OVERVIEW OF AND FOREIGN PERSPECTIVE ON THE INDIAN INSOLVENCY AND BANKRUPTCY CODE 2016

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Legal Briefings – By **Clive Barnard, Kevin Pullen, Alexander Aitken and Soumya Rao**

The Indian Insolvency and Bankruptcy Code 2016 (**Code**) introduces a completely new insolvency and resolution regime for India. Key provisions of the Code and related regulations came into effect this month, the latest of them being the provisions relating to the liquidation of corporates and related regulations which came into effect on 15th December. The provisions of the Code that are now in effect introduce a new corporate insolvency resolution process and liquidation process, along with corresponding rules and regulations.

INTRODUCTION TO THE CODE

The Code introduces a completely new insolvency and resolution regime for India. The passing of the Code on 28 May 2016 was the first step in its introduction.

Key provisions of the Code relating to the new corporate insolvency resolution process came into effect earlier this month, with the liquidation process related provisions coming into effect on 15th December. The corresponding rules and regulations have also been notified and have come into effect.

The Code creates a new, regulated, insolvency profession and information utilities, both of which will develop over time (see below for a more detailed analysis). It is nevertheless envisaged that the new regime will be fully operational by the end of 2016, and relevant government departments are working to that objective.

The key provisions of the Code that are still to come into force relate to the bankruptcy processes applicable to individuals.

This article briefly describes:

- the background and drivers behind the introduction of the new Code;
- a high-level summary of the key elements of the Code applicable to corporate debtors (with a particular focus on the new corporate insolvency resolution process); and
- the new administrative structures created under the Code.

While we do not cover the new bankruptcy process which applies to individuals in this note, we do acknowledge there is some overlap between the regimes that apply to individuals and corporates in India given the prevalence of promoter personal guarantees.

BACKGROUND TO LAW REFORM

The Indian Government’s main objectives in putting forward this legislation were twofold:

- to improve India’s poor ranking on the World Bank’s ease of doing business index and to stimulate the growth of the Indian capital markets. In order to achieve this, an effective system for dealing with non-performing debtors was required; and
- to consolidate and replace the relevant insolvency, restructuring and winding up provisions which were spread over a number of Indian statutes. It is generally accepted that the previous system did not generally produce desired outcomes.

BANKRUPTCY LAW REFORM COMMITTEE

A Bankruptcy Law Reform Committee (**BLRC**) was established to draft the new Code. Throughout the process, the BLRC sought the opinion of a wide range of parties with experience in the restructuring, turnaround and insolvency areas, both within the region and globally.

Herbert Smith Freehills (**HSF**) was invited by the BLRC to contribute thoughts from a foreign perspective, and worked closely with Bahram Vakil of AZB (a member of the BLRC) in this regard. HSF provided input to the BLRC on their various papers and thought processes, by sharing our United Kingdom (**UK**) experience on the development of a new English bankruptcy code in the 1980s and its evolution since then.

We are grateful to the BLRC for their acknowledgment of HSF's contribution in their final report published in November 2015.

BRIEF OVERVIEW OF THE CODE

The Code is a unified and comprehensive piece of legislation for the resolution of insolvency in respect of companies, limited liability partnerships, partnership firms and individuals. The Indian Government is in the process of proposing a separate framework for insolvency processes in relation to banks and other financial sector participants. The Code creates a new institutional framework which consists of adjudicatory bodies, a regulator, insolvency professionals and information utilities.

The Code provides for two corporate insolvency processes:

- corporate insolvency resolution process, a new time bound resolution process; and
- liquidation, a winding up process.

After careful deliberation, the BLRC elected to follow a system similar to that of the UK's practitioner led insolvency procedures as opposed to the US Chapter 11 debtor-in- possession system, which it perceived would have required much more involvement of the Indian courts. As a result, architecturally the Code has many similarities to the UK's Insolvency Act 1986 and administration process; however it differs in a number of important respects.

THE CORPORATE INSOLVENCY RESOLUTION PROCESS

The Code empowers any creditor (whether financial or operational, secured or unsecured, domestic or foreign) to trigger the corporate insolvency resolution process (**resolution process**) by filing an application with the relevant adjudicatory body upon the occurrence of a payment default. Payment default is the only test of insolvency; there is no balance sheet insolvency test in the Code. The resolution process applies in all cases; however the procedure to initiate a resolution process differs depending on whether the application is filed by a financial creditor, an operational creditor or the debtor. It is important to note that there is no mechanism to file for liquidation without first seeking a resolution. This is in contrast to the UK administration system, which makes the resolution process optional, allowing flexibility where an immediate liquidation is in the interests of creditors and there is no prospect of the business surviving. In our view, the current approach in the Code is likely to result in costly delay in circumstances where liquidation is inevitable.

The resolution period is strictly time bound and limited to 180 days, with the exceptional possibility of extension by a further 90 days in defined circumstances. During the resolution period, the resolution professional (a registered and regulated person appointed by the adjudicator) manages the affairs of the corporate debtor and is responsible for maintaining the business as a going concern. The powers of the board of directors are suspended during such time, and the management and creditors of the debtor are required to act in accordance with the instructions of, and cooperate with, the resolution professional.

It is not entirely clear as yet how the resolution professional would exercise their powers and how they would be funded. Since the resolution plan is required to provide for the payment of the insolvency resolution process costs in priority to the repayment of other debts, presumably they would be funded by the company.

THE RESOLUTION PLAN AND THE CREDITORS’ COMMITTEE

The resolution professional must invite lenders, investors and other relevant persons to put forward a resolution plan, and present all resolution plans at the meetings of the creditors' committee.

The committee comprises all financial creditors and representatives of operational creditors, though only the financial creditors may vote. The rules vary where the debtor only has operational creditors. The way the committees operate is set out in detailed regulations but they do not identify how voting is to be determined and/or weighted.

It is, through international eyes, odd that a distinction is made between financial creditors and operational creditors in their right to vote and that financial creditors (even if, for example, unsecured and deeply under water) must participate and should have a vote if in fact they have nothing to gain or lose in a resolution process or liquidation. In addition, the extent to which intercreditor arrangements can be varied, ignored or set aside during a resolution period will be an obvious concern of the creditors' committee but is at the moment very unclear.

The resolution plans are voted on by the creditors' committee. If no resolution plan is approved by a 75% majority of the financial creditors, liquidation follows. If approved by the requisite majority, the resolution plan is implemented.

MORATORIUM

A broad moratorium applies during the resolution period. However, unlike the UK regime, secured creditors should not stand back as the creditors' committee has a broad range of powers including the power to vary security and therefore security will not be sacrosanct during and as a result of the resolution process.

The Code provides that the supply of "essential" goods and services to the corporate debtor shall not be terminated or suspended by the counterparty during the moratorium period, but what comprises "essential" and the basis on which the suppliers are expected to continue to deal with the debtor is not yet clear.

INTERIM FINANCE

Interim finance may also be raised by the resolution professional during the moratorium period to enable the running of the business of the debtor during the resolution period.

Any interim finance raised during the resolution period will have super priority, subject to the approval of the existing secured creditors (prior to the formation of the creditors' committee) or the creditors' committee (following its formation), as applicable. Clearly, the availability of funding will determine whether the resolution process itself is viable.

ANTECEDENT TRANSACTIONS

The ability of both liquidators and resolution professionals to challenge antecedent transactions is an important feature of the Code, and is a step in the right direction to achieving an effective regime that ensures promoters and others do not strip value from a company in distress. It also provides protection for the general body of creditors against fraudulent preferences and transactions at an undervalue. The imposition of personal liability in relation to such matters has proved to be an effective discipline in other jurisdictions.

ADMINISTRATIVE MACHINERY UNDER THE CODE

The passing of the Code is the first step to achieving a completely new insolvency regime for India. Significant structures have been created under the new Code and it will take time to see how they operate in practice and if they operate as intended by the draftsmen. This section discusses these structures and the challenges they may face.

ADJUDICATION BODIES

Corporate insolvency will be dealt with in the National Company Law Tribunal (**NCLT**), which was established under the *Companies Act 2013* but only recently constituted on 1 June 2016. The NCLT will also oversee the enforcement of personal guarantees relating to corporate debtors.

The existing Debt Recovery Tribunals (**DRTs**), will handle cases of individual insolvency and continue to be responsible for recovery of debts under the *Recovery of Debts due to Banks and Financial Institutions Act (1993*) and the *Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (2002)* (**SARFAESI Act**). The DRTs are struggling to handle their existing workload and will need much better resourcing to handle this significant extra workload.

Most modern insolvency systems use a specialist judiciary within the general court system which is generally very well resourced and supported by the public administration infrastructure. The success of the approach adopted by India to address the need for a specialised insolvency judiciary will depend on building similar levels of specialist competency in the NCLT and DRT akin to that found in London's Chancery Division courts, and ramping up the resources available to both bodies very significantly; so that they can handle the vast amount of extra work required within the tight timetables proposed.

While there is some logic in the split of cases between the NCLT and the DRT, it is not a distinction generally seen in other systems where consistency between the approach to insolvency and bankruptcy and the need to deal with connected corporate insolvencies and individual bankruptcies is seen as important. There are also some areas of overlap, e.g. DRT dealing with the SARFAESI Act, which governs the realisation of security by qualified security holders, whether granted by an individual or a corporate. As present, this machinery is not sufficiently resourced or developed in time and an initial period of difficulty seems inevitable. Efforts are being made to apprise members of the NCLT of various aspects of the new Code including the organisation of colloquia with key stakeholders and restructuring and turnaround experts, the most of recent of which was held in the first weekend of December in New Delhi.

INSOLVENCY PROFESSIONALS

India does not currently have an established body of insolvency professionals. There are a number of market participants who would be well positioned to help with this development. The UK insolvency practitioner ranks are now dominated by the accountancy firms and we would expect India to draw on their global experiences and systems. For example, their sophisticated ability to make speedy financial assessments of the viability of failing businesses will be essential, assuming the necessary information is available as proposed by the introduction of the information utilities.

The rules and regulations issued under the Code contain transitional provisions which permit individual foreign insolvency professionals qualified outside India, but resident in India, to apply for transitional registration as insolvency professionals under the Code. They would be allowed to act as resolution professionals for such period of time as may be notified by the Government.

The insolvency professional agencies set up by the Institute of Chartered Accountants of India and the Institute of Company Secretaries of India have presently been granted certificates of registration by the Insolvency and Bankruptcy Board (**IBBI**).

INFORMATION UTILITIES

The new Code is built around the development of new information utility systems that collect, collate, authenticate and disseminate financial information of debtors from and to companies, financial creditors and operational creditors in centralised electronic databases. The objective of introducing information utilities was to eliminate information asymmetry and minimise disputes about the existence of a default or security and the Code is predicated on the transparency of information regarding payment defaults. Financial creditors are required to submit financial information and information regarding secured assets to the information utilities.

As the Code has come into effect before the complete operationalisation of the information utilities, it is likely that the processing of applications triggering a resolution process and the formation of creditors' committees will take longer than envisaged under the Code, which will also have an impact on the strict 180 day timeline for the resolution period.

INSOLVENCY AND BANKRUPTCY BOARD

The IBBI, which was established in October 2016, will oversee the functioning of insolvency intermediaries (i.e. insolvency professionals, insolvency professional agencies and information utilities) and regulate the insolvency process. The IBBI will have ten members, including representatives from the central Government and the Reserve Bank of India.

SUBORDINATE LEGISLATION

The Code sets out the main principles and procedures to be followed under the new insolvency systems in India. However, as is the case in most jurisdictions, the detail has been left to subsidiary legislation adopted by the executive. The Ministry of Corporate Affairs in collaboration with a working group of practitioners and experts have drafted the relevant rules and regulations, which have now been notified.

The rules and regulations were prepared under a tight timetable (as indeed was the Code itself) and they will inevitably require amendment in light of experience and further review as the practical effectiveness of the new regime is dependent on them.

The UK insolvency regulations have been amended many times since their implementation. This flexibility of the system and the use of external advice drawn from the people most embedded in the system worked to provide a coherent and maturing set of rules in the UK. However we agree with the BLRC's view for the need to balance the flexibility as seen in the UK approach with the certainty that investors look for by not regularly making changes to the system so as to introduce an element of legal certainty in investors' minds.

CONCLUSION

We are hopeful that this exciting chapter of legal and regulatory change will facilitate the deepening of the Indian loan and capital markets and stimulate greater interest domestically and internationally from credit suppliers.

Please feel free to contact us if you would like to discuss the Code or other related legal and regulatory changes in the Indian market and the opportunities they present or their implications for your business from the foreign legal perspective.

FURTHER INFORMATION AND UPDATES

We are continuing to update our in-depth analysis of the Code and the rules and regulations issued under it from the foreign creditor/investor perspective. Please contact us if you are interested in receiving further more detailed analysis in respect of the Code.

HSF also publishes a guide to Restructuring, Turnaround and Insolvency in Asia Pacific, which includes a chapter on India's new insolvency and restructuring regime. To request a copy of the Guide, please email Asia Publications.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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