The Evolution of Corporate Bankruptcy Law in India

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Abstract

The Indian post-independence industrial policies, such as import substitution, industrial licensing, and limited private ownership, fostered a breed of inefficient and uncompetitive companies. Deregulation, foreign competition and financial reform led many financially unviable firms to consider exit or restructuring options. However, the existing legal, political and social system did not provide the appropriate framework for efficient and equitable resolution of insolvency cases, thus dramatically slowing the pace of the much needed industrial restructuring. This paper shows that there is no single comprehensive and integrated policy on corporate bankruptcy in India comparable with the bankruptcy code in the US. Instead, there are a number of legislative acts and special provisions, which provide procedural guidance on the liquidation or reorganisation process and there is an involvement of different agencies, having overlapping jurisdiction, which creates systemic delays and complexities in the process. In so far as the objective of a well functioning bankruptcy system is to promote economic efficiency by maximising the total value of assets, the Indian system fails, as under this system, liquidation or reorganisation is extremely time and resource costly; the system does not encourage optimal valuation outcomes; and creates incentives for managers or stockholders to take actions that generate private benefits at the expense of firm value. The paper evaluates the existing corporate bankruptcy system; and the incentives and biases it has created, given the Indian socio-political context and economic goals. It assesses the new Companies (Second Amendment) Act, 2002, and the possibility of its success in streamlining and correcting the shortcomings of the existing process.

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The Protectionist Past

After its independence from British rule in 1947, India adopted a socialistic and state dominated economic system and over the next four decades aggressively pursued a series of protectionist policies designed to develop and promote the domestic industrial base. Policies such as import substitution, industrial licensing, limited private ownership, and price fixing gave rise to a new breed of Indian companies that

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were inefficient, uncompetitive and yet able to extract high rents. At the same time, the nationalised banking sector was encouraged to provide credit at highly subsidised interest rates to these Indian businesses, and because these banks were managed by bureaucrats who were incentivised to grow the size of the loan portfolios, not much attention was paid to recovery and monitoring of these loans. As such, the need for an efficient and equitable bankruptcy system was much less pronounced and the haphazard and cumbersome insolvency procedures inherited from the British system seemed to do an adequate job for those rare occasions.

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A Changing Context

A few shocks, such as the fiscal and balance-of-payment crisis of 1991, triggered a move towards privatisation and rapid dismantling of these protectionist policies through the 1990s. Deregulation and introduction of foreign competition coupled with financial reform have exposed the vulnerabilities (financial and business) of the incumbent firms, forcing many of them to consider exit or restructuring options. However, the current legal, political and social system have lagged behind in providing the appropriate forum or policy framework for efficient and equitable resolution of insolvency cases, thus dramatically slowing the pace of a much needed industrial shakeout. Also, as much of public sector and institutional credit is locked up in these poor investments, India is paying a huge opportunity cost for not being able to redeploy this capital towards its ambitious goals for economic development; hence a growing consensus for development of a robust bankruptcy system. As of March 2001, there were 3,317 financially distressed large and medium sized firms with an unpaid debt of Rs. 258 billion (or US$5.4 billion at the 2001 exchange rate), roughly 2 per cent of 2001 gross domestic product (GDP) or 10 per cent of the total outstanding industrial credit provided by banks in 2001. These "sick" loans have been growing faster than GDP at an annual rate of about 10 per cent over the last 10 years (Mitra, 2001).

This paper will focus on (1) evaluation of the corporate bankruptcy system that had existed until very recently (referred to as the existing system in this paper) until a new amendment was passed in January 2003, the incentives and systemic biases it has created, given the Indian social and political context and the goals for economic development; and (2) assessment of the suitability of the recently passed amendment (new system) in correcting the shortcomings of the existing system.

The Existing Bankruptcy System

There is no single comprehensive and integrated policy on corporate bankruptcy in India comparable with the Chapter 11 or Chapter 7 bankruptcy code in the US. There are three major legislative Acts and several special provisions, which provide procedural guidance on the liquidation or reorganisation process. As a result, four different agencies, the High Courts, the Company Law Board, the Board for

Industrial and Financial Reconstruction (BIFR), and the Debt Recovery Tribunals (DRTs), have overlapping jurisdiction, which creates systemic delays and complexities in the process. Key provisions are summarised below, followed by an assessment and implications for the companies in financial distress.

Companies Act, 1956

A comprehensive legislation, modelled after the British Companies Law, confers a variety of powers on the federal (Union) government (the Department of Companies Affairs via the Company Law Board) and the judicial system (the High Courts) to monitor and regulate companies. Under this Act, liquidation of a company facing financial distress can be accomplished via two modes: voluntary liquidation by creditors or involuntary liquidation by court. In the first and the more efficient case of voluntary liquidation, shareholders vote for liquidation and hand over control of the liquidation process to secured creditors, who then hire a private or an official liquidator to oversee the asset sales and distribution of proceeds. In the second case, a creditor with a minimal amount of Rs. 500 of unpaid and undisputed debt, after giving three weeks' notice to the debtor, can petition the court for involuntary liquidation, in which case, the court will determine the validity of the claim and the reasonableness of the petition before ordering liquidation. However, the court's actions are purely discretionary and "the court may refuse to hold the company insolvent on other considerations including that of public interest" (Mitra, 2001). During the time it takes the courts to decide upon a case, the debtor remains in possession of the assets but once the winding-up has been ordered by the court, an official liquidator (government employee) is appointed who then takes charge of the entire process from claiming and selling assets, recovering "uncalled capital from contributories"[2] and paying off the company's liabilities. In settling the claims, the highest priority is accorded *pari passu* to secured creditors and workers' dues, followed by preferential status of government and administrative claims (employee severance pay and accrued insurance and pension benefits), with the residual going towards settling the claims of unsecured creditors and equity holders. Fraudulent and preferential transfers that occur within six months of the liquidation petition are treated as in the US Bankruptcy code. An interesting feature of this provision is the absence of an automatic stay in the interim period between filing of the petition and a ruling by the court, and this interim period, which can last up to a year, is usually characterised by a frenzy of lawsuits by all kinds of claimants and in some cases sale of collateral in possession of creditors.

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Restructuring under this Act is limited to either a merger & acquisition strategy or a voluntary compromise arrangement between

[2] Contributories are registered shareholders who have unpaid capital on the face value of their shares.

the company and the creditors if a change in the capital structure (changing debt for equity or reducing equity) is warranted as part of the compromise. The compromise arrangement can be proposed by any party (creditors, management, government, official liquidator) but has to be approved by creditors (majority in numbers and three-fourth in value) and confirmed by the court, which has the power to supervise the implementation of the compromise. There is no provision similar to a "cram-down," which would make the compromise binding without the approval of the requisite block of creditors. Also, the liquidation and reorganisation petitions here are not necessarily sequential and either proceeding can trigger the other at any time until an order for liquidation is passed.

Any action prescribed by the BIFR can be contested before the courts by the management or the creditors, and often the courts refer the case back to the BIFR for further review causing an endless loop of delays.

Sick Industrial Companies (SIC) Act, 1985

This Act, constituting the closest alternative to a comprehensive bankruptcy framework, established a quasi-judicial body, the Board for Industrial and Financial Reconstruction (BIFR), to secure timely detection of "sick" industrial companies and to provide the appropriate type of intervention. The process is applicable only for industrial companies that have been registered for more than five years and have accumulated losses at the end of any year greater than their net worth.[3] The Board of Directors of the company is required to file an application with the BIFR within 60 days "from the finalisation of the audited accounts of the year in which the company has fallen sick" (Mitra, 2001). Once an application for intervention has been filed, the BIFR has three alternatives. It can (1) approve a management/creditor sponsored plan without concessional financing, (2) determine unviability of the business and recommend liquidation to the court (governed by Companies Act, 1956 discussed above) or (3) claim that the firm must be rehabilitated in "public interest" (currently registered sick cases employ ~ 2.2 million workers[4]) and approve a plan requiring major concessions and "sacrifices" from the various parties including subsidies from the government. In options 2 and 3, the BIFR appoints an operating agency (OA), usually the largest secured lender (a bank or financial institution), to determine the viability of the company and propose a turnaround plan. In this case, an automatic stay against all claims, suits and legal proceedings against the "sick company" is granted as soon as the case is registered with the BIFR but the debtor remains in possession of the assets. Any action prescribed by the BIFR can be contested before the courts by the management or the creditors, and often the courts refer the case back to the BIFR for further review causing an endless loop of delays.

[3] The SIC Act defines net worth as the sum of paid up capital and "free reserves"; free reserves include all reserves from profits and share premium account but not from revaluation of assets, depreciation write-offs or amalgamation.

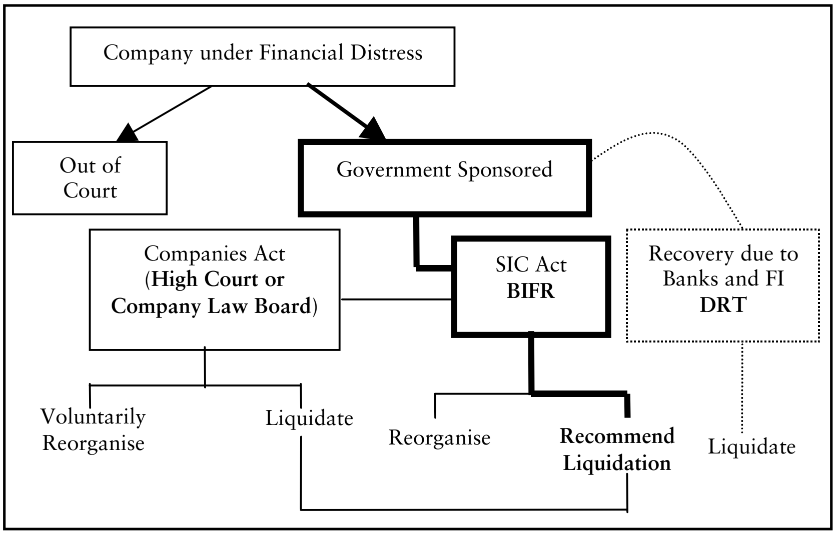
[4] BIFR published statistics.

Recovery of Debts due to Banks and Financial Institutions Act, 1993

An extremely controversial and frequently disputed legislation enacted as part of the financial reforms in the early 1990s, this Act allows banks and financial institutions to pursue recovery of outstanding debts greater than Rs. 1 million by filing a petition before a Debt Recovery Tribunal (DRT). The DRT issues a recovery order (primarily via liquidation of assets) after a relatively swift process of appraising and validating the claim, which may override the other two regulations in jurisdiction, preference and priority of claims. The rationale for this conflicting legislation is that "the civil courts are burdened with diverse types of cases. Recovery of dues due to banks and financial institutions is not given any priority by the civil courts. The banks and financial institutions like any other litigants have to go through a process of pursuing the cases for recovery through civil courts for unduly long periods" (Justice Eradi Committee Report, 2000). Figure 1 below shows a schematic summary of the various legal routes available to companies under financial distress.

If the overarching objective of a well functioning bankruptcy system is to promote economic efficiency by maximising the total value of assets, then the Indian system is a miserable failure on this score.

FIGURE 1
Schematic of the Indian Bankruptcy Process



Notes: The bold lines indicates the actual process pursued in majority of the cases of financial distress.

Implication of the Current System

If the overarching objective of a well functioning bankruptcy system is to promote economic efficiency by maximising the total value of assets, then the Indian system is a miserable failure on this score. Judged by Gilson's (Gilson, 1994) criteria for a robust bankruptcy process, the Indian process systematically destroys value because (1) liquidation or reorganisation is time consuming and very costly;

(2) it does not ensure the optimal outcome by encouraging "insolvent firms to reorganise when their going-concern value exceeds their liquidation value, while forcing them to liquidate when their liquidation value exceeds their going-concern value" and (3) it creates "incentives for managers or stockholders to 'game' the system ex ante by taking actions that generate private benefits at the expense of firm value" (Gilson, 1994). However, critics often point out that in India this goal of economic efficiency has to be balanced with the social policy of protecting worker rights and providing employment. Unfortunately, the current system falls short on the social criteria as well because these arcane laws only serve to hinder economic development which is perhaps the single most important driver of public welfare in a developing country such as India.

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Inefficient and Costly Process

Although data are not available to accurately estimate the costs involved in reorganising or liquidating a firm's operation, we can easily surmise the time value of money costs (erosion of ~ 50 per cent of value) due to the time intensive nature of the process for reorganising or liquidation under the SIC Act. Although the data in *Table 1* are based on total process time for decisions made in 2002, anecdotal evidence suggests that these average times are representative of the BIFR process and one of the prime reasons why the process is condemned as a failure by the creditors, companies and the government.

TABLE 1
Average time to reach decision via BIFR process
(BIFR Decision in 2002—Year the Case registered)

Reorganisation Recommended	*Dismissed* [i]	*Liquidation Recommended*	*No Longer Sick* [ii]	*Reorganisation failed* [iii]
7 years	1 year	6.5 years	8 years	11 years

[i] Cases where management had a false case (e.g. accounting manipulation, etc.).
[ii] Companies whose net worth became positive after a reorganisation plan was implemented.
[iii] Cases that had been declared no longer sick but could not sustain the positive net worth.

The commonly cited reasons for the delays include sheer workload (~40 cases are reviewed each month), dilatory tactics used by the management and workers such as litigating the BIFR decision and not providing appropriate financial records, and lack of cooperation from creditors when asked to make concessions.

The process of liquidation under the jurisdiction of the Companies Act, 1956, is also a cumbersome process riddled with endless loops of procedural delays. Once a recommendation for liquidation is made by the appropriate agency, the process of disposing of assets and settling claims is very lengthy because of the involvement of the government and the judicial system. For example, the Official Liquidator (OL) is responsible for the actual asset disposal procedure which involves (1) inspection of assets, (2) validation of claims, (3) appointment of security agency, (4) valuation of assets, (5) fixing of reserve price, (6) advertisement of tenders, and (7) bidding process. Interestingly enough, these OLs are government employees who may not have the appropriate legal, accounting or business acumen required during the liquidation process. Also, the OL has to keep going back and forth to the court at several points in this process to force compliance by the company's debtors, management and contributories, and settle the suits filed by or against the company by various parties to this process. In addition to the lengthy process, the OL staff does not have the capacity or the technological infrastructure to support the volume of liquidation cases. "In a typical case, the winding up procedure takes between 3-10 years. Delay has twin effects: cost of liquidation process (security and administrative charges) goes up; and realisable value of the assets drops, often to absurd levels. Very often, there are security lapses and pilferage of fixed assets" (Mitra, 2001). Another complicating element is the overlapping jurisdiction of the various labour and land regulations, which impose rigid restrictions on redeployment of human and land capital. For example, according to certain sections of the Industrial Disputes Act of 1947, a factory establishment employing 100 or more workmen needs to obtain prior permission of the appropriate government (generally State Government for private enterprises) for closure, layoffs or retrenchment which in most cases is turned down. The employer then has to pursue the lengthy route of appeals to the High Court and Tribunals and "typically closure through this route takes anything between 3-15 years, during which substantial erosion of the value of assets takes place" (Wadia, 2000). "The problems of liquidating firms in India steer banks and financial institutions towards sub-optimal decisions. The ability to liquidate totally unviable Indian firms rapidly has often compelled creditors to support going-concern restructuring when they should have cut their losses and forced these companies to wind-up" (Goswami, 1996). *Table 2* shows that it takes more than 5-10 years for most companies to navigate the Indian liquidation process when conducted by the official liquidators, implying huge costs involved in the liquidation process.

Although the BIFR has the authority to propose a wide range of remedial reorganisation plans, the SIC Act's sickness definition and its corresponding selectivity bias towards the worst possible cases explain the high proportion of liquidation recommendations made by the BIFR.

TABLE 2
Years taken in the OL liquidation process for companies (3/12/1999)

Years	*0-5*	*5-10*	*10-15*	*15-20*	*20-25*	*>25*	*Total*
Active Cases	1065	603	482	321	251	473	3195
% of Total	33%	19%	15%	10%	8%	15%	

Source: Justice Eradi Committee Report, 2000.

An intrinsic bias among the management and creditors to file for restructuring rather than outright liquidation might be due to the social pressure to preserve jobs, which tends to be driven by the elevated status of the local businesses as social benefactors.

Bias against Restructuring & Liquidation

The definition of sickness proposed by the Sick Industrial Companies Act (1993) prevents any intervention by the BIFR until the accumulated losses have completely wiped out equity and reserves, which is simply too late for any meaningful rehabilitation of the company's financial condition. In the words of a previous chairman of the BIFR, "We find typically that in a sick unit…the entire net worth has been eroded, the working capital has all but disappeared, there are no stocks, and the unit is characterised by very low levels of capacity utilisation…. For all practical purposes, the sorts of cases that come before BIFR are almost mortuary cases" (Mitra, 2001). The absurdity of the definition of sickness is evident in the data reported by the BIFR at the end of 2002: for 4,318 registered cases, cumulative net worth was Rs. 468 billion and the accumulated losses were almost twice the net worth at Rs. 891 billion. Hence, although the BIFR has the authority to propose a wide range of remedial reorganisation plans, the SIC Act's sickness definition and its corresponding selectivity bias towards the worst possible cases explain the high proportion of liquidation recommendations made by the BIFR (of 1,711 active cases at end of 2002, 63 per cent were recommended for liquidation, 22 per cent were reorganised successfully,[5] 15 per cent were still under rehabilitation[6]).

If we think of the Companies Act as analogous to Chapter 7 and the SIC Act to Chapter 11, then the numbers in *Table 3* imply that an overwhelming number of firms chose to file for restructuring even if it may not have been a viable option, since a majority of these cases ended up being recommended for liquidation eventually. Thus voluntary liquidation (Chapter 7) is a rare occurrence in the Indian landscape. Hence, the system has created an interesting mismatch whereby the right policy prescriptions are available to the wrong candidates and vice versa, causing widespread scepticism and disappointment on the part of all involved. An intrinsic bias among the management and creditors to file for restructuring rather than outright liquidation might be due to the social pressure to preserve jobs, which tends to be driven by the elevated status of the local businesses as social benefactors within their communities.

Other barriers to restructuring include the land and labour regulations mentioned above which make it much harder to consolidate, merge and redeploy labour and physical assets. For example, "a sick firm like the National Textile Corporation sits on land potentially worth hundreds of crores,[7] but it is an encumbered asset since state governments would not give permission to sell that land" (Kapur and Ramamurti, 2002).

[5] Net worth became positive at some point after the reorganisation plan was implemented.

[6] Reorganisation plan has been implemented but net worth is still negative

[7] 1 crore = 10 million.

TABLE 3
Annual Outcomes via Legislative Process

	Companies Act, 1956		*SIC Act data from BIFR website*		
	Voluntary Liquidations	*Liquidations under Court Order*	*Reorganisation Recommended*	*Liquidation Recommended*	*Dismissed*[i]
1996	13	39	29	85	25
1997	14	42	13	85	22
1988	19	81	13	50	36
1999	35	102	13	65	70
2000	34	52	10	153	158

[i] Cases where management had a false case (i.e. accounting manipulation, etc.).
Source: Department of Company Affairs *Annual Report*, 2001.

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For sick companies, since liquidation will wipe out equity, the debtor-in-possession and automatic stay further create incentives for the promoters to delay the process and siphon off value in the interim.

The 2002 Securitisation Bill (a descendant of the Financial Recovery due to Banks and Financial Institutions Act) has further complicated the process, by allowing banks and financial institutions to seize assets if a borrower defaults on a repayment and fails to respond within 60 days of a notice issued by the creditors. A Supreme Court ruling establishes that when statutes conflict with each other, such as the 2002 Securitisation Bill and the 1985 SIC Act, the more recent statute overrides the older one.[8] This would imply that secured creditors could seize assets of sick companies, violating the automatic stay provided by the 1985 SIC Act. The 2002 Securitisation Bill is still being challenged in courts,[9] but there have been numerous cases of a mad rush among creditors to take control of the assets although an interim injunction prevents them from disposing of the assets. This represents an appalling example of the system's bias towards sub-optimal outcomes.

Perverse Incentives

In the case of a liquidation petition, during the time it takes the court to review the petition and recommend liquidation, the assets remain under the control of the management which is frequently accused of fraudulent and illegal transfers during this interim period because there is really no effective monitoring mechanism by the creditors despite the absence of an automatic stay to prevent asset stripping other than the threat of ex-post litigation, which in the Indian context has been pretty weak so far. This phenomenon is partly to blame for the delays that official liquidators experience in trying to regain control of all assets and reconciling financial statements. For

[8] View taken by the Supreme Court in *Allahabad Bank v. Canara Bank*. Interview with Gunjan Shah, Lawyer, Amarchand Mangaldas, a New Delhi law firm.

[9] In *Mardiya Chemicals v. ICICI and others*. Interview with Ashish Rana, Third Year Law Student, Amity Law School, New Delhi.

sick companies, since liquidation will wipe out equity (with accumulated losses exceeding net worth), the debtor-in-possession and automatic stay further create incentives for the promoters[10] to delay the process and siphon off value in the interim. From this perspective, it is not surprising that on an average the accumulated losses for companies filing for protection under SIC Act are twice the net worth indicating that the management waits too long to seek any viable restructuring based solutions. Banks and financial institutions allege that "companies are increasingly resorting to the protection afforded by BIFR to escape the loan discipline" or that management "has forced the companies into sickness, just to obtain bank concessions…".[11] In fact, 20 per cent of the total cases brought before the BIFR are dismissed due to evidence of financial statement manipulation or other wrong doing by the management (Justice Eradi Committee Report, 2000), which supports the perception of SIC Act as a safe haven for the promoters. Current laws disallow creditors from initiating recovery proceedings, and as a result, "creditor rights were weakened while unprincipled managements enjoyed the flexibility to mismanage companies and divert resources" (Ahluwalia, 2002). This contrasts with the US Code, which allows either the creditor or the debtor to initiate the bankruptcy proceedings. For the workers, fear of liquidation and loss of jobs creates incentives to bind with the promoters and misuse the veto power to block any reorganisation plan.

Given the noisy and the fractured nature of the Indian democracy, any change in the bankruptcy system has to be balanced with the interests of the various political factions, and is therefore by contextual definition "gradual".

Additionally, in situations where the BIFR forces concessions, such as subsidies from the government, the marginal costs of these poorly performing companies are distorted vis-à-vis their healthy competitors, thereby introducing excess capacity in the short term. Examples of government-sponsored bailouts include waivers of electricity duty, power consumption tariffs, and sales taxes for a period of five years (as has been proposed in the recent case of Dunlop, a tyre manufacturer).[12] The perception within the Indian media is that these bailouts have allegedly enriched both management and public officials at the expense of creditors.

It is not surprising that the Indian bankruptcy system had been widely criticised by developmental agencies such as the International Monetary Fund (IMF) and the Asian Development Bank (ADB), as well as the Indian intelligentsia. Numerous reports have been published by various task forces and special committees appointed by the government to propose reforms to correct the value destruction biases of the current system. However, given the noisy and the fractured nature of

[10] The inside shareholder or the entrepreneur who holds a controlling interest and is actively involved in management of the company.

[11] In *Mardiya Chemicals v. ICICI and others*, p. 30. Interview with Ashish Rana, Third Year Law Student, Amity Law School, New Delhi.

[12] "Dunlop creditors back its draft rehab scheme," *Economic Times*, March 29, 2003, available from ISI Emerging markets, http://www.securities.com.

the Indian democracy, any change in the bankruptcy system has to be balanced with the interests of the various political factions, and is therefore by contextual definition "gradual" because of its attempts to minimise or delay social costs. It was not until 2002 that the country's legal framework for addressing corporate bankruptcies was amended in any significant way.

The Companies (Second Amendment) Act, 2002

Recognising that India's arcane bankruptcy laws could hinder the country's long-term economic growth, Parliament passed the Companies (Second Amendment) Act, 2002 (the 2002 Act), which received Presidential assent in January 2003.[13] The Act amended certain provisions in the 1956 Companies Act and repealed the 1985 Sick Industrial Companies Act outright. The 2002 Act sought to achieve the following goals:

- Remodel India's insolvency laws so that they are in line with international standards;[14]
- Expedite the rehabilitation or liquidation process to within a time frame of two years;
- Protect the interest of workers affected by the restructuring or liquidation process (Gupta, 2001)

The Act followed the recommendations of Justice V. Balakrishna Eradi, a Retired Justice of the Supreme Court of India, who was instructed by the Government to form a committee "which consisted of experts in several fields to examine the law relating to insolvency and winding up of companies" (Gupta, 2001).

The 2002 Act addresses the shortcomings of the bankruptcy system identified by the Eradi Committee by repealing the 1985 SIC Act and amending the 1956 Companies Act by including the following provisions:

- **A New Definition of "Sickness":** A new definition of "sickness" will result in early identification of distressed companies allowing for quick, efficient restructuring or liquidation.
- **Establishment of a National Company Law Tribunal:** This Tribunal will handle all cases pertaining to corporate matters previously heard by the BIFR and the Company Law Board, both of which will be abolished, and the High Courts, which will then be free to focus on civil cases.
- **Time-bound restructuring or liquidation guidelines:** These

[13] "India's Competition & Companies Bill Receives Presidential Assent," *Asia Pulse*, January 20, 2003, available on Lexis Nexis Academic, http://www.lexis-nexis.com.

[14] "Companies (Amendment) Bill 2001," US India Business Council Information Sheet.

guidelines will limit the restructuring or liquidation process to about two years. The Tribunal would institute monitoring mechanisms throughout the restructuring process to prevent management from engaging in rent-seeking behaviour.

- **Introduction of a Rehabilitation and Revival Fund:** A tax will be levied on revenues of all Indian companies to build a Fund that will compensate displaced workers of sick companies. This fund would enable the Tribunal to restructure or liquidate distressed companies without penalising labour.

The definition of "Sickness" in the 1985 SIC Act had been considered restrictive by the Eradi Committee, in that by the time a company had accumulated losses equal to or exceeding its entire net worth, chances of recovery were remote.

Redefining "Sickness"

The definition of "Sickness" in the 1985 SIC Act had been considered restrictive by the Eradi Committee, in that by the time a company had accumulated losses equal to or exceeding its entire net worth, chances of recovery were remote. The requirement that firms must be registered for at least five years further limited the scope of companies covered by the Act. Given that the 1985 SIC Act was the only means by which a firm could restructure under the aegis of the courts, such a restrictive definition ensured few companies would actually be restructured. The 2002 Act redefines a "Sick Company" as one:

(a) which has accumulated losses in any financial year equal to 50 per cent or more of its average net worth during four years immediately preceding the financial year in question, or
(b) which has failed to repay its debts within any three consecutive quarters on demand for repayment by its creditors (Gupta, 2001).

The 2002 Act also lifts the five-year registration restriction on industrial companies (Rana, 2003).

Establishment of a National Company Law Tribunal

The 2002 Act establishes the National Company Law Tribunal (the Tribunal) to consolidate the powers and jurisdictions of the Company Law Board (CLB), the BIFR, and various offices of the High Courts that deal with affairs surrounding company insolvency. The BIFR and the CLB now cease to exist. "The multiplicity of litigations before various bodies for revival or rehabilitation or merger or amalgamation or winding up of companies will be avoided and the Tribunal will hear and decide these matters" (Rana, 2003). The Tribunal, like its predecessor bodies, adjudicates on plans offered by creditors and management, or proposes a plan itself (unlike Chapter 11 of the US Bankruptcy Code, where creditors and management negotiate and vote on an appropriate plan that is sanctioned by the Court). The Tribunal is headquartered in New Delhi and has 10 branches throughout the country in the High Court offices. Appeals against the Tribunal are heard by the Appellate Tribunal, and appeals contesting the Appellate Tribunal judgements will be heard in the Supreme Court.

The 2002 Act recommends that the Tribunal "should be headed by a sitting judge or a former judge of a High Court and each of its benches should consist of a judicial member and a technical member".[15] The Chairperson of the Appellate Tribunal "shall be a person who is, or has been, a judge of the Supreme Court or Chief Justice of a High Court".[16] However, finding qualified members to sit on the Tribunal may be easier said than done: several positions in the CLB, (the 1956 Act's predecessor to the Tribunal), have been vacant for many years (Datar, 2001).

Time-bound Restructuring or Liquidation Guidelines

The 2002 Act reduces the length of time taken to rehabilitate or liquidate distressed companies from 10–15 years under the old bankruptcy system to less than two years under the current system. See *Table 4* for steps in the rehabilitation process and the associated time periods for each step as specified by the 2002 Act.

Finding qualified members to sit on the Tribunal may be easier said than done: several positions in the CLB have been vacant for many years.

Step 1 of the restructuring process involves a referral to the Tribunal. The company can refer itself to the Tribunal within 180 days of coming to know "of the relevant facts giving rise to causes of such reference or within 60 days of final adoption of accounts, whichever is earlier" (The Companies Act, 2002). The Tribunal assigns a panel of auditors to certify that either of the two criteria determining the company is "sick" has been met. State-owned enterprises can only be referred to the Tribunal following the approval of the Central or State governments. With respect to private companies, the Tribunal can act on referrals from managers, or petitions from creditors, or without provocation if it has reason to believe the company is distressed and needs to be restructured (The Companies Act, 2002, p. 18).

In **Step 2** of the rehabilitation process the Tribunal appoints an Operating Agency to conduct an initial exploration of whether the "sick" company should be restructured and if so, how the restructuring should take place. The Tribunal also appoints a Director to oversee the day-to-day operations of the company and ensure that management does not participate in rent-seeking behaviour. This Director submits an initial report regarding the state of affairs in the company and is conferred upon the rights and responsibilities of a director of the company. The Tribunal must now decide in **Step 3**, given the information from the Operating Agency report, the Director's report, and other information provided to it by management and creditors, whether the company needs to be restructured, or whether it simply needs more time to get its house in order.

[15] "Eradi panel proposals on insolvency law – Core Group to examine changes in Companies Act," *Business Line Internet Edition*, September 3, 2000.
[16] "Companies (Amendment) Bill 2001," December 6, 2001.

TABLE 4
Proposed restructuring time period

Order of Events	*Action*	*Recommended Time Period*
1	The earlier of (a) Company comes to know of "relevant facts" that could provide cause for restructuring; and (b) Accounting statements show Company should be restructured; Or, Tribunal comes across information on its own, perhaps through creditor petitions, that Company should be restructured.	6 months 2 months
2	Tribunal appoints Operating Agency to conduct initial enquiry. Agency submits report to Tribunal.	1 month
2 (Simultaneously)	Tribunal appoints Director to Company Board to safeguard interests of creditors and the public. Director submits "state of affairs report".	2 months
3	Tribunal decides whether Company should be given more time to improve its health or whether rehabilitation proceedings should be initiated.	2 months
4	Operating Agency and Creditors must submit their restructuring schemes.	2 months
5	Tribunal must sanction a restructuring scheme. It is free to make modifications of its own.	2 months
6a	If Tribunal decides to restructure the Company, it may monitor the restructuring process periodically until restructuring is complete.	Varies
6b	If Tribunal decides to liquidate the Company, it must appoint an Official Liquidator to commence liquidation proceedings.	1 year
7	Aggrieved parties may appeal to the Appellate Tribunal after hearing Tribunal decision.	1.5 months
8	Appellate Tribunal must decide on case.	6 months
9	Aggrieved parties may appeal to Supreme Court after hearing Appellate Tribunal decision.	2 months

Source: 2002 Companies (Second Amendment) Act.

If the Tribunal concludes that the company must be restructured (**Step 4**), it will direct an Operating Agency to prepare a restructuring plan. The company may also submit a proposed rehabilitation plan (when it initially applies to the Tribunal) and creditors may also do so, provided their scheme has been approved by at least three-fourths in value of the creditors. The Tribunal will review any or all restructuring schemes (**Step 5**), and has the power to make whatever modifications it deems necessary in the light of suggestions and objections it receives from what it deems to be relevant parties. The Tribunal must decide whether a restructuring plan will be adopted (**Step 6a**) or a liquidation plan will be adopted (**Step 6b**). The Tribunal's chosen restructuring or liquidation scheme is binding on the distressed company, its shareholders, creditors, and employees, and creditors or other public or private financial institutions may have to "provide for financial assistance by way of loans, advances or guarantees or relief or concessions or sacrifices" (The Companies Act, 2002, p. 23).

The Tribunal can order liquidation at any time if it feels the company "is not likely to become viable in the future and that it is just and equitable that [it] should be wound up" (The Companies Act, 2002, p. 24). The Tribunal appoints an Official Liquidator, who must execute the liquidation proceedings within one year of receiving the order from the Tribunal. To accelerate the liquidation process, the Official Liquidator is given broader powers to appoint accountants and secretaries to assist him in the performance of his duties. Official Liquidators will also receive "success fee based remuneration… payable on the realisation value of assets sold or debt recovered," ensuring that "only serious professionals with high standards of achievement and quality will come forward to undertake these activities".[17]

Rehabilitation and Revival Fund

According to the 2002 Companies Act, the interest of the workers affected by restructuring and liquidation must be protected. The Central Government has thus decided to tax all companies a set percentage of around 0.1 per cent of revenues for the purpose of creating a fund that relates to the restructuring of companies.[18] This fund, entitled the Rehabilitation and Revival Fund (the RRF), will be utilised by the Tribunal to make interim payments on workers' wages, protect the assets of the sick company, and whatever else the Tribunal sees fit in order to revive or rehabilitate the company.

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Implications of the 2002 Act

It is clear that the 1956 and 1985 Acts fail miserably when judged against Gilson's three criteria (Gilson, 1994) for understanding the efficacy of bankruptcy systems in different countries. We can apply these litmus tests on the 2002 Companies Act to gauge whether the amendments put forward by the Act bring India any closer to a bankruptcy system that promotes economic efficiency. These criteria are as follows:

(a) reorganisation or liquidation must be accomplished at minimum cost;
(b) insolvent firms must reorganise when their going-concern value exceeds their liquidation value, and liquidate when their liquidation value exceeds their going-concern value;
(c) managers and stockholders must be dissuaded from "gaming"

[17] Federation of Andhra Pradesh Chambers of Commerce and Industry (FAPCCI) Review, 2002, p. 10.

[18] FAPCCI Review, 2002, p. 28.

By streamlining the work of various judicial bodies such as the Courts, the CLB, and the BIFR into one Tribunal, the restructuring process should be less vulnerable to the innumerable delays that plagued the previous system.

the system and taking actions that generate private benefits at the expense of firm value (Gilson, 1994).

Because the 2002 Act was approved only recently, we lack the data necessary to accurately measure the impact of these reforms and can only speculate as to what improvements these amendments will engender.

Will Restructuring and Liquidation Proceedings Take Less Time?

One of the goals of the authors of the 2002 Act was to "expedite the rehabilitation or liquidation process to within a time frame of two years, versus 10 to 15 years under the previous system." Delay is the enemy—it provides management with time to engage in perverse activities, it depletes asset values, and it reduces the time-value of money that can be directed to more profitable projects. We can reasonably assume that the time taken to order the restructuring or liquidation of companies will be drastically reduced from 10–15 years for two reasons: first, the mere existence of a timeline should serve to accelerate proceedings; second, by streamlining the work of various judicial bodies such as the Courts, the CLB, and the BIFR into one Tribunal, the restructuring process should be less vulnerable to the innumerable delays that plagued the previous system.

According to the timeframe in *Table 4*, the Tribunal must sanction a restructuring or liquidation plan to be implemented 12–14 months after the company is referred to the agency. The Official Liquidator has been given one year to complete the liquidation process, and his powers have been broadened to equip him with greater decision rights, thereby removing the need to seek approval from the courts, a common source of delay. This two-year period stands in marked contrast to the data in *Table 2*, which examines the fate of 3,195 companies that were referred to the Official Liquidator as per the 1956 Companies Act and shows the median liquidation period to be 5–10 years. However, the average time to restructure companies under the 2002 Act could be longer than two years, if one includes firms which are liquidated following a failed restructuring process overseen by the Tribunal.

The 12–14 month period the Tribunal expends to reach its decision is still a welcome improvement over the BIFR, which took on average seven years simply to conclude its inquiry and propose a restructuring plan, according to *Table 1*. When it comes to executing a restructuring plan, however, the Tribunal may face the same source of delay as faced by the BIFR, viz., the 1947 Industrial Disputes Act, which forces firms to seek government approval when laying off more than 100 workers, though the minimum threshold has recently been increased to 1,000 workers in the 2002-03 budget session.[19]

[19] "Cabinet okays amendment to Industrial Disputes Act," *rediff.com*, February 22, 2002, available on http://www.rediff.com.

It is widely agreed that the dualism inherent in the previous bankruptcy regime, for example, between the High Courts and tribunals such as the BIFR and the CLB, or between the 1956 Act and the 1985 Act, has been a source of considerable delay. The 2002 Act eliminates this dualism by transferring all cases managed by the Courts, the BIFR, and the CLB to the Tribunal. One benefit of removing this dualism is that once the Tribunal decides a company must be liquidated, it need not refer the case to the High Court as the BIFR once did. However, this streamlining could itself cause additional delays. For example, although the Tribunal has 10 branches throughout the country, there is only one Appellate Tribunal in New Delhi, in contrast to the 10 Appellate Courts, each of which would handle appeals relating to decisions made by the corresponding High Court (Datar, 2001). The two judiciaries were often located in the some building. It remains to be seen whether the Appellate Tribunal will be clogged with appeals relating to decisions made by the 10 Tribunals.

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Will the Right Companies be Restructured and Liquidated?

An efficient bankruptcy system ensures that companies whose going-concern value is less than liquidation value are liquidated, while those whose going-concern value is greater than liquidation value are restructured. Under the bankruptcy system embodied in the 1956 and 1985 Acts, there existed some companies that should have been restructured or liquidated, but would be permitted to continue as going concerns. A common example would be state-owned enterprises, which would simply receive additional funding from the government, without being restructured or liquidated when necessary.

Table 5, a variation of Gilson's schematic framework for comparing alternative bankruptcy systems (Figure 10.1, Gilson, 1994), illustrates potential outcomes of the previous bankruptcy system, given that a firm should be restructured or liquidated. Each box lists possible reasons why these sub-optimal outcomes might occur. Sub-optimal outcomes (e.g., firm that should be restructured is allowed to continue as a going concern because it does not meet the definition of "sickness" outlined by the BIFR) are shaded in grey. By tackling specific root causes relating to sub-optimal outcomes, such as the government's inability to retrench workers, exemption of state enterprises, etc., the 2002 Act can limit the type of sub-optimal outcomes that might occur.

The 2002 Act has attempted to remedy the underlying issues behind these sub-optimal outcomes. For example, "sickness" has been redefined to include non-payment of debt as a contributing factor, thereby enabling creditors to force companies to restructure. Broader powers have been conferred upon the Official Liquidator to accelerate the liquidation process. The dualism inherent in the system as a result of two legislations addressing the issue of corporate bankruptcy has been removed; now one Act and one agency will handle all aspects of the corporate bankruptcy process. A set restructuring timeframe has been introduced to reduce the time taken to 12–14 months for the agency to decide on either a restructuring plan or a liquidation plan. Creditors are now able to petition the Tribunal to initiate restructuring proceedings and submit plans while previously they could only restructure out of court or force liquidation. Management fraud is addressed by appointing Directors, auditors, and OAs to oversee the restructuring process.

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TABLE 5
An analysis of which sub-optimal outcomes might occur under the previous bankruptcy system. Each of the shaded boxes represents a sub-optimal outcome

		what should happen to the firm	
		firm should be liquidated	*firm should be restructured*
what	**firm continues as going concern**	• government unwilling to retrench workers • Official Liquidator powerless • conflicting labour or land • State enterprises exempt	• definition of sick is too narrow • government unwilling to retrench workers • conflicting labour and land • State enterprises exempt • Creditors unable to initiate restructuring proceedings
does	**restructure**	• government unwilling to retrench workers • wrong agency handles case • management fraud under BIFR umbrella	• takes too long
happen	**liquidate**	• takes too long	• wrong agency handles case • restructuring plan poorly executed—firm subsequently liquidated

The Central Government, with the introduction of the RRF, also hopes to mitigate the apprehension that restructuring and liquidation are against "public interest" because workers will be worse off. The RRF enables the Tribunal to focus solely on maximisation of distressed assets, as the fund will compensate displaced workers and ensure that the restructuring process does not go against public interest. Critics worry, however, that the funds in the RRF may be appropriated for other purposes, or that the Tribunal would have trouble accessing proceeds of the RRF (Rana, 2003). Because the tax is levied on company turnover, not profit, even firms that are incurring losses will have to contribute to the RRF (Rana, 2003). Critics also assert that wages offered to displaced workers "should not be used as a dole for the displaced employees but should be used to retrain them so that they are able to face up to the challenges of a competitive environment".[20]

[20] FAPCCI Review, 2002, p. 10.

External forces will still influence the effectiveness of India's bankruptcy system, despite the positive strides taken through the 2002 Act. For example, the Tribunal cannot recommend a state industrial enterprise be restructured or liquidated without the consent of the relevant state government. The RRF, however, may encourage lay-off-conscious state governments to reform their industrial enterprises, whose losses are contributing towards an ever-increasing proportion of their budget deficits. India's consolidated budget deficit, including central and state governments and state-owned businesses, is 11 per cent of GDP[21]. One piece of legislation, the 2002 Securitisation Bill (if it eventually makes it through the Courts), could enhance the rights of secured creditors to seize the assets against non-performing loans, especially if fraud is involved on the part of the borrower.[22] Because the 2002 Companies Act was instituted *after* the approval of the 2002 Securitisation Bill, the Tribunal will be able to override provisions of the Securitisation Bill whenever it believes the Bill is acting against the interests of creditors as a whole. It is possible that this Bill, in conjunction with the new definition of "sickness", will spur more voluntary out-of-court settlements or referrals to the Tribunal. The recent amendment to the 1947 Industrial Disputes Act is also a positive sign.

External forces will still influence the effectiveness of India's bankruptcy system, despite the 2002 Act. For example, the Tribunal cannot recommend a state industrial enterprise be restructured or liquidated without the consent of the relevant state government.

A more fundamental issue regarding whether the right companies will be restructured or liquidated is whether a system of "restructuring by tribunal," embodied by the 1956 Act, the 1985 Act, and the 2002 Act, is superior to a system of negotiated settlements by creditors and management, akin to Chapter 11 in US corporate bankruptcy law. The BIFR, according to one author, "prolongs the inevitable liquidation of the company. If there is scope for rehabilitation, banks and financial institutions are competent enough to assess the possibility" (Datar, 2001). This author envisages that "a substantial part of the Tribunal's time and energy is going to be wasted on rehabilitation schemes which will seldom be implemented" (Datar, 2001). In its analysis of bankruptcy laws in 2001, the Reserve Bank of India (RBI), India's central bank, urged the Central Government to scrap the command-approach to resolving bankruptcies:

> The Advisory Group is of the opinion that the formalistic design or facility created for parties to restructure and renegotiate must have a veil of juristic neutrality, that is, absence of any privilege or favour to any of the parties. The formalistic procedure of restructuring, as for example, Chapter 11 restructuring of the US Code, is a simple creation of neutral environment for the parties to renegotiate. It is

[21] "Small savings, big headache," *The Economist*, March 27, 2003, available from the Economist website, http://www.economist.com.

[22] "RBI Definition of Willful Defaulters to Help Banks Nail Culprits," *Financial Express*, November 7, 2002, available from Lexis Nexis Academic, http://www.lexis-nexis.com.

only an additional opportunity for voluntary re-negotiation for reorganisation of the borrower institution. Any effort for restructuring must be based on a voluntary effort of all creditors, secured and unsecured, the members of the company, its promoters and management. There is no place for any command. In case the parties want, the Trustee can provide expert's advice either from in-house or from external expert agencies, hiring the services of such agencies.[23]

An additional concern relates to the fact that the Tribunal will be composed of retired High Court judges who have primarily handled civil cases. If it is believed that it may not possess adequate knowledge of bankruptcy laws, or that it could be influenced, or that a severe backlog of cases could plague the Tribunal and Appellate Tribunals, then the RBI's recommendations should be adopted. However, in a socialist economy such as India, where the protection of the worker, as articulated by the goals of the 2002 Act, is paramount, the government may simply not trust creditors and managers to formulate an outcome in "public interest," despite the intentions of the RRF and the *pari passu* distribution of claims between secured creditors and workers' dues.

In a socialist economy such as India, where the protection of the worker is paramount, the government may simply not trust creditors and managers to formulate an outcome in "public interest".

Will Managers and Stockholders Still Game the System?

The 2002 Act institutes a number of provisions designed to address concerns that under Indian bankruptcy laws, "bankrupt companies rot in government-sponsored rehabilitation, their assets tied up, their creditors unpaid but their promoters often richer by raiding retirement funds and pocketing primary and secondary investors' money".[24] The Act removes the automatic stay against creditors except when explicitly sanctioned by the Tribunal. There are stringent controls on management with the appointment of a Director representing the Tribunal to sit on the company's Board of Directors and with the appointment of Operating Agencies and the enhanced powers of the Official Liquidator. A team of auditors verifies the accounts of the company when it applies to the Tribunal, to ensure management is not manipulating its financial statements for the sole purpose of seeking protection against creditors. A defined timeframe will limit opportunities for management to engage in perverse behaviour.

It is interesting to note that two hallmarks of Chapter 11 in the US, the automatic stay and control of assets by the management team during the restructuring process, have both been curbed in the 2002 Act. Similar provisions of the Indian bankruptcy system led to rent-seeking behaviour on behalf of both management and public officials. This misbehaviour may not have been solely a result of the automatic stay or debtor control of assets, but it may reflect structural flaws in the

[23] Mitra, 2001, p. 30.

[24] "Thus Capital," *The Statesman (India)*, January 29, 2002, available on Lexis Nexis Academic, http://www.lexis-nexis.com.

bankruptcy system. For example, without a defined timeframe in which to execute the proceedings, debtors have ample time to siphon off or sell assets. The BIFR may have lacked enforcement mechanisms to align incentives of management with the greater public interest, or the agency may have been confused as to which objective was paramount, maximisation of the value of the distressed assets, or protection of jobs.

Given the negative public perception of company management in high profile bankruptcies such as Dunlop and Unit Trust of India (UTI), it is reasonable to expect that automatic stay and debtor control of assets will only be granted on a case-by-case basis, under the control of some judicial authority. Even the RBI recommends that a Trustee be appointed to "take full charge of the entity as if it were the CEO of the entity" as soon as a bankruptcy petition is filed by either the debtor or creditors (Mitra, 2001, p. 28).

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Conclusion

The conflict between the government's implicit social contract to protect the public interest and its role in promoting economic efficiency via maximisation of value of assets has been and will continue to be a defining feature of the bankruptcy laws in India. Given these contextual constraints, it remains to be seen whether the 2002 Companies Act will adequately address the deficiencies of India's corporate bankruptcy laws. Legislation to further amend bankruptcy laws might, however, accompany future efforts to liberalise India's economic infrastructure, in the areas of labour law reform, deregulation of industries, and privatisation of state-owned enterprises.

Although further improvements could have been instituted to bring India's framework in line with Western countries adopting a "gradualist" approach to bankruptcy law reform may have been more politically sensible: those opposed to economic reform may have scuttled attempts to radically overhaul the existing infrastructure overnight. Indian economist Montek S. Ahluwalia notes[25] that when reform goals are indicated only as a broad direction, with the precise end-point and pace of transition left unstated, opposition is minimised, and the government is given room to retreat if necessary. As a result, progress is made, albeit in "fits and starts". The alternative approach, which would consist of a more thorough debate, with a clear delineation of what needs to be done, could create gridlock in India's highly pluralistic democracy. So it is possible that the 1956, 1985, and 2002 Acts relating to Indian bankruptcy laws are really just a series of legislations that will culminate in an Indian version of Chapter 11, but we cannot let the Opposition know that, or they will threaten to walk out of Parliament. That secret is safe with us.

[25] Ahluwalia, 2002.

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