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Legislation: Intent and interpretation

Interpreting the margins at the cost of core legislation could be costly for the economy

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The Insolvency and Bankruptcy Code (IBC), 2016, is founded on the basic principles of economics. *Default* is an outcome of market forces and it must be resolved by the market. The IBC, therefore, provides for a corporate insolvency resolution process (CIRP) to rescue a corporate debtor (CD) in default, or close it, as the market considers expedient. This includes initiating the CIRP. It is the market that takes the call whether to initiate the CIRP in case a CD defaults, considering the reasons for its default, the options available to deal with the default, the feasibility and viability of the business of the CD, etc.

Section 6 of the IBC provides for initiating the CIRP only when a CD has defaulted. The *notes on clauses* appended to the IBC Bill elaborate the approach and rationale of the provision. It explains that a simple test of default for entry into the CIRP permits early intervention for better outcomes.

Section 7 requires a financial creditor (FC) to provide proof of *default* for initiating the CIRP and the Adjudicating Authority (AA) "shall" ascertain default within 14 days. The *notes on clauses* explain that proof of default ensures that an FC does not file applications for extraneous considerations. It states that once the AA is satisfied that there is default, it "shall" admit the application. This ensures that the parties do not abuse the legal process to delay the admission.

The legislative intention is a simple test of default to be applied for initiating the CIRP and neither the parties nor the AA must use any other consideration for initiation, which can delay the admission. This is in sync with the design principles devised by the Bankruptcy Law Reforms Committee (BLRC). A key principle underlying the IBC is that the AA must supervise the process of resolution but not make business decisions. The BLRC explicitly avoided *insolvency* as the trigger for the CIRP and chose *default* to reduce the burden on the AA for speedy admission. The IBC accordingly envisages quick admission to get faster and better outcomes. Quick admission is possible if the parties and the AA use a simple test and default fits the bill. This seemed to be the settled position of the law for initiating the CIRP until the recent ruling of the Supreme Court in *Vidarbha Industries Power Limited vs Axis Bank Limited*.

The court has interpreted section 7(5): *"Where the Adjudicating Authority is satisfied that — (a) a default has occurred ... it may, by order, admit such application; or (b) default has not occurred ... it may, by order, reject such application."* Relying on the word "may", it held that it was erroneous that there was no option for the AA but to admit an application filed by an FC where the CD is in default. Noting that no extraneous matter should come in the way of admission, the court ruled the viability and financial health of the CD were not extraneous. Initiating the CIRP arises only if a company is bankrupt or insolvent and not otherwise. It is certainly not the object of the IBC to penalise solvent companies temporarily defaulting in repaying its financial debts, by initiating the CIRP. Therefore, it is discretionary for the AA to admit an application of an FC for initiating the CIRP. It may keep the admission in abeyance and there is no time limit within which such an application has to be admitted. However, in the case of an application by an operational creditor (OC), it is mandatory for the AA to admit the application if it is satisfied that there has been default.

With this ruling, several anomalies have surfaced. The IBC rests on the premise that FCs have commercial wisdom while OCs may not. According to this ruling, the AA has to be satisfied of the existence of default and must not look into the commercials of the CD in the case of an application by an OC, who does not have commercial wisdom. However, it must look into the commercials of the CD to ascertain insolvency in the case of application by an FC. Similarly, this ruling empowers the AA to reject an application of an FC even if it is satisfied there is default, and admit an application even where there is no default. Thus, the AA can foist the CIRP on a CD that has not even defaulted. Further, a market economy works if a decision maker faces the consequences of its actions. Markets fail if an FC suffers consequences where the AA does not admit an application or keeps the admission in abeyance.

The ruling has somewhat modified the basic premise of the IBC. It considers the CIRP to be a penalty, which it is not. It considers the CIRP necessary only if a company is insolvent or bankrupt, which excludes timely action to rescue it. The ruling requires the AA to examine the viability and overall financial health of the CD, for which it is not equipped. The parties may present different views on the health of the CD, which may make the admission process adversarial. With the simple default test today, admission is often taking years. With the test of the insolvency and financial health of the CD, coupled with the AA's discretion to hold admission in abeyance indefinitely, admission may take much longer, as against the legislative intent of 14 days.

The IBC was enacted because of the sickness of the Sick Industrial Companies Act (SICA). The order on Vidarbha Industries may take the IBC to the path of the repealed SICA, at an enormous cost to the economy.

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