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Client Alert Commentary

Latham & Watkins Restructuring, Insolvency & Workouts Practice December 6, 2016 | Number 2040

India Implements Radical Reforms to Insolvency and Rehabilitation System[1]

With a new Insolvency and Bankruptcy Code that has become effective on 1 December 2016, India seeks to expedite the process for creditors seeking payment or foreclosure through the courts.

India is currently a tough place to be a creditor, especially an unsecured creditor. Multiple statutes and forums govern the current insolvency regime for corporations in India. A creditor seeking payment or foreclosure through the courts may have to wait over 10 years to obtain relief. The average time for an insolvency to be resolved in India is 4.3 years, as opposed to 1.5 years in the US and one year in the UK. India seeks to remedy this problem through a new Insolvency and Bankruptcy Code (the Code). Although the new Code is a good start, to effect real change, the government must follow up by establishing an infrastructure necessary to implement and enforce the Code, otherwise creditors may continue to struggle in India.

The New Insolvency and Bankruptcy Code

In May 2016, the Indian Parliament passed its first nationwide Insolvency and Bankruptcy Code. The purpose of the Code is to have a single comprehensive law to resolve insolvency cases more expeditiously, and maximize the value of insolvent businesses' assets through promoting reorganization as opposed to liquidation. The Code was passed as part of other economic reforms and measures to revamp the Indian banking industry and to cultivate a business environment conducive to foreign investors. Since the passing of the Code, the Ministry of Corporate Affairs has drafted rules and regulations (the Draft Regulations) for the purpose of implementing the Code and released them to the public for comments in October 2016. Although the Code is a step in the right direction, how the Code will operate in practice remains to be seen.

Insolvency Resolution Process

The debtor or any creditor (financial or operational) with a default in excess of a statutory minimum can institute an insolvency resolution process by filing an application with the National Company Law Tribunal (the Tribunal). The Tribunal has 14 days from receiving the application to ascertain the existence of the default. Once the Tribunal is satisfied the default has occurred and the application is in the prescribed form, contains all the requisite information and is accompanied with the prescribed fee, the Tribunal will admit the application. The date of the admission is the Insolvency Commencement Date.

Moratorium

Upon admission of the application, the Tribunal is required to declare a moratorium on creditors' taking collection actions or foreclosing on security, on lessors' recovering property occupied or possessed by the

debtor, and on the debtor transferring or encumbering its assets. The moratorium will be effective until the insolvency resolution process is completed, either as a result of the resolution plan being approved or an order for liquidation being entered. Unlike in the US or UK, however, where the moratorium starts upon filing of the petition, the moratorium under the Code starts when the Tribunal admits the application (*i.e.*, on the Insolvency Commencement Date). Although the Tribunal has only 14 days to decide whether to admit the application, the delay in the effectiveness of the moratorium could lead to creditors taking action against the debtor or its assets during the period between the application filing and admission. Once the moratorium is in place, it has teeth. Violating the moratorium will attract criminal liability.

On the Clock

After the Tribunal admits the application, the insolvency resolution process must be completed within 180 days, with a one-time 90-day extension by the Tribunal on application if the Tribunal is satisfied that the insolvency resolution process cannot be completed within 180 days, for a maximum of up to 270 days (the Reorganization Deadline). A Resolution Professional's decision to apply for extension should be made after approval by a 75% vote at a meeting of the committee of creditors. If the insolvency resolution process is not completed by the Reorganization Deadline, the debtor is put into liquidation. One of the Draft Regulations issued for public comments is the draft Insolvency and Bankruptcy (Insolvency Resolution Process for Corporate Persons) Regulations 2016,(the 2016 Regulations), which provide that the Tribunal will hear no such application if the application is presented more than 30 days after the end of the 180-day period. This in effect means the entire insolvency resolution process can be stretched out for a total of 120 days (a 90-day one-time extension with a 30-day period to make an application).

Resolution Professional

The Tribunal will appoint an insolvency professional as interim Resolution Professional within 14 days after the Insolvency Commencement Date, to manage and operate the debtor's business and protect and preserve the value of the debtor's property, similar to an administrator in the UK. At that point, the interim Resolution Professional will exercise the powers of the board of directors. Management is required to cooperate and provide all assistance requested by the interim Resolution Professional in managing the debtor's affairs. The interim Resolution Professional's term will not exceed 30 days. The creditors' committee will either re-appoint the interim Resolution Professional as the permanent Resolution Professional or replace him or her with a different permanent Resolution Professional.

Creditors' Committee

The interim Resolution Professional identifies the financial creditors that will serve on the creditors' committee. The debtor and large operational creditors will be invited to attend creditors' committee meetings, but are not permitted to vote. There are no classes of creditors as in schemes of arrangement in the UK or chapter 11 plans in the US. Rather, all financial creditors vote in a single class. All creditors' committee actions require a 75% affirmative vote by amount of claims. The creditors' committee appoints the permanent Resolution Professional and must approve all his or her material decisions, such as obtaining financing, creating a security interest, changing the debtor's capital structure, disposing or permitting the disposal of the debtor's shares and undertaking any related-party transactions.

Financial and Operational Creditors Distinguished

The Code distinguishes between financial creditors, such as banks and bondholders, and operational creditors, such as trade creditors and government authorities. Only financial creditors can serve on the creditors' committee.

Resolution Plan

The Resolution Professional will present the resolution plan (either formulated by the Resolution Professional or submitted by any other person) to the creditors' committee. If the creditors' committee approves the plan, the Resolution Professional will submit the plan to the Tribunal.

A resolution plan must provide for the following: (a) payment of the costs of the insolvency resolution process; (b) payments to operational creditors of at least the amounts they would receive in a liquidation; (c) the management of the debtor's affairs after the resolution plan is approved; (d) the implementation and supervision of the reorganization after resolution plan approval; and (e) compliance with any laws or regulations currently in force or adopted by the Insolvency and Bankruptcy Board.

This limited number of requirements for an acceptable reorganization plan combined with the concept of all financial creditors, secured and unsecured, voting for the proposal as a single class, could lead to reorganizations that are unfair to a minority creditor class. For example, if 75% of a corporation's financial debt is unsecured bond debt, secured creditors could be bound to a reorganization that fails to provide the benefit of their secured position.

The 2016 Regulations, if enacted, should remedy this situation by requiring that dissenting creditors receive at least what they would receive in a liquidation. The 2016 Regulations provide a list of mandatory contents of an acceptable resolution plan, which includes:

- An estimate of the insolvency resolution process costs likely to be incurred, the assets that will be used to meet such costs, and an estimated timeframe for paying these costs
- The liquidation value for the operational creditors, the assets that will be used to meet the liquidation value and provide for payment of the liquidation value to the operational creditors before any recoveries will be made by the financial creditors voting in favor of the resolution plan
- The liquidation value for the financial creditors who voted against the resolution plan, the assets that will be used to meet the liquidation value and provide for payment of the liquidation value to the dissenting financial creditors before any recoveries will be made by the operational creditors and financial creditors voting in favor of the resolution plan
- The proposed term for the resolution plan and whether during this term, the management and control of the business and operations will continue to vest with the Resolution Professional, revert to original management or vest with any other person

Insolvency and Bankruptcy Board

The Code establishes an Insolvency and Bankruptcy Board to regulate insolvency professional agencies and insolvency professionals, and issue regulations and guidelines regarding the Code. The insolvency professional agencies will grant memberships to insolvency professionals, lay down standards of professional conduct and monitor insolvency professionals' performance. The Insolvency and Bankruptcy Board will require insolvency professionals to be members of insolvency professional agencies, register with the Board and pay a prescribed fee. The Insolvency and Bankruptcy Board oversees not only the insolvency professional agencies and insolvency professionals, but also information utilities.

Information Utilities

Information utilities are professional organizations that will collect and store financial information and provide access to the Resolution Professional, the creditors and other stakeholders in the insolvency resolution process, so that all stakeholders can make decisions based on the same information.

Liquidation

The corporate debtor will be put into liquidation if a resolution plan is not accepted by the requisite vote of the creditors' committee and approved by the Tribunal prior to the Reorganization Deadline.

Priority of Claims

The priority of claims upon a liquidation under the new Code is as follows:

- The costs of insolvency resolution, including any interim financing received during the insolvency resolution process, and liquidation costs (other than the cost of the liquidator)
- Secured claims (in the event such creditor relinquished security) and claims of workmen for services performed in the preceding 24 months
- Claims of employees other than workmen for services performed in the preceding 12 months
- Claims for financial debt owed to unsecured creditors
- Claims for government dues and any secured creditors' claims in excess of the value of their collateral
- Any remaining claims
- Preferred shareholders (if any)
- Equity shareholders or partners (as the case may be)

The liquidator's fees will be deducted from each class of claims that receives a distribution on a pro rata basis.

Intercreditor Agreements May Be Unenforceable

The Code provides that a liquidator will ignore intercreditor agreements among creditors within a class if the agreement would prioritize one creditor over another within that class. This provision effectively renders intercreditor agreements unenforceable in a liquidation. Creditors with the benefit of intercreditor agreements will need to try to separately enforce those contracts outside of the insolvency process.

Avoidance Actions

If certain preferential transactions have been entered into with creditors, sureties or guarantors, or if undervalue transactions have been entered into other than in the ordinary course of business within one-year prior to the Insolvency Commencement Date (two years prior for transfers to related parties), the Resolution Professional or liquidator can apply to the Tribunal to set aside such transactions. Extortionate credit transactions involving the receipt of financial or operational debt two years before the Insolvency Commencement Date can also be avoided if the terms of such transactions require the debtor to make exorbitant payments.

Liability for Misfeasance

If the debtor's business has been carried on with intent to defraud creditors or for any fraudulent purposes, the Resolution Professional or liquidator can apply to the Tribunal to impose personal liability on persons who are knowingly parties to the carrying on of the business. There are also extensive provisions imposing criminal liability punishable with imprisonment on debtor officers who commit fraudulent acts or fail to cooperate with the Resolution Professional, such as making false entries in books and records, concealing or fraudulently removing debtor property, and failing to disclose all details of the debtor's property to the Resolution Professional.

Cross-Border Insolvency Rules

The Code did not adopt the United Nations Commission on International Trade Law (UNCITRAL) model law for cross-border insolvencies. However, the Code enables the Central Government of India to enter into treaties and agreements with other countries regarding cross-border insolvencies, and permits the Tribunal to send a letter of request to foreign tribunals requesting the Code be enforced with respect to assets outside India.

Conclusion

The current process for collecting debts in India is slow, cumbersome and confusing, and the recovery rate for creditors is low. Having a single insolvency law and a single forum with strict timeframe requirements in which insolvencies will be resolved is an improvement. However, how the Code will be implemented and how it will work in practice remains to be seen. Unlike the US and UK, which have extensive rules and a developed body of case law guiding the insolvency process, the Insolvency and Bankruptcy Board that will govern and regulate the insolvency process has only been established in October 2016 with four members, and the insolvency professional agencies and information utilities have yet to be established and licensed. Accordingly, although the future looks brighter, in the near-term creditors will have to continue to endure uncertainty regarding the resolution of insolvencies in India.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

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The authors would like to express sincere gratitude to Shardul Amarchand Mangaldas & Co. for their contributions to this *Client Alert*.

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Endnotes

[1] This *Client Alert* is limited to a review of the new Insolvency and Bankruptcy Code's provisions regarding companies and limited partnerships other than financial service providers such as banks and insurance companies. There are separate provisions dealing with proprietorships, unlimited partnerships and individuals.