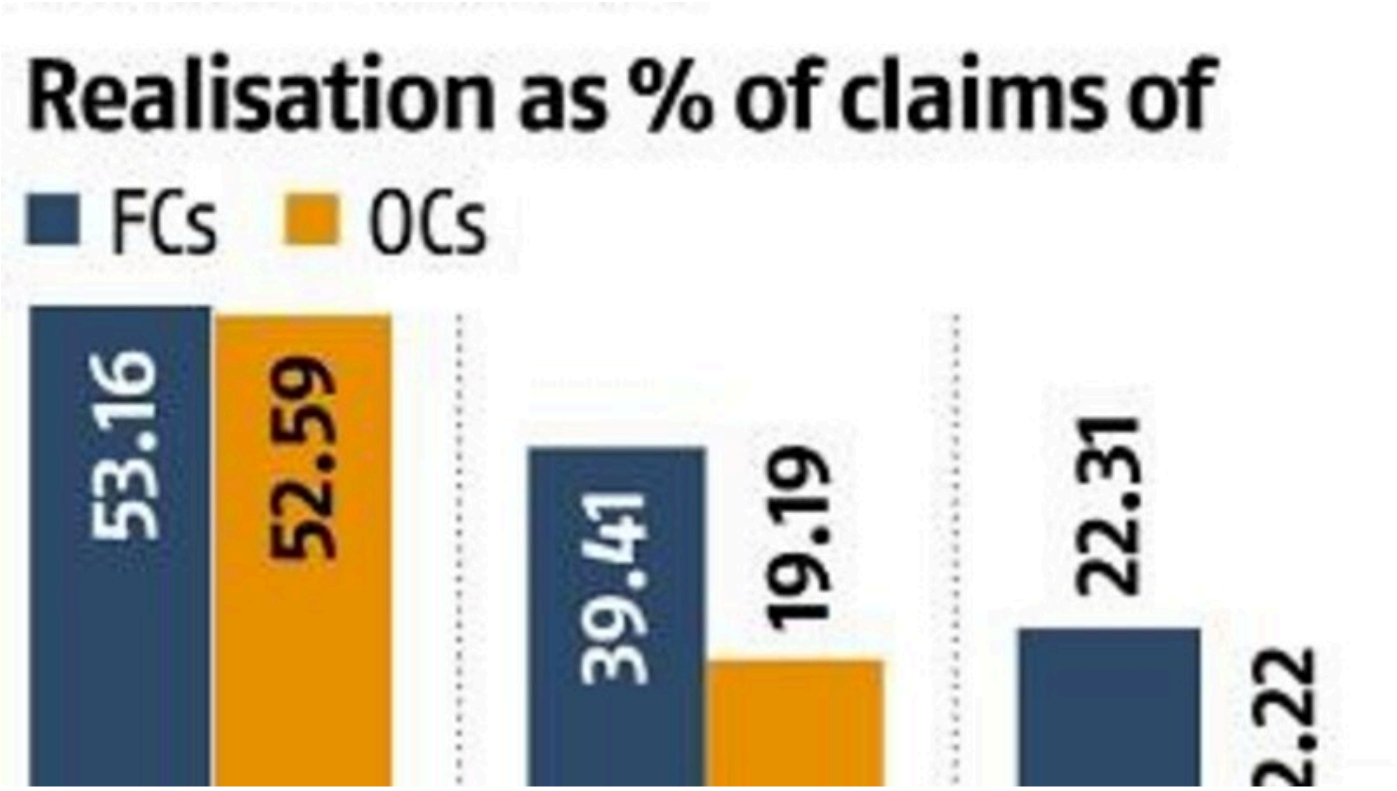
Business Standard

The Cinderella of insolvency

Undermining operational creditors is against the basic spirit of IBC

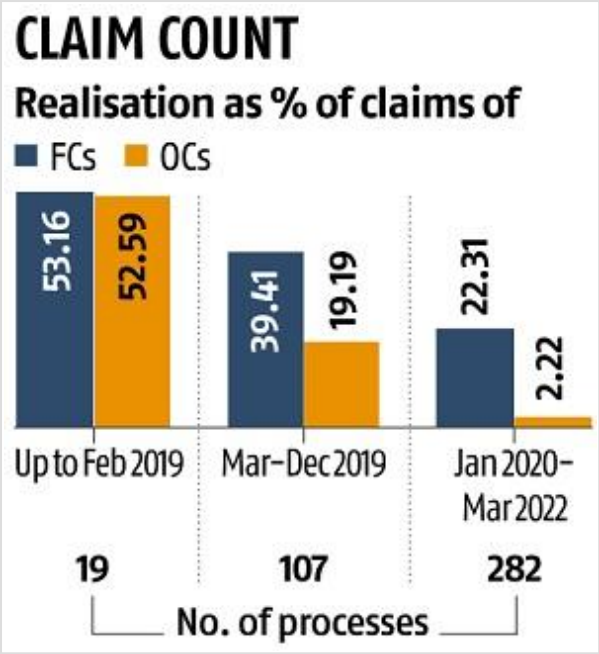
C K G Nair | M S Sahoo |



The Insolvency and Bankruptcy Code (IBC) 2016, aims at resolution of stress of a company, among others. It envisages three key benefits from resolution, namely, (a) promotion of entrepreneurship, (b) improvement of availability of credit, and (c) balancing interests of stakeholders. These benefits, particularly the last two, accrue only if the resolution safeguards interests of creditors, and balances their interests inter se.

Unlike most jurisdictions, IBC puts a committee of creditors (CoC) comprising only financial creditors (FCs) to drive the resolution process. The Bankruptcy Law Reforms Committee (BLRC), which conceptualised IBC, had reasoned that as compared to operational creditors (OCs), the FCs have two abilities, namely, the ability to take a haircut and the ability to take commercial decisions. In the interest of availability of credit — financial and operational — it obliged the CoC to ensure

that the liabilities of OCs are met in resolution.



IBC, as enacted originally, therefore, provided for payment of at least X (the amount payable to the OCs as per waterfall in the event of a liquidation). This implied that even if the resolution plan yields less than the liquidation value (LV), OCs shall be paid at least X. Where it yields more than LV, given the ability of FCs to take haircuts, OCs should get more than X. Regulations further strengthened fair and equitable treatment of OCs and even provided priority in payment to them over FCs. In sync with this philosophy, in its order in Rajputana Properties Pvt. Ltd. in 2018, the National Company Law Appellate Tribunal (NCLAT) pressed that the OCs must get at least similar treatment as the FCs. On appeal, the apex court did not find any infirmity in the said order. This understanding of the law in initial days yielded similar realisations or haircuts for both FCs and OCs.

In Swiss Ribbons Pvt. Ltd. in January 2019, the Supreme Court noted that while looking into the viability and feasibility of resolution plans, the NCLAT had always gone into whether OCs are given roughly the same treatment as FCs, and if not, such plans are either rejected or modified. Considering this and appreciating the intelligible differentia between the FCs and OCs, it upheld the constitutional validity of differential treatment between FCs and OCs in the resolution process. In February 2019 in K. Sashidhar, it accorded paramount status to the commercial wisdom of the CoC and kept it outside judicial scrutiny. These pronouncements emboldened FCs, who changed their stance, reducing the relative share of OCs in resolution proceeds in subsequent days.

Illustration: Ajay Mohanty

Is the distribution of resolution proceeds among creditors a matter of commercial wisdom? The NCLAT did not think so in Standard Chartered Bank in July 2019, as this does not have a bearing on the viability and feasibility of the resolution plan. IBC was amended quickly to include distribution of proceeds within the commercial wisdom. In Committee of Creditors of Essar Steel India Limited in November 2019, the Supreme Court upheld the amendment. This explicit empowerment of the CoC further changed its stance, dampening relative realisation of OCs further. The table (Claim count) presents average realisation of FCs vis-à-vis OCs in relation to their claims from resolution plans, with changing import of commercial wisdom.

The table does not tell the complete story. Realisation for FCs does not include realisations from equity, guarantors and avoidance transactions while their claims often include guarantee twice. In contrast, most claims of OCs, being disputed, are either not considered or considered at a token amount. Therefore, realisation for OCs is much less and for FCs is much more than presented in the table. Though resolution plans are capturing almost the entire going concern surplus, over and above the LV, it does not seem to benefit OCs at all. They are realising as little from resolution plans as from liquidations.

If the resolution process yields liquidation, both FCs and OCs would receive only LV as per waterfall. Let the LV be distributed vertically among FCs and OCs, as per waterfall. Any excess of resolution proceeds over the LV belongs to all creditors and must be equitably shared. Let it be distributed horizontally among all creditors in proportion to their claims. Let us assume LV is 100, while the company owes 900 and 100 respectively to FCs and OCs and resolution plan offers 190 for creditors. Let FCs get LV of 100, and the excess 90 be distributed to FCs and OCs in the ratio of their remaining claims of 800:100, whereby FCs get 80 and OCs get 10.

There are several other concerns in relation to rights of OCs. For example, an OC does not have the right to sit in the meetings of the CoC, while promoters and directors of the company, who were probably responsible for stress, have, albeit without voting rights. Further, performance of FCs in the last five years have cast doubts on their abilities based on which BLRC distinguished them from OCs.

Balancing the interests of FCs and OCs is fundamental to the harmony and success of IBC. Any deviation needs to be corrected fast. The outcome of this realisation should end like the happy ending of the story of Cinderella.

Sahoo is Distinguished Professor, National Law University Delhi. Nair is Director, National Institute of Securities Markets.

Views are personal.

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