India Unleashed

July 2016 – Insolvency edition

Dear Readers,

Ease of exit is perhaps as important as ease of entry for businesses. Reforms in the areas of insolvency and bankruptcy in India have been waiting in the wings for a long time. The existing debt recovery process as well as the process of winding-up of companies is time consuming, riddled with delays and subject to several piecemeal legislation. To make matters worse, the growing problem of non-performing assets on the balance sheets of India's banks poses a systemic risk and there is an urgent need for the banks to get their act together.

*Bolstered by the reformist agenda of the NDA Government and its commitment to increasing the ease of doing business in India, India now has a brand new Insolvency and Bankruptcy Code, 2016 **(Code)**. The Code brings together several disjointed laws and aims to be the single governing legislation for all aspects pertaining to insolvency, bankruptcy and restructuring. Since the Code is path breaking on several fronts, we decided to dedicate a special mid-quarter edition of India Unleashed to discussing key aspects of the Code.*

We hope you find India Unleashed useful. Please feel free to provide your feedback at indiaunleashed@khaitanlegal.com.

Warm Regards,

Sakate Khaitan
Senior Partner

In Brief

Key Highlights of The Insolvency and Bankruptcy Code 2016

- The Code provides a single insolvency legislation for companies, partnership firms and individuals.
- The Code allows a company, its operational creditors or financial creditors to initiate the corporate insolvency process.
- To initiate the insolvency process for corporate debtors, the default should be at least INR 100,000 (which limit may be increased up to INR 10,000,000 by the Central Government). The Code proposes two stages:
  - Insolvency Resolution Process, during which the creditors determine whether the debtor's business is viable to continue and the options for its revival; and
  - Liquidation, if the insolvency resolution process fails or the creditors decide to wind up the company and distribute the assets of the debtor.
- The corporate insolvency resolution process is to be completed within 180 days which is extendable for another 90 days. If within the stipulated timeline no resolution plan is achieved, the company is directed to be liquidated.
- The Code also allows for a fast track insolvency process for certain entities which remain to be specified. This process is to be completed within 90 days which is extendable for a further period of 45 days.
- To initiate insolvency process against individuals and unlimited partnerships, the minimum default amount is INR 1,000 (which limit may be increased up to INR 100,000 by the Central Government). The Code envisages two processes:
  - Fresh start, where the debtor can make an application for fresh start to discharge his debt personally or through a resolution professional; and
  - Insolvency Resolution by the creditors by way of approving a repayment plan.
- Insolvency and liquidation process of companies is to be dealt with by the National Company Law Tribunal (**NCLT**) and that of individuals and partnership firms by the Debt Recovery Tribunal.
- Upon admission of an insolvency resolution petition, the NCLT will declare moratorium, during which time no debt recovery or enforcement actions can be initiated or continued against the debtor. During such moratorium, the insolvency professional (**IP**) will control the assets of the corporate debtor under the supervision of the NCLT.
- The Code has modified the waterfall for the distribution of proceeds and given priority to the costs of the insolvency process. Workmen dues and secured creditors have been given at par status and Central and State Government dues have been brought down in the list just before residual creditors.
- The Code provides for the constitution of the Insolvency and Bankruptcy Board of India, which will be responsible for overseeing the functioning of IPs, insolvency professional agencies (**IPAs**) and information utilities (**IUs**) and regulating the insolvency process. The insolvency resolution process will be conducted by IPs who will be members of IPAs. The IUs will be established to collect, collate and disseminate financial information to facilitate insolvency resolution.
- The Code has also done away with the distinction of members' voluntary winding-up and creditors' voluntary winding-up and envisages that for a voluntary winding-up a special resolution is required to be passed by the company's members, which is to be approved by 2/3 of creditors by value.
- The Code provides for cross border insolvency by enabling the Government of India to enter into bilateral agreements with governments of other countries to enforce the provisions of the Code.

India's Insolvency and Bankruptcy Code 2016:

Managing non-performing loans*

Introduction

Despite India being one of the world's largest and fastest growing economies, Indian banks have struggled recently to pro actively manage a growing portfolio of non-performing assets (**NPAs**). Gaps in the legislative framework for the efficient restructuring and insolvency of companies, together with delays in obtaining judgment and enforcement in the Indian courts, has led to a reluctance by lenders in actively pursuing recovery of debts and restructuring of unviable businesses.

Currently, corporate insolvencies in India take an average of more than four years to complete, at the same time only achieving recovery rates of around 25%, compared to much shorter time scales and better recoveries in most other large economies. Promoters have also taken advantage of this, resulting in a significant number of companies continuing to operate, which should otherwise have been restructured or liquidated.

As a direct consequence, the Indian Parliament has recently taken positive action in passing much needed legislation aimed at simplifying and speeding up the current restructuring and insolvency processes. The Insolvency and Bankruptcy Code 2016 (the **Code**) aims to create an efficient and effective legislative framework for the restructuring of companies and resolution of insolvency. The Code has received Presidential assent and it is expected that the provisions will be made operative before the end of 2016, once all other institutional frameworks necessary to implement the Code are in place.

The Code will harmonise the provisions of the existing complex and disjointed laws covering corporate insolvency in India, such as the Companies Acts 1956 and 2013, the Securitisation and Restructuring of Financial Assets and Enforcement of Security Interest Act 2002 and the Sick Industrial Companies (Special Provisions) Act 1985. The Code will also provide a legal framework for the insolvency of partnerships and the bankruptcy of individuals.

Courtesy: Twitter

The Insolvency and Bankruptcy Code 2016

The primary objective of the Code is to consolidate and amend the existing laws relating to the restructuring and insolvency of companies, partnerships and individuals, making the processes more time efficient and aiming to maximise returns to creditors. It also aims to promote entrepreneurship, the availability of credit and to balance the interests of all key stakeholders.

As the name suggests, the Code is aimed at entities who are financially distressed or are insolvent. The intent of the Code is to revive such entities where possible, but also to facilitate an efficient and timely recovery of assets if revival is no longer possible. This approach is a thoughtful improvement against the existing regime, wherein companies have the ability to declare themselves 'sick' and continue their existence for an extended period of time, leading to unrecovered debts, a build-up in NPAs and sometimes protracted litigation.

The Code also touches upon cross border insolvency by enabling the Government of India to enter into bilateral agreements with governments of other countries to enforce the provisions of the Code.

Triggering the Code for companies

The Code allows either the debtor or its creditors to initiate a 'corporate insolvency resolution' (**CIR**) process in circumstances, where any corporate debtor commits a default. Creditors are defined as either 'operational' or 'financial' (typically, institutional lenders) creditors, with each having differing rights in the insolvency resolution process.

For example, the Code permits a financial creditor to petition the National Company Law Tribunal (**NCLT**) (a newly formed body charged with *inter alia* governing and supervising the Code for corporate entities) immediately following a default. An operational creditor is able to approach the NCLT after first issuing a demand notice where the debtor within a period of 10 days, either does not pay the demand and provide evidence thereof or fails to provide evidence to the operational creditor of the existence of a dispute.

Once a petition is admitted by the NCLT (within 14 days of notification by the creditor or debtor), a moratorium is created and the CIR process commences. The moratorium stays in place until the completion of the CIR process, during which time no legal action can be commenced or continued against the debtor. It should be noted that the CIR is subject to a maximum time limit of 180 days and can only be extended by a further 90 days upon approval of both the creditors' committee and the NCLT.

On commencement of the CIR process the NCLT is required to appoint an insolvency resolution professional (an **IRP**) who will assist and oversee the CIR process. The petitioning creditor may also put forward their own nominee for IRP, which may be accepted by the NCLT.

A new supervisory body, the Insolvency and Bankruptcy Board of India (**IBBI**), will regulate all insolvency professionals who may be accepted to act as an IRP. It is still to be determined what experience is required to qualify as a suitable professional. One possible concern is that, in the short-term, whether India will have enough sufficiently qualified professionals to take on these new roles, and whether overseas professionals may be allowed to provide support in the interim.

From the date of their appointment, the IRP shall take responsibility for the management of the debtor and will assume the powers of the board of directors. The main duties of the IRP are to protect and preserve the assets for the benefit of the creditors and to seek to agree a 'Resolution Plan' for the repayment of creditors. However, certain powers of the IRP are

** First published in the June 2016 edition of INSOL International News Update* restricted and require the prior approval of an appointed creditors' committee, such as raising any interim finance, creating security interests over assets, recording change in ownership, amending constitutional documents and changing management.

A creditors' committee is required to be formed by the IRP within 30 days of their appointment and following the adjudication of creditors' claims. Interestingly, the creditors' committee is to consist of all of the financial creditors, but none of the operational creditors. Decisions of the creditors' committee will be carried by a vote of 75% in value of the financial creditors. This has echoes of similar restructuring tools in other jurisdictions, such as the UK's Scheme of Arrangement, although here there does not seem to be a distinction yet for the different classes or priorities of the various creditors.

The Resolution Plan is required to be agreed by the IRP and the creditors' committee, before being presented to the NCLT for final approval. The Code is not prescriptive of what can be included within a Resolution Plan and as a consequence, the solutions could potentially be wide ranging. As a minimum the Resolution Plan needs to provide for a return to creditors of at least what they would expect to receive in a liquidation. If a resolution plan is not agreed within the time prescribed by the Code (180 days, with a provision for an additional 90 days extension by approval of the NCLT), or is rejected by the NCLT, the NCLT has the power to direct the immediate liquidation of the debtor. This seems quite an ambitious timeframe given the historical issues with the existing Indian insolvency legislation, particularly if any of the decisions of the process are challenged in the courts.

Key changes and similarities to other jurisdictions

The Code looks to provide a number of benefits to creditors and whilst it embodies provisions from a number of jurisdictions, it arguably shares many similarities with the UK insolvency legislation. It is widely considered that creditors, in particular financial creditors, will be supportive of the Code, as it provides them with a mechanism for establishing significantly more control and options than is currently the case.

For example, one significant change is that all corporate insolvency matters will now fall within the sole jurisdiction of the NCLT, and not the civil courts. Establishing a single adjudicating authority, similar to the Chancery Division in the UK's High Courts, should enable insolvency processes to be conducted more efficiently and reduce the risk of challenge. It also addresses previous issues whereby debtors could frustrate the restructuring process through manipulating the differences and complexities of various laws.

A significant element of the Code is the establishment of a very short period of time (180 days, extendable by 90 days) in which to complete the CIR process. The Code also allows for a 'fast-track' process, reducing the already short timeframe down to 90 days (extendable for a further 45 days). This provides an interesting challenge, as this timeline is considerably shorter than the average processes conducted in other well established jurisdictions such as the UK (one year) and the USA (two years), and significantly shorter than the current Indian legislative framework allows.

The Code also paves the way for specialist insolvency professionals to be engaged with Indian restructurings, as the Code requires IRPs to be registered with the IBBI. The provisions for the appointment of an independent, experienced and suitably qualified practitioner is common across many established jurisdictions, and having a professional who is well versed in guiding restructurings should ensure an improved outcome for creditors. This should in theory go a long way in addressing the historical issues in Indian insolvencies, such as the significantly low recovery rates and alleviating the inherent bureaucracy under the current regime.

Another key benefit of the Code, which is similar to a number of jurisdictions, is the creation of a moratorium prohibiting creditor actions upon the commencement of the CIR process. This is a key benefit in improving the efficiency of restructurings, as it will allow the IRP and the creditors' committee to have full focus on developing a suitable recovery plan, rather than having to negotiate with disruptive stakeholders during the process.

The Code also draws upon a key principle established in the Chapter 11 Bankruptcy Code; 'Debtor-In-Possession' financing. With the sanction of the creditors' committee, the IRP may enter into interim financing arrangements in order to facilitate the restructuring. This is an interesting development, as it should improve the likelihood of a successful restructuring being concluded free from liquidity constraints, which otherwise could force sub-optimal decision making.

With regards to specific changes to prior legislation, the Code has amended the waterfall for the distribution of proceeds and given priority to the costs of the insolvency process. Certain claims of employees have also been given enhanced priority, similar to other jurisdictions.

The Code has also sought to simplify the process for a voluntary winding-up of a company and has done away with the distinction between a members' voluntary winding-up and creditor's voluntary winding-up. For a voluntary winding-up a special resolution is required to be passed by the company's members and subsequently approved by 2/3 of creditors by value.

In addition, the Code provides a mechanism to challenge various offences by a company prior to the insolvency process commencing, including punishment for directors and officers of the company, and the threat of jail terms of up to five years in certain instances. The period of scrutiny for fraudulent transfers has also been increased to two years in the case of related parties.

Conclusion

The Code ambitiously aims to modernise one of the slowest insolvency regimes of any major economy into one of the fastest. Once operational, it is expected to significantly reduce the recovery time for banks and financial institutions, allowing them to recycle funds into better performing business and help further drive the Indian economy. Only time will tell if this is successful, but it is surely a significant improvement to the historical position.

It appears to be shaped on established legislation and practices of other developed jurisdictions, which should improve on the inefficiencies of the current insolvency regime. Furthermore, the Code has cleared the path for the development of a specialist insolvency profession in India, and may also create an opportunity for insolvency professionals in other jurisdictions with already developed insolvency practices.

Given the efficient resolution and liquidation process envisaged under the Code, it is also hoped that foreign investment in India would see an increase, since investors could see an easier exit option should things not go quite as planned.

The Code is a welcome step in the Indian insolvency regime and is expected to not only facilitate quicker debt recovery but also ease doing business in India. It will, however, be important that measures are taken to enable smooth and quick implementation of the Code.

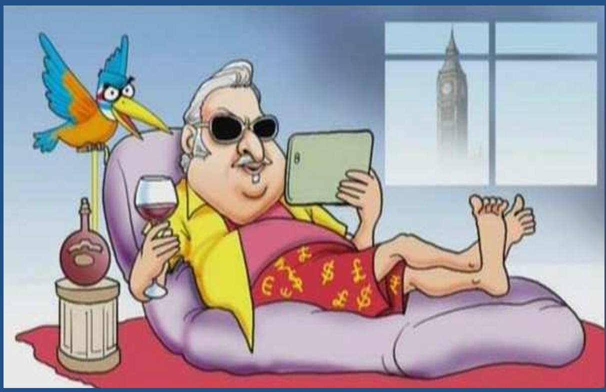
However, as with any new legislation, the devil is always in the detail and it will potentially take a number of years for best practice to be established and for the benefits to achieve their desired outcome.

Authors : Kevin Coates, Alix Partners and Sakate Khaitan, Khaitan Legal Associates

The King's Escape: Failure of Cross-Border Insolvency!

If media reports are to be believed, India's 'King of Good Times' is reportedly ensconced in Hertfordshire, UK, leaving a consortium of Indian banks to their fate. Vijay Mallya's Kingfisher Airlines (**KFA**) owes about INR 9,000 crores to the consortium of banks, and these banks have been attempting to recover their loans at several levels – approaching debt recovery tribunals, seizing collateral, auctioning KFA trademarks and so on.

The banks' recovery strategy in the KFA situation has been criticized as too little, too late. Given the delay in enforcement, it's possible that even if the banks exhaust all legal remedies, they may not be able to recover the full extent of the loan, and would then have to enforce Mallya's personal assets and other corporate guarantees. Mallya owns sizeable real estate across the globe; however, it's likely that any transfer of these would be governed by local laws, and given that these assets have not been specifically provided as security, Indian banks have an uphill task.



Courtesy : Google Images

The KFA case is unique; however, it clearly underscores the pressing problem of non-performing assets (**NPA**) in Indian banks, collusion between banks and high-profile promoters, and the need for addressing issues relating to cross border insolvency.

The Code is currently silent on the cross border insolvency framework. There are however enabling provisions which state that the Government can enter into bilateral agreements for enforcing the Code. Further, in the course of proceedings under the Code, if any assets are situated outside India, assistance can be sought from the appropriate authority in the other jurisdiction. The Code however, does not include any substantive cross border insolvency provisions; these would instead be dependent on mutual negotiations and reciprocity. Though there have been past recommendations regarding India adopting the UNCITRAL Model Law on Cross Border Insolvency (**Model Law**), the Code makes no reference to the Model Law.

Though adopting the Model Law would have several advantages for India, all is not lost, for the Code incorporates certain provisions which can address a Mallya-like situation much earlier. For instance, under the Code, employees and operational creditors have the right to move for insolvency, post which the professionals would take over – thus reducing chances of siphoning funds and asset stripping. In Mallya's case, however, it sure seems that more skeletons will fall out; his battle with the Indian legal system will be an enduring one.

Impact of the Code on India's 'Ease of Doing Business' Ranking

In the World Bank survey on Doing Business 2016, India was ranked at 136 out of the 189 countries surveyed, for 'Resolving Insolvency'. The enactment of the Code is expected to affect India's ranking positively. Below is our take on the impact of the Code on India's ranking vis-à-vis 'Resolving Insolvency', taking the World Bank's criteria as a base.

STRENGTH OF INSOLVENCY FRAMEWORK

- Consolidated framework for individuals, partnership firms and companies.
- DRT and NCLT to have jurisdiction for individuals and partnership firms; and for companies respectively. Reduction of multiplicity of fora.
- Insolvency resolution process and moratorium made time-bound.
- Since the Code has not yet been brought into force, effectively, the insolvency framework still remains the same.

COMMENCEMENT OF PROCEEDINGS

- Upon initiation of the insolvency proceedings, insolvency resolution is the first step. Winding-up only resorted to if the company cannot be revived.
- Under the Code, insolvency resolution can be initiated against a corporate debtor in case of default exceeding INR 100,000.

MANAGEMENT OF DEBTOR'S ASSETS

- Costs of insolvency resolution process (including interim finance) and liquidation costs have first priority in the distribution waterfall.

REORGANIZATION PROCEEDINGS

- Decisions with respect to the reorganisation, including appointment of resolution professional, are taken by 75% majority of the committee of creditors.
- The financial creditors have not been divided into different classes for the purposes of voting priority in on the reorganization plan.
- Committee of creditors to consist only of financial creditors. No representation to operational creditors.

CREDITORS' PARTICIPATION

- In case of rejection of its claim by the liquidator, the creditor has the right to appeal to the NCLT against the decision of the liquidator.

Mumbai
1st Floor, Century Bhavan,
771, Dr. Annie Besant Road,
Worli, Mumbai - 400 030
T: +91 (0) 22 6140 0000
F: +91 (0) 22 6140 0099

London
Ground Floor,
29 Gloucester Place,
London, W1U 8HX
T: +44 20 7034 1430
F: +44 20 7034 1431

: @KhaitanLegal
E: indiaunleashed@khaitanlegal.com
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