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EXAMINING THE VALIDITY OF DEBT RECOVERY LAWS AND AMENDMENTS IN INDIA WITH SPECIAL FOCUS ON INSOLVENCY AND BANKRUPTCY CODE

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Abstract

This comprehensive article focuses on the Insolvency and Bankruptcy Code, 2016, as implemented in India. It starts by introducing the concepts of insolvency and bankruptcy, followed by a discussion on various theories related to insolvency law, such as the creditor's bargain theory, communitarian theory and risk-sharing theory.

The background of the previous legal framework in India before the enactment of the Insolvency and Bankruptcy Code is also discussed, including laws related to company insolvency, debt recovery, and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

The research objectives outlined in the text include analyzing the processes and procedures for insolvency proceedings under the Insolvency and Bankruptcy Code, identifying any shortcomings, and suggesting improvements. The significance and importance of the study are emphasized, as the implementation of the Insolvency and Bankruptcy Code can have a profound impact on the economy and various stakeholders.

It further delves into the definitions of key terms related to insolvency proceedings under the Insolvency and Bankruptcy Code, such as claim, debt, creditor, default, secured creditor, and financial creditor. It also discusses the threshold for initiating insolvency proceedings and defines terms like corporate applicant and corporate guarantor.

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Overall, this article provides a detailed overview of insolvency and bankruptcy laws, particularly focusing on the legal framework in India and the implementation of the Insolvency and Bankruptcy Code, 2016.

INTRODUCTION

While every entrepreneur sets out to make a successful business and earn large profits, not every entrepreneur is successful in their endeavour. The failure of the business affects not only the business entity but also its creditors that have done business with the debtor and are now facing the prospect of attempting to recover the debts owed to them from the failed business entity. The failure of the business may be due to genuine circumstances beyond the control of the entrepreneur or the business entity such as the advent of a natural disaster, spread of a pandemic or unpredictable market forces.

However, it can also arise as a result of negligence or fraudulent activity on behalf of the business entity[2]. Regardless of the reasons, ultimately, creditors are left scrambling to recover the debts owed to them. In sucha scenario, insolvency and bankruptcy laws come into the picture. Insolvency and bankruptcy laws balance two priorities *i.e.*, firstly, repaying the creditors of the bankrupt entity to the maximum extent possible and secondly, to ensure that the bankrupt entity is put back on its feet and is able to continue with business operations as far as possible. While the first priority is important, recognition of the second priority is growing as well. If overtly harsh insolvency and bankruptcy laws lead to the legal death of the bankrupt entity, not only will the economy be deprived of a productive producer of goods or services while also rendering the employees ofsuch bankrupt entity jobless, but such dissolution of businesses will also discourage entrepreneurs from attempting to start business ventures which will reduce economic productivity. Therefore, insolvency and bankruptcy laws must, in terms of the societal and economic situation, balance interests of the creditors and the debtors. Before proceeding further, it is critical to have a basic understanding of the concepts and also the legal theories with regard to insolvency and bankruptcy.

- **BACKGROUND OF THE STUDY**

[2] M. S. Sahoo, *—Freedom to Exit Code builds the third pillar of economic freedom*, The Quarterly Newsletter of IBBI, 2016.

- **CONCEPT OF INSOLVENCY AND BANKRUPTCY**

Insolvency can be defined as the state when a person, juristic or otherwise is unable to repay obligations once they become due or when a person‘s properties are less than their liabilities. Whereas Bankruptcy, is a legal status determined by Courts/tribunals of law on the basis of the insolvency of a person. Legal orders are passed pursuant to determination of bankruptcy, so as to address the issue of insolvency.

Therefore, while a person may be insolvent, they will not be declared bankrupt until adjudication by a court of law/tribunal. However, a person who has become bankrupt, will certainly be insolvent.

Depending on the laws prevailing in the country, a person can be declared bankrupt on an application made before the courts of law/tribunals by the person itself or bya creditor whose debt has not been cleared.

The terms bankrupt and bankruptcy have been defined under the Insolvency and Bankruptcy Code, 2016 (hereinafter referred to as the **Code**‘), in part III under Section 79 (3) and (4) as follows:

—(3) bankrupt means— (a) a debtor who has been adjudged as bankrupt by a bankruptcy order underSection 126; (b) each of the partners of a firm, where a bankruptcy order under Section 126 has been made against a firm; or (c) any person adjudged as anundischarged insolvent

—(4) bankruptcy means the state of being bankrupt

- **THEORIES OF INSOLVENCY**

Various theories have been evolved regarding the aims & the ultimate purpose of insolvency law. These theories envisage a wide variety of goals & objectives for the insolvency process. For the purposes of the present study, it is critical to comprehend the purpose of insolvency proceedings. The various theories dealing with insolvency are discussed as follows.

Jackson proposed the creditors bargain theory which has gone on to become one of the most influential theories regarding corporate insolvency. Jackson posits that if the debtor and its creditors were rational, they would negotiate *ex ante* and would restrain their individual claims in favor of a collective debt collection mechanism. Bankruptcy as a collective mechanism would reduce the costs andwould maximise value. As per Jackson, bankruptcy procedure should aim for increase in efficiency of the debt collection process, increase in value of the debtor, and reduction of strategic cost in the debt collection process. The aim of bankruptcy procedure should not be to protect the rights of non-investors *i.e.*, persons whose claims will be damaged by the debtor's insolvency but do not enjoy s legal claim over the assets of the debtor[3]. Thereby larger interests such as those of the community need not be protected by insolvency law in terms of the creditor‘s bargain theory.

Rejecting the view that insolvency must only cater to the rights and interest of creditors of the debtor, Gross proposes the Communitarian Theory, as per which, the concerns of any and all people impacted by the debtor's insolvency need to be taken into account. The larger interests of the community also need to be considered with regard to the insolvency process[4].

Similarly, other scholars such as Warren and Korobkin seek to provide a value-basedaccount of insolvency not limited solely to consideration of the persons who are owed debts. Under this approach, examining bankruptcy solely as a reactiontowards the dilemma of debt collection is eschewed. A more holistic approach towards bankruptcy is proposed with bankruptcy being considered as a tool for rendering a complete response towards financial distress & not merely as a means for optimizing economic outcomes. Korobkin defines financial distress to not only include the economic distress suffered by a corporate entity but also the impact on the human participants. In Korobkin's view, bankruptcy is a tool to provide a larger perspective as well as reflective capacity so that conflicting values and interests between the participants may be resolved and rehabilitation may occur. Mokal, on the other hand, proposes the Authentic Consent Model under which a Rawlsian and contractual approach towards insolvency law is

[3] Thomas H. Jackson‖, ―The Logic and Limits of Bankruptcy Law‖ (2001).
[4] Karen Gross, *Taking Community Interests into Account in Bankruptcy: An Essay*, 72 Wash. ULQ1031 (1994).

undertaken. Under the model proposed by Mokal, the parties affected by insolvency, are said to be in a state of dramatic ignorance wherein they are ignorant of their own attributes, circumstances and also whether the debtor would actually be rendered insolvent circumstances, the stakeholders would select principles to govern insolvency which would equally safeguard the needs of all. Thereby, insolvency process should be conducted in such a manner and using such methods as would be approved by affected parties in a state of dramatic ignorance[5].

Blair & Stout[6] proposed the team production theory with regard to corporate governance and this theory was applied to corporate insolvency by Lopucki. In terms of this theory, the aim of bankruptcy procedure is not limited to maximising economic benefits for the shareholders and creditors of the debtor. The Parties constituting the corporation are considered akin to a team which leaves to the corporation's directors the authority for deciding the direction to be taken by the enterprise as well as the division of earnings amongst the team members, through an agreement or contract between the team members. The bankrupt corporate must protect interests of the creditors or shareholders and also seek to fulfil its commitments towards persons making investment at a request of the corporate & which investment could not be protected otherwise by the corporate.

Risk Sharing theory was proposed by Jackson and Scott. This theory seeks to explain corporate insolvency in terms of the risks shared by parties arising from potential business failure of the debtor. It is proposed that the creditors would agree to distribute risks for a debtor‘s failure and the party, which is best capable of dealing, mitigating or controlling a particular type of risk, is left to bear it. In the case of management failure, the shareholders would be in the best position to deal with the associated risks as they would be in a position to supervise the functioning of the management of the debtor corporation. However, for common risks, allcreditors would agree to share them on a common basis as no specific and individualstrategy could be carved out for them.

[5] Rizwaan Jameel Mokal, The Authentic Consent Model—Justifying the Collective Liquidation Regime(2001)
[6] Margaret M. Blair & Lynn A. Stout,*Team production in business organizations: An introduction*, 24 J. Corp. L. 743 (1998).

- **BACKGROUND OF THE PREVIOUS LEGAL FRAMEWORK EXISTING IN INDIA**

Before the Code was enacted, the recovery of debts and Bankruptcy as well as initiation of Insolvency, tended to be governed by a network of laws in India. For corporations, the Companies Act, 1956, governed the playing field. With regard to people living within the territory of the former ―presidency towns of ―Calcutta, Bombay & Madras, the governing law was the ―Presidency Towns Insolvency Act, 1909, while the ―Provisional Insolvency Act, 1920, was applicable to everyone else.[7] Apart from the above, the ― Sick Industrial Companies (Special Provisions) Act, 1985 was also applicable with regard to industrial companies with 60 months of history whose net worth was zero or negative, having 50 or more workers whereby the provision for proposing debt restructuring was given to the companies suffering under debt. The Recovery of Debts Due to Banks and Financial Institutions Act, 1993, was also passed to facilitate retrievalof loans.

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, also granted, an opportunity to quickly recover secured assets without the intervention of the Court from debtors. Apart from these laws, the ―Reserve Bank of India had also introduced ―Corporate Debt Restructuring Scheme (**CDR Scheme**) which provided guidelines by which debtrestructuring was to be undertaken by the banks.

The enactment of the Code was a reaction to the surge of defaulted debts. The Code introduces a comprehensive mechanism for persons undergoing Corporate Insolvency Resolution Process and also provides for liquidation, in cases wherein creditors failed to agree to a resolution.

Insolvency processes for corporate persons

Preliminary issues as well as definitions are dealt with in Part I while Part II deals with the Corporate Insolvency Resolution Process (hereinafter referred to as the **CIRP**‘) and liquidation. While the previous chapter served as an introduction for the entire research, the present chapter analyses the CIRP and the liquidations process as well as ―pre-packaged

[7] IBBI, Handbook on ―Understanding the IBC: Key Jurisprudence and Practical Considerations‘‘ (2020).

insolvency resolution process (**PIRP**‘), fast track CIRP and voluntary liquidation for Corporate Persons and analyses the same.

PRELIMINARY PROVISIONS

Certain important definitions under the Code are discussed as follows. Claim has been defined to mean a right to payment, whether or not such right is reduced to judgment, fixed, disputed, undisputed, legal, equitable, secured, or unsecured and also includes the right to remedy for breach of contract under any law for the time being in force, if such breach gives rise to a right to payment, whether or not such right is reduced to judgment, fixed, matured, unmatured, disputed, undisputed, secured or unsecured.[8] A person has been defined to include an individual, a Hindu Undivided Family, a company, a trust, a partnership, limited liability partnership and any other entity established by a statute and includes a person resident outside India. A corporate person has been explained to be a company as defined in clause (20) of section 2 of the Companies Act, 2013 (18 of 2013), a limited liability partnership, as defined in clause (n) of sub-section (1) of section 2 of the Limited Liability Partnership Act, 2008 (6 of 2009), or any other person incorporated with limited liability under any law for the time being in force but shall not include any financial service provider. Furthermore, corporate debtor has been explained to be a corporate person who owes a debt to any person. A debt‖ has been explained to be a liability or obligation in respect of a claim which is due from any person and includes a financial debt and operational debt. A creditor has been explained to be any person to whom a debt is owed and includes a financial creditor, an operational creditor, a secured creditor, an unsecured creditorand a decree-holder. Default has been explained to mean the non-payment of debtwhen whole or any part or instalment of the amount of debt has become due andpayable and is not paid by the debtor or the corporate debtor, as the case may be.

Secured creditor means a creditor in favour of whom security interest is created. Security interest, on the other hand, ―means right, title or interest or a claim to property, created in favour of, or provided for a secured creditor by a transaction which secures payment or

[8] V. S. Wahi, Treatise on Insolvency & Bankruptcy Code (2017).

performance of an obligation and includes mortgage, charge, hypothecation, assignment and encumbrance or any other agreementor arrangement securing payment or performance of any obligation of any person. Provided that security interest shall not include a performance guarantee. In order to initiate insolvency proceedings, the threshold for default is rupees 1crore. Constitutional document refers to, in relation to a corporate person, includes articles of association, memorandum of association of a company and incorporation documents of a Limited Liability Partnership[9]. Corporate Applicant refers to the corporate debtor, or a member or partner of the corporate debtor who is authorised to make an application for the corporate insolvency resolution process or the pre- packaged insolvency resolution process, as the case may be under the constitutional document of the corporate debtor or, an individual who is in charge of managing the operations and resources of the corporate debtor, or a person who has thecontrol, and supervision over the financial affairs of the corporate debtor. A corporate guarantor has been explained to be a corporate person who is the surety in a contract of guarantee to a corporate debtor.

Dispute has been explained to be any suit or arbitration proceedings relating to the existence of the amount of the debt or the quality of goods or services provided or the breach of a representation or warranty.

A financial creditor is any person to whom a financial debt is owed and includes a person to whom such debt has been legally assigned or transferred to; Furthermore, a financial debt is means a debt along with interest, if any, which is disbursed against the consideration for the time value of money and includes money borrowed against the payment of interest, any amount raised from an allottee under a real estate project shall be deemed to be an amount having the commercial effect of a borrowing *etc*. An operational creditor has been explained to be a person to whom an operational debt is owed and includes any person to whom such debt has been legally assigned or transferred. Furthermore, operational debt is a claim in respect of the provision of goods or services including employment or a debt in respect of the payment of dues arising under any law for the time being in force and payable to the Central Government, any State Government or any local authority. The insolvency resolution

[9] Ministry of Corporate Affairs, Notification No. S. O. 1205(E) (Issued on 24.03.2020).

process costs are the amount of any interim finance and the costs incurred in raising such finance, the fees payable to any personacting as a resolution professional (**RP**‘), any costs incurred by the RP in running the business of the corporate debtor as a going concern, any costs incurred at the expense of the Government to facilitate the insolvency resolution process and any other costs as may be specified.

PIRP costs are the amount of any interim finance and the costs incurred in raising such finance, the fees payable to any person acting as a resolution professional and any expenses incurred by him for conducting the pre-packaged insolvency resolution process during the pre-packaged insolvency resolution process period, any costs incurred by the resolution professional in running the business of the corporate debtor as a going concern, any costs incurred at the expense of the Government to facilitate the pre- packaged insolvency resolution process and any other costs as maybe specified[10]

A related party with regard to a corporation is:

- *a director or partner of the corporate debtor or a relative of a director or partner of the corporate debtor;*
- *a key managerial personnel of the corporate debtor or a relative of a key managerial personnel of the corporate debtor;*
- *a limited liability partnership or a partnership firm in which a director, partner,or manager of the corporate debtor or his relative is a partner;*
- *a private company in which a director, partner or manager of the corporate debtor is a director and holds along with his relatives, more than two per cent. of its share capital;*
- *a public company in which a director, partner or manager of the corporate debtor is a director and holds along with relatives, more than two per cent. of its paid- up share capital;*

CONCLUSION

The present study has examined the provisions of the Code as well the provisions of certain foreign laws with regard to insolvency and bankruptcy and various judgments

[10] Code, §5(23C) (May 28, 2016).

connected to the aforesaid, in order to fulfil the research objectives as set out in the introduction. The present conclusion discusses the core findings arrived at in the study. Thereafter, the various suggestions for streamlining and improving the Code as discussed in the previous chapters are brought forth and summarised.

SUGGESTIONS WITH REGARD TO THE INSOLVENCY AND BANKRUPTCY CODE, 2016

In the present section, the aforesaid suggestions are consolidated and summarised as follows:

- One of the major delays in ―insolvency‖ and ―bankruptcy‖ processes is delay in resolving litigation due to lack of adequate judicial structure and failure to appoint the members of the AAs in a timely fashion. If the timelines under the Code are to be adhered to which, is essential, to maximise a debtor's value, the judicial infrastructure must be strengthened and must not be allowed to wither away. The sanctioned strength of the members of the AAs must be maintained at all times and prior to the retirement of any member, the recruitment process should already be initiated so that at most, within two weeks of the retirement of the member, a replacement is appointed. Furthermore, the AAs must be encouraged to record reasons for delay in adjudication beyond the timelines specified under the Code mandatorily to reduce frivolous delays and to ensure transparency. Another aspect with regard to judicial delays is the fact that the regard to the NCLAT and the NCLTs which are the AAs with regard to debtor corporations, the aforesaid tribunals are burdened with various non-insolvency matters which increases the burden on the aforesaid tribunals. Thereby, the NCLAT and the NCLTs should be solely vested with insolvency matters and other matters such as matters with regard to Companies Act, 2013, and the Competition Act, 2002, should be transferred to dedicated tribunals setup for such purpose.

- Non-cooperation by the debtor or their employees should be discouraged by empowering the AAs to impose heavy fines for each day of delay caused by such wilful non-cooperation by the debtor or their employees.
- A period of limitation should be provided for challenging the sanction of a resolution plan‖. In the present scenario, in the time taken by the AAs to decide the sanction of a ―resolution plan‖, more objections are filed while the resolution plan is pending approval which further delays the process.
- Duplication of effort under the insolvency and bankruptcy process should be avoided. For example, the IRP authenticates ―claims‖ of ―creditors‖ during CIRP but during a liquidation process, the entire claim submission process is initiated from scratch. The liquidator should carry on with the liquidation process with the claims of the creditors as verified by theIRP and the RP unless any claim is objected to or is sought to be rectified by any party or by the liquidator *suo moto*.