

Legislative Brief

The Insolvency and Bankruptcy Code (Amendment) Ordinance, 2019

The Insolvency and Bankruptcy Code (Amendment) Ordinance, 2019 was promulgated on December 28, 2019.

The Insolvency and Bankruptcy Code (Second Amendment) Bill, 2019 (similar to the Ordinance) was introduced in Lok Sabha on December 12, 2019.

The Bill was referred to the Standing Committee on Finance on December 23, 2019.

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Highlights of the Ordinance

- ◆ The Code allows creditors to initiate an insolvency resolution process, if a company defaults on its payments. The Ordinance introduces an additional threshold for certain classes of financial creditors, including allottees of real estate projects, for initiating the resolution process. At least 10% of them or 100 such persons have to jointly initiate the process.
- ◆ The Ordinance empowers the resolution professional to require suppliers to continue providing goods and services. This provision will not apply if the debtor has unpaid dues arising from such supplies during the moratorium period.
- ◆ The Ordinance provides that the company will not be liable for any offence committed prior to the insolvency resolution process, if there is a change in the management or control of the company.
- ◆ Under the Code, the insolvency resolution process commences when the Insolvency Resolution Professional (IRP) is appointed. The Ordinance states that the IRP must be appointed on the date of admission of the application by NCLT, which will be considered as the insolvency commencement date.

Key Issues and Analysis

- ◆ In case of defaults by real estate developers, the insolvency resolution application should be filed jointly by at least 100 homebuyers or 10% of their total number. The rationale for adding such a threshold only for certain creditors is unclear. Further, a homebuyer wishing to initiate the process may not have details of other allottees.
- ◆ The Ordinance empowers the resolution professional to require suppliers to continue providing goods and services during the moratorium period. This provision overrides the agency of suppliers to negotiate and decide whether to continue a contractual arrangement. It may also force supply of goods and services even if the supplier finds it risky or unviable.
- ◆ In order to balance the rights of the suppliers, the Ordinance provides that suppliers have to continue supplying only if their current dues are paid. In other countries, additional safeguards are available. These include the right to seek a payment guarantee, and court-granted permission to terminate contract in cases where the supplier demonstrates that continuation will cause hardship.

PART A: HIGHLIGHTS OF THE ORDINANCE

Context

The Insolvency and Bankruptcy Code, 2016 (IBC) provides a time-bound process to resolve insolvency among companies. Insolvency is a situation when a company is unable to repay its debt. If the company defaults by one lakh rupees, a creditor (such as banks or suppliers) can initiate the insolvency resolution process.

A Committee of Creditors is constituted to decide regarding the insolvency resolution. The Committee consists of financial creditors to the insolvent company. Financial creditors include creditors who had given loans to the company. Other creditors such as suppliers and employees to whom the company owes money are called operational creditors. The IBC was amended in 2018 to classify allottees of real estate projects as financial creditors. The Committee may consider a resolution plan which typically provides for payoff of debt by merger, acquisition, or restructuring of the company, and may require creditors to forgo some amount. If a resolution plan is not accepted by the Committee, the assets of the company are liquidated. In case of liquidation, proceeds from the sale of assets are used to settle the claims as per a specified order.

In November 2017, the Insolvency Law Committee was set up to review IBC, identify implementation issues, and suggest changes. It submitted its report in March 2018. The Committee recommended that the supply of goods and services essential to keep a particular business running cannot be terminated when a company is undergoing insolvency resolution.¹

In a few cases, after successful resolution, investigations or actions (e.g. attachment of property) were initiated against companies for offences committed by previous promoters. For instance, after NCLT approved JSW Steel's resolution plan for Bhushan Power and Steel, the Enforcement Directorate attached the latter's properties for its prior offences.²

In this context, the IBC (Second Amendment) Bill, 2019 was introduced in Lok Sabha on December 12, 2019. The Bill was referred to the Standing Committee on Finance on December 23, 2019 for examination. Subsequently, the IBC (Amendment) Ordinance, 2019, similar to the Bill, was issued on December 28, 2019.

Key Features

- **Threshold for certain creditors for initiating resolution process:** The Code allows the creditors to initiate an insolvency resolution process, if the amount of default by the debtor is at least one lakh rupees. The Ordinance adds an additional requirement for certain classes of financial creditors for filing application. These classes include real estate allottees and security or deposit holders represented by a trustee or agent. The application by these creditors should be filed jointly by at least 100 such creditors or 10% of their total number, whichever is less.
- **Supply of critical goods and services not to be discontinued:** The Ordinance mandates that the supplies of goods and services considered critical by the resolution professional cannot be discontinued during the moratorium period. Moratorium period refers to the time period during which NCLT prohibits persons from taking certain actions against the corporate debtor, such as filing or continuation of suits, execution of court orders, or recovery of property. This applies to goods and services that are considered critical to protect and preserve the value of the debtor and manage its operations as a going concern. Suppliers of critical goods and services can stop supplying if: (i) the debtor has not paid dues arising from the supplies during the moratorium period, or (ii) in certain other circumstances as may be specified.
- **Licenses and permits not to be terminated due to insolvency:** The Ordinance states that any existing license, permit, registration, or clearance given by any government authority to the debtor will not be suspended or terminated due to insolvency. This provision will be applicable as long as the debtor does not default in the payment of current dues arising for the use or continuation of such licenses or permits.
- **Liabilities for prior offences:** The Ordinance states that the company will not be liable for any offence committed prior to the commencement of the insolvency resolution process. Such liabilities will cease and the company will not be prosecuted from the date the resolution plan is approved by the NCLT. Further, the Ordinance provides immunity to the company from actions against their property in relation to such offences. Such actions include attachment, seizure, retention, or confiscation of property.

Immunity to the company will be given only if the resolution plan results in a change in the management or control of the company. The new management should not include: (i) a person who was a promoter, or in the management or control, of the company, (ii) a related party of such a person, or (iii) a person suspicious of abetting or conspiring for commission of the offence against whom a complaint has been filed in court. Further, officers in default or persons associated with the company and directly or indirectly involved in the offences committed by the company will continue to be liable for those offences.

- **Appointment of the Interim Resolution Professional and commencement date:** Under the Code, the insolvency commencement date is the date on which an application for corporate insolvency resolution process (CIRP) is admitted. An Insolvency Resolution Professional (IRP) is required to be appointed within 14 days from the date of admission of the application for CIRP. The date of appointment of the IRP is treated as the insolvency commencement date. The Ordinance states that the IRP must be appointed on the date of admission of the application, which will be considered as the insolvency commencement date.

PART B: KEY ISSUES AND ANALYSIS

Additional threshold for certain creditors for initiating resolution process

Ordinance:
Clause 3

The IBC allows any creditor to initiate an insolvency resolution process, if the amount of default by the debtor is at least one lakh rupees.³ The Ordinance adds an additional requirement for certain classes of financial creditors for filing application. These classes include real estate allottees and security or deposit holders represented by a trustee or agent. The application by these creditors should be filed jointly by at least 100 such creditors or 10% of their number. The question is whether a threshold based on the number of creditors should be specified for filing of an application. Other financial creditors or an operational creditor can file an application based on a default of one lakh rupees or more. However, these specified classes of creditors will not be able to file an application if they are unable to meet this additional threshold, irrespective of the amount of default.

Code:
Section 7

The threshold aims to prevent potential abuse of the Code by certain classes of financial creditors.⁴ As of September 2019, of the 10,860 IBC cases pending with NCLT, 1,821 cases (17%) have been filed by homebuyers.^{5,6} While the threshold may prevent abuse of the Code by deterring the filing of frivolous applications by a few persons, it can also act as a barrier in genuine cases of default. It may be argued that the objective may be achieved through other measures as well. For instance, for homebuyers, the Supreme Court pointed out that any fraudulent intention behind the filing of an application can be proven by the developer before NCLT at the stage of examining the application.⁷ Note that NCLT can impose a penalty of up to one crore rupees on persons filing applications with fraudulent or malicious intent for any purpose other than insolvency resolution or liquidation.

Further, creditors of these specified classes may be unduly burdened with finding sufficient fellow creditors. Meeting the threshold may prove to be difficult as the required information about other such creditors may not be available. For example, if a homebuyer intends to file an application, he may not have information regarding other allottees under that real estate project which can be used to identify or contact them. Such information may only be available with the defaulting company.

Continuation of supply of critical goods and services

Interference in contractual arrangements

Ordinance:
Clause 5(b)

Typically, supply of goods and services are arranged through contracts which allow either party to terminate the contract in certain cases. These include those circumstances where an insolvency proceeding may have been initiated against one of these parties.⁸ The Ordinance empowers the resolution professional to require vendors to continue supplies of critical goods and services during the moratorium period. It may be argued that the provision overrides the agency of a supplier to negotiate the terms and to decide whether to continue a contractual arrangement.

Code:
Section 14

Ensuring the continuation of supply of goods and services, which are critical to the business, may enhance the earning potential of the company and maximise its value.⁹ This would ultimately benefit all the creditors in the event of sale or liquidation of the company.⁸ While this may be necessary to enable the company's survival, it may lead to an adverse impact on the business of a supplier as he is obligated to continue supplying even if it is risky or unviable.⁸ Hence, the question is whether such interference in contractual arrangements is appropriate.

Note that the IBC already provides an enabling mechanism to the resolution professional to secure necessary supply contracts. A resolution professional is allowed to raise funds to manage operations of the company as a going concern. Insolvency resolution process costs, which have the highest priority in payment upon liquidation include any costs incurred in managing operations during the moratorium period and any financial debt incurred to meet such costs.⁹ Therefore assurance of priority in payment may be used by the resolution professional to persuade suppliers to continue supplies through a mutual agreement.⁸

Safeguards for suppliers

In order to balance the rights of the suppliers, the Ordinance provides that suppliers have to continue supplying only if their current dues are paid. Insolvency laws in other countries such as USA similarly allow the resolution professional to require the supplier to continue performing the contract.^{8,10,11} In United Kingdom, the insolvency law only provides for a narrow list of essential goods and services (gas, water, electricity and communication services) whose supply cannot be terminated on the grounds of insolvency.¹² These laws also provide certain additional safeguards to the suppliers.

These additional safeguards include: (i) the right of suppliers to seek a payment guarantee, (ii) specified timeline for clearance of dues of supplies during the moratorium period (in United Kingdom, within the period of 28 days from the day on which payment is due) (iii) the right to seek compensation for monetary losses caused by defaults, (iv) court-granted permission to terminate contract in cases where the supplier can demonstrate that continuation will cause hardship, and (v) treatment of all obligations, including any past dues before the start of the insolvency proceedings, as part of the administrative costs and assurance of a priority in payment.^{8,10,11,12}

The Ordinance does not provide such additional safeguards to protect the interests of vendors supplying critical goods and services to an insolvent company.

Immunity to the corporate debtor from liabilities for prior offences

Ordinance:
Clause 10

Under the Code, liabilities for offences committed by the company before CIRP starts (prior offences), where such liabilities are known, become a part of the claims against the debtor. These claims are settled as per the approved resolution plan or liquidation order. However, liabilities for prior offences may also arise after the CIRP gets over because of an ongoing prosecution or investigation, or a new investigation. In these cases, the corporate debtor may be held liable for prior offences, even if a third party takes control of the company. The Ordinance gives immunity to the debtor, including its properties, from prior offences, provided the resolution process results in a change in its management or control. Although the debtor (company as a legal entity) will be given immunity from prior offences, the individuals responsible for committing such offences on behalf of the debtor will still be held liable.

Code:
Section 32

The question may be whether the debtor should be given a blanket immunity and absolved of prior offences due to insolvency resolution under IBC. Such immunity would not be available if a company changed hands through the normal market mechanism of merger or acquisition. That said, in the case of a merger or acquisition, the acquiring company may require the seller to provide indemnity; in the case of a CIRP, there is no seller, so the law may have to provide protection to the person who acquires the company.

1. [Report of the Insolvency Law Committee](#), Ministry of Corporate Affairs, March 2018.
2. *JSW Steel Limited vs Mahendar Kumar Khandelwal & Anr.*, [Company Appeal \(AT\) \(Insolvency\) No 957 of 2019](#), NCLAT, New Delhi, October 14, 2019.
3. [The Insolvency and Bankruptcy Code, 2016](#), Ministry of Corporate Affairs, as on November 2019.
4. [The Insolvency and Bankruptcy Code \(Second Amendment\) Bill, 2019](#), Ministry of Corporate Affairs, December 12, 2019.
5. [Lok Sabha Unstarred Question No. 32](#), Ministry of Corporate Affairs, November 18, 2019.
6. [Rajya Sabha Unstarred Question No. 1613](#), Ministry of Corporate Affairs, December 3, 2019.
7. *Pioneer Urban Land and Infrastructure Limited and Anr. Vs. Union of India & Ors.*, [W.P. \(C\) No. 43 of 2019](#), Supreme Court of India, August 9, 2019.
8. [Chapter II E "Treatment of contracts"](#), Part 2, Legislative Guide on Insolvency Law, United Nations Commission on International Trade Law, 2005.
9. [Discussion Paper on Corporate Insolvency Resolution Process](#), Insolvency and Bankruptcy Board of India, November 3, 2019.
10. [Section 365, Chapter 3, Title 11-Bankruptcy, U.S. Code](#).
11. [Executory Contracts in Bankruptcy – Assumption and Rejection. Civil Resource Manual, Justice Manual](#), Department of Justice, Government of United States of America, as accessed on January 28, 2020.
12. [Section 233, Insolvency Act 1986](#), United Kingdom.

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