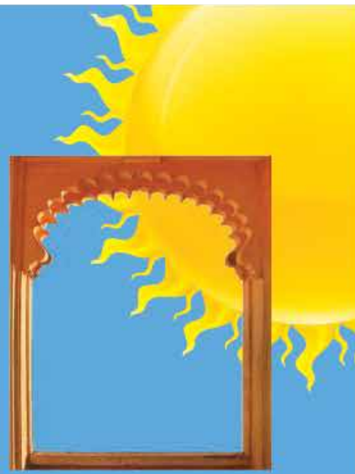
Quarterly Briefing

NSE Centre for Excellence in Corporate Governance

April 2017 | No. 17



The Insolvency and Bankruptcy Code: Implications for Corporate Governance

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Executive Summary

- The Insolvency and Bankruptcy Code ("Code") signals the beginning of an epoch in bankruptcy resolution in India by ushering in a creditor-in-control system of bankruptcy resolution, a paradigm shift from the status quo of debtor-in control system.
- The new regime promises efficient bankruptcy resolution, incentivizes entrepreneurship and maximizes value of assets; clearly, it is a positive development for corporate governance in the country.
- The governance mechanisms built into the Code checks opportunistic and strategic action by corporates nearing the zone of insolvency by holding the directors accountable for such actions and thereby creating strong deterrence.
- A critical feature of the Code is the low default threshold for initiation of insolvency proceedings. Once a company is rendered insolvent, the Code empowers the creditors of the corporate debtor to control the management and affairs of the corporate debtor.
- By putting in place appropriate incentives, the Code seeks to maximize the probability of revival of insolvent companies, which is in the interest of all shareholders.

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Valuable inputs from Prof. Umakanth Varottil and Prof. Bala are gratefully acknowledged.

I. Rationale for a creditor-in-control bankruptcy regime

The Insolvency and Bankruptcy Code ("Code"), a landmark legislation replacing the existing patchwork of regulations with a consolidated regulatory framework governing the re-organization and insolvency resolution of incorporated entities was enacted by the Parliament in May 2016. The Code has arrived at a very critical time for the Indian economy when the domestic banking industry is struggling to cope with mounting bad loans and looking for an effective legal framework. By facilitating the resolution of 'insolvency situation' of a corporate debtor or, in extreme cases its liquidation through a time-bound and credible mechanism--the absence of which has hurt the Indian economy for decades—the Code not only addresses the need of the hour, but also provides a more efficient solution to the corporate insolvency issue for years to come.

The insolvency resolution process entailed by the Code is a paradigm shift in governance of insolvent companies from debtor-in-possession regime under the SICA (Sick Industrial Companies Act, 1985), where the existing management and promoters continued to remain in control of the company and its assets during the period of insolvency resolution, to a creditor-in-control system. Under the earlier system, the management--as a debtor-in-possession--controlled not only the daily operations of the debtor, its investment decisions and its financing decisions, but also the fate of the reorganization of its business or liquidation. This led to several distorted incentives that deterred the debtor company from (a) submitting an appropriate rescue plan and (b) timely liquidation of unviable companies. In fact, it was in the interest of the managers of the debtor company to delay the SICA process and indulge in siphoning of the debtor companies' assets (Varottil forthcoming). Further, this model for insolvency resolution is particularly unsuitable for companies with concentrated ownership, which dominate the Indian corporate landscape. As David Hahn (2004) has argued "…leaving incumbent management to run the corporation while in bankruptcy plays into the hands of the strong shareholders and exacerbates the risk of loss to the creditors. Because the corporation is insolvent, shareholders will tend to direct the management to engage in overly risky projects and gamble for a yield with the creditors' money. It follows then, that to neutralize this risk and better represent the creditors' interest in bankruptcy, management should be removed from control of the firm."

The Code has been designed to address these issues. The aim of this Note is to examine the 'checks and balances' that underpin the corporate governance of the new insolvency resolution regime and their rationale.

II. Process Flow under the Code

To achieve early resolution of distress, the Code prescribes certain 'early detection' triggers which can be activated on first signs of stress. The corporate insolvency resolution process (CIRP) under the code may be initiated by either a financial creditor or an operational creditor [3] or even the debtor itself by applying to NCLT [4] in case the debtor commits a default of at least Rs. 100,000. [5] Within 14 days of receiving the application, the NCLT shall ascertain the existence of an undisputed default. [6] After this, the NCLT may admit the application resulting in commencement of CIRP and simultaneously (a) appoint an Interim Resolution Professional (IRP) who will manage the affairs of the corporate debtor until completion of the resolution process and (b) declare a moratorium that will operate for a period of 180 days from the commencement of the resolution process. [7] At this point, the existing board of directors, which in normal times act as the lynchpin of corporate governance, vacates office and cedes the entire control of the affairs of the company to the IRP. The IRP will collate all claims and constitute a Committee of Creditors (CoC). A 'resolution plan' (that is, a turnaround plan for financial restructuring, operational improvement and sale of assets) is required to be designed and approved by the Committee of Creditors by majority of 75% voting. The resolution plan also requires a final approval from NCLT.

[3] An operational creditor refers to a person to whom an operational debt is owed and includes any person to whom such debt has been legally assigned or transferred.

[4] The NCLT is the designated adjudicating authority for corporate resolution under the Insolvency and Bankruptcy Code, 2016, s. 5(1).

[5] Insolvency and Bankruptcy Code, 2016, s. 6.

[6] Ibid, s. 7(4). In recent judgments, different benches of NCLT have expressed differing views on the existence of a 'dispute'. The code expects commencement of legal proceedings to take cognizance of a dispute.

[7] Ibid, s. 14. The moratorium is quite wide and operates even against actions initiated by banks and financial institutions under the SARFAESI Act. Although the moratorium must be specifically declared by the NCLT, the use of the word "shall" in the provision suggests that the NCLT does not have any discretion, thereby making the moratorium virtually automatic.

Failure to approve the resolution plan (by a majority of 75 % voting) within 180 days will cause initiation of liquidation. The RP acts as the liquidator, and exercises all powers of the Board of Directors. The liquidator shall form an estate of the assets, and consolidate, verify, admit and determine value of creditors' claims. As regards the distribution of assets of the liquidated company, there is a clearly defined 'order of priority' or the waterfall mechanism, which is same as the one provided under the Companies Act 2013, with some minor exceptions. It is noteworthy that the waterfall renders government dues junior to most others. Further, unsecured portion of secured creditors rank lower than other unsecured creditors.

III. The Code and Corporate Governance

Corporate governance measures are typically designed for situations when a company is solvent. In such situations, the directors of a solvent company owe fiduciary obligations to stakeholders such as the corporation and its shareholders, but not to the creditors, because of the latter's powers to contractually protect themselves by way of debt covenants. However, when a company is insolvent certain common law jurisdictions prescribe that the interests of the shareholders must be reduced in importance as compared to those of the creditors. Even when corporations are in the 'zone of insolvency', its directors of are required to attempt to reach a fair and efficient result, without the fear of a fiduciary breach to shareholders whose interests, considered alone, would force excessively risky "bet the ranch, go for broke" decisions.

The Code has ushered in a regime in line with this thought process by requiring the creditors' interest to be protected not only when a company is rendered insolvent by the NCLT (that is, when CIRP has been initiated), but also in the period prior to that (when the company is heading towards financial insolvency).

III.1 Fraudulent and Wrongful Trading

The Code seeks to deal strictly with the perpetrators of fraudulent and wrongful transactions made by the corporate debtor, regardless of whether they were undertaken before or after the CIRP begins. If any business of the corporate debtor has been carried out during the CIRP with an intent to defraud its creditors, the NCLT is empowered to pass orders on application by the Resolution Professional (RP) to require persons who were knowingly parties to such an act, to make contributions to the assets of the corporate debtor in a manner it deems appropriate. Further, the NCLT may require a director of the corporate debtor to make such contributions if, before the commencement of the CIRP, such director had actual or constructive knowledge ('knew or ought to have known') that there was no reasonable prospect of avoiding the commencement of the CIRP; and such director or partner did not exercise due diligence in minimising the potential loss to the creditors.

The Code also provides for the declaration of transactions involving fraudulent preference among creditors if undertaken during the Relevant Period [8] as void and a reversal of the effects of such transactions.

Finally, the Code also provides for certain 'lookbacks' in its penal provisions for contraventions prior to the commencement of CIRP, e.g. during the period of twelve months before the commencement of the CIRP. If any officer of the corporate debtor wilfully conceals, destroys, falsifies or makes false entries in any books affecting the property of the corporate debtor or conceals the knowledge of such doing by other persons, the Code imposes a strict punishment on such officer: imprisonment of 3 - 5 years and/or with fine of Rs. 1 lakh – Rs. 1 crore.

III.2 Preventing Abuse of Related Party Transactions

To prevent misuse and potential value erosion, the Code has an expansive definition of 'related parties', wherein it goes beyond the principles under the Companies Act, 2013 and listing regulations to include within its ambit persons who are associated with the corporate debtor by: (i) participation in the policy making processes of the corporate debtor, (i) having two or more common directors, (iii) interchange of managerial personnel between the

[8] Relevant period means two years preceding the date of commencement of the CIRP for transactions involving related parties and one year preceding the date of commencement of the CIRP for transactions involving persons other than related parties.

corporate debtor and such person, and (iv) provision of essential technical information to, or from the corporate debtor. Further, a financial creditor who is a related party does not have any right of representation, participation or voting in a meeting of the CoC.

III.3 Role of Resolution Professional (RP)

As stated earlier, after the initiation of the CIRP, the board of directors of a corporate debtor stands superseded by the Resolution Professional, who is entrusted with the duty of corporate restructuring, with oversight by the CoC. Thus, in a significant departure from the 'debtor-in-possession' model under SICA, it is the creditors of a corporate debtor who control the management and affairs of the corporate debtor under the Code. The Code mandates the promoters and management of corporate debtor to cooperate and extend all assistance to the RP during the CIRP. The NCLT is also authorised to issue directions in this regard in the event of non-compliance.

III.4 Role of Committee of Creditors (CoC)

The CoC, the predominant decision making authority when a company is rendered insolvent, is vested with affirmative rights in relation to the management of the corporate debtor. Any decision of the CoC including key decisions such as approving the 'resolution plan' can only be implemented by a 75% vote; the resolution plan needs to address the interests of both the secured and unsecured creditors. In protecting the interests of creditors, the Code strikes a balance between secured and unsecured creditors.

Significantly, the CoC comprises only financial creditors of the corporate debtor (with voting rights commensurate to the extent of debt owed to them). The operational creditors have participation rights but have no voting rights in CoC meetings except in exceptional circumstances. The Code, however, does seek to protect their interests by requiring any resolution plan to provide for the repayment of debts of operational creditors in such a manner which shall not be less than the amount they would have received in the event of liquidation.

Furthermore, any related party transaction to be undertaken during the course of the CIRP also requires clearance by the CoC.

III.5 Independence of Resolution Professional (RP)

The Code recognises that the CIRP must be conducted in an independent, skilful and careful manner to achieve the objective of resuscitating an insolvent corporate debtor effectively. For the CIRP to be an independent process, the Code requires the RP to be independent of the corporate debtor by stipulating that (i) only a person eligible to be an independent director of the board of the corporate debtor under S.149 of the Act can be appointed as an RP and (ii) RP must not be a related party of the corporate debtor, and so on. The Code requires that during the tenure as RP, a person or his or her relatives do not knowingly acquire any assets of the corporate debtor unless it is shown that there was no impairment of objectivity, independence or impartiality. Further, the Code imposes an obligation of continuing disclosure on the RP in respect of any pecuniary or personal relationship with any stakeholders entitled to distribution in accordance with Chapter III of the Code. The Code also prohibits RPs and their relatives from accepting gifts or hospitality which undermines their (RPs') independence.

IV. Summary and conclusion

The Code is a landmark legislation which has put India on the global map, with insolvency laws adhering to internationally accepted standards. It overhauls the existing regime relating to insolvency and bankruptcy in India by emphasizing a time bound resolution of delinquent debts on one hand and eliminating the distorted incentives of the earlier regime on the other.

A critical feature of the Code is the low default threshold for initiation of insolvency proceedings. This imposes an additional burden on the boards to monitor their financial and operational debts. Fiduciary duties are heightened when a corporate approaches a potential insolvency event. Since directors can never know ex ante whether and when the corporate debtor enters the Relevant Time (when the transactions are put through stricter scrutiny), they would tend to be vigilant about the board's conduct all the time. The institutional structure and the checks and balances entailed by the Code appear to be appropriate and incentive compatible, raising thereby the probability of resuscitating insolvent companies, which is in the interest of all stakeholders and not just the creditors.

However, certain issues remain. For instance, the hairline trigger proposed by the Code may lead to its misuse. Further, shareholder interest if considered subservient to the interest of the lenders during the CIRP may not be adequately addressed in the terms of a resolution plan. Finally, the institutional framework required for smooth functioning of the new system may need years to develop in an economy like India.

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