is believed that when the management is not the cause for the failure of a company, they should be allowed to remain in control as they understand the business best and could play a significant role in turning the situation around (Armour). This can also help incentivize managers to file for corporate insolvency proceedings at a suitably early time (Franken). Moreover, hiring new managers and getting them up to speed could be a wasteful exercise. The DIP Financing creditors in the Chapter 11 process usually rely on target based compensation package for the existing managers to facilitate an efficient reorganization (through retention bonuses, payouts linked to asset sales and success of the reorganization process). (c) In addition to exerting influence over the board through the DIP Financing agreement, the creditors exercise significant control over the board through veto powers on several issues.

(D) Insolvency Officials:

It is widely recognized that the efficacy of an insolvency regime is also dependent on the competence of its insolvency officials. It is suggested that such competence should include knowledge of both law and business. Educational programs initiated by the Government can play a very significant role here.

Some countries have licensing and training requirements for insolvency professionals, enabling them to resolve insolvencies more effectively (Cirmizi, Klapper, Uttamchandani). It is argued that "educational programs frequently make more difference in the actual function of a legal system than the incentives and disincentives so carefully included in the law itself" (Westbrook). Having a dedicated, "Insolvency Practitioners" profession must also be considered in order to improve the outcomes in this field.

(E) Other Developments

The 'Doing Business 2014' report notes that the reorganization process has been the focus of most recent reforms the world over. The report observes that the Czech Republic insolvency regime is a good example of how well directed corporate insolvency reforms can have a real impact on the economy. By streamlining the system (the time taken to resolve insolvencies has fallen by 4.4 years over a period of 5 years) and introducing 'educational and professional' requirements for the officials, the regime has been able to save many financially distressed (but economically viable) companies. As a consequence of the reforms, the recovery rate for creditors increased by three times between 2008 and 2013. [22]

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[22] Please see 'Resolving Insolvency', available at http://www.doingbusiness.org/reports/global-reports/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB14-Chapters/DB14-Resolving-insolvency.pdf

5. CROSS - BORDER INSOLVENCY

The legal regime governing cross-border insolvencies faces several challenges. The absence of a comprehensive cross-border insolvency framework is the foremost among them. The consequent conflicts between legal systems results in the wastage of valuable resources. It also results in disparate treatment of foreign and domestic creditors. There have been a few notable attempts to address these concerns. These include The UNCITRAL Model Law on Cross-Border Insolvency, 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.

5.1. Jurisdictional Parameters[23]

Without reference to any particular legal system, this section attempts to chalk out the potential criteria on the basis of which the jurisdiction of Courts in cross-border insolvencies may be based:

(A) The place of incorporation:

This approach locates jurisdiction on the basis of place of incorporation of the insolvent debtor. While certainly enhancing predictability, it is feared that this may often point to a jurisdiction which has very little real connection with the insolvent company (Irit Ronen-Mevorach). European Courts have often proceeded on the basis of a presumption that the center of main interests of a company lies in the place of incorporation. However, this presumption is rebuttable (*Eurofood IFSC Ltd case*).

(B) The location of principal assets:

The asset-based test is considered as one of the weakest factors for determining the jurisdiction for international insolvency proceedings (Irit Ronen-Mevorach). In most circumstances, it is time consuming and expensive to ascertain the international assets of the company. Moreover, asset-based jurisdiction can only be determined after the insolvency proceedings have begun. This makes the preliminary determination of jurisdiction unpredictable and prone to manipulations.

(C) The center of main interests:

Article 3(1) of the EU Regulation confers jurisdiction on the State where the "centre of a debtor's main interests is situated". However, the Regulation does not define that phrase. But the Virgos and Schmit Report and the recitals to the EU regulation are instructive. They suggest that it refers to the place where the debtor company conducts its administration on a regular basis and is therefore ascertainable by third parties (Recital 13). The Court of Justice of the European Union had occasion to consider an interesting question on the interpretation of Article 3(1) in its recent decision in *Interedil Srl* (Case C-396/09). The question before the court there was as regards the point in time

[23] It may be noted that other issues that assume importance in a cross-border insolvency case are (a) scope (whether the proceedings will have effect outside the jurisdiction or not), (b) recognition and assistance (obligations of courts of other jurisdictions to recognize the proceedings and offer assistance), and (c) applicable law.

with regard to which the center of main interests of the insolvent company must be determined. It was held that, "it is the location of the debtor's main centre of interests at the date on which the request to open insolvency proceedings was lodged that is relevant for the purpose of determining the court having jurisdiction."

5.2. Anti-Suit Injunctions

In cross-border insolvencies, creditors may circumvent centralised liquidation proceedings and file suits in local jurisdictions so as to obtain priority over other claims against the company. It is feared that this will result in the inequitable distribution of assets and unfairly prejudice some creditors to the detriment of others. Anti-suit injunctions are one method of addressing this concern. In *Aerospatiale v Lee Kui Jak*[24], the Privy Council held that English Courts have the power to issue anti-suit injunctions to protect the integrity of insolvency proceedings pending before the Court. Restraining a person from seeking, by foreign proceedings, to obtain the sole benefit of certain foreign assets was named as one instance where issuance of such as injunction is warranted.

5.3. UNCITRAL Model Law

The UNCITRAL Model Law attempts to provide a modern legal framework for the regulation of cross-border insolvency. The model law is of special relevance to India as its adoption with suitable modifications has been recommended by several expert panels including the including the J J Irani Committee.

(A) Objectives and Scope:

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 Model Law, however, does not undermine the autonomy of individual nations to adopt their own insolvency rules. Substantial autonomy in implementation is ensured.

a) Recognition of Foreign Proceedings:

Recognition of foreign insolvency proceedings is a prerequisite under the Model Law (Articles 25 and 26). This is intended to ensure effective implementation of the other provisions relating to access to foreign creditors and parity of treatment. A foreign proceeding may be a "Foreign Main Proceeding" ("FMP") or a Foreign Non-Main Proceeding" (FNMP). This classification determines the relief that can be granted by the foreign court. The Model Law defines a FMP as a "foreign proceeding that takes place in the debtor's home country, or the location of the debtor's "centre of its main interest."

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[24] [1987] AC 871

(Article 2(b) and 2(c)) The initiation of an FMP results in automatic stay of all the proceedings in other jurisdictions and mandates transfer of all the assets of the debtor to the foreign proceeding subject to local law of the State (Article 20). In the case of an FNMP however, the Court can only grant permissive relief that includes a further stay, an examination of witnesses and taking of evidence, and the entrustment of the debtor's assets to the foreign representative provided the entrustment does not prejudice the interest of local creditors.

b) Judicial Cooperation:

Coordination between the Courts of different jurisdictions is essential to ensure an efficient and cohesive international insolvency legal regime envisaged under the Model Law. While respecting the autonomy of courts, the Model Law provides a list of methods to facilitate cooperation like appointment of a mediator, coordination of the proceedings, communication directly or through an official. It prevents duplicity of legal proceedings, but confining the jurisdiction of any non FMP proceeding to the local assets. It also mandates that any other proceeding should act in coordination and cooperation with the FMP proceeding in providing relief that relates to assets that under local law should be administered in the FMP. If the domestic proceeding is in progress before the initiation of the FMP proceeding, then the provision of automatic stay does not apply. Moreover, the FMP proceeding can only grant relief that does not conflict with the domestic proceeding.

6. THE LIMITATIONS OF THE INDIAN INSOLVENCY REGIME

In this Section, we evaluate the reasons for the failure of the Indian insolvency regime.

6.1. Doing Business 2014 (World Bank Report) Findings

The 'Doing Business 2014' Report studies the efficiency of the Indian insolvency regime on the basis of four parameters: (a) time required to recover debts; (b) cost required to recover debts; (c) outcome i.e. whether the business continued to operate or was sold; and (d) Recovery rate for creditors. The crucial findings made by the report on the Indian insolvency regime are summed up in this passage: "According to data collected by Doing Business, resolving insolvency takes 4.3 years on average and costs 9% 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 25.6 cents on the dollar…" When ranked in accordance with the ease of resolving insolvency, India was found to be at 121 among 189 economies.

Interestingly, on three of the four parameters listed above, namely, time required to recover debts, cost of recovery and recovery rate for creditors, there was found to be no notable change in the efficiency of the Indian legal regime in the decade between 2004 and 2014. It may be some consolation however that the global average in this period also remained more or less stagnant. However, there was a significant improvement in the regional average of South Asian countries between 2007 and 2008 as far as cost of recovery is concerned. A far more alarming trend however is the fact that, between 2009 and 2014, the report notes no significant reform measure in the Indian legal regime. The sole exception to this is the year 2010 which saw minor reforms that made it easier for companies to close businesses.

6.2. Reasons cited by commissions[25]

Most attempts to study the efficiency of the Indian insolvency regime paint a very poor picture. The report on company law headed by Dr. Jamshed J Irani is an example. The following passage from that report is particularly telling:

"The Indian system provides neither an opportunity for speedy and effective rehabilitation nor for an efficient exit. The process for rehabilitation, regulated by the Sick Industrial Companies (Special Provisions) Act 1985 through the institutional structure of BIFR is amenable to delays and does not provide a balanced or effective framework for all stakeholders. The process of liquidation and winding up is costly, inordinately lengthy and results in almost complete erosion of asset value."

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[25] This Section is based on the analysis of the relevant Committee Reports by Dr. Kristin van Zwieten in her doctoral research project at the University of Oxford. Please see Section 6.4 below for her findings on the failure of the Indian corporate insolvency regime.

(A) Historical Reasons – Inordinate Focus on Industrial Companies

There was a relative absence of concerted efforts to effect meaningful reforms in Indian insolvency regime for a long period after independence. This is attributable to the inordinate focus on the insolvency and rehabilitation of industrial companies alone. That was the finding made by a committee of bankers appointed by the RBI in 1981 to review the role of banks and financial institutions in rehabilitation of sick industries (Tiwari Committee Report, 1984). As far as the role played by financial institutions in responding to industrial sickness, the Tiwari Committee report made three central findings: (a) it was often assumed that viable sick industrial companies were entitled to financial assistance; (b) viability was defined in an extremely liberal manner; even a company that could be expected to service its debts within eight to ten years was considered 'viable'; (c) exceptionally, even debtors who did not meet the requirement of viability were offered rehabilitation packages.

Similarly, the Narasimham Committee report (1991) was critical of the abundance of credit facilities available to the targeted markets industrial firms. This, according to the committee came at a great cost – 'the cost of deterioration of the quality of the loan portfolio, the growth of overdues and consequent erosion of profitability'. More importantly, the committee was critical of the issue of government interference in the lending decisions of institutional creditors. In that regard, the Report remarks:

"But by far the most serious damage to the system and one which has contributed to the decline in the portfolio quality has been the evidence of political and administrative interference in credit decision making. Populism and political and administrative influence bordering on interference should have no place in the lexicon of banking and finance but unfortunately, over the years, competitive populism has affected banking and credit operations."

This inordinate institutional focus on the rehabilitation of sick industrial companies came at the expense of evolving a comprehensive legal regime for insolvencies of all companies.

(B) Other Explanations for the Failure of the Insolvency Regime

Procedural delays have often been pointed out as being among the central deficiencies in the Indian insolvency regime. Both the Sachar Committee report (1978) and the Eradi Committee report (2002) support that view. In particular, they point to delays after the making of the winding up order. The Sachar Committee report traces the causes of this delay in three stages. The first among them is the delay by managers of the insolvent firm in providing adequate information to the official liquidator. In that regard, the Report notes:

"there is always a time-lag of more than one year between the presentation of a petition for winding up and the date on which the company is wound up by the court... in fact, since the records are not complete and not updated, the ex-directors are unable to submit the statement of affairs"

The second stage of delay concerns the extremely slow judicial process. A major reason for this is said to be the requirement of court approval at every stage of the winding up process. Notably, this delay also feeds into the first stage. This is because in most cases, the only effective way of enforcing information disclosure by delinquent managers is through judicial proceedings. A third reason for the delay was traced to the internal resource constraints of liquidators.

In response to the deficiencies in the process of administration carried out by liquidators, the Eradi committee proposed two recommendations: (a) creation of new company law tribunals and transferring adjudicatory jurisdiction from High Courts to these tribunals; (b) opening of the private market of liquidators for compulsory liquidation.

The new Companies Act, 2013 attempts to deal with some of these issues, but many others remain to be addressed.

6.3. Political Economy Problems

Aside from law in the books, the political and economic environment in India has considerably influenced the practical effects of its insolvency regime. Some studies suggest that judicial delays have the consequence that a typical winding up proceeding in India takes as long as 10 years from start to finish (Omkar Goswami). There are similar problems with the implementation of legislation. An example of this is SICA. It was enacted ostensibly to provide an improved means for the reconstruction of distressed industrial firms. With the aim of controlling distressed firms, it created a quasi-judicial agency - the Board for Industrial Financial Reconstruction (BIFR). However, in practice, it has been noted that the only effect of this legislation was to keep failed firms in operation to mask unemployment (Armour and Lele).

Furthermore, there is some evidence that sector specific regulatory agencies (such as SEBI and RBI) have been far more effective in evolving improved legal rules as compared to the Parliament. The best evidence of this may be found in the rapid development of shareholder protection norms (regulated by SEBI) as contrasted with the stagnancy of the legal protection offered to creditor's rights (regulated mainly through primary legislation)(Armour and Lele).

A third implication of the political environment is the effect of lobbying by certain interest groups. As regards corporate insolvency law, trade unions feature most prominently in this category. There is some evidence that they have had at least two important implications as far as the Indian insolvency regime is concerned. First, though they have been relatively inactive as far as investor protection norms evolved by SEBI and RBI are concerned, they have played a more conspicuous role as far as insolvency regulation is concerned. Some suggest that they have effectively lobbied against reform measures that may have had the effect of taking away certain pro-employee features of the current law (Umarji M. R.). Secondly, among the petitioners in the public interest litigation challenging the creation of the National Company Law Tribunal, a sizeable number were trade unions (Armour and Lele).

6.4. van Zwieten Research Findings

This four-year doctoral research project[26] was completed by Kristin van Zwieten (now Clifford Chance Associate Professor of Law and Finance at Oxford) under the supervision of Professor John Armour (Hogan Lovells Professor of Law and Finance at Oxford). The project analysed the development of corporate insolvency law in India over time, beginning with the initial transplant of company liquidation law in the colonial period, and charting the evidence of the operation of both liquidation and corporate rescue law from independence to present day.

The project focused particularly on the influence of judges on the development of Indian corporate insolvency law. To investigate this, the author compiled two large datasets of Indian case law: one containing judgments on a creditor's petition for winding-up (on insolvency grounds) under the compulsory liquidation procedure in the Companies Act 1956; the other containing judgments of the superior civil courts and some tribunals concerning companies registered (or expected to be registered) under the corporate rescue procedure in SICA. These cases were reviewed to see how judges interpreted and applied corporate insolvency law rules in practice. After reviewing the cases, the author reported that for both the company liquidation procedure under the Companies Act 1956, and the corporate rescue procedure under SICA, there had been a series of significant innovations by judges in their interpretation and application of the law. She concluded that these innovations had had a significant impact on how these 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, the author 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 and attendant delays;[27]
- 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.[28]

The author 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).

[26] *The Demise of Corporate Insolvency Law in India* (2011, doctoral thesis in law, University of Oxford)

[27] See ibid Section 5.2.1, and the literature and cases there reviewed.

[28] See ibid Section 5.2.2, and the literature and cases there reviewed.

For *corporate rescue* under SICA, the author revealed a series of innovations by judges that influenced the operation of this Act in practice.[29] Two of the developments that she highlighted were:

- a change in the interpretation of 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 delayed civil courts;[30]

- relatedly, the development of a judicial practice in the High Courts of permitting SICA companies to explore rehabilitation after the issuance of a liquidation opinion by the BIFR, achieved through a range of procedural devices including adjournments and stays.[31]

She concluded that these developments added significantly to the delays associated with the disposal of proceedings under 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). Please see Section 7.2 (A) below for some implications of her findings for reform.

[29] These findings and some of their implications are also set out in K van Zwieten, "The Rescue of Insolvent Industrial Companies in India", Working Paper, University of Oxford (2014).

[30] See *The Demise of Corporate Insolvency Law in India* n x Section 8.2.3, and the literature and cases there reviewed.

[31] See ibid Section 8.2.2, and the literature and cases there reviewed.

7. PROPOSALS FOR REFORM

In the first part of this section, we summarize the recommendations of some key committees on reforming the corporate insolvency regime. In Part-2, we explore further reforms drawing from other sections of the note. More specifically, we propose that a two-pronged strategy of introducing (a) institutional and (b) substantive and procedural changes to the system be pursued for reforming the system holistically.

7.1. Committee Recommendations

"A Hundred Small Steps", the Report of the Committee on Financial Sector Reforms headed by Professor Raghuram Rajan identifies the following key ideals of an insolvency regime: (a) Legal Framework for Creditor Rights; (b) Effective legal framework capable of distinguishing between proper cases for winding up and rehabilitation; (c) Legal Framework for informal workouts (d) Institutional and Regulatory capacity for implementing the law. Significantly, the report also chalks out the foundations for building an effective formal rehabilitation scheme.

The notable features of the proposed scheme include: (a) Eligibility: the report notes the need for clear and objective bright line rules to determine cases that should be eligible for rehabilitation scheme and those that must not be. This requires the law to strike a balance between functions such as debt collection and taking into the broader socio-economic purpose that the company may serve; (b) Commencement of Proceedings: the report affirms the finding of the Dr. JJ Irani Committee that the most appropriate test for commencement is the 'liquidity test'. It notes that the application of this test has been found to be highly objective; (c) Moratorium and Timeframes: the report notes the necessity of evolving principles on the basis of which a moratorium on the seizure of the debtor's assets may be imposed. This is crucial in affording sufficient time for the debtor organisation to re-organise itself; (d) Control of the debtor: contrasting the two competing approaches to the management of the debtor, namely, the debtor in control approach and the methodology of employing an insolvency administrator, the report prefers the latter. This is because it has been found to result in drastically less contentious proceedings and consequent judicial intervention. The report suggests that the debtor in control approach should be adopted only in cases where such decision has been put to vote and approved by the majority of creditors; (e) Post-commencement financing: in many cases, the continued operation of the debtor company during the period of restructuring may call for additional financing. After considering a relatively radical proposal – that of creating a super-charge over the assets of the company in favour of the lender – the report recommends a more conservative approach. It suggests that the ideal solution would be for the debtor to 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.

It may be noted that the recently appointed FSLRC also reiterated some of the recommendations made by the Raghuram Rajan report for reforming the corporate insolvency regime.

A second notable proposal for reform is the one put forward by the JJ Irani Committee. After noting attempts such as the UNCITRAL Model Law on Cross-border insolvency, the JJ Irani Committee report notes that a comprehensive framework on insolvency issues is likely to make a material contribution to the productivity of the Indian economy.

The JJ Irani Committee report makes the following key recommendations: (a) Rehabilitation and Liquidation: the report notes the need to strike a balance between rehabilitation and liquidation. The latter must be resorted to only when the former option is clearly foreclosed. Even when there has been a resort to liquidation, there must exist opportunities to convert from one set of procedures to the other; (b) Time-bound proceedings: in the light of evidence that insolvency proceedings in India are subject to inordinate delays, the report suggest that the proceedings must proceed in a strictly time-bound manner. It suggests a total period of two years for liquidation proceedings to be completed. As a general rule, it is recommended that separate time limits must be prescribed for each stage of the rehabilitation process. Extensions at every stage should be allowed only in exceptional circumstances.[32] Even when they are, this must be done, as far as practicable, without affecting the outer time limit for the entire process; (c) Applicability and Accessibility: the report recommends the application of an identical insolvency process for all enterprises including small and medium enterprises.[33] Special procedures may however be prescribed for banks, financial institutions and insurance companies. The report however recommends a restriction on the accessibility of the insolvency regime. It provides that debtors must be allowed to approach the tribunal only with a draft scheme for rehabilitation. The report however recommends the opening up of the insolvency regime in an important respect i.e. creditors of 3/4th value may also file a scheme for rehabilitation; (d) Governance and Management: The report prefers the system where the management of the debtor company is replaced by a qualified administrator appointed by the tribunal. Such an administrator will act under the similar obligations to creditors as the management itself; (e) Creditor's Committees: the report recommends the creation of separate committees for secured and other creditors. Apart from facilitating deliberation and consensus building among creditors, this is expected to expedite the insolvency process. The committee representing creditors other than secured creditors plays a more passive role in the rehabilitation process; (f) Appointment of Liquidators: The report recommends the creation of the panel consisting of professionals such as advocates, accountants, company secretaries, costs and works accountants and other experts from whom administrators and liquidators may be appointed.

The new Companies Act, 2013 takes some of these recommendations into account, but several others remain to be addressed.

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[32] It is submitted that the law should not allow any exceptions. Empirical research shows that by subjecting the process to strict time limits (with no possibility of extensions), the regime can show significant improvements in terms of rate of recovery and overall efficiency (Gamboa-Cavazos and Frank Schneider).

[33] It is submitted that the costs of formal proceedings are often prohibitive for small companies and subjecting them to the same extensive process may not be productive.

7.2. Specific Recommendations

(A) Institutional Reforms

There are a number of possible implications for Dr. Kristin van Zwieten's findings (discussed in 6.4 above) for the corporate insolvency law reform agenda in India. She suggests that:

(a) *Practice and procedure in corporate insolvency law cases should attract much more scrutiny,* given the evidence that practice and procedure may have contributed significantly to the problem of delays under the existing law. Practices that delay the disposal of winding-up petitions can dramatically increase the cost of proceedings in an individual case, but they may also have broader effects: delays can reduce the scope for company liquidation law to perform a disciplinary function[34], and they may lead to reduced recourse to the procedure altogether - reducing the law's ability to perform a commercial morality function.[35] In corporate rescue procedures, practices that allow companies to enjoy protection from their creditors (under a stay imposed by corporate rescue law) even after they have been found incapable of rescue could be predicted to have an effect on creditors' willingness to lend to such companies.

(b) *The relationship between the NCLT and the superior courts should be closely monitored and subject to ongoing review.* Like the BIFR, the National Company Law Tribunal (NCLT) is intended to deliver a swift resolution where the High Courts have failed to do so (for example, in company liquidation cases). The ability of the NCLT to deliver this will presumably depend on, among other things, its ability to be insulated from merits review by the superior civil courts. Otherwise, there would appear to be a risk of significant delays while the merits of decisions are re-agitated in other fora, and stakeholders may be perversely incentivised to litigate to achieve such delays.

(c) *Judicial training in relation to both (1) and (2) may be appropriate*, and indeed may be essential if some of the challenges of the past are to be avoided under the new Companies Act 2013 regime.

(B) Substantive and Procedural Changes

a) Reforming the Rescue and Liquidation Mechanisms:

i. It is argued that private parties or the market can be better decision-makers than courts or third parties in certain situations involving an insolvency (Franken). It is submitted that the out-of-court rescue mechanisms that go beyond formal reorganizations should be introduced in India (please see the discussion in Section 4.1 (B) of this note). The pros and cons of such measures and their suitability in the Indian context need to be studied further. The introduction of these measures will require amendments to the Companies Act, 2013 and separate rules for the processes.

ii. Introduction of measures for post-petition financing (like DIP financing in the US) should be introduced for the reorganization process.

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[34] Ibid (Section 3).

[35] Ibid (Section 3).

iii. Debtors (with viable businesses) should be penalized for not initiating the formal reorganization procedure on the occurrence of certain events (within a specified time limit).The unviable businesses should be sent for liquidation directly.
iv. More specific time limits need to be introduced for both the rescue and liquidation provisions without any possibility of extensions.
v. If a company cannot be reorganized within a specified time limit, the liquidation provisions should get triggered automatically.
vi. Having a dedicated, 'Insolvency Practitioners' profession (with licensing requirements) for appointing Administrators and Liquidators should be considered. Once appointed, the practitioners should be closely monitored by an independent authority under the Ministry of Corporate Affairs (and not the courts or tribunals). It must be recognized that complex transactions may require more than one insolvency practitioner.
vii. The selection and appointment mechanism for administrators and liquidators should be prompt.
viii. Unpaid wages of employees (and not just 'workmen') should be adequately addressed.

b) Corporate Governance:

While it is acknowledged that the directors of a company have no direct duties to the creditors, the law should adjust the duties owed to the company in favour of the creditors when the company is in the vicinity of insolvency. Introduction of liability for wrongful trading also needs to be considered in this regard. Further, liability for auditors and advisors could also be considered for 'deepening the insolvency' of a company. These measures could be introduced through amendments and rules.

c) Cross-border Insolvency:

As also recommended in the committee reports discussed in Section 7.1 above, the UNCITRAL Model law on cross-border insolvency should be adopted and implemented in India (with suitable modifications, as may be required). However, such adoption should take place only after reforming the domestic insolvency regime.

d) Rationalization of the Debt Enforcement Regime:

The corporate insolvency law should not be burdened with cases primarily intended for debt enforcement against solvent companies. The debt enforcement laws should be strengthened to perform that function more effectively. The FSLRC recommendations for reforming the debt enforcement regime need to be implemented to ensure the availability of inexpensive and effective debt enforcement remedies for use against solvent but recalcitrant corporate debtors. This requires amendments to the Recovery of Debts Due to Banks and Financial Institutions Act 1993 and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

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