Jus Corpus Law Journal

Open Access Law Journal – Copyright © 2021 – ISSN 2582-7820

Editor-in-Chief – Prof. (Dr.) Rhishikesh Dave; Publisher – Ayush Pandey

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Insolvency and Bankruptcy: A Long Journey of Legislations

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Received 16 August 2021; *Accepted* 04 September 2021; *Published* 13 September 2021

Insolvency and bankruptcy are ever-evolving concepts both on national and international levels. On legal lines, every day a new change is taking place in the law regime to keep up with the pace and development taking place all over the world. Every day the foundation for a new strong economic empire is being made and every day a fragile economic unit is coming to its end, but this is conventional in the economic sphere. What matters more is what are the after-effects of this end, how and why such economic organizations come to an end, what is the effect of such ends on the various stakeholders. There are apparent distributional effects because the interest of a lot of parties is involved in the sphere of bankruptcy, ranging from banks, suppliers, creditors, employees, and even the government. Any capitalist system must have bankruptcy rules. They lay the groundwork for the orderly dissolution or reorganization of extensive business structures, counting sole proprietorships, partnerships, and limited liability corporations. This results in bankruptcy laws making it simpler to re-distribute capital that is locked up in a failed enterprise. Insolvency and bankruptcy are affected by both political and economic factors. The article aims to understand and analyze the reasons why the time-to-time different legislations were adopted, what was the difference between each legislation passed in this field, and attempts to study the current law in the regime.

Keywords: *insolvency, bankruptcy, legislative history, SICA, RDDBFI.*

INTRODUCTION

In the initial years after independence, the government adopted a more socialist nature with major means of production being under its control. Since the government owned and controlled a big share of industries, risk-taking was comparatively low and issues such as insolvency and bankruptcy were generally neglected. Until 1985, the Companies Act of 1956 set the legal background for dealing with business insolvency and bankruptcy. The Companies Act was based as per the suggestions of the Bhabha Committee[1], which was established in 1950 and issued its findings in 1952. The Presidency Towns Insolvency Act, 1909[2], and The Provisional Insolvency Act, 1920[3], were the only personal bankruptcy laws that existed. The former was for people who lived in the former presidential towns of Calcutta, Bombay, and Madras. The latter referred to everyone else.

Regarding corporate insolvency, Section 425 of the Companies Act, 1956[4] established a structure for both involuntary and voluntary dissolution (compulsory winding up, as defined in the Act). Despite having various provisions dealing with the resolution process, the 1956 Act was unable to deal with corporate insolvencies. Insolvency costs were not included in the Act, and insolvency costs were not given super-priority in the Act. It delegated the majority of difficulties to the courts, which in turn delegated due process to an official liquidator, who was frequently a court-appointed lawyer with little expertise in the company's operations. Extensive resolution delays and minimal recovery for creditors and workers were caused by inexpert liquidators with narrow comprehension in technology, auction theory, organisational behaviour, or financial engineering.

The Companies Act gave the judiciary (jurisdictional High Courts) sole authority to decide on the merits of dissolution, but the courts were not given any statutory framework to analyze the

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[1] Department of Company Affairs, 'Report of the Company Law Committee' (*Manager of Publications* 1952) <http://reports.mca.gov.in/Reports/22-Bhabha%20committee%20report%20on%20Company%20law%20committee,%201952.pdf> accessed 05 August 2021

[2] Presidency Towns Insolvency Act 1909

[3] Provisional Insolvency Act 1920

[4] Companies Act 1956, s 425

merits. Due to the lack of a supportive legislative framework, the legal system became jumbled, with each High Court deciphering individual cases discretely and issuing orders that often contradicted those of other High Courts. Slowly and gradually, industrial stagnation started taking place and the period of the fourth and fifth plan phase (1965-1975) saw acute industrial stagnation.

All this cleared the way for the Sick Industrial Companies Act,1985[5] (SICA). It was a landmark piece of legislation that addressed India's widespread industrial disease. The Sick Industrial Firms Act (SICA) was enacted in India to help detect financially infeasible ("sick") or possibly sick companies and assist in their revival or liquidation, if practicable. This step was done to free up investment that had been locked up in unprofitable businesses and put it to better use elsewhere. The purpose of this enactment was to tackle the chronic issue of the Indian economy that was industrial stagnation. A sick industrial unit, according to the statute, has been in operation for a minimum of five years and has amassed losses equal to or exceeding its whole net worth after any financial year. The Sick Industrial Companies Act (SICA) recognized several internal and external variables as contributing to the epidemic. Mismanagement, overestimation of demand, incorrect location, bad project implementation, unnecessary expansion, personal extravagance, inability to modernize, and bad labour-management interactions were among the internal problems affecting the firms. An energy crisis, a scarcity of raw materials, infrastructural constraints, insufficient financial facilities, technological shifts, and global market pressures were among the external reasons.

"SICA created the Board for Industrial and Financial Reconstruction, and the first-time matters relating to insolvency and bankruptcy were diverted away from the high courts. SICA was preventive legislation with first preference for restructuring rather than winding up."[6] Industrial sickness resulted in a loss of government income, a concentration of limited resources in ill units, an upsurge in non-performing assets held by banks and financial

[5] Sick Industrial Companies Act 1985
[6] Saket Hishikar, 'Insolvency and Bankruptcy Reforms: The Way Forward' (2020) 45 Vikalpa: The Journal for Decision Makers

institutions, an increase in unemployment, a loss of output, and low productivity. SICA was put in place to address these negative socioeconomic impacts.

However, the government's efforts to manage ailing industrial units in the interim and nationalize ailing industries were in vain. Worker's compensation was rising, the recovery of loans was sluggish, and unemployment was on the rise. Moreover, there was an excess abuse of section 22 of The Sick Industrial Companies Act; which allowed the corporations to seek a stay of execution, arbitration, recovery litigation, security interest enforcement, and so on, and it was frequently abused by unscrupulous promoters. According to the Eradi Committee, the SICA recovery rate was only 19%, which further complicated the issue due to low recovery. The failure of the above-mentioned legal reforms along with the balance of payments economic crisis paved the way for the later legal reforms.

Later down the line, came The Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDDBFI) to act as a catalyst in the recovery process. The earlier act was majorly concerned with financially sick companies, whereas RDDBFI especially focused on banks and financial institutions. These reforms came after the Narasimhmam Committee – 1 studied all the aspects related to the financial systems' structure, organization, activities, and processes, as well as made recommendations for improving their efficiency and productivity. RDDBFI is aimed at overcoming the issues that banks have been dealing with for a long time. Loans can be easily recoverable, speedy spot justice in certain cases, and unblocking the money that has been frozen. RDDBFI provided for Debt Recovery Tribunals (DRTs).

DRT has the jurisdiction under Section 17 of the RDDBFI Act to consider any application from banks and financial institutions to recover debts for such banks and financial institutions. The Appellate Tribunal, the DRAT, shall have jurisdiction to hear appeals from any order made by a DRT under the Act. However, the Supreme Court has ruled that DRT and DRAT cannot rule on matters such as property succession rights, receipt issuing, and so on. Its authority is limited to the matters listed in section 17 of the Act.

Other courts, aside from the Supreme Court and High Court, which get their power from Articles 226 and 227 of the Constitution, are now forbidden from looking into debt cases under Section 18 of the Act. This clause is in keeping with the L Chandra Kumar decision[7], which stipulates that tribunals are simply a supplement to the High Courts, not a replacement for them. DRTs performed exceptionally well in the beginning, but soon the figure of pending cases rose and overburdened them.

The Government introduced another legislation in lieu under the name of The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act, 2002) to allow banks or financial institutions (FIs) to collect on nonperforming assets (NPAs) without the need for court involvement. The SARFAESI Act led to the formation of two important organs that are the Securitization Company (SCO) and the Reconstruction Company (RCO) with asset securitization and reconstruction its objective. Along with its core objective, SCOs and RCOs were allowed to carry on other operations such as, on the furtherance of any bank or financial institution, acting as a recovery agent. Assuming the role of manager to oversee the management of secured assets whose possession has been taken over by the secured creditor.[8] If a Court or a Debt Recovery Tribunal appoints them as a receiver, then they will be able to do so.

The SARFAESI Act was a major addition to the legislation covering insolvency and bankruptcy in India, but it had some shortcomings too like it didn't cover the unsecured creditors under its ambit and many more. Such shortcomings were dealt with in the next legislation under the name of "Insolvency and Bankruptcy Code, 2016".

1. Insolvency and Bankruptcy Code, 2016

Between 2008 and 2014, banks lent to everyone who wanted money. This resulted in a high number of non-profitable assets (NPAs), which were flagged by the RBI's asset quality reviewers. This was the beginning of some serious economic issues in India.

[7] *L Chandra Kumar v Union of India* MANU/TN/0597/1988
[8] The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, s 13(4)(c)

To tackle this, the foundation for the Insolvency and Bankruptcy Code, 2016 was laid which aims to amalgamate the existing framework by establishing an integrated insolvency and bankruptcy legislation and to enhance the interaction between creditors and debtors. The Lok Sabha enacted the IBC, 2016 on May 5, 2016, and the Rajya Sabha passed it on May 11, 2016. In 2016, the President of India gave his approval, and IBC became operational six months later, in December 2016. The government established the National Company Law Tribunal (NCLT) and its appellate body on June 1, 2016, under the Companies Act, 2013, to arbitrate disputes arising under the Act in the areas of companies and limited liability partnerships. The adjudicating authority in the instance of individuals and partnerships will be in the hands of the Debt Recovery Tribunal (DRT), which was formed by the Recovery of Debts Due to Banks and Financial Institutions Act, 1993. Under this act, insolvency can be filed by both people and businesses. The main distinction is that it is referred to as bankruptcy for individuals and corporate insolvency for businesses. It occurs when an individual or corporation is unable to pay a debt in the present or near future, and their assets are worth less than their liabilities.

The Insolvency and Bankruptcy Code (IBC) of 2016 was adopted to consolidate the current insolvency and bankruptcy legislation. Insolvency is a condition in which a firm is unable to operate due to financial issues. Various types of changes were required to alleviate the load of rising non-performing assets. However, the Insolvency and Bankruptcy Laws needed to be changed. As a result, the Bankruptcy Law Reforms Committee (BLRC), chaired by Mr. T.K. Viswanathan, former Union Law Secretary, was established in 2014 to set up an Indian Bankruptcy Code to replace the existing rules, which would apply to both non-financial organisations and people. In 2015, a draft of the Insolvency and Bankruptcy Code was submitted.

IBC consists of various unique characteristics such as:

National Company Law Tribunal and Debt Recovery Tribunal

NCLT and DRT are judicially established special bodies tasked with adjudicating insolvency and bankruptcy cases. The National Company Law Appellate Tribunal (NCLAT) hears NCLT appeals, and following NCLAT, the party can appeal to the Supreme Court of India. Similarly, DRT appeals go to the Debt Recovery Appellate Tribunal, which finally goes to the Indian Supreme Court. The NCLT and the DRT are two different tribunals. NCLT is for corporations and limited liability partnerships, whereas DRT is for sole proprietorships and unlimited liability partnerships.

Committee of Creditors (COC)

Section 21 of the Insolvency and Bankruptcy Code of 2016 establishes a Committee of Creditors (COC). COC is made up entirely of financial creditors. The COC's duty in the Corporate Insolvency Resolution Process is to approve or disapprove the resolution plan provided by the resolution professional (CIRP). In a COC meeting, a majority vote of 75 percent is necessary to adopt the resolution plan. Operational creditors are authorised to attend a committee of creditors' meetings, but they do not have voting rights.

Insolvency Professionals

Interim insolvency professionals and insolvency professionals are the two sorts of insolvency specialists. Interim insolvency professionals are appointed by the adjudicating body within 7 days of the application being accepted, and insolvency professionals are appointed by a committee of creditors by a majority vote of 75 percent at the COC's first meeting. If the COC is dissatisfied with the chosen interim insolvency experts, they can apply with the adjudicating body to have them replaced.

Insolvency and Bankruptcy Board of India (IBBI)

The Insolvency and Bankruptcy Board of India (IBBI) was recognized on October 1, 2016, to oversee and combat various insolvency and bankruptcy cases filed by financial and operational creditors, such as Indian banks, home buyers, and others. The IBBI is governed by the Insolvency and Bankruptcy Code of 2016.

All insolvency resolution processes, professional insolvency agencies, and information utilities are regulated by the IBBI. The list of resolution professionals is approved by the IBBI.

Bifurcation of Creditors

Under IBC, creditors are bifurcated into three different terms, namely; Financial Creditors, Operational Creditors, and Corporate Creditors. Financial creditors are defined as creditors who pay money to the promoters under section 5(7) of the IBC 2016. Banks, house purchasers, and other promotional creditors are included. In the event of a default, debtors must follow the procedures outlined. Operational creditors, as defined in section 5(20) of the IBC 2016, are creditors who deliver goods and services to the promoters rather than money or currency. Corporate debtors are defined as promoters who receive loans or money from financial creditors or accept products or services from operational creditors as a debt under section 5(a) of the IBC 2016.

CONCLUSION

Over time, IBC has aided in the achievement of ease of doing business through the faster resolution of insolvency, as well as increased confidence and a sense of security among creditors and investors. In 2016, India was rated 136th out of 189 nations in the World Bank's index on the ease of resolving insolvencies; in 2019, India is placed 63rd in the World Bank's index on resolving insolvencies. There have been many landmark cases under IBC, such as the Bhushan Steel case, Essar Steel case, Jet airways case, Reliance Communications case, Dewan Housing Finance Ltd. case, and many more. According to the 2020 economic survey report, the Insolvency and Bankruptcy Code improved the resolution process in India when compared to previous legislation. The recovery rate for NPA cases under the IBC is 42.5%, compared with 14.5% under the SARFAESI Act.[9] The IBC resolved cases within 340 days, which used to take 4.3 years under previous legislation.[10] One of the most significant successes of the 2016 Insolvency and Bankruptcy Code is the reduction of non-performing assets (NPAs).

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[9] ETBFSI, 'IBC Recovered 42.5% of Total Bad Loans Filed with NCLAT: Economic Survey' (*Economic Times,* 31 January 2020) <https://bfsi.economictimes.indiatimes.com/news/banking/ibc-recovered-42-5-of-total-bad-loans-filed-with-nclat-economic-survey/73803095> accessed 10 August 2021

[10] *Ibid*