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Bankruptcy practice in India

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ABSTRACT

The bankruptcy framework prevailing in India, traces its roots back to colonial rule. That framework has undergone a number of amendments over the past 200 years, creating a plethora of overlapping and sometimes conflicting articles. The latest attempt at reconciliation of these various Acts was made under the Companies Act, 2013. This paper drives through the land mark amendments in the history of India, leading to the current bankruptcy framework. Each Act is discussed based on the requirements, procedures and outcomes post enactment. Also, the major pros and cons of the different Acts are identified, and a critical analysis is presented of the latest Act, Companies Act, 2013. Moreover, the provisions of Chapter 7 and Chapter 11 of the U.S Bankruptcy Framework are compared against the provisions of these Acts. The paper then presents a diluted, easy to understand, step by step procedure of the current bankruptcy framework. Followed by a case analysis of a recent prominent Bankruptcy, to elicit the issues in the current framework. In conclusion, a list of recommendations is presented, to improve the Bankruptcy Framework in India.

1. Introduction

As of July 1st 2014, India accounted for 17.5% of world population, with a UN estimated head count of over 1.26 billion. Measured in terms of purchasing power parity, India's GDP of $7.376 trillion (compared with $1.877 trillion by standard counting) ranks it the third largest economy in the world. Clearly India bulks large in the global scene.

With its wealth and resources, India has always been a fertile ground for entrepreneurial inceptions and foreign establishments. As of July 2013, India had over 1.3 million registered companies. Of these, 0.26 million companies have been closed for various reasons such as bankruptcies and liquidations. According to the Department of Industrial Policy and Promotion (DIPP), the total foreign investment inflows soared by 24.5% to $ 44.9 billion during FY2015, from $ 36.0 billion in FY2014.

The above noted massive corporate and financial services with comparably large dissolutions, call for a commensurate bankruptcy framework. The current Indian bankruptcy framework is, however, arrantly disorganized. In a recent statement, the finance minister, Arun Jaitley has identified the reformation of the current bankruptcy system as a key priority for the overall development of the country.

2. Overview

The Indian bankruptcy procedures are extremely time consuming and resource intensive. Their inefficiencies, resulting from excessive regulation of economic activity, have accumulated ever since India's independence. Indian post-independence industrial policies, such as limited private ownership, industrial licensing and import substitution led many financially unviable firms to consider exit or restructuring options. However, the existing social, political, and legal system did not contain an appropriate framework for fair and systematic resolution of insolvency cases. This has substantially slowed the pace of the much needed industrial restructuring.[1]

Over the years, several changes have been made to the bankruptcy system and its underlying procedures. Nonetheless, no single comprehensive and integrated policy on corporate bankruptcy in India compares to the Chapter 11 (reorganization) or Chapter 7 (liquidation) bankruptcy code in the US. Four separate agencies, the High Courts, the Company Law Board, the Board for Industrial and Financial Reconstruction (BIFR), and the Debt Recovery Tribunals (DRTs), have overlapping authorities, which creates systemic delays and complexities in the process.[2] Three important legislative acts and a number of special provisions lay out procedural guidelines for the liquidation or reorganization process.

Formal insolvency laws in India can be traced to "The Presidency Towns Insolvency Act 1909" and "Provincial Insolvency Act, 1920". These Acts dealt with non-trader insolvency/consumer insolvency. Corporate/Trader insolvency is dealt with under the Companies Act, 1956, which is a landmark in Indian Insolvency Law system. After a series of amendments and transitions of different laws dating back to the

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[1] Nimrit Kang and Nitin Nayar, The evolution of corporate bankruptcy law in India, March 2004.
[2] Omkar Goswami, Corporate Bankruptcy in India—A comparative perspective, January 1996.

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Government of India Act 1800, the numerous fragments of Corporate Insolvency laws converged into the Companies Act, 1956. The intent of this law was to consolidate the various laws for the "new" post-independence India of 1947. The Companies Act, 1956 saw major amendments in 1988 on recommendations of the Sachar Committee, followed by amendments in 2002 based on recommendations of Eradi committee report. Finally the companies Bill 2009 set out a list of amendments to the Companies Act, 1956 with the intent to recreate a leaner version of the original Companies Act, 1956.

Herein, we shall discuss the implications of various bankruptcy reforms that have been implemented in India. We will observe how these reforms molded the Indian bankruptcy system into its current, far from ideal form. We conclude with a detailed review of a prominent recent bankruptcy case.

3. Indian Insolvency Laws

3.1. Companies Act, 1956

The Companies Act of 1956 is a detailed piece of legislation modelled after the British Companies Law. It grants a variety of monitoring and regulatory powers to the federal/union government and the High Courts. According to the guidelines laid out under this Act, liquidation of a company facing financial distress can be accomplished in two ways: voluntary liquidation by creditors or involuntary liquidation by the court.

The former, voluntary liquidation, is a more efficient process that proceeds after shareholders vote for liquidation. Control of the liquidation process is handed over to secured creditors. These secured creditors, then, appoint either a private or official liquidator who oversees the sale of assets and distribution of proceeds. The latter, involuntary liquidation, is a less efficient and a more time consuming process. Any creditor with a minimum of INR 500 unpaid and undisputed debt (US $8), upon giving three weeks' notice to the company, can petition the court for involuntary liquidation. The court, then, validates the claims and the fairness of the petition before ordering liquidation. The court, acting with pure discretion, has the authority to decline the petitioners claim to hold the company insolvent on "considerations including that of public interest".[3]

The debtor remains in possession of the assets while the court decides the case. However, as soon as the winding-up is ordered by the court, an official liquidator (appointed by the court, usually a government employee) takes control of the process, which includes claiming and selling assets, recovering preferential payments made, and settling the company's liabilities. During settlement of claims, highest priority is given to secured creditors and workers'/employees' back wages, followed by government and administrative claims like severance pay of employees and pension benefits. The residual is used to settle claims of unsecured creditors and equity holders. Unlike the US bankruptcy code, no provision exists for an automatic stay[*] in the period between filing of the petition and ruling by the court. This period, which can last up to a year, is characterized by a delirium of lawsuits by all types of borrowers. In fact, in some cases, creditors even resort to sale of those debtor's assets which they hold in their possession. The result of this chaos is a further wastage of time, as the courts have to deal with these actions before giving an equitable judgement in the overall case. The fraudulent transfers and preferential payments made within the six month period, spanning from the time when the liquidation petition was filed, are dealt in the same manner as in the US bankruptcy code. In addition, a provision for restructuring limited to either a merger and acquisition strategy or a voluntary compromise arrangement between the company and the creditors may be used in order to change the capital structure, if authorized as part of a compromise. The proposal for compromise can be made by one or more of the involved parties, which include creditors, management, government and the official liquidator. Such a complaint must be approved by the court, as the court supervises the implementation of the compromise. Note that unlike the "cramdown" concept adopted as part of the US Chapter 11 reorganization plan, the compromise here is not enforced by the court, and is actually carried out only when approved by the creditors.

Though it has been amended a number of times over the years, the Companies Act, 1956 holds a major share of active judicial clauses. The Ministry of Corporate Affairs annual report as shown below, released the count of petitions received, disposed and pending over the year 2010–2011. The Companies Act, 1956 performs fairly impressively by disposing 10,798 cases in 2010, but it still ended with a pending balance of 2853 cases.

Consolidated Statement of Petitions/Applications Received, Disposed of and Pending for the period 01.04.2010 to 31.12.2010 under Companies Act, 1956.

	Previous balance	Receipts	Disposal	Pending
Filed Under Companies Act, 1956	4549	9102	10,798	2853

Calculated on data retrieved from "*Ministry of Corporate Affairs, Annual Report, 2010–2011*".

3.2. Sick Industrial Companies Act (SICA), 1985

This Act establishes a comprehensive legal framework for reorganizing the activities of a sick industrial organization. As defined under SICA,[4] a company is considered "sick" if it: a) has been registered for at least seven years, b) has incurred cash losses for two consecutive years, including the current year, c) has cumulative losses that amount to more than its net worth. However, through an amendment to SICA, passed in 1993, condition a) was revised to reduce the limitation of registered duration to 5 years, and condition b) was eliminated.

Under this Act, in order to ensure timely detection of "sick" industrial organizations and provide the required intervention, a quasi-judicial body—the Board for Financial and Industrial Reconstruction—was constituted. The application for intervention must be filed by the Board of Directors within 60 days "from the finalization of audited accounts of the year in which the company has fallen sick".[5] Once the application has been filed, the BIFR exercises one of three options: a) approve a management/creditor sponsored plan without concessional financing, b) determine unviability of the business and recommend liquidation to the court or c) claim that the firm must be reconditioned in the public interest, and approve a plan requiring major concessions and sacrifices from various parties including subsidies from the government. In options b) and c), to determine the viability of the company and propose a turnaround plan, the BIFR appoints the largest secured lender as the operating agency (OA).

Concomitantly, an automatic stay is granted against all claims, suits and legal proceedings against the "sick company", but the debtor remains in possession of the assets. The management or the creditors can challenge in the court, any action prescribed by the BIFR. The courts often refer the case back to the BIFR for further review, which leads the case into a vicious circle.[6]

[3] Mitra, N. L., 2001, "Report of The Advisory Group on Bankruptcy Laws," May 9, 2001, available from the Reserve Bank of India, http://www.rbi.org.in/ s/20,811.pdf.

[*] In United States bankruptcy law, an ***automatic stay*** is an automatic injunction that halts actions by creditors, with certain exceptions, from collecting debts from a debtor who has declared bankruptcy. Under section 362 of the United States Bankruptcy Code, the stay begins at the moment the bankruptcy petition is filed. Secured creditors may, however, petition the bankruptcy court for relief from the automatic stay upon a showing of cause.

[4] SICA 1985, "Regulatory Requirements: SICA", June 2000, available from http://business.gov.in/closing_business/sica.php.

[5] Mitra, N. L., 2001, "Report of The Advisory Group on Bankruptcy Laws," May 9, 2001, available from the Reserve Bank of India, http://www.rbi.org.in/ s/20,811.pdf.

[6] Nimrit Kang and Nitin Nayar, The evolution of corporate bankruptcy law in India, March 2004.