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CORPORATE INSOLVENCY WITH SPECIAL REFERENCE TO INDIA*

INTRODUCTION

Insolvency means the inability to pay one's debts as they fall due.[1] Usually used to refer to a business, insolvency refers to the inability of a company to pay off its debts.

Business insolvency is defined in two different ways:

(i) Cash flow insolvency: Unable to pay debts as they fall due.
(ii) Balance sheet insolvency: Having negative net assets – in other words, liabilities exceed assets.

A business may be 'cash flow insolvent' but 'balance sheet solvent' if it holds illiquid assets, particularly against short term debt that it cannot immediately realize if called upon to do so. Conversely, a business can have negative net assets showing on its balance sheet but still be cash flow solvent if ongoing revenue is able to meet debt obligations, and thus avoid default: for instance, if it holds long term debt. Many large companies operate permanently in this state. Insolvency is not a synonym for bankruptcy, which is a determination of insolvency made by a court of law with resulting legal orders intended to resolve the insolvency. Insolvency is defined both in terms of cash flow and in terms of balance sheet in the UK Insolvency Act 1986, Section 123, which reads in part:[2]

> *123. Definition of inability to pay debts*
>
> *(1) A company is deemed unable to pay its debts*
>
> *(e) if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due.* This is known as cash flow insolvency.
>
> *(2) A company is also deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.* This is known as balance sheet insolvency[3]

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[1] Downes, John, and Jordan Elliot. Goodman. *Dictionary of Finance and Investment Terms*. Hauppauge, NY: Barron's Educational Series, 2003. Print.

[2] Article named "United Kingdom - The Insolvency Act 1986: Company Insolvency - Companies Winding Up: Part Iv - Winding Up Of Companies Registered Under The Companies Acts". Retrieved on 7th February, 2016 at 2 pm

[3] Sara Isham, "UNCITRAL's Model Law on Cross-Border Insolvency: A Workable Protection for Transnational Investment at Last", 26 Brook. J. Int'l L. 1187 (2001)

Insolvency can affect people or corporations legally. If you are in a legal situation involving insolvency issues, it is important to hire a qualified professional lawyer. Seek out lawyers with bankruptcy and insolvency experience if you are an individual dealing with a corporate insolvency claim. The term insolvency applies to both people and companies, but generally the word bankruptcy is applied to individuals. The terms come from laws in the United Kingdom. There the bankruptcy laws have a relative set of principles that are applied to both personal and other kinds of insolvency.

There are ten basic principles to keep in mind in reference to corporate insolvency law. They are having complex interpretations which make it important to hire a professional lawyer for legal matters.

1) The rights under the general laws are accrued before any liquidating of assets begins.
2) The creditors may only seize properties or assets belonging to the company with the outstanding debt.
3) Any real world holdings or security interests that were made before the insolvency are not affected.
4) Those in charge of liquidation are subject to any limitations upon the assets.
5) The right to take the money from liquidation supersedes any personal rights or claims.
6) The company is no longer the owner of the assets at the point of liquidation.
7) No creditor is allowed personal interest in the business assets or their outcomes.
8) The creditor has the right to quickened payments due to the liquidation process.
9) There is equal rank or place for unsecured creditors.
10) Individual members of a company are not in whole held responsible for the debts, but only to a lesser amount.[4]

The issue of corporate insolvency has attained great significance with the globalization of economy. In recent times, there has been a massive growth of retail loans to individuals, housing loans and credit card users in India. In this background, a need has been felt for bringing about reforms in the sphere of law of insolvency. The basic objectives of corporate insolvency are to restore the debtor company to profitable trading where it is practicable; to maximize the return to creditors as a whole where the company itself cannot be saved; to establish a fair and equitable system for the ranking of claims and the distribution of assets among creditors, involving a redistribution of rights; to provide a mechanism by which the causes of failure can be identified and those guilty of mismanagement brought to book; placement of the assets of the company under external control; substitution of collective action for individual pursuits; avoidance of certain transactions and fraudulent conveyances, dissolution and winding up etc. Under the provisions of the Companies Act, 1956, a company is liable to be wound up when is unable to pay its debts. A company is said to be unable to pay its debt and the Registrar of Companies makes out a case of inability to pay debts when a company's entire capital is lost in heavy losses and no accounts are prepared and filed and no business is done for one year. The court established under Companies Act has the jurisdiction to deal with corporate insolvency. The Board for Industrial & Financial Reconstruction deals with the distributive and rehabilitative aspects of insolvency. When

[4]LoPucki Lynn M., "*Cooperation In International Bankruptcy: A Post-Universalist Approach*", Cornell Law Review, March, 1999. p. 698

BIFR finds that company is not capable of revival, it sends a report to the court with a suggestion to commence insolvency proceedings in accordance with the Companies Act. Upon winding up of the company, the custody of the company's property and its vesting is transferred to the Official Liquidator.[5]

1.1. Indian Corporate Insolvency Law

Indian insolvency law failed to keep pace with the domestic and international developments. Both, the Companies Act, 1956 under which winding up of companies is carried out and Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) which deals with revival of companies fail to capture the true relevance of the insolvency law besides not meeting the dynamics of the modern economic system. The two laws were enacted to cater to meet the expectations of industries thriving in a protectionist environment unexposed to competition in a closed economy. Both the laws do not provide for engagement of professionals and their skills in the insolvency system. Thus, the winding up of companies remains a long drawn affair. It takes years in obtaining the statement of affairs, books of account, records and assets, realization of debts and sale of assets, settlement of list of creditors and contributories, distribution of assets to creditors, members etc. before a company is finally dissolved with the sanction of the court. In the process, substantial corporate assets remain unrealized and undistributed. The inordinate delay in proceedings mars the possibilities of rapid use of productive assets lying dormant throughout the country. The provisions of SICA have been abused by erring debtors to seek protection and moratorium from recovery proceedings. The unscrupulous promoters are easily able to enter into the reference, sometimes by manipulating their accounts to reflect net worth erosion and are then able to attract immunity against the recovery action by the creditors and this benefit is then attempted to be perpetuated. Registration of reference is dependent upon the erosion of net worth and this may be achieved by accounting manipulations. There is no fear of reprisal or punitive action against the companies indulging in this malpractice. The inefficiency of the laws led to erosion of the confidence of the key stake holders viz. the creditors who sought alternate measures to recover their assets. A need has been felt for long for bringing about reforms in this law. 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 instance, 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.[6] 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, which is a quasi-bankruptcy proceeding. The provisions of the SICA have been

[5]Retrieved from http://www.lexuniverse.com/insolvency-laws/india/Corporate-Insolvency.html on 12th February 2016 at 10 p.m

[6]Press Information Bureau, Government of India, Latest Releases, Justice Eradi Committee on Law Relating to Insolvency of Companies.

merged into the Companies Act, 1956. 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 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 may deliver equitable justice. There is a provision for professionals to be appointed as OL.

The statement of affairs, 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 the perspective of consistency, of at least two significant related fields – reorganization 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, 1956, 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 s. 424A will be applicable, and those under which a winding up order may be passed under s. 433. For instance, 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 must be the first consideration and those where liquidation will be ordered. For instance, under the US Bankruptcy law, the court must be satisfied that the recoveries under are organization 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 statutes in India, including the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interests Act, 2002, in case of secured creditors being banks and financial institutions, Recovery of Debts due to Banks and Financial Institutions Act, 1993, in case creditors being banks or financial institutions, State Finance Corporations Act, 1951, 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 pre-serve. 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 The Companies Act, 1956, ss. 529 and 529A. 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 must not be true in cases which will certainly lead to winding up. For instance, if floating charge holders 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 ss. 529 or 529A seek to preserve are completely frustrated.

1.1.1. Insolvency Laws Under The Companies Act, 2013

Under the Constitution of India '*Bankruptcy & Insolvency*' is mentioned under Entry 9 in List III - Concurrent List,[7] i.e. both Centre and State Governments can make laws relating to this subject. Insolvency is a ground of Winding Up and in India the process of winding up of companies is regulated by the Companies Act and is under the supervision of the court.

Although Article 19 (1)(g) of the Constitution of India gives freedom to practice any profession or to carry on any occupation, trade or business to the citizens of India, there are restrictions on closure of any industrial undertaking. Such restriction is justified on the ground that it is in public

[7] Article 246 –Seventh Schedule to The Constitution of India, 1950

interest to prevent unemployment. As a result of such policy there is a freedom to undertake any industrial activity, but there is no freedom to exit.[8]

The term 'insolvency' has not been defined anywhere under the Companies Act, 1956 (as mentioned before) and the term appears under Section 433 of The Act[9] being a ground for compulsory winding up of a company, meaning, unable to pay off its debts. The inability to pay debt amplified in Sec 434[10]31i.e. when a creditor with due of Rs. 500[11] or more serves a demand by registered post; company neglects to pay, secure or compound the same in 3 weeks; Execution of a decree in favour of a creditor returned unsatisfied in whole or in part or Court is otherwise satisfied that the company is unable to pay debts and in determining the inability to pay the debts the Court will take into account the Companies prospective and future liabilities. As observed by the Court in a case[12]

"Test is commercial insolvency, based on prevailing assets and prevailing liabilities; test based on current assets; whether the company can remain a going concern".

Sec 446[13] provides for stay on all suits; the winding up court to decide all suits by and against the company. The corresponding section 279 of the Companies Act requires time bound disposal i.e. within 60 days by the tribunal of any application seeking leave to commence or proceed with suit or other legal proceedings. Priority is decided by statutes and generally speaking, there are three categories according to their priority; claims with preference, secured claims and unsecured claims.

In insolvency procedure, shareholders rights are placed under the unsecured creditors. Wage claims have priority with that of secured claims in the Indian insolvency laws. Tax and government interests, however, have been considered in different way. Nobody wants to lose its interest even in the insolvency procedure. It is also true to the government. Most countries put the tax claims on the high priority over the secured claims. There are pros and cons on the high priority of tax. The comparison and evaluation between public interest and private interest is a matter of policy choice in nature. In India tax and Government interest are placed below the secured claims. The debts due as workmen's dues and the claims of the secured creditors sacrificed to workmen have an overriding preferential claim or priority to all debts.

The debts payable shall be paid in full, unless the assets are insufficient to discharge the liabilities, subject to *pari passu* charge on pro rata basis. The main purpose for insertion of such a provision is to ensure that the workmen should not be deprived of their legitimate claims in the event of the liquidation of the company. The workmen of the company is treated as secured creditors in respect of their claims against the company and the assets of the company would remain charged for the payment of the workers' dues and such charge will be *pari passu* with the charge of the secured creditors. Under section 529A of the Companies Act 1956 which corresponds to Section 326 of the Companies Act 2013 that the dues to the secured creditors are to be treated pari passu, and have to be treated as prior to all other dues.

[8] *Ibid*

[9] Companies Act, 1956 which Corresponds to Section 271 of Companies Act 2013

[10] Corresponds to Section 271 of the Companies Act 2013

[11] Amended to INR 1,00,000, not effective

[12] Amalgamated Commercial Traders 35 Comp. Case 456 (SC)

[13] of The Companies Act, 1956 which corresponds to Section 279 of The Companies Act 2013

The principle underlined under section 530 of the Companies Act 1956[14] is that the debts and liabilities, other than those mentioned in section 529-A, should be treated as preferential debts. However, after coming into force of section 529-A, debts and claims enumerated under that section will have priority even over the preferential claims enumerated under this section.

Therefore, only if there is any balance left after satisfying the claims under section 529A will the State or other creditors get any share. Rule about secured creditors and workmen[15] under the Act states that Secured creditor may opt to prove his debt and if affirmative, secured creditors and workmen have pari passu interest in the value of a security.[16] Workmen's dues include wages, holiday pay, retrenchment compensation, dues from employee benefit fund maintained by the company. If secured creditor realizes his security, he will cede a rateable proportion for workmen's claims to the extent of the sacrifice the secured creditor makes for workmen's portion, his claim becomes a an overriding preferential claim.[17] The stacking order of priority during Corporate

> Insolvency is that first comes the workmen and secured creditors to the extent they sacrificed their interest to the workmen[18], and then comes the costs and expenses of winding up[19], preferential creditors and lastly the unsecured creditors.
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> The *pari passu* principle is said to be the "the foremost principle in the law of insolvency around the world".[20]

1.1.2. Application Of Insolvency Rules In Winding Up Of Insolvent Companies

The Companies Act, 1956, s. 529 applies only to insolvent companies. A company is insolvent if its assets are insufficient to meet its liabilities after the costs and expenses of the winding up have been paid. Rules of insolvency apply to secured and unsecured creditors by virtue of s. 529(1)(c). Rules of insolvency means the principles which regulate the affairs in insolvency proceedings which are rules contained in the Presidency Towns Insolvency Act, 1909, ss. 46-50 and the Provincial Insolvency Act, 1920, ss. 45-50.

In *Allahabad Bank* v. *Canara Bank*,[21] the Supreme Court noted that secured creditors fall in two categories: (1) those who desire to go before the company court; and (2) those who like to stand outside the winding up. In so far as the first category was concerned the insolvency rules applicable are those contained in the Provincial Insolvency Act, 1920, ss. 45 to 50. S. 47(2) states that a secured creditor who wishes to come before the official liquidator has to prove his debt and he may prove his debt only if he relinquishes his security for the benefit of the general body of creditors. In that event, he will rank with the unsecured creditors and has to take his dividend as provided in s. 529(2). As regards the second category, proviso to s. 529 provides that where a

[14] Section 327 of Companies Act 2013

[15] Workmen defined with reference to Industrial Disputes Act

[16] Section 529(1) of the Companies Act, 1956 which correspond to Sec 325 of the Companies Act,2013

[17] Sec. 529A of the Companies Act 1956 corresponding to Section 326 of the Companies Act, 2013, Workmen's dues, and the claims of secured creditor sacrificed to workmen are over-riding preferential claims

[18] Ibid

[19] Sec 327 of the Companies Act, 2013

[20] Andrew Keay and Peter Walton, *"The preferential debts regime in liquidation law: in Public Interest"* [1999],C.f.i.L.R. 84, 85.

[21] *Allahabad Bank* v. *Canara Bank* AIR 2000 SC 1535.

secured creditor instead of relinquishing his security and proving his debts, opts to realize his security: (1) the liquidator will be entitled to represent workmen and enforce such charge; (2) any amount realized by the liquidator by way of enforcement of such charge will be applied ratably for the discharge of workmen's dues; and (3) so much of the debt due to such secured creditor as could not be realized by him by virtue of above provisions or the amount of workmen's portion in his security whichever is less will rank *pari passu* with workmen dues for the purpose of s. 529A

1.2. Basic Philosophy Of The Corporate Insolvency 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 corporate, the first issue that any insolvency regime must confront is if it would be in the 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 power houses that their removal from the scene might affect many; including workers, consumers and even the whole system might be at stake. As corporate 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.[22] 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.

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 this is also the position under the UK Insolvency laws, Under the US Bankruptcy Code, however, commencement of bankruptcy petition puts a stay on the rights of the secured creditor: Bankruptcy Code, Title 11, s. 362most significantly, take care of interests of some interest groups such as workers and preferential creditors. Individual pursuits by creditors may be totally insensitive to claims of other creditors, particularly unsecured creditors and workers.

1.3. Scheme Of Insolvency Laws

The stream of insolvency laws may be segregated chiefly under two heads: personal insolvency, which deals with individuals and partnership firms governed by Provisional Insolvency Act, 1920 and Presidency Towns Insolvency Act, 1908 and corporate insolvency, whose consequence is winding up of the company under the Companies Act, 1956. In the process of liberalization, deregulation and adopting market economy, India is experiencing a massive growth of retail loans to individuals, housing loans and credit card users. On account of phenomenal rise in retail lending it will be necessary in the near future to give a re-look at the personal insolvency laws to ensure that any insolvency proceedings against individuals are also expeditiously decided. However, the

[22] *M K Ranganathan* v. *Government of Madras* AIR 1955 SC 604; see old ruling of James L J in *Re David Lloyd and Company* (1877) 6 Ch. D. 339.

basic tenets of corporate insolvency may be classified as: restoring the debtor company to profitable trading where it is practicable; to maximize the return to creditors as a whole where the company itself may not be saved; to establish a fair and equitable system for the ranking of claims and the distribution of assets among creditors, involving a redistribution of rights; and to provide a mechanism by which the causes of failure may be identified and those guilty of mismanagement brought to book; placement of the assets of the company under external control; substitution of collective action for individual pursuits; avoidance of certain transactions and fraudulent conveyances, dissolution and winding up etc. In context of corporate laws, the word 'insolvency' has neither been used nor defined. However, s. 433 (e) covers a company, which is 'unable to pay its debts', and thus constitutes a ground for winding up of the company. Inability to pay its debts would be a case where, a company's entire capital is lost in heavy losses and no accounts are prepared and filed and no business is done for one year. In such circumstances, the registrar of companies makes out a case of inability to pay debts. These debts however, would only include debts, incurred after the legal incorporation of the company. Inability to pay debts has even been amplified in s. 434 wherein, a creditor with a due of Rs. 500 or more serves a demand by registered post and the company neglects to pay, secure or compound the same in three weeks, in cases where the execution of a decree returned unsatisfied and also where the court is otherwise satisfied that the company is unable to pay its debts.

1.4. Conclusion

Indian insolvency law failed to keep pace with the domestic and international developments. Both, the Companies Act, 1956 under which winding up of companies is carried out and SICA which deals with revival of companies fail to capture the true relevance of the insolvency law besides not meeting the dynamics of the modern economic system. The two laws were enacted to cater to meet the expectations of industries thriving in a protectionist environment unexposed to competition in a closed economy. Both the laws do not provide for engagement of professionals and their skills in the insolvency system. Insolvency laws must provide for rules of jurisdiction, recognition of foreign judgments, co-operation and assistance among courts in different countries and choice of Law. Many countries have already adopted the UNCITRAL Model Law on Cross Border Insolvency with or without modifications. Adoption of the Model Law by India may also be considered with suitable modifications keeping pace with its adoption by countries having significant trade/investment linkages with India. The law must contain enabling provisions to deal with issues concerning treaties and arrangements entered into with different countries by India, present and future. India has developed commercial relationship with new countries in recent years and there would be more new business relationships in future leading to treaties and arrangements from time to time. The law must facilitate recognition of jurisdiction, courts, judgments, cooperation and assistance from these countries.

The hallmark of a free market economy is that there will be insolvencies. An axiomatic feature of all modern States is the need for bankruptcy laws. The origin of insolvency laws traces back to the dawn of civilization, when it was first realized that the existence of commerce is inherently juxtaposed with the inevitable failure of some enterprises. Due to rapid growth of modern technology, enterprises have become multinational entities and their bankruptcies have consequently grown by leaps and bounds. Additionally, the proliferation of regional trade agreements has expanded the stream of commerce across borders, allowing for the establishment of continental corporations. Given that these new businesses are subject to the jurisdiction of all the countries in which they are incorporated, it is essential that an effective and efficient apparatus be instituted for handling the complexities of cross border insolvency cases. Harmonization of insolvency laws, or at a minimum, increased cooperation among trading partners must be established to maintain the current trend towards globalization. Otherwise, fearing potential losses if a foreign business associate files for insolvency relief, entrepreneurs may stop investing internationally. It becomes very important for India to formulate cross border

insolvency principles over the matters identified by the Mitra committee. UNCITRAL model law must be adopted with few modifications. Japan's experience shows that a modified universal framework can accommodate flexibility. Any system can benefit from flexibility. The modified universal and secondary hybrid approaches both incorporate and take advantage of two kinds of flexibility. First, these regimes allow for a court to opt out of cooperating in an international insolvency. Second, these systems provide the courts with the flexibility to custom-tailor the specific form of cooperation to the facts of the case. None of the other options provide for both types of flexibility; instead, these models merely impose one-size-fits-all solutions. The flexibility to deny cooperating with a foreign insolvency outright is one of the chief attributes of the modified and hybrid approaches.

Law has to grow in order to satisfy the needs of the fast changing society and keep abreast with the economic developments taking place in the country. As new situations arise the law has to be evolved in order to meet the challenge of such new situations. Law cannot afford to remain static. We have to evolve new principles and lay down new norms which would adequately deal with the new problems which arise in globalization of commerce.