

# Insolvency and Bankruptcy Hotline

November 27, 2017

## BANKRUPTCY CODE: GHOST OF RETROSPECTIVITY RETURNS TO HAUNT

- Promoters and their connected persons held ineligible to participate under the Bankruptcy Code
- The net of *ineligible persons* is cast wider than was initially contemplated and includes holding companies, subsidiary companies as well as associate companies
- Bar on approval of resolution plan already submitted and under consideration

### INTRODUCTION

The Insolvency and Bankruptcy Code, 2016 (“**Bankruptcy Code**”) has proved to be a game-changer for corporate India and has witnessed several key amendments sparked by inputs received from market participants. Being a new enactment, loopholes are bound to exist and are being quickly plugged in an effort to ensure the sanctity of the process. In an attempt to further address the increasing concerns, including with respect to the *much-talked-about* eligibility for submission of resolution plans under the Bankruptcy Code, the President on November 23, 2017 promulgated the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2017 (“**Ordinance**”), which has come into force. The Ordinance, amongst other things, attempts to put safeguards to prevent unscrupulous persons from misusing or vitiating provisions of the Bankruptcy Code and is aimed to keep out wilful defaulters associated with non-performing assets from submitting resolution plans. Our analysis of the amendments are as under:

### AMENDMENT AND ANALYSIS

#### 1) Expansion of whom the Bankruptcy Code applies to:

##### Amendment

Bankruptcy Code to also apply to (i) personal guarantors to corporate debtors; (ii) partnership firms and proprietorship firms; and (iii) individuals (other than personal guarantors).

##### Analysis

- With respect to inclusion of personal guarantors of corporate debtors, though the Allahabad High Court in a recent case<sup>1</sup> had the occasion to analyse and opine on the initiation of insolvency process against a personal guarantor, personal guarantors were not expressly covered within the process contemplated under the Bankruptcy Code. The Ordinance now brings the much needed clarity in relation to the applicability of the Bankruptcy Code to personal guarantors, who now fall within its ambit. The question of application *qua* personal guarantors to corporate debtors will require some additional clarity including the triggers.
- The rationale for including applicability of Bankruptcy Code to partnership and individuals is possibly also to facilitate commencement of Part III of Bankruptcy Code related to insolvency and bankruptcy of individuals.
- Inclusion of proprietorship firms is a welcome step. Since most medium and small enterprises in India work on a proprietorship model, it was essential to streamline the mechanism for insolvency and bankruptcy of proprietorship firms. While the amount of loan availed by such proprietorship is comparatively less, the number of proprietorship firms availing loans is significantly high.<sup>2</sup> Further, since such proprietorship firms do not have a primary legislation governing compliances, the chances of default in repayment of loan is higher. However, considering the nature of restructuring required for proprietorship is different from the restructuring required for a company, there may be need for carve outs to the existing code for such proprietorship firms in terms of costs, time and keeping in mind the business environment they operate in and such carve outs may be focused more on consultation approach. It will also have to be seen whether the insolvency and bankruptcy proceedings for proprietorship firms will be carried on under Part III of the Bankruptcy Code or will new provisions be inserted for the purposes of such proceedings.

#### 2) Number of applicants:

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Amendment

The Resolution Applicant means a person who individually or jointly with any other person, submits a resolution plan to the resolution professional pursuant to the invitation made under clause (h) of sub-section (2) of Section 25.

Analysis

- The Ordinance has amended the definition of a '*resolution applicant*'. The Bankruptcy Code now explicitly allows persons to either singly or jointly submit a resolution plan.
- At the outset, this change will prove beneficial to persons who wish to jointly present a resolution plan pursuant to the an invitation in accordance with Section 25(2)(h) of the Bankruptcy Code and will facilitate acquisition of large stressed assets.
- There are existing implications under the Competition Act, 2002 in cases where due to the size/value of an undertaking (either the acquirer or the corporate debtor), approval from the Competition Commission of India may be required have still not been addressed and in fact, given the ability of persons to jointly submit resolution plans, may only get further exasperated. While the erstwhile Sick Industrial Companies (Special Provisions) Act, 1985 had specific exemptions to this effect, similar provisions may also need to be included to the Bankruptcy Code. This may see the need for additional amendments.

3) Need for invitation and imposition of conditions for the resolution applicants to fulfil:

Amendment

The resolution applicant is required to fulfil such criteria as may be determined by the resolution professional with the approval of the committee of creditors, depending upon the complexity and scale of operations of the business of the corporate debtor, and such other conditions as may be specified by the Board.

Analysis

- As a result of the Ordinance, the resolution professional is required to impose certain criteria for resolution applicants to fulfil, in order to enable them to receive an invitation to submit a resolution plan. Further, these criteria have to be imposed (i) with the prior approval of the committee of creditors; (ii) having regard to the complexity and scale of operations of the business of the corporate debtor; and (iii) as may be specified by the Insolvency and Bankruptcy Board of India ("**IBBI**");
- The said amendment appears to be made in light of the recent debates related to the credibility, both financial and legal, of the resolution applicants. The market has recently been polarized with respect to the eligibility criteria of the bidders submitting resolution plans for taking over stressed assets.

4) Barring certain class of persons from submitting resolution plan:

Amendment

The Ordinance mandates that certain classes of identified persons or any other person acting jointly with such person or the promoter or any person in management of such person from submitting the resolution plan.

Analysis

- Promoters of stressed companies have also expressed interest in submitting resolution plan for their own companies. In a bid to ensure that past track record of the resolution applicant is evaluated, IBBI had issued a notification amending the IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016<sup>3</sup>, which provided for details of the applicant of the plan such as identity, conviction for any offence, identification as a wilful defaulter, details of promoter etc. to be incorporated in the plan.
- (a) The Ordinance now makes certain persons ineligible to submit resolution plans. A person shall be ineligible to submit a resolution plan if such person, or any person acting jointly with such person, or any person who is a promoter or in the management or control of such person is an undischarged solvent;
- (b) has been identified as a wilful defaulter by the Reserve Bank of India ("**RBI**");
- (c) whose account is classified as non-performing asset ("**NPA**") by the RBI and period of one year or more has lapsed from the date of such classification and who has failed to make payment of all overdue amounts with interest and charges relating to the NPA before submission of the resolution plan;
- (d) has been convicted of any offence punishable with imprisonment for two years or more;
- (e) has been disqualified to act as a director under Companies Act 2013;
- (f) has been prohibited by the Securities and Exchange Board of India from trading in securities or accessing the securities markets;
- (g) has indulged in preferential or undervalued or fraudulent transaction in respect of which an order has been made by the National Company Law Tribunal; or
- (h) has executed an enforceable guarantee in favour of creditor, in

respect of a corporate debtor under Insolvency resolution process or liquidation under the Code.

Further, any 'connected person' in respect of persons mentioned above, shall also be barred from submitting resolution plan.

- A connected person for the purposes of the Bankruptcy Code means:
  - i) Any person who is promoter or in the management or control of the resolution applicant; or
  - ii) Any person who shall be the promoter or in management or control of the business of the corporate debtor during the implementation of the resolution plan; or
  - iii) The holding company, subsidiary company, associate company or related party of a person referred to in clauses (i) and (ii).
  - (iv) Has been subject to any disability, corresponding to above provisions, under any law in a jurisdiction outside India.
- The said amendment appears to be made in the light of the recent debates related to the credibility, both financial and legal, of the resolution applicants. The market has recently been polarized with respect to the eligibility criteria of the bidders submitting resolution plans for taking over stressed assets.
- The said amendment imposes stringent limits and constraints on potential suitors who are able to submit a bid for stressed assets. On the face of it, a number of potential applicants would stand affected by this amendment and it would now be obligatory on resolution applicants to disclose all details about themselves and the persons acting jointly with them for submission of resolution plans.
- The definition of 'connected person' may also result in unwarranted bar on certain financial investors'. Moreover, this amendment now affects and brings within its ambit persons who may have been affected by disabilities even in jurisdictions other than India.
- Imposition of such limits, whilst arguably warranted, will certainly affect price discovery and will reduce the ability of the creditors of the company to be able to recover their debts.

#### 5) Proviso on bar to committee of creditors to sell:

##### Amendment

Proviso to existing Section 30 (*dealing with submission of resolution plan*) has been inserted pursuant to which the committee of creditors shall not approve a resolution plan submitted before the Ordinance, if the resolution applicant is ineligible under Section 29A and if no other resolution plan is available, the resolution professional to invite fresh plan.

##### Analysis

- Per the Ordinance, committee of creditors have been barred from approving a resolution plan, which is submitted before the commencement of the Ordinance, but which is submitted by a resolution applicant who is ineligible by virtue of amendments made by way of the Ordinance. The Ordinance thus has retrospective effect and shall be applicable on the resolution plans that are already submitted and under consideration.
- While the intention may be to bring transparency and credibility to as many resolution plans as possible, such retrospective applicability may give grounds to applicants who have already submitted their resolution plans, to question the legality of the Ordinance before the Courts, thus resulting in further delay in the implementation of the resolution plan. This will further negatively affect the stringent timelines contemplated under the Bankruptcy Code.

#### 6) Bar on sale to person who does not satisfy the 'resolution applicant' test:

##### Amendment

Proviso to existing Section 35 (*Powers and Duties of Liquidator*) inserted that prohibits the sale of immovable property/movable property/actionable claim of the corporate debtor to any person not eligible to be a resolution applicant.

##### Analysis

- The liquidator is allowed to sell properties or actionable claims of a corporate debtor under insolvency to a person who is eligible to be a resolution applicant.
- The amendment ensures that the liquidator also ensures that the satisfaction of the criteria for being eligible as a resolution applicant is met before sale of any property which belongs to corporate debtor is made under the Bankruptcy Code.

#### 7) Punishment for contravention of the Bankruptcy Code:

##### Amendment

Section 235A inserted to the Bankruptcy Code which provides that any contravention of the Bankruptcy Code or

##### Analysis

- The referenced amendment shall ensure that the violation of any of the provisions enacted by the Ordinance, for which no specific penalty stands imposed already, shall be punishable with fine. The

the rules or regulations for which no quantum of the high fine shall act as a deterrent against any penalty or punishment has been violation.  
prescribed shall be punishable with fine  
of not less than INR 100,000 but which  
may extend to INR 20,000,000.

## 8) Further powers to IBBI:

### Amendment

The Ordinance amends the existing Section 240 (*Power to Make Regulations*) giving IBBI power for making regulations under Section 25(2) (h) and Section 30(4).

### Analysis

■ For the purposes of empowering IBBI for notifying any further regulations that may be needed to achieve the objective of the Ordinance, amendment has been to bring promulgation of regulations further to the newly inserted Section 25(2) and Section 30(4) within the scope of IBBI under Section 240.

## CONCLUSION

While the Ordinance is designed to streamline the process of credible bidding by removing the backdoor entry of promoters (and connected persons), the impact of the Ordinance in ensuring effective sale of stressed assets is yet to be seen. Imposing such wide eligibility criteria as sought to be done by the Ordinance, will restrict the number of participants and may affect price discovery.

## Impact on M&A

It will be interesting to see how promoters, who have defaulted due to factors beyond their control, especially in sectors like infrastructure (e.g. delay in obtaining approvals, litigations pertaining to land etc.), and now are barred from submitting resolution plans, choose to react to the Ordinance. Further, the ramifications of who is now rendered ineligible to participate may have unintended consequences and may bring within its fold financial investors.

One would expect parts of this Ordinance to be challenged by persons who fall under the *just introduced* Section 29A of the Bankruptcy Code, where those persons have already submitted resolutions plans prior to the Ordinance, which are under consideration. This may throw up its fair share of litigation at various Courts, which may effectively work to derail the ongoing time bound process under the Bankruptcy Code.

— Swati Sharma, M.S. Ananth, Sahil Kanuga & Pratibha Jain

You can direct your queries or comments to the authors

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<sup>1</sup>Sanjeev Shriya v. State Bank of India & others C. No. 30285 of 2017

<sup>2</sup> The Fourth All-India census of MSMEs published in 2011 reported a total of 36 million MSMEs

<sup>3</sup> <http://www.ibbi.gov.in/cirpregulation19.pdf>, last accessed on November 24, 2017

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