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MAJOR DEVELOPMENTS IN WORLDWIDE INSOLVENCIES AND REORGANIZATIONS

AN OVERVIEW OF THE INDIAN DEVELOPMENTS

By

Sumant Batra[1]

[1] Mr. Sumant Batra is Partner (Litigation), Kesar Dass B & Associates, Advocates & Solicitors, New Delhi. His biographical details are annexed.

PREFACE

The advancement of technology and the opening up of the Indian economy for investment by foreign creditors triggered a slew of reforms in the country. The process of economic liberalization resulted in an ever-churning whirlpool of fierce economic competition. The puny Indian industry was suddenly found competing with the mighty multinational corporate producing many casualties in the process.

The existing laws and systems proved incapable to deal with the new economic dynamics. Sick Industrial Companies (Special Provisions) Act, 1985 (SICA), which presently deals with the revival and rehabilitation of companies, failed to turn around sick companies.[2] The Board for Industrial and Financial Reconstruction (BIFR) set up under SICA to deal with revival and rehabilitation of companies turned into a haven for defaulting borrowers that rushed to BIFR only to get statutory protection from the creditors wanting to recover their dues. The bureaucratic and cumbersome provisions of the Companies Act, 1956 (the 1956 Act), which deals with liquidation of companies, obstructed expeditious liquidation of companies resulting in blocking of huge national resources in liquidation proceedings. The Debt Recovery Tribunals set up under the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 for expeditious adjudication and recovery of debts due to banks and financial institutions failed to serve their purpose[3].

Despite progressively complying with international prudential norms and accounting practices, the banking and financial sector in India suffered from the lack of a level playing field as compared to other participants in the financial markets in the world. Unlike international banks, financial institutions and banks in India lacked the power to take possession of securities and sell them. The number of Non Performing Assets (NPA) grew alarmingly and the banking industry faced a serious threat to their sustainability and endurability leaving them with substantial losses[4].

Justice Eradi Committee

In the year 1999, the Government of India set up a High Level Committee headed by Justice V.B.Eradi, a superannuated Judge of Supreme Court of India to examine and make recommendations with regard to the desirability of changes in existing law relating to winding up of companies and for having a self-contained law for reorganization and liquidation of companies with a view to creating confidence in the minds of investors, creditors, labour and shareholders. The committee completed its work and submitted its report to the Central Government in the year 2000.

Narsimham & Andhyarujina Committee

The Narasimham Committee and later on, the Andhyarujina Committee was set up to examine the banking sector reforms and changes in the legal system required to facilitate inter alia, speedy recovery of bank dues. By its Reports dated 20th February, 2000, the Andhyarujina Committee suggested that Banks and Financial Institutions be given powers to take possession of and sell securities without the intervention of the Court and also legislation for facilitating securitisation of financial assets and the legal and legislative frame-work for undertaking securitisation transactions.

In December, 2002, accepting the recommendations of the said Committees and in order to meet the crying need of the economy, the Indian Parliament passed the Companies (Second Amendment) Act,

[2] Only a measly 7 percent of the companies that approached BIFR since its inception in 1985 were revived.

[3] Since the inception of these Tribunals and till 30th September 2001, only 9,814 cases for recovery of Rs. 6,264.71 crore pertaining to public sector banks were decided. Out of this, the debt recovered amounted to only Rs. 1,864.30 crore. This is to be compared with the huge task on hand for the Tribunals where, as of 30th September 2001, 33,049 cases involving Rs. 42,988.84 crore are still pending.

[4] As of 31.3.2001, the aggregate gross NPAs of Banks and Term Lending Institutions amount to Rs. 87,383 crore – a number which has continued to grow by approximately 15% every year.

2002 (Second Amendment) to restructure the 1956 Act in a big way leading to the new regime of tackling corporate rescue and insolvency. The provisions of the Second Amendment are, however, yet to be notified and SICA still remains to be repealed by passing of the Sick Industrial Companies (Special Provisions) Repeal Bill, 2001 by the Parliament. Till then BIFR continues to deal with revival and rehabilitation of companies, the High Court retains its jurisdiction as the liquidation court under the 1956 Act.

In the same month of the year 2002, the Indian Parliament passed another significant legislation - The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARESI) to regulate, for the first time in the country, the securitisation and reconstruction of financial assets. SARESI also deals with enforcement of secured interest by secured creditors without the intervention of court.

This paper provides a critical analysis of the salient provisions of the Second Amendment and SARESI.

I. THE COMPANIES (SECOND AMENDMENT) ACT, 2002: AN ANALSIS OF THE MAIN PROVISIONS

The Companies (Second Amendment) Act, 2002 (Second Amendment) proposes amendment of the provisions of the 1956 Act for setting up of a National Company Law Tribunal[5] (NCLT) and its Appellate Tribunal[6]. NCLT will have -

- The power to consider revival and rehabilitation of companies[7] – a mandate presently entrusted to BIFR under SICA.

- The jurisdiction and power relating to winding up of companies presently vested in the High Court. The winding up proceeding pending in High Courts shall stand transferred to the Tribunal.

- The jurisdiction & power exercised by the Company Law Board under the 1956 Act. The Company Law Board will stand abolished.

A composite law will, therefore, now deal with reorganization and liquidation of companies.

Composition of NCLT, qualifications of Members & its benches

- NCLT will consist of a President and such number of Judicial and Technical Members not exceeding sixty-two in numbers.
- The President of NCLT will be a former judge or any person qualified for appointment as a High Court Judge.
- The Principal Bench will be located at New Delhi and Benches may be constituted at other places.
- Each of the Benches of NCLT will comprise of atleast a Judicial Member and a Technical Member. The winding up and reorganization matters will, however, be handled by Special Benches having three or more members comprising of atleast one Judicial Member, Technical Member and Member appointed under Labour related category[8].
- While the Judicial Member will be a person who has the prescribed experience as a judicial officer or as a member of Indian legal Services or Indian Company Law Services or has fifteen years experience as a practitioner, the Technical Member will be a person who has requisite experience as a Chartered Accountant, Cost and Works Accountant, Company Secretary etc.

No such qualifications are provided under SICA for appointment of Members with the result that BIFR has become a rehabilitation center for retired bureaucrats. There is no permanent Judge presiding over Liquidation Court and the Chief Justice designates a High Court Judge as a Company Court Judge by rotation of roster.

The Second Amendment seeks to improve upon the standards to be adopted to measure the competence, performance and services of a bankruptcy court by providing specialized qualification for appointment of members of NCLT and a transparent process for their selection and appointment. However, the quality and skills of judges, newly appointed or existing will need to be reinforced by continuing appropriate training.

Commencement of Restructuring Proceedings

[5] A new Part IB (Section 10FB to 10FP) has been incorporated by the Companies (Second Amendment) Act, 2002.
[6] A new Part IC (Section 10FQ to 10GF) has been incorporated by the Companies (Second Amendment) Act, 2002.
[7] A new Part VIA (Section 424A to 424L) has been incorporated by the Companies (Second Amendment) Act, 2002.
[8] Section 10FA of the Companies (Second Amendment) Act, 2002.

The Second Amendment seeks to provide easy, convenient, inexpensive and quick access while providing adequate safeguard against misuse of the provisions by defaulting and dishonest debtors as experienced under SICA. The Second Amendment requires that when an industrial company has become a sick industrial company[9], the board of directors of the said company shall make a reference to NCLT, and prepare a scheme for its revival and rehabilitation and submit the same to NCLT for determination of the measures, which may be adopted with respect to the company. The reference would be accompanied with Auditors Certificate from an Auditor from a panel of Auditors appointed by NCLT certifying causes of the net worth being fifty percent or less or default in repayment of debt.

The trigger point under SICA is different. SICA requires the board of directors of a sick industrial company to make a reference to BIFR within sixty days from the date of finalization of the duly audited accounts of the company for the financial year as at the end of which a company has become a sick industrial company. A sick industrial company under SICA means an industrial company (being a company registered for not less than five years and employing fifty or above workmen), which has at the end of any financial year accumulated losses equal to or exceeding its entire net worth[10]. If the Board has sufficient reasons even before finalization of accounts to form an opinion that the company has become a sick company, it shall, within sixty days after it has formed such an opinion, make a reference to BIFR.[11]

Inquiry by NCLT and declaration of sickness

On receipt of a reference, the NCLT may make an order as to if the said industrial company has become a sick industrial company and such an order shall be final. NCLT may make such inquiry as it consider fit for determining whether the industrial company has become a sick industrial company. NCLT may require an Operating Agency[12] (OA) to enquire and make a report with respect to such matters as may be specified by it.

Similar provisions exist under SICA except that now it has been provided that the order of NCLT in this regard shall be final and further that the definition of OA is limited to public financial institutions, banks or any other person which may be specified as OA by BIFR.

Preparation and sanction of scheme

If after making an inquiry about the sickness of the company, NCLT is satisfied that a company has become sick, the NCLT shall decide whether it is practicable for the company to make its net worth exceed the accumulated losses or make the payment of its debt within a reasonable time. If NCLT decides that it is practicable for a sick company to make its net worth exceed the accumulated losses or make the payment of its debt within a reasonable time, it shall give the company, such directions as it may deem fit to make its net worth exceed the accumulated losses or make the payment of its debt within a reasonable time.

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[9] Section 46AA the Companies (Second Amendment) Act, 2002 defines sick industrial company as an industrial company which has at the end of any financial year accumulated losses equal to fifty percent or more of its average net worth during four years immediately preceding such financial year or failed to pay its debts within any three consecutive quarters on demand for its repayment by a creditor or creditors of such company.

[10] The definition of "net worth" under SICA has been retained under the Second Amendment and means has been defined as the sum total of the paid up capital and free reserves. For the purposes of net worth, "free reserves" means all reserves credited out of the profits and share premium account but does not include reserves credited out of re-valuation of assets, write-back of depreciation provisions and amalgamation.

[11] Section 15(1) of Sick Industrial Company (Special Provisions) Act, 1985.

[12] Section 31AA of the Companies (Second Amendment) Act, 2002 defines Operating Agency as a group of experts consisting of persons having special knowledge of business or industry in which the sick industrial company is engaged and includes public financial institutions, banks or any other person which may be specified as the Operating Agency by NCLT.

If NCLT decides that it is not practicable for a sick industrial company to make its net worth exceed the accumulated losses within a reasonable time and it is necessary to adopt remedial measures, it may direct an OA to prepare a scheme providing for such measures in relation to such company as it considers necessary from out of the parameters laid down under the Second Amendment.

The OA shall prepares a scheme providing, *inter alia* for any one or more of the measures – the financial reconstruction of the sick company by change in or take over of, management of the sick company; the amalgamation of the company with any other company; the sale or lease of a part or whole of any industrial undertaking of the sick company; the rationalization of managerial personnel; such incidental, consequential or supplemental measures as may be necessary; change in Board of Directors etc.

The creditors (if approved by atleast three fourth of creditors) of the company may also prepare a scheme for revival and rehabilitation and submit to NCLT.

Similar provisions exist under SICA except that the time frame has been defined or redefined for various stages and it has been added that the ability of the company to make the payment of its debt within a reasonable time will also required to be seen by NCLT while issuing directions after it finds that the company has become a sick industrial company. Though a specific provision has been made for creditors to file a scheme, there was no bar against there filing a scheme under SICA.

Circulation/Sanction of Scheme & its binding effect

The Second Amendment provides that where the scheme prepared by the OA relates to preventive, ameliorative, remedial and other measures with respect to any sick industrial company, it may provide for financial assistance by way of loans, advances or guarantees or reliefs or concessions or sacrifices from the Central Government, State Government, any scheduled bank or other bank, a public financial institution or state level institution or any institution or other authority to the sick industrial company.

Every such scheme is required to be circulated to every person to provide financial assistance for its consent within a period of sixty days from the date of such circulation. If no consent is received, it is deemed that consent has been given and NCLT shall sanction the scheme and on and from the date of such sanction, the scheme shall be binding on all concerned. However, if the consent so required is not given, in that case NCLT may adopt such other measures, including the winding up of the sick industrial company, as it may deem fit.

The Second Amendment provides a number of broad guidelines to OA to prepare the scheme. All the options are made available. However, the most common types of plans that are framed are based on hair cut by creditors and sale of surplus assets or on one time settlement of dues of creditors. However, the law does not address the manner in which the priority has to be accorded to classes of creditors. The parties are left to negotiate the best deal between themselves on the basis of a realistic scenario.

As regards the approval of plan, for a scheme to be sanctioned, the law provides that the consent of all secured creditors or a statutory bodies which are required to provide financial assistance under the proposed scheme either by way of reliefs or concessions or sacrifices shall be required. Therefore, every such creditor has a right to veto the scheme. Little discretion lies with the Court in the matters of approval of scheme.

Implementation & modification of Scheme

Once sanctioned, the scheme has a binding effect on all concerned by operation of statute. A scheme based on One Time Settlement of dues deals with discharge of creditor(s). The implementation of the sanctioned scheme will be monitored by court and if required, the scheme can be modified. Any person aggrieved by the sanction of the plan can challenge it before the Appellate Tribunal or seek review of the order.

Recommendation of Winding Up of Sick Industrial Company

Where the NCLT comes to the conclusion that the sick industrial company is not likely to make its net worth exceed the accumulated losses within a reasonable time while meeting all its financial obligations and that it is not possible to revive the company in future and that it is just and equitable that the company should be wound up, it shall record its finding and order winding up of the company.

Under SICA, the BIFR does not have the jurisdiction to order winding up of the company. If the BIFR concludes that it is not possible to revive the company and that it is just and equitable that the company should be wound up, it records its opinion and forwards the same to the concerned High Court which, on the basis of this opinion, may order winding up of the company and may proceed and cause to proceed with the winding up of the sick industrial company in accordance with the provisions of the 1956 Act.[13]

Time frame

This is one of the highlights of the Second Amendment. The new time frame requires:

- Reference to be filed within 180 days from the date on which the Board of Directors has come to know the causes of making a reference or within 60 days of adoption of final accounts.
- Enquiry by OA to determine whether the company is a sick industrial company – 21 days, which is extendable to 40 days.
- Time for OA to prepare the scheme - 60 days extendable by 90 days.
- Sanction within 60 days from receipt of suggestions/objections to draft scheme.
- Consent of creditors required to give financial assistance in any form – 60 days.

Appellate Tribunal

There will be a National Company Law Appellate Tribunal (NCLAT) to hear appeals from the orders of NCLT. The Chairperson of NCLAT will be a retired Judge of Supreme Court of India or Chief Justice of a High Court.

The Appeal from the order of NCLAT will lie to the Supreme Court of India.

No suspension of legal proceedings and Contracts

The Second Amendment does away with the infamous provision under SICA which provides that where in respect of an industrial company, an inquiry is pending or any scheme is under preparation or consideration or a sanctioned scheme is under implementation or where an appeal is pending, no proceedings for the winding up of the industrial company or for execution, distress or the like against any of the properties of the industrial company or against its guarantor or for the appointment of a Receiver shall lie or be proceeded with further except with the consent of the BIFR or as the case maybe, the Appellate Authority.[14] This provision is one of major causes for the failure of SICA as legislation.

However, taking away the provision altogether appears to be a knee jerk reaction.

Misfeasance proceedings – fixing liability

The Second Amendment requires that if in the course of scrutiny or implementation of a scheme, NCLT find that any person has misapplied or retained or become liable or accountable for any money or property or has been guilty of any misfeasance, malfeasance or non-feasance or breach of trust, it

[13] Section 20 of Sick Industrial Company (Special Provisions) Act, 1985.
[14] Section 22 of Sick Industrial Company (Special Provisions) Act, 1985.

may direct him to repay or restore the money or property or order such compensation as it may deem appropriate. Identical provision exists under SICA.

Formation of Rehabilitation and Revival Fund

The Second Amendment introduces a provision for levy and collection of cess for the purposes of rehabilitation or revival or protection of assets of the sick industrial company at such rate not less than 0.005 per cent and not more than 0.1 per cent on the value of turn over of every company or its annual gross receipt which ever is more. It also requires the creation and setting up of a Rehabilitation and Revival Fund. The sources from which amounts will be credited to the Fund have also been specified. This fund will be transferred to the Consolidated Fund of India and amount released to NCLT from time to time for the purposes specified in the second Amendment.

The good companies are terming this provision as a premium on good businesses.

Cases in which company may be wound up by the court

Apart from the existing grounds[15], the following additional grounds for winding up of a company have been added by way of the Second Amendment:

- If the company has acted against the interest of the sovereignty and integrity of India, the security of the State, friendly relations with foreign States, public order, decency or morality.

- If the company has defaulted in filing with the Registrar its Balance Sheets and Profit & Loss Account or annual returns for five consecutive financial years.

- If the NCLT comes to the conclusion that the sick industrial company is not likely to make its net worth exceed the accumulated losses within a reasonable time while meeting all its financial obligations and that it is not possible to revive the company in future and that it is just and equitable that the company should be wound up.

Test for Insolvency

The test followed in insolvency proceedings is the liquidity test. Liquidity is based on cash-flow criteria and relates to a debtor's inability to service its debts as they come due. Balance sheet test is also applied. However, there is no automatic stay against the debtor's transfer, sale or disposition of assets or parts of the business without court approval, except to the extent necessary to operate the business. But such an order can be passed on an application made by the petitioning person and if in the opinion of court sufficient ground is made out for injunction.

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[15](a) The court may wind up a company
if the company has by special resolution resolved that it be wound up;
if the company does not commence its business within a year from its incorporation, or
suspends its business for a whole year;
if it is unable to pay its debts. A company shall be deemed to be unable to pay its debts - if a creditor to whom the company is indebted in a sum exceeding one lakh, has served on the company a demand by registered post at its registered office requiring it to pay the sum so due and the company has for three weeks thereafter \ neglected to pay the sum; or if execution or other process issued on a decree or order of any court in favour of a creditor of the company is returned unsatisfied; or if it is proved to the satisfaction of the court that the company is unable to pay its debt. ;

if a default is made in delivering the statutory report to the Registrar or in holding the statutory meeting;
if the number of members is reduced in the case of a public company below seven and in the case of a private company below two;
if the court is of the opinion that it is just and equitable that the company should be wound up.

Commencement of Insolvency Proceedings

The Second Amendment clearly identifies the entities to which it applies. All enterprises or corporate entities including the State-owned corporations are subject to the same insolvency law as private corporations. An application to the NCLT for the winding up of a company, can be by way of a petition presented

- By the company;
- By any creditor or creditors including contingent or prospective;
- By any contributory or contributories;
- By the Registrar of Companies;
- In a case falling under Section 243 of the 1956 Act, by any person authorised by the central government in that behalf.

The financial institutions and insurance companies are dealt with under the Banking Regulations Act though liquidation, if initiated under the said Act, ends up before the ordinary liquidation court.

The provisions provide easy excess to creditors and debtors.

Power of court on hearing petition

The provisions in this head have not been changed under the Second Amendment. On hearing a petition, the NCLT may dismiss it or adjourn it conditionally/unconditionally or make any order of winding up or pass any interim order or make any other order as it may deem fit. However, it has been added that in case the ground for filing the petition is non filing of statutory report, the NCLT may direct that such a report be filed and impose costs instead of making order of winding up.

Disclosure of information.

The Second Amendment provides for a specific provision for debtor to disclose the relevant information in liquidation proceedings. It has further been provided that where a petition for winding up is opposed, that company shall file its statement of affairs, last known addresses of all directors and company secretary, details of location of assets and their value, details of debtors and creditors with addresses, details of workmen/employees and of the amount outstanding to them and such other details as may be specified.

The Court has inherent power to seek information on the causes of the debtor's financial difficulty and a review of past transactions that may be avoided under the avoidance provisions of the insolvency law.

Moratoriums and suspension of proceedings in liquidation proceedings.

The Indian law prohibits the unauthorized disposition of the debtor's assets, if requested and suspends actions by creditors to enforce their rights or remedies against the debtor or the debtor's assets by operation of law. There is wide discretion on grating injunction.

The law not does not provide a statutory moratorium on repayment of debts but stays enforcement of creditors rights in liquidation proceedings.

When a winding up order has been made or the OL has been appointed as Provisional Liquidator, no suit or legal proceeding can be commenced, or if pending at the date of the winding up order, can be proceeded with against the company except by leave of the NCLT and subject to such terms as the court may impose.[16] However, after the coming into the effect of Recovery of Debts Due to Banks and Financial Institutions Act, 1993, the Supreme Court of India, while interpreting its various

[16] Section 446 of Companies Act, 1956.

provisions has held that the Banks and Financials do not require to obtain leave of the Company Court for initiating proceedings under the said Act[17].

The NCLT, which is winding up the company shall have jurisdiction to entertain or dispose of any suit or proceeding by or against the company; any claim made by or against the company. Secured creditors, however, can choose to stay outside the winding up proceedings. Any suit or proceeding by or against the company which is pending in any court other than in which the winding up of the company is proceeding may be transferred to and disposed of by that court.

Administration during pendency of Proceedings

Under the 1956 Act, there is an OL attached to every High Court, which acts as a Liquidator. The OL is an employee of the government and represents a highly inefficient and bureaucratic department. The Second Amendment provides for appointment of court appointed professionals as Liquidators who will be capable and competent of handling insolvency proceedings much more efficiently. It provides for OL to be appointed from a panel of Chartered Accountants, Cost Accountants, Lawyers and Company Secretaries. This is a star feature of the Second Amendment.

In rehabilitation proceedings, the debtor remains in possession and administers the company. The OA appointed by BIFR acts as an extended arm of BIFR and assists in discharge of its functions which are confined to holding inquiry in sickness of company, preparation of scheme and its monitoring.

There is no drastic curtailing of the powers of management and only a close watch is maintained.

This is another area where adequate provisions will required to be introduced by further amendment and/or in the drafting of the new rules.

There is no creditors' committee. Creditors protect their interests through directly participating in the proceedings or through the liquidator. There is an adequate participation by creditors at every important stage of the proceedings.

Where a winding up order has been made or where a Provisional Liquidator has been appointed, the Liquidator shall take into his custody or under his control all the property, effects and actionable claims to which the company is or appears to be entitled. All the property and effects of the company shall be deemed to be in the custody of the court as from the date of the order for the winding up of the company.[18]

Though the Second Amendment provides for obtaining information on debtors assets, it only slightly improves upon the provisions for the collection, preservation and disposition of all property belonging to the debtor, including property obtained after the commencement of the case.

Voluntary winding up

A company may be wound up voluntarily when the period if any, fixed for the duration of the company by the Articles has expired or the event, if any, has occurred on the occurrence of which the Articles provide that the company is to be dissolved and the company in general meeting passes a resolution requiring the company to be wound up voluntarily or if the company passes a special resolution that the company be wound up voluntarily. The provisions under this heading remain unchanged under the Second Amendment.

Recognition of creditor's rights & preferential payments

The provisions under this heading remain unchanged under the Second Amendment except that the remuneration of OL shall be treated as first charge on the realization of the assets.

[17] Allahabad Bank vs. Canara Bank: *2000(1) Bank CLR 481 SC*
[18] Section 456 of Companies Act, 1956.

The Indian law recognizes the rights and priorities of creditors established prior to insolvency under commercial laws.

In the winding up of a company, workmen's dues and debts due to secured creditors to the extent such debts rank *parri passu* with such dues, shall be paid in priority to all other debts. The debts payable shall be paid in full unless the assets are insufficient to meet them in which case they shall abate in equal proportions.[19]

Directors and officers liability

This issue has been part of national debate on corporate governance. A number of provisions already exist in the 1956 Act and SICA in this regard. A few more amendments were introduced earlier in the year 2002 in the 1956 Act to make the provisions more stringent.

Another significant provision has been added by the Second Amendment in this direction which provides that if in the course of winding up, NCLT find that any person has misapplied or retained or become liable or accountable for any money or property or has been guilty of any misfeasance, malfeasance or non-feasance or breach of trust, it may direct him to repay or restore the money or property or order such compensation as it may deem appropriate.

Fraudulent or preferential transfers

Fraudulent Preference
Any transaction with a creditor entered into by a Company in preference of other creditors within six months prior to the date of commencement of winding up is to be deemed a fraudulent preference of its creditors and is accordingly invalid[20]. But if a Company makes payment to a creditor who is pressurizing the Company with a threat of a suit and attachment of property, then such a payment cannot be called 'fraudulent' provided the debt was really due.

Voluntary Transfer
Under Section 531A of the 1956 Act, a transfer of property whether movable or immovable or any delivery of goods by the Company within a period of one year prior to the presentation of a winding up petition is void as against the Liquidator, unless the transfer/ delivery was made in the usual course of Company business; and the transfer was in favor of a purchaser or encumbrance in good faith and for real and valuable consideration.

Transfer of Shares
When a Company is undergoing voluntary winding up, any transfer of shares or changes in the status of member after commencement of such proceedings is void, unless a prior permission of the Liquidator is taken[21]. The same position prevails in case of winding up by Court or under supervision of Court, with the difference that such a transfer is valid if permission of Court is obtained either before or after the making of the transfer.

Transfers for benefit of all creditors to be void.
Any transfer or assignment by a company of all its property to trustees for the benefit of all its creditors is void[22].

Effect of floating charge
Where a company is being wound up, a floating charge on the undertaking or property of the company created within the twelve months immediately preceding the commencement of the winding up, is invalid unless it is proved that the company immediately after the creation of the charge was solvent, except to the amount of any cash paid to the company at the time of, or subsequently to the

[19] Section 529 of Companies Act, 1956.
[20] Section 531 of The Companies Act, 1956.
[21] Section 536 of The Companies Act,1956.
[22] Section 532 of the Companies Act, 1956.

creation of, and in consideration for, the charge, together with interest on that amount at the rate notified by the Central Government in this behalf.[23]

Disclaimer of onerous property in case of a company, which is being wound up.
Where any part of the property of a company which is being wound up consists of (a) land of any tenure, burdened with onerous covenants; (b) shares or stock in companies; (c) any other property which is unsaleable or is not readily saleable, by reason of its binding the possessor thereof either to the performance of any onerous act or to the payment of any sum of money; or (d) unprofitable contracts; the liquidator of the company may, with the leave of the Court, by writing signed by him, at any time within twelve months after the commencement of the winding up or such extended period as may be allowed by the Court, disclaim the property. The Court may make an order rescinding the contract on such terms or otherwise as the Court thinks just and any damages payable under the order to any such person may be proved by him as a debt in the winding up.

The Court may make an order for the vesting of the property in, or the delivery of the property to, any person entitled thereto or to whom it may seem just that the property should be delivered by way of compensation for such liability as aforesaid, or a trustee for him, and on such terms as the Court thinks just; and on any such vesting order being made, the property comprised therein shall vest accordingly in the person therein named in that behalf without any conveyance or assignment for the purpose provided that, where the property disclaimed is of a leasehold nature.

Pre-bankruptcy period within which transfers may be reviewed and are subject to avoidance
Any transaction with a creditor entered into by a Company in preference of other creditors within six months prior to the date of commencement of winding up is to be deemed a fraudulent preference of its creditors and is accordingly invalid. Under Section 531A of the 1956 Act, a transfer of property whether movable or immovable or any delivery of goods by the Company within a period of one year prior to the presentation of a winding up petition is void as against the Liquidator.

II. SECURITISATION AND RECONSTRUCTION OF FINANCIAL ASSETS AND ENFORCEMENT OF SECURITY INTEREST ACT 2002 (SARESI): THE BROAD FEATURES

SARESI provides for the enforcement of security interests in movable (tangible or intangible, including accounts receivable) and immovable property without the intervention of court, by way of a simplistic, expeditious and a cost effective process. Where any borrower makes any default in repayment of secured debt or any installment thereof, and his account in respect of such debt has been classified by the secured creditor as non-performing asset, then, the secured creditor may call upon the borrower by way of a written legal notice to discharge in full, his liabilities within sixty days from the date of the notice failing which the secured creditor would be entitled to exercise all or any of the rights set out under SARESI. The notice must contain details of debt and secured assets.

Any bank or public financial institution or any other institution or non-banking financial company as specified by Central Government or International Finance Corporation or a consortium thereof can invoke the provisions of SARESI relating to security of interest.

Enforcement of Security Interest

SARESI provides that where any borrower makes any default in repayment of secured debt or any installment thereof, and his account in respect of such debt has been classified by the secured creditor as non-performing asset, then, the secured creditor may call upon the borrower by way of a written legal notice to discharge in full, his liabilities within sixty days from the date of the notice failing which the secured creditor would be entitled to exercise all or any of the rights set out under SARESI. The provisions of SARESI relating to security of interest can be invoked by:

[23] Section 534 of The Companies Act, 1956.

- any bank or
- public financial institution under Section 4A of the Companies Act, 1956 or
  any institution specified by Central Government under sub clause (ii) of clause (h) of section 2 of Recovery of Debt due to Banks and Financial Institutions Act, 1993 or
- any other institution or non banking financial company as specified by Central Government or
- International Finance Corporation or a consortium thereof.

Taking Possession of Assets

On the expiry of sixty days if the debt is not fully paid by the borrower, the officer(s) so authorised can enter the premises where the secured asset is lying and take its possession. If there is resistance or there is likely to be resistance from the borrower and/or its agents in the taking over of the possession, such officer may write a request to the Chief Metropolitan Magistrate (CMM) or the District Magistrate (DM) in whose jurisdiction such secured asset is situate to take possession.

Take Over of Management of Secured Assets

Another option available under SARESI is to take over the management of the secured assets. The manner and effect of take over has been set out under SARESI. While in possession of borrowers business, the secured asset can be sold simultaneously to recover the dues.

Appointment of Manager for the Secured Assets

The duties and responsibilities of the manager are not defined any where in SARESI. However, it appears that the function of a manager would be confined to managing the asset and not to sell or transfer the asset. The manager would be a custodian of the assets and will otherwise have full control over the asset to the extent empowered. Manager can be assigned the responsibility to manage the asset but cannot be empowered to sell unless the manager is also acting under clause (a) of sub section (4) of section 13 of SARESI.

Procedure in case of Take Over of Co-financed Assets

In case of financial assets by more than one secured creditors or joint financing of a financial asset by secured creditors, no secured creditor shall be entitled to exercise any of the rights conferred on him unless exercise of such rights is agreed upon by the secured creditor representing not less than three fourth in value of the amount outstanding as on record date and such action shall be binding on all secured creditors

Appeal before Debt Recovery Tribunal

Any person (including borrower) aggrieved by any of the measures referred to in sub-section (4) of section 13 taken by the secured creditor or his authorised officer under this chapter, may prefer an appeal to the Debts Recovery Tribunal having jurisdiction in the matter within forty-five days from the date on which such measures had been taken. However, such appeal shall not be entertained by unless the borrower has deposited with the Debts Recovery Tribunal seventy-five per cent of the amount claimed in the notice. Any person aggrieved by any order by the Debts Recovery Tribunal under section 17 may prefer an appeal to an Appellate Tribunal.

Protection to Secured Creditors

No suit, prosecution or other legal proceedings shall lie against any secured creditor or any of his officers or manager exercising any of the rights of the secured creditor or borrower for anything done or omitted to be done in good faith under SARESI. However, any offence by the company during the time the Directors of the secured creditor are holding appointment, would be treated as would an offence committed by a company in a normal case is treated.

Jurisdiction of Civil Court barred

No civil court will have jurisdiction over any of the matters stated under SARESI.

Asset Reconstruction Companies (ARC)

Chapter II of SARESI provides for the setting up of the Reconstruction and Securitisation Companies for "Securitisation" i.e. acquisition of financial assets from its owner, whether by raising funds by such Securitisation or Reconstruction Company from qualified institutional buyers by issue of security receipts representing undivided interest in such financial assets or otherwise. SARESI deals with the Registration of these Companies, their pre-requisite qualifications etc.

Measures for Asset Reconstruction

The measures that a Securitisation or Reconstruction Companies can take for the purpose of Asset Reconstruction are:

- Take-over of the management of the business of the borrower.
- Sale or lease of a part or whole of the business of the borrower.
- Reschedulement of payment of debts payable by the borrower.
- Enforcement of security interest in accordance with the provisions of the Act.
- Settlement of the dues payable by the borrower.
- Taking possession of secured assets.

Additionally, such Company can perform the following functions:

- Acting as an agent for any bank or financial institution for the purpose of recovering their dues from the borrower on payment of such fees as may be mutually agreed.
- Acting as a Manager.
- Acting as a Receiver.

An ARC can acquire financial assets by issuing a debenture or bond or any other security in the nature of a debenture for consideration agreed and by incorporating such terms in the agreement; or entering into an agreement for the transfer of such financial assets to such company on such terms and conditions as may be agreed.

The terms and conditions of acquisition can be negotiated and agreed between the parties. However, such terms and conditions would have to be in consonance with the guidelines framed and directions issued by Reserve Bank of India.

Legal Consequences of Acquisition

ARC shall be deemed to be the lender and all rights of lender shall vest in the ARC in relation to such financial assets. All contracts, deeds, bonds, agreements, power of attorney, grants of legal representation, permissions, approvals, consents or no objections and instruments relating to financial assets subsisting before the acquisition of financial assets by the ARC shall have full force and be enforced as if they had been issued in favour of ARC or as the case maybe.

No suit, appeal or proceedings shall abate or be discontinued for the reasons of acquisition of financial assets by the ARC. However the appeal may be continued, prosecuted and enforced by or against the ARC. However, such company in respect of which an ARC carries out acquisition of assets can file no reference.

Procedure for Acquisition - Notice of Acquisition

Though no procedure, as such, has been laid down under SARESI, a notice of acquisition may be sent to the Obligor (generally speaking, the borrower) or to any other concerned person (such as, co-lenders, statutory authorities etc.) and the Registering Authority in whose jurisdiction the asset is located. Such notice is not mandatory. The notice is not of proposed acquisition but of the acquisition already carried out. If any payment is received from the Obligor after acquisition, the same shall be in trust and be forwarded to ARC.

Resolution of Disputes

Disputes relating to non-payment of any amount due including interest arising amongst Bank, FIs, ARC and Qualified Institutional Buyer shall be settled by conciliation or arbitration as provided in the Indian Arbitration and Conciliation Act, 1996.

III. SOME GENERAL OBSERVATIONS ON THE NEW LAW

Second Amendment & SARESI: Need for effective implementation

Though the Second Amendment and SARESI came as a pleasant new year gift to the financial institutions and bank, the rejoicing is muted. For, the alternative mechanism drawn up under the Bill is perceived as an old tablet in a new foil. In other words, the Bill merely renames BIFR. The powers and jurisdiction of BIFR are now to lie with the Tribunal with some cosmetic changes with the only substantial difference being that while the BIFR had the responsibility of attempting revival of dying companies, the Tribunal will have to not only attempt revival but also perform the last rites if the attempt to revive fails.

Only time will tell whether the Second Amendment will provide an orderly exit mechanism for failed enterprises, ending unproductive uses of business assets and transferring them to more efficient market participants. A closer look at some of the provisions of the two legislations sets in a realization that there is a lot more required to be done to make the said laws predictable, transparent and affordable enforcement of both unsecured and secured credit claims by efficient mechanisms outside of insolvency, as well as a sound insolvency system. Also, the Second Amendment does little to expedite and simplify insolvency procedures.

SARESI is a bold and firm initiative in the direction of providing a final and equitable debt collection mechanism for creditors and in improving the enforcement of creditor rights to expand credit flows but the legislation, howsoever, well intended, carries holes leaving scope for further dispute and litigation, rather than proving an efficient vehicle for resolving individual disputes between creditors and debtors.

The laws are nevertheless, a big leap in the direction of providing an effective and compatible enforcement system. The Government has resisted all pressures and is determined to introduce further reforms in this direction. A number of other amendments have been made or are being carried out for facilitating and enforcing corporate governance with emphasis on disclosure norms and strict adherence to accounting and auditing standards. It will now for the administrators of NCLT to enforce the provisions of law effectively and meaningfully. The guidelines, rules and regulations to be framed under the two laws should be drafted in the light of the World Bank Principles after their reconciliation with the domestic social, economic and other compulsions.

The essential features governing a model formal restructuring process in any part of the world are common if not alike though they may be structured differently. SICA, in India, is structured, more or less, on the above principles. The question, which, thus, arises for consideration, is at to why SICA has failed to work. In my opinion, any sound legislative framework for its success is dependent upon predictable and effective judicial process coupled with efficacious enforcement mechanisms. We need to focus and improve upon our implementation and execution mechanism. Also, there is a need for

more creative and commercial approach to corporate entities in financial distress and attempt to revive them rather than applying the more traditional and conservative approach of liquidation or bankruptcy. As such, the socio-economic compulsions dictate that before liquidating financially distressed companies, some attempts must be made towards corporate rescue operations.

Tribunalisation of Justice and an over-burdened Tribunal

Though tribunalisation of justice is now a recognized trend, the Indian experiment with Tribunals has been nothing to boast about. They have largely failed to serve the purpose with which they are set up. Flowing from such diverse dimensions of judicial functions, NCLT would be burdened with workload of enormous magnitude and in the process would be likely to lose focus on revival and rehabilitation of sick entities. Change in eligibility criterion for making a reference would itself generate greater workload. In the process, the objective of expedient disposal of the matter may become casualty; leave aside matters, which NCLT would have to decide relating to its other two functional roles. Though the number of Members has been fixed at sixty two, past performance has shown that even under SICA, with the number of Members fixed at fifteen (including the Chairman) the BIFR has never worked with a full contingent of Members and even now is functioning with less than 50% strength for the last two years.

Suspension of proceedings

The Indian experience with rehabilitation has been so disappointing that there has been a knee jerk reaction by taking away the moratorium provision, which, under SICA, sounded the death bell for many creditors. Hopefully, there will be re-thinking and a brief moratorium would be provided to give the debtor time to negotiate a consensual business solution.

SICA failed on implementation front and it is hoped the new regime will be continuously monitored to ensure that it is being implemented in accordance with the policies and purposes for its design.

Defective trigger point for reorganization

In the existing provisions of SICA, it was experienced that the entry level for seeking ameliorative measures by the sick unit was too late owing to the criterion of hundred percent erosion of net worth. Under the Second Amendment, fifty per cent of erosion in average net worth for the last four years of the reference year or three successive defaults in paying installments to the creditors becomes the deciding factor for entry-level eligibility of a sick unit. However, the objective of bringing into purview of NCLT, a case of incipient sickness would be defeated considering the period of 180 days and a further extension by a further time period of 90 days being provided for filing a reference.

Redefining net worth is a very good development though the proposed definition may also suffer from the same problem which besets the present legislation and that is to prevent and curb the flair for creative accounting by changing the accounting policies to feign sickness. This could have been curbed by making the definition of “erosion of net worth” and “accumulated losses” more clear and unambiguous.

Certificate by Auditors

The new provision for establishing a panel of Auditors to give certificate with regard to the parameters of sickness is a good move. However, it may turn out to be duplication as under the present dispensation the Statutory Auditors are required to give their opinion on sickness of a company under the Manufacturing and other Companies (Auditors Report) Order, 1988. It is not clear as to how this duplication would help as the Auditors on the panel will come from the same stream of Chartered Accountants and may be liable to the same failings as the Statutory Auditors of the Company except that the Auditors out of the panel maintained by NCLT will be giving the certificate.

No Comprehensive Bankruptcy Code and Road Map

The Second Amendment stops short of providing comprehensive Bankruptcy Code to deal with corporate bankruptcy. In the fast changing scenario of growing cross-border investment, trade and commerce, cross-border insolvency problems are bound to increase and a comprehensive Bankruptcy Code alone can address such issues taking into consideration international practices. It does not introduce the required road map of the bankruptcy proceedings viz. application for initiating bankruptcy proceedings; appointment of Trustee: empowerment of the Trustee; operational and functional independence; accountability to the court, including the power of the court to remove Trustee in case of mismanagement; relationship with current management; monitoring or substitution; day-to-day operation, etc; time bound restructuring/recognition plan: who should submit; procedure of acceptance; mechanism to sell off; pro-active initiative of the Trustee; number of time-bound attempts for restructuring: decision to go for insolvency and winding up; and strategies for realization and distribution.

International insolvency in India

Unfortunately, the Second Amendment ignores the recommendation of Eradi Committee and fails to provide a framework for cross-border insolvencies, with recognition of foreign proceedings. The Government of India though proposes to deal with the issue near future.

In this area, the recommendations of Eradi Committee have been ignored in the Bill. Indian insolvency laws do not have any extra-territorial jurisdiction, nor do they recognize the jurisdiction of foreign courts in respect of branches of foreign banks operating in India. Therefore, if a foreign company is taken into liquidation outside India, its Indian business will be treated as a separate matter and will not be automatically affected unless an application is filed before an insolvency Court for winding up of its branches in India. At present, thankfully, the Government is considering the adoption of UNCITRAL Model Law on Cross-Border Insolvency to meet the demands of globalization of economy and to deal with international insolvency. This will radically change the orientation of Indian law and make it suitable for dealing with the challenges arising from globalization and increasing integration of Indian economy with the world economy. While drafting the substantive and procedural rules of bankruptcy, international standards for both national and cross-border insolvency should be taken into consideration which, based on Indian situation, should be suitably incorporated.

Need for an effective Out of Court Restructuring mechanism

Presently, the Corporate Debt Restructuring (CDR) Scheme of Reserve Bank of India deals with out of court work out in India. The CDR Scheme has not been very effective and is hardly invoked by debtors. The CDR Scheme is presently under review. The INSOL Global Principles have been made available to the concerned authorities for their consideration and adoption.

Bankruptcy proceeding for banks and financial institutions

Bankruptcy proceedings against banks and financial institutions have a very special significance as it affects the domain of the monetary system and management and financial stability. In several developed countries there is a separate bankruptcy code for banks and financial institutions. In India, this is primarily a responsibility of Reserve Bank of India. The new law and procedure should be structured to handle the bankruptcy proceedings in the case of banks and financial institutions in consultation with the Reserve Bank of India.

BRIEF INTRODUCTION OF SUMANT BATRA

Born on 10th December, 1965, Mr. Sumant Batra is the founder partner of Kesar Dass B. & Associates (KDB), a New Delhi based corporate and commercial law firm. His areas of specialization include, amongst others, advising and representing in the matters of restructuring and reorganization of sick industrial companies, insolvency and liquidation proceedings, recovery of corporate debt, asset management and reconstruction, corporate and commercial litigation/documentation and international arbitration. All the leading Indian financial institutions & banks in India are seeking the professional services of Mr. Batra.

Involvement in profession related organizations and bodies

Mr. Batra is Hony. Secretary of the AAIFR and BIFR Bar Association (of Insolvency Practitioners) of India.

He is Hony. Founder Secretary of INSOL India – the Indian federation of Insolvency Professionals. www.insolindia.com

He sits on the Board of INSOL International – the International Federation of Insolvency Professionals with HO in London, U.K. www.insol.org

He is Founding Member of International Insolvency Institute, Virginia, U.S.A.

Mr. Batra is Director on the Board of Family Business Network-India, the country chapter of FBN-International, Switzerland.

He is Chairman of Small Practices Issues Committee of INSOL International and Member of its Membership Committee.

He has been invited as Vice Chair of the Insolvency Committee of Inter Pacific Bar Association (IPBA) from November 2003 and to act as the Chief Liaison of the Committee with World Bank, UNCITRAL and Asian Development Bank etc.

He is Member of Business Law & Insolvency Committee of LAWASIA.

He is Member of Bar Association of Delhi High Court and Debt Recovery Tribunal Bar Association.

He is Life Member of SAARC Law - the legal arm of South Asian Association of Regional Countries comprising India, Pakistan, Nepal, Sri Lanka, Bhutan, Bangladesh and Maldives.

He is assisting professionals in Nepal, Sri Lanka, Pakistan and Bangladesh in setting up Association of Country Federations in their country to facilitate law reforms.

Involvement with law related international projects

Mr. Batra was a member of panel of international experts on a World Bank sponsored project for the Chinese State Economy and Trade Commission (SETC) entitled "Studies on Alternative Approaches to Debt Restructuring of Distressed Enterprises" for revival of State Owned Enterprises (SOEs) in Peoples Republic of China.

He has been appointed by the World Bank to conduct an assessment of the insolvency and creditors rights system in India under a joint World Bank-IMF program to develop Reports on Observance of Standards and Codes (ROSC).

He has contributed the Indian Report on the INSOL International project and publication titled "Directors in Twilight Zone" relating to liabilities and obligations of Directors.

Mr. Batra is assisting INSOL International on its project for updating the Wiley's publication on Recognition and Enforcement of Cross-Border Insolvency.

Mr. Batra has provided inputs from India to INSOL International in the UNCITRAL project of drafting the Model Law on Insolvency.

Involvement with non-legal associations

Mr. Batra is President of Natural Habitat Preservation Centre, a society for protection of habitat.

He is Life Member of Friends of Forums, Indian Council of Cultural Relations.

International conferences, seminars and travel

Mr. Batra has addressed various international and domestic conferences as a speaker from India, including:

The 6th World Congress of INSOL International held in London in 2001;

Asian Institute of International Financial Law (University of Hong Kong) Symposium on Comparative Study on Insolvency Law held in Hong Kong in April 2002;

INSOL Annual Conference held in Beijing in October 2002;

University of Hong Kong Conference on Insolvency Law held in Hong Kong in October 2002;

2nd Forum for Asian Insolvency Reform (FAIR) organized by World Bank, OCED, ADB, the Government of Japan, AusAid and Ministry of Justice of Thailand in Bangkok, December 2002.

Global Forum on Insolvency Risk Management (FIRM) organised by The World Bank in January 2003 in Washington D.C.

Annual Conference of Inter-Pacific Bar Association (IPBA) held in New Delhi in February 2003.

He has been invited as a speaker at International Insolvency Conference being organised by Singapore Government in Singapore in March 2003.

Mr. Batra has successfully organised the First and the Second INSOL India Congress in New Delhi in 2000 and 2002,respectively.

He is widely traveled and has, amongst others, frequently visited U.S.A., U.K, France, Germany, Switzerland, Austria, Netherlands, China, Thailand, Honk Kong, Malaysia, Singapore, Sri Lanka and Nepal.

Contributions as a writer

He is on the Editorial Board of INSOL India publication, *INSOL Bulletin* and INSOL International's publication, *INSOL World*.

He regularly contributes by writing articles or write-ups for various international and domestic publications including Families in Business produced in official association with The Family Business Network. He reads and writes poetry and has a publication to his credit.

Contact details

Sumant Batra
Partner – Litigation Support Office
Kesar Dass B & Associates
Advocates & Solicitors
D-228-229 Lajpat Nagar-Part 1
New Delhi-110 0024
Tel: 91-11- 2981 2106, 91-11-26915303
Fax: 91-11-29813630
Mobile: 98100 28892
E-mail: sumant.batra@kesardass.org