
DRAWING THE LINE BETWEEN MALFEASANCE AND BUSINESS FAILURE UNDER CIRP

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ABSTRACT

This paper critically looks at the fine line between malfeasance and actual business failure under the Corporate Insolvency Resolution Process (CIRP) by the Insolvency and Bankruptcy Code, 2016 (IBC). The IBC was not designed as a debt recovery mechanism since its creation was a reformative framework to advance timely resolution, value maximization, and revival of distressed entities. Nevertheless, the increasing tendency to initiate CIRP based on only evidence of default, and without sufficient examination of the true financial situation of the debtor, can be seen as the failure to adhere to the objectives of the Code.

This paper suggests that admission into CIRP should be based on insolvency rather than on default, through a doctrinal examination of statutory provisions, the Bankruptcy Law Reforms Committee Report and landmark judicial pronouncements. It emphasizes the importance of adjudicatory authorities to differentiate between wilful misconduct and bona fide financial distress, which, in particular, applies to temporary or technical default by otherwise viable enterprises.

The paper reiterates that insolvency should not be a decision of first resort but should be to restore the economic well-being of the business and protect the stakeholders, as opposed to finding managers culpably liable and liquidating the business prematurely.

INTRODUCTION

The Insolvency and Bankruptcy Code, 2016¹ is an umbrella legislation for the Insolvency resolution process applicable to all the person or entities, corporate bodies or individuals in India. The Insolvency and Bankruptcy code was enacted as a comprehensive set of rules and guidelines aimed at ensuring progression towards a mature market economy, foster the freedom of exit of a commercial establishment or discontinuing the business and enhancement of the recovery mechanism in India. The two major objectives of the code are one; to regulate Insolvency or Bankruptcy resolutions of commercial entities either through corporate insolvency resolution process (CIRP), ultimately ending or not in liquidation or through voluntary winding up process and second; maximization of the wealth of the corporate debtor, i.e., the commercial entity into insolvency or bankruptcy. The intention of the makers of the law with respect to the former was in securing continued existence of the corporate debtors who are viable and with respect to the latter, in protecting the interests of the stakeholders of the corporate debtors in case of such financial crisis.

The code, enacted in 2016, marks a significant milestone in the recovery of commercial entities in the process of debt recovery. In 2014, the Government of India formed the Bankruptcy Law Reform Committee (BLRC)² to review and put forward changes to the existing insolvency and bankruptcy laws. The committee under the guidance of Dr. T.K. Vishwanathan, the committee was tasked to build a more effective frame work for insolvency related issues. The report submitted in November 2016 by the committee played a major role in giving the code a final shape. The report of the Committee on Corporate Insolvency Resolution process and the Parliamentary Standing Committee report were among the other major reports submitted by the legislature which contributed towards the refinement of the code. The Finance Minister, Nirmala Sitharaman proposed in the budget of the FY 2024-25 that the government would take steps to make necessary amendments to the code including the development of a digital public infrastructure application and to strengthen the role of the tribunals. She stated that, “The success of the IBC, which has resolved over 1,000 cases, resulting in the realization of Rs 3.3 lakh crore for creditors.”³

¹ Insolvency and Bankruptcy Code, 2016, No. 31, Acts of Parliament, 2016 (India).

² Bankruptcy Law Reforms Committee, Vol. I: Rationale and Design (2015).

³ TIMES OF INDIA, <https://timesofindia.indiatimes.com/business/india-business/changes-will-be-made-to-ibc-to-strengthen-tribunals-fm-nirmala-sitharaman/articleshow/111950174.cms> (last visited Sep. 9, 2024)

Mr. Abhishek Dafria, Senior Vice President and Group Head, Structured Finance Ratings, at ICRA, while addressing the increasing number of resolution plans approved by the NCLTs under the IBC code in the financial year 2024, stated that, “*In FY2024, about Rs 1.7 lakh crore of admitted claims by creditors were resolved, 13% higher than the Rs. 1.5 lakh crore recorded in FY2023, through a resolution plan under the IBC.*”⁴ This highlights the fact that the code has been successfully implemented to achieve its object to recover the corporate debtors from Insolvency or Bankruptcy as compared to the number of resolution plans admitted in the previous years, thereby continuing to keep the corporate debtors as going concerns. However, the number of CIRPs ending in liquidation continues to outpace those ending in admitted resolution plans. This paper in its latter chapters discusses about the admission of corporate debtors into the CIRP process under sections 7 and 9 by the financial creditors and the operational creditors, respectively. The paper emphasises on the importance of the status of the corporate debtor as a pre-condition for initiating the proceedings under the above sections.

RESEARCH OBJECTIVES

1. To gain an overall understanding of the IBC code and the CIRP process in specific.
2. To explore into the CIRP process by analysing the relevant legal provisions under the code.
3. To emphasize on the role of the code as a revival mechanism of commercial entities in bona fide financial crisis as against the tool for mere debt recovery in the hands of the deceitful creditors.

RESEARCH METHODOLOGY

The current research topic requires doctrinal research to better analyze it, which is evident in the case studies selected for the study. The analysis of the many provisions of the statute, the interpretations of these provisions by other authors, and the examination of judicial precedents relevant to the current topic require the researcher to pay attention to the wording and the intricate details they contain. Court precedent will help to understand the general idea of the

⁴ Naznin Prodhani, *Record high number of resolution plans approved under IBC in FY2024; increase in average duration of the resolution process though remains a worry*, ICRA (Sep. 9, 2024, 9.24 PM), <https://www.icra.in/CommonService/OpenMediaS3?Key=6962fa25-2d04-4a06-b6f7-dd98f9a6e8fe#:~:text=The%20notable%20increase%20can%20be,declined%20to%20987%20corporate%20debtors>

current topic and its practical application. The interpretation of the terms and the reference to relevant precedents for the present case are both a matter of doctrinal inquiry. Therefore, the researcher proposes a study that is doctrinal as it best fits the current analysis of the case study.

CORPORATE INSOLVENCY PROCEEDINGS

The Corporate Insolvency Resolution Process is covered under Part 2⁵, sections 7 to 32 of the code. It regulates the entire process from initiation of the proceedings against the corporate debtor before the National Company Law Tribunal NCLT till the approval of the Resolution plan of the Committee of Creditors or the entry of the corporate debtor into liquidation. The process aims at balancing the interest of the company and the creditors by preserving the value of the company and at the same time, maximizing the value of the company's assets for disposal or their continuance in the business.

INITIATION AND ADMISSION INTO CIRP

The first instance where the code talks about the right to initiate the proceedings of CIRP is under section 7⁶ where it states that the Financial Creditors of the corporate debtor may in an individual capacity file an application for default amounting to 1 Crore rupees or more. The debt shall arise from the same transaction or perpetual sub-transactions relating to the same transaction of business. Section 8 and section 9 talk about the right vested with the operational creditors to initiate CIRP against the company in default. Section 8⁷ states that a demand notice shall be sent to the corporate debtor demanding the payment of the debt to which the corporate debtor shall send a reply either mentioning about a dispute in existence or showing the proof of payment of the debt. In both such cases, the proceedings are not admitted by the tribunal. If the reply is unsatisfactory to the creditor, he may apply for CIRP under section 9⁸. The role of NCLT in admitting or rejecting the application under the above sections is restricted to the determination of the existence or non-existence of the default. The tribunal is not empowered to delve into the kind of default once the existence of such default is proved.

MORATORIUM

Once the tribunal admits the application against the corporate debtor under any of the above

⁵ Insolvency and Bankruptcy Code, 2016, PART II, No. 31, Acts of Parliament, 2016 (India).

⁶ Insolvency and Bankruptcy Code, 2016, § 7, No. 31, Acts of Parliament, 2016 (India).

⁷ Insolvency and Bankruptcy Code, 2016, § 8, No. 31, Acts of Parliament, 2016 (India).

⁸ Insolvency and Bankruptcy Code, 2016, § 9, No. 31, Acts of Parliament, 2016 (India).

sections, the moratorium period kicks in. As per section 14 of the code, a prohibition is laid on the company and its management in conducting any business-related operations like sale or transfer of assets, winding up, disposing of certain liabilities resulting in avoidance transactions or PUF transactions under sections 43, 45, 46 and 50 of the code respectively. However, the company is permitted to undertake basic operations like payment of office expenses, acceptance of raw materials, etc., which are necessary to keep the company as a going-concerns during CIRP. Once the application is admitted, the entire proceedings shall be completed within 12 months from the date of such admission as provided for under section 10⁹ of the code.

APPOINTMENT OF THE RESOLUTION PROFESSIONAL

To achieve the purpose mentioned above, the entire management of the corporate debtor is transferred to the Resolution Professional or the Interim Resolution Professional. In accordance with section 16¹⁰ of the code, the Adjudicating Authority shall appoint an interim resolution professional till the CoC is convened and the resolution professional is appointed. However, in the case of **Venus India Asset Finance Pvt Ltd vs Mr. Suresh Kumar Jain**¹¹, National Company Law Appellate Tribunal Principal Bench, New Delhi, has held the following, “*We, therefore, find that Section 27 of the IBC empowers the CoC to replace a Resolution Professional who has been appointed under Section 22 of the IBC at any time during the CIRP.*”

The IRP or the RP is duty bound to maintain communication between the committee of creditors and the management of the CD, to manage the operations of the corporate debtor, to ascertain and value the assets and liabilities of the corporate debtor, to calculate the share of each creditor in the total debt and most importantly, to prepare and submit the Resolution plan for approval of the CoC and subsequently of the NCLT according to sections 24¹² and 25¹³ of the code respectively.

RESOLUTION PLAN – SUCCESSFUL BIDDING OR LIQUIDATION

The NCLT shall act in a prudently and cautiously in analysing and reviewing the plan placed

⁹ Insolvency and Bankruptcy Code, 2016, § 10, No. 31, Acts of Parliament, 2016 (India).

¹⁰ Insolvency and Bankruptcy Code, 2016, § 16, No. 31, Acts of Parliament, 2016 (India).

¹¹ Venus India Asset Finance Pvt Ltd vs Mr. Suresh Kumar Jain, (2023) ibclaw.in 121 NCLAT.

¹² Insolvency and Bankruptcy Code, 2016, § 24, No. 31, Acts of Parliament, 2016 (India).

¹³ Insolvency and Bankruptcy Code, 2016, § 25, No. 31, Acts of Parliament, 2016 (India).

before it. Once the plan is approved, the RP is vested with the duty to get the plan implemented in accordance with the changes made by the NCLT, if any. This results in continuing of the business as a going concern either under the same management or not. However, if the plan is not approved by the NCLT, the corporate debtor enters into liquidation where the assets of the corporate debtor are compiled into a liquidation estate and disposed to settle the debt as per section 31¹⁴ of the code. The corporate debtor is ultimately dissolved as per section 32¹⁵ of the code.

PROOF OF INSOLVENCY OR BANKRUPTCY

The Insolvency and Bankruptcy code was designed with a primary aim of facilitating the revival of companies in financial distress and rehabilitating those struggling companies. Through the proceedings under the code, the makers of the code intended to maximize the value of the assets, regain the health of the business and maximize the recovery ability of the creditors through a resolution plan that revives the initial position of the corporate debtor. However, the focus has evidently shifted from the code being used to revive the companies from crisis to being a mere debt recovery tool in the hands of the creditors. Although the code gives a right to the injured creditors to initiate proceedings in case of a default, it lays down certain prerequisites which shall not be overlooked. One of such prerequisites is the status of Insolvency or Bankruptcy of the company at the time an application is filed under section 7¹⁶ or section 9¹⁷ of the code.

APPLICABILITY OF THE CODE

Section 2¹⁸ of the code determines the applicability of the code and states that,

“2. The provisions of this Code shall apply to—

(a) any company(e)individuals,

in relation to their insolvency, liquidation, voluntary liquidation or bankruptcy, as the case

¹⁴ Insolvency and Bankruptcy Code, 2016, § 31, No. 31, Acts of Parliament, 2016 (India).

¹⁵ Insolvency and Bankruptcy Code, 2016, § 32, No. 31, Acts of Parliament, 2016 (India).

¹⁶ Ibid 6

¹⁷ Ibid 8

¹⁸ Insolvency and Bankruptcy Code, 2016, § 2, No. 31, Acts of Parliament, 2016 (India).

may be.”

The above implies that the code can be made applicable to only those companies which are under insolvency or bankruptcy and proceedings under the code can be initiated only against such companies.

Part 2 of the code deals with the resolution process and liquidation of corporate debtors in insolvency or bankruptcy.¹⁹(books) The code also provides for CIRP resulting in liquidation or voluntary liquidation by the corporate debtors themselves but, that too must arise out of insolvency or ill health of the company.

BANKRUPTCY LAW REFORMS COMMITTEE REPORT

The BLRC report²⁰ on IBC states that, *“In most other jurisdictions, the trigger to start insolvency resolution procedures against an entity requires evidence that is based on a test of insolvency. The outcome of the tests are taken by the adjudicating authority as evidence to consider the entity to be insolvent.”* This makes it clear that the cardinal precondition, the Adjudicating Authority shall probe into immediately after an application is filed before it by the financial or operational creditors is the evidence establishing the status of insolvency of the corporate debtor as a reason for non-payment of debt resulting in default, beyond any reasonable doubt. The report also discusses about ‘drawing the line between malfeasance and business failure’ and elucidate that the Adjudicating Authority shall differentiate between idea that the default involves malfeasance and the idea that the company is genuinely insolvent and the promoters can be held personally liable for the defaults that they control. The report emphasises with genuine financial breakdown and states that *“Above all, bankruptcy law must give honest debtors a second chance, and penalise those who act with mala fide intentions in default.”*

JUDICIAL REVIEW

In the landmark case of **Swiss Ribbons Pvt. Ltd. & Anr. v. Union of India & Ors**²¹, the Supreme court highlighting the object of the code held that,

¹⁹ Narender Kumar, Key to Insolvency and Bankruptcy Code – Practice and Procedures 3 (2022).

²⁰ Ibid 2.

²¹ Swiss Ribbons Pvt. Ltd. & Anr. v. Union of India & Ors, (2019) ibclaw.in 03 SC.

*“12. It can thus be seen that the primary focus of the legislation is to ensure revival and continuation of the corporate debtor by protecting the corporate debtor from its own management and from a corporate death by liquidation. The Code is thus a beneficial legislation which puts the corporate debtor back on its feet, not being a **mere recovery legislation for creditors.**”*

In another recent case of landmark case of **Vidarbha Industries Power Limited v. Axis Bank Limited**²², the Hon’ble court held that,

*“81. The title “Insolvency and Bankruptcy Code” makes it amply clear that the statute deals with and/or tackles insolvency and bankruptcy. It is certainly **not the object of the IBC to penalize solvent companies, temporarily defaulting in repayment** of its financial debts, by initiation of CIRP.”*

*“82. The Adjudicating Authority (NCLT) failed to appreciate that the question of time bound initiation and completion of CIRP could **only arise if the companies were bankrupt or insolvent and not otherwise.**”*

The above judgement was later reviewed and given a different view in the case of **M. Suresh Kumar Reddy v. Canara Bank & Ors**²³, that the view taken by the court in the above case was exceptional and not a rule. However, the Hon’ble court restricted its review to the question whether the Adjudicating Authority had any discretion in probing into the existence of a default in a petition filed under section 7 of the code. Therefore, it is safe to conclude that the above interpretation of the court with regard to the applicability of the code in cases of temporary default of payments still holds good.

It is therefore resolved that if the financial creditor has failed to publish proof of the state of insolvency of the corporate debtor, it places the case outside the purview of the code. The proceedings under the code have serious consequences on the functioning of the corporate debtor including restructuring or sale of the company, in turn having serious consequences on the shareholders, workmen, creditors and ultimately the public at large. Therefore, the admission of a company into the CIRP proceedings shall be treated as a last remedy available

²² Vidarbha Industries Power Limited v. Axis Bank Limited, (2022) ibclaw.in 91 SC.

²³ M. Suresh Kumar Reddy v. Canara Bank & Ors, (2022) ibclaw.in 1080 NCLAT.

to a creditor for recovering his dues.

CONCLUSION

It is therefore resolved that if the financial creditor has failed to publish proof of the state of insolvency of the corporate debtor, it places the case outside the purview of the code. The proceedings under the code have serious consequences on the functioning of the corporate debtor including restructuring or sale of the company, in turn having serious consequences on the shareholders, workmen, creditors and ultimately the public at large. Therefore, the admission of a company into the CIRP proceedings shall be treated as a last remedy available to a creditor for recovering his dues.

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