CORPORATE INSOLVENCY LAW IN INDIA

REFORMS REQUIRED

-- Vinod Kothari

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Corporate insolvency law is an integral part of the system of facilitating and governing business in any economy. Insolvency is a possible outcome of an enterprise – it is impossible to conceive of a business that is completely insolvency-remote. Enterprise involves risk-taking, and risks may overwhelm the capital of an enterprise and take it to bankruptcy.

Basic philosophy of the corporate law

Corporate insolvency seeks to serve several objectives. **First**, insolvency is not necessarily to be viewed with indignation. Here, one must note the basic difference between a consumer going insolvent and a corporate going insolvent. In the former case, insolvency might be the result of profligacy but in case of business ventures, especially, corporations, unless wrongful trading or misfeasance is established on the part of those running the show, it is presumably a case of a genuine business failure.

Secondly, in case of individual insolvency, there is no question of reorganization or resurrection of the insolvent. In case of corporates, the first issue that any insolvency regime must be confronted with is: would it be in larger interest to reorganize and restructure the business to make it work, or is it to be taken into liquidation. Corporate bankruptcies today are far more than mere claims of creditors: many of them are so substantial powerhouses that their removal from the scene might affect many, including workers, consumers and even the whole system might be at stake. As corporates have become increasingly more concentric, corporate bankruptcy has become a social rather than a mere commercial issue.

Corporate bankruptcy must be distinguished from another connected issue: enforcement of security interests by creditors. In case of secured lending, most legal systems allow a secured lender the right to enforce security interest. In most countries, this is so, even if the debtor were in bankruptcy[1]. This is based on the premise that the claim

of a secured creditor is primarily against the security and collaterally against the company. It is open for the secured creditor to relinquish his security interest and prove for his debt before the bankruptcy court.[2] While the enforcement of security interest by a secured creditor is an individual pursuit, a bankruptcy proceeding is a collective process. The key distinction here is: in case of a bankruptcy, all creditors, including the secured creditors who choose to relinquish security interest and prove their debt, are to be paid equitably and ratably through an external agency, namely, the liquidator. This agency is bound to abide by rules of fair play and parity, and most significantly, take care of interests of some interest groups such as workers and preferential creditors. Individual pursuits by creditors can be totally insensitive to claims of other creditors, particularly unsecured creditors and workers.

Corporate bankruptcy law in America

Corporate bankruptcy is understandably a hugely common thing in the US. While individual bankruptcies form an overwhelmingly large percentage of total filings, corporate bankruptcies are typically huge. The Jack Murray Reference Library[3] gives some interesting facts about US bankruptcy filings. Total bankruptcy filings for the calendar year 2002 increased by 5.7 percent over the previous year (which itself was a record year for bankruptcy filings), setting a record of 1,577,651 (compared with 1,492,129 in 2001). (The previous record year was 1998, with approximately 1,440,000 total filings). However, the total number of business bankruptcy filings in 2002 actually fell by 1,559 cases, from 40,099 in 2001 to 38,540 in 2002. Chapter 11 filings fell by 1.3 percent to 11,270 in calendar year 2002, from the 11,424 Chapter 11 filings in 2001. During the 12-month period ended September 30, 2003 there were a record 1,661,996 bankruptcy filings, a 7.8 percent increase over the previous 12-month period.

Corporate bankruptcies, though small in number, can involve huge size of debt and assets. The previous record of Enron was smashed by Worldcom, which took USD 103.9 billion worth pre-bankruptcy assets into bankruptcy. The adjoining Table 1 gives data about some of the largest US bankruptcies.

The US bankruptcy law[4] is a

Table 1: Largest US corporate bankruptcies

Company	Bankruptcy Date	Total Assets Pre-Bankruptcy	Filing Court District
Worldcom, Inc.	07/21/02	$103,914,000,000	NY-S
Enron Corp.*	12/2/01	$63,392,000,000	NY-S
Conseco, Inc.	12/18/02	$61,392,000,000	IL-N
Texaco, Inc.	4/12/1987	$35,892,000,000	NY-S
Financial Corp. of America	9/9/1988	$33,864,000,000	CA-C
Global Crossing Ltd.	1/28/2002	$30,185,000,000	NY-S
Pacific Gas and Electric Co.	4/6/2001	$29,770,000,000	CA-N
UAL Corp.	12/9/2002	$25,197,000,000	IL-N
Adelphia Communications	6/25/2002	$21,499,000,000	NY-S
MCorp	3/31/1989	$20,228,000,000	TX-S
Mirant Corporation	7/14/2003	$19,415,000,000	TX-N
First Executive Corp.	5/13/1991	$15,193,000,000	CA-C
Gibraltar Financial Corp.	2/8/1990	$15,011,000,000	CA-C
Kmart Corp.	1/22/2002	$14,600,000,000	IL-N
FINOVA Group, Inc., (The)	3/7/2001	$14,050,000,000	DE
HomeFed Corp.	10/22/1992	$13,885,000,000	CA-S
Southeast Banking Corporation	9/20/1991	$13,390,000,000	FL-S
NTL, Inc.	5/8/2002	$13,003,000,000	NY-S
Reliance Group Holdings, Inc.	6/12/2001	$12,598,000,000	NY-S
Imperial Corp. of America	2/28/1990	$12,263,000,000	CA-S
Federal-Mogul Corp.	10/1/2001	$10,150,000,000	DE
First City Bancorp.of Texas	10/31/1992	$9,943,000,000	TX-N
First Capital Holdings	5/30/1991	$9,675,000,000	CA-C
Baldwin-United	9/26/1983	$9,383,000,000	OH-S

Source: bankruptcydata.com

[1] See, for example, *M K Ranganathan* vs *Govt of Madras* AIR 1955 SC 604. This is also the position under the UK Insolvency laws, see old ruling of James L J in *Re David Lloyd and Company* (1877) 6 Ch. D. 339. Under the US Bankruptcy Code, however, commencement of bankruptcy petition puts a stay on the rights of the secured creditor: - sec 362 of Title 11, Bankruptcy Code

[2] See proviso to sec. 529 (2) of the Indian Companies Act. See also UK Insolvency Rules, 1976, rule 4.75 (1) (g) and rule 4.88

[3] At http://www.firstam.com/faf/html/cust/jm-bankfacts.html

common code for business and consumer bankruptcies. For larger parts of the law, distinction is not made based on the form of organization. Particularly for corporate bankruptcies, it is highly inclined to restructuring failed businesses. Relevant to corporate bankruptcies, there are basically two choices: a filing under Chapter 7 of the Bankruptcy code, or Chapter 11 of the Code. Chapter 7 relates to liquidation – which is largely similar to winding up under the Indian law. Chapter 11 is a filing for re-organization, which is similar to a Court-supervised compromise or arrangement plan. Most businesses file for protection under Chapter 11, which offers several advantages: the debtor may remain in possession and may continue to run its business, prepare and file a re-organization plan, and if the Court confirms the re-organization plan, the plan will be executed. On the contrary, in case of Chapter 7, the assets are taken over by the trustee, who starts liquidating the same. A court may, of course, convert a Chapter 11 filing into a Chapter 7 case.

US bankruptcy laws are perceived to be more debtor-friendly[5]. This is primarily due to the pro-debtor stance of Chapter 11 proceedings. Under Chapter 11, the debtor has the exclusive right to prepare and file a re-organization plan[6]. A plan has to be approved by a 2/3rd majority of a class of claims or interests[7]. Typically, the re-organization plan is carried out with debtor-in-possession financing, approved by Court. Normally speaking, plans lead to impairment, at least in part, of claims.

Corporate bankruptcy law in United Kingdom

The UK law on bankruptcies was historically split – corporate bankruptcies were dealt with by the winding up provisions of the Companies Act and individual bankruptcies were dealt with by the bankruptcy laws. The Insolvency Law Review Committee, popularly known as Kenneth Cork Committee, made major recommendations on insolvency law reform in the UK, including the consolidation of both individual and corporate insolvency under a common law. Pursuant to its recommendations, the Insolvency Act 1985 was enacted, which was later replaced by the Insolvency Act 1986 – the current prevailing law on corporate and individual insolvencies. Though the law is apparently a common code on bankruptcies, there are separate chapters dealing with individual insolvencies and those dealing with corporate insolvency.

As the UK insolvency law has been inspired by several sources – the tradition of winding up principles in the Companies Act as also the US bankruptcy laws – the law presents several alternatives to resolving bankruptcies. These are:

1. Corporate voluntary arrangements, which are compromises or arrangements agreed mutually by creditors but supervised by the Court;
2. Administration: putting the company temporarily under the control of an administrator who prepares a plan for revival of the company, drawn up on lines of Chapter 11 of the US law but with overwhelming supervision of the administrator;
3. Administrative receivership: a process whereby a floating charge holder, in pursuance of a term contained in the debenture or debenture trust deed, appoints a receiver who takes control of substantially the whole of the property of the company;
4. Liquidation, whether compulsorily by the Court or a creditors' voluntary winding up, based on a resolution of members
5. Compromises or arrangement under the Companies Act.

Data about various filings under these procedures are available which show that liquidations form the largest part of the total procedures under the

[4] Title 11 of the US Code. For link to the full text of the code as also other relevant references, see author's site at http://vinodkothari.com/nujs/

[5] See, for instance, comment in report of World Bank Group on Debtor-Creditor Regimes, BUILDING EFFECTIVE INSOLVENCY SYSTEMS, Washington DC, Sept 14-15, 1999zz

[6] Sec 1121, US Bankruptcy Code [7] Sec 1126, *ibid*

Insolvency Act. Administrative receiverships and administration orders are lesser in number, but would presumably involve larger cases of corporate failures.

The process of reform of UK bankruptcy laws has been going on for the last 3-4 years. In April 2000, The Insolvency Service published a consultation paper ("Bankruptcy – A Fresh Start") which proposed changes to the law relating to personal as well as corporate insolvency. As regards corporate bankruptcies, the practice of administrative receiverships and the rights of floating chargeholders came under particular attack. Culminating into a legislation called the Enterprise Act 2002, these changes, relative to corporate bankruptcies made some very significant changes, including:

- The right to appoint administrative receivers was limited to certain excepted classes, such as capital market transactions, project finance transactions, public-private partnership transactions, etc.
- Floating chareholders were statutorily required to cede a part of the property securing their interest to meet the claims of unsecured creditors. The amount notified is 20% of the value of the property exceeding GBP 10000, limited to GBP 600000.

The purpose of these reforms is to allow more fair treatment to unsecured creditors, who, in a floating charge regime, are left with virtually no assets to take care of their interest.

Indian corporate insolvency law

The Indian insolvency law is still embedded into the UK tradition under which the insolvency laws as such pertain to individual insolvencies, and insolvencies of artificial legal entities are pursued under the respective laws under which they are incorporated. While the UK has moved to a consolidated insolvency law, the same has not been done in India. In 2001, the Report of the Advisory Group on Bankruptcy Laws, called the N L Mitra Committee, made several recommendations on bankruptcy law reforms, the first among which was consolidation of bankruptcy laws into a separate code. However, no legislative steps have still been taken in this regard.

Several significant recommendations were also made by the Report of High Level Committee on Law relating to Insolvency of Companies (Balkrishna Eradi Committee) that made its report to the Department of Company Affairs. The Eradi Committee, among other things, went into the working of the offices of the Official Liquidator (OL) and certain facts pointed out by it, on the face of it, seemed sadly surprising. For example, the data about the average time taken in resolution of winding up cases in different regions, could go up to 25 years or above, with the Eastern Region taking the first prize as far as the time taken in concerned. (See Table 2).

The sad state of affairs was explained by several factors such as non-filing of statement of affairs, inadequate staffing and equipment support at the OL offices, etc. The Eradi Committee also went into the functioning of the Board for Industrial and Financial Reconstruction (BIFR), which is a quasi-bankruptcy proceeding.

The Committee made several recommendations, many of which were a part of the Companies (Second Amendment) Act, 2002. These amendments have not yet been given effect to. Significant positive changes include:

- **The provisions of the Sick Industrial Companies Act (SICA) have been merged into the Companies Act.**
- **The jurisdiction on winding up cases is to be passed over to the National Company Law Tribunal. This is, by itself, a curious position as in most**

Table 2: Age of companies in Winding up in India (As per Eradi Committee report)

	0-5 Years	5-10 Years	10-15 Years	15-20 Years	20-25 years	25 Years and above	Total
Northern Region	259	130	86	56	47	66	644
Eastern Region	126	77	83	73	71	293	723
Southern Region	325	212	89	68	51	78	823
Western Region	355	184	224	124	82	36	1005
Total	1065	603	482	321	251	473	3195

other global jurisdictions, it is Courts that preside over bankruptcy matters. Bankruptcy proceedings are proceedings of equity – and it may be an arguable issue as to whether a non-judicial body as the NCLT can deliver equitable justice.

- **There is a provision for professionals to be appointed as official liquidators.**
- **The State of Affair, which as per the findings of the Eradi Committee took the most time, is now to be filed, in case of voluntary winding up, along with the winding application, and in case of an involuntary proceeding, at the time of the first defense.**
- **The liquidation program would be time bound. Among other things, liquidators may also remunerate themselves based on realization.**

Despite these welcome changes, there is still a need for a thorough overview, from viewpoint of consistency, of at least two significant related fields – re-organization or revival of sick companies, and the mutual relation between the enforcement of security interests and bankruptcy proceedings.

As far as reorganization proceedings are concerned, the provisions inserted in the Companies Act are substantially a restatement of the existing provisions of the SICA. First of all, there is no delineation of the circumstances in which reorganization under Section 424A will be applicable, and those under which a winding up order may be passed under Section 433. For example, inability to pay a debt is a ground for winding up, which is also a ground for treating a company as a sick company. A creditor may possibly make reference/application under either provision, and since the adjudicating body is the same under both the provisions, there must be clear guidance as to cases where revival should be the first consideration, and those where liquidation shall be ordered. For instance, under the US Bankruptcy law, the Court must be satisfied that the recoveries under a reorganization plan will not be worse than those in case of a liquidation.

There is also tremendous confusion as far as enforcement of security interests versus bankruptcy proceedings are concerned. Enforcement of security interests, and enforcement of claims of special creditors is dealt with by several statues in India, including the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act in case of secured creditors being banks and financial institutions, Recovery of Debts due to Banks Act in case creditors being banks or financial institutions, State Finance Corporations Act in case of creditors being State Finance Corporations, etc. Most of these laws provide for sweeping security enforcement provisions, without regard to the equities and interests that bankruptcy laws seek to preserve. Enforcement of security interests by the secured creditor is a global norm, but in India, a special position has been conferred on the workers by proviso to Section 529, and Section 529A of the Companies Act. Workers have been put at par with the interests of the secured creditor: if this is true for winding up, it is difficult to understand why this should not be true in cases which will certainly lead to winding up. For instance, if floating chargeholders were allowed to enforce security interests under the SARFAESI by declaring a default, there would be no assets left with the company. While this is sure to lead to bankruptcy of the company, the interests of workers that Section 529/529A seek to preserve are completely frustrated. ■