NAVIGATING FINANCIAL DISTRESS IN INDIA: EVALUATING THE EFFICACY OF THE INSOLVENCY AND BANKRUPTCY CODE, 2016 AND COMPROMISE PROVISIONS UNDER THE COMPANIES ACT, 2013

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ABSTRACT

The "Insolvency and Bankruptcy Code of 2016" also known as IBC was introduced to simplify India's bankruptcy laws, foster a favorable business environment, and give precedence to business revival instead of immediate liquidation. Recent judicial decisions indicate that, even amid liquidation proceedings, there may be opportunities to propose revival plans, although the IBC does not explicitly incorporate this provision. This study's primary objective is to examine the interaction between the feasibility of compromise or arrangement proposals under Section 230 of the Companies Act and the concept of disqualifying promoters as outlined in Section 29A of the IBC. Recent pronouncements by the "National Company Law Appellate Tribunal" also known as NCLAT and amendments introduced by the "Insolvency and Bankruptcy Board of India" also known as IBBI introduce further complexity to this discourse.

The research paper seeks to comprehensively scrutinize the legislative intent, consequences, and practical intricacies entailed in this regard. It tries to investigate whether there exists a contradiction between the essence of Section 230 of the Act and the stipulations of the IBC. The paper delves into the legal, procedural, and pragmatic dimensions surrounding the coexistence of these provisions within the context of insolvency proceedings and corporate rejuvenation. The paper also evaluates the effectiveness of the IBC, particularly considering the growing prevalence of liquidations in contrast to resolution attempts. It underscores the imperative need for a delicate equilibrium between revival and liquidation.

Keywords: Financial Distress, Compromise Provisions, Revival and Liquidation, Harmonization, Liquidation, etc.

INTRODUCTION

The Insolvency and Bankruptcy Code, 2016 stands as an autonomous bankruptcy law that was profoundly necessary. This comprehensive legal framework marks a significant stride in rectifying the convoluted state of bankruptcy and resolution laws in India. The primary purpose behind enacting the IBC was to unify and revise the prevailing legal structure governing the reorganization and resolution of insolvent and bankrupt entities. Its enactment also aimed to enhance the business environment and promote ease of doing business in India. A core tenet of the IBC is the emphasis on "Revival over Liquidation." However, can the prospect of revival persist once a company has entered the liquidation phase? Intriguingly, recent judgments by appellate judicial and quasi-judicial bodies propose

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that even after the commencement of liquidation proceedings, schemes for revival could still be proposed (Aggarwal, 2021). Although such revival schemes are not explicitly integrated into the IBC, The Companies Act has consistently maintained the provision for arrangement schemes to be presented even amidst winding up proceedings. The proposed revisions to the IBBI (Liquidation Process), as outlined in the 2019 Amendment Regulations, establish a specific timeline to be adhered to when a revival scheme is proposed after the initiation of corporate debtor liquidation (Aggarwal, 2022). The introduction of Sec. 29A within the Insolvency and Bankruptcy Code of 2016, which imparts ineligibility upon promoters to submit plans of resolution or acquire the assets of the company undergoing liquidation, introduces a complex dimension to the discourse. The focal point of the paper is to discuss the intricate intersection of the feasibility of a scheme of harmonization arrangement and the principle of promoter disqualification (Editor, 2019).

Research questions are underlined as follows:

1. How does the recent NCLAT ruling's interplay with Sec. 230 [1]impact the alignment of compromise schemes with the core principles of the IBC in the context of liquidation proceedings?(Obhan & Associates blog, 2023)
2. To what extent does the rising trend of liquidation outweighing resolutions under the IBC compromise the achievement of its original objectives and necessitate a reconsideration of its effectiveness?

The specific research objectives are outlined as follows:

1. To comprehensively examine the historical context and legislative intent behind the incorporation of Section 230 within the framework of the Companies Act, 2013.
2. To critically analyze the far-reaching implications and repercussions of promoter disqualification as stipulated by Section 29A of the IBC, focusing on its implications for the formulation of resolution plans and participation in compromise or arrangement schemes.
3. To delve into the intricate practical obstacles and complexities that arise when endeavouring to harmonize the foundational tenets of compromise or arrangement schemes as prescribed by Section 230 of the Companies Act with the disqualifying criteria outlined under Section 29A of the IBC.

LIQUIDATION

Liquidation entails the comprehensive procedure of divesting an entity of all its assets, settling outstanding debts, allocating any remaining funds to shareholders, and formally concluding its legal existence[2]. This process materializes as a viable consequence of insolvency, which transpires when a company confronts inadequate funds to meet its creditor obligations. In the context of India, company liquidation denotes the systematic cessation of operations for registered companies, prompted by diverse factors. Investors might initiate the liquidation of a company due to a range of economic challenges and unresolved debt issues. In the spheres of finance and economics, liquidation refers to the conclusive cessation of business operations and the equitable dispersion of assets to rightful claimants. This event typically unfolds when a company becomes insolvent, meaning it cannot fulfil its financial commitments as they come due. After the conclusion of the company's operational activities, the remaining assets are systematically organized to fulfil the obligations of both creditors and shareholders. This is accomplished through a predetermined hierarchy of claims, commonly known as the 'waterfall mechanism.

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Overview of Company Liquidation

Company liquidation is a procedural undertaking rather than a mere term. It embodies the structured process through which a company is ended. Within the framework of the Insolvency and Bankruptcy Code (IBC),(Sharma,2020) company liquidation can occur in two main forms[3]

- Voluntary Liquidation: This occurs when a company is financially solvent and chooses to wind up its affairs voluntarily.
- Compulsory Liquidation: This ensues when a company is insolvent, meaning it lacks the financial means to fulfil its obligations, leading to a court-mandated winding up.

The primary role of the liquidator is to convert the company's assets into liquid assets like cash and equivalents, and subsequently allocate the generated funds amongst the company's creditors to the best extent possible. Any remaining surplus is then apportioned among the members of the company that is undergoing liquidation.

Implications and Outcomes of Company Liquidation[4]

The moratorium established by Section 14 of the IBC, which grants protection against legal actions, will terminate on the day when the NCLT issues the orders for liquidation.

According to Section 52 of the IBC, legal suits or proceedings cannot be instituted during the liquidation process of a corporate debtor. However, by acquiring prior authorization from the Adjudicating Authority, the liquidator may be authorized to commence legal action on behalf of the corporate debtor.

Furthermore, the order of liquidation acts as a discharge notice for the corporate debtor's officers, employees, and workers, unless the liquidator, acting within the confines of the IBC, continues to operate the corporate debtor's business throughout the liquidation process.

Simplified Company Liquidation Process[5]

Key Stages and Legal Provisions are discussed as follows:

Stage I: Appointment of Liquidator

- Designation of a Liquidator (Section 34) who must have given written consent using Form AA from Schedule II.
- Within five days of the liquidation order, a public notice in Form B from Schedule II must be disseminated to invite claims, which need to be submitted within 30 days from the commencement of liquidation.
- Upon issuance of the liquidation order, the resolution professional should file CIRP-5.

Stage II: Verification of Claims & Reporting

Scrutiny and validation of claims, along with the engagement of Valuers.

Formulation of various reports:

- Asset Memorandum: Assessment of company assets, leading to a report within 75 days (Section 35(1)(c), Regulation 5(1), Regulation 34).
- Progress Report: Mandatory reporting of liquidation progress within 15 days after each quarter's end (Section 35(1)(n).
- Preliminary Report: Submission within 75 days as per Regulation 13 (Regulation 2(1) (f) r/w Regulation 13).

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- First Progress Report: Quarterly report, due within 15 days after each quarter's end (Regulation 2(1) (g) r/w Regulation 15).
- Subsequent Progress Report: If the insolvency professional ceases, this report should be presented within 15 days of cessation.
- Sale Reports: Accompanying Progress Reports after each asset sale (Regulation 5(1) r/w Regulation 36).
- Minutes of Consultation: After every stakeholder meeting, the minutes are to be circulated in accordance with Regulation 5(1) combined with Regulation 8.
- Final Report: Before the distribution process, the final report is to be submitted within a year, following the stipulations of Regulation 5(1) in conjunction with Regulation 45.
- Dissemination of Reports and Minutes: Provision of reports and minutes to stakeholders can be executed in either electronic or physical format, contingent upon stakeholder application, cost compensation, and adherence to confidentiality commitments as per Regulation 5(3).

Stage III: Distribution of Proceeds

- The Liquidator forms the Liquidation Estate (inclusive of assets) and establishes a bank account for receiving owed amounts.
- Completion of the liquidation process within a year, even if avoidance transaction applications are pending.
- Restriction on selling any property to ineligible Section 29A applicants.
- Distribution of proceeds within 90 days (previously six months) among stakeholders (Regulation 42).
- Assets distributed based on the waterfall mechanism (Section 53) after submission to the Adjudicating Authority.

Stage IV: Dissolution of Corporate Debtor

- After asset liquidation, the Liquidator petitions the Adjudicating Authority for dissolution under Section 54.
- Option for early dissolution if assets are insufficient for costs and further inquiry isn't warranted (Regulation 14).
- Orders for dissolution filed with the appropriate authority of the CD's registration.
- Legislation Guiding Company Liquidation.
- Resolution Plan approval or liquidation order (Section 31 and Section 33) by adjudicating authority, NCLT, in the absence of Resolution plan application within the stipulated timeline.
- CoC opting for liquidation before resolution plan confirmation.
    - CD violating terms of the NCLT-approved resolution plan (Consultants,2021).

Liquidation in respect of the IBC

Company Liquidation, as outlined within the IBC[6], stands as a last resort, aligning with the overarching objective of the IBC to promote the ongoing viability of the "Corporate Debtor" also known as a CD through corporate restructuring. This process operates within a defined timeframe, is guided by efficiency, and is subject to the oversight of NCLT. Nonetheless, it is imperative to acknowledge that the Company Liquidation process under the IBC can be resource-intensive and protracted, often resulting in a substantial decline in asset value. In circumstances where a Liquidation order has been pronounced, the Liquidator holds the potential to explore various avenues, as sanctioned by the Company Liquidation

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Regulations, to sustain the CD as a functioning entity. These alternatives can circumvent complete liquidation and asset erosion:

Compromise or Arrangements: As per Regulation 2B of the Company Liquidation Regulations, this avenue facilitates the exploration of compromises or arrangements to maintain the CD's operational continuity.

In essence, while company liquidation serves as a final recourse, the regulatory framework surrounding the IBC provides avenues for the CD's sustainability even in the face of liquidation, aligning with the broader goal of corporate revival and continuity.

ARRANGEMENT[7] AND WINDING OF COMPANIES UNDER COMPANIES ACTS

The possibility of introducing compromise or arrangement schemes for companies undergoing liquidation is not only feasible but also intriguing to note that the original intention, both in the UK and India, and even in countries influenced by UK law, was to serve as a rescue mechanism for companies that were otherwise headed towards winding up. This concept dates to the Indian Companies Act of 1913, wherein Section 153 defining the term "company" for this purpose referred to a company "liable to be wound up under this Act." This definition persisted in Sec. 390(a)[8].

Sec. 391 explicitly allowed the liquidator to present a scheme if the company was in the winding-up phase). However, through judicial interpretation, it was elucidated that this term encompassed all companies that could be subjected to winding-up under the Act as per the prescribed winding-up procedure. This extended the purview to include financially sound companies, rendering them eligible for consideration within the realm arrangement and compromise scheme. Notably, the judgment of the Bombay High Court in "*Khandelwal Udyog and Acme Manufacturing Co Ltd*"[9], differed from the previous interpretation upheld by the same court in *Seksaria Cotton Mills Ltd.* v. *A.E. Naik*[10] which had confined the provision solely to companies teetering on the brink of insolvency (New Delhi,2023).

Numerous instances can be found both in India and the UK, where companies that have undergone prolonged periods of liquidation have experienced revitalization through the implementation of arrangement schemes. Particularly noteworthy is the case of *Meghal Homes P. Ltd.* v. *Shree Niwas Girni K.K. Samiti*[11], in which a company was directed for winding up in 1984; however, a scheme of arrangement was put forth in 1994, showcasing the potential for revival even after extended liquidation periods.

RECONCILING SECTION 230 OF THE COMPANIES ACT AND THE IBC

Is there a contradiction between the essence of Sec. 230 and the provisions outlined in the IBC? Sec. 230, pertains to the "Authority to Compromise or Arrange with Creditors and Members." This provision confers NCLT with the power to issue orders upon receiving applications from the company, creditors, members, or, in the context of a company undergoing liquidation, from the liquidator, for proposed arrangement or compromise, including the scope of Corporate Debt Restructuring[12]. This mechanism offers an avenue for resolving disputes between creditors and the company through institutional means (Chandra, 2023). Its goal is by reaching a consensus among the majority creditors so that the company by any chance may avert the insolvency process. The company as well as the creditors possess the ability to engage the NCLT—creditors can bring a defaulting company under the IBC to the NCLT, while Section 230 gives a great opportunity for companies to approach the NCLT and propose a settlement plan to creditors. Opting for the NCLT route under Sec. 230 can be a judicious move as it empowers management to maintain control over the company.

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JJ Irani Committee Report[13] (Ministry of Company Affairs,2005)underscored the importance of a comprehensive insolvency law that effectively manages the equilibrium between revival and liquidation. The committee stressed the necessity for an approach that fosters authentic endeavors to investigate the restructuring or rehabilitation prospects with the consensus of stakeholders. In instances where revival or rehabilitation is unviable, winding up is deemed appropriate. The committee also advocated for easy transitioning between procedures when circumstances warrant, enabling businesses undergoing liquidation to potentially turn around. The report underscored the adaptability of proceedings based on evolving situations.

Recognizing liquidation as a final recourse, IBC does not encompass provisions for converting liquidation proceedings into restructuring procedures. The Bankruptcy Laws Reform Committee strongly suggested for the principle of irreversibility in the liquidation procedure.

In summary, the alignment between Sec. 230[14] and the IBC allows for a comprehensive approach to addressing financial distress, catering to both rehabilitation and liquidation needs while upholding the principles of stakeholder consensus.

Ensuring Corporate Debtor Continuity during Liquidation

The liquidation process should encompass strategic measures aimed at revitalizing and safeguarding the 'Corporate Debtor' from managerial risks and the potential demise brought on by liquidation itself[15]. The imperative steps necessary for achieving this objective are outlined as follows:

a) **Compromise or Arrangement Under Section 230**

Engage in negotiations or arrangements with creditors, or specific classes of creditors, as well as members or designated classes of members. This provision serves as an avenue for the revitalization of the 'Corporate Debtor' through consensus-driven solutions.

b) **Sale of Corporate Debtor's Business as a Going Concern**

The Corporate Debtors' business as a seamless, operational entity, which includes the employees will be on sale by the liquidator if the above proceeding fails to be of any use.

The goal is to evade the undesirable outcome of corporate liquidation and its associated repercussions. The entire liquidation process is ideally expected to conclude within two years to maintain efficiency. In the case of *S.C. Sekaran* v. *Amit Gupta & Ors*[16], the Appellate Tribunal sanctioned 90 days to initiate activities according to Section 230. Should situations warrant an elongation of the stipulated period for executing actions under Section 230, the Adjudicating Authority holds the prerogative to elate the timeframe if the likelihood of approving a scheme or arrangement persists.

The case of *R. Vijay Kumar v. Kasi Viswanathan*[17] revolves around a scenario in which the 'Resolution Professional' invoked Sec. 33 of the IBC before the Adjudicating Authority due to the ineffectiveness of the resolution process. In response, on 26th February 2019, the NCLT issued a liquidation order. Notably, the appellants, who serve as Directors of corporate debtors i.e., M/s. Gemini Communication Limited put forth an argument that while the liquidation value of the corporate debtor's assets amounted to Rs. 3 Crores, the ‘Promoters’ were willing to contribute Rs. 30 Crores. Regrettably, their submission was dismissed on the grounds of ineligibility as per Sec. 29A of the IBC.

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NCLAT introduced a significant perspective by asserting that, during the liquidation phase, the exploration of a compromise scheme should take precedence before resorting to the liquidation of the company's assets. Nonetheless, the NCLAT avoided delving into the crucial issue of whether such schemes could be introduced by current promoters who are disqualified under Sec. 29A of IBC. In response to the evolving dynamics, IBBI has enacted amendments to its liquidation regulations, particularly focusing on Regulation 2B. This modification streamlines the incorporation of a compromise or arrangement as per Sec. 230[18]. The stipulated timeframe of 90 days from the date of inception of the liquidation process is given to execute such a compromise (ARRANGEMENT OF SECTIONS, 2013). Notably, the revised provision refrains from explicitly specifying the prerequisites for individuals or entities proposing such schemes.

EFFECTIVENESS OF IBC IN LIGHT OF INCREASED LIQUIDATION CASES

Amidst the escalating number of cases culminating in liquidation, the efficacy of the Insolvency and Bankruptcy Code (IBC) warrants evaluation. The fundamental question arises: Is the new insolvency law, the IBC, indeed successful, considering this growing trend? The Preamble of the IBC explicitly articulates its fundamental purpose, i.e., consolidating and revising laws about the reorganization and resolution of insolvency for a wide range of entities, encompassing corporations, partnership firms, and individuals. This legislative initiative is propelled by the crucial objective of achieving these aims within well-defined timeframes, thereby facilitating the optimal realization of asset values held by the relevant entities. Concurrently, the IBC aspires to nurture entrepreneurial endeavors, improve access to credit, and carefully balance the interests of all stakeholders, all the while establishing the framework of the IBBI.

Central Objective of IBC and Last-Resort Liquidation

The central aim of the IBC resides in discovering fitting solutions for stressed assets, with liquidation being a measure of last resort. This perspective aligns with the sentiment that the IBC is intended to offer a comprehensive framework, minimizing the necessity for liquidation.

The fundamental objective underpinning IBC is the identification of fitting solutions for distressed assets, emphasizing that liquidation stands as the ultimate recourse. This sentiment is vividly captured in the pronouncement of the Hon'ble Apex Court in the case of "*Swiss Ribbons Pvt. Ltd. & Anr. v. Union of India & Ors*.",[19] perceptively noted that the Preamble of the IBC is conspicuously silent on the matter of liquidation.

The observation resoundingly underscores the principle that liquidation serves as a remedy of last resort—a measure to be resorted to only when all other avenues have been exhaustively explored. The Preamble, which serves as the guiding philosophy of the IBC, intriguingly refrains from mentioning liquidation. Instead, it delineates the pursuit of resolution plans that align with the spirit of the law, with liquidation reserved for circumstances where viable resolution plans are absent or inadequately formulated.

This perspective champions the notion that liquidation should be a rare occurrence, transpiring only when the absence of inadequacy of viable resolution plans leaves no alternative. The IBC, in essence, is a mechanism for resuscitating stressed assets and facilitating business revival, thereby positioning liquidation as a measure taken only when no other viable alternatives remain.

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CONCLUSION

The recent NCLAT ruling in SC *Sekaran v. Amit Gupta*, coupled with the IBBI's recent regulatory amendments, has illuminated a potential backdoor avenue for errant promoters to regain control of their enterprises at a considerably diminished valuation. The central tenet of the IBC revolves around the principle of curbing shareholders' influence post-default, discouraging a reinstatement of management control by defaulting promoters while creditors bear the brunt of write-offs. Upon examining the recent judgment of the NCLAT, a distinct contrast emerges between the empowerment of promoters to engineer compromises or arrangements with creditors as per Sec. 230 of the Companies Act and the core principles of the IBC. The NCLAT firmly emphasizes the exclusion of promoters from engaging in the formulation of compromise schemes. However, a nuanced approach could entail introducing qualifications for promoters seeking recourse under Sec. 230. A critical yardstick could encompass instances of grave criminal transgressions or culpability in fraud, rendering promoters ineligible to propose compromise schemes under Section 230.

While the question of Section 29A's applicability to Section 230 appears to be resolved after the NCLAT's pronouncement, other intricate concerns still loom, such as participation protocols and voting thresholds within the liquidation process, warranting further clarity. Additionally, a stark trend has emerged within the IBC landscape—liquidation outweighs resolutions over the past couple of years. This trend is evident in data from the IBBI, underscoring a preponderance of liquidation proceedings and signalling potential imbalances. This trajectory could indeed compromise the fundamental intent of the new insolvency framework. While the recent NCLAT judgment offers some clarity, it unveils the necessity for revisiting the IBC's alignment with Sec. 230[20]. Moreover, the prevalent pattern of liquidations outweighing resolutions necessitates a closer examination of the IBC's overall effectiveness, urging a recalibration to ensure the achievement of its original objectives.

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