

Insolvency and Bankruptcy Code, 2016

May 2016

Executive summary

Challenges in the existing framework

- The current Indian bankruptcy regime is highly fragmented, borne out of multiple judicial forums resulting in a lack of clarity and certainty in jurisdiction. Decisions are often appealed, stayed or overturned by judicial forums having a concurrent or overlapping jurisdiction.
- The pro-revival approach of the judicial systems leads to delays in the closure of unviable businesses since the standstill mechanism has been misused by corporate debtors.
- Secured and unsecured creditors, employees, regulatory authorities have different and often competing rights with no common regulatory process to determine the priority of claims.
- Lack of adequate and credible data regarding the assets, indebtedness and security situation of companies further accentuates the problems.
- As a result, the average time to resolve insolvency in India is 4.5 years, as compared to 0.8 years for Singapore and one year in London; India has the lowest recovery rate in the world at about 20 per cent of debt value as per World Bank report (2014).
- Large amounts of stressed assets at 12 per cent of the total advances at 31 December 2015 as per RBI report are either restructured or NPAs with low recovery rates due to a lack of enabling environment for enforcement of creditors rights.

Insolvency and Bankruptcy Code, 2016

- Insolvency and Bankruptcy Code, 2016 (Code) provides for a specialised forum to oversee all insolvency and liquidation proceedings for individuals, SMEs and corporates.
- It empowers all classes of creditors (secured and unsecured lenders, employees, trade creditors, regulatory authorities) to trigger a resolution process in case of non payment of a valid claim.
- Provides for immediate suspension of the Board of Directors and promoters' powers.
- Provides for an insolvency professional to take control of the Corporate debtor.
- Enables a 'stand-still period' which provides stakeholders time to facilitate discussions and arrive at a common resolution rather than running independent processes.
- Offers a finite time limit within which the debtor's viability can be assessed and a resolution process agreed. The power of commercial decision to revive or liquidate the Company is on the creditors rather than the courts.
- Provides for a balanced approach between rehabilitation and recovery and provides for compulsory liquidation of corporate debtors in the event the resolution has not been agreed within 180 days of the resolution process.
- Aims to develop a detailed and accessible information system to reduce information asymmetry between the various participants of the insolvency process.
- Provides for a clearly-defined waterfall mechanism for payment of debt in the event of a liquidation.



Proposed ecosystem



Adjudicating Authority is a body that would have exclusive jurisdiction to deal with insolvency-related matters. The Code provides for application to be made to the appellate tribunal for an appeal against the order of an Adjudicating Authority.



Insolvency and Bankruptcy Board of India (IB Board) would consist of members including representatives from MCA, MoF, Reserve Bank of India and would regulate the appointment of insolvency professionals, information utilities and promote transparency in governance. The board will also make model bye laws for regulating insolvency professionals.



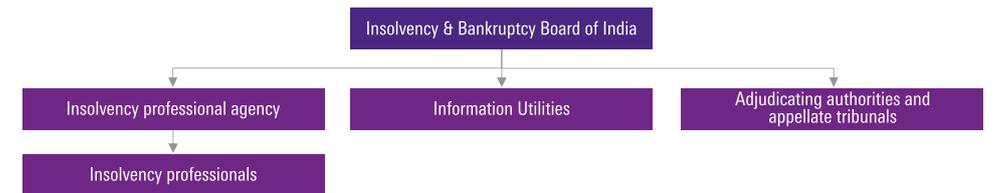
Information utilities are specialised licensed bodies which would collect, maintain and disseminate information relating to the indebtedness of companies.



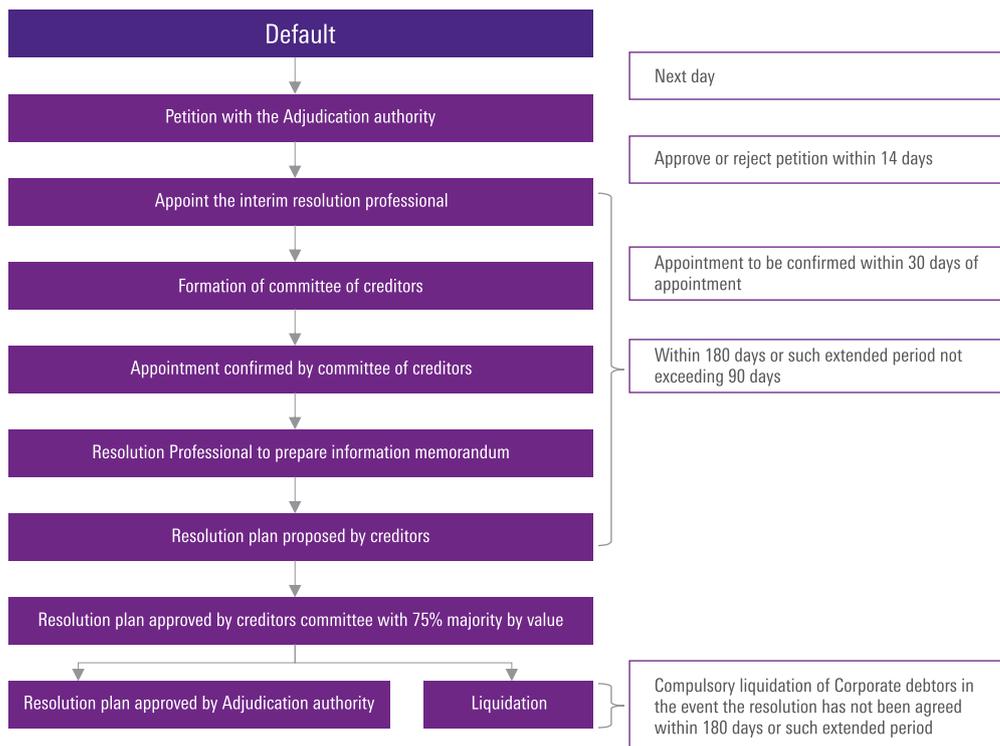
Insolvency professional agency is the body that would admit insolvency professionals as members and develop a code of conduct and promote transparency and best practices in governance.



Insolvency professionals are licensed professionals appointed by insolvency professional agencies who would take on the roles of resolution professional or liquidator/ bankruptcy trustee in an insolvency resolution process.



Source: KPMG in India's analysis of the Insolvency and Bankruptcy Code, 2016



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Salient features of the Code (1/6)

Adjudication authority

- National Company Law Tribunal (NCLT) would deal with matters relating to corporate insolvency, Limited Liability Partnership and enforcement of personal guarantees related to Corporate debtors.
- Debt Recovery Tribunal (DRT) would deal with individual insolvency and partnership.
- Adjudication authority ('AA') would have exclusive jurisdiction to deal with insolvency related matters, no injunction shall be granted by any court, tribunal or authority in respect of any action taken, or to be taken, in pursuance of any power conferred on the NCLT/ DRT.

Financial and Operational creditors

- The Code makes a distinction between creditors holding Financial debt and creditors holding Operational debt. Financial debt and Operation debt are as defined below.
- **Financial debt:** means debt extended against consideration for the time value of money, and includes the following:
 - a. Term Loans, Working capital loans etc.,
 - b. Non fund based limits such as bank guarantees
 - c. Bonds, notes, debentures, loan stock or any similar instrument;
 - d. Lease or hire purchase agreements
 - e. receivables sold or discounted (other than any receivables to the extent they are sold on a non-recourse basis);
 - f. any other transaction, having the commercial effect of a borrowing;
 - g. Certain types of derivative transactions
 - h. Certain types of counter-indemnity obligations
 - i. Liabilities in respect of guarantees or indemnities.
- **Operational debt:** means debt incurred in exchange for the provision of goods or services (including employment) or debt in respect of the payment of dues arising under any law for the time being in force payable to the Central Government, any State Government or any regulator;
- Creditors includes secured, unsecured creditors including foreign creditors.

Salient features of the Code (2/6)

Default and 'Proof of default'

- 'Default' is defined as the state when debt exceeding INR 1 lakh is due and is not repaid by the Corporate debtor. Such cash flow-based assessment of insolvency can lead to an early detection of insolvency trends compared to the net worth or balance sheet based assessments prescribed in the existing laws.
- Proof of default for Financial creditors is the default recorded with the information utility or such other proof of default as may be specified by the Code.
- Proof of default for Operational creditors will be the expiry of the period of ten days from the date of delivery of the notice demanding payment, if the Operational creditor does not receive payment from the corporate debtor or notice of dispute from corporate debtor.

Who can file for corporate insolvency resolution?

- **Financial Creditor:** Person to whom 'Financial debt' is owed, and includes a person to whom such debt may have been legally assigned or transferred in accordance with law (including a person residing outside India). Default may be in respect of Financial debt owed to any Financial creditor of the corporate debtor and not only the applicant Financial creditor.
- **Operational Creditor:** Person to whom 'Operational debt' is owed and includes any person to whom such debt may have been legally assigned or transferred;
- **Corporate Debtor:** Shareholder of the entity, an individual who is in charge of managing the overall operations, a person who has the control, supervision or oversight of the financial affairs of the corporate debtor;
- The Code prescribes penalties for false and frivolous petitions.

'Creditor in possession' approach

- Post the acceptance of the petition by the AA, the board of the Corporate debtor is suspended and the court appoints an interim resolution professional. The committee of creditors needs to be formed and needs to approve the appointment of the interim resolution professional within 30 days of its appointment by the AA.
- The interim resolution professional must make every endeavour to protect and preserve the value of the property of the corporate debtor and manage the operations of the corporate debtor as a going concern
- This process is likely to prevent mismanagement of the Corporate debtor which could be detrimental to the interests of the creditors, and misappropriation of funds by debtors during the IRP period.

Salient features of the Code (3/6)

Who appoints the resolution professional ('RP')?

- Financial creditors filing the petition should propose the name of interim resolution professional in the petition.
- The interim resolution professional's appointment will be subsequently approved by 75% of the creditors by value in the first creditors committee meeting. Fees of RP to be decided by creditors committee.
- The creditors committee may appoint a new RP subject to the approval of the IB Board. The replacement of existing RP cannot be without cause and needs to be approved by the IB Board.
- It is optional for Operational creditors to propose the name of RP in the petition. If no RP is proposed, the AA may recommend the name of interim RP which needs to be approved by 75% of creditors in the creditors meeting.

Powers of RP

- The management of the affairs of the corporate debtor shall be vested on the interim resolution professional.
- The powers of the board of directors shall be suspended and be exercised by the interim resolution professional.
- The officers and managers of the corporate debtor shall report to the interim resolution professional and provide access to such documents and records of the corporate debtor as may be demanded by the interim resolution professional.
- Management of the company needs to support the RP in performing his/her duties.
- The interim resolution professional shall have immunity from criminal prosecution and any other liability for anything done or omitted to be done in good faith in the discharge of his/her duties as an insolvency resolution professional under the Code.

Duties of RP

- To collect all information relating to the assets, finances and operations of the corporate debtor for determining its financial position
- To receive and collate all the claims submitted by creditors to him/her
- To constitute a committee of creditors
- Take custody of assets and monitor the assets.

Salient features of the Code (4/6)

Moratorium

- The Code provides for an automatic moratorium of 180 days against any debt recovery actions by the creditors. The moratorium can only be extended by a further period of 90 days in exceptional circumstances.
- The period of moratorium would be excluded for computation of period of limitation.
- The moratorium can give stakeholders time to facilitate discussions and arrive at a common resolution mechanism rather than running independent processes.

Creditor Committee

- The resolution professional, after evaluating all claims received against the corporate debtor shall review the financial position of the corporate debtor and constitute a committee of creditors. The committee of creditors would consist of Financial creditors of the Corporate debtor but exclude related party creditors.
- The Operational creditors and Corporate debtor will be non-voting members on the creditors committee and will be invited to all meetings.
- When a corporate debtor does not have any Financial creditors, the committee of creditors shall be constituted and comprise such persons to exercise such functions in such a manner as may be specified by the IB Board.
- All material decisions taken by the RP such as the sale of assets, raising interim funding, creation of security interest, settlement of legal disputes etc. need to be approved by the creditors committee. All decisions taken by the creditors committee will be by way of a majority of 75% of the Financial creditors by value.

Resolution plan and approval process

- The RP will prepare an information memorandum of all information about the Corporate debtor. Creditors (or through a resolution agency) or RP will propose a resolution plan.
- The creditors will decide the manner in which the entity would be operated as a going concern or liquidated and such a plan is to be approved by way of a majority of 75% of the creditors by value.
- There is no guidance on what the resolution plan should consist of, however the resolution plan should at minimum provide for
 - Payment of costs of IRP and liquidation
 - Repayments to Operational creditors, which should not be lesser than the amount to be received by them in case of liquidation of the corporate debtor
 - Provide for management, implementation and supervision of the resolution plan after its approval
 - The resolution plan must comply with applicable laws and regulations and other criteria as may be specified by the IB Board.
- If the Adjudicating Authority is satisfied that the resolution plan conforms to these requirements, it shall by order approve the resolution plan which shall be binding on the corporate debtor and its employees, shareholders, creditors and guarantors and other stakeholders involved in the resolution plan.

Salient features of the Code (5/6)

Liquidation

- Liquidation is triggered in case the following circumstances arise:
 - Resolution plan does not meet the minimum required guidelines prescribed under the Code (discussed earlier)
 - Creditors' committee does not reach an agreement during the stipulated period of 180 days or any extended period thereof
 - Creditors' committee decides to proceed with liquidation
 - Corporate debtor fails to adhere to the terms of the approved resolution plan.
- Where the Adjudicating Authority passes an order for liquidation of the corporate debtor the resolution professional appointed for the corporate insolvency resolution process shall act as the liquidator.
- The liquidator must try to maximise the value of the assets of the entity in the most efficient manner of disposal and create a liquidation trust for distribution. Distribution to the creditors would be as per the priority of payment set out in the Code.
- The liquidation process cannot be appealed after the expiry of the prescribed period after passing of the order of liquidation. An appeal to stay the liquidation may be considered by the AA only on very limited grounds.

Distribution of assets

- The proceeds from the sale of the liquidation assets shall be distributed in the following order of priority:
 - the insolvency resolution process costs and the liquidation costs to be paid in full
 - claims of secured creditors and workmen dues (capped up to 24 months prior to liquidation) would rank pari passu
 - employees' salaries other than workmen (capped up to 12 months prior to the commencement of liquidation)
 - financial debt owed to unsecured creditors
 - any amount due to the relevant State Government or the Government of India (capped at 2 years before commencement of liquidation) and unpaid dues to secured creditors after enforcement of security interest would rank pari passu
 - any remaining debts and dues.
- The fees payable to the liquidator shall be deducted proportionately from the proceeds payable to each class of recipients, and the proceeds to the relevant recipient shall be distributed after such a deduction.

Salient features of the Code (6/6)

Avoidance transactions

- Liquidator has the rights to cancel certain transactions of preferential nature entered into in order to benefit a creditor or a set of creditors. Such transactions entered into within one year before the commencement of liquidation with third parties and before two years with related parties can be cancelled by the liquidator.

Voluntary liquidation

- The directors of the Company can initiate the voluntary liquidation of the Company upon filing a petition for the voluntary winding up along with affidavit of solvency of the Company.
- The petition needs to be approved by a special resolution in a general meeting of members along with two – thirds majority of creditors in value of the debt held by such creditors.

Model bye-law to be made by IB Board

- Since it is envisaged that there would be multiple IPAs, which may lead to lack of uniformity in the bye-laws to be followed by different insolvency professional agencies, the code provides for model bye- law which would be adopted by the IPA.
- The model bye law will provides for manner of conducting examination and minimum standards of professional competence for members, standards for professional and ethical conduct, setup of governing board for internal governance and management of IPA, mechanism for redressal of grievances against members amongst others.

Cross border insolvency

- While the Code has not adopted the UNCITRAL model of cross border insolvency, it provides for an enabling provision for Central government to enter into agreements and treaties with the governments of foreign countries for enforcing the Code.
- In case of enforcing the Code on an assets situated outside India, the AA may issue a 'Letter of Request' to a competent court of the foreign country where the asset is located.



Way forward

Passage of the Code

The code was approved in the Lok Sabha on 5 May 2016 and Rajya Sabha on 11 May 2016. Once the President signs the legislation, India will have a new bankruptcy law. However, before the notification date, the Central Government will need to create the infrastructure and ecosystem proposed under the Code to make it effective.

Infrastructure surrounding the Code

The Central government will need to focus on building an insolvency ecosystem including:

- Appointing of members of the Board
- Appointing judges for the Adjudication Authority
- Setting up of benches for the Adjudication Authority
- Identifying and licensing insolvency agencies
- Licensing information utilities
- Grandfathering of insolvency professionals to create capacities in the interim period
- Constituting an examination board to conduct exams for the licensing of insolvency professionals.

Operationalising the Code

The Board will also have to set up rules and bye-laws for the orderly functioning and conduct of the Code. Rules will need to be framed around:

- Functioning of the Adjudication Authority
- Model bye-laws for the conduct of Insolvency Professional
- Guidance notes around the conduct of IRP such as the presentation and reporting of financial statements, management of the Company during IRP, summoning a meeting of creditors, etc.
- Training of IPs
- Creating awareness amongst the judicial community, lenders and other stake holders.

Conclusion

Overall this legislation is a huge step towards the ease of doing business in India and has the potential to bring business practices in India closer to more developed markets over the long term.



KPMG in India contacts:

Nitin Atroley

Partner and Head

Sales and Markets

T: +91 124 307 4887

E: nitinatroley@kpmg.com

Vikram Hosangady

Partner and Head

Deal Advisory

T: +91 44 3914 5101

E: vhosangady@kpmg.com

Varun Gupta

Partner

Deal Advisory

T: +91 22 3090 2132

E: varungupta1@kpmg.com

Shailen Shah

Director

Deal Advisory

T: +91 22 3090 2041

E: shailenshah@kpmg.com

KPMG.com/in

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