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Understanding the new Insolvency Code – Part II: Liquidation of corporate debtors

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The first part of this series examined the impact of the insolvency resolution process under the Insolvency and Bankruptcy Code, 2016 of India (the "**Code**") in the context of the existing debt restructuring scenario in India. This part discusses the regime for liquidation of corporate debtors under the Code, which is intended to speed up the liquidation process but which is now only available after the debtor has gone through the insolvency resolution process. It also considers a number of significant changes to provisions relating to avoidance of past transactions and the impact of some of the recent amendments to the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ("**SARFAESI Act**") and other allied laws on creditors' rights.

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1 Introduction

Parts of the Code have now been brought into effect through a series of notifications. As at the end of December 2016, the provisions in relation to insolvency resolution and liquidation of corporate persons (other than voluntary liquidation, and the fast track procedure for liquidation of smaller entities) are in force[1]. The Insolvency and Bankruptcy Board of India ("**IBBI**"), which is responsible for registration and oversight of insolvency professionals ("**IPs**") and insolvency professional agencies ("**IPAs**")[2], has been established, and the National Company Law Tribunal ("**NCLT**"), which is the adjudicating authority for corporate insolvency resolution and liquidation, is in place. The rules for registration of insolvency professionals and insolvency professional

[1] "Corporate persons" for the purpose of the Code are companies, limited liability partnerships and other incorporated entities which have limited liability, but excludes financial service providers. The treatment of financial service providers has been discussed in paragraph 4. The provisions in relation to insolvency of individuals and partnership firms are not in force yet.

[2] IPs are individuals who are members of an IPA, and are registered with the IBBI as IPs. They can act as resolution professionals in the context of an insolvency resolution process and as liquidators in the context of a liquidation process. As at the beginning of 2017, the website of the IBBI indicates that close to 1000 individuals have registered as IPs. An IPA is a not-for profit company registered with the IBBI and is meant to be a type of self-regulatory organisation required to regulate IPs which are its members. As at the end of December 2016, three IPAs, established respectively by the Institute of Chartered Accountants of India (ICAI), the Institute of Company Secretaries of India (ICSI) and the Institute of Cost Accountants of India, have been registered with the IBBI.

agencies[3] and those governing the liquidation process[4] have also been issued.

Changes have also been made to various related laws. Notably:

(i) The Sick Industrial Companies (Special Provisions) Repeal Act, 2003 has been notified, finally bringing an end to the Sick Industrial Companies (Special Provisions) Act, 1985, which has long been viewed as a debtor friendly statute which assisted industrial companies to evade creditor action[5].

(ii) The Companies Act, 2013[6] ("**CA 2013**") has been amended to remove the provisions for winding up of companies by creditors. Liquidation of a company by its creditors is now solely governed by the Code.

(iii) Changes have been made to SARFAESI Act and the Recovery of Debts due to Banks and Financial Institutions Act, 1993 ("**RDB Act**") to enhance rights available to creditors in respect of enforcement of security and recovery of debt.

2 Creditor action: what has changed?

In Part I of this article, we reviewed the existing avenues available to creditors for debt restructuring[7], the process for debt restructuring under the Code, and the interaction between the two. If restructuring is not a viable option for a creditor, the options for enforcement and recovery of debt need to be considered.

Existing debt recovery mechanisms

Debt recovery has traditionally been seen as a difficult and time consuming process in India, primarily because of delays in the court system. As a starting point, all creditors (including foreign creditors) have had access to the civil courts in relation to unpaid debt, with

[3] The Insolvency and Bankruptcy Board of India (Insolvency Professionals) Regulations, 2016 and Insolvency and Bankruptcy Board of India (Insolvency Professional Agencies) Regulations, 2016

[4] The Insolvency and Bankruptcy Board of India (Liquidation Process) Regulations, 2016 (the "**Liquidation Process Regulations**")

[5] There has been no similar repeal of state level debt relief statutes such as the Bombay Relief Undertaking Act, 1958, and any "debt relief" or moratorium under such statutes may continue to vex creditors. In one of the first reported cases under the insolvency resolution process filed by ICICI Bank against Inventive Industries, it has been reported that the NCLT has not passed any order admitting or rejecting the insolvency resolution application, as required under the Code. One of the grounds raised was that no proceedings can be taken against the company as it was under protection under the Maharashtra Industrial Development Act, 1961.

[6] Note that the provisions in relation to winding up under the CA 2013 had not been notified until December 2016, and winding up of companies continued to be governed by the Companies Act, 1956 ("**CA 1956**"). The relevant provisions of the CA 2013 were amended by the Code on 15 November 2016 and then notified (as amended) with effect from 15 December 2016 (the same day that the provisions of the Code governing liquidation of corporate debtors became effective)

[7] In summary, these existing mechanisms consist of: (i) RBI mandated mechanisms, being corporate debt restructuring ("**CDR**") and restructuring taken up by a joint lenders forum ("**JLF**") through various means, including conversion of debt to equity under the strategic debt restructuring ("**SDR**") mechanism, conversion of debt into long dated instruments under the scheme for sustainable structuring of stressed assets (""**S4A**"), which are available to banks, and in some cases, non-banking finance companies ("**NBFCs**") in India; and (ii) schemes of arrangement under the CA 2013. Restructuring under SICA was an additional option, which now no longer exists.

certain types of debt holders (being deposit holders and debenture holders) having additional recourse to company courts[8] for specific matters. Two statutes were enacted in the 1990s and the early 2000s to address delays within the court system. The RDB Act provided for establishment of debt recovery tribunals as a separate set of tribunals for banks and specified financial institutions to recover debt due to them, and provided for a bar of civil courts in order to prevent borrowers to cause delays by bringing parallel proceedings. In 2002, the SARFAESI Act was introduced to enable banks and specified financial institutions to enforce security privately, outside of the court system. The SARFAESI Act is generally seen as having been more successful in assisting secured creditors with debt recovery. However, both statutes have until now largely been limited to banks in India. Other categories of creditors, such as bondholders and foreign creditors have not had access to these mechanisms. Finally, all creditors, including trade creditors, bondholders and foreign creditors, have had the ability to file for winding up of a company on the ground of "inability to pay its debts as they fall due", although, as explained below, any such application would not necessarily be successful.

Recent changes to debt recovery laws

Certain changes were introduced under RDB Act and SARFAESI Act in October 2016: (i) a number of non-banking finance companies were notified as "secured creditors" under the SARFAESI Act; and (ii) debenture trustees in respect of listed debentures were notified as "financial institutions" both under the SARFAESI Act and the RDB Act, thus providing access to these mechanisms to debenture holders (including eligible foreign holders) holding listed debentures, through the debenture trustee. These have been welcomed by the industry as being a step to strengthening the non-bank credit segment. However, these changes do not extend to other foreign creditors (including bondholders of foreign currency or rupee denominated overseas bonds), domestic bondholders of unlisted bonds (unless they are a domestic bank or notified NBFC) and trade creditors.

Changes under the Code

Under the CA 1956 and the CA 2013, a company could be wound up for its "inability to pay its debts as they fall due", usually referred to as the "cash insolvency" test. There is extensive jurisprudence on the difference between not paying a specific debt and the inability to pay debts more generally, and courts have consistently held that winding up is not a mechanism for a creditor to resolve its dispute with a non-paying borrower. Nevertheless, filing a winding up petition has been a key tool used by creditors to bring borrowers to the negotiating table. The Code has made a significant change by amending the CA 2013 to remove this ground for winding up of companies. Instead, the Code provides for the following grounds for liquidation of a corporate person:

[8] Previously the company law board, and now the NCLT

(iv) no resolution plan being submitted within the maximum period permitted in respect of an insolvency resolution process;

(v) the resolution plan being rejected by the adjudicating authority for non-compliance with the Code;

(vi) a decision by the creditors committee during the insolvency resolution process (before submission of a resolution plan) to liquidate the debtor; or

(vii) where the debtor contravenes the provisions of a resolution plan, based on determination of such contravention by the adjudicating authority.

In other words, if a creditor wishes to liquidate a company, it must first go through the insolvency resolution process (which is supposed to last for a maximum of 270 days). If the resolution process does not result in an approved resolution plan within the statutory timetable, the debtor will, under the new legislation, go into liquidation.

3 Insolvency principles and process: changes under the Code

Once creditors and the debtor have gone through the insolvency resolution process, and pursuant to one or more grounds set out above being satisfied, the debtor is to be put into liquidation, the principles set out in Chapter III of the Code will govern that liquidation process. These principles are relevant not only to the actual outcome of the liquidation process, but also underpin any debt restructuring (whether contractual or through the insolvency resolution process under the Code) in respect of the debtor, since they determine the "baseline" outcome if the restructuring were to fail.

Liquidator appointment and timelines

One of the major changes brought in through the Code, not just in the context of liquidation, but more generally, is the introduction of insolvency professionals. In relation to liquidation, the Code provides that the IP appointed during the insolvency resolution process will be appointed as the liquidator, unless the adjudicating authority replaces the IP because: (i) the resolution plan submitted during the resolution process was rejected for being inconsistent with the requirements of the Code; or (ii) the IBBI recommends the replacement of the IP for reasons to be recorded in writing. The liquidator must in all cases be independent of the debtor. The winding up process under the CA 1956 was managed by official liquidators, and has been subject to inordinately long delays. It is expected that appointment of dedicated professionals will significantly help to reduce such delays. The Code and the Liquidation Process Regulations also prescribe certain timelines to help streamline the process[9]:

(i) all claims of creditors are required to be submitted to the liquidator within a period of 30 days from the date of commencement of the liquidation process (being the date on which the adjudicating authority passes the order for liquidation)[10];

(ii) the liquidator is required to: (a) verify these claims within a further period of 30 days, and to communicate their acceptance or rejection to the creditors within a period of 7 days thereafter; and (b) file a list of stakeholders with the adjudicating authority within 45 days;

(iii) the liquidator is required to submit progress reports to the adjudicating authority within 15 days after the end of each quarter (and the progress report for the fourth quarter of a financial year must include audited accounts of the liquidator's receipts and payments for the financial year);

(iv) within 75 days of the liquidation commencement date, the liquidator is required to: (a) prepare an asset memorandum; and (b) submit a preliminary report to the adjudicating authority indicating the capital structure and estimated assets and liabilities of the debtor; and

(v) the liquidator is required to complete the liquidation process within 2 years. If that is not possible, the liquidator must apply to the adjudicating authority, along with reasons and specifying the additional time required.

Once the assets are completely liquidated, the liquidator is required to make an application to the adjudicating authority to dissolve the debtor and the debtor will stand dissolved from the date on which the adjudicating authority passes such order.

A number of the timelines appear to be fairly aggressive, particularly in relation to agreeing contingent or disputed claims, and it could, in practice, prove hard to comply with this timetable in more complex cases. It is worth noting that the rules envisage a supervisory role for the adjudicating authority (rather than the committee of creditors) during the liquidation process.

[9] These timelines have been prescribed for a regular liquidation process. The Code also envisages a "fast track" liquidation process for smaller corporate entities but these provisions have not yet been brought into force.

[10] The Liquidation Process Regulations provide for a pro forma claim form for operational and financial creditors in order to streamline the claim process. Submissions can be made either electronically or physically.

Avoidance of past transactions

The Code has made some changes to the provisions for avoidance of pre-liquidation transactions by the liquidator. The CA 1956 provided for avoidance of: (i) transactions entered into by a company within the six months period before the commencement of winding up with the intention of preferring one particular creditor over the others; (ii) any transfer of property or goods by a company within one year before the commencement of winding up otherwise than in the ordinary course of business or otherwise than in good faith and without valuable consideration; and (iii) floating charges created within one year before the commencement of winding up except to the extent of any money paid in consideration for the creation of the charge.

Under the Code, there are three categories of transactions which a liquidator can seek to avoid – preferences, transactions at an undervalue and extortionate credit transactions. Some key points to note:

(i) The avoidance period for preferences and transactions at an undervalue is one year preceding the insolvency commencement date[11] for regular transactions, and two years for related party transactions. The avoidance period for extortionate credit transactions is two years prior to the insolvency commencement date.

(ii) The test for preference transactions has changed from an intention to prefer one creditor over others to having the effect of putting one creditor in a more beneficial position (as compared to the position that creditor would have been in on a liquidation). A safe harbour has been provided for security interests securing new value given at the time of creation[12].

(iii) The test for transactions at an undervalue is transfer for a consideration which is "significantly less" than the value of the consideration provided by the debtor and the transaction not having taken place in the ordinary course of business of the debtor.

(iv) Extortionate credit transactions are a new category of avoidable transactions introduced under the Code. The Liquidation Process Regulations state that a transaction shall be considered an extortionate credit transaction where the terms require the debtor to make "exorbitant payments" in respect of the credit provided or is unconscionable under the principles of law relating to contracts. The Code provides a safe harbour to a debt extended by financial service providers which is "in

[11] The insolvency commencement date is the date on which the application for the insolvency resolution process is admitted by the adjudicating authority.
[12] "New value" does not include any financial or operational debt substituted for existing financial or operational debt. How refinancing transactions will be treated in this context remains to be seen.

compliance with any law for the time being in force in relation to such debt".

Secured creditors' rights and liquidation priority

The Code, similar to the CA 1956, allows secured creditors to either retain their security and sell the secured assets outside the liquidation process, or to relinquish their security and become a part of the liquidation proceeds waterfall. Specific provisions clarifying the manner in which secured creditors can act in connection with their enforcement have been included. The priority accorded to various stakeholders in relation to the liquidation proceeds has been simplified and certain key changes have been introduced:

(i) Costs of insolvency resolution and liquidation have been accorded the highest priority, in order to incentivise insolvency professionals to take up liquidation mandates[13].

(ii) If a secured creditor chooses to retain its security and enforce outside the liquidation process, under the CA 1956, any shortfall in recovery was treated on par with the dues of all other unsecured creditors. However, under the Code, such shortfall will be recoverable after financial debts due to unsecured creditors have been paid off in full. However, if a secured creditor relinquishes its security, the entire amount due to that secured creditor will be paid in priority to unsecured financial creditors. This is a new provision, introduced to incentivise secured creditors to become part of the liquidation process (and potentially help the liquidator to realise higher value for the assets as a whole). How this provision will work in practice remains to be seen. There does not appear to be any correlation envisaged between the value of security relinquished and the extent of priority accorded which potentially opens this provision up to abuse – e.g., a creditor with token security or a second charge relinquishing its security and ranking at the same level as another creditor who has given up substantial security. Query also how a second chargeholder would be treated for the purpose of determining "relinquishment" of an asset over which there are multiple charges.

[13] The fees and costs of the IP in the context of the insolvency resolution process are determined as follows: (i) the costs of an interim resolution professional must be borne by the applicant and will be reimbursed as part of the resolution plan provided such costs have been approved by the committee of creditors; (ii) the costs of the resolution professional will be fixed by the creditors committee and are required to be reimbursed as part of the resolution plan. The fees and costs of the liquidator in the context of the liquidation process are determined as follows: (i) where the liquidation process is initiated because ether no resolution plan was presented during the insolvency resolution process or the committee of creditors voted in favour of liquidation, the fees and costs of the liquidator are determined by the committee of creditors; (ii) where the liquidation process is initiated because either the adjudicating authority rejects the resolution plan presented during the insolvency resolution process, or because the debtor has contravened the resolution plan, the Liquidation Process Regulations set out the schedule of fees payable to the liquidator, with 50% of such fees only being payable after the distribution of proceeds of liquidation has been completed.

(iii) The deeming fiction which created a pari passu charge over secured assets to secure workmen's dues has been done away with. Workmen's dues for 24 months before the liquidation commencement date, and dues of secured creditors which have relinquished their security, are at the same level, just below liquidation and resolution costs.

(iv) Employees dues (other than workmen's dues) for 12 months before the liquidation commencement date fall in priority to unsecured creditors but below workmen's dues and dues of secured creditors who have relinquished their security.

(v) Financial debts owed to unsecured creditors come next. The waterfall under the CA 1956 did not distinguish between financial and operational debt.

(vi) Sovereign dues, which, under the CA 1956, had priority to unsecured claims, have been moved below the claims of unsecured creditors in respect of financial debt. These now rank at the same level as any shortfall due to a secured creditor which has chosen to enforce its security outside the liquidation process

(vii) Other remaining debts and dues, which will include trade creditors, fall below sovereign debt and secured creditors' shortfall

(viii) Then come preference shareholders, and last, equity shareholders.

One important point to note is that the liquidation priority under the Code overrides the provisions of all other central and state laws. This addresses the often problematic issue of certain dues owed to State Governments which had "super-priority" under various state statutes.

Determination of creditors' claims and other relevant provisions

A few other points worth highlighting in relation to the liquidation process:

(i) **Set-off**: The Liquidation Process Rules provide that where there are mutual dealings between the corporate debtor and another party, the sums due from one party will be set off against the sums due from the other party, and the net amount due from the debtor will be taken into account for the distribution of proceeds. This is not a new position as the CA 1956 read with the personal insolvency provisions, as interpreted by courts, also provided for set off, but it is useful to have a clear provision in this regard.

(ii) **Foreign currency debt**: The Liquidation Process Rules provide that claims denominated in foreign currency will be converted into Indian Rupees at the reference rate published by the RBI as at the liquidation commencement date.

(iii) **Future claims**: The Liquidation Process Rules provide for a method of determination of the present value of claims where payment has not fallen due at the time of liquidation, discounting the value of the claim using the rate of return on government securities of comparable maturity.

(iv) **Disclaimer of contracts and property**: Similar to the position under the CA 1956, the liquidator has the ability to disclaim onerous contracts and property.

(v) **Sale of assets**: The liquidator has the discretion to sell assets separately or by way of a "slump sale". It is ordinarily expected to sell assets by way of an auction, but can opt for a private sale if: (a) the assets in question are perishable or likely to deteriorate in value significantly if not sold immediately; (b) the asset is sold at a price higher than the reserve price of a failed auction; or (c) the prior permission of the adjudicating authority has been obtained for such sale.

4 Exception for financial service providers

The definition of "corporate person" under the Code excludes financial service providers. The definition of financial service providers is fairly wide, and will exclude banks, insurance companies, asset and investment managers, pension funds, portfolio managers, financial record keeping agencies, payments and securities system intermediaries and the like from the ambit of the liquidation process under the Code. The intent behind the exclusion appears to be that insolvency of financial sector entities can have a wide ranging impact (particularly in light of the global financial crisis) and ought to be dealt with separately. This is borne out by the draft Financial Resolution and Deposit Insurance Bill, 2016 released by the Ministry of Finance, which covers financial service providers. However, until the bill is enacted, there remains a vacuum with respect to financial distress and liquidation of these entities, since the relevant provisions of the CA 1956 and CA 2013 have been done away with by the Code. This is a matter of concern, particularly in relation to entities such as banks and non-banking finance companies which have extensive borrowings.

5 Impact

Set out below are some of the key takeaways for creditors under the new liquidation regime:

(i) It is now mandatory to go through the insolvency resolution process before liquidating a company for non-payment of its debt.

(ii) The Code has increased the breadth of insolvency avoidance provisions – any debt restructuring during a pre-insolvency period involving a new security package for pre-existing debt will need to factor in the increased avoidance risk.

(iii) The increased avoidance period of two years for related party transactions is a welcome change, but needs to be kept in mind when using intercompany funding structures.

(iv) Secured creditors will need to weigh the pros and cons of standing outside the liquidation process given the relative subordination of any shortfall after enforcement.

6 Conclusion

The new regime for financial distress and insolvency is now reality and here to stay. The first few insolvency resolution cases are underway[14], and are keenly being watched to see how the process will work and which stakeholders stand to benefit. There will no doubt be teething troubles in the form of administrative capacity, judicial challenge and the need to refine and amend the rules – however it is important to remember that the new law squarely focusses on dealing with financial distress in a cohesive, comprehensive manner and has creditor protection at its heart. The next few years will be key to determine how effectively it can be used, and the collateral benefits it ought to bring in terms of growth of credit in the Indian economy, in particular in the bond and other non-bank segment of the markets.

[14] See footnote 5 above in relation to the insolvency resolution application filed by ICICI Bank against Innoventive Industries, one of the first cases filed under the Code. The initial failure of the NCLT to either reject or admit the application within the stipulated time period has disappointed those who are watching developments under the Code.

Contacts

For further information please contact:

TT&A – Mumbai	Linklaters – Asia	Linklaters – London
Sonali Mahapatra Partner, Mumbai (+91) 22 6613 6988 sonali.mahapatra@tta.in	**David Kidd** Partner, Hong Kong (+852) 2901 5558 david.kidd@linklaters.com	**Narayan Iyer** Partner, London (+44) 207 456 4837 narayan.iyer@linklaters.com
Rituparno Bhattacharya Partner, Mumbai (+91) 22 6613 6936 rituparno.bhattacharya@tta.in	**Philip Badge** Partner, Singapore (+65) 6692 5731 philip.badge@linklaters.com	**Jo Windsor** Partner, London (+44) 207 456 4436 jo.windsor@linklaters.com
	Aditya Shroff Counsel, Singapore (+65) 6692 5701 aditya.shroff@linklaters.com	