

Corporate Insolvency and Recovery of Debt Due to Banks

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Introduction

Insolvency is the phenomenon when individual or corporation or any other organization is unable to pay the debts they are due. Insolvency can also occur when certain things happen, some of which may include: poor cash management, increase in cash expenses, or decrease in cash flow. Insolvency laws have been introduced to enable the creditors to exercise rights of recovery of loans against the insolvent debtors. For example, outstanding debts may be paid off by liquidating assets of the insolvent party. Prior to proceedings, it is common for the insolvent entity to meet with the creditor in order to attempt to arrange an alternative payment method.

It is possible that a business may be “insolvent” in cash flow, yet still solvent on the balance sheet. These cases may involve illiquid assets, which help the balance sheet's solvency but not the cash flows. This can also work the other way around with negative net assets (balance sheet insolvency), yet a positive cash flow. In this case, the flow of cash is simply enough to pay off debts, despite the fact that the business has more liabilities than assets.¹

The stream of insolvency laws can be segregated chiefly under two heads:

1. Personal Insolvency, which deals with individuals and partnership firms governed by Provisional Insolvency Act, 1920 and Presidency Towns Insolvency Act, 1908.
2. Corporate Insolvency, whose consequence makes winding up of the company under the Companies Act, 1956.

In Indian corporate laws, the term “insolvency” has not been defined except under section 433 (e) of Companies Act, covers a company, which is “unable to pay its debts”, and thus constitutes

¹ Graeme Pietersz, “Moneyterms Investment Definitions”

a ground for winding up of the company. A company is declared insolvent when its entire capital is lost in heavy losses and no accounts are prepared and filed and no business is done for one year. In such circumstances, the Registrar of Companies makes out a case of inability to pay debts. These debts however, would only include debts, incurred after the legal incorporation of the Company. Inability to pay debts has even been amplified in Section 434 of the Companies Act, 1956 wherein, a creditor with a due of Rs. 500 or more serves a demand by registered post and the company neglects to pay, secure or compound the same in three weeks, in cases where the execution of a decree returned unsatisfied and also where the Court is otherwise satisfied that the company is unable to pay its debts.

Bankruptcy

Bankruptcy is not exactly the same as insolvency. Technically, bankruptcy occurs when a court has determined insolvency, and given legal orders for it to be resolved. Bankruptcy is a determination of insolvency made by a court of law with resulting legal orders intended to resolve the insolvency. Insolvency describes a situation where the debtor is unable to meet his/her obligations. Bankruptcy is a legal maneuver in which an insolvent debtor seeks relief.²

Regulatory framework for insolvency laws in India

The legal framework regulating the system recovery of debts due to banks and financial institutions comprises two distinct regimes – one for individual insolvency, and another for corporate insolvency – having no connectivity with each other as such. The legal framework for corporate insolvency has seen a series of enactments, shadowed by administrative changes and judicial decisions.

India does not have any single exhaustive statute to govern corporate insolvency but there are number of statutes and administrative authorities which regulate the debt recovery system by the banks and financial institutions.

² Merriam-Webster Dictionary, “Bankrupt - Definition And More From The Free Merriam-Webster Dictionary”.

The most relevant laws at present, governing corporate insolvency and bankruptcy in India are:

- The Companies Act of 1956. The Companies Act governs liquidation of a company in financial distress via: (i) voluntary winding-up; (ii) involuntary winding-up by the courts; or (iii) winding-up subject to supervision by the courts which has been deleted by Companies (Amendment Act) 2002 and is yet to be notified.

- The Sick Industrial Companies (Special Provisions) Act, 1985 (SICA). SICA covered comprehensively the framework for reconstruction of sick companies under the supervision of the Board for Industrial and Financial Reconstruction (BIFR). SICA, however, only applies to “sick” companies in select industries that have been incorporated for at least five years, have at least 50 workers on any day in the preceding 12 months and have a factory license. Although technically, SICA has been repealed by the Sick Industrial Companies (Special Provisions) Repeal Act, 2003 (the Repealing Act), it still continues to be good law today because, to date, the Repealing Act has not yet come into force.

Two major committees formed to study the issue made a series of recommendations. The first, the High Level Committee on the Law relating to Insolvency of Companies (headed by V.B.Eradi³), recommended in 1999, *inter alia*

- (a) the creation of a tribunal for a centralised winding up process, with professional liquidators;
- (b) the harmonisation of Indian with international law/international best practices, both substantively (for instance, the “first sell, then adjudicate priorities” rule) and procedurally (for instance, smoothen the process for cross-border insolvencies using the UNCITRAL Model Law on Cross Border Insolvency as guidance).

The second, the Advisory Group on Bankruptcy Laws⁴, headed by N.L.Mitra, went one step further in 2001, recommending the disbanding of the BIFR⁵ / AAIFR and the consolidation of

³ <http://www.indlaw.com/guest/displaynews.aspx?35fe2ffb-c589-440d-a496-45866ec104a8>

⁴ <Http://Rbidocs.Rbi.Org.In/Rdocs/Publicationreport/Pdfs/20811.Pdf>

insolvency laws into a separate comprehensive bankruptcy code to govern corporate insolvencies.

In response, the Government appeared to have accepted the former suggestion of the Advisory Group (though not the latter) – with the Companies (Second Amendment) Act, 2002 providing for the creation of a consolidated tribunal – the National Company Law Tribunal (NCLT)⁶⁷, and its appellate authority, the National Company Law Appellate Tribunal (NCLAT)⁸ – to take over the functioning of the BIFR and AAIFR and the High Courts as regards insolvency; and the SICA (Special Provisions) Repeal Act, 2003 formally abolishing the BIFR and AAIFR. However, these changes did not come into effect for two reasons:

(a) the constitutionality of the provisions in the Companies (Second Amendment) Act, 2002 creating the NCLT / NCLAT were challenged on the ground of excessive judicial delegation – a petition not disposed by the Supreme Court until 2010 (when the constitutionality was upheld in principle but changes were recommended in certain specifics such as appointment criteria to such bodies); and

(b) various other provisions in the Companies (Second Amendment) Act, 2002 and the SICA (Special Provisions) Repeal Act, 2003, were *not notified*, and therefore not brought into effect by the Government through publication in the Official Gazette.

As a result, the Companies Act, 1956 continues to prevail as does the SICA, 1985⁹. Consequently, in terms of administrative machinery for the insolvency framework, the BIFR/AAIFT also continued to function.

- The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act, 2002 (SARFAESIA). SARFAESIA empowers banks or financial institutions with

5 Bajjal, Pradip, “The Board For Industrial And Financial Reconstruction: The Jessop Story”, 2008. ISBN 8131712486, “Disinvestment In India: I Lose And You Gain. Pearson Education India”.

⁶ ASSOCHAM, “National Company Law Tribunal Under The New Companies Act, 2013”.

⁷ Section 408 Companies Act 2013.

⁸ Section 410 Companies Act 2013.

⁹ As The Sica Repeal Act, 2003 Is Yet To Be Notified

a presence in India or which have been notified by the Government of India to recover on non-performing assets without court intervention. An asset is classified as non-performing if interest or installments of principal due remain unpaid for more than 90 days.¹⁰ SARFAESIA consists of three methods of recovery of NPAs: taking possession, selling and leasing the assets underlying the security interests such as movable property (tangible or intangible, including accounts receivable) and immovable property without the intervention of the courts. The SARFESIA is not available to secured creditors, which are not Indian banks, or financial institutions notified.

Conclusion

Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act and Recovery of Debts due to Banks & Financial Institutions (RDBFI) Act which were amended by Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Act, 2012, facilitates the recovery of debts due to banks and financial institution with least intervention of the court. But, we can witness instances of conflicts existing between the tribunal and the application of SARFAESI by the banks. The borrower can file an appeal in DRT within 45 days of from the date on which measures under section 13(4) are taken by the lender, thereby giving more time to defaulted borrower. Even though application under section 17 shall be disposed within 60 days but long delays in passing the orders can be seen in practical scenario.

Therefore even though recovery mechanism with least intervention of the court is provided under SARFAESI, by the Amendment Act 2012 DRT have been given more power and henceforth banks are get dragged to DRTs on flimsy grounds.

Further there are other practical difficulties regarding the delay of orders by DRT, interpretation of NPA, distinguishing between willful defaulter and non-cooperative borrower, etc

But looking at the brighter side these enactments have played a vital role in developing the economy by making the bad debts held in the bank accounts to get out in the market by way of

¹⁰ RBI/2014-15/74, Master Circular - Prudential Norms On Income Recognition, Asset Classification And Provisioning Pertaining To Advances, July 1, 2014.

auctions of the secured assets or security receipt. Who would have known that even Corporate Insolvency could also prove boon to the economy by way of securitization and reconstruction.

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7. R Gandhi, "Banks, debt recovery and regulations - a synergy", 9 Jan 2015