The Insolvency and Bankruptcy Code, 2016 was enacted to provide a time-bound process to resolve insolvency among companies and individuals. Insolvency is a situation where an individual or company is unable to repay their outstanding debt. Last month, the government promulgated the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2018 amending certain provisions of the Code. The Insolvency and Bankruptcy Code (Second Amendment) Bill, 2018, which replaces this Ordinance, was introduced in Lok Sabha last week and is scheduled to be passed in the ongoing monsoon session of Parliament. In light of this, we discuss some of the changes being proposed under the Bill and possible implications of such changes.

What was the need for amending the Code?

In November 2017, the Insolvency Law Committee was set up to review the Code, identify issues in its implementation, and suggest changes. The Committee submitted its report in March 2018. It made several recommendations, such as treating allottees under a real estate project as financial creditors, exempting micro, small and medium enterprises from certain provisions of the Code, reducing voting thresholds of the committee of creditors, among others. Subsequently, the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2018, was promulgated on June 6, 2018, incorporating these recommendations.

What amendments have been proposed regarding real estate allottees?

The Code defines a financial creditor as anyone who has extended any kind of loan or financial credit to the debtor. The Bill clarifies that an allottee under a real estate project (a buyer of an under-construction residential or commercial property) will be considered as a financial creditor. These allottees will be represented on the committee of creditors by an authorised representative who will vote on their behalf.

This committee is responsible for taking key decisions related to the resolution process, such as appointing the resolution professional, and approving the resolution plan to be submitted to the National Company Law Tribunal (NCLT). It also implies that real estate allottees can initiate a corporate insolvency resolution process against the debtor.

Can the amount raised by real estate allottees be considered as financial debt?

The Insolvency Law Committee (2017) had noted that the amount paid by allottees under a real estate project is a means of raising finance for the project, and hence would classify as financial debt. It had also noted that, in certain cases, allottees provide more money towards a real estate project than banks. The Bill provides that the amount raised from allottees during the sale of a real estate project would have the commercial effect of a borrowing, and therefore be considered as a financial debt for the real estate company (or the debtor).

However, it may be argued that the money raised from allottees under a real estate project is an advance payment for a future asset (or the property allotted to them). It is not an explicit loan given to the developer against receipt of interest, or similar consideration for the time value of money, and therefore may not qualify as financial debt.

Do the amendments affect the priority of real estate allottees in the waterfall under liquidation?

During the corporate insolvency resolution process, a committee of creditors (comprising of all

financial creditors) may choose to: (i) resolve the debtor company, or (ii) liquidate (sell) the debtor's assets to repay loans. If no decision is made by the committee within the prescribed time period, the debtor's assets are liquidated to repay the debt. In case of liquidation, secured creditors are paid first after payment of the resolution fees and other resolution costs. Secured creditors are those whose loans are backed by collateral (security). This is followed by payment of employee wages, and then payment to all the unsecured creditors.

While the Bill classifies allottees as financial creditors, it does not specify whether they would be treated as secured or unsecured creditors. Therefore, their position in the order of priority is not clear.

What amendments have been proposed regarding Micro, Small, and Medium Enterprises (MSMEs)?

Earlier this year, the Code was amended to prohibit certain persons from submitting a resolution plan. These include: (i) wilful defaulters, (ii) promoters or management of the company if it has an outstanding non-performing asset (NPA) for over a year, and (iii) disqualified directors, among others. Further, it barred the sale of property of a defaulter to such persons during liquidation. One of the concerns raised was that in case of some MSMEs, the promoter may be the only person submitting a plan to revive the company. In such cases, the defaulting firm will go into liquidation even if there could have been a viable resolution plan.

The Bill amends the criteria which prohibits certain persons from submitting a resolution plan. For example, the Code prohibits a person from being a resolution applicant if his account has been identified as a NPA for more than a year. The Bill provides that this criterion will not apply if such an applicant is a financial entity, and is not a related party to the debtor (with certain exceptions). Further, if the NPA was acquired under a resolution plan under this Code, then this criterion will not apply for a period of three years (instead of one). Secondly, the Code also bars a guarantor of a defaulter from being an applicant. The Bill specifies that such a bar will apply if such guarantee has been invoked by the creditor and remains unpaid.

In addition to amending these criteria, the Bill also states that the ineligibility criteria for resolution applicants regarding NPAs and guarantors will not be applicable to persons applying for resolution of MSMEs. The central government may, in public interest, modify or remove other provisions of the Code while applying them to MSMEs.

What are some of the other key changes being proposed?

The Bill also makes certain changes to the procedures under the Code. Under the Code, all decisions of the committee of creditors have to be taken by a 75% majority of the financial creditors. The Bill lowers this threshold to 51%. For certain key decisions, such as appointment of a resolution professional, approving the resolution plan, and making structural changes to the company, the voting threshold has been reduced from 75% to 66%.

The Bill also provides for withdrawal of a resolution application, after the resolution process has been initiated with the NCLT. Such withdrawal will have to be approved by a 90% vote of the committee of creditors.

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