INTERNATIONAL LAW JOURNAL

WHITE BLACK LEGAL LAW JOURNAL

ISSN: 2581-8503

Peer - Reviewed & Refereed Journal

The Law Journal strives to provide a platform for discussion of International as well as National Developments in the Field of Law.

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WHITE BLACK LEGAL is an open access, peer-reviewed and refereed journal providededicated to express views on topical legal issues, thereby generating a cross current of ideas on emerging matters. This platform shall also ignite the initiative and desire of young law students to contribute in the field of law. The erudite response of legal luminaries shall be solicited to enable readers to explore challenges that lie before law makers, lawyers and the society at large, in the event of the ever changing social, economic and technological scenario.

With this thought, we hereby present to you

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EFFECTIVENESS OF INSOLVENCY AND BANKRUPTCY CODE, 2016: A CRITICAL ANALYSIS

AUTHORED BY - DAEINN A P

Abstract

This paper to investigates the evolution of corporate insolvency law in India, specifically examining the shift from a manager-driven paradigm before the implementation of the Insolvency Code to a manager-displacing model thereafter. By evaluating the established theoretical underpinnings of India's corporate insolvency law and analysing its real-world application, the study yields noteworthy insights. In the paper it is contended that, given the unique structure of corporate ownership in India, the Insolvency and Bankruptcy Code of 2016 may not fully realise its intended objective of prioritising creditor interests, contrary to the prevalent evolutionary theory. This article highlights that the Indian corporate insolvency regime, as it stands in legislation, follows a manager-displacing model, while practical implementation often aligns with a manager-drivenapproach.

Introduction

In India after Independence, corporate objectives underwent significant transformations in responseto shifts in political and economic policies. These changes also influenced corporate insolvency legislation[1]. Prior to the implementation of the Insolvency and Bankruptcy Code (IBC) in 2016, both voluntary and involuntary winding up were common methods for resolving company crises.

The evolution of corporate insolvency law can be traced back to the enactment of the Sick Industrial Companies Act (SICA) in 1985. SICA introduced the debtor in possession model of insolvency, allowing existing management to retain control even after insolvency declaration. However, SICA was exclusively applicable to firms in the production sector and had several shortcomings, including misuse by intentional defaulters and inefficient revival plans.

Following SICA, the Insolvency and Bankruptcy Code of 2016 (IBC 2016) introduced a creditor-driven framework, granting creditors control over management when insolvency proceedings are initiated. This shift aimed to establish a public debt market and improve the success rate of insolvency settlements. However, data reveals a notable disparity between the number of liquidationcases and resolution cases, with a high percentage of cases resulting in liquidation orders. The effectiveness of

insolvency proceedings is influenced by cultural norms and corporate ownership structures in India, characterised by a hybrid model with both promoter-owned and institutionally- owned entities. Promoters and majority shareholders have a competitive edge in evaluating troubled

[1] UmakantVarottil, 'The Stakeholder Approach to Corporate Law: A Historical Perspective from India', Edward Elgar Publishing (2018), in: Research Handbook on the History of Corporate and Company Law.

companies, while dispersed ownership reduces knowledge asymmetry among stakeholders. The IBC 2016 includes provisions for the substitution of managers or transferring promoter power to the "committee of creditors" (CoC), but this presents challenges in acquiring relevant information undera hybrid ownership structure. Despite the law favouring liquidation, managers play a significant role in the implementation of the insolvency regime.

Impact of Changing Ownership Structure on Insolvency Dynamics.

The ownership structure of Indian corporations is characterised by a prominent presence of promoters, aligning with the insider system of corporate governance (Sarkar and Sarkar, 2000). Thispromoter dominance can be traced back to the post-independence era when underdeveloped equity markets prevailed, leading to a reliance on private lending. The absence of government debtmarkets further promoted debt financing as a cost-effective source of funding for firms. However,as India underwent post-liberalisation changes, there was a shift towards widespread stock distribution and the development of the debt market (Pant and Pattanayak, 2007; Sarkar, 2017). Legal reforms were introduced to establish creditor rights, and businesses increasingly turned to equity financing over debt. This shift in the financial landscape raised questions about the future of manager-driven bankruptcy in India, with the presence of equity investors potentially influencingthe insolvency landscape.

In recent times, institutional investors, particularly banks, have become more involved in company holdings, contributing to the changing dynamics of corporate ownership. The rise in dispersed shareholdings in India could further align with a manager-driven bankruptcy approach, as suggested by Skeel's evolutionary theory (1998). However, despite these changes, the debt market in India remains significantly reliant on banks, with limited competition from the corporate bond market. Efforts to promote the bond market have been visible, but controlling owners seem to prefer dispersed debt only when their ownership stakes are diluted, such as through initial public offerings (IPOs).

The Central Bank has also made efforts to reduce corporate dependence on bank financing. However, there's a notable contradiction as a growing decentralised bond market may require a bankruptcy framework supportive of a manager-driven approach, while the current bankruptcy legislation in India primarily follows a creditor-driven or manager-displacement regime. The dominance of banks, especially in light of the Insolvency and Bankruptcy Code (IBC) of 2016, could potentially hinder the progress of the bond market. To address this, separating bank-loan-

driven insolvency law from the goal of nurturing the debt market[2] might be a way to promote the structured development of the public debt market in India.

Promoter Involvement in Indian Insolvency: A Complex Balancing Act

The establishment of a legitimate space for the involvement of promoters in the insolvency process in India is a complex issue. In Indian enterprises, the relationship between controlling owners (such as government entities, business families, and promoters) and management has been explored in previous studies. Controlling owners often wield influence by appointing executives, which grants them information symmetry. In contrast, banks in India typically lack significant influence as an interest group. Banks with strong alignment of interests with controlling owners may lack motivation to pursue a manager-displacing insolvency strategy. Under the Insolvency and Bankruptcy Code (IBC) of 2016, the appointment of resolution professionals (RPs) adds complexityto the insolvency process. When a borrower enters the resolution process, the creditor(s) appointRPs responsible for overseeing the distressed company's daily operations. However, resolution professionals may face limited cooperation from the company's promoters who possess privileged information.

The Committee of Creditors (CoCs) plays a pivotal role in financial restructuring, evaluating the feasibility of a corporate debtor's proposed resolution strategy. The CoCs also handle requests for withdrawal or settlement following the acceptance of an insolvency petition, assessing the feasibility and viability of the resolution plan. The potential drawback of exerting influence on governance during bankruptcy proceedings is that secured creditors may opt for liquidation when a feasible and successful resolution plan is not available. This preference may face challenges due to the purposive interpretation of the Insolvency and Bankruptcy Code of 2016 and the Companies Actof 2013. In the event of corporate liquidation, it's necessary for the liquidator to follow the procedures outlined in the Companies Act before selling the debtor company's assets. The National Company Law Tribunal (NCLT) can approve a compromise and arrangement scheme if it demonstrates the potential for reviving the corporate debtor while addressing the interests of variousstakeholders. The interaction between the Companies Act and the IBC allows for the possibility of promoter involvement, even during the liquidation phase. This intricate balance between creditor interests and revival opportunities underscores the need for a nuanced and flexible approach to insolvency in India.

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[2] SEBI, Securities and Exchange Board of India (Issue, and Listing of Debt Securities) Regulations 2008, https://www.sebi.gov.in/legal/regulations/jun-2008/sebi-issue-and-listing-of-debt-securities-regulations-2008_6503.html.

Revamping the Resolution Model: RBI's Approach to Stressed Assets

The Reserve Bank of India (RBI) responded to the mounting issue of non-performing assets (NPAs) with a unique approach. Since 2001, the RBI has been striving to enhance the Corporate Debt Restructuring system. In 2018, they introduced the Resolution of Stressed Assets - Revised Framework, aiming to expedite debt restructuring for financially viable companies and streamline the bankruptcy process. Banks that share an exceptional alignment of interests with controlling owners might not find a convincing incentive to support the manager-displacing approach toinsolvency. The reorganisation process becomes intricate with the appointment of resolution professionals (RPs) under the Insolvency and Bankruptcy Code (IBC)[3]. When a borrower initiates the resolution process, creditors take charge by appointing RPs, whose responsibility is to oversee the day-to-day operations of the insolvent company. Throughout the resolution process, the RPs[4] may encounter limited or no cooperation from the company's promoters, who possess privileged information.However, this framework was invalidated by the Supreme Court of India for violating Article 14 of the Indian Constitution, the right to equality. To address this, the RBI introduced the Prudential Mechanism for Resolution of Stressed Assets in 2019. This new framework requires banks to initiate a preliminary examination of the borrower's account within 30 days of default, followed by the formulation of a Resolution Plan (RPn) through an inter-creditor agreement (ICA) involving all lenders. The RBI is empowered to issue directives to banking companies for stressed asset resolution under Section 35AB of the Banking Regulation Act. In cases where the RBIinitiates insolvency resolution under the Insolvency and Bankruptcy Code (IBC), Section 35AA is the governing authority.

This approach offers informal negotiations between debtors and creditors, deviating from the strict IBC procedures, providing relief for promoters. The structure resembles the UK's London approach, and an external tribunal resolution structure has been established. RBI's strategy priorities efficient resolution for NPAs, aligning with a preference for manager-friendly solutions to strengthen the banking industry.

Enhancing Extrajudicial Settlement Mechanisms in the Insolvency and Bankruptcy Code

The Binani Cements insolvency case exemplifies the ongoing struggle for extrajudicial settlement within India's Insolvency and Bankruptcy Code (IBC). The case started with the financial creditors

[3] Insolvency and Bankruptcy Code 2016, No 31 of 2016, Act of Parliament, 2016, s. 2(27)& 18

[4] The Economic Times, "*Welcome reform in India's bond market*",2018 available at: https:// economictimes.indiatimes.com/blogs/et-editorials/welcome-reform-in-indias-bond-market/ IRPs receiving suboptimal cooperation from the company concerned.

of Binani initiating the insolvency process, which led to the bidding process by the Committee of Creditors (CoCs). Dalmia Bharat Ltd. emerged as the winning bidder, but their bid was challenged by UltraTech Cement Ltd., a subsidiary of the Aditya Birla Conglomerate. UltraTech and Binani's promoters submitted a higher bid, prompting the National Company Law Tribunal to allow the CoCs to evaluate it, as it aimed to maximise the value of Binani Cement's assets and consider stakeholders' interests. Subsequently, UltraTech and Binani Management proposed a resolution under Section 12A of the IBC, allowing for an exit from insolvency. However, the National Company Law Appellate Tribunal rejected the claim, as IBC norms prohibit such exits.

These decisions highlight the institutionalisation of market-oriented decision-making, prioritizing stakeholder interests and value maximisation. The Supreme Court has also endorsed external settlements outside of the IBC, even after insolvency proceedings have started, signaling a more debtor-friendly approach. To address potential appeals, the Supreme Court suggested amending the IBC to allow for exits after application admission. The Insolvency Law Committee and the Insolvency and Bankruptcy Code (Second Amendment) Act, 2018 introduced Section 12A, allowing withdrawal of an accepted application if supported by a committee of creditors with a 90% voting share. This amendment reflects legislative flexibility to permit IBC withdrawal, although the 90% threshold can be challenging to achieve, especially with holdout creditors.

In the context of consensus issues, majority creditors supporting an informal workout with the debtor may turn to pre-packaged bankruptcy arrangements. This involves an agreement with the debtor and obtaining National Company Law Tribunal approval to enforce the arrangement on all stakeholders. Pre-packs are akin to a debtor-in-possession bankruptcy system, allowing management to retain authority and a consultation agreement between promoters/debtors and creditors to address insolvency situations.The COVID-19 pandemic led to a temporary halt in IBC insolvency applications. While creditors might consider the Companies Act of 2013's[5] scheme of arrangement, the suspension of the IBC may stimulate the development of an external IBC settlement market, showcasing majority shareholders' willingness to engage in the insolvency resolution. This underscores the need for ongoing legislative strengthening of extrajudicial settlement mechanisms within the IBC. Even if the corporate debtor has been dragged to the liquidation process, the liquidator has to resolve the process in terms of Section 230[6] of the CA, before he/she steps to sell the assets of the debtor company. The scheme of compromise and arrangement can be approved by the National Company Law Tribunal (NCLT) when a scheme

[5] Y. Shivram Prasad v. S. Dhanapal&Ors Company Appeal (AT) (Insolvency) No. 271 of 2019

[6] Companies Act 2013, ACT NO. 18 OF 2013, Act of parliament, India, s. 230

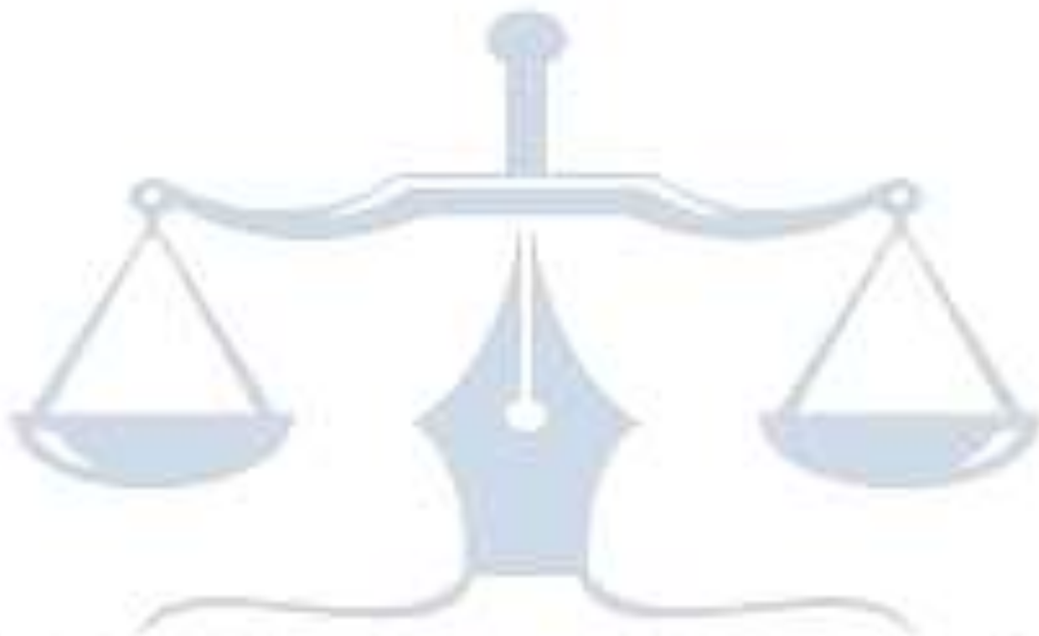
maximises the possibility of revival of the "corporate debtor" and balance the competing interest of the stakeholders, e.g. "financial creditors", "operational creditors", "secured creditors" and "unsecured creditors"[7]. The back-and-forth interaction between CA and the IBC creates leeway for promoter participation even at the liquidation stage.

Unlocking Efficiency: The Pre-Packaged Bankruptcy Scheme

The pre-packaged bankruptcy scheme, or pre-pack, is a structured approach used by financially distressed companies to efficiently reorganise their operations and manage their debts. It wasproposed by legal reformers before the implementation of India's Insolvency and Bankruptcy Code (IBC). The Ministry of Corporate Affairs is currently exploring the viability of pre-pack schemes within the IBC, especially due to the rigours associated with pre-negotiation in the resolution process. The concept of pre-packs was initially discussed in the Interim Report of The Bankruptcy Law Reform Committee in 2015. Pre-pack schemes can enable the use of hybrid-rescue methods, offering an alternative to the existing IBC. However, to implement pre-packs effectively in India, specific regulations are necessary to protect the interests of all parties involved. Stakeholder consultation is crucial before permitting pre-packaged sales as part of schemes of arrangement. Pre- pack schemes draw inspiration from practices in the United States, where a manager-driven strategyis commonly used. They provide promoters with the opportunity to propose ideas to creditors, primarily banks, in times of financial distress. This approach allows promoters to use their personal financial resources to assist troubled companies, collaborating with majority shareholders to develop and execute an effective strategy.

Pre-packs assure promoters of a higher chance of successful recovery, maintaining the company asa going concern. Pre-packs enable the uninterrupted continuation of the debtor company's business, preventing interference from restructuring professionals. They address workforce downsizing and optimise asset utilisation. Informational asymmetry between promoters and restructuring professionals is mitigated, promoting a proactive approach from lenders to resolve matters outside bankruptcy proceedings. The inter-creditor agreement, proposed by the Reserve Bank of India, aligns with the concept of pre-packs, expediting the consensus among creditors for resolution plans outside of bankruptcy. This approach is based on logical reasoning. Pre-packaged insolvencyarrangements aim to facilitate the involvement of strategic promoters or majority shareholders, leveraging their insider knowledge of the distressed debtor to prevent its collapse. This allows for

[7] North East Centre for Technology Application and Reach v. Sri Vari Metal Works Pvt. Ltd. &Anr NCLAT Company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the restructuring or reorganisation of the business with creditor cooperation, aligning with the principles of prompt resolution and value preservation.

Functional Challenges in the Insolvency and Bankruptcy Code: Impediments for Creditors The prevalence of bank finance in India can be attributed to state-controlled banking institutionsand regulated capital markets, influencing corporate finance and capital structure. The Insolvencyand Bankruptcy Code (IBC) aimed to empower secured creditors, particularly banks and financial institutions, in contrast to the previous approach where creditors' committees held the authority to determine resolutions through a majority vote. For a creditors' committee to secure a majority vote, they must represent at least 75 percent of the financial liabilities by weight. The committee'sselection is crucial, given its significant authority in deciding the fate of the entity, whether it should be maintained as a viable operation or undergo liquidation. Committee members are required to beboth creditors capable of assessing the debtor's financial sustainability and open to modifyingcurrent liabilities.

With the climaxed position of non-performing assets (NPAs) growth to a disproportionate level, the money market regulator proposed an extra-ordinary solution. RBI continued its effort to improvised Corporate Debt Restructuring mechanism since 2001(Reserve Bank of India, 2001a)[8]. The latest framework was launched in 2018 – Resolution of Stressed Assets – Revised Framework. Though the resolution framework was quashed[9] by the Hon'ble Supreme Court of India on the grounds of violation of right to equality guaranteed under Article 14 of Constitution of India, the predominant objective of the framework released by RBI is to ease and expedite the debt restructuring of viable corporations in a value-maximising approach and free from the host of regulatory subjection in a formal bankruptcy process.Operational creditors, on the other hand, generally lack decision-making authority when it comes to a company's insolvency and are disinclined to defer payments toimprove the debtor's prospects. To expedite proceedings, the Code recommended that the creditor's committee be limited to financial creditors only. Despite the focus on safeguarding secured creditors' rights, the Code contains provisions for operational creditors to initiate the Corporate Insolvency Resolution Process (CIRP) against a corporate debtor. Section 50 of the Code mandates including a certificate along with the application by financial institutions, though the use of "shall"

[8] For timelines for introduction of Stressed Assets Resolution Framework, see Annex 3, page 11 of Reserve Bank of India Resolution of Stressed Assets – Revised Framework Resolution of Stressed Assets-Revised Framework, 2018.

[9] Dharani Sugars And Chemicals Ltd. v Union Of India &Ors Transferred Case (Civil) NO.66 OF 2018

made this requirement seem mandatory. Treating it as such could potentially infringe on constitutional provisions.

Regulation 38(1) priorities the payment of operational creditors over financial creditors in a resolution plan. This change was prompted by concerns that the liquidation value guaranteed to operational creditors may be insufficient, given their classification as residual creditors. The IBC's second amendment recognised homebuyers as financial creditors, providing them with equal status. The essence of allowing outside IBC settlement was evidenced at Supreme Court decisions inUttara Foods and Feeds Pvt. Ltd.[10], Mothers Pride Dairy India Pvt. Ltd.[11] and Lokhandwala Kataria Construction Pvt. Ltd.[12] In these cases, the Supreme Court exercised its inherent powers under

Article 142 of Indian Constitution and allowed outside IBC settlement even after the application for insolvency proceedings has been admitted. The Hon'ble Supreme Court also reiterated the call for an amendment of IBC to allow exit even after the admission of application in the apprehension of huge heap-up of appeals cases.The Supreme Court has acknowledged the need to protect property buyers' rights, given their disadvantaged position. This inclusion of homebuyers has the potential to impact future insolvency proceedings by involving them in the process. However, the involvement of various stakeholders in the insolvency resolution process has introduced uncertainties for financial creditors. Disputes and delays may arise due to disagreements between creditors, as seenin cases like Essar Steel, where the resolution plan faced opposition. The National Company Law Appellate Tribunal has had to intervene to ensure fair distribution between operational and financialcreditors, potentially causing delays in the resolution process.

The inclusion of revisions and judgments may extend the timeframe of insolvency proceedings. The financial creditor faces uncertainty regarding the maximisation of projected value, while the presence of discrimination in the allocation of funds further complicates the resolution process. The concept of equitable distribution seeks to harmonise the interests of operational creditors andsecured creditors but may result in reduced satisfaction for secured creditors. This, coupled with challenges to the resolution plan, can lead to significant delays in the approval of insolvency resolution. Instances like the Bhushan Power case, which took over 570 days, highlight the potential

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[10] Supreme Court in Uttara Foods And Feeds Private Ltd v. Mona Pharmachem CIVIL APPEAL NO. 18520 OF 2017

[11] Mothers Pride Dairy India Private Limited v. Portrait Advertising and Marketing Private Limited, Civil Appeal NO. 9286 OF 2017 Supreme Court of India, www.ibbi.gov.inMothersPrideDairyIndiaVsPortraitAdvertising9286_2017SP.pdf

[12] LokhandwalaKataria Construction Private Limited v. Nisus Finance and Investment Managers LLP, Civil Appeal NO. 9279 OF 2017 Supreme Court of India, https:// ibbi. gov. in/ Lokhand

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for operational creditors to further complicate the process. Operational creditors have the ability to voice concerns in the Committee of Creditors (CoC), potentially leading to prolonged disputes and value degradation of banks' assets due to delays.

Rationale of Manager-Driven Paradigm

Public sector banks, dominant players in India's debt market, often face influences from politically motivated bureaucrats on their boards, impacting their evaluation of resolution plans for troubled firms. These bureaucrats' ambitions may diverge from stakeholder-oriented corporate governance strategies, potentially leading to decisions driven by political interests. The Insolvency and Bankruptcy Board of India, as the regulator under IBC, may also be influenced by government policies rather than market imperatives, potentially affecting the interests of secured creditors. Despite bank finance being a significant source of corporate funding in India, the responsibility for monitoring and controlling borrowing entities' management was often not effectively exercised by banks. This lack of influence might be attributed to the substantial impact of promoter holdings and a lack of incentives for banks to exert control. This approach can sometimes undermine thecreditors' inclination to maintain the troubled entity's operations and instead push for inefficient liquidation. Insolvency, in such cases, should focus on economic recovery rather than punitive actions against management, especially in instances of fraud, as its primary goal is to revive and restructure distressed firms. However, the IBC's approach takes a one-size-fits-all stance on the treatment of displaced promoters and managers, which may not align with the nuances of each case.

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Conclusion

India traditionally adheres to a manager-driven insolvency regime, where state intervention in corporate financing and insolvency has constrained debt funding for corporations. Family capitalism is a dominant aspect of the Indian market, and the existing manager-displacing model under the Insolvency and Bankruptcy Code (IBC) might be seen as an offshoot of evolutionary theory. However, this practice presents a paradox within the evolutionary theory. The distress resolution is increasingly moving towards informal methods due to limitations within the IBC framework. Users of the IBC have been shifting towards outside bankruptcy resolution, primarily due to these limitations. Institutional investment patterns in family/promoter-owned companies are showing a transition, contrary to conventional expectations. This shift may have significant implications for the institutionalisation of the manager-displacing bankruptcy strategy under the IBC.

As non-performing assets (NPAs) continue to burden banks, the manager-displacement strategy may lead creditors to perceive the insolvency process as liquidation-oriented. Large haircuts and the expenses of bankruptcy governance can outweigh the benefits. External IBC settlements currently pose a challenge to the ongoing shift from manager-driven bankruptcy to creditor-driven bankruptcy. Implementing pre-packs under the IBC, similar to Chapter 11 of the US Bankruptcy Code, can provide a solution. Pre-packs offer an automatic stay of creditors' individual procedures and protect the corporate debtor from creditors' management control. This mechanism can facilitate efficient and value-maximising revival of distressed debtors, allowing promoters/majority shareholders to participate effectively. It can also prevent the risk of converting the resolution process into liquidation.

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