Indian Institute of Corporate Affairs

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MARCH 2019

The design of India's insolvency code

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The Insolvency and Bankruptcy Code (IBC) of India is most likely to succeed because of its distinct design. The design combines executive and judicial powers in the National Companies Law Tribunal (NCLT). The NCLT is the first level of decision-making (cutting edge level) and such a fusion of executive and judicial powers has made the legal process of insolvency follow an inquisitorial system as is practiced in Continental Europe and is a major reason for the success of the Insolvency and Bankruptcy Code (IBC). As appeals are filed before the National Companies Law Appellate Tribunal NCLAT and the Supreme Court there is complete separation of judiciary from the executive as provided in the Constitution of India. The design of IBC, thus, consists of an admixture of mix of executive and judicial powers at the cutting edge level and complete separation at higher levels and this unique feature is a major reason for the success of the IBC.

The British realized this early and designed a system that was a mix of executive and judicial powers at the cutting level with provisions for appeal and review at higher levels by the judiciary. This was changed in 1973 when the judiciary was completely separated from the executive. Unlike the British who gave judicial powers to the executive, the IBC has given executive powers to existing judicial bodies (e.g. NCLT). In this way the IBC has followed a reverse process, however, importantly shows the importance of combining judicial and executive powers in the unique operating environment of India.

Distinct model of Indian institutions

The British administration was based on an adversarial model. In practice, however, it was a mix of the French Prefect and Europe's inquisitorial system and this is how the executive and judicial powers came to be combined in the executive in India. The French Prefect system originated during the time of Napoleon in the 1800s and has two defining characteristics. First, the sole responsibility for local administration is conferred on Prefects who look after areas - regions, departments, *arroundissements* and communes. The resemblance to divisions, districts, sub-divisions and tehsils in India is unmistakable. Second, they performed a variety of local functions, (1) exercise oversight on the police and gendarmerie, (2) supervise some civil security aspects, such as helping coordinate aid during floods and storms, (3) direct local ministry offices (e.g. health, environment, culture, sport, finance) and different aspects of local government, and (4) establish contacts with local elected representatives and other partners or associations in fields as varied as industry, agriculture and crafts. The Prefect, thus, has a dual role, as a local agent of the central government and chief executive of the department. Again, the similarity with the role of the district officer (also called deputy commissioner, collector or district magistrate in India) is clearly seen.

In the inquisitorial system in France the prosecutor plays an important role in the administration of the criminal justice system. The French prosecutors are not only active in the actual trial but also in pre-

trial phase and they are considered as good as the Judges. The French prosecutors are considered to be magistrates belonging to judiciary. The British had also designed a similar role for the district officer, who could monitor investigations, appoint prosecutors and hold trial as a judicial magistrate. The judicial powers were withdrawn when the judiciary was separated from the executive at the district and sub-district levels in 1973. Let us see how this historical system has made a come back in the Insolvency and Bankruptcy Code.

Position prior to IBC

Prior to the enactment of the IBC, the basic entity for debt recovery in India was the civil court. If the loan was backed by security, it was enforced as a contract under the law. The Companies Act 2013 contains some provisions for rescue and rehabilitation of all registered entities in Chapter XIX, and Liquidation in Chapter XX. The legal framework for bankruptcy resolution (called winding up of a company on inability to pay debt) continued to be the provisions in Companies Act 2013 with a separation of the executive and judiciary. Out-of-court mechanisms was set up after 2000 for banks to restructure loan contracts with debtors include Corporate Debt Restructuring (CDR) and the Joint Lending Forum and the Strategic Debt Restructuring Forum (2015). However, none of these entities combined the judiciary with the executive as the Insolvency and Bankruptcy Code has done.

The Sick Industrial Companies (Special Provisions) Act (SICA), 1985 was the law for rescue and rehabilitation for industrial companies. Under SICA, a specialized Board of Industrial and Financial Reconstruction (BIFR) assessed the viability of industrial companies. Once it was found to be unviable, BIFR used to refer the company to the High Court for liquidation. The SICA was repealed in 2003. The Recovery of Debt Due to Banks and Financial Institutions Act 1993 gives banks and a specified set of financial institutions greater powers to recover collateral at default. The law provides for the establishment of special Debt Recovery Tribunals (DRTs) to enforce debt recovery by these institutions and Debt Recovery Appellate Tribunals as the appellate forum. Under certain specified conditions, the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI) 2002 enables secured creditors to take possession of collateral without requiring the involvement of a court or tribunal. This law provides for actions by secured creditors to take precedence over a reference by a debtor to BIFR. The DRT is the forum for appeals against such recovery.

The unique design of the IBC

The National Companies Law Tribunals are established under the Companies Act (2013), not the IBC. Under the Insolvency and Bankruptcy Code, additional powers have been conferred upon the NCLTs in order to enable them to deal with insolvency and bankruptcy proceedings of corporates and it is this expansion of the range of functions that has transmuted the NCLT from a pure judicial forum to hybrid one with some executive powers. In practice, the conferment of executive powers has made the NCLT follow an inquisitorial system in practice. Below, are given some examples.

In an adversarial system the court acts as a referee between the prosecution and the defense and

the whole process is a contest between two parties. The underlying principle is to place a distance between the investigation and the person who ultimately decides the outcome. The legal regime before the advent of IBC was based on this dictum. At that time, unsecured creditors had three ways of recovering their claims from defaulting debtors, either by lodging a civil suit, or going in for arbitration or petitioning the High Court for winding up if the debtor was a company. There is ample anecdotal and empirical evidence that civil suits did not lead to speedy recovery due to huge backlog of cases. Arbitration continues to be expensive and winding up of companies is a long and cumbersome process taking on an average of 5-10 years. What is most important is that in all these methods of recovery, the process requires filing of a case by a creditor before a judicial body to adjudicate. There continues to be a distance between the creditor and the adjudicating body and the adjudicating body never gets involved in the nuts and bolts of the resolution. In fact, there is a common feeling that the law and the adjudicating body showed a bias towards rehabilitation and debtors and that debtor had greater rights than creditors.

In an inquisitorial system the conduct of the trial is in the hands of the court. The trial judge determines what witnesses to call and order in which they are to be heard. The judge plays an active rule for questioning and hearing the parties directly. The case management depends upon the judges so the contribution of judges is very high for the disposal of any case. Case management is effective as Judges sit with the parties and exchange views for making decisions to speedy disposal of any case. In contrast, in an adversarial legal system representatives from each party take opposing positions to debate and argue their case, whilst the Judge's role is to uphold principles of fairness and equality and to remain neutral until the very end when she gives judgment.

The IBC process resembles the inquisitorial system where the court is actively involved and plays a significant role in preparing evidence, questioning witnesses and finding the truth.. In the IBC, the NCLT plays an active role assisted by the Insolvency Professionals (IPs) and the Insolvency Professional Agencies (IPAs). The trigger for starting the IBC is a petition to the NCLT. This petition is referred to as an insolvency petition. When an insolvency petition is filed, the role of the NCLT is to identify whether the debtor has committed a default in repayment of an undisputed debt to the petitioning creditor. If, the NCLT finds that the debtor has defaulted to the creditor; and has not disputed the claim of default by the creditor beforehand, the NCLT must allow the petition to go through else it must dismiss the petition. When an Insolvency Professional presents a resolution plan that has been approved by the prescribed majority in the creditors committee, the NCLT sanctions the plan, ensuring that due process has been followed in reaching the final vote. Some other functions are, approving schemes of mergers and amalgamations and dealing with complaints of shareholder oppression and mismanagement. Throughout, the NCLT actively participates in the insolvency process in order to ensure the integrity of the resolution process and build trust in the legal framework.

One key objective of the inquisitorial system is to reduce the time for disposing a case and to ensure speedy justice. The Judge plays an active role in deciding time petition and may accept or reject time petition. Prior to the enactment of the IBC there were multiple judicial for a adjudicating on bankruptcy. Often, the fora entrusted with adjudicating on matters relating to insolvency and bankruptcy

did not possess business or financial expertise, information or bandwidth to decide on such matters. This led to delays and extensions in arriving at an outcome, and increased the vulnerability to appeals of the outcome. This has changed in new insolvency regime and the process is more akin to the inquisitorial one and one key feature is that once the IBC is triggered, there is timeline for all major activities, including case disposal.

Conventionally, judicial precedent is set by "case law" which helps flesh out the statutory laws; moreover, in some cases, new substantive law comes from pronouncements where statute and precedent are silent. There is little use of judicial precedent in inquisitorial systems. This means Judges are free to decide each case independently of previous decisions by applying the relevant statutes. In India case law connected to insolvency and bankruptcy is still developing and there is hardly any judicial precedent available. One reason is that insolvency is a new legal regime. Second, reviews of judgments of the High Courts on BIFR cases, the DRTs and DRATs and the Supreme Court shows a matrix of fragmented and contrary outcomes, rather than coherent and consistent precedents, in both debtor and creditor led processes. Therefore, the NCLT has substantial freedom to decide on insolvency and bankruptcy cases without being bound by precedent case law.

As we have noted, the earlier bankruptcy and insolvency legal regime was more like the adverserial legal system and biased in favour of debtors. One important reason for this perception was that the debtor retained control over management and operations of the company during the bankruptcy process. In the new IBC regime the control over day-to-day working of the company passes onto a professional. As a result, company managements do not have the freedom to choose what evidence to present before the NCLT and the professional has complete control over evidence and conduct of the case from start to judgment. Additionally, there are several other actors in the eco-system and the NCLT has much greater say in steering the case process. This is similar to the inquisitorial systems where Judges decide what evidence is admitted by both parties, before questioning the witnesses themselves and going on to make an informed decision on the outcome.

Before the IBC came into force, the bankruptcy process for firms was highly fragmented. Powers of the creditor and the debtor for insolvency were provided for under different Acts. There was lack of clarity of jurisdiction. In a situation where one forum decides on matters relating to the rights of the creditor, while another decides on those relating to the rights of the debtor, the decisions were easily appealed against and either stayed or overturned in a higher court. Similar to the way functions linearly converge on the Prefect in France, the IBC shifts away from a debtor-in-possession approach to a model where creditors decide on the resolution and a linear process is followed that allows for a collective mechanism where both creditors and debtors operate within a framework of equity and fairness to all stakeholders to preserve economic value under the guidance of the NCLT.

Way forward

Working of the IBC shows that the statutory period of 180-270 days for disposal of cases is being breached. Of the 12 major cases referred by the RBI last year, four have been resolved, while the rest are

pending for longer periods than the ceiling prescribed. Around 30 percent of the more than 800 ongoing cases have exceeded their timelimits and another 20 percent have crossed the six-month timeline. In order to ensure that the IBC does not go the DRT way, it is imperative that we build on the unique design of the IBC. The IBC should not revert back to the adverserial legal system where the debtors and creditors have 'equality of arms' and the better resourced debtors are able to delay cases. As in an inquisitorial system the members of the NCLT should involve themselves actively and steer the collation and preparation of evidence. The IBC will escape the bane of case overload if changes in the law and practice are made in the direction to make it more along the lines of an inquisitorial system.

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