

The Insolvency and Bankruptcy Code, 2016: Issues for consideration

The Insolvency and Bankruptcy Code, 2016 was passed in Lok Sabha on May 5, 2016 and is currently pending in Rajya Sabha.¹ The Code was recommended by the Joint Committee of Parliament on April 28, 2016. The Committee was setup to examine the Insolvency and Bankruptcy Code, 2015, which was introduced in Lok Sabha on December 21, 2015.² In this note, we present some issues with the 2016 Code as passed by Lok Sabha.

The successful implementation of the Code will depend on establishment and smooth functioning of new entities proposed to be setup under the Code: (i) Insolvency and Bankruptcy Board of India, (ii) insolvency professionals, (iii) insolvency professional agencies, and (iv) information utilities. It also requires adjudication by two agencies: (a) National Company Law Tribunal under Companies Act, 2013, which has not yet been set up, and (b) Debt Recovery Tribunals (DRT) which are overloaded with pending cases. (As of December 2014, there were 62,000 cases pending with DRT and the disposal rate is about 10,000 cases per year.)

Insolvency Professionals and Agencies

Code: Under the Code, the Bankruptcy Board will regulate insolvency professional agencies (IPAs). The primary function of the IPAs will be to regulate insolvency professionals (IPs) by conducting examinations to enrol them, and enforcing a code of conduct. The IPs will be responsible for carrying out the resolution process and managing the company during insolvency resolution. In this context, we discuss some aspects related to IPAs and IPs.

Clauses 196, 205, 208

Regulation of IPs by regulated entities, different from existing frameworks

Code: The Code envisages a regulatory framework in which the Bankruptcy Board regulates the functioning of IPAs, and the IPAs regulate the IPs. This may lead to regulated entities (IPAs) further regulating professionals (IPs). The Code also allows all IPAs to: (i) conduct examinations to certify and enrol IPs, and (ii) enforce a code of conduct. The rationale behind multiple IPAs overseeing the functioning of their member IPs, instead of a single regulator is unclear. It may be argued that such a structure of regulation may lead to a conflict of interest for an IPA.

Clause 204, 205

The Code allows for multiple IPAs to operate simultaneously, which could enable competition in the sector.³ However, this may also lead to a conflict of interest between the regulatory and competitive goals of the IPAs. On one hand, an IPA will regulate the IPs by enforcing a code of conduct. On the other hand, it may want to project a positive public image to stay competitive in the sector. In an attempt to project the image of a high quality institution, the IPA may be unwilling to take action against its erring members.

The proposed structure of regulation differs from other statutory regulators overseeing regulation of licensed professionals in the corporate sector. For instance, regulators such as Institute of Company Secretaries of India (regulating company secretaries) and Institute of Chartered Accountants of India (regulating chartered accountants) are directly responsible for conducting examinations and enforcing a code of conduct on their registered members.

Eligibility of insolvency professionals to work with other IPAs unclear

The Code allows every IPA to conduct its own examination to qualify and enrol an IP. However, it does not clarify if an IP qualifying an examination by one IPA, will also be eligible to work as an IP with another IPA. Further, the Code does not clarify if an IP will be eligible to enrol with multiple IPAs. If there is a restriction in an IP moving from one IPA to another, there would be adverse implications for a competitive environment for IPAs.

Priority in distribution of assets different from existing regime

Code: Under the Code, the creditors committee may choose to either revive a company or liquidate its assets for repayment of the debtor's outstanding dues. In case of liquidation, the assets will be distributed based on an order of priority.

Clauses 52, 53

If the creditors committee decides in favour of liquidation, a secured creditor may: (i) opt to participate in the process and give up his right over the collateral, or (ii) opt out and sell the collateral to recover his outstanding dues. If he participates in the process, he will be ahead of all other creditors (except workmen's dues for one year) in receiving his dues. It is unclear why the secured creditor will have priority in receiving his entire outstanding amount, rather than the amount equal to the collateral value held by him.

For example, a secured creditor X extends a loan of Rs 1,000 to a debtor Y, backed by a collateral which is liquidated at a value of Rs 750. Under the Code, when other assets of Y are liquidated, X will get preference over other creditors for the remaining Rs 250 owed to him. This provision is different from the United Kingdom, where a secured creditor would receive priority in distribution of assets, only to the extent of collateral held by him.⁴

Further, during liquidation, trade creditors (such as raw material suppliers) will receive their dues after unsecured financial creditors in the priority order. It may be argued that financial creditors extend credit after assessing the risk involved, whereas trade creditors may not undertake the same level of assessment, owing to the nature of their business. The order of priority in the Code differs from Companies Act, 2013, where both unsecured creditors and trade creditors are treated at par.⁵ Similarly, insolvency laws in United Kingdom and United States of America treat the unsecured creditors and trade creditors on the same priority level, during distribution of assets.^{6,7}

The Code also provides that the government dues will be paid off after paying secured creditors, unsecured creditors, employees and workmen. This differs from Companies Act, 2013, where government dues are repaid after secured creditors and workmen, but alongside employees and before other creditors (including unsecured financial creditors).⁵

Purpose of establishing the Insolvency and Bankruptcy Fund is unclear

Code:
Clause 224 The Code creates an Insolvency and Bankruptcy Fund which may receive voluntary contributions from any person. A person contributing these funds will be able to withdraw them for reasons including making payments to workmen only in case of insolvency proceedings being initiated against him. In addition, the contributors will not earn interest on the funds contributed by them. The Code does not mention any other purpose for which the fund may be used. It is unclear why any person will voluntarily contribute to the Fund.

Rationale behind proposing an interim regulator is unclear

Code:
Clauses 188, 195 The Code sets up the Insolvency and Bankruptcy Board of India to act as a regulator for supervising entities being established under it. However, it also provides that until the Board is established, a financial sector regulator (such as RBI, SEBI, IRDA and PFRDA) will discharge its functions. Since provisions for setting up the Board have been provided in the Code, it is unclear why an interim regulator has been proposed.

Eligibility limits for Fresh Start Process may be unreasonable

Code:
Clause 80 The Code provides for a Fresh Start Process, under which an individual having assets and debt under a threshold will be eligible for a debt waiver of up to Rs 35,000. These limits include (i) gross annual income of less than Rs 60,000, (ii) assets under Rs 20,000, and (iii) no ownership of a house. It may be argued that these limits are unreasonably low as there may be few individuals that meet these criteria and who will be credit-worthy to receive loans.

1. The Insolvency and Bankruptcy Code, 2016, <http://www.prsindia.org/administrator/uploads/media/Bankruptcy/Bankruptcy%20Code%20as%20passed%20by%20LS.pdf>.
2. The Insolvency and Bankruptcy Code, 2015, <http://www.prsindia.org/uploads/media/Bankruptcy/Insolvency%20and%20Bankruptcy%20code.%202015.pdf>.
3. Bankruptcy Law Reforms Committee, Ministry of Finance, 4 November 2015, http://finmin.nic.in/reports/BLRCReportVol1_04112015.pdf.
4. Clause 60 of United Kingdom Insolvency Act, 1986, http://www.legislation.gov.uk/ukpga/1986/45/pdfs/ukpga_19860045_en.pdf.
5. The Companies Act, 2013, www.mca.gov.in/Ministry/pdf/CompaniesAct2013.pdf.
6. United Kingdom Insolvency Act, 1986, http://www.legislation.gov.uk/ukpga/1986/45/pdfs/ukpga_19860045_en.pdf.
7. United States Code Title 11-Bankruptcy, <https://www.law.cornell.edu/uscode/text/11>.

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