Insolvency and Bankruptcy Code

The journey so far and the road ahead

December 2018

V | D H | Centre for Legal Policy

Foreword

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Mukherjee

Founding Member
Vidhi Centre for Legal Policy

Despite being a fundamental requirement for any well-functioning economy, India lacked an efficient bankruptcy system. While many government-appointed committees had recommended changes to the old regime, those recommendations were never implemented despite the gravity of the problem and its cost to the economy. The Insolvency and Bankruptcy Code, 2016 (Code) is being hailed as one of India's biggest structural reforms in the economic sphere after independence. As long as it continues to be implemented properly, the Code will have a far-reaching impact on corporate governance (for both banks and borrowers) and the availability of credit in India. As corporate borrowers internalize the costs of bankruptcy (which did not amount to much before the Code was enacted), they are likely to become more disciplined and avoid inefficient expansion. Banks too are likely to deploy better screening and monitoring practices to limit exposure to unviable projects.

We, at Vidhi Centre for Legal Policy, take great pride in having contributed to this reform since the time of its conceptualization. Consolidating on our bankruptcy law and policy experience over the last five years, we have started a Bankruptcy Studies Programme at Vidhi to carry out independent research on bankruptcy issues in collaboration with all interested stakeholders. We believe that the program will help us track bankruptcy law developments (in India and other major jurisdictions) and produce collaborative research that helps in bringing about meaningful change. This is our first publication under the program. It attempts to evaluate the developments since the implementation of the Code in 2016, and in this light, make suggestions for the next generation of reforms required to make the insolvency eco-system more robust. We are very happy to have collaborated with EY for this. I am very thankful to Shreya Prakash, the Coordinator of the program, for taking the lead in putting this together on behalf of Vidhi. I also thank Anjali Anchayil, Vedika Mittal Kumar, Aishwarya Satija, Ulka Bhattacharya and Nayan Banerjee for contributing to this publication.

As better-informed citizens demand the government and the legal system to be more accountable, the Indian economy will continue to become more "rule of law" based. The Code as well as the political and economic forces that caused its enactment are emblematic of this development. If the law causes an over-correction (if, for example, it has a chilling effect on borrowing activity or reduces the risk appetite of businesses), the same forces that caused its enactment are also likely to ensure that it gets reformed again to strike a balance. We hope that our program will provide a steady platform for keeping a close eye on this space and recommend meaningful reforms in the best interest of the economy.

After GST, the Insolvency and Bankruptcy Code is probably the most important legislative reform of our time, as it is expected to resolve the incumbent non-performing asset (NPA) crisis and the resultant logjam in the availability of credit and, in turn, fast track GDP growth. The thrust of the Code has been on:

- Rescue of companies in a time-bound manner and their rehabilitation in due course;
- Shift in control to the creditor via the resolution professional; and
- Empowering the commercial stakeholders to make decisions backed by timely court intervention

Dinkar
Venkatasubramanian

Partner, Restructuring and Turnaround Services, EY

The Code, with its structure and the accompanying intent to implement, has earned praise from all quarters. It is, today, well and truly entrenched and has become the preferred route for corporate distress resolution. While the full impact of the new insolvency regime is not expected to be visible in the short term, some successes have been recorded already.

On the other hand, the Code has faced concerns on readiness of the infrastructure to support the speed of implementation intended. In particular, the bandwidth of the legal system and the ability of the resolution professionals have been subjects of keen scrutiny. The ability and willingness of the stakeholders – creditor, business owner, resolution professional and trade creditors – to work towards a common goal, leaving their inherent insecurities behind, is also a key determinant of the success of the Code.

It might be early to pronounce judgment, but a comprehensive assessment of the Code is surely due. This document, perhaps a bit ambitiously, sets out a report card for the IBC, measuring its progress in light of the challenges that it was up against at inception and over the last two years.

This document also outlines some of the matters that a successful resolution regime should focus on in the Indian context in the near future. A couple of these are immediate and imperative for the intended impact that we seek in corporate distress resolution:

- There is a dire need for an effective pre-insolvency bilateral work-out mechanism by creditors. Owners, professional managers and potential capital providers of stressed assets should, proactively, focus on developing a bonafide and credible rescue plan and engaging with their creditors in time. Such a mechanism should enable creditors to acknowledge signs of stress early and act decisively in support of deserving businesses in their revival efforts. This mechanism should become the norm to resolve stress/ distress while IBC may be best served as a nuclear option
- As much as resolution of the debt issue is critical, the ultimate objective of economic growth and revival cannot be achieved without an effective operational turnaround of the underlying distressed businesses. Rescue plans developed under a resolution/ insolvency should be comprehensive, led by operational turnaround and capital restructuring both

We thank Vidhi Centre for Legal Policy for providing an oppotunity to be associated with this document. We hope that this document by Vidhi-EY is a useful contribution to building out an effective corporate distress resolution regime of the future.

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KKR India

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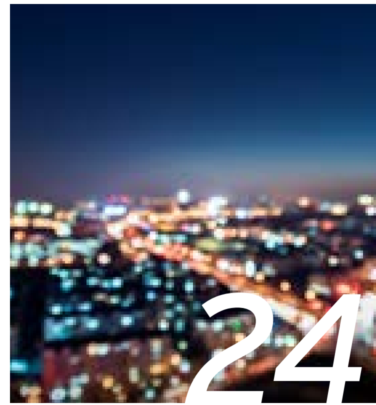


Looking ahead
The next generation of insolvency reforms

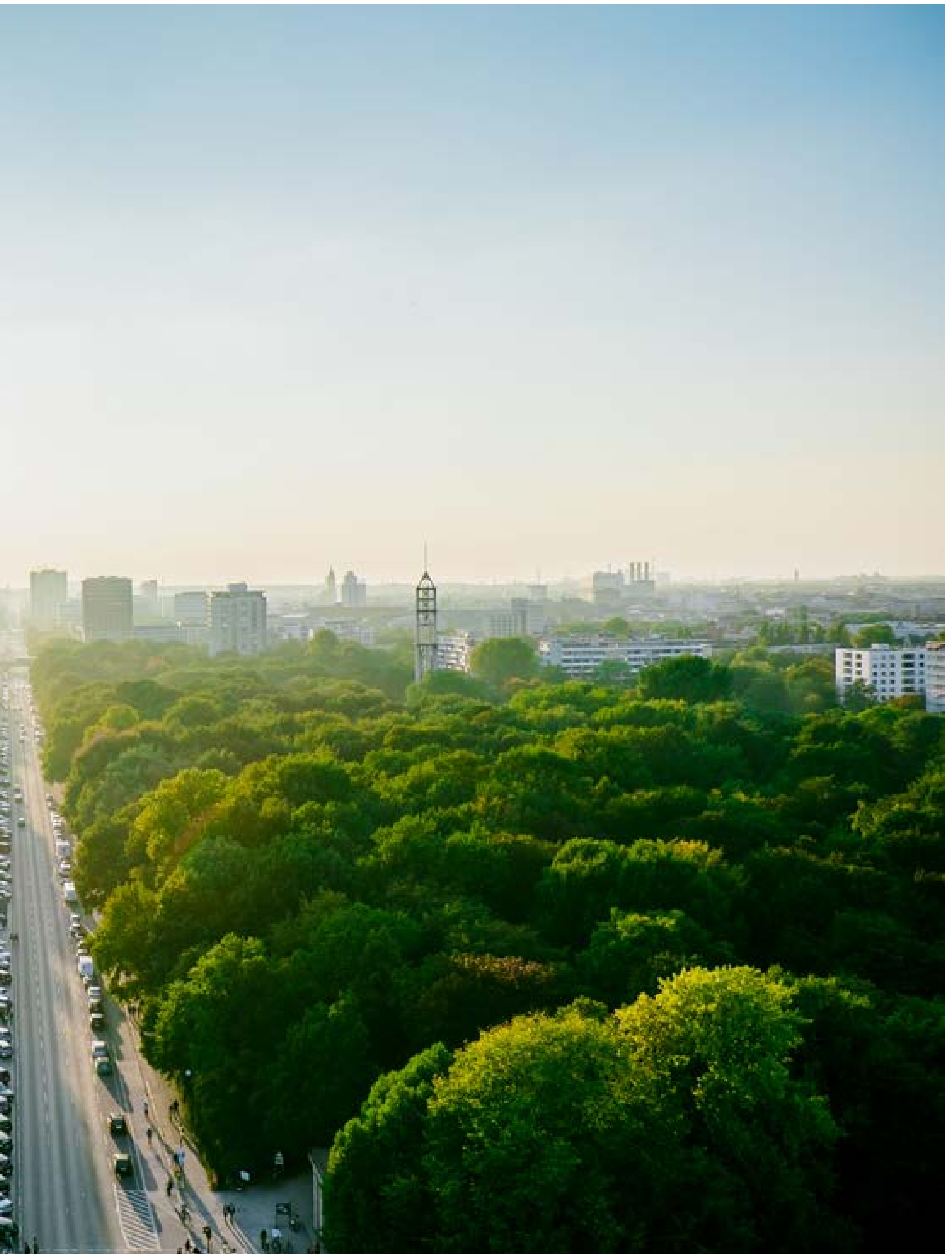
Augmenting the framework
- Introducing a principle-based system of distribution
- Tackling group insolvency
- Introducing pre-packaged insolvency resolution

Streamlining the process
- Improving information availability in the corporate insolvency resolution process
- Dealing with ipso facto clauses
- Safeguarding the interests of consumers

Developing the eco-system
- Incentivizing the use of transaction avoidance and director liability provisions under the Code
- Alternate insolvency resolution mechanisms for personal insolvency

In **retrospect**

A look back on the two years of IBC



Dec 2016
IBC made operational from 1 Dec 2016

Jan 2017
First application of corporate insolvency accepted by Mumbai, NCLT (Innoventive Industries)

Mar 2017
Regulations pertaining to information utilities and voluntary liquidation were notified

Jun 2017
RBI direction to file for CIRP of 'Big 12' cases

Nov 2017
First IBC Ordinance- Section 29A introduced

Feb 2018
RBI circular on Revised framework for resolution of stressed assets

Mar 2018
The report of the Insolvency Law Committee released

May 2018
ArcelorMittal places 7,000 cr in escrow to pay Uttam Galva dues

May 2018
TATA Steels takes over Bhushan Steel

Jun 2018
Second IBC Ordinance - Home buyer as FC, Voting threshhold reduced to 66%/51%

Jun 2018
Vedanta takes management control of Electrosteel Steels

Aug 2018
Supreme court order on Jaypee Infratech - Initiating the CIRP again

Sep 2018
JSW Steel, acquire 88% stake in Monnet Ispat

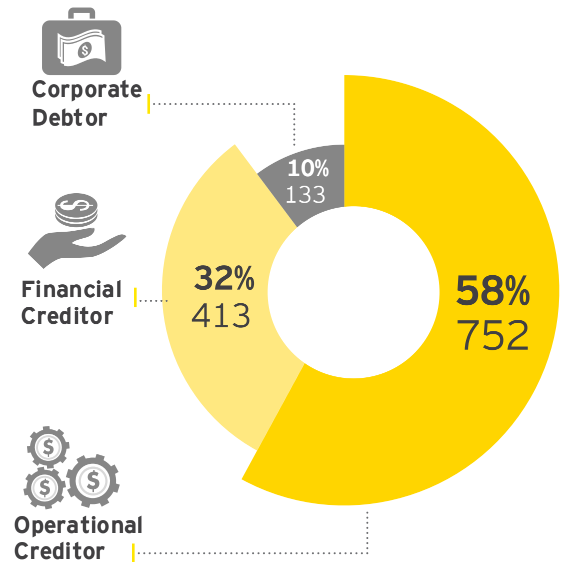
Oct 2018
SC judgement on Essar Steel - Lays down principle on Sec 29A and roles & responsibilities of CoC, RP & RA

Nov 2018
UltraTech takes over Binani Cements. Plan approved by NCLAT & SC, giving 100% recovery to creditors

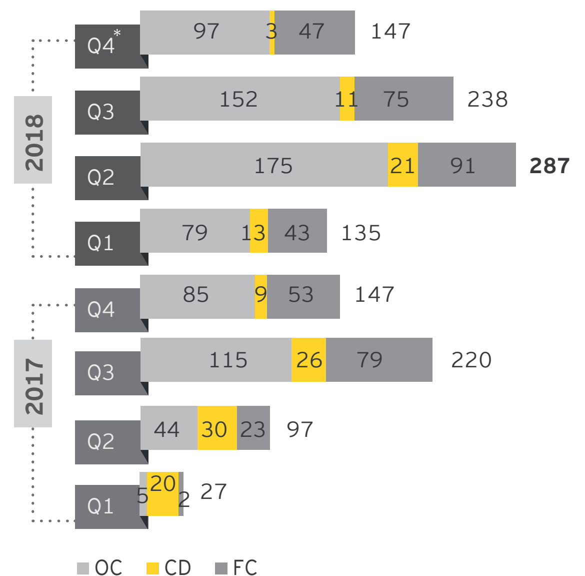
Status check

The code on ground

Applicants initiating CIRP



CIRP Cases admitted



* till 1 December 2018

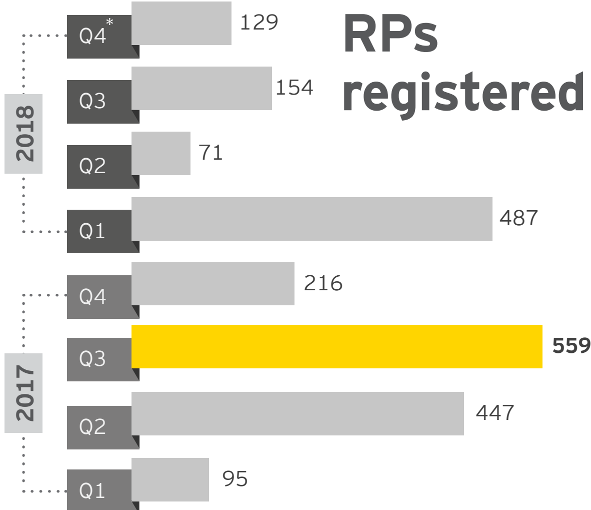
Source: ibbi.gov.in

CIRP initiated Total **1,298**

RPs registered Total **2,158**

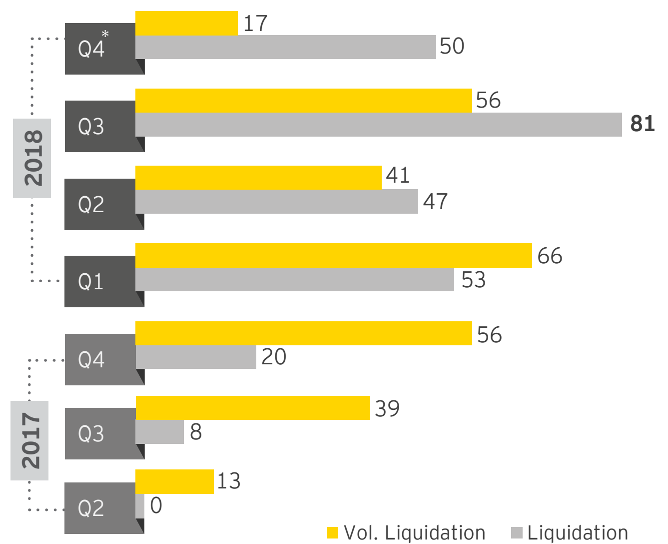
Below map provides a representative split for only selected states

State	CIRP initiated	RPs registered
Punjab	22	56
Haryana	42	98
Rajasthan	19	39
Gujarat	69	120
Madhya Pradesh	17	35
Maharashtra	307	450
Karnataka	44	99
Tamil Nadu	179	209
Delhi	260	485
Uttar Pradesh	62	82
West Bengal	118	176
Telangana	60	154



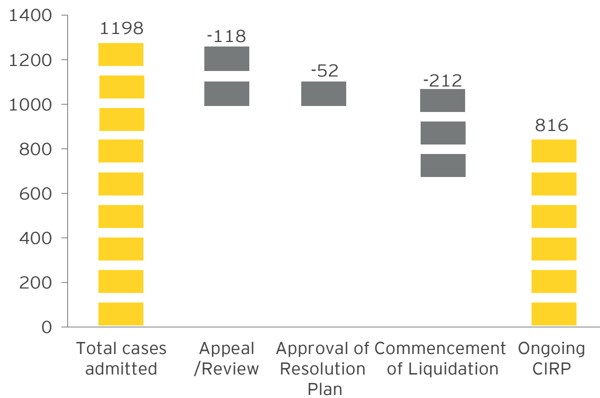
* till 1 December 2018

Liquidation filings

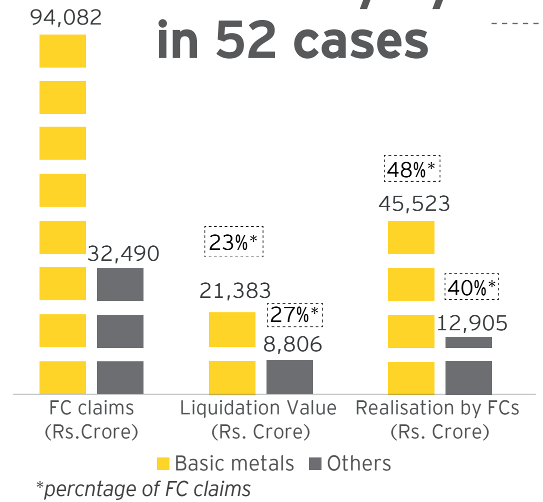


Source: ibbi.gov.in

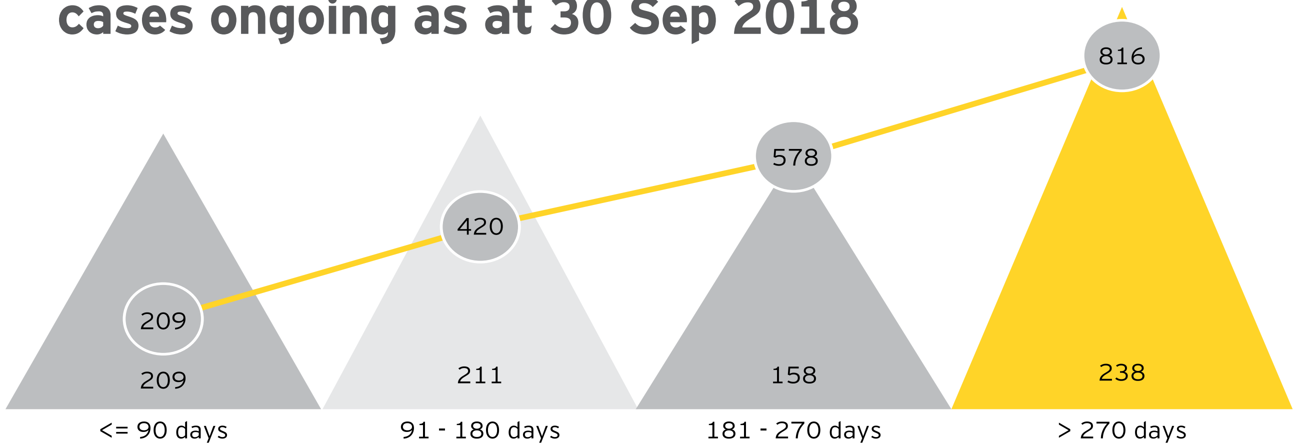
Cases admitted till 30 Sep 2018



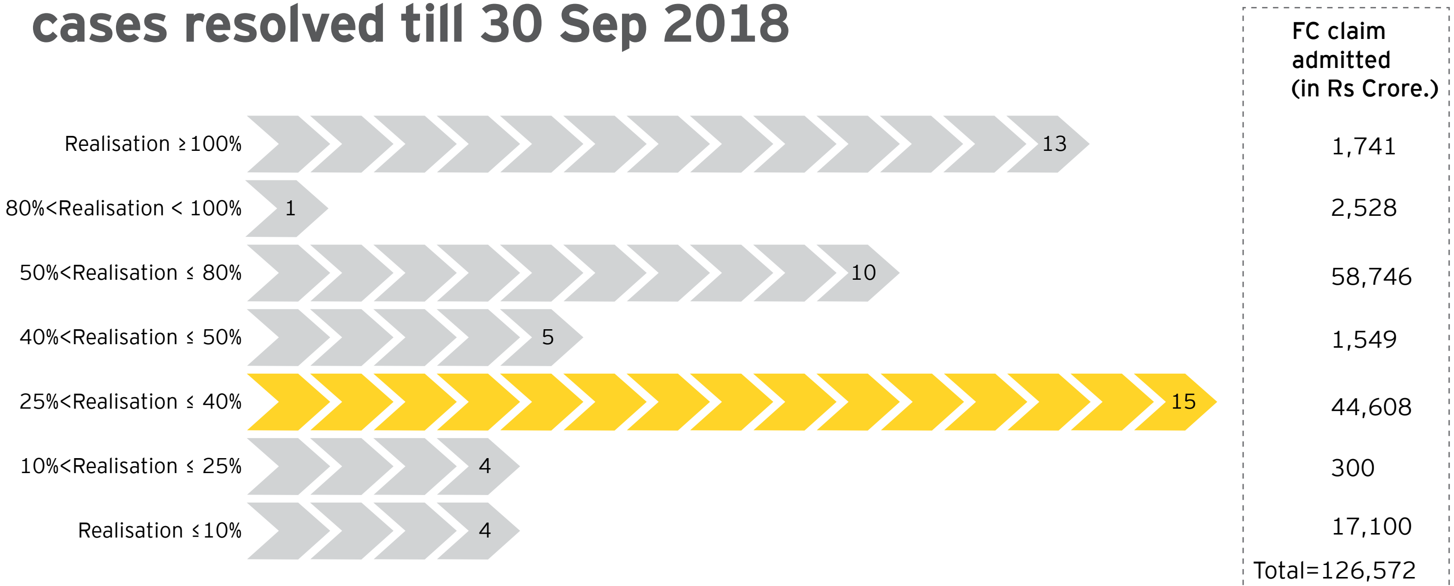
Recovery by FC in 52 cases



Days elapsed since inception for 816 cases ongoing as at 30 Sep 2018

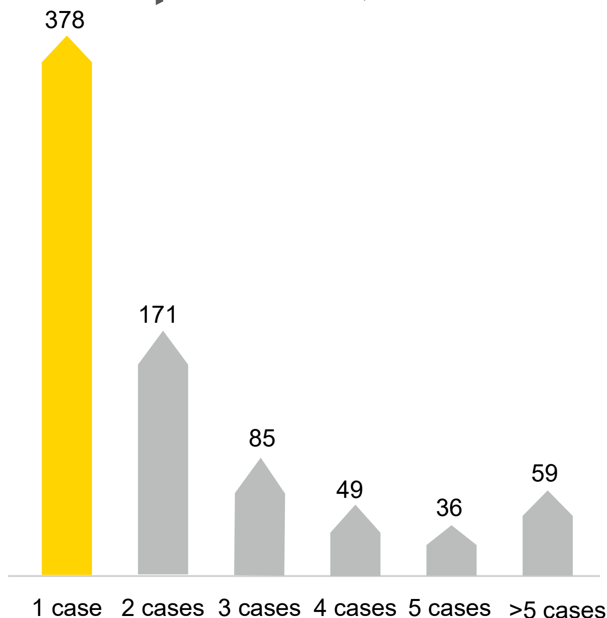


Range of realisation made by FC on 52 cases resolved till 30 Sep 2018

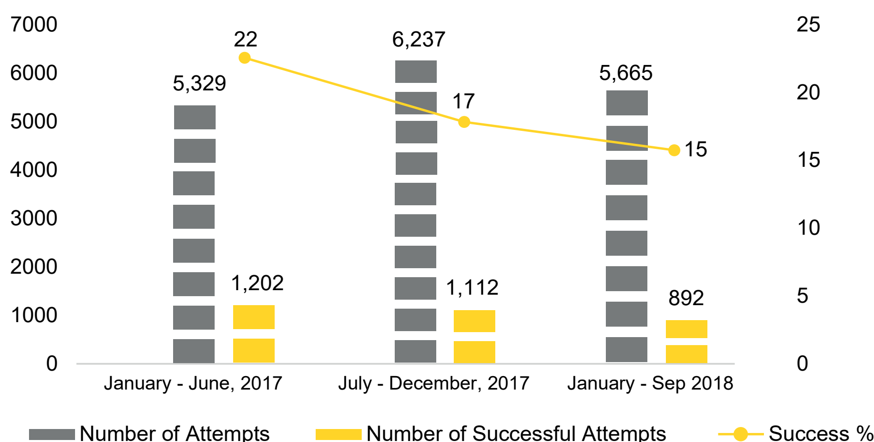


Source: ibbi.gov.in

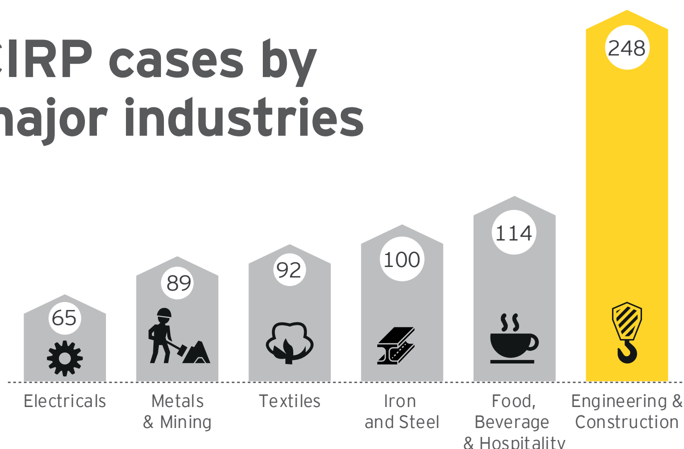
RPs handling cases (CIRP, liquidation, vol. liquidation)



Limited Insolvency Exam - Status



CIRP cases by major industries



Source: ibbi.gov.in

1,298 cases admitted for CIRP till1 Dec 2018, ~4% have been resolved. ~ 30% of pending cases have crossed 270 day timeline till 30 Sep 2018

46% is the average recovery for FC from the 52 cases resolved till 30 Sep 2018

~ 60% of the cases admitted are filed by OC. This is after majority of OC filing are settled after filing but before admission

In 206 cases (till 30 Sep) IRP was replaced in first CoC by another RP. More than 75% of such cases were initiated by OC or CD

259 cases out of 1,298 CIRP have gone into liquidation. 75%+ of liquidation cases were erstwhile BIFR cases

288 cases of voluntary liquidation filed; 50% + are filed for closing down of operations

17,231 attempts have been taken for limited Insolvency examination; success rate of 19%. Out of 2,158 RPs registered, 60% are registered with ICAI (CA)

Out of 2,158 RPs registered, 778 RPs are working or have worked on total 1,845 cases (1,298 CIRP, 259 Liquidation and 288 Vol liquidation)

Implementation journey of the Code

Since its announcement on **1 December 2016**

The processes applicable to corporate persons in the Insolvency and Bankruptcy Code, 2016 (Code) were implemented in December 2016, and welcomed in the market with a sense of great hope and anticipation. Two years on, it seems appropriate that we take stock to consider the successes of the Code, and identify the challenges and opportunities for the future. In October 2017, in EY's report "Experiencing the Code", the implementation journey of the Code was reviewed. The report provided a point-by-point review of the top concerns based on interactions with insolvency professionals, lawyers, creditors, promoters, resolution applicants and other stakeholders. This is an updated review of the implementation journey of the Code as on 1 December 2018.

Concern	Remarks

Judicial interpretation

The National Company Law Tribunal (NCLT), and the appellate framework of the National Company Law Appellate Tribunal (NCLAT) and the Supreme Court (SC) deal with insolvency-related matters. Since the implementation of the Code, the judiciary has provided clarity on key conceptual issues such as the mandatory nature of time lines; nature of financial debt and operational debt, and the applicability of the Code, in case of conflict with other laws. The judiciary's extraordinary efforts have been key to maintaining the momentum with respect to the Code.

However, there is still a lack of clarity on vital issues. For instance, since the inclusion of Section 29A, there has been an ambiguity surrounding the meaning of the terms "acting in concert", "control", "management", etc. While the SC has attempted to provide guidance on these terms in ArcelorMittal India Private Limited v. Satish Kumar Gupta & Ors, further clarity is required to distill principles that can be applied across the cases. In absence of this, we may find that promoters become fearful of the implication of failure to the point of paralysis, which may hinder economic growth at large. Moreover, in some cases, different benches of the NCLT have adopted divergent interpretations, and legislative amendments have been necessary to clarify the law.

Improvement in judicial support and available infrastructure will help cases be resolved faster and hopefully reduce appeals, further delay and burden on senior courts.

Role of the regulator
(Insolvency and Bankruptcy Board of India)

IBBI has continued to be pro-active and responsive to the industry and its developments. It seeks to engage and take action, for example by putting in place training modules for new IPs and even for its own officers. As the market and regulator continues to mature, it's important that a measured response is given to developments and that the objectives of the IBBI continue to be at the forefront of its decision making.

There is a wealth of data now available to the IBBI which should be used for empirical research and to benefit both professionals and the industry, through its quarterly reporting.

The job for IBBI has not been easy and expectations remain high. Considering the role played by regulators in matured markets, we believe IBBI has to continue to provide the lead role in continued engagement and development of the Code over the next few years.

On track

In process

Requires attention

Concern	Remarks

Committee of creditors

The committee of creditors (CoC) have had 24 months to mature into their role and have demonstrated the wherewithal to appraise and select resolution plans for the corporate debtor. Developments evidence that both the IBBI and NCLT are alive to the importance of the CoC in achieving a successful resolution outcome, and also the impact of the CoC's conduct on the statutory timelines. The IBBI, for instance, has mandated that meeting notices to CoC members should state that only persons who are authorized to take decisions in the meeting, without deferring decisions for want of approvals, should be represented in the CoC.

In some instances, there has been some criticism levelled at CoC's for not taking decisions in the interest of all stakeholders and protecting the interest of the CoC members only. However, on an overall basis, the responsibility of being a CoC member has begun to sink in, and the recognition that the CoC is to support a resolution in the benefit of the corporate debtor and all its stakeholders is understood.

The CoC must work together with the resolution professional who acts in place of the suspended board, to genuinely resolve the corporate debtor's distress. This dynamic is creating the need for genuine corporate turnaround expertise. The CoC's development will be, supported through internal training provided by financial institutions for their own people and the insolvency and restructuring community who will continue to support the CoC's learning on each situation.

Behavioural change

The Code has made an impact in the way repayment of debts are viewed and treated by promoters and management. There is now a conscious move to encourage promoters/directors and all participants to engage with difficulties earlier, at the first signs of distress.

The Ministry of Corporate Affairs has indicated that the Code has had an impact of around INR 3 lakh crore on non-performing assets (NPAs) and more specifically, the resolution cases have led to recovery of about INR 71,000 crore, cases at a mature stage of resolution stand at INR 51,000 crores, which total INR1.2 lakh crore from resolution *(Source: MCA Secretary - Post FICCI Press conference).* Some of the recovery has also been made through payments made by the debtor after default, but before the initiation of the formal insolvency process under the Code.

The Code kick-started a cultural shift in the dynamic between lender and borrower, promotor and creditor. Coupled with the central bank circular, there is now a framework which endorses and supports pro-active action to address distress, without recourse to formal insolvency proceedings.

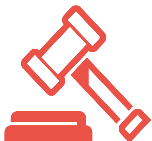
Concern	Remarks

Insolvency professionals

The insolvency professional (IP) has evolved in a short time since 2016. A total of 2,158 IPs have been registered as on 1 December 2018. However, only a few of these have accepted and taken appointments. The selection of an IP, prior to appointment as an interim resolution professional/resolution professional, is likely to be based on a combination of their experience, qualifications and ability to deliver a successful resolution of the corporate debtor.

There is a recognized need for additional training and continued professional development to be provided to IPs. There is equally, a recognition of the obligation of IPs to maintain their own professional development to keep their knowledge and skills up to the date. Where the high bar is not being achieved, IBBI has commenced issuing disciplinary orders in respect of some of the worst behaviours/offenders, which is a positive step for the industry.

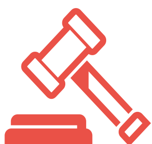
Continued professional education of insolvency professionals is key, as it is maintaining a positive dialogue between professionals, regulator and market participants. The industry would anticipate that the IBBI or the insolvency professional agency's (IPAs) will commence reviews of IPs' cases conduct in due course. Therefore, while the supply-side concern has been addressed, the jury is still out on the quality and performance of IPs.



Creditor rankings

The ranking of creditor claims (and the consequent priority of distribution) is provided in Section 53 of the Code. However, the lack of clarity surrounding the classification of creditors and the ranking of their claims is a cause of concern. For instance, there is limited clarity on how secured FC's are to be treated as compared to unsecured FC. Also, among the secured FC, how would one treat an exclusive or first charge holder vis-à-vis a second charge holder. Similarly, reclassification of home-buyers as financial creditors and the imposition of requirements regarding the treatment of inter-se creditors and similarly placed creditors in a resolution plan have created uncertainty for all creditors and market participants, which is impeding timely resolution.

Uncertainty with regards to creditor ranking causes a variety of challenges for the market. However, we anticipate that case law supporting the rightful recognition of security and the appropriate treatment of creditors in a particular rank to be further tested and eventually obtain positive legal precedent in due course.



International investment

The majority of successful resolution applicants have been strategic investors, who are aware of the situation on the ground and are willing, as well as able, to transact in India. While international players are investing more resources in India as they look to build both capability and knowledge, major challenges remain. These include uncertainty of outcomes, information asymmetry and challenges in carrying out a meaningful diligence during the compressed CIRP timeline.

We expect uncertainty of outcomes to settle with time as outcomes become clearer and the process embeds. However, there is concern on the ability to generate meaningful information about the corporate debtor and actively market corporate debtors during the CIRP. These must be addressed to attract international investments and funds.

Concern	Remarks

Resolution implementation

A successfully approved resolution plan is a job half done. The real work of resolution begins on implementation, where the steps outlined in the resolution plan to take control and resolve previous issues that had caused distress are executed. However, some challenges have emerged as the implementation of resolution plans has started.

An objective test for successful resolution can only be known in the future, following the resolution applicant having fully taken over operations and delivering positive returns. Or will we see situations where implementation of the resolution plan is unsuccessful resulting in liquidation or could certain corporate debtors become serial insolvents re-entering the corporate insolvency resolution process. In the absence of certainty, it's clear that further work will be needed to aid in the implementation phase to support successful resolution applicants.

Timeliness

One of the key objectives of the Code was to achieve time-bound resolution of distress since delays severely affect deal value, particularly as scare capital does not wait to be deployed. However, since the implementation of the Code, delays in obtaining approvals from the Committee of Creditors (CoC) and delays due to litigation have been a cause for concern. Of the total 1,298 admitted cases *(source: IBBI)*, only 52 (4%) have been disposed of with approved resolution plans, 259 (20%) are in liquidation and 987 (76%), ongoing. Of those 52, over half (35) took >270 to obtain approval.

Steps have been taken to provide a model timeline for the processes under the CIRP, and the Supreme Court has emphasized the mandatory nature of the 180+90 days timeline under the Code. Notwithstanding this, the timelines pertaining to admission of an application have been held to be directory and not mandatory, and time taken by the adjudicating authority (AA) to pass orders has been excluded from the scope of the 180+90 days timeline. This is particularly concerning, since severe delays are experienced once a resolution plan is filed with the AA for its approval.

Ensuring that the processes under the Code are conducted in a time-bound manner should be a priority, to preserve and enhance value. While the thrust from the Supreme Court is to adhere to timelines under the Code, and the clarity coming in with judgements settling positions of law is likely to help, steps must be taken to increase institutional capacity of and provide greater institutional support to the Adjudicating Authority.

Top concerns of the market as at **1 December 2018**

Judicial interpretation providing clarity on matters that have been challenged & quality in the orders following proceedings

The **role of the regulator** continues to evolve to meet the needs of the market and industry

CoC's continue to learn and evolve, they recognise the importance of obtaining the right expertise and will continue to develop

Behavioural change is taking place with management increasingly seeking to engage proactively at the first signs of stress

Insolvency professionals will require further training and support to ensure the high level of integrity, competence and professionalism is maintained

Creditor rankings for distributions will get settled as we see more cases dealing with payments to classes of creditors

International investment needs consistency of outcome and assets to be taken to the market appropriately

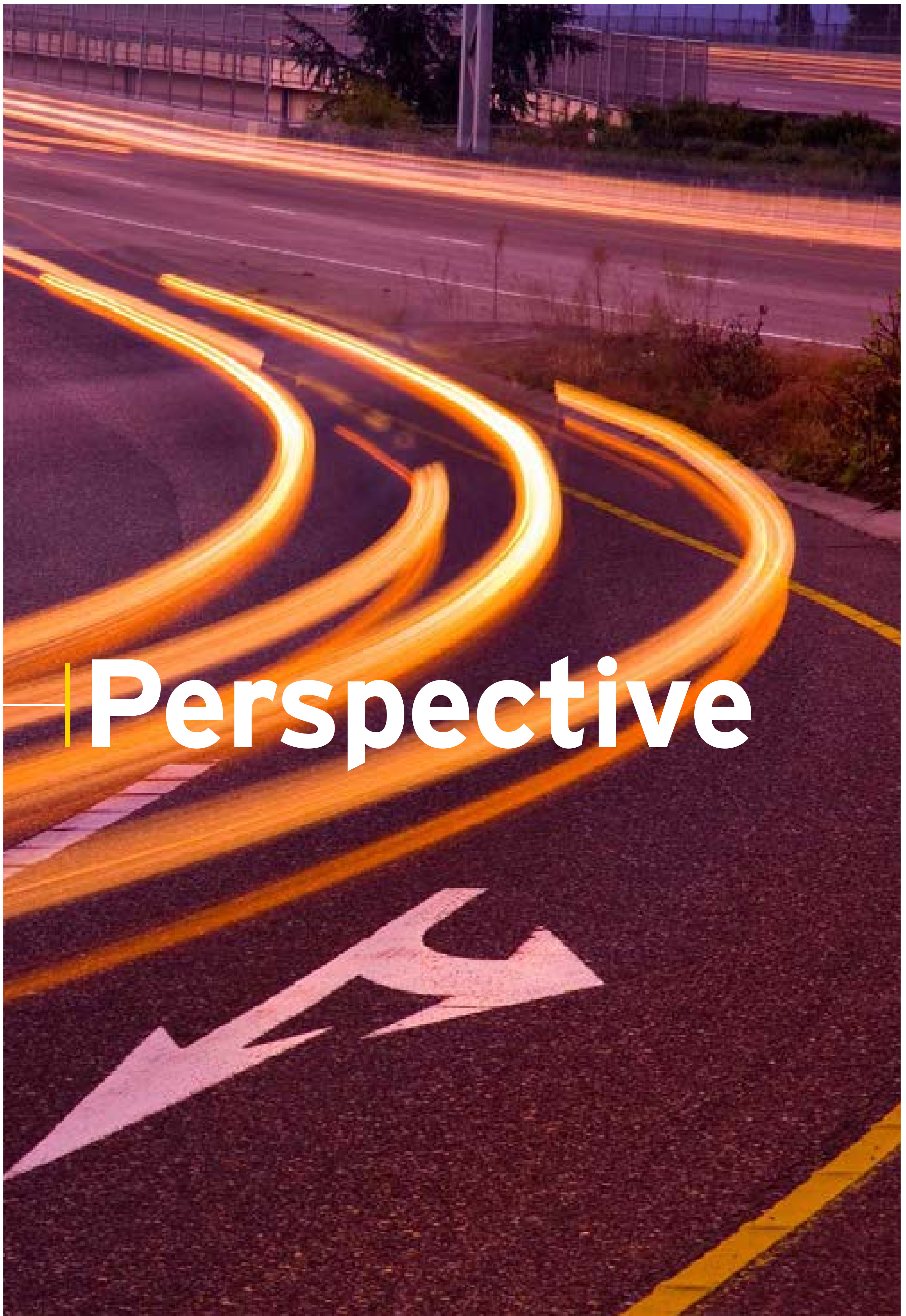
Resolution applicants are anticipated to deliver genuine resolution, but significant challenge may continue to be seen

Timeliness has proved a challenge to achieve the envisaged 180/270 day timeline

In conclusion

It would have been hard to anticipate where the Code and insolvency eco-system would be in the next two years. In these two years, some large gains have been achieved and some challenges remain to be worked through.

The Code remains one of the success stories of recent Indian economic reform and continues to develop as it gains maturity. However, the honeymoon period is over and the hard task of sustaining momentum starts now, as more debtors come into the system. There is a need to prepare the market to support resolutions for the larger number of cases that are likely to come in the next few years. The system must also remain prepared to evaluate how successful the implementation of approved resolution plans are. At the same time, alternative restructuring options prior to formal invocation of proceedings have to be generated by the market, potentially in the window created by the RBI circular. One hopes that corporate debtors are provided with the lifeline that the Code envisages through the corporate insolvency resolution process, effecting rescue, rather than potentially suffering death by a thousand cuts.



Perspective

In conversation with

Dr. M. S. Sahoo

Chairperson,
Insolvency and Bankruptcy Board of India

How has your experience implementing the Insolvency and Bankruptcy Code, 2016 been?

India's experience implementing the Code is best encapsulated by a quote from Ernest Hemingway's book, The Sun Also Rises, - "How did you go bankrupt? Gradually, then suddenly." The insolvency reform has been in works for the last 25 years, but it took shape all of a sudden in early 2016. The enactment of the Code and its implementation have been very swift, no parallel, to my knowledge, inside or outside the country.

India did not have any prior experience of an insolvency regime that is proactive, incentive-compliant, market-led, and time-bound. Many institutions required for implementation of a modern and robust insolvency regime did not exist. The Code and the reform envisaged under the Code was, in many ways, a leap into the unknown and also a leap of faith. Yet, the entire regulatory framework and the entire ecosystem was in place and debtors and creditors commenced corporate insolvency resolution process under the Code within six months of its enactment.

Though the state triggered the reform, the stakeholders lapped it up. For me, what has been the most notable about implementing the Code is that it was a collective effort - a reform by, for and of the stakeholders. Please note that whenever any change is envisaged, there is usual scepticism as well as reluctance to accept the change. Big ones wait till commoners have tried their hands and come out successful. In the initial days, a lot of operational creditors filed applications for initiating reforms. To me, reforms do well, when the commoners make use of it. All in all, we could not have asked for a better start.

In comparison with previous insolvency regimes in India (such as Sick Industrials Companies Act, etc.), how do you believe the Code has fared?

The Code provides a time-bound resolution of insolvency, wherever possible, and exit, wherever required. It addresses four fundamental concerns of the past regime: it (a) shifts control of the firm to creditors for resolving

> *For me, what has been the most notable about implementing the Code is that it was a collective effort - a reform by, for and of the stakeholders. Wherever we went we saw tremendous enthusiasm from all stakeholders*

insolvency when the firm fails to service the debt; (b) empowers and facilitates the stakeholders of the firm and the adjudicating authority to decide matters within their respective ambit expeditiously; (c) mandates closure of resolution process in a time-bound manner and, therefore, aids in preservation of value; and (d) prohibits and discourages recovery in several ways during resolution process.

There have been hiccups, it is important to realise that everyone (IPs, creditors, debtors, adjudicating authority, IBBI, etc.) has been undertaking this activity for the first time while there are huge vested interests to frustrate the Code.

What, in your view, is the single most positive change brought about the Code, since its enactment?

The single most important change has been behavioural. Much evidence has appeared in the recent past in relation to behavioural changes. We have seen debtors have been begging, borrowing, and stealing to settle defaults, prior to filing of applications for initiation of insolvency resolution process and prior to admission of the application. This is very positive. Such conduct reduces the incidence of default and consequently the need for invoking the Code. Perhaps in the long run, the best use of the Code would be not using it at all.

What do you perceive has been the biggest challenge for the insolvency eco-system in the last two years?

The biggest challenge for the system was scepticism. In the initial stages, the scepticism was in relation to the lack of infrastructure, lack of IPs, lack of clarity on who would use this system, etc. Even the Economic Survey in 2016 argued that the new insolvency regime should be tried first with smaller cases and the system would take considerable time before it was ready to handle the large, complex stressed assets and therefore made out to create a Public Sector Asset Rehabilitation Agency (PARA) to address stressed assets problem of banks. Despite this, the Code has taken off. Even since implementation, there has been scepticism about the percentage of recoveries. They compare what a financial creditor is getting in relation to its claim amount, not in relating to liquidation value. It is important to acknowledge that recoveries are dampened since a lot of debtors being resolved under the Code were in the BIFR system or not going concerns.

How do you believe some of the challenges can be augmented to build a more robust eco-system?

Use of Technology: Every process has many repetitive tasks which can be programmed by technology and delivered by machines. This will compress the time for completion of the CIRP. Technology can be harnessed to make individual insolvency accessible to everyone and reduce costs of resolution. I feel that the next big frontier is to use technology to allow for automation of debt contracts.

The biggest challenge for the system was scepticism. The single most important change has been behavioural.

Capacity of IPs: The IBBI is conceptualizing an exquisite global insolvency programme for graduate students, to produce top-quality IPs who can deliver world-class services as resolution professionals, liquidators or in other capacities.

IPAs: There are three issues: The IPAs do not compete with one another; they do not have a decent revenue stream and the IBBI has been doing some of the tasks which they should be doing. A rethink on their role may, therefore, be required.

Capacity of IUs: Given that this is a unique institution, we need to wait for some more time for market to accept it. I think, IU has huge potential. For example, it is uniquely positioned to dematerialise the loan agreements, store and retrieve all records created under the Code, etc.

Capacity of the market: The capability of the CoC and of the Resolution Applicants needs considerable enhancement. The market needs to have depth to come up with resolution plans for every corporate debtor undergoing resolution

In conversation with

Challa Sreenivasulu Setty

Deputy Managing Director,
State Bank of India

What has been your experience of the first two years of Code?

The Code tried to bring in an element of time-bound and systematic resolution of insolvencies for maximization of value for all stakeholders and balancing of information asymmetry besides protection of interest of all stakeholders. However, on account of the overwhelming number of cases referred to the NCLTs, there have been delays in admission, which require to be addressed. We are quite satisfied with outcomes in large cases though we would be happy, if the medium and small companies attract interest of investors.

How would you rate Code against some of the erstwhile resolution mechanism like Corporate Debt Restructuring, Board for Industrial and Financial Reconstruction (BIFR), Strategic Debt Restructuring, etc ?

The Code is a much superior mechanism as it allows acceptance of real situation by stakeholders and then looks for a viable resolution which is market driven. Hence, all viable businesses facing insolvency have a much better probability of coming out of distress through a resolution plan under the Code than in any other previous mechanism.

Do you think the Code has brought about a shift in the credit culture?

We are seeing a marked shift in the credit culture both in the borrowers and lenders as well as other stakeholders. While borrowers have become more discrete in their borrowing decisions and are wary of committing a default, financial creditors are focusing more on borrowers' cash flow, covenants and monitoring the loan accounts more closely.

The Code is contributing in creating a culture of compliance and transparency which compels the promoter of a distressed company to seek an early and timely resolution, rather than hiding the situation from its lenders.

Is the Code a strong force to push promoters to come forward with a credible resolution plan?

The Code was designed to make promoters to come out with a credible resolution plan which has to compete with resolution plans from other investors/interested bidders. While after the introduction of Section 29A, many promoters of corporate debtors (except those of micro, small and medium enterprises (MSMEs) currently referred to NCLT under the Code would be ineligible to submit resolution plans, the Code has given an indirect push to other defaulting promoters who are coming forward to settle their dues on reasonable terms before the lenders initiate or even threaten to initiate CIRP under the Code.

Is there anything you would have liked to be done differently in the first two years of the Code?

We would have preferred more number of NCLT benches and a more robust response from market players in bidding for assets. However, as this was a new law designed to fundamentally change the way market players react to insolvency and interact thereafter, it was expected to face initial resistance and legal challenges. We are happy with the outcome so far and are highly hopeful of the future.

What do you view as the biggest risk that can halt the success of the Code journey in next 12 months?

The insolvency professionals and NCLTs are the two most critical components of the entire insolvency regime of the Code. Hence, for the success of the Code, it is important that these two entities play their role in most professional, efficient, objective and clinical manner. Apart from this, the infrastructure's bottlenecks are also required to be addressed expeditiously.

Currently, the Code is the only an effective resolution mechanism available to banks. Do you feel that the present infrastructure is unable to handle the demand?

The Code is not the only effective resolution mechanism available to banks but if a distressed loan can be resolved or settled out of court, it can be a much more time- and cost-efficient process. However, what the Code is contributing is that it is creating a culture of compliance and transparency which compels the promoter of a distressed company to seek an early and timely resolution, rather than hiding the situation from its lenders. Even banks/financial institutions (FIs) are now encouraged to identify and acknowledge the problem loan early, which is something very healthy for credit markets.

We would have preferred more number of NCLT benches and a more robust response from market players in bidding for assets.

How do you see the Code unfolding in the near to medium future?

In the near term, we foresee more number of CIRP initiations, investors are feeling more confident in bidding for good assets, better credit discipline in borrowers and quicker and more resolutions. In the medium term, the flow of CIRP applications may ebb, as more promoters and lenders would focus on resolutions outside NCLT, right at the initial stages of default.

In conversation with

Sanjay Nayar

Chief Executive Officer,
KKR India

What has been your experience of the Code in the first two years?

The experience has been positive overall. With the government and regulatory bodies backing the implementation, the Code has recently been on a steep upward curve. The concessions granted by MCA, SEBI and the tax departments have been very well received.

The success of IBC should be measured by companies getting resolved pre-NCLT. Credit culture, is likely to change now with higher emphasis on due diligence, credit appraisal and monitoring of financial covenants by lenders.

How do you rate the Code against some of the erstwhile resolution mechanism like CDR, BIFR,SDR, etc.?

The Code has definitely been seen more success in a shorter time frame. NCLT is definitely better equipped to handle the cases. Two key improvements have been (i) the Code is a creditor in possession model, which allows lenders to control the outcome of restructuring more effectively; and (ii) ensuring judicial discretion is limited to checking compliance with laws.

Do you think the Code has brought about a shift in the credit culture and promoter behaviour?

Promoter behaviour towards lenders and new investors is changing. Promoters are eager to re-negotiate/ restructure debt at the earliest sign of distress which helps in value preservation. The consequences of the Code on various stakeholders are well known and there is a concerted effort to find a resolution. The success should also be measured by the number of companies getting actively resolved pre-NCLT.

Credit culture, especially new lending, is likely to change now that the Code is here to stay as the final recourse for lenders. There is likely to be a higher emphasis on due diligence, credit appraisal and monitoring of financial covenants by lenders.

Is the Code a strong force to push promoters to come forward with a credible resolution plan to avoid going to CIRP?

Yes, promoters and equity holders have most to lose if their company goes to NCLT. They have a strong incentive to partner with new investors to resolve pre-NCLT. Anecdotal evidence suggests that promoters are proposing more viable one-time settlement offers to reduce haircuts for lenders so as to avoid a filing under the Code.

Why is the number of transaction by international financial investors still limited? Do you think this will change in the next one to three years?

There are challenges which are faced by institutional investors including private equity players. Firstly, the exemption from Section 29A(C) of Code (relating to the NPA disqualification) applies worldwide and the exemption for "financial entities" is limited to regulated financial entities. Depending on regulatory reasons in offshore jurisdictions, the applicant investor may not be regulated but its manager/trustee, etc. may be. Secondly, the evaluation criteria used by the creditors focusses excessively on industry domain experience and ability to turnaround stressed companies in the sector. Distressed investors often invest in multiple sectors and several of them being new investors in India, may not have a track record of turning around companies. These need to be addressed for foreign capital to flow into the market and not stay on the sidelines.

KKR, as the global leader in distressed assets, has overcome similar challenges in other jurisdictions and is looking to invest in this space. We have the right combination of on-ground experience, turnaround capabilities and an understanding of the Code to make this happen.

What challenges do you expect from the implementation of approved resolution plans?

Continued litigation by operational creditors (who have already been allocated their stipulated statutory dues) and delay is a concern for the new owners. The transition period, especially until all statutory obligations are completed, is a challenge. Further, bidders who violate a resolution plan after NCLT approval should be penalized and blacklisted from making further bids under the Code.

What do you see as the biggest risk that can halt the success of the Code's journey in the next 12 months?

The courts must respect the design of the Code which vests commercial decision making on restructuring with the CoC. It is also important to ensure that CoC is seen as acting fairly by all the stakeholders. The Code's implementation has been more successful for larger cases due to strategic interest. It is important to see the Code work for the next, more diversified list of cases.

The Code's implementation has been more successful for larger cases due to strategic interest. It is important to see the Code work for the next, more diversified list of cases.

Looking **ahead**

The next generation of insolvency reforms

1. Augmenting the framework
2. Streamlining the process
3. Developing the eco-system

Augmenting the framework

Introducing a principle-based system of distribution

Issue

The Code provides limited guidance insofar as distribution to creditors under a resolution plan is concerned. The Code mandates that a resolution plan must provide for: (a) the payment of insolvency resolution process costs in priority to the payment of other debts of the corporate debtor, and (b) the payment of debts of operational creditors in such a manner that they receive at least the amount that they would receive in the event of a liquidation of the corporate debtor. In contrast, insolvency regimes in other countries typically provide for a system of priority of payments that may be made to various categories of creditors in formal insolvency proceedings. For instance, the Insolvency Act 1986 (UK) provides a priority system for the distribution of payments that may be made to various categories of creditors in case of administration as well as winding up. The US Bankruptcy Code also has a similar requirement under its "absolute priority" rule.

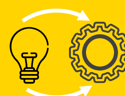
In a recent case of Binani Industries, the National Company Law Appellate Tribunal (NCLAT) had ruled that a resolution plan must treat dissenting and assenting financial creditors equally, and cannot discriminate between two sets of creditors who are similarly situated.[1] Subsequently, the NCLAT has ruled that a resolution plan must provide for a similar treatment to the dues of financial and operational creditors.[2] The NCLAT also held that the Code or the regulations thereunder should not provide for differential treatment between similarly situated creditors. These judgements, however, leave room for ambiguity as to the applicability of this principle, and may result in each resolution plan being tested against an unclear metric by different NCLTs, having different judicial views.

Solution

While distribution under a resolution plan should be a commercial decision, left to be negotiated between the resolution applicant and the CoC, there needs to be clarity on the parameters within which commercial judgement can apply.

- There is a need to have a well-defined system of priorities, which is applicable even to distributions made under a resolution plan, as is the case in other jurisdictions. This would ensure that the entitlements of various categories of creditors are clearly defined, and that resolution plans do not discriminate in favor of one class of creditors at the expense of other creditors.
- Since the Code already provides for a system of distribution in the case of proceeds from the sale of assets of a corporate debtor undergoing liquidation, the logical approach would be to make it applicable to the distribution of proceeds under a resolution plan as well. To enable this, an analysis may also be made of Section 53 and clarity may be brought in regard to issues with the same.

This would also ensure that a consistent approach is taken towards distributions under the Code – whether as part of a resolution plan in a corporate insolvency resolution process or as part of a liquidation.



Implementation

To implement this:

- Section 30(2) of the Code would need to be amended to provide that the resolution plan should make distributions following the order of priority set out in Section 53 of the Code.
- Clarity may be brought to ambiguities in Section 53. For instance, the rights of payment of secured creditors under the distribution waterfall in Section 53 may be restricted to the extent of their security, or property right as is international best practice.

1 Central Bank of India v. Resolution Professional of the Sirpur Paper Mills Ltd. & Ors., Company Appeal (AT) (Insolvency) No. 526 of 2018.
2 Binani Industries Limited v. Bank of Baroda and Anr. and connected appeals, Company Appeal(AT) (Insolvency) No. 82 of 2018.

Augmenting the framework

Issue

Presently, the Code does not provide for the treatment of insolvency of group companies, and the insolvency of different companies in a group is dealt with in a piece-meal manner. On occasion, the SC has stepped in and, in effect pierced the corporate veil by making a parent company liable for obligations of a subsidiary company undergoing insolvency proceedings. Such cases highlight the necessity to provide guidance within the Code regarding treatment of group insolvencies.

A fragmented approach, where different benches of the NCLT hear insolvency applications of different companies belonging to the same group also allows debtors an opportunity to exploit information asymmetry and lack of coordination among different NCLT benches. There is also unnecessary duplication of work if different NCLT benches individually appreciate and consider the same or similar facts in order to piece together a complete picture. The resultant delay and clogging up of insolvency infrastructure has long term negative consequences.

Tackling group insolvency

Recently, during the CIRP of one of the companies in the RBI's list of 12 largest NPAs, media reports quoted several potential bidders stating that buying the company without its key subsidiaries did not make a prudent business sense. In most cases higher valuations are likely for a consolidated pool of assets if group insolvencies are treated in a holistic manner rather than as fragmented sales of intrinsically-linked companies. Apart from being advantageous to creditors, this may also aid in a successful turnaround of the group in the long term.

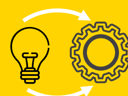
There are several other advantages of adopting a holistic approach to treatment of group insolvencies such as easier enforcement of corporate guarantees provided by group companies, easier detection and mitigation of undervalue and preferential transactions, increased ownership of the resolution plan as interests of all creditors shall be factored in, faster disposal of insolvency applications of group companies and reduction in resolution/liquidation costs for the group as a whole.

Solution

The European Union (EU[3]) and Germany[4] recently amended their insolvency legislation to provide for treatment of group insolvencies. Both jurisdictions essentially obligate insolvency representatives of group companies as well as courts involved to cooperate and coordinate with each other. Both, EU and Germany also permit commencement of "group coordination proceedings", which is a voluntary mechanism managed by a group coordinator. In the Indian context a similar approach may be followed by:

- Having one insolvency professional manage or coordinate proceedings of different debtors within a group. This would mean that group complexity can be more readily understood and increased efficiencies can be achieved throughout the insolvency process. A potential challenge here may arise where there may be different lenders in the group structure. However, potentially this is an arena where Sashakt could be utilized and helpful to bind creditors through the inter-creditor agreement.
- Prior to entering into insolvency, group structures should be reviewed to establish the most appropriate point of entry for the insolvency proceedings. The corporate debtor and lenders should seek to identify those entities that need to be placed into insolvency protection, and apply for the admission of the applications for their insolvency.
- Applications or actions being taken against the group companies of the corporate debtor should be referred to one NCLT. This is to ensure that knowledge of the insolvency does not need to be built up from ground zero constantly. The NCLT should consider any insolvency application in the context of any group situation the corporate debtor may be a part of.

This approach may also be combined with a "substantive consolidation" approach followed under the US Bankruptcy Code. Under this approach, courts treat the entire group as one entity and confirm a common plan for all the stakeholders.



Implementation

To implement this:

- The Code may be amended to include a mechanism for dealing with insolvency of group companies based on global best practices and views of stakeholders.
- Adequate training in the various modes and methods of co-ordination and cooperation, determination of point of entry for insolvency, etc. maybe be imparted to various benches of the NCLT.

3 Chapter V, Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings (Recast) < https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0848&from=en> (accessed 18 November 2018).

4 Thomas Hoffmann and Isabel Giancristofano, 'Corporate Recovery and Insolvency 2018 | Germany' (International Comparative Legal Guides, 25 April 2018) <https://iclg.com/practice-areas/corporate-recovery-and-insolvency-laws-and-regulations/germany> (accessed 18 November 2018).

Augmenting the framework

Issue

The triggering of the formal insolvency resolution process under the Code has significant effects on the debtor against whom the process is triggered. Such a corporate debtor has to shoulder the loss of goodwill associated with the initiation of insolvency proceedings, as well as the direct costs of the running the proceedings and coordinating between all the stakeholders. These higher costs result in lower recoveries available for distribution to all stakeholders. In many cases, especially where the nature of assets is such that they lose value rapidly, entities may not be able to survive the loss of goodwill or bear these costs, which may lead to closure of businesses even when such closure is not the most commercially desirable outcome. Accordingly, there is a need to propose an insolvency process where groundwork for resolution can be conducted confidentially prior to the commencement of formal proceedings but that becomes binding on all stakeholders through a quick court approval, and is subject to scrutiny ex post.

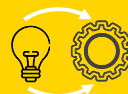
Introducing pre-packaged insolvency resolution

Solution

Some classes of corporate debtors should be given the opportunity to opt for a procedure similar to the pre-packaged administration procedure in the United Kingdom, but with adequate safeguards to suit the Indian context. The key features of such a regime would be as follows:

- Confidential negotiations regarding the resolution of the debtor's insolvency would happen before formal proceedings are initiated.
- A confidential claims collection process would be conducted by an insolvency professional.
- The negotiations would be led by the insolvency professional, who has the duty to pursue the most value maximizing resolution in the interests of all the stakeholders. The consent of secured creditors, however, may be required before their rights over secured property are displaced.[5] Importantly, this resolution process should also enable business sale.
- The resolution plan drawn up by the resolution applicant in consultation with the resolution professional, and consented to by the secured creditors, may then be presented to and approved by the NCLT simultaneously with the admission of the application.
- Experience in other jurisdictions suggests that it is possible for this procedure to result in value being unduly captured by stakeholders having higher bargaining power or by the defaulting promoters themselves. Given this, certain restrictions may be placed on who may be able to propose a resolution in such proceedings, particularly where connected parties are involved.[6]
- The details of the claims collection process, marketing exercise and negotiations carried out may be disclosed to all stakeholders after the approval by the NCLT.[7] In addition, the resolutions achieved through this process may be made subject to the review of an independent commercial entity or pre-pack pool, whose report may also be placed before the NCLT.
- Any determination of wrongdoing may result in imposition of liability on the insolvency professional and other parties responsible.

Introducing such a procedure would result in lower costs and higher chances of the resolution of the debtor's insolvency in a value maximizing manner.



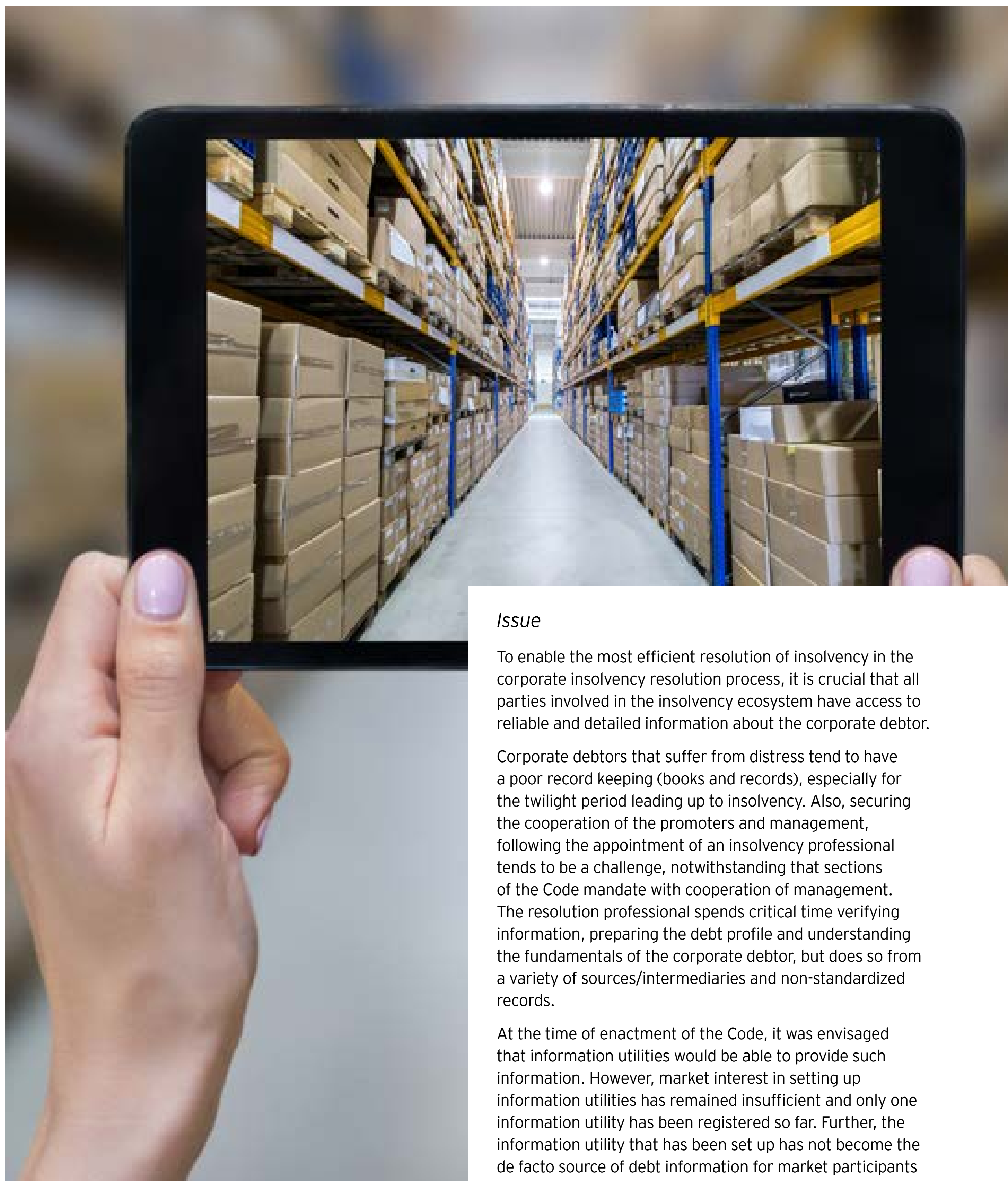
Implementation

To implement this:

- A new chapter to the Code that enables the conduct of such a process with adequate safeguards would have to be introduced. The definition of resolution plan may also need to be amended to enable a business sale in a resolution plan.
- The classes of corporate debtors who could have recourse to such a procedure would have to be defined. Such a procedure may not result in the most value maximizing outcomes where the corporate debtors can withstand the costs of the corporate insolvency resolution process. This is because an open claims collection and marketing exercise in the corporate insolvency resolution process is likely to give an access to a larger number of resolution plans, and is more likely to result in the most efficient insolvency resolution.
- There is a need to make efforts to improve the capacity of insolvency professionals to carry out such transactions, given that their role in the regular corporate insolvency resolution process is different.
- There is a need to strengthen the enforcement regime against insolvency professionals so that breach of duties by insolvency professionals would result in expeditious and meaningful actions.

5 Roy Goode, Principles of Corporate Insolvency Law (4th edition, 2011)
6 Lorraine Conway, Pre-pack administrations, (House of Commons Library, Briefing Paper, Number 5035) (13 December 2017)
7 Graham Review into Pre-Packaged Administration (June 2014), available at https://www.gov.uk/government/publications/graham-review-into-pre-pack-administration; SIP 16, Pre-Packaged Sales in Administrations, Version 3 (effective 1 November 2015)

Streamlining the process



Issue

To enable the most efficient resolution of insolvency in the corporate insolvency resolution process, it is crucial that all parties involved in the insolvency ecosystem have access to reliable and detailed information about the corporate debtor.

Corporate debtors that suffer from distress tend to have a poor record keeping (books and records), especially for the twilight period leading up to insolvency. Also, securing the cooperation of the promoters and management, following the appointment of an insolvency professional tends to be a challenge, notwithstanding that sections of the Code mandate with cooperation of management. The resolution professional spends critical time verifying information, preparing the debt profile and understanding the fundamentals of the corporate debtor, but does so from a variety of sources/intermediaries and non-standardized records.

At the time of enactment of the Code, it was envisaged that information utilities would be able to provide such information. However, market interest in setting up information utilities has remained insufficient and only one information utility has been registered so far. Further, the information utility that has been set up has not become the de facto source of debt information for market participants in the insolvency ecosystem.

Improving information availability in the corporate insolvency resolution process

Further, in an ideal world, the insolvency professional should be able to commence the marketing process soon after appointment. However, given the procedural requirements of the corporate insolvency resolution process, there are challenges with being able to make information available to interested parties earlier. This reduces the time parties have to complete due diligence.

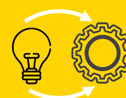
Even when information is presented to resolution applicants, it is usually not available on a single platform and information requests and documentation uploads are likely to be ongoing throughout and right up until the transaction date. The dynamic nature of decision-making required by such uncertainty of information can lead to potentially sub-optimal outcomes when structuring asset bids or acquisition proposals (i.e. resolution plans) are put together.

Consequently, the current process suffers from information asymmetries that may lead to adverse selection and moral hazards concerns, and high divergence between pricing and valuation.

Solution

Information availability in corporate insolvency resolution process can be achieved by following a three-pronged approach:

- Given limited market interest in setting up information utilities, it should be considered whether an information utility is better structured differently. Given the vital nature of the information intended to be stored by information utilities and the nominal cost involved relative to the formulation of an asset bid, in order to encourage the creation of a competitive market, the restrictions on fees and requirements on interoperability and ownership may be revised.
- The resolution professional should be given more powers to commence a marketing process on day one of the corporate insolvency resolution process, potentially alongside the public announcement. The expression of interest criteria can be completed commercially by the resolution professional, in consultation with creditors to accelerate the process. This could also be ratified at the first meeting of the committee of creditors.
- To facilitate smooth formulation of an asset acquisition proposal (i.e. the resolution plan) resulting in value maximization, simultaneous to the preparation of the information memorandum, resolution professionals may be required to create and maintain a single electronic virtual data room (VDR) in which all available documentation and information from across sources should be uploaded, suitably categorized and shared with a qualified prospective resolution applicant. Limited information from such VDR may also be monetized and made available for the purposes of debt assignment, that is, made available for a fee (but on an 'as is where is' basis without liability on the corporate debtor or the resolution professional) to buyers of a debt of a corporate debtor that has been admitted by the resolution professional. In the event that the corporate debtor enters liquidation, the maintenance of such a VDR along with the information in it should pass on to the appointed liquidator.



Implementation

To implement this:

- The Insolvency and Bankruptcy Board of India (Information Utilities) Regulations, 2017 may be amended to enable for a more dynamic fee, operation and ownership structure.
- The Code and the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 may be revised to permit an insolvency professional, in consultation with creditors, to take any steps necessary to accelerate the obtaining of expressions of interest during CIRP.
- Section 25 of the Code may be amended to include the creation and maintenance of a VDR as a duty of the resolution professional. A new section 25B may be inserted in the Code permitting the resolution professional to provide limited access (without any liability, and for a fee that would form a part of the corporate debtor's assets) to such a VDR upon a written request of a creditor and after submission of the proposed buyer's information. Such section should also specify the kind of information that may be accessed for the fee.

Streamlining the process

Issue

Commercial contracts typically contain clauses that permit one party to exercise certain rights under such contracts on the occurrence of an insolvency event in respect of the counterparty. These clauses are commonly known as ipso facto clauses and contemplate varied consequences, which include the termination of the contract, enforcement of security, suspension of further credit, or cessation of supply of goods or services. In the Indian context, such ipso facto clauses are also common in some licenses granted by sectoral regulators, which empower the regulators to terminate a license on the occurrence of an insolvency event. Ipso facto clauses are put in place to allow parties to choose to terminate or modify their contracts where counterparties are insolvent and presumably unable to perform their obligations. However, permitting the termination or modification of contracts through ipso facto clauses can restrict the access to credit, raw materials, etc. and thereby become a serious impediment to corporate rescue. This may lead companies further down the path of insolvency and deplete the value of their assets. The above outcome is particularly severe in respect of companies

Dealing with ipso facto clauses

whose business is reliant on supply contracts. Ultimately, the operation of such clauses may significantly diminish any chances of a successful recovery and may seriously undermine the resolution process (or even liquidation, if a going concern sale is attempted during liquidation).

The Code does not per se prohibit the operation of ipso facto clauses during insolvency proceedings. However, Section 14 provides for a limited exception prohibiting the termination, suspension or interruption of specified "essential goods or services" (i.e. water, electricity, telecommunication services and information technology services to the extent they are not direct inputs to the output produced or supplied by the corporate debtor), and also provides relief to the corporate debtor from the recovery of any property by an owner or lessor during the moratorium. The continued supply of other critical goods or services is currently obtained by an agreement between the resolution professional and the supplier, often with the approval of the CoC. Recognizing this, the Insolvency Law Committee also suggested that a resolution professional should be permitted to make an application to the NCLT to mandate continued supply of such critical goods and services in addition to the essential goods and services covered above.[8]

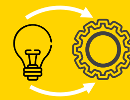
Solution

For contractual ***ipso facto*** clauses,

A complete stay on the operation of ipso facto clauses would constitute a serious restraint on the freedom of contract and would effectively compel suppliers to perform contracts even when such an action is against their commercial interests. Accordingly, only a conditional stay on the operation of ipso facto clauses may be appropriate.

- Such a stay would operate from the insolvency commencement date, subject to the CoC approving the making of payments either on an on-going basis or as a part of CIRP costs to facilitate continued performance of the contract, in order to provide relief to corporate debtors and prevent the depletion of the value of their assets during the insolvency resolution period under the Code. If the CoC does not grant such an approval, then such a stay would lapse on its own.
- For ipso facto clauses under a license, the stay on their operation can be more absolute to facilitate going concern resolution or sale (even in liquidation), subject to other requirements of the license.

The above approach would not affect the operation of ipso facto clauses prior to the insolvency commencement date, but would only grant a conditional stay from the insolvency commencement date which adequately balances the interests of suppliers and corporate debtors. This would also not be subject to the NCLT's approval, which would save judicial time.



Implementation

To implement this:

- ·The Code may be amended to insert a provision providing for a stay on the operation of ipso facto clauses during the moratorium, provided that the committee of creditors approve the making of payments as suggested above. However, the provision should not prohibit the right of parties to terminate for breach of contract, such as non-payment or non-performance of contractual obligations. The provision should be tailored to avoid the prohibition on ipso facto clauses from being circumvented.
- For ipso facto clauses under a statutory license, a stay on their operation during the period that the moratorium under Section 14 is in effect may be provided for by inserting a new sub-clause (e) in Section 14(1) of the Code.

8 Insolvency Law Committee, Report of the Insolvency Law Committee, available at http://www.mca.gov.in/Ministry/pdf/ILRReport2603_03042018.pdf.

Streamlining the process

Safeguarding the interests of consumers

Issue

In the insolvency of a corporate debtor that takes prepayments from consumers, such as retailers, the rights of a large number of consumers would be affected. Given their weak bargaining power and low capacity to monitor the debtor, consumers cannot be expected to adjust the terms of their transactions with the debtor ex ante to protect themselves against this risk. Moreover, since typically, consumers are not financial creditors of the corporate debtor, there is a concern that their interests would not be adequately considered by the committee of creditors, comprising of financial creditors and their rights may be displaced and value due to them, may be captured by stakeholders that are better placed. This may have implications on reliance on consumer advances for financing.[9]

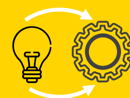
An example of the kinds of concerns that may arise in respect of consumers were witnessed in the insolvency resolution of home developers,[10] which led to an extended litigation. The concerns of home-buyers were also deliberated by the Insolvency Law Committee and following their recommendations, home-buyers have been deemed to be financial creditors. However, following such an approach of deeming consumers to be financial creditors, may not be feasible for all classes of consumers. Consequently, it is important to define consumer rights in a manner that creates certainty for all classes of creditors, reduces litigation in individual cases and respects the entitlements of consumers.

Solution

A three-pronged scheme should be adopted to safeguard the rights of consumer creditors. This would be similar to the scheme proposed in the United Kingdom in the event of retailer insolvency, where this issue would be most relevant.[11]

- All consumers, even in those cases where they are not classified as operational creditors, should be guaranteed a minimum liquidation value in any resolution plan.
- A part, or whole of the advance payments that are received from consumers as parts of saver schemes or instalment payment schemes where the goods or services have not been provided, should be mandatorily held in trusts that cannot be distributed to other stakeholders in a resolution plan. Given that such consumers are least likely to be able to afford a loss of money, this will ensure that their payments are secure and fall squarely within the ambit of Sections 18 and 36, which place limitations on the manner in which assets owned by third parties may be applied in the insolvency resolution process or liquidation process.
- Rights of consumers in general law should be clearly defined, so that they may be respected in the event of the debtors' insolvency. This will enable consumers to claim their property in a cost-effective and non-litigious manner.

This scheme safeguards the rights of consumer creditors in a manner that does not disturb the pre-insolvency entitlements of stakeholders or adversely affects the rights of other stakeholders, but takes into account the special issues associated with consumer prepayments.



Implementation

To implement this:

- The Code and Regulations thereunder should be amended to guarantee payment of liquidation value to all consumer creditors, whether operational creditors or not.
- The Companies Act, 2013, the Limited Liability Act, 2008 and other laws incorporating corporate persons may be amended to require that consumer prepayments of the kind outlined above should be kept in the form of a trust. Amendments may also be made to the Code to recognize that such amounts under such trusts may not be utilized for distributions to other creditors.
- Laws such as the Sale of Goods Act, 1930, and other sector specific laws may need to be amended to clarify consumer rights. The rights conferred by this regime should then be recognized under the Code.

9 See: Bankruptcy Code 11 USC s 507(a) (7) (United States), Layby Sales Act 1971, s 11(1) (New Zealand).
10 Chitra Sharma v. Union of India, Writ Petition(s)(Civil) No(s).744/2017
11 Law Commission, Consumer Prepayments in Retailer Insolvency, 2016 (United Kingdom)

Developing the eco-system

Incentivizing the use of transaction avoidance and director liability provisions under the Code

Issue

An important goal of the Code is to encourage responsible ***ex-ante*** behaviour on part of insolvent debtors, so that creditors are not exposed to more risk than is necessary. On the other hand, where debtors have carried on activities such as claim dilution, asset dilution or siphoning off or directors have wrongfully carried on business, the goal of the Code is to ex post protect recoveries from these avoidance transactions and penalize directors, to swell the assets of the debtor, so that all stakeholders may recover maximum value.

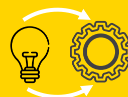
Presently, the Code contains provisions aimed at holding the management of the corporate debtor accountable for actions in the "***twilight zone***" leading up to insolvency. These include prohibitions on preferential transactions under Section 43, avoidance of undervalued transactions under Section 45, and the prohibition on wrongful/fraudulent trading under Section 66. However, the operation of these provisions requires an active involvement of the resolution professional and/ or liquidator, who are already tasked with substantial duties under the Code. The insolvency process has a resolution period of 180 days and may not have the adequate bandwidth or expertise to carry out detailed investigation. Moreover, creditors may not be willing to fund investigation and litigation in these areas. Indeed, since the enactment of the Code, these provisions have not been used extensively despite evidence of siphoning-off, including in cases presently undergoing resolution under the Code.

Hence, there is scope to enhance effective deterrence for errant promoters by incentivizing the use of transaction avoidance and director liability provisions under the Code.

Solution

To ensure that the provisions under the Code result in improving incentives of parties' ***ex ante***, they must pose a credible threat to stakeholders indulging in wrongful conduct in the lead up to insolvency. To achieve this:

- A comprehensive regime to disqualify directors who have been proven to have indulged in prohibited actions in the run-up period to insolvency, including inter alia wrongful trading, may be put in place, on the lines of the Company Director Disqualification Act, 1986 in the United Kingdom.[12]
- To improve litigation funding for the use of the existing provisions of the Code, enabling assignment of claims (that may be brought by the resolution professional and liquidators) may be explored as a long-term goal.
- A specialized class of professionals with expertise in conducting assessments and investigations into such transactions, may be registered by IBBI. The market would then be able to provide professionals to assist the insolvency professional appointed under the Code in conducting investigations for the purpose of private recovery.



Implementation

To implement this:

- Amendments may be made to the Code, relevant regulations issued under the Code and the Companies Act, 2013.
- An institutional set-up may be set up to enable IBBI and the Registrar of Companies to coordinate to make the director disqualification system enforceable and create linkages between misconduct in insolvency and a potential director disqualification regime.
- Institutions would have to be put in place for the creation of an enabling eco-system for litigation funding support in India, since globally, litigation funding arrangements play a critical role in incentivizing the institution of actions against errant directors by third-parties, who are active players in the market for such claims.

12 Insolvency Act, United Kingdom (1986); Company Directors Disqualification Act, United Kingdom (1986); House of Commons Library, Briefing Paper Number CBP 7936, Company Insolvency: Potential Liabilities of Directors (28 March 2017).

Developing the eco-system

Alternate insolvency resolution mechanisms for personal insolvency

Issue

Globally, the insolvency of natural persons is dealt with differently than the insolvency of corporate persons, as its primary aim is to rehabilitate debtors in the society by enabling them to discharge their debts in a timely manner. Accordingly, the thrust of a personal insolvency regime must be to find an accessible time and cost-effective way to resolve insolvency.

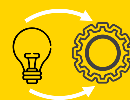
Implementation of Part III of the Code which provides the framework for insolvency procedures for individuals and partnership firms, poses distinct challenges which are yet to be experienced. It provides debt recovery tribunals (**DRTs**) as the adjudicating authority for disputes relating to insolvency and bankruptcy procedures under Part III of the Code. Considering the widespread application of these insolvency procedures, the present caseload and limited presence of DRTs across the country may limit the accessibility of insolvency processes. Lack of accessibility may lead to an increase in costs of litigation for the parties involved.

Where parties are able to afford and access insolvency procedures, the low trigger of INR1,000 for initiating an insolvency resolution process, as per Section 78 of the Code, may lead to DRTs being overburdened due to filing of a large number of cases.

Solution

To enable easier access, and reduce the time and cost of such insolvency proceedings, while ensuring that creditors are paid in a timely manner, the following approach may be followed:

- Portals similar to the Money Advice Service in the United Kingdom, set up by the government, the Citizens Advice Bureau or StepChange Debt Charity, set up by private parties, may be put in place. These portals would provide guidance to persons struggling with paying their debts regarding how to manage their finances, the kinds of pre-insolvency procedures they may access, how to file for insolvency and how to contact relevant insolvency professionals. This would reduce the cost of accessing insolvency or debt management related procedures.
- An alternate mechanism to resolve insolvency could be put in place. This mechanism could be accessed either prior to filing of insolvency or even once an insolvency petition is filed with the adjudicating authority's approval.
- Where the mechanism is used prior to the insolvency resolution process of the Code, it may be accessed by filing an online application. Trained professionals would then attempt to enable a settlement resulting in a debt management plan between the debtor and the creditors. This settlement could include terms that debar creditors from asking the debtor to pay the full amount at a later stage or from recovering the debt except in accordance with the settlement. This settlement could be recognized by the DRTs as well, in the event of filing of insolvency.
- The DRT may also be empowered to order access to the alternate mechanism of insolvency resolution. This mechanism should attempt to enable parties to reach a debt management plan in a defined period, and which may be implemented under the supervision of a trained professional. A discharge may then be obtained from the DRT or an automatic discharge may be given to the debtor following an online filing of a discharge application by the professional. The provisions of the debt management plan itself may not be subject to appeal. Where there is a failure to reach a debt management plan, the case may be remitted back into an insolvency resolution process, with an adjusted timeline. Inspiration for designing such a scheme may be garnered from jurisdictions such as the United States.[13]



Implementation

To implement this:

- IBBI may facilitate the setting up of a portal similar to the Money Advice Service and regulate and train a cadre of professionals to administer such an alternate insolvency resolution procedure across the country.
- Recognition of pre-insolvency alternate insolvency resolution procedures may be built into Part III of the Code.
- Access to a post-insolvency alternate insolvency resolution procedure may be built into Part III of the Code.

13 Jacob A. Esher, Alternate Dispute Resolution in US Bankruptcy Practice, volume 4 issue 1, University of Massachusetts Law Review (2009), 84.

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Next frontier

Operational turnaround

Next frontier

Operational turnaround

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With the advent of a creditor-friendly insolvency regime and RBI's 12 February circular 2017, typical lassiez-faire approach to dealing with financial stress is clearly detrimental to incumbent management and shareholders. With stronger creditor rights protection, both Indian and foreign distressed asset investors will play a much greater role in resolving stress, leading to greater emphasis on governance and time taken to drive an operational turnaround.

What is an operational turnaround?

A typical operational turnaround involves crisis management, stakeholder management, refocusing the business, operations restructuring and leadership change. More on these later but critical (and under-appreciated) differences between a turnaround and a transformation are the severity of the crisis, value of time, cash-focused decision making, stakeholder management (especially external) and the type of leadership required.

Most operational turnarounds start with a dip stick of how severe the problem is. Often the starting question to be answered is whether the business can survive and if yes, what will it take for the business to survive. In the experience of this author, the ground reality is always worse than initial assessment of the management, shareholders and lenders. In the Indian context and in the stressed cases we are seeing today, this reality gap is largely driven by poor governance and misreporting of actual performances. As we go along, the reality gap will arise largely due to three reasons:

- as a result of initial blips in performance being covered by utilizing accumulated reserves;
- business managers continuing to invest in new projects and products, while the deterioration in business fundamentals continue to develop deeper roots, leading to a hidden crisis; and
- denial of crisis and misreporting of financials by business managers, who still believe that the problem is short term and that the steps they have taken will yield desired results in future, even though the odds may have turned completely.

Why is operational turnaround relevant today?

Under the new regime, it is the incumbent management and shareholders who stand to lose the most. It seems logical then, that they should take appropriate action at first signs of financial distress rather than wait for an event of default to happen.

Banks leading a restructuring under RBI's 12 February circular should insist on a plan that has been developed alongside a credible advisor, who in turn can commit to deliver on the planned performance.

One-time settlements financed by genuine financial investors, will similarly require help in the implementation of planned initiatives. Asset reconstruction companies and other distressed asset investors, typically have a short investment horizon of less than five years and look to rapidly turnaround business performance in order to pocket mid-high teen US$ returns.

Ingredients of an operational turnaround

Before we delve into what the key ingredients of a successful turnaround plan are, it is important to understand that lack of time can drive even the most "savable" businesses into liquidation. Not only that, the longer a business continues to deteriorate, the higher the destruction in value for all stakeholders and specifically in case of shareholders, the higher the loss of control.

As mentioned earlier, the key ingredients of a turnaround can be considered in five perticular area:

1. Crisis stabilization and management

Stressed businesses are like patients in a road accident. Every minute counts. Everyone around has a point of view as to how bad the situation is but no one knows what to do. Then, someone decides to call the Emergency Response (ER) team. The ER urgently performs a check on few critical parameters, performs immediate rehab, determines the nature and gravity of injury and carries the patient to a hospital ER. The hospital ER stabilizes the patient (stop loss of blood, new blood infusion, stabilizes heart rate, etc.) and gets the patient ready for a surgery, if required. Post the surgery, the patient is put on a rehab and gradually gets back to better health (emphasis on the word "gradually" is to demonstrate that the difference between operational turnaround and transformation is not just semantics but real and meaningful). All along, the doctor and nursing staff engage with the well-wishers to calm anxious nerves but more on that later.

Experienced turnaround professionals would relate to the above analogy. The healthcare staff are the turnaround team. Someone making the call could be one of the lenders, shareholder, their lawyer or the management.

Upon being called into a stressed situation, the turnaround professional would carry out a quick check about how dire the situation is and whether a turnaround is possible. Once that is out of the way, immediate priority items to be addressed include the short-term cash situation and general oversight of the business (and in some cases, take interim management roles). A tight control over use of cash is imposed, which may include changing authority structures, not just for payments but also to create new liabilities,

including procurement, hiring and capex commitments. Cash generating opportunities like surplus stock, scrap sale, delayed debtors, non-encumbered asset sale, etc. are pursued more aggressively. Longer term capex and research and development programs may have to be put on hold. Cost reductions that seem obvious are implemented without delay.

Another important aspect is to repair lost trust by creating more transparency and predictability about operations and cash flow. A standard and well-accepted tool for achieving that is a 13-week rolling cash flow that creates near term visibility on liquidity and identifies potential gaps that need to be planned for.

2. Leadership change

Stressed businesses are chaotic and volatile. Employees, vendors and other stakeholders look for leadership and clear direction. Often the management has either weakened due to the departure of key personnel or they have lost the trust of key stakeholders. In such situations, new leadership is required to manage the turnaround. Where the incumbent CEO is held responsible for ongoing stress, stakeholders will have to debate his/her role going forward, e.g., more often than not lenders insist on restricting access for promoters and their involvement in business, when the corporate debtor is admitted under the Code.

Where a change is deemed necessary, debate is often around the type of chief executive officer (CEO) to be appointed to lead the turnaround. Relative emphasis on competence to lead a turnaround versus industry experience, will have to be evaluated. As mentioned earlier, time is a critical resource, hence appointing an interim turnaround leader might be necessary while a longer duration search for an industry CEO could continue simultaneously.

Another approach that may work is to appoint a Chief Restructuring Officer (CRO), who works along with the existing senior management team and leads all restructuring efforts. A CRO must have adequate seniority and ideally should report to the board or lenders directly. Having a CRO provides leadership bandwidth where the incumbent management can focus on day to day operations matters and the CRO drives restructuring initiatives. Other benefits of having a CRO include:

- Objective assessment of the situation for incumbent/new lenders;
- Developing confidence with vendors and employees, so they continue to support the turnaround efforts;
- Ensuring that initiatives agreed with lenders/new investors are implemented;
- Stepping into the shoes of the CEO, should such a need arise;
- Bringing in additional expertise (interim chief financial officer (CFO), head of treasury, procurement, supply chain, etc.) at short notice and especially, when attracting good talent for a distressed business is difficult.

3. Stakeholder management

In the earlier analogy, healthcare staff were seen engaging with the well-wishers of the patient. Similarly, for a troubled business, communicating with all stakeholders is absolutely critical. Providing an objective assessment of the situation in itself is a significant progress and a step towards repairing and rebuilding trust. Appropriate engagement with key stakeholders during the development phase of the turnaround plan is vital to garner their support, where additional funding and longer trade terms are required. Engaging with key customers is important to give them comfort that all efforts are being made to ensure that their supply chain will not be disrupted. Loss of key customers will adversely impact enterprise value and consequently weaken support from lenders and new investors.

Regular updates on actual cash flows (vis-à-vis forecast) and operating performance will help calm nerves, strengthen trust and build confidence in the expertise of the turnaround professional.

4. Refocusing the business

Too often businesses get into trouble due to:

- Aggressive growth strategies e.g., full service airlines taking over their low-cost competitors
- Investing into unrelated businesses e.g., textile businesses venturing into real estate development, electrical cable manufacturing business venturing into consumer electronics, etc.
- Making investments for short term gains that do not materialize viz., real estate, stock markets, etc.
- Taking on too many projects simultaneously without regard to management bandwidth or leverage ratios e.g., Engineering Procurement Construction (EPC) companies
- Horizontal integrations that do not work out due to regulatory changes, lack of management bandwidth, cash flow mismatches, etc.

In such instances, it is important to identify that part of the business which continues to earn a return on capital ahead of its costs. Not every business has a right to survive, so closing those businesses that no longer generate positive returns is a prudent strategy.

In case of large global companies with a broad range of products and customers, the task of identifying the core can be complicated and time consuming. All stakeholders will have to be brought on board to give adequate time to such an analysis as the wrong strategy can lead to loss of value for all stakeholders.

5. Operations restructuring

At the heart of a turnaround plan are a range and wide variety of well thought through operations restructuring initiatives. Given below is sample list of initiatives that may be evaluated and quantified as part of the plan development:

	Procurement	Manufacturing	Product or service	Distribution	Sales and marketing
Revenue			▶ Stock keeping unit rationalization ▶ New product introduction ▶ Price increases	▶ White spaces ▶ Modification of terms and conditions (tandc's)	▶ Strengthening sales team ▶ Re-prioritization of marketing spend
Direct costs	▶ Vendor base consolidation and/or diversification ▶ Reverse auctions	▶ Footprint rationalization ▶ Shift rationalization ▶ Line efficiency improvements ▶ Labor productivity			
Indirect costs	▶ Procurement function consolidation	▶ General admin and overhead rationalization		▶ Warehouse consolidation ▶ Reverse auctions ▶ Space management ▶ Shift to third-party distribution	▶ Rightsizing of sales team
Working capital	▶ Negotiate credit period ▶ Vendor financing	▶ Overall improved sales and operations planning process	▶ Slow moving inventory		▶ Lower credit period
Enablers	▶ Cash management ▶ Robust budgeting and management information systems tracking ▶ Performance management systems				

The above mentioned initiatives should be discussed with the incumbent management in order to secure their buy-in for implementation. Lack of credible information to quantify initiatives and resistance to achievability are common challenges that the turnaround experts face. They have to often rely on their own experiences and abilities to get things done.

There will be inherent conflicts between initiatives where some will be beneficial for profitability and/or market share but require significant working capital or maintenance capex investment. Prioritizing the initiative that needs to be taken in the initial phase will depend on the availability of cash and stakeholders' willingness to wait for an outcome. Selected initiatives will have to be further prioritized on the basis of their impact versus duration and cost of implementation.

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About Vidhi Centre for Legal Policy

The Vidhi Centre for Legal Policy ('Vidhi') is an independent, not-for-profit think-tank, with offices in New Delhi and Bengaluru. Vidhi is committed to producing legal research of the highest standard with the aim of informing public debate and contributing to improved governance. Vidhi has been at the forefront of the bankruptcy reforms process in India since the time of its conceptualization. One of Vidhi's first independent research projects focussed on outlining the reasons for failure of the Indian insolvency regime and suggesting a combination of substantive and institutional reforms for making the regime more effective. We believe that this research was instrumental in initiating the process that culminated with the passage of the Insolvency and Bankruptcy Code, 2016. Vidhi has advised the Ministry of Finance and the Bankruptcy Law Reform Committee on the design and drafting of the Code. Thereafter, we have worked with the Ministry of Corporate Affairs, the Insolvency and Bankruptcy Board of India for its speedy and effective implementation. We have also advised the recently constituted Insolvency Law Committee and the Ministry of Corporate Affairs on ironing-out implementation-related issues in the Code and on designing a proposal for a regime dealing with cross-border insolvency.

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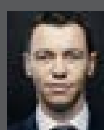

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