

Insolvency and Bankruptcy Law in India
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Week 01
Lecture 01

Welcome to NPTEL courses. Today, we're going to discuss the course on Insolvency and Bankruptcy Law in India. My name is Sridhar, Assistant Professor from NALSAR University of Law. As part of this course, today we're going to discuss lesson number 1 on the topic “**Introduction and History of Insolvency Laws in India**”. Let us discuss.

The modern insolvency law was introduced during the British period, although we have traces of insolvency law even before the British period as well. To regulate that, as the British entered India and established their colonies in India, to regulate trade-related operations in the presidency towns, they enacted one legislation called the **Indian Insolvency Act of 1848**. But this legislation, the Indian Insolvency Act of 1848, was applicable only to the presidency towns, and provincial towns were not regulated; they were not covered under this legislation. Accordingly, subsequently, in the year of 1909, the **Presidency Towns Insolvency Act of 1909**, which was regulating the presidency towns, and the **Provincial Insolvency Act of 1920**, which was regulating the provinces, were passed by the British government.

Subsequent to that, after independence, at present, we are having the **Insolvency and Bankruptcy Code of 2016**. The major aim of this legislation is to consolidate the existing legal framework relating to insolvency law. Before this Insolvency and Bankruptcy Code of 2016, the law relating to insolvency used to be scattered.

We had various provisions under various legislations, and they were not in one place. Like, we had some provisions relating to insolvency under the Presidency Towns Insolvency Act of 1909, which regulated the insolvency proceedings in the presidency towns. And we had the Provincial Insolvency Act of 1920, where the insolvency proceedings in the provinces were regulated under this legislation. Then, after independence, we had one legislation called **SICA, the Sick Industrial Companies Act of 1985**. If any company becomes sick, we are going to discuss what SICA is and its overview, and what is considered to be a sick industry under the Sick Industrial Companies Act subsequently, but the SICA Act was enacted in the year of 1985. Then, we have the provisions under the **Companies Act of 2013**. Before the Companies Act of 2013, we had the **Company Act of 1956**, where we had some provisions relating to liquidation and winding up of the company.

Then, after liberalization, in the era when we adopted the LPG policy in the era of 1991, subsequent to that, as the NPAs were mounting up, the government of India thought we needed to have a specific regulation aimed at the recovery of debts for banking institutions. Accordingly, we have one legislation called the **Recovery of Debt Due to Banks and Financial Institution Act of 1993**. In the year of 1993, we had one legislation. Then, as the NPAs were mounting up, the government of India thought that we needed to have a stringent legislation where more powers were given to the banking institutions for the recovery of NPAs. Accordingly, we have one legislation called the **Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act of 2002**.

So, these are all the various legislations, like the Presidency Towns Insolvency Act, Provincial Towns Insolvency Act, SICA, Companies Act, Recovery of Debt Due to Banks and Financial Institutions, SARFAESI—these are all the various legislations we previously had dealing with insolvency. So, all these legislations were consolidated, and now we have the Insolvency and Bankruptcy Code of 2016.

Though the Insolvency and Bankruptcy Code of 2016 is a legislation that is consolidating all these legislations as we have discussed, but the Securities and Asset Reconstruction and Recovery of Debt and Provincial Insolvency Act, Presidency Towns Insolvency Act—these legislations were not yet repealed. We are going to discuss in detail in the subsequent lessons why these legislations were not yet repealed.

Let us try to understand.

Before understanding the history, let us try to understand the objectives of insolvency law.

The primary object of insolvency law is the allocation of risk among the participants in a market economy. This is the first and foremost object of insolvency law. As we know that in economics, you must have studied factors of production. Land, labor, capital, entrepreneurship—these four are considered to be factors of production. Factors of production are scarce in nature. We need to utilize these factors of production to the maximum extent. Whenever you are using these factors of production, there is always a risk of loss. Maybe you are using the capital; whenever you are doing business by investing some capital, there is always a possibility of risk. So, this risk must be allocated equitably so that the business can flourish.

What is the basic object of any insolvency law? It should be predictable. What is the meaning of predictable? Whenever I, as an investor, am investing in any country, I should know what the law is that's regulating the business. If I am successful in a business, I can continue the business. Suppose, if I fail to do the business or if the business is a failure, then I should also have the exit mechanism.

The insolvency law provides the exit mechanism, and in case if I fail to do the business, if there is a failure in the business, how to exit from the business should be. We should have a mechanism that is predictable in nature; that should be systematized. So that any person who is investing in any company can know how to exit from the business. So, that is one of the objects of insolvency law.

Then, **equitable treatment**. So, what is this equitable treatment? Equitable treatment means because, as we know, there are various factors of production. The stakeholders, whoever is interested in the company, have invested in the company. For example, investors, shareholders, they invested in the company. Creditors, they gave a loan to the company. Creditors can be of various categories. Depending on their nature of credit, their rights and obligations will differ. So, whenever there is distress in the company, we should provide equitable treatment.

Here, we are using the word **equitable treatment**, not **equal treatment**, because there is a difference between equal treatment and equitable treatment. When I am using the word equal treatment, all categories of creditors must be treated equally. When I am using the word equitable treatment, equitable means, depending on the size of the creditor, depending on the rights of the creditor, depending on the type of the creditor, we should treat them. So, that means equals must be treated equally, un-equals must be treated unequally. So, the insolvency regime should provide equitable treatment, which means, suppose if you take our own legislation, the Insolvency and Bankruptcy Code, we have two categories of creditors: operational creditors and financial creditors. Though operational creditors and financial creditors have a participation in the CIRP process, their treatment is different. Okay, so because operational creditors and financial creditors have different natures. So, depending on the nature of the creditor, we have to give a treatment. So, there should be equitable treatment among the creditors. So, this should be one of the objectives of insolvency law.

And another objective is that **transparency**. So, what is this transparency? During the insolvency proceedings, interested participants must be given sufficient information so that they can participate in the proceedings.

Let me give you one example. Suppose one company is in the process of CIRP; the CIRP process is going on. Unless you give proper information, the resolution applicant—though I am using some words, but these words we are going to discuss in detail in the subsequent lessons, who a resolution applicant is, what a COC is, all these things we are going to discuss in the subsequent lessons—the resolution applicant, unless he has proper information, he cannot participate in the bid. Unless he has proper information, he cannot participate and he cannot give a proper bid. So, we need to have a transparency mechanism so that all the participants, whoever is interested, they can participate and they can take the informed decision.

Let us take the example of the committee of creditors.

When the company went into the process of CIRP and the process started, the COC will take over the management of the company with the help of the resolution professional. The resolution professional is going to replace the board of directors, and the COC is going to manage the company. They are going to take major decisions. Here, the law should facilitate them to get the information from the former management, that is, the board of directors, that is, the suspended board of directors under the legislation. So, like this, the insolvency law should always maintain transparency. So that any investor who is interested, maybe as share capital, maybe as debt capital, who is interested in investing in the company, they can know, they can predict what the law should be, and there should be equitable treatment and there should be transparency.

And the second object of insolvency law is to **protect and maximize the value for the benefit of interested parties**. So, when I am using the word maximizing the benefit to the interested parties, here all stakeholders are involved. One of the basic objectives of insolvency law in any country is to maximize the value of the assets. Why? Because when the management of the company—that is, the existing board of directors—fails to run the company, then the committee of creditors will enter into the picture, and they will appoint one professional. In India, it is called a resolution professional; we are going to appoint them, and the COC is going to manage the company. Then, subsequently, they are going to find out any investor who is interested, whereby the management of the company will shift to the new investor, whereby we are replacing the existing board of directors with the new set of investors. So, here the creditors are going to maximize their returns, and whenever you are considering the insolvency proceedings, it should be **time-bound**. We have to do that within the time limitation only. Why? Because if we are unable to complete the resolution process within the time limitation, as we know that as time goes on, the depreciation on the assets will increase. So, whereby the asset valuation will tend to reduce. So, this is another objective of the insolvency law.

Then, why do we need to have bankruptcy laws in India?

One of the main aims is the **renewal of the substance of concerning capital**. Unless you are renewing the capital, let me give you one example. I am investing in one company, maybe as a debt capital. If I am unable to recover the debt capital as a banking institution, I cannot invest somewhere else. If you observe the definition of banking, banking means accepting deposits for the purpose of lending. So, lending is one of the major activities of a banking institution. So, when I am lending, I should be in a position to recover it. Unless I am recovering this money, I cannot invest somewhere else. So, this has to be renewed. The capital I am investing in one place, this capital has to be renewed, and I should be in a position to invest it somewhere else. So, this is facilitated by the insolvency law in any country. And if you are able to facilitate these types of activities, I

can ensure financial stability and business continuity. Why? Because unless the banking institutions are strong enough in any country, you cannot achieve financial stability because they are the people who are investing in any company as a debt capital. If they are unable to recover the money properly, then obviously it is going to affect their financial stability. As a result, the entire economy is going to be affected. So, this is one of the reasons why we need to have bankruptcy law in any country.

Then, it is essential to regulate the financial activities and also to protect the creditors' rights because the creditors are the people who are giving a loan to any business entity. If they are unable to recover it properly, then obviously they won't invest in the company, so it is going to impact the economy as a whole at the macro level. So that's why we have to protect the interest of the creditors and we have to maintain the economic order. So, this is another reason why we need to have insolvency law or bankruptcy laws in India. Then, it ensures creditors do not lose confidence in lending, which is vital for economic growth.

Let us try to understand more.

Suppose I am a creditor who is giving the loan. Unless I have a confidence that I am able to recover the money, I will not invest because there is a risk. So, if you are facilitating me to invest in any credit, to invest in any company where I can recover for sure, then I am going to invest, and subsequently, when I am able to recover the money, I can invest somewhere else, okay. So, this is very essential for the economic growth of any country. It guarantees paid distribution of debtors' assets among the creditors. So, another essential feature of any insolvency law is to ensure that the debtor's assets are equitably distributed among the creditors.

Again, I am using the word **equitable distribution**, not **equal distribution**, okay. So, in the subsequent lessons, we are going to discuss about the waterfall mechanism, okay. So, under Section 53 of the Insolvency and Bankruptcy Code, we have a waterfall mechanism where all the creditors, according to their ratio, are going to receive the assets, okay, in case of liquidation of the company. So, the law should ensure that fair distribution is happening, okay; the debtor's assets are distributed among the creditors fairly. So, this is another objective, and promoting impartiality and reducing the risk of exploitation.

So, the law should ensure that all the stakeholders are getting equitable participation. So, when you are ensuring transparency, when you are ensuring equitable participation to all the stakeholders, you are ensuring impartiality and reducing the risk of exploitation as well. So, that means there is a least possibility that the secured creditors are going to exploit the interest of the unsecured creditors because the law is very clear under the waterfall mechanism who is supposed to receive first and who is supposed to receive

next. So, the waterfall mechanism is very clear. So, there is a possibility that we are going to reduce the risk of exploitation.

Then, it prevents creditors from filing legal actions against the bankrupt individuals or businesses. This is another important feature of any insolvency law in any country for that matter, okay. So, whenever you have any insolvency law, generally we are going to have the concept of **moratorium**. We are going to discuss this in detail in the subsequent lessons.

Anyway, let me give you a basic introduction. A moratorium is if insolvency proceedings were started against any person or any individual. During the moratorium period, no one can file a criminal complaint against a person, and no one can file a case against the person. So, suppose, take the example, I am the company, the company went into liquidation, now the CIRP process started. In such a scenario, no creditor can file a case, so the creditors are prevented from filing a legal case, and they have recourse only under the IBC. So, we can avoid duplication of proceedings against the company, and unnecessary harassment to the company can also be avoided. And upon the bankruptcy declaration, the debtor's assets are entrusted to the official liquidator or official collector. So, once the company or debtor is declared to be bankrupt, then in such cases, we are going to appoint the official liquidator, where the official liquidator is going to form the liquidation estate. All assets of the company are a part of the liquidation estate, then he is going to ensure that the liquidation estate is realized, then subsequently he is going to distribute to the creditors according to the waterfall mechanism. So, once the bankruptcy declaration is done, the debtor's assets are entrusted to an official collector, then structured repayment to the creditors is ensured through the system of insolvency, ensuring fair and legal procedure. Because when you have an insolvency regime or a properly established insolvency regime, then fair procedures are established.

So, the person who is investing in any company or who is investing in any business entity, they can know or they are very sure about their rights and obligations, their rights. So, the legal proceedings are settled, and the procedure is very settled so that I can know what I am going to get in the near future in case of a failure of the business.

Let us recap what we have discussed today.

Today, we have discussed about the objectives of insolvency law, where we have discussed what the reasoning behind insolvency law is worldwide.

Then, subsequently, we have discussed the need for insolvency law, why we need to have insolvency law, what is the necessity of having the insolvency law, and how it is going to impact the economy as a whole we have discussed.

Then, we have discussed how insolvency laws help the economy at the macro level. Please remember, as we have already discussed, insolvency law will help the economy at the macro level, whereby insolvency law will encourage the investors to invest in any country.

Then, how insolvency law facilitates the reinvestment of funds. So, we have discussed that when in any country if we have the insolvency law which helps the creditor to recover the money quickly, and such money whatever is recovered, he can invest somewhere else; that is, reinvestment can be done, and whereby the funds may be utilized subsequently.

In the next class, we are going to discuss about the history of insolvency and bankruptcy law in India, where we are going to discuss history from the time of ancient history as well as before independence and after independence history.

Thank you.