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Decoding the bankruptcy code

Proposed changes to the insolvency regime will boost credit markets and entrepreneurship, argues Debanshu Mukherjee

The Insolvency and Bankruptcy Code, 2015, which was introduced in parliament in December 2015, proposes large-scale reforms to India's corporate insolvency regime. If implemented in its present form, the code will significantly impact the promotion of credit markets and entrepreneurship.

The Sick Industrial Companies Act, 1985 (SICA), is currently the only law that deals with resolving insolvency. However, it applies only to industrial companies and excludes a large number of businesses. The trigger event for initiation of proceedings under SICA is based on a test of erosion of net worth, which does not facilitate timely resolution of the problem.

The proposed code will apply to a wide range of corporate debtors and will cover all forms of businesses. It will allow proceedings to be initiated on the occurrence of any payment default, thus facilitating early intervention by stakeholders.

Further, SICA allows the "management", i.e. the board of an industrial company, to remain in control of the company during its rehabilitation. Several law reform committees have pointed out that this feature of SICA (along with the provision for an automatic stay on legal proceedings, known as a moratorium) was a key factor that led to the failure of the SICA regime. Although the code also provides for a moratorium during the resolution process to facilitate orderly conduct of proceedings, the management's powers will be suspended during the insolvency resolution process and the company will be under the control of an independent resolution professional.

Displacement of the existing management (albeit temporarily) during the resolution process is one of the most important features of the code. It has been argued that the code should have followed Chapter 11 of the US Bankruptcy Code, which allows the management to retain possession of the company during the resolution process. The SICA experience suggests that this may not be a viable proposition for India, as a debtor-in-possession system can work only when a company's management is not controlled and supervised by its promoters (as is the case with many family-owned businesses in India).

A further problem with SICA was its pro-rehabilitation bias. SICA was enacted to solve the problem of "industrial sickness". The adjudicating authorities and courts under the SICA regime used this justification to allow rehabilitation packages for several non-viable companies, which led to complete failure of the system. The code provides that decisions relating to the viability of a corporate debtor will not be taken by an adjudicator but by a committee of financial creditors, such that market forces (and not courts) will determine if a company deserves to be revived or liquidated.

Although the Companies Act, 2013, includes a chapter on insolvency resolution, it does not address the most important issues responsible for the failure of the existing regime. For instance, the Companies Act does not provide for displacement of the management in all cases. Such displacement can take place only under directions of the adjudicating authority (which makes the system highly susceptible to litigation). Thus, the Companies Act does not address the most problematic part of the SICA regime.

Further, the Companies Act provides for five decision points during the rescue process: admission of proceedings; declaration of sickness; examination of viability and decision on whether to rescue or liquidate; preparation and approval of a scheme by the creditors; and approval of the scheme by the adjudicator. Since four of these decision points involve an order from the adjudicator, recurrent appeals and litigation are possible. The entire process can take about a year, or more if any of the intervening decisions are challenged.

In contrast, the code provides for a streamlined and objective process with just two major decision points involving a judicial order, i.e. admission of the case and approval of the resolution plan. Once a case has been admitted, the resolution plan needs to be finalized within 180 days (extendable by 90 days in complex cases), failing which the company automatically goes into liquidation.

The Companies Act, 1956, provides that a company may be liquidated if it is unable to pay its debt. This provision has been retained in the new Companies Act. Whether a company is unable to pay its debt is to be determined by an adjudicator. Currently, the liquidation of assets is carried out by official liquidators, who are severely under-resourced and overburdened, creating significant delays in the liquidation process.

To address this, the code provides that a committee of financial creditors will determine whether a company should be liquidated. This will ensure that liquidation becomes an objective commercial decision and not subject to other considerations. Further, the liquidation of assets will be carried out by a regulated but independent insolvency professional whose fee will be proportionate to the recoveries and the speed at which the job is completed.

Market forces should improve the efficiency and transparency of the insolvency resolution and liquidation process in India. The code contains significant improvements to India's corporate insolvency regime, which could generate positive outcomes for the economy in the long run. ■

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