India

Cyril Suresh Shroff,
Managing Partner
M/s Amarchand & Mangaldas & Suresh A Shroff & Co

Ashwani Puri, Executive Director
PricewaterhouseCoopers

Companies in India are governed by the following insolvency and restructuring regimes:

- winding-up or liquidation under the Companies Act 1956;
- schemes of arrangement or compromise under the Companies Act; and
- restructuring of 'sick' companies (companies whose accumulated losses are equal to or exceed their net worth) in certain specified industries under the Sick Industrial Companies (Special Provisions) Act 1985.

While most of the relevant legislation is contained in the Companies Act and the Sick Industrial Companies Act, the same do not apply to certain entities incorporated under various specific statutes, including public sector banks and insurance companies. The winding-up of such entities must be in accordance with the procedure prescribed by the Indian government at that time.

Winding-up/liquidation is used to realise the debtor's assets for distribution to its creditors and members. Although the other two methods can be categorised as corporate rescue mechanisms, schemes of arrangement and compromises are primarily designed for internal restructuring and reorganisation of the debtor. While winding-up and schemes of arrangement are carried out under the aegis of the courts, the Board for Industrial and Financial Reconstruction has been set up for the restructuring/rescue of sick companies.

Amid widespread criticism of the length of court processes and the ineffectiveness of the Board for Industrial and Financial Reconstruction, which has largely been used by debtors to defeat creditors' claims, the Companies Act was amended in 2002 to overhaul the insolvency and restructuring regime. The amended act envisaged combining the powers of the courts, the Board for Industrial and Financial Reconstruction and the Company Law Board in one specialised tribunal – the National Company Law Tribunal. Liquidation of companies, schemes of arrangement/compromises and restructuring of sick companies would all be carried out under the aegis of the tribunal, thus streamlining the regime. However, the tribunal is yet to be constituted.

In furtherance of its efforts to attract foreign investment, in 2004 the government undertook a broad-based consultation exercise to reform the Companies Act. The government circulated a concept paper on company law for public comment and subsequently constituted an expert committee – the Irani Committee – to review the feedback. In early 2005 the Irani Committee submitted its report, recommending several revisions to the Companies Act, including provisions for transparent and globally acceptable insolvency and restructuring procedures. The government is now working on a revised concept paper in response to public comments and the recommendations of the Irani Committee

The Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 also provides for the establishment of asset reconstruction companies, which would undertake the management/realisation of non-performing loans acquired from secured creditors. The act

allows asset reconstruction companies to take over, change the management of and restructure companies in the course of the non-performing loan management process. The act envisages a competitive private sector asset reconstruction company model, with no direct government support. To date, the Reserve Bank of India (RBI) has granted licences to three asset reconstruction companies, but only one – Asset Reconstruction Company India Limited – is operational. Pursuant to recent amendments to the foreign investment policy allowing foreign direct investment in asset reconstruction companies, it is expected that pending licence applications will be processed expeditiously.

Most Indian banks and financial institutions have entered into contractual arrangements for the corporate debt restructuring (CDR) of companies with multi-lender involvement pursuant to guidelines issued by the RBI. These contractual arrangements have not yet been signed by foreign banks, a few private banks, insurance companies and the Unit Trust of India, although these are understood to have the arrangements under consideration. The signatories have agreed that if the majority of lenders (75 per cent by value) agree to a restructuring package, the dissenting banks will be bound by the same. The guidelines also permit non-signatories to participate on a case-specific basis. This mechanism has been widely used to restructure several companies with multiple lenders. The RBI has recently issued a revised set of CDR guidelines. Key changes include:

- extension of the scheme to entities with debt exposure exceeding Rs100 million;
- requirement of the consent of 60 per cent of creditors by number as well as 75 per cent by value for the CDR scheme to be binding on the remaining creditors;
- discretion to the core group in dealing with wilful defaulters;
- requirement of restoration of asset classification prevailing on the date of referral to the CDR forum for implementation of the CDR package within four months of the date of approval of the package;
- *pro-rata* sharing of the additional finance requirement by term lenders and working capital lenders; and
- introduction of one-time settlement as part of the CDR mechanism to make the exit option more flexible.

The RBI recently issued separate guidelines for the restructuring of small to medium-sized enterprises (with less than Rs100 million in plant and machinery).

The primary drawback of the Indian insolvency and restructuring regime is the lack of a comprehensive bankruptcy code. Against the backdrop of growing cross-border investment, international trade and commerce, the need for a comprehensive code which addresses national and international concerns is further accentuated.

1. Legal framework and the effectiveness of court processes/legal remedies

1.1 Describe the nature and effectiveness of the following:

(a) Debt recovery remedies where the creditor has no security

An unsecured creditor may exercise any of the following remedies in order to recover a debt:

- Sue the debtor for payment and obtain attachment and sale of the debtor's property in order to satisfy the debt;
- Institute recovery proceedings before a debt recovery tribunal (specialised institutions for the recovery of debt and/or enforcement of security), where the creditor is a bank or financial institution and the debt is at least Rs1 million;
- File a summary suit under Order XXXVII of the Code of Civil Procedure 1908, where the claim is based on bills of exchange, hundies or promissory notes;
- Initiate winding-up proceedings against the debtor, where the creditor can prove that the debtor is unable to pay its debts; or
- Exercise other rights that may be available (eg, the right of set-off).

However, recovery proceedings in civil courts and liquidation proceedings are protracted and often involve low recovery rates. Although the debt recovery tribunals were instituted to provide for the swift recovery of debts, there is still adequate scope for expediting the process. As at June 30 2004, of the 63,600 cases filed with the tribunals, involving a total of Rs919.26 billion, only 27,956 cases involving Rs253.58 billion had been adjudicated, and the total recovered amount stood at just Rs78.45 billion.

(b) The enforcement of security

Security may be enforced with judicial intervention or, in certain cases, through exercising self-help remedies.

Banks, financial institutions and asset reconstruction companies must approach a debt recovery tribunal where the claim exceeds Rs1 million.

Self-help remedies – the right to appoint a private receiver and the right of private sale without court intervention – are available in the case of mortgages in the English form (ie, mortgages where the property is transferred absolutely to the mortgagee with an obligation to retransfer upon payment of the debt), and if such rights are provided in the mortgage. However, these remedies are rarely exercised for a number of reasons, including fear of third-party intervention and employee resistance. Additionally, the Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Act affords self-help remedies – such as the right to take over the management of the borrower's business, and the right to take possession of and sell the secured assets – to certain defined secured creditors. These may be exercised once the creditor declares the loan account a non-performing asset and secured creditors holding 75 per cent of the outstanding amount agree to exercise self-help remedies under the act. Recent amendments to the act have removed the previous requirement to deposit 75 per cent of the claim with the debt recovery tribunal in order to challenge an enforcement action, and established a timeframe within which the tribunal must dispose of such applications. The act further permits secured creditors to halt any procedure pending before the Board for Industrial and Financial Reconstruction.

(c) Corporate bankruptcy/liquidation processes

Two liquidation processes – winding-up by the National Company Law Tribunal/court and voluntary winding-up – are available to debtors for realisation of their assets. Liquidation is usually fairly protracted, taking an average of 10 years (as opposed to one to six years in other countries, according to a recent World Bank survey) and often yielding low recoveries. The Irani Committee has emphasised the need to expedite proceedings and has suggested a two-year timeframe for the completion of liquidation proceedings.

(d) Formal corporate rescue processes

The two formal corporate rescue mechanisms are schemes of arrangement/compromise and restructuring of sick companies.

Debtors can enter into compromises with their creditors and/or members under the Companies Act. In a compromise with creditors, the creditors affected by the scheme are divided into appropriate classes. The scheme must be approved by a majority in number, representing 75 per cent in value, of creditors in each class present and voting at the meeting. The National Company Law Tribunal/court must sanction the convening of the creditors' meetings, as well as the scheme after its approval by each class of creditors. This process has been successfully carried out in several recent cases. As the tribunal/court must hear all objecting creditors, the process is fairly protracted. However, it is useful to bind dissenting creditors once the majority have agreed. The company may also apply to the tribunal/court for protection against creditor actions pending approval of the scheme.

Where a company with an 'industrial undertaking', as defined, becomes sick, the directors must refer the company to the Board for Industrial and Financial Reconstruction. If the board is satisfied that restructuring is appropriate, it will appoint an operating agency (usually the lead lender) to prepare a restructuring scheme. Upon referral to the board, there is an automatic statutory moratorium on the enforcement of security and the initiation of legal proceedings against the company by its creditors. The board has wide powers to restructure sick companies, and once a scheme is sanctioned by the board it becomes binding on the members and creditors. However, if the debtor requires any concessions or additional funding from creditors, the scheme must be circulated to each affected creditor for approval prior to sanction by the board. This process has been extensively used by corporates, but is perceived largely as a means of defeating creditor claims. It rarely results in successful restructuring because of either delays in preparing the scheme or objections by the company or the affected creditors.

In an attempt to prevent corporates from using this process to shelter themselves from creditors, the Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Act permits secured creditors (if 75 per cent by value exercise any of the self-help remedies available under the act) to abate any procedure pending before the board. Further, no reference may be

made to the board where secured creditors have taken enforcement measures under the act.

The amended Companies Act envisaged similar powers for the National Company Law Tribunal, except that no automatic moratorium is available thereunder. Further, it specifies a fixed timeframe for completion of the rehabilitation process and the involvement of industry experts in the preparation of the scheme. However, these provisions have not been implemented pending constitution of the tribunal.

The Irani Committee has observed that there is a need to balance liquidation and restructuring processes, and has recommended the easy conversion of proceedings from one process to another, providing a reasonable opportunity for rehabilitation. It has further suggested that the option of rehabilitation should be extended to all insolvent companies, not just those with industrial undertakings. Further, the test for determining 'sickness' should be based on the principle of liquidity rather than that of negative net worth. It has also recommended that when a debtor's accumulated losses in any financial year are equal to 25 per cent or more of its average net worth over the last two financial years and the debtor defaults on payments to creditors, the company should convene a shareholders' meeting to consider insolvency proceedings. Further, the committee favours a limited standstill period where specifically requested with the approval of majority creditors. However, the committee's recommendations are still under consideration and have not been given legislative force.

(e) Informal corporate rescue processes

Companies with multi-bank financing and outstanding debts of more than Rs100 million may be restructured by their creditors under the CDR scheme. The restructuring scheme must be approved by the creditors within 90 days (extendable to 180 days) of admission of the case to the CDR process. Once 75 per cent of the lenders by value and 60 per cent in number agree to the scheme, it becomes binding on all creditors. However, CDR is restricted to those creditors which have acceded to the relevant contractual arrangements (most Indian banks and financial institutions). The CDR signatories have agreed not to initiate legal proceedings for debt recovery and enforcement of security while the process is pending. The CDR guidelines also permit non-CDR signatories to join the CDR mechanism on a case-by-case basis. As of August 31 2005, 169 cases involving Rs804.87 billion have been referred to CDR, while 124 cases involving an aggregate debt of Rs727.21 billion have been restructured. Of the restructured cases, 97 were reportedly fully implemented, with almost 75 per cent of the companies performing well. This system is fairly quick and has been widely used by Indian banks in several recent cases.

In addition, asset reconstruction companies may, in an attempt to realise value from non-performing loans, exercise their powers under the Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Act to take over or change the management of a company, or sell or lease all or part of the business. However, the exercise of such powers is subject to RBI guidelines, which are still awaited.

A recent amendment also permits secured creditors to take over the management of the debtor's business, including the right to transfer by lease, assignment or sale the whole or a part of the business for realisation of the secured asset. However, such rights of secured creditors are subject to the following conditions:

- If the management of the business is severable, the secured creditor can take over management of just that part of the business which relates to the security, and not the whole business; and
- A substantial part of the business must be held as security.

1.2 What are the formal processes to effect a liquidation of the company's assets?

The Companies Act provides for two different modes of winding-up: winding-up by the National Company Law Tribunal/court and voluntary winding-up. Their effects on third-party rights are identical.

Winding-up by tribunal/court: The tribunal/court may wind up a company in certain circumstances, including where it is unable to pay its debts or the shareholders resolve that it should be wound up. The company, its creditors or shareholders may initiate the process by filing a petition.

Voluntary winding-up: A voluntary winding-up may be initiated if the company's articles of association provide for its dissolution at a particular time or if the shareholders decide on dissolution by way of special resolution (approved by a 75 per cent majority at the shareholders'

meeting). If the company is solvent and the directors make a declaration to this effect, the liquidator may be appointed by the shareholders. However, if the company is not solvent, a creditors' meeting must be convened to discuss the company's affairs and the creditors will have the right to nominate a liquidator. Where this differs from the liquidator appointed by the shareholders, the creditors' nomination will prevail.

1.3 What is the effect on debt collection and the enforcement of security of:

(a) An adjudication of corporate bankruptcy/ liquidation?

A secured creditor can either enforce its security outside the winding-up process or relinquish its security and prove its claim before the liquidator. Once a winding-up order has been passed or the National Company Law Tribunal/court has appointed a provisional liquidator, no proceedings for debt collection or the enforcement of security may be commenced, except with the approval of the tribunal/court.

In a voluntary winding-up, the liquidator, a shareholder or a creditor may apply to the tribunal/court to set aside or stay any proceedings initiated against the debtor.

(b) The commencement of a formal corporate rescue process?

In a scheme of arrangement/compromise, proceedings for debt collection or the enforcement of security may be initiated, unless the tribunal/court has ordered a stay.

Upon referral of a sick company to the Board for Industrial and Financial Reconstruction, there is an automatic stay on all proceedings for debt collection and the enforcement of security, and invocations of guarantees in respect of such debt. The Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Act permits secured creditors (if 75 per cent by value exercise any of the self-help remedies available under the act) to abate any procedure pending before the board. Once secured creditors have taken enforcement measures against the debtor under the act, the company cannot be referred to the board.

The Irani Committee has recommended a limited standstill period on proceedings before the National Company Law Tribunal to explore possible avenues for restructuring. However, the recommendations have not been given legislative force.

(c) The initiation of an informal corporate rescue process?

The commencement of an informal corporate rescue process usually does not affect debt collection or the enforcement of security. However, CDR signatories have contractually agreed (by signing debtor-creditor and inter-creditor agreements) not to take action against a debtor during a 90-day standstill period (extendable to 180 days), which commences once the CDR forum decides to admit a case for restructuring.

(d) The initiation of an insolvency or insolvency-related process under any special legislation?

Special legislation provides for separate insolvency regimes in relation to specific entities (eg, public sector banks), which are to be wound up in accordance with government directions. As this legislation contains no provisions on insolvency processes, it is not possible to predict its effect on debt collection and enforcement.

1.4 Are insolvency procedures involving a corporation incorporated in your jurisdiction recognised if they are started in another jurisdiction?

Indian courts regard insolvency proceedings commenced in India as the primary insolvency proceedings for companies incorporated in India, as the jurisdiction of foreign courts is not recognised under the Indian insolvency regime. India is not party to any international conventions on insolvency and its laws do not provide for cross-border insolvencies. If liquidation proceedings are initiated against a company outside India, the Indian branch of such company will be treated as an independent entity and will not automatically be affected, unless a winding-up petition is filed before an Indian court. However, the government is considering adopting the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvency in order to facilitate cross-border insolvency proceedings.

1.5 In what circumstances would the directors or officers of a company in financial difficulties face potential personal liability for continuing to trade? In practice, are any such provisions actually enforced?

Under Section 542 of the Companies Act, when a company is wound up its directors or officers are personally liable if they were knowingly party to business carried on with the intent to defraud the creditors or any other persons, or for any fraudulent purpose. In such cases the directors or officers are personally liable for such debts or other liabilities as the National Company Law Tribunal/court may direct. These provisions can be enforced only if it is proved that the directors or officers were knowingly party to fraud.

2. What are the advantages and disadvantages of triggering a formal procedure?

The main advantage of initiating a scheme of arrangement/compromise is that it can bind dissenting creditors. Additionally, the National Company Law Tribunal/court may impose a moratorium on actions for debt collection and the enforcement of security. However, this is a time-consuming process as the tribunal/court must hear all objections before sanctioning the restructuring scheme.

The main advantage of the Board for Industrial and Financial Reconstruction mechanism is an automatic moratorium on actions for debt collection and the enforcement of security until the board inquiry to determine whether the company is sick is underway, or any restructuring scheme is under preparation or implementation. However, this has been misused by companies to stave off claims while continuing in business. Further, the timeframes are extendable, and since all creditors and the debtor must consent to the scheme, the process takes longer, with some cases continuing for years.

The amended Companies Act does not provide for an automatic moratorium where a case is referred to the National Company Law Tribunal; rather, it envisages a fixed timeframe for completion of the process (60 days, extendable to 90 days). The Irani Committee has suggested a limited standstill period on specific application and with the approval of the majority creditors (in value), subject to a prohibition against unauthorised disposition of the debtor's assets.

The formal processes have seldom been used successfully, although recently the scheme of arrangement has been used to bind dissenting minority creditors to accept a restructuring package.

3. What are the practical options for out-of-court restructuring?

Until August 2001, out-of-court restructurings were largely based on protracted negotiations between the debtor and individual creditors. Thereafter, the CDR mechanism was introduced under the aegis of the RBI, providing for specified timelines for restructuring and the ability to bind dissenting minority lenders. The CDR scheme has emerged as an effective platform for out-of-court restructurings, especially in multi-lender exposure cases. However, in recent times the sale of non-performing loans to asset reconstruction companies under the Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Act has been perceived as a more effective alternative to the CDR mechanism.

4. What is the effect on the management of a company of:

4.1 An adjudication of corporate bankruptcy/liquidation?

If a company is being wound up by the National Company Law Tribunal/court, the winding-up order and appointment of the official liquidator have the effect of discharging all officers and employees of the company and causing the directors' powers to cease. If necessary, the court may limit the provisional liquidator's powers.

In a voluntary winding-up, the directors' powers cease upon appointment of a liquidator.

4.2 The commencement of a formal corporate rescue process?

The commencement of a scheme of arrangement does not generally affect the management.

In proceedings before the Board for Industrial and Financial Reconstruction/National Company Law Tribunal, these bodies have the right to appoint special directors to safeguard the company's interests, or in the public interest. These directors must act in accordance with the directions of the board/tribunal, and may restrict the company from disposing of its assets. The sanctioned scheme may also involve a change of

management of the company.

The Irani Committee has recommended that, upon application by a majority of the creditors in value, the National Company Law Tribunal may prohibit debtors from transferring, selling or disposing of assets or parts of the business, and that permission for the disposition of assets may be granted by the National Company Law Tribunal only to the extent necessary to operate the business. It has also recommended a limited standstill on creditors' enforcement actions where specifically requested and with the approval of the majority creditors (in value). It has further suggested that the debtor's capacity to manage the business should be tested in consultation with the secured creditors, which should have the right to replace management. However, these recommendations are under consideration and have not been given legislative effect.

4.3 The initiation of an informal corporate rescue process?

The commencement of CDR has no impact on the company's management.

Asset reconstruction companies, as part of the non-performing loan management process, and secured creditors, for purposes of recovering their debts, may take over or change the management of a company. If this happens, all existing directors shall be deemed to have vacated their posts. The Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Act allows the asset reconstruction company or secured creditor to appoint directors to take control of the company and its assets. Upon realisation of the debt in full, the original management must be restored. However, guidelines on the exercise of these powers by asset reconstruction companies have not yet been issued.

A secured creditor may exercise these powers provided that, if the management of the company's business is severable, it can take over management of just that part of the business which relates to the security, and not the whole business. Further, the right to transfer by way of lease, assignment or sale for realising the secured asset may be exercised only if a substantial part of the business of the borrower is held as security. It is unclear what constitutes a 'substantial part' of the business.

4.4 The initiation of an insolvency or insolvency-related process under any special legislation?

Special legislation governing corporations and specific classes of organisations contains no principles regarding insolvency processes, so it is not possible to predict their impact on management.

5. Roles of key players involved in the restructuring and insolvency process

5.1 Who is responsible for the 'case management' control and administration of a corporate bankruptcy/liquidation, a formal rescue or an informal rescue?

Corporate bankruptcy/liquidation: In a winding-up by the National Company Law Tribunal/court, the decision to liquidate is made by the tribunal/court upon the petition of company creditors or members, or by the company itself.

In voluntary winding-up, the decision is made by the shareholders (75 per cent majority).

Once the winding-up order has been issued, the official liquidator is appointed. A provisional liquidator may be appointed in the interim. In voluntary winding-up, the liquidator is appointed by the shareholders. If the company is insolvent, the creditors must approve the appointment. A corporate body cannot be appointed as liquidator in a voluntary winding-up.

The amended Companies Act envisaged the appointment of a firm of professionals, a corporate body comprised of government-approved professionals or a government-appointed officer as the official liquidator in winding-up by the tribunal/court. However, this provision has not been implemented pending constitution of the tribunal. The Irani Committee has recommended that a panel of liquidators comprised of professionals with appropriate experience and knowledge of insolvency practice be established and maintained by an independent body in order to administer the liquidation process.

The liquidator has overall control and is responsible for administrating the assets and distributing the proceeds among the creditors. The Companies Act confers several powers on the liquidator, including the power to:

- sell property;
- defend any suit on behalf of the company; and
- carry on the company's business as may be necessary with the approval of the

tribunal/court or the creditors/members, as the case may be.

Formal rescues: A scheme of compromise/arrangement may be proposed by a company or by its creditors/shareholders. Once sanctioned, the scheme must be implemented under the supervision of the National Company Law Tribunal/court. The business remains under the control of the management.

In proceedings before the Board for Industrial and Financial Reconstruction/National Company Law Tribunal, the operating agency (usually the lead lender) is responsible for preparing the restructuring scheme, which is then sanctioned by the board/tribunal. The company and the other creditors also participate in this process. The board/tribunal may restrict the company from disposing of its assets, and may also appoint special directors to safeguard the company's interests, or in the public interest. The board/tribunal may also monitor implementation of the scheme, which may involve a change in management.

The amended Companies Act includes similar provisions on the operating agency, but the list of possible appointees was widened to include industry experts. The Irani Committee has recommended that the National Company Law Tribunal have a general, non-intrusive and supervisory role in liquidation/rehabilitation proceedings, with independent administrators and other qualified professionals assuming the role of operating agency.

Informal corporate rescues: In a CDR scheme, the lead bank plays a key role and works closely with the company to prepare the restructuring scheme. The company's financial advisers sometimes assist in negotiations with creditors.

While asset reconstruction companies may, in an attempt to realise value from non-performing loans, exercise their powers under the Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Act to restructure a company by taking over or changing the management, guidelines in this regard are yet to be issued by the RBI.

5.2 Who is responsible for the 'case management' control and administration of a case of corporate insolvency under any special legislation?

Special legislation governing corporations and specific classes of organisations contains no principles regarding insolvency processes, so it is not possible to predict who would be responsible for case management and administration under the special legislation.

5.3 Who is responsible for preparing the restructuring plan in a formal or informal rescue?

If a scheme of arrangement/compromise is initiated under the Companies Act, the company's management takes the lead in preparing the restructuring plan in consultation with the majority creditors.

Where a sick company is referred to the Board for Industrial and Financial Reconstruction, the board will appoint an operating agency (usually the lead lender) to enquire into the company's affairs and prepare a restructuring scheme, usually in discussion with the company and its creditors (which must approve any concessions/additional funding). The amended Companies Act makes similar provision for an operating agency, with the list of possible appointees widened to include industry experts. The Irani Committee has recommended that greater responsibility and authority be given to professional insolvency practitioners such as administrators, liquidators and valuers.

The management of a sick company must also submit a restructuring plan when the company is referred to the National Company Law Tribunal. The creditors may propose a restructuring plan if 75 per cent by value agree to it.

Under the CDR scheme, the lead bank usually prepares the restructuring scheme in consultation with the company. The management sometimes engages financial advisers to assist it in proposing a scheme and in negotiations with creditors.

5.4 Who is responsible for preparing the restructuring plan in a case of corporate insolvency under any special legislation?

Special legislation governing corporations and specific classes of organisations contain no principles on insolvency processes, so it is not possible to predict who would prepare a restructuring plan in such cases.

6. What financial information is available to creditors in a corporate bankruptcy/liquidation, a formal rescue and an informal rescue?

Loan agreements usually require companies to

provide their lenders regularly with substantial financial information. Especially in large consortium financing, independent auditors or financial advisers authorised to report to the lenders may be used to carry out concurrent audits or act as monitoring agencies.

The Companies Act further requires companies to file their annual balance sheets and profit and loss accounts with the registrar of companies, and creditors may inspect these. Although filed with the registrar of companies, the profit and loss accounts of private limited companies are not available for public inspection. Since the records are available only from the registrar of companies where the registered office of the company is located, there are geographical obstacles to accessing such information. Further, there are often delays and defects in recordkeeping, as records are still being computerised and online access has not been developed. Hence, there are practical barriers to accessing recent company information.

Creditors are entitled to inspect the register of charges maintained by the company, which specifies the property charged, the amount of the charge and the names of the charge holders. This information is also available from the registrar of companies, but there are similar barriers to access. A central registry is currently being set up.

Listed companies are also required to provide copies of their audited and unaudited accounts to the stock exchange, and publish their summary financial accounts on a quarterly basis.

If a company is being wound up by the National Company Law Tribunal/court, the official liquidator must prepare accounts at least once every six months; these are available for inspection by the creditors. In a creditors' voluntary winding-up, the liquidator must call a creditors' meeting, at which the accounts are presented, at least once a year.

In schemes of arrangement/compromise and CDR schemes, the creditors may request and usually receive relevant financial information to facilitate a decision on whether to approve the scheme. This normally includes the latest available audited accounts and provisional accounts for any significant interim period. Occasionally, the creditors may require that independent accountants review the company's financial position.

7. Financial issues

7.1 What are the main areas from which funding is generally utilised by companies undertaking either formal or informal restructuring?

Indian lenders are often reluctant to extend additional assistance to distressed companies, and have been unwilling to afford preferential treatment to a lender that agrees to bring in new money. In the past, companies have thus relied on sponsors' funding – including the induction of new equity stakeholders, the sale of business assets or more efficient working capital management – for additional funding in restructurings.

To facilitate additional funding in CDR schemes, the RBI guidelines afford cash-flow (repayment) priority to providers of additional finance, whether existing or new, in respect of additional exposure. There have recently been instances of specialised non-performing loan investors lending additional money/buying out existing lenders.

The amended Companies Act envisages the establishment of a Rehabilitation and Revival Fund under the aegis of the National Company Law Tribunal. The fund, to be financed through a levy on companies in India, is intended to be used to revive sick companies and rehabilitate their employees. The Irani Committee observed that such a levy would penalise efficient firms for the benefit of inefficient firms, and recommended that the provision be repealed. It recommended instead that an insolvency fund, to be financed through government grants and voluntary contributions by companies, be set up to meet the costs of insolvency processes. A decision on the creation of such a fund or an alternative mechanism is pending.

7.2 In what order are creditors paid in a corporate bankruptcy/liquidation?

Secured creditors can either enforce their security outside the winding-up process or relinquish their security and prove their debt in the winding-up process, where they will be treated on a par with unsecured creditors. If a secured creditor elects to enforce its security, it must share the proceeds with the liquidator for workmen's compensation payments on a *pari passu* basis.

Further, if a company's assets are insufficient to meet its liabilities, the proceeds from enforcement of a floating charge are used to make certain preferential payments prior to paying the charge

holder. If the charge holder cannot recover the whole amount of its claim, it may prove the balance as an unsecured creditor in the winding-up. In such case any excess proceeds from the enforcement of security must be handed over to the liquidator.

Funds realised from a company's assets are distributed by the liquidator in the following order:

- workmen's compensation payments, and payments to secured creditors of any amounts they may have paid to workmen out of the proceeds of enforcement of their security;
- expenses incurred during liquidation, including the liquidator's remuneration. In a winding-up by the National Company Law Tribunal/court, the tribunal/court may pass an order changing the priority of these amounts;
- preferential payments – that is:
  - taxes due to the central/state government or any local authority;
  - employees' wages/salaries;
  - accrued holiday remuneration due to employees;
  - amounts due in respect of contributions payable as an employer under the Employees' State Insurance Act 1948 or any other law;
  - amounts due in respect of any compensation or liability for compensation under the Workmen's Compensation Act (1923) due to the death or disablement of any employee;
  - sums due to any employee from a provident fund or any fund for the welfare of employees; and
  - expenses of any investigation held in certain circumstances;
  - claims of unsecured creditors; and
  - payments to shareholders, according to their rights and interests.

Assets are distributed among each class on a *pari passu* basis.

7.3 Are there any legal provisions that might operate to invalidate the creation of security, the disposal of an asset or the payment of a creditor by a company in financial difficulties?

The Companies Act contains specific provisions for declaring certain transactions invalid, where such transactions took place within a specified period prior to the winding-up.

Fraudulent preferences: Under Section 531, the National Company Law Tribunal/court can set aside any transfer of property, payment or property-related transaction effected in the six months prior to the commencement of winding-up with the intention of preferring one particular creditor. The liquidator is entitled to recover money or property paid to any person in case of fraudulent preference.

Avoidance of voluntary transfer: Under Section 531-A, the tribunal/court can declare invalid any transfer of property or goods effected otherwise than in the ordinary course of business or otherwise than in good faith and without valuable consideration, if it was made within one year of the commencement of winding-up. The tribunal/court may also order that the proceeds of sale of the company's property be handed over to the liquidator and that the company be compensated for its loss. As per Section 532, any transfer or assignment by a company of all its property to trustees for the benefit of all creditors is void.

Avoidance of floating charges: Under Section 534, floating charges created by an insolvent company in the year prior to commencement of the winding-up are invalid, except to the extent of any money paid in consideration for creation of the charge.

7.4 What is the position of both unsecured and secured creditors that vote against, do not agree with or do not consent to a formal or informal rescue plan?

Once approved by a majority in number, representing at least 75 per cent in value, of each relevant class of creditors present and voting at the creditors' meeting, and sanctioned by the National Company Law Tribunal/court, a scheme of arrangement becomes binding on the creditors. The tribunal/court will hear objections from dissenting creditors to ensure that the majority act in good faith and for the common benefit of the entire class. Once the scheme is sanctioned, aggrieved creditors can appeal to the appellate authority.

A restructuring scheme under the direction of the Board for Industrial and Financial Reconstruction/National Company Law Tribunal is binding on all creditors. However, a scheme involving concessions or additional funding must be circulated to all creditors and is deemed approved if no objections are received within 60 days of circulation.

Upon being approved by 60 per cent in number

and 75 per cent in value of the creditors, a CDR scheme is binding on all CDR signatories. However, the RBI guidelines also offer exit options to any creditor which does not agree to the restructuring package. A dissenting creditor can sell its stake to any majority creditor at a price to be agreed, or to any other lender that agrees to be bound by the terms of the restructuring. Where additional funding is required, dissenting creditors bound by the scheme can either:

- arrange for their share of additional funding to be provided by a new/existing creditor; or
- agree to the deferment of the first year's interest due to them after approval of the CDR scheme. This deferred interest would be payable to the creditor along with the principal's last instalment.

7.5 What actions can creditors take if they are not satisfied with the conduct of either a formal rescue procedure or a corporate bankruptcy/liquidation?

Creditors involved in a winding-up have the right to ensure that the liquidation proceedings are carried out as efficiently and economically as possible. Creditors dissatisfied with the decisions or actions of the liquidator can appeal to the National Company Law Tribunal/court, which may direct the liquidator to reconsider his decisions or pass other appropriate directions. An appeal can also lead to the removal of the liquidator or a stay of all proceedings in relation to the winding-up.

Creditors dissatisfied with a voluntary winding-up can present a petition for winding-up by the tribunal/court.

Creditors dissatisfied with a scheme of arrangement can apply to the tribunal/court for its modification. If the creditors believe that the scheme cannot be implemented satisfactorily, they can request the tribunal/court to order the winding-up of the company.

Creditors aggrieved by orders of the Board for Industrial and Financial Reconstruction/National Company Law Tribunal can appeal to the Appellate Authority for Industrial and Financial Reconstruction or the National Company Law Appellate Tribunal respectively, with a right of further appeal to the Supreme Court.

The Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Act further permits secured creditors (if at least 75 per cent by value exercise any of the self-help remedies available under the act) to halt any procedure pending before the board.

8. General

8.1 Can the insolvency regime be described as systematic and efficient for:

(a) The liquidation of businesses incapable of being restructured?

The insolvency regime remains largely unsatisfactory despite recent initiatives of the government and the RBI. Under the Sick Industrial Companies Act, where the Board for Industrial and Financial Reconstruction, after enquiring into the operations of a sick industrial company and hearing all concerned parties, believes that the sick industrial company is unlikely to become viable in the near future and winding-up is appropriate, it may forward its opinion to the concerned high court, which will appoint the official liquidator to liquidate the company.

The act requires that a mandatory reference to the board be made upon net-worth erosion. This criterion often results in a scenario where there is limited scope for rehabilitation. Further, the overall process takes a long time, with up to three or four years elapsing before the board explores possible rehabilitation options and decides on winding-up. Where the board recommends winding-up to the high court, proceedings begin afresh and the appointment of the official liquidator takes some time. The winding-up process is a protracted affair, resulting in low realisable value for creditors.

(b) The restructuring of debt?

A company may enter into an arrangement/compromise with its creditors to restructure its debt; this process has been successfully utilised in several recent cases. Although it may be rather time consuming, as the National Company Law Tribunal/court is required to hear the objections of all creditors, the process is useful to bind dissenting creditors once the majority have agreed. The company may also apply to the tribunal/court for protection against creditor enforcement pending approval of the scheme.

The Board for Industrial and Financial Reconstruction process has been perceived largely as a means of defeating creditor claims. It has seldom resulted in successful restructurings as the criterion of net-worth erosion required for reference to the board provides limited scope for effective restructuring.

In addition, the informal CDR mechanism has

been used to restructure the debts of companies with multiple lenders. However, this is a purely contractual arrangement and binds only the signatories to the scheme. Further, with the establishment of asset reconstruction companies under the Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Act, the sale of non-performing loans to those companies is perceived as a more viable option than CDR.

8.2 What are the biggest legal and non-legal impediments to the systematic and efficient liquidation of businesses and restructuring of debt?

The efficient functioning of rehabilitation and liquidation processes is largely hindered by the lack of:
- a comprehensive bankruptcy code that meets international standards;
- an effective trigger for the rehabilitation of sick companies;
- timeframes for restructuring and liquidation proceedings;
- adequate infrastructure for effective handling of insolvent companies; and
- participation of insolvency experts.

8.3 Has the insolvency regime been reformed in the last two years? If so:

(a) What are the reforms?

(b) Are the reforms being implemented so as to facilitate the systematic and efficient handling of corporate insolvency cases?

The following reforms to the insolvency regime have been undertaken in the last few years.

National Company Law Tribunal regime: The amended Companies Act envisages the establishment of a common tribunal vested with jurisdiction and powers for winding-up and rehabilitation. The regime envisages a fixed timeframe for completion of the rehabilitation process, and the involvement of professionals and industry experts. However, these provisions have not been implemented pending constitution of the tribunal.

Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Act: The act provides for the establishment of asset reconstruction companies and confers on such companies and secured creditors special enforcement rights, including the right to take over, change the management of and restructure companies. However, asset reconstruction companies cannot exercise these powers until the RBI issues guidelines in this regard. Secured creditors may exercise special enforcement rights subject to the protections granted to debtors under the act. Pursuant to the recent amendment, where secured creditors take self-enforcement measures under the act, any action pending before the Board for Industrial and Financial Reconstruction/ National Company Law Tribunal will automatically halt and no fresh reference may be made.

Amendments to CDR guidelines: The following are the key amendments to the CDR guidelines:
- extension of the scheme to entities with debt exposure exceeding Rs100 million;
- requirement of the consent of 60 per cent of creditors by number as well as 75 per cent by value for the CDR scheme to be binding on the remaining creditors;
- discretion to the core group in dealing with wilful defaulters;
- requirement of restoration of asset classification prevailing on the date of referral to the CDR forum for implementation of the CDR package within four months of the date of approval of the package;
- *pro-rata* sharing of the additional finance requirement by term lenders and working capital lenders; and
- introduction of one-time settlement as part of the CDR mechanism to make the exit option more flexible.

Irani Committee Recommendations: In early 2005 the Irani Committee submitted its recommendations on revisions to Indian corporate law, including provisions on corporate insolvency and restructuring. The key recommendations include:
- easy conversion of proceedings from liquidation to rehabilitation and vice versa;
- definite timeframes for completion of rehabilitation/insolvency proceedings;
- supervision of insolvency/restructuring proceedings by a neutral forum, and increased involvement of qualified professionals and experts; and
- greater involvement of various stakeholders.

These recommendations are still under

consideration and have not been given legislative effect.

8.4 Are there any other legal or non-legal changes in the last two years that have impacted on the operation of the insolvency law regime?

The government has set up several expert committees to recommend measures to improve corporate governance. To this end, Clause 49 of the Listing Agreement has been amended to require all listed companies to set up independent and qualified audit committees, which would oversee and review the financial reporting process and the disclosure of financial information. The amendment further requires listed companies to adopt a whistleblower policy.

The Irani Committee has recommended stringent penalties for non-observance of the requirement to disclosure financial information, and that full financial statements of companies be made available on request.

Against a backdrop of stock market scams, failure of non-banking financial companies, 'vanishing' companies and plantation companies, the government has set up the Serious Fraud Investigation Office to investigate white-collar crimes referred under Sections 235 to 237 of the Companies Act. While the office has carried out fraud investigations into several major companies, it has not been vested with sufficient independence to carry out effective investigations into corporate fraud. Its powers also overlap with the jurisdiction of the RBI and the Economic Affairs Division of the Finance Ministry. In order for the office to be more effective, it must have greater independence and its jurisdiction must be clarified.

8.5 Is statistical information on insolvency cases and corporate insolvency published? If so, how? Is it easily and freely accessible?

The Companies Act requires a company to file liquidation information with the registrar of companies of the state where its registered office is located. As discussed, there are often delays and defects in recordkeeping, so there are practical barriers to accessing recent information relating to companies. A central registry is being set up.

The Board for Industrial and Financial Reconstruction website provides information on cases registered with it, and a broad status update. Further, the Credit Information Bureau of India Limited publishes an online list of companies that have wilfully defaulted in paying their debts.

8.6 What is the most urgent reform required to facilitate the systematic and efficient handling of corporate insolvency cases (formal and informal)?

The following issues must be addressed to bring the existing insolvency into line with international practices:

- enactment of a comprehensive bankruptcy code providing for winding-up, reorganisation and settlement of all other issues, including corporate insolvency;
- establishment of the National Company Law Tribunal as a common authority with full competence for winding-up, including powers to rehabilitate and revive companies;
- evolution of an effective trigger point for bankruptcy, and time-bound bankruptcy proceedings;
- adoption of insolvency procedures for the expeditious sale of available assets and the subsequent adjudication of claims and distribution of proceeds; and
- institution of a dedicated bench of judges as a bankruptcy court, and replacement of the role of official liquidator by insolvency practitioners, professionals and experts with appropriate education and experience.