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NEWSALERT

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ORDINANCE AMENDS INSOLVENCY & BANKRUPTCY CODE

1. INTRODUCTION

The President of India promulgated the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2018 (the "**Ordinance**") on 6 June 2018 to amend the Insolvency and Bankruptcy Code, 2016 (the "**Code**"), which amongst other things, categorizes homebuyers as financial creditors, amends decision making thresholds and clarifies whether proceedings against guarantors fall within or outside of the moratorium during the corporate insolvency process.

The Ordinance has immediate effect and was introduced primarily to address some of the issues arising from the interpretation and implementation of the Code. We discuss some of the key amendments that the Ordinance introduces below.

2. THE AMENDMENTS

2.1 Categorization of Home Buyers as Financial Creditors

An explanation has been incorporated in the definition of 'financial debt'[1] to clarify that any amount raised from an *allottee* for a real estate project shall have the commercial effect of borrowing.

As a result, homebuyers will now be treated as 'financial creditors' and form a part of the *committee of creditors* of a corporate debtor (the "**CoC**") and play a part in the decision-making process, determining the corporate insolvency resolution process of a corporate debtor, including whether to accept or reject a resolution plan. The classification as a 'financial creditor' also enables homebuyers to initiate the corporate insolvency resolution process.

2.2 Initiation of insolvency resolution process by Operational Creditors

Unlike 'financial creditors' who can initiate the insolvency resolution process by directly filing the application with the National Company Law Tribunal (the "**NCLT**"), on the occurrence of a *default*, 'operational creditors' were first required to deliver a demand notice or invoice to the corporate debtor, who had 10 days to either pay off the debt *or* notify the creditor of the existence of a dispute *and* provide a record of the pendency of the suit or arbitration proceedings filed *before* the receipt of the notice.

[1] Section 5(8)(f) of the Code

The Ordinance waters down the requirement for the corporate debtor to provide evidence of any pending suit or arbitration proceeding and essentially clarifies that an operational creditor will be barred from filing an application for initiating the insolvency resolution process if a dispute exists but is yet to be filed before the courts or an arbitration tribunal.

Earlier, operational creditors were also required to file a certificate from their bankers, to certify that no amounts had been received from the corporate debtor to satisfy the 'operational debt'[2]. Such certificate has now been made optional and is to be filed only if available.

2.3 **Approval of shareholders for initiation of insolvency resolution process by corporate applicant**

Previously, for a corporate applicant (the corporate debtor itself or persons in control or management) to file an application for initiation of the insolvency resolution process, there was no requirement to obtain shareholders' approval.

Section 10 of the Code has been amended to provide that a *special resolution* approving the filing of the application by the corporate applicant is now a pre-requisite.

The Ordinance has taken into consideration the circular issued by the Ministry of Corporate Affairs in October 2017 and the Ordinance amends the Code to provide that such approvals *normally* required from shareholders under the Companies Act, 2013 (or any other law in force) should be deemed given for the purposes of implementation of the resolution plan.[3]

2.4 **Voting thresholds for decision making by the CoC**

All important decisions of the CoC were previously approved by a vote of 75% of the voting shares. Such decisions include the extension of time period for completion of the insolvency resolution process, approval or rejection of the resolution plan and replacement of the insolvency professional. The amendment has now lowered the threshold to 66%.[4]

However, for permitting the withdrawal of an application for initiation of the insolvency resolution process, once the application has been admitted by the NCLT, the threshold has been kept at 90% of the voting share of the CoC[5].

It may be noted that previously there was no provision under the Code enabling the *withdrawal* of the application *after* admission by the NCLT. Under Rule 8 of the Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016, the NCLT could only permit the withdrawal of an application on a request by the applicant *before* its admission.

[2] Section 9 (3) (c) of the Code
[3] Explanation to Section 30(2) of the Code
[4] Sections 12, 22, 27, 28, 30(4) of the Code
[5] Section 12A of the Code

2.5 Applicability of moratorium to guarantors

Putting to rest various conflicting judgments of the NCLT as well as the National Company Law Appellate Tribunal (the "**NCLAT**") and the High Courts,[6] the amendment has settled the issue of whether the provisions of Section 14 relating to the *moratorium* are to apply to the corporate debtor and its assets alone or to the assets of guarantors of the corporate debtor as well.

The amendment has categorically clarified that the assets of guarantors are outside the purview of Section 14 and no *moratorium* would be applicable on such assets.

2.6 Streamlining Section 29A of the Code

To streamline Section 29A, the Ordinance has brought about a slew of changes, some of which are discussed below:

(a) Financial entities[7] having accounts, or an account of a corporate debtor under its control, or of which it is a promoter, and which have been classified as non-performing assets ("**NPAs**") have been permitted to submit resolution plans *if* they are not a *related party* to the corporate debtor. Further, the term '*related party*' has been defined to *exclude* financial entities who are financial creditors of the corporate debtor and are a related party of the corporate debtor solely because of conversion of their debt into equity or instruments convertible into equity;

(b) Resolution applicants who hold an account, or accounts of a corporate debtor under its control or of which it is a promoter, and which have been classified as an NPA, and which was acquired pursuant to the insolvency resolution process under the Code, then such resolution applicants would not be disqualified from submitting a resolution plan, for a period of 3 years from the date of approval of the resolution plan pursuant to which the NPA was acquired;

(c) Resolution applicants who have been the promoters or are in control of a corporate debtor in which a preferential, undervalued, extortionate, or fraudulent transaction has taken place, would be eligible to submit a resolution plan provided that such transactions occurred *prior* to the acquisition by the resolution applicant of such corporate debtor and under the provisions of the Code, or pursuant to a scheme or plan approved by a financial sector regulator or a court. Further, the resolution applicant should not have in any way contributed to the aforesaid transactions; and

(d) Resolution applicants, who have provided a guarantee to a creditor in respect of a corporate debtor against which an application has been admitted under the Code, were previously barred from submitting a resolution plan. The Ordinance clarifies that for such resolution

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[6] Alpha and Omega Diagnostics (India) Ltd. v. Asset Reconstruction Company of India - NCLAT, New Delhi, Company Appeal (AT) (Insolvency) No. 116/2017; Sanjeev Shriya v. State Bank of India - 2017 (9) ADJ 723; State Bank of India v. V. Ramakrishnan and Veeson Energy Systems - NCLAT, New Delhi, Company Appeal (AT) (Insolvency) No. 213/2017

[7] Asset reconstruction companies, scheduled banks, Alternate investment funds, overseas financial institutions, investment vehicles, foreign institutional investors, foreign portfolio investors and foreign venture capital investors

applicant to be disqualified, such guarantee should have been invoked by a creditor and should remain unpaid whether in part or in full.

2.7 **Consents and approvals**

Although the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations set out that the resolution plan may provide details for obtaining relevant approvals from government authorities to implement the plan,[8] there was no outer limit to obtain such approvals.

Under the Ordinance, such approvals are required to be obtained by the resolution applicant within a period of *one* year from the date of approval of the resolution plan or such time period as specified in the relevant law, whichever is later.

2.8 **Limitation Act to apply to the Code**

Settling the position on the applicability of the Limitation Act, 1963 (the "**Limitation Act**") to proceedings under the Code, the Ordinance provides that the Limitation Act shall be applicable on proceedings and appeals filed under the Code.[9]

2.9 **Relaxation for MSMEs**

The Ordinance provides that the promoters of corporate debtors who are micro, small and medium enterprises (commonly known as "**MSMEs**") would be eligible to submit a resolution plan for the revival of the MSME.[10]

INDUSLAW VIEW

Interpreting and implementing the Code raised a number of complicated issues for consideration, and the Ministry of Corporate Affairs constituted the Insolvency Law Committee (the "**ILC**") with the mandate to make recommendations on such issues.

The ILC submitted its report at the end of March 2018 and based on the recommendations of the ILC, the Code was amended by the Ordinance, to address many of those issues.

Classifying home buyers as *financial creditors* and as a result, providing them with a right to initiate the insolvency resolution process as well as decision-making power on the CoC, is underpinned by an innovative definition of 'financial debt'. Amounts raised from homebuyers are used to finance real estate projects and in some cases the amounts advanced by homebuyers could be more than the debt availed from the banks.

Whilst the classification of homebuyers as a 'financial creditor' seems to be an equitable solution, it will not go without consequence. The bankability of real estate development projects and lender concerns

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[8] Regulation 37
http://ibbi.gov.in/webadmin/pdf/legalframwork/2018/Apr/word%20copy%20updated%20upto%2001.04.2018%20CIRP%20Regulations%202018_2018-04-11%2016:12:10.pdf
[9] Section 238A of the Code
[10] Section 240A of the Code

may see interest rates rise on loans to developers, or otherwise, lenders may require a greater equity contribution to the project, additional costs which are likely to be passed on to the consumer.

Critically, although homebuyers have been classified as 'financial creditors', no amendment has been made to the Code to clarify whether homebuyers would be treated as *secured* or *unsecured* creditors when it comes to the distribution of proceeds arising from the sale of assets in the event of liquidation of the corporate debtor.

It is therefore unclear whether homebuyers will rank *pari passu* with *secured* financial creditors in a liquidation scenario. Comments in the media, seem to suggest that such status may be subject to agreement between the developer and the homebuyer in any agreement for purchase, though due to the inequality of bargaining power, it's unlikely that homebuyers will be afforded *secured financial creditor* status in such agreements.

Further, it remains to be seen as to how homebuyers will agree instructions for any representative at the meetings of the CoC. Potentially, in the case of a large project developer becoming insolvent, there could be thousands of homebuyers to consider.

The clarification that operational creditors will be barred from filing applications initiating the insolvency resolution process, even if an ongoing dispute has not yet reached the stage where it has been taken to the courts (or is the subject of arbitration) is in line with a recent decision of the Supreme Court of India.[11]

This is broadly intended to mitigate operational creditors filing on *vexatious* grounds. However, on the flip side of the coin, *should* operational creditors be restricted when the same rules don't apply to *financial creditors*, and, particularly in cases, where the *operational debt* is larger than some of the *financial debt* provided by financial creditors?

Nevertheless, it could be the case that a dispute may arise only a few days *before* an application is filed for initiation of the insolvency resolution process and therefore, constitute a dispute even if it has not yet reached the courts or the arbitral tribunal. Further, even the law of limitation allows for a considerable time between the occurrence of a dispute situation arising and the filing of a case.

Relaxing the requirement of a certificate from a financial institution is sensible, removing an unnecessary impediment for the operational creditor. Obtaining a certificate from a financial institution could be problematic for a number of reasons, especially where the creditor has a number of bank accounts, together with question marks over the format for such certificate. Further, what would happen when operational creditors have bank accounts in jurisdictions other than India: foreign banks are not considered to be *financial institutions* under the Code.[12]

Requiring prior approval of the shareholders by way of a special resolution to trigger an application by the corporate applicant for initiating the insolvency resolution process, underlines the importance and interest of the shareholders of the corporate debtor. The insolvency resolution process obviously has far reaching implications on the corporate debtor and its shareholders, who are last in line in any statutory liquidation distribution. It is therefore imperative that shareholder consent is obtained in such cases.

The lowering of the threshold for decision making by the CoC should further the objective of promoting the resolution of corporate debtors and use liquidation as a last resort.

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[11] *Mobilox Innovations Private Limited v. Kirusa Software Private Limited* - Civil Appeal No. 9405 of 2017

[12] Section 3 (14) of the Code

Clarifying that the moratorium will not apply to the assets of the guarantor re-affirms the underlying principle of contract that the liability of the debtor and the guarantor is co-extensive, joint and several. The creditor has the right to *enforce* its right against *either* of the parties *or* both.

If the moratorium extended over the assets of the guarantor, it could lead to a situation whereby shareholder guarantors recklessly drive the corporate debtor towards the insolvency resolution process, knowing that their assets are immune from enforcement.

The eligibility criteria for resolution applicants under Section 29A of the Code (introduced by the Insolvency and Bankruptcy Code (Amendment) Act, 2018 on November 23, 2017) has raised a great deal of debate. Pursuant to the introduction of Section 29A, various resolution plans and applicants have been caught in a quagmire and much litigation has been filed in relation to the *eligibility* of such applicants.

This has led to delays in the resolution process itself and has had unintended consequences by limiting the scope of those persons eligible to submit resolution plans. Although Section 29A has been amended and amongst other things, *relaxes* the provisions about pure play financial entities, certain other amendments could have been brought in to further streamline the provision by defining the term '*any other person acting jointly or in concert*'.

MSMEs hold an important position in the Indian economy and the market for potential resolution applicants is much narrower than other corporate entities. The Ordinance therefore recognizes that in such circumstances, its shareholders may be the only class of person who are likely to be resolution applicants.

Generally, it is important to consider that only certain provisions of Section 29A of the Code have been relaxed and promoters are still ineligible if they are willful defaulters or undischarged insolvents.

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