International Journal of Trade and Commerce-IIARTC
January-June 2014, Volume 3, No. 1
ISSN-2277-5811 (Print), 2278-9065 (Online)

Insolvency Law in India with Special Reference to Corporate Insolvency

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Abstract

The Corporate insolvency is dealt under the Companies Act of 1956. Besides the Companies Act the other relevant legislations are – the 'Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) this is currently incorporated into the current amended Companies Act, the Recovery of Debts due to Banks and Financial Institutions Act, 1993 (RDDB Act). The related legislations are 'The Transfer of Property Act, 1882, and 'The Securities and Exchange Board of India Act 1992. The Companies Act has since seen as many an amendment. Some of the major amendments to the Act were made through Companies (amendment) Act of 1988 on the recommendations of Sachar Committee and then again in 1998, 2000 and finally in 2002 though the Companies (Second Amendment) Act of 2002 as a consequence of Eradi Committee Report. The Eradi committee was set up by the Government of India in 1999 and was headed by Justice Eradi – a retired judge from the Supreme Court of India.

Key Words: *Insolvency, SICA, SARFAESI, RDB, BIFR, ARCIL*

PAPER/ARTICLE INFO
RECEIVED ON: 1/9/2013
ACCEPTED ON: 11/04/2014

Reference to this paper should be made as follows:

Deepti Kanojia, Meenakshi (2014) "Insolvency Law in India with Special Reference to Corporate Insolvency" *Int. J. of Trade and Commerce-IIARTC*, Vol. 3, No. 1, pp. 121-126

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1. INSOLVENCY

Insolvency occurs when an individual, corporation, or other organization cannot meet its financial obligations for paying debts as 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. A finding of insolvency is important, as specific rights are enabled for the creditor to exercise against the insolvent individual or organization. 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.

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 context of corporate laws, the word "insolvency" has neither been used nor defined in India. However, Section 433 (e) of the Companies Act, 1956 covers a company, which is "unable to pay its debts", and thus constitutes a ground for winding up of the company. Inability to pay its debts would be a case where, a company's 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.

2. 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.

3. REASONS BEHIND INSOLVENCY

The main reasons behind insolvency are primarily poor management and financial constraints. This is much more prevalent in smaller companies. Specifically, the reasons are:

- **Market** – Company did not recognize the need for change
- **Bad debts** – obviously money owed by customers

- **Management** – failure to acquire adequate skills, imprudent accounting, lack of information systems
- **Finance** – loss of long-term finance, over gearing or lack of cash flow
- **Knock on effect** – i.e. from other insolvencies
- **Other** – for example excessive overheads etc

It is however observed that the larger the company, the better the chance of survival and of receiving remedial treatment and of paying creditors.

4. INTRODUCING INDIAN CORPORATE INSOLVENCY LAW

Under the Constitution of India 'Bankruptcy & Insolvency' is Entry 9 in List III - Concurrent List, (Article 246 –Seventh Schedule to the Constitution) i.e., both Centre and State Governments can make laws relating to this subject. In India, the process of winding up of companies is regulated by the Companies Act and is under the supervision of the court. Although article 19 (1)(g) of the Constitution of India gives freedom to practice any profession or to carry on any occupation, trade or business to the citizens of India, there are restrictions on closure of any industrial undertaking. Such restriction is justified on the ground that it is in public interest to prevent unemployment. As a result of such policy there is a freedom to undertake any industrial activity, but there is no freedom to exit.

In the process of deregulation and liberalization number of restrictions on undertaking industrial activity has been withdrawn and relaxed. There is a need to take the process of liberalization a step further and recognize that so long as a company is acting in the interest of shareholders and otherwise observing the law of the land it should have the freedom to manage its affairs, merge, amalgamate, restructure and reorganize or otherwise plan its affairs as it considers best in the interest of the stakeholders. Interference by the Government or court or any tribunal should only be in the event of any detriment to the shareholders or under the Competition Act to prevent monopolies or restrictive trade practices. While undertaking reforms in the Insolvency Laws there is a need to change the focus from strict regulation of the activities of companies to granting freedom to the industry in conducting its business activities and lay down norms for protection of interest of stakeholders.

5. INSOLVENCY LAWS FOR INDIVIDUALS AND CORPORATE

In India the term insolvency has not been defined anywhere, but still the word is commonly used to describe the process of insolvency. The stream of insolvency laws in India can be segregated under four heads:

1. **Pre-Insolvency Workouts: The Schemes include-**
    - Companies Act, 1956 (Sections 391 to 396)
    - The Sick Industrial Companies (Special Provisions) Act, 1985
    - Corporate Debt Restructuring Scheme
    - Asset Reconstruction under Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI)
    - RBI Guidelines on Special Mention Accounts.

2. **Insolvency of individuals and unincorporated entities:** This deals with individuals and partnership firms going insolvent. The consequence of this personal insolvency is declaration of insolvency and incapacity to contract. It is governed by Provincial Insolvency Act, 1920 and Presidency Towns Insolvency Act, 1909.
3. **Corporate Insolvency:** This deals with corporate going insolvent. The consequence is usually winding up of the company under the Companies Act, 1956.
4. **Insolvency of incorporated associations and other incorporated bodies:** This deals with insolvency of bodies like co-operative societies and body corporate incorporated under certain legislations.

There are certain common principles to corporate as well as individual insolvency. In any insolvency it is a grounded principle that all creditors must be treated equally. The only exception to this rule is that – preferential creditors are paid out in preference to ordinary creditors and secured creditors get priority next to preferential creditors.

6. PRESENT NATURE OF INSOLVENCY PROCESS IN INDIA

1. Insolvency/ Liquidation process essentially encompasses aspects of recovery, revival, reconstruction and winding up and, therefore, the process has to be seen in a holistic manner with all such aspects in sight.
2. No Separate Unified Insolvency Code covering all the above aspects in one place is present. Therefore, the process is complicated, time consuming and ineffective.
3. The present Legal and procedural framework relating to Corporate Insolvency apart from several other special provisions like debt recovery laws, is laid out by 4 major legislations, namely:
   - Companies Act 1956
   - Sick Industrial Companies (Special Provisions) Act, 1985 [SICA]
   - Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI) Act, 2002 also known as the Securitization Act
   - Recovery of Debts due to Banks and Financial Institutions Act, 1993 (RDB Act) [Debt Recovery Tribunals are set up under this Act]

7. LAWS, LAW-MAKING INITIATIVES AND THEIR EFFECTS

Laws relating to insolvency of companies in India is governed by the Companies Act 1956 and restructuring of 'sick' or 'potentially' sick companies in certain specified industries are covered under the Sick Industrial Companies (Special Provisions) Act 1985 (SICA in short). The Securitization, Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SARFAESI) provides for the establishment of Asset Reconstruction Companies (ARC), which would undertake the management/realization of non-performing loans acquired from secured creditors by taking over, change the management. While winding-up and schemes of arrangement are carried out under the aegis of the Courts, the Board for Industrial and Financial Reconstruction (BIFR) has been set up (under SICA) for the restructuring/rescue of sick companies.

There are other categories of companies incorporated under various specific statutes, including public sector banks and insurance companies are to go by liquidation and reconstruction process in accordance with government regulatory process and such are more of administrative in nature.
In 1981, the RBI appointed **T. Tiwari Committee** to examine the legal and other problems faced by the banks and financial institutions in rehabilitation of sick industrial units and to suggest remedial measures for effectively tackling the problem of sickness. Following the recommendations of the Tiwari Committee, the Government of India enacted the Sick Industrial Companies (Special Provisions) Act, 1985, (SICA) in order to provide for timely detection of sickness in industrial companies and for expeditious determination of the preventive, ameliorative, remedial and other measures and for enforcement of the measures. Although, the object of the Act was laudable, the Act was factually misused by the erring promoters' to defeat the object of the Act, the most notable of such provisions was the protection under Section 22 of the Act. Due to such inherent defects of SICA and again, for some unexplained reasons, BIFR failed to fulfill the purpose and mandate as envisaged therein.
Then came **Justice V.B. Balakrishna Eradi Committee** Report in 1999 recommending, inter alia, setting up of a **National Company Law Tribunal (NCLT)** to be vested with the functions and power with regard to rehabilitation and revival of sick industrial companies, a mandate presently entrusted with BIFR under SICA and forming of a liquidation committee consisting of creditors of the company in the lines of Section 141 of the Insolvency Act, 1986 of UK to assist the Liquidator and by adopting the necessary principles enunciated under International Monetary Fund's propagated norms for 'Orderly and Effective' insolvency procedures. The financial statement of affair, which took the most time, is now to be filed, in case of voluntary winding up, along with the winding up application, and in case of an involuntary proceeding, at the time of the first defense. The liquidation program is bound to be time bound.
In 2001 came the Report of the Advisory Group on Bankruptcy Laws, called the **N L Mitra Committee** appointed by the RBI which made several recommendations on bankruptcy law reforms, the first among which was consolidation of bankruptcy laws into a separate code. However, no legislative steps have still been taken in this regard.
In line with the Eradi Report and long felt need and widespread criticism from different quarters, we saw the **Companies (Amendment) Act, 2002** and repeal of SICA proposed to the new regime of tackling corporate rescue and insolvency procedures in India with a view to creating confidence in the minds of investors, creditors, labour and shareholders. The amended Act has suggested for change by combining the powers of the Courts, the BIFR and the CLB in one specialized NCLT in respect of liquidation of companies, schemes of arrangement/compromises and restructuring of sick companies, thus streamlining the regime. However, six years on, the intended Tribunal is yet to be constituted.
Then we saw **JJ Irani Committee Report 2005** formulated to review the laws concerning liquidation and restructuring of the companies recommended several revisions to the Companies Act, more particularly for a transparent and globally acceptable insolvency and restructuring procedures, in short. According to the report, "it is important that the basic principles guiding the operation of corporate entities from registration to winding up or liquidation should be available in a single, comprehensive, centrally administered framework". Having recognised the need for a

single centre of control, the report goes off on a tangent on this issue. For instance, about the need to demarcate the respective jurisdictions of the MCA and SEBI, the Irani Report states that "this perception is misplaced". More importantly, the report does not recommend which government or regulatory agency should be held principally accountable if there is gross incompetence or worse in the management of companies. Almost three years have passed since the Irani Report was finalised and submitted, companies law currently being revamped, yet to be put in place.

In the meanwhile, tireless efforts of the RBI need to be noted. The RBI approval is given to asset reconstruction companies under SARFAESI Act. Amongst approved, Asset Reconstruction Company India Limited (ARCIL), a loan player, thereby, has been very active in assets reconstruction of the sick or potentially sick companies who are in default of repayment of loans. Recent changes in foreign investment policy allowing foreign direct investment in asset reconstruction companies is expected that pending license applications will be processed expeditiously. According to the guidelines issued by the RBI, Indian banks excepting foreign banks, and financial institutions have entered into contractual arrangements for the Corporate Debt Restructuring (CDR) of companies with multi-lender involvement. The RBI has recently issued a revised set of CDR guidelines. The RBI recently issued separate guidelines for the restructuring of small to medium-sized enterprises (with less than Rs100 million in plants and machinery).

Lastly, the new Credit Information Companies Act of 2005 covers the rights and responsibilities of credit bureaus to both maintain accurate credit reporting and safeguard customer confidence.

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