

SOLVING INDIA'S INSOLVENCY PROBLEM

The insolvency system is not up to the standards of India's economy. Read how the insolvency process works and in what ways it needs to be improved.



Since the colonial days, textile mills had employed thousands of people in India. The ageing industry, troubled with a volatile unionised workforce, was in the doldrums by the 1960s, forcing the government to take over many of the ailing companies and forming National Textiles Corporation (NTC) in 1968. Yet, in the four decades since then and despite government support in procurement of raw material, finance and distribution, the

119 mills under NTC and its 9 subsidiaries continued on their downhill trip. From 1992 to 1994, 8 NTC subsidiaries owning 104 mills were referred to the Board of Industrial Finance and Reconstruction (BIFR), a quasi-legal body under the Sick Industrial Companies Act (SICA).

BIFR is entrusted with the role of detecting bankruptcy and recommending rehabilitation and restructuring schemes to sick industrial companies. Any industrial company that finds its net worth eroded to half has

to appeal to the BIFR. After hearing the case and deliberating over the issues raised by NTC management, the financial institutions, suppliers of raw material and the trade unions, BIFR recommended a financial restructuring and rehabilitation package in 2002.

However, the option of seeking BIFR help in detecting signs of impending bankruptcy is available only to industrial companies. Suicides by failed businessmen or people hounded by recovery agents for unpaid

loans are frequently reported in newspapers. Rarely does a company, big or small, file for insolvency, unless it has to do so statutorily. "The stigma attached to bankruptcy forces companies to run far too long even when the market conditions turn grossly adverse or when the cash flow reaches precarious levels", says Vinod Kothari, a corporate tax expert.

The business of winding up companies

Kothari also blames the rigid

WHAT IS INSOLVENCY?

Companies must meet stringent rules to be declared bankrupt in India

In India, according to Section 6 of the Provincial Insolvency Act, 1920, a company (or person) is insolvent (bankrupt) under any of the following conditions:

- if the property of the debtor is transferred to a third party with the intent of defeating creditors
- if the debtor leaves the country, residence or usual place of business with the intent of default or delay creditors
- if any part of the property of the debtor is sold with the decree of any Court for the payment of money
- if the debtor petitions to be adjudged an insolvent
- if the debtor gives notice to any of the creditors that he has or will suspend payment of debts
- if the debtor is imprisoned in execution of the decree of any Court for the payment of money
- if a creditor obtains a final decree or order against the debtor for the payment of money and the debtor does not comply.

When a company is adjudged as insolvent and the failure of its debt is established, it will have to wind up operations.

When a debtor makes a declaration of insolvency and petitions for winding up in accordance with the Companies Act, 1956, it is referred to as 'a members' voluntary winding up'. Other cases are referred to as 'creditors' voluntary winding up'.

As illustrated in the two charts, the procedure for declaring insolvency is no cakewalk. When a company wishes to wind up voluntarily, the majority of the directors need to hold a board meeting and declare verified by an affidavit that they have made a full inquiry into the affairs of the company and that they have formed the opinion that the company has no debts, or that it will be able to pay its debts in full within three years from the commencement of the winding up.

The declaration will have no effect for the purpose of the Companies Act, 1956 unless:

- it is submitted to the Registrar of Companies at least five weeks prior to the date of passing the resolution for winding up the company, and
- it is accompanied by copies of the company's financial statements, and a declaration from any of the directors that debts shall be repaid within a specified period. ■

exit rules for deterring Indian companies from declaring insolvency voluntarily. In most old economy industries, labor is unionised and the hire-and-fire rules as in the US do not apply. "A company cannot wind up or even close down operations till it pays compensation to the workforce," according to Kothari. Financial restructuring or negotiations with lenders take years to be resolved by which time the company's financials turn from bad to worse.

Arindam Guha of solicitor firm, Fox and Mandal, agrees that the judiciary system in India is not geared to speedily dispose of winding-up cases. There is no bankruptcy court in India and all cases are heard at the state High Courts. In the 21 High Courts of India, over 3.2 million civil cases are pending. In 2005, there were 6,259 winding up cases pending at the various courts. The number has but increased since then.

A World Bank study found in 2005 that on average, it takes 10 years to wind up a company, at costs of 9% of the estate and a recovery rate of 13 cents to a dollar for the creditors. So the study concluded "the absence of effective tools and instruments to supervise and manage the insolvency process renders the liquidation process an insignificant part of market dynamics".

"The number of lawsuits filed in Indian courts is many times that in US courts as the legal costs are not as prohibitive as in the US", Guha says. The speed of disposal of cases is slow since the judicial process allows for appeals at various stages, besides the inadequate number of judges available to handle the huge

number of cases. For example, in Kolkata High Court, only about 10-12 cases are disposed of each day, compared to 70-80 cases filed, Guha noted.

The arbitration-conciliation system, introduced to lessen the burden of the courts, has also failed as the appeal system can be prolonged even here. In fact, the orders of the arbitrator can also be challenged in any court so that this mechanism is usually employed only as a lower court and not the final decision-maker. The various tribunals like the Land Tribunal, the Bank Tribunal and Debt Tribunal, set up to supplement the courts, have also not enabled a faster bankruptcy process.

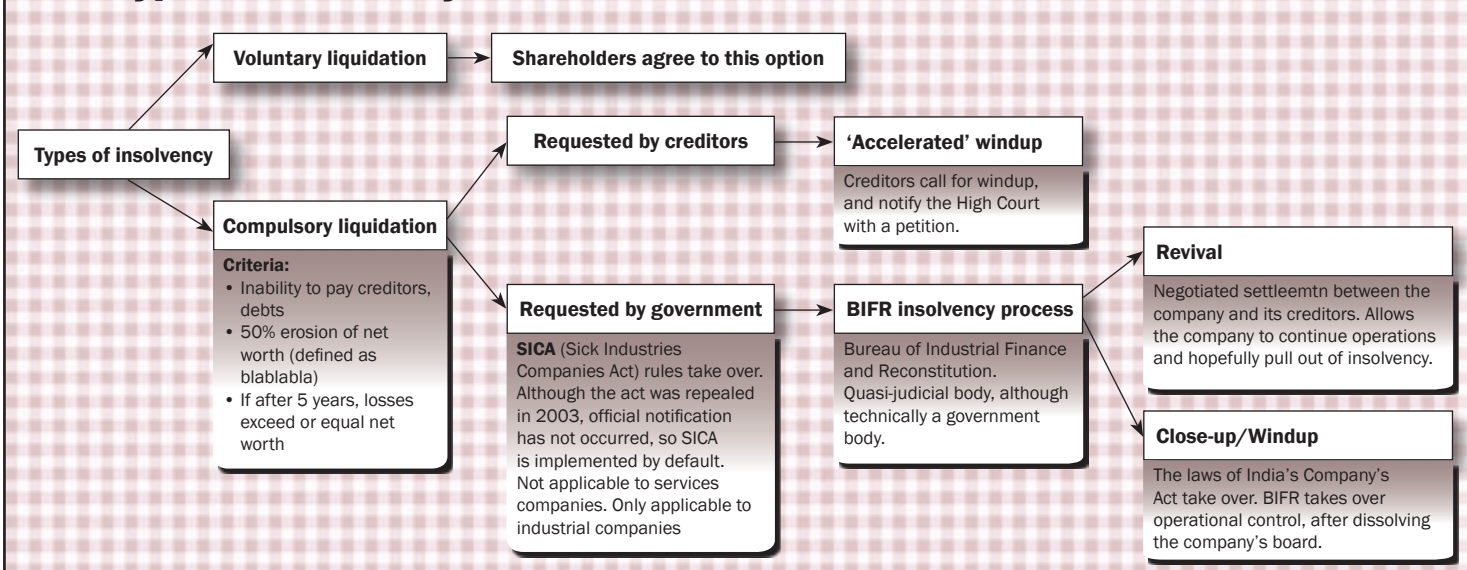
Bankruptcy protection

There is no single comprehensive and integrated policy on corporate bankruptcy in India that could be compared to Chapter 11 or Chapter 7 bankruptcy code in the United States.

Chapter 11 Bankruptcy Code provides guidance on "reorganisation" of a business that may be a corporation, sole proprietorship or partnership to make it profitable once again. It also provides protection from creditors. A chapter 11 debtor proposes a plan of reorganisation to keep the business alive and pay creditors over time. Chapter 7 covers liquidations. Overall, the American system is somewhat in tune with the entrepreneurial rules of fail-to-succeed: fail often, fail quickly, fail cheaply.

In India, three major legislative Acts – the Provisional Insolvency Act, 1920, the Companies Act, 1956 and the Sick Industrial Companies Act 1985 – and several provisions constitute

What types of insolvency exist?



the procedural guidance on liquidation and reorganisation process.

SICA is the closest alternative to a bankruptcy framework in India.

It deals with special provisions with a view to securing the timely detection of sick and potentially sick companies owning industrial undertakings. Section 3(o) of the Act defines a "Sick Industrial Company" as one registered for not less than five years, which has at the end of the financial year accumulated losses equal to or exceeding its entire net worth.

Under the mandate of SICA, BIFR was set up as a quasi-judicial body that would detect "sickness" of an industrial company and provide a restructuring and rehabilitation program. If an industrial company's net worth is reduced to half in any financial year, the Board of Directors have to file an application to the BIFR within 60 days of finalisation of accounts.

Once an application for intervention is filed to the BIFR, it has three choices:

- 1) approve a management/creditor sponsored plan without concessional financing,
- 2) determine unviability of the business and recommend liquidation to the court, governed by Companies Act, 1956, or
- 3) claim that the firm must be rehabilitated in "public interest" and approve a plan requiring major concessions and "sacrifices" from the various parties including subsidies from the government.

In the case of NTC, BIFR chose the third option as it considered that the large company, which still owned considerable assets and has the potential to generate

substantial employment, should be rehabilitated in "public interest". BIFR usually appoints an Operating Agency, usually a third-party financial institution, to recommend a restructuring exercise.

The process of bankruptcy

Under the Companies Act, 1956, companies facing financial crisis can resort to winding up either voluntarily or through the Court Order. In the case of voluntary winding up, the shareholders vote for liquidation, pass a resolution at a Board meeting, deliver it to the Registrar of Companies and hand over control of the process to liquidation to secured creditors who then hire a private or an official liquidator to oversee the asset sales and distribution of proceeds.

A creditor with a minimum amount of Rs 500 of unpaid and undisputed debt, after giving three weeks' notice to the debtor, can also petition the court for involuntary liquidation of the company. The court determines the validity of the claim and the reasonableness of the petition before ordering liquidation. However, the decision of the court is purely discretionary and may also refuse to hold the company insolvent on other considerations, including that of "public interest".

Till the court decides upon the case, the debtor remains in possession of the assets but once the winding up has been ordered by the court, an official liquidator - a government employee - is appointed for overseeing the entire process of claiming and selling assets, recovering debts and paying off the company's liabilities. In settling the claims, the highest priority is accorded

NO RELIEF IN SIGHT?

An expeditious bankruptcy procedure should have been initiated in 1999. That was forgetting that many lawyers were involved

In 1999, the government appointed a high-level committee to look into corporate insolvency. The committee recommended that the SICA, and under its aegis, BIFR, should be abolished. In its place, it recommended the setting up of the National Company Law Tribunal (NCLT) that would have the jurisdiction, power and authority to wind up companies. It also recommended that the Companies Act 1956 should be amended so that the powers to wind up companies should be taken away from the High Courts and vested on NCLT.

The Companies (Amendment) Act, 2002, provided for the setting up of the NCLT, which should have assumed the functions of the BIFR, the Company Law Board (CLB) and the Appellate Authority of Industrial and Financial Reconstruction (AAIFR) and also relieved the High Courts of these duties. The Act also made it obligatory for financial institutions to inform NCLT of any signs of corporate sickness.

However, the NCLT hit a roadblock when, in 2004, the Madras Bar Association objected to some clauses, claiming that not enough qualified professionals existed to man the tribunals in different cities. The Madras High Court ruled in favor, and the government has now approached the Supreme Court to allow the establishment of the NCLT.

In the meantime, the SICA has been repealed although BIFR continues to operate. The government is now mulling giving CLB the legal authority to decide on winding up issues. This would, however, be only a short-term measure since CLB has only nine members in its benches in Delhi, Chennai, Mumbai and Kolkata. When the NCLT is set up, it should have its principal bench in Delhi and other benches in 15 locations, with 62 members in all. ■

to secured creditors and workers' dues, followed by preferential status of government and administrative claims (employee severance pay and accrued insurance and pension benefits) and the rest goes towards settling claims of unsecured creditors and equity holders.

An interesting feature of this provision is the absence of an automatic stay in the interim period between filing of the petition and a ruling of the court. As this interim period may last up to a year, it is usually characterised by a frenzy of lawsuits by all kinds of claimants and in some cases

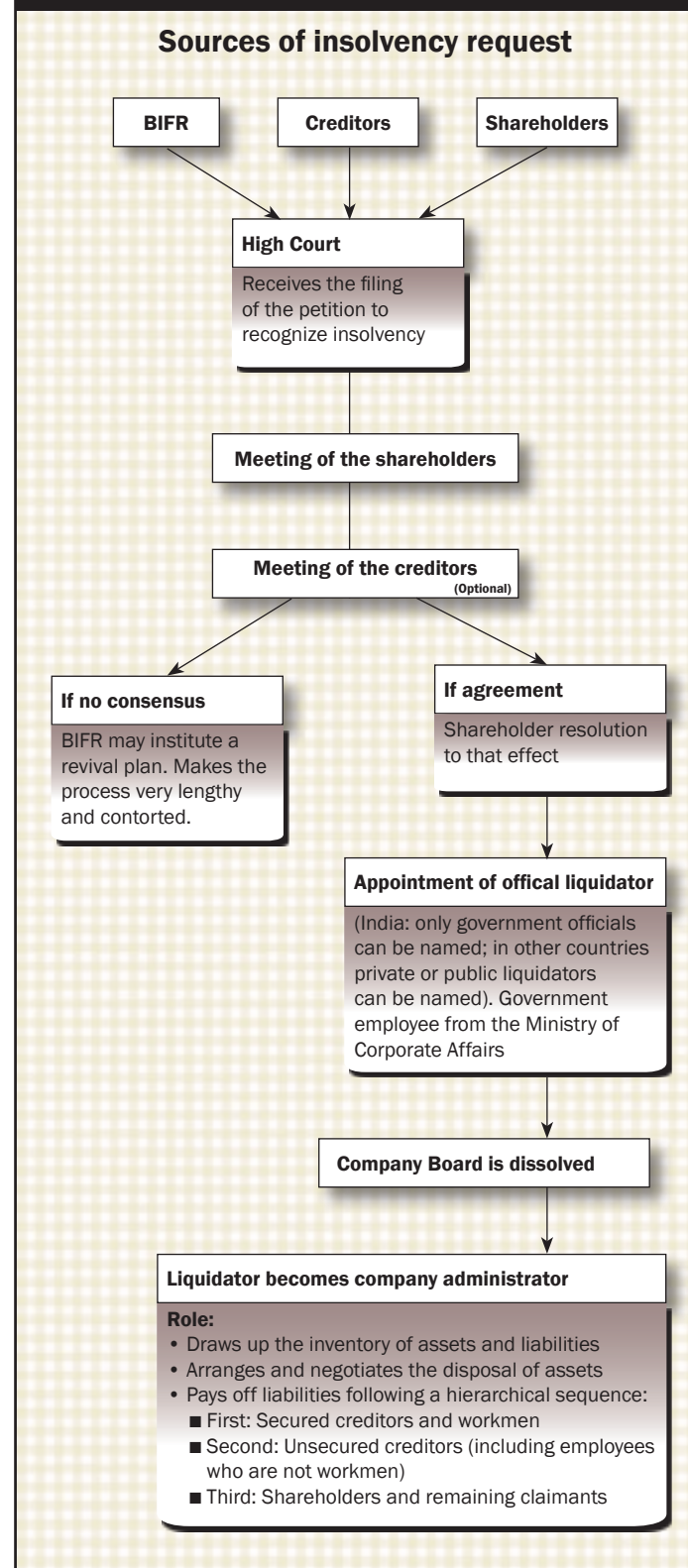
sale of collateral in possession of creditors. In the US, Chapter 11 grants an Interim Stay Order by which all judgments, collection activities, foreclosures, repossession of property are suspended, preventing any debt claim that arose before the filing of the bankruptcy petition.

Performance of BIFR

The JJ Irani Committee on Company Law found in 2005 that bankruptcy cases take as long as 25 years to be disposed. The Committee even found cases dating prior to Independence in 1947.

BIFR filing has turned out to

INSOLVENCY PROCESS IN EASY BUT LONG STEPS



be an easy way for promoters to manipulate debt since the creditors can be kept at bay till the case is resolved. BIFR can only recommend strategies but has no legal authority. Liquidation proposal has to be filed in the overburdened High Courts where legal proceedings take years to even begin. Till then, the promoters may continue to default on debt with no remedy for creditors.

A golden lining in the scenario is that the number of companies referred to BIFR has been on a downtrend since 2002. From a high of 559 companies referred to BIFR in 2002, only 180 companies appealed for reorganisation to BIFR in 2005. The improvement of the economic scenario and better commodity prices brought many distressed industrial companies out of the red.

Textile and metallurgical companies comprised 18 and 16 percent of the total number of cases referred to the BIFR over 1987-2005. Many of these companies could pull out from the BIFR once they posted profits through restructuring processes they implemented or because of better market conditions. As many as 29 percent of the cases filed with the BIFR have been dismissed, as these either do not qualify as "sick" companies or have come out of the status. About 9 percent of the companies have been revived by BIFR and another 5 percent is undergoing the process of revival. That leaves 24 percent of the companies which are in the liquidation process and 33 percent that have filed to the BIFR have not been heard yet.

The way ahead

The BIFR is now waiting for a burial as the Companies Act (Amendment) 2002 has recommended its replacement by the National Companies Law Tribunal (NCLT). The SICA has been repealed but the setting up of NCLT awaits a go-ahead from the Supreme Court. The Madras Bar Association has moved the Supreme Court claiming that India does not have enough

qualified professionals needed to operate benches at 15 locations with 62 members (See Box: No relief in sight?).

It is not that there is a dearth of lawyers in India. There are about 1 million lawyers in India and 80,000 men and women graduate from law schools every year. What is needed is a dedicated bankruptcy court that can dispose of restructuring or liquidation cases speedily and at minimum costs. The Federation of Indian Chambers of Commerce and Industry (FICCI) feels that India needs an Insolvency Act on the lines of the Bankruptcy Act of Chapter 11 in the US. For sick companies that have no chance of revival, FICCI wants a mechanism that would enable speedy exit so that unproductive resources can be deployed elsewhere.

The Indian system is not yet in a position where the entrepreneurial rules of fail-to-succeed (fail often, fail quickly, fail cheaply) are easily respected. Time will tell whether NCLT is able to enable such a failure-friendly mindset. ■

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