INSOLVENCY AND BANKRUPTCY CODE, 2016

with Rules, Regulations & Guidelines and JURISPRUDENCE

(Supreme Court, High Courts, NCLAT & NCLT)

Foreword by

Justice A K Sikri

Former Judge, Supreme Court of India

Dr. M S Sahoo

Former Chairperson, Insolvency and Bankruptcy Board of India

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NLU DELHI

NATIONAL LAW UNIVERSITY DELHI

Dr. M. S. Sahoo
Distinguished Professor
(Former Chairperson, Insolvency and Bankruptcy Board of India
Former Member, Competition Commission of India
Former Whole-time Member, Securities and Exchange Board of India)

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FOREWORD

THE IBC: What it is and What it is not

I. What it is?

The Insolvency and Bankruptcy Code, 2016 (IBC/ Code) is a noble law. Its long title reads: "*law relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximisation of value of assets of such persons, to promote entrepreneurship, availability of credit and balance the interests of all stakeholders, including..*".

Resolution of Stress

The Code is a law for reorganisation and insolvency resolution, that is, resolution of the stress of corporate persons, partnership firms, and individuals. It envisages resolution in a time-bound manner for maximisation of the value of assets of the stressed persons. Such maximisation of value promotes entrepreneurship and the availability of credit and balances the interests of all stakeholders. Thus, the sole objective of the Code is the stress resolution of listed persons. If stress is resolved in the manner the IBC provides, like a time-bound process, clean slate takeover, altered priority order of payment of Government dues, etc., it yields several benefits, namely, maximises the value of the assets of the stressed person, promotes entrepreneurship, and improves credit availability in the economy, and balances the interests of stakeholders. The objective is only one, while the benefits are many.

It is useful to recall the Tinbergen Rule, named after the first Nobel Laureate in economics sciences. The Rule prescribes a basic principle of policy efficacy that the policymakers should have at least one policy for each objective. There can be more than one policy to achieve one objective but having one policy to achieve more than one objective is troublesome. It is not easy to kill more than one bird with one stone, particularly when they are flying in opposite directions. There can be many policies for stress resolution. In fact, there are. One may resolve stress under the RBI's prudential framework, the Companies Act, 2013, or the IBC, or even outside any formal framework. Thus, IBC is one of the options available for resolution of stress. Resolutions under different frameworks yield different benefits: the benefits arising from resolutions under the IBC could be different from those accruing from resolutions under the Companies Act. For example, unsecured financial debts have a priority above Government dues to promote alternative sources of finance and the consequent development of bond markets in India and credit availability.

Two Ways of Resolution

The Code, which provides for insolvency resolution of corporate persons (companies and LLPs) and individuals (personal guarantors, proprietorship and partnership firms, and other individuals), is being implemented in phases. The provisions relating to corporate insolvency (resolution process, liquidation process, and voluntary liquidation process), and individual insolvency dealing with the resolution and bankruptcy process of personal guarantors to corporate debtors are currently in operation. The provisions relating to individual insolvency dealing with the fresh start process, proprietorship and partnership firms, and other individuals are yet to come into force. This foreword, therefore, limits to corporate insolvency, which has been in vogue for about seven years.

In the case of a company, the Code provides for stress resolution in two ways, first by the rescue of the company through a resolution plan, failing which, by the closure of the company through liquidation. A company is under stress if it is not performing well, that is, the resources at the disposal of the company are underutilised. If the company has a viable business, it should be possible to revive it. The IBC provides for corporate insolvency resolution process (CIRP) that enables the market to find a feasible and viable resolution plan to revive the company as a going concern. If such a plan is approved, the company gets a new lease of life, and resources are put to optimal use. If the company has an unviable business, the market is unlikely to find a resolution plan. In such a case, the company gets into the liquidation process which closes the company, releasing resources, including entrepreneurs, as per the priority rule to stakeholders, for optimal use elsewhere.

The Code enables the market to make the choice. The market usually chooses to rescue a company if its business is viable or close it if it is unviable. In either case, the stress is resolved: the company either continues without any stress and uses the resources optimally, or disappears along with stress, releasing the resources for optimal use elsewhere. Both resolution plan and liquidation serve the same economic purpose: resolve stress by putting resources to optimal use. It does not matter whether stress is resolved by way of a resolution plan or liquidation. The IBC does not envisage stress resolution by a resolution plan only. Liquidation is equally efficacious in stress resolution.

Since liquidation typically takes a little longer than a resolution plan to put the resource back to optimal use, the IBC requires the market to first explore the possibility of a resolution plan. The exploration need not continue long, the market could decide to commence liquidation as early as 30 days from the commencement of CIRP. Further, the market may fail to distinguish between a viable company and an unviable company at the margin and consequently liquidate a viable company or rescue an unviable company, by mistake. Since liquidation of a viable company is irreversible, the law provides for certain incentives like interim finance and write-off of claims, to make the company viable if it has a viable business. Beyond this, the law is agnostic about the outcome- resolution plan or liquidation.

The Code defines 'resolution plan' as a plan for insolvency resolution of a corporate debtor as a going concern. It thus leaves the texture and structure of the resolution plan to the imagination of stakeholders. It may entail a change of management, technology, or product portfolio; acquisition or disposal of assets, businesses, or undertakings; restructuring of organisation, business model, ownership, or balance sheet; strategies of turn-around, buy-out, merger, amalgamation, acquisition, or takeover; and, in fact, anything everything that resolves the stress. It must, however, be feasible and viable, and compliant with applicable laws.

Overarching Contract

IBC overwrites the rights and entitlements of stakeholders in a company. It even takes away the 'divine' right of the promoters to cling to the company. Further, its provisions override the provisions in any other law. Such overwriting and overriding are necessary for the resolution of stress. The 2016 Nobel Laureate in economics sciences, Oliver D. Hart explains that in practice, contracts cannot specify what is to be done in every possible contingency. It is because every economic actor has bounded rationality and cannot anticipate all possible future contingencies while entering into a contract. Therefore, it enters into contracts, and renegotiates and modifies them, as and when circumstances change, and yet every contract at any point in time remains an incomplete one, with gaps and missing provisions.

A firm uses contracts to borrow to take advantage of leverage. It enters into a series of incomplete bilateral contracts which allow every creditor foreclosure rights over the firm's assets in lieu of credit. Every creditor feels comfortable on a standalone basis and extends credit to the firm. Every one of them has foreclosure rights against the same business/ assets. The firm meets commitment towards each creditor in a normal course and life goes on.

However, when the firm is stressed, it does not have enough in the pot to discharge the obligations of every creditor fully. It can honour claims of one or a few creditors fully, but not all creditors simultaneously. It is a situation where the claim of an individual creditor is consistent with assets but the claims of all creditors together are inconsistent with the assets of the firm. Elementary economics tells us that when a firm has inadequate assets to discharge all claims, creditors may rush to recover their claims before others do, triggering a run on the company's assets. They recover on a first come first serve basis till the assets of the company are exhausted, bleeding the company to death. This is a negative-sum game.

If every creditor sticks to its pre-insolvency rights, neither resolution of stress is possible nor can a creditor realise its dues. The insolvency framework endeavours to resolve such stress while discharging obligations towards creditors to the extent realistically possible under the circumstances. It obliterates the rights and entitlements of parties under bilateral contracts, creates new rights and entitlements of parties, puts them in a hierarchical order (priority rule), and binds them to the priority rule. It, however, does not ignore pre-insolvency rights altogether. It does not, for example, put unsecured creditors above secured creditors or put secured and unsecured creditors at par.

The Code is thus an overarching contract that completes all incomplete bilateral and multilateral contracts, makes claims of all creditors consistent, and prevents a value-reducing run on the assets of the firm and thereby tries to rescue the debtor and creditors. But for the overarching contract, the parties would enforce a series of incomplete contracts, which may wipe out the debtor and write off some creditors. Even where the company is not rescued, the stakeholders get their entitlements as per the priority rule.

Thus, the IBC has only one objective, that is, stress resolution, and nothing else. It overwrites all bilateral contracts/ recasts rights and entitlements to make resolution possible. It envisages resolution in either of two ways, namely, resolution plan, and liquidation. The resolution plan is a plan/ scheme that resolves the stress of a company as a going concern. Where stress cannot be resolved as a going concern, the company is liquidated. This understanding is necessary to dispel the narrative that is slowly creeping in that the primary objective of the Code is revival of the company, that is, revive the company/ avoid liquidation of the company at any cost.

II. What it is not?

A promoter of a company, which shifts to a successful resolution applicant through the resolution plan under the Code, may cry foul of the IBC. It is not surprising that the IBC has several adversaries, who are out to malign the IBC for its failure to achieve something which it is not intended to or designed for.

Liquidations

Some of them aver that the IBC process is yielding relatively more liquidations- only 678 CIRPs ended up with resolution plans while 2030 with liquidations till March 2023- and therefore, it is not good for the economy. This is motivated and misleading. Liquidation is not bad as such. It is a legitimate means of resolution of stress. Considered even from the perspective of the adversaries, the numbers do not look that bad. 678 companies resolved by resolution plans had assets valued at ₹1.70 lakh crore, while the companies referred to for liquidation had assets valued at ₹0.64 lakh crore when they were admitted into CIRP. Thus, though in terms of number, three fourth of companies were resolved by liquidations, three fourth of stressed assets were resolved by resolution plans in value terms. In fact, of the companies resolved by resolution plans one-third were either sick or defunct.

Further, the rescue of 678 companies by resolution plans is only a part of the story. Over and above this, thousands of companies are rescued at different stages of the IBC process. For example, about a thousand companies were rescued by the withdrawal of applications after the commencement of CIRP. Thousands of companies are resolving stress in the early stages. They are resolving when the default is imminent, on receipt of a notice for repayment but before filing an application, after filing an application but before its admission, and even after admission of the application. Till March 2023, the stress of about 25000 companies was resolved after applications were filed for initiation of CIRP but before admission of the applications. If the universe of stressed companies is considered, the percentage of companies proceeding for liquidation is negligible, under 1%.

The incidence of liquidation under IBC is not different from that in advanced jurisdictions. In the USA, the stakeholders have the option of starting liquidation directly, without exploring a resolution plan. Of the insolvency proceedings initiated by them, about 60% start with liquidation. An attempt is made to rescue companies through a resolution plan in case of balance 40% of proceedings, of which some end up with liquidation. The sum of direct liquidations and liquidations on failure to have a resolution plan in the USA exceeds the liquidations under IBC.

It is important to note the kind of companies getting liquidated. Of the companies resolved by liquidation, three-fourths were either sick or defunct. At this stage, the value of the company is substantially eroded. The companies ending up with liquidation had assets, on average, valued at about 5% of the outstanding debt, when they entered the CIRP. If a company has been sick for years and its assets have depleted significantly, the market is likely to liquidate it. More companies would be rescued if stakeholders initiate the proceeding in the initial stages of stress. The companies which are getting rescued by resolution plans have assets, on average, valued at about 17% of the outstanding debt, when they entered the CIRP. Every company would be rescued if they enter into CIRP when they have assets valued at 90% of the outstanding claims. IBC enables stakeholders to commence the process early and close it expeditiously to avoid liquidation.

Haircuts

Till March 2023, the creditors recovered only ₹2.86 lakh crore against their claims of ₹8.99 lakh crore through resolution plans. The recovery is about 32% of the claims, meaning a haircut of 68%. Therefore, the IBC has turned out to be a tool for haircuts, claim the enemies of IBC. This is equally motivated and misleading. The IBC is not intended to recover the dues of creditors. In fact, the law provides for and the Adjudicating Authority imposes huge penalties on the parties who trigger CIRP to recover their dues.

It must be noted that the companies, which have been rescued by resolution plans till March 2023, had assets valued, on average, at 17% of the amount due to creditors when they entered the IBC. This means that the creditors were staring at a haircut of 83% to start with. The IBC not only rescued these companies but also reduced the haircut to 68% for creditors. The haircut only reflects the extent of value erosion by the time the companies entered the CIRP. Further, most of the debt and defaults that came to IBC were written off years ago. There is no write-off on account of resolutions through IBC. Despite the haircut, recovery under the IBC is the highest among all options available to creditors for recovery.

It is appropriate to see the haircut in relation to the assets available on the ground and not the claims of the creditors. Because the market offers a value in relation to what a company has on the table, and not what it owes to creditors. IBC maximises the value of the assets at the commencement of the process. The realisable value of the assets available with the 678 companies rescued, when they entered the CIRP, was ₹1.70 lakh crore. The resolution plans realised ₹2.86 lakh crore, which is around 168% of the liquidation value of these companies. Any other option of recovery or liquidation would have recovered at best ₹100 minus the cost of recovery/liquidation, while the creditors recovered ₹168 under the Code. The excess recovery of ₹68 is a bonus from the Code for the creditors while rescuing the companies.

It is axiomatic that a company coming to IBC does not have adequate assets to fully repay all its creditors. About two years ago, *Ghotaringa Minerals Limited, and Orchid Healthcare Private Limited* caught media attention. They together owed ₹ 8,163 crore to creditors, while they had absolutely no assets when they entered the IBC process. Obviously, creditors had to take a 100% haircut. On the contrary, Binani Cements and MBL Infrastructure have yielded zero haircuts, in addition to rescuing the companies. The question arises why does IBC yield zero haircut in one case and 100% in another? It depends on several factors, including the nature of the business, business cycles, market sentiments, and marketing efforts. It, however, critically depends on at what stage of stress, the company enters the IBC, as much as at what stage a patient arrives in the hospital. The best hospital can do little if the patient reaches with a substantial haircut to his health. Similarly, if the company has been sick for years, the IBC may yield a huge *haircut* or even liquidation.

There are serious issues in the way haircut is being computed. It is typically total claims minus the amount of realisation divided by the amount of claims. This formulation does not tell the complete story. The amount of realisation often does not include the amount that would be realised from equity holding post-resolution, and through a reversal of avoidance transactions and insolvency resolution of guarantors. The amount of claim often includes NPA, which may be completely written off, and interest on such NPA. It may include loans as well as the guarantees against such loans. These deflate the numerator and inflate the denominator and therefore, project a higher haircut than it is. That is why the World Bank finds realisation of 71.6 cents on a dollar, implying a haircut of only 28%.

Assessing IBC

Motivated assessment is gaining credibility in the absence of any systematic assessment of the working of the IBC in terms of its objective. There are a few non-motivated studies/ findings. They use parameters that are not necessarily reflective of the objective of the Code. For example, the World Bank Doing Business Report (DBR) tracks the outcomes of insolvency reforms in 200 economies. It uses a common template that tracks the time, cost, and recovery of insolvency proceedings to arrive at a score for resolving insolvency for each of the 200 economies. In terms of its resolving insolvency parameter, India's rank improved from 136th to 52nd position in the first three years of implementation of IBC (DBR is not available for subsequent years). For India, in the first three years, the overall recovery rate for creditors jumped from 26.0 to 71.6 cents on a dollar and the time taken for resolving insolvency came down significantly from 4.3 years to 1.6 years.

Without expressing any view as to how the IBC is working, a professional assessment may, keeping in view its sole objective, consider whether the Code is resolving stress and, if so, with what efficiency in terms of value rescued, cost, and time. This in turn may consider seven layers of outcomes of the IBC, as under:

(a) The growth, strength, and efficiency of the **insolvency ecosystem** consisting of insolvency professionals, insolvency professional agencies, registered valuers, registered valuer organisations, information utilities, Adjudicating Authority, Appellate Tribunal, IBBI, Government, Courts, etc.;

(b) The strength, efficiency, and efficacy of **processes,** namely, corporate insolvency resolution, corporate liquidation, voluntary liquidation, fresh start process, individual insolvency resolution, and bankruptcy. This reflects the use of the IBC process vis-à-vis other avenues for achieving the objectives.

(c) The growth and efficiency of **markets** such as markets for interim finance, resolution plans, liquidation assets, and insolvency services, along with cost efficiency, information efficiency, etc.;

(d) The efficiency of IBC for stress resolution, as compared to other modes of resolution available;

(e) The impact **on businesses** on the cost of capital, capital structure, availability of credit, entrepreneurship, capacity utilisation, creative destruction, competition, and innovation, etc.;

(f) **Behavioural changes** amongst the debtors and creditors, trust of the creditors in debtors, meritocratic lending, non-observable impact, and proactive/preventive impact of the Code; and

(g) The **overall impact** on employment and economic growth of the nation.

It is imperative to have a clearly defined framework of indicators to monitor and measure outcomes of the Code that are tracked and reported on a regular basis against the objective. This would facilitate informed public debate and encourage research in matters of policy design and implementation while throwing up the concerns to be addressed. This will avoid the IBC from getting into the trap of its adversaries who wish to project the failure of the IBC in terms of parameters completely unrelated to its objective.

III. Evolution of Law

India did not have any experience with a modern insolvency regime that is proactive, incentive-compliant, market-led, and time-bound. The Code and the underlying reforms, in many ways, was a journey into unchartered territory - a leap into the unknown and a leap of faith. Implementation of a law of such significance threw up several challenges. All

concerned took the challenges head-on and resolved them expeditiously. The Code and regulatory framework underwent several amendments and refinements in sync with the emerging market realities. A standing committee, the Insolvency Law Committee continuously reviews the implementation of the Code to identify issues and make recommendations to address them.

Economic law is essentially empiric. It evolves continuously through experimentation. The Code is no exception; it has been a road under construction and it would remain so for decades. The very first resolution plan approved under the Code yielded a haircut of 94% for financial creditors, while promoters wrested control of the company. This was considered rewarding unscrupulous persons at the expense of creditors, which was not acceptable. The Code made prompt course correction through an Ordinance that prohibited persons with specified ineligibilities from submitting resolution plans in a CIRP to ensure sustained resolution of stress. The Code has so far witnessed six legislative interventions, five of which are by way of Ordinances in view of urgencies that demonstrate the keenness of the Government to continuously improve the resolution framework. Each of these six amendments has strengthened the processes in sync with the emerging market realities and reinforced the primary objective of the Code, namely, the resolution of the stress of companies.

Economic legislation is typically a skeleton structure. Judicial pronouncements provide flesh and blood to it and resolve grey areas. It takes several years, at times decades, for a major economic law to settle down and to be there for complete clarity, certainty, and predictability for the stakeholders. The Adjudicating Authority, the Appellate Authority, and Judiciary have settled several conceptual and contentious issues with alacrity, and delivered several landmark orders and judgments, bringing clarity as to what is permissible and what is not, and streamlining the process for the future. The insolvency regime of India today boasts of probably the largest body of case laws.

The Code faced tough resistance right from day one, as it altered the rights of stakeholders and the balance of power among them. The intensity of resistance increased with its implementation, as defaulters gradually lost their paradise while companies changed hands. Almost every provision in the Code in respect of corporate insolvency was challenged on grounds of constitutional validity. While upholding various provisions in the Code, the Supreme Court accorded a certain degree of deference to the legislative judgment in economic choice, apart from the presumption of constitutionality in economic legislations. The experiment contained in the Code, judged by the generality of its provisions and not by so-called crudities and inequities, passed the constitutional muster. Every amendment to the Code went through intense constitutional scrutiny and was upheld. The insolvency reforms developed deeper and stronger roots, with every judgment delivered by the courts of law.

IV. Appreciation

It is necessary to capture the evolution of law through legislative intervention, jurisprudence, and customs and practices, not only for insolvency practitioners but also for practitioners, researchers, and students of law and economics. This book does this precisely- tracks and records the evolution of law, mostly through judicial pronouncements, and presents the settled position as of date. This arranges the text of the IBC with the relevant case laws, section-wise, with a precise head note highlighting the ratio of the case.

I am sure this book will prove to be an invaluable resource for legal professionals, insolvency practitioners, policymakers, scholars, and students seeking a holistic understanding of the IBC and its practical application. I am certain that it will motivate more inquisitive minds to delve deeper into various aspects of the IBC from an interdisciplinary perspective, enriching the Indian literature on insolvency and bankruptcy in the days ahead.

I compliment the author, *Ms. Shweta Bharti*, a Senior Partner at Hammurabi and Solomon Partners for this seminal work. I also compliment the publisher, *Corporate Law Adviser* for serving as the conduit for knowledge transfer from the author to readers.

M. S. Sahoo

(Dr. M. S. Sahoo)