IBC (Amendment) Ordinance, 2020 – FAQs and Open Issues

Date : June 08,2020

Advocate K. Vaitheeswaran

Advocate Yeswanthram CJ

The **increase of default threshold** to INR 1 crore from INR 1 lakh was one of the first few COVID- 19 relief measures announced by the Finance Minister. The Finance Minister had also hinted that the government is also contemplating a suspension of fresh insolvency initiations for a period of 6 months. Thereafter there has been a lot debate as to whether such suspension would be a step in the right direction.

The announcement by the Government of its decision to suspend the initiation of the insolvency proceedings as part of the Atmanirbhar Bharat Relief Package further added to the confusion. Though the government was clear about the suspension, there remained uncertainty over the debts and defaults that might be covered by the suspension.

With the promulgation of the **Insolvency and Bankruptcy (Amendment) Ordinance, 2020** some questions have been answered and some remain unanswered. The FAQs are an attempt to answer the possible questions that may arise in the context of the Ordinance.

1. ***Is there a complete bar on the initiation of insolvency proceedings?***

No, there is no complete bar on the initiation fresh insolvency proceedings. Under the Code a petition for initiation of insolvency can be filed only on the occurrence of a default in payment of a debt. The suspension concerns only defaults which have occurred on or after 25.03.2020. If a Corporate Debtor has defaulted in payment of debt before 25.03.2020, such a Corporate Debtor will not be protected by the suspension. Petitions for initiation of insolvency can be filed against the Corporate Debtor if the default has occurred before 25.03.2020.

2. ***What will be duration of the suspension and from what date does the suspension come into force?***

The Suspension will extend to for a period of six months from 25.03.2020. The central government will have the power to extend the suspension up to a period of one year through a notification. Section 10A introduced by the Ordinance reads as under

"Notwithstanding anything contained in Section 7, 9 and 10, no application for initiation of corporate insolvency resolution process of a corporate debtor shall be filed for any default arising on or after 25th March, 2020 for a period of six months or such further period, not exceeding one year from such date, as may be notified in this behalf:"

The words *such date* and *as may be notified* and their placement seems to raise some issues and is likely to come up for interpretation. The question that arises is whether such date refers to a date that would be notified by the government or whether such date refers to 25.03.2020? It clearly appears that the intent of the Government was to confer itself the power to extend the suspension through the issue of a Notification subject to an outer limit of 1 year from 25.03.2020.The language used in the amendment could have been better.

3. ***Can insolvency proceedings be initiated after the culmination of the suspension period in respect of defaults that occurred during the suspension period?***

The proviso to the newly inserted Section 10A states clearly that no application for initiation of insolvency proceedings shall ever be initiated for defaults that have occurred during the period of 6 months (extendable up to 1 year) starting from 25.03.2020. Even after the culmination of the 6 months or one year as the case may be, no application shall be filed before the NCLT in respect of defaults that have occurred during this period. Section 10A places a perpetual embargo on the initiation of insolvency proceeding based on defaults that occurred during the suspension period.

4. ***What will be fate of the applications that are pending before the NCLT?***

The petitions pending before the NCLT will most certainly be petitions where the date of default would be before 25.03.2020. Section 10A will not be applicable to such circumstances. That being the case NCLT may, based on the facts of the petition, admit the petition for initiation of insolvency resolution.

5. ***Can a new application be filed before the NCLT for defaults that have occurred before 25.03.2020?***

Yes, Section 10A protects only defaults that have occurred on or after 25.03.2020. Explanation to Section 10A which states that Section 10A shall not apply to defaults committed before 25.03.2020 has also provided clarity in this regard.

6. ***How to determine the date of default?***

A *default* occurs when the debt become due and payable and is not paid. The date of default is the date on which defaulted debt fell due. The date on which the debt fell due shall be determined in accordance with the facts of each case based on the agreement between the parties.

7. ***Does the amendment protect debts that have been incurred during the suspension period?***

Section 10A protects only defaults that have occurred during the 6 month or 1year period starting from 25.03.2020. Therefore,

if a debt has been incurred during the suspension period and if the default of the same occurs within the suspension period then such default shall be protected by Section 10A. Whereas, if the debt has been incurred during the suspension period and the default occurs after culmination of the suspension period such default may not have the protection of Section 10A.However this can be a subject matter of interpretation and the surrounding facts the nature of the agreement, the action taken, the communications and correspondence between the parties may all come into play

8. ***Does the suspension give rise to any legal issues?***

Default is always a journey. Culminations of factors result in a default. The cut – off date appears to be a bit rigid. Many parts of the world were affected by COVID even before the cutoff date and business was getting affected with lock down and closure in other countries. WHO identified the Wuhan cluster in December 2019 and after a series of escalations WHO categorized COVID as a pandemic on 11th March 2020.Non realization of export proceeds or cancellation of orders or non-arrival of cargo or many other reasons can affect the financial health of an entity and it may have defaulted just before 25.03.2020 on account of these factors. COVID could be the reason for default but the rigidity of the provision may prevent the applicability of the suspension. This could be tested in Courts. Special perpetual suspension may also be tested in Courts from Article 14 perspective.

Identification of the default date might be contentious. This is more so when the there are no clear terms between parties regarding the due date of the debt. Further, the default amount calculation in cases of a continuing default as highlighted in FAQ No. 8 might bring about a lot of litigation.

9. ***What is the effect of amendment to Section 66 of the Code?***

Section 66(2) empowered the NCLT to direct the director or partner of the corporate debtor to contribute to the assets of the corporate debtor, on an application made by the resolution professional, if it comes to the following conclusion:

(a) That the director or partner of the corporate debtor knew or ought to have known, even before the insolvency commencement, that there was no reasonable prospect of avoiding the commencement of a corporate insolvency resolution process, and

(b) That the director or partner did not exercise due diligence in minimizing the potential loss to the creditors of the corporate debtor.

Section 66(3) has been inserted through the Ordinance. This amendment provides protection to the directors and partners of the corporate debtor which may undergo insolvency resolution process in future. The amendment places an embargo on the resolution professional from filing an application under section 66(2) based on defaults that occur during the suspension period envisaged in section 10A.

10. ***Is suspension the best solution?***

What the Ordinance has tried to achieve is to protect the corporate debtors from the defaults that occur during the suspension period. Such protection is not confined to the suspension period but it continues forever. Since there is a perpetual embargo on the initiation of insolvency proceeding in respect of defaults that have occurred during the suspension period, the usage of the term *suspension* does not appear to be correct. Suspension would normally indicate a temporary phase. An eclipse with restoration after the suspension period is over .But the Ordinance contemplates perpetual suspension

It would have been far simpler to have carved out an exception in the definition of default in Section 3(12) to say that defaults occurring during the period of 6 months starting from 25.03.2020 shall not be considered as default for the purposes of the code. This would have helped achieve the same objective.

11. ***Is Protection extended to personal guarantors to a corporate debtor?***

In the event a corporate debtor commits a default of a debt that has been guaranteed, the creditor has the option to invoke the guarantee and proceed against the person who provided the guarantee to recover the debt. The insolvency resolution process for personal guarantors to a corporate debtor is contained in Part III of the Code. The Ordinance does not protect these personal guarantors to a corporate debtor. There is no logic in limiting the protection only to the corporate debtor .It clearly could not have been the intent of the Government. This would require one more amendment.

12. ***What is the position for voluntary initiation?***

Section 10 of the Code deals with the voluntary initiation of insolvency proceedings. The objective behind the Ordinance is to provide protection to businesses from insolvency initiation resulting from defaults arising during the lockdown. The suspension of initiation of insolvency under Section 7 and 9 can be justified as applications under the said sections are filed by third party creditors. Whereas an application under section 10 being voluntary it does not need the protection offered by the Ordinance.

Moreover, voluntary initiation of insolvency would have helped the corporate debtor to take advantage of the moratorium in these uncertain times and reorganize its debts. Delaying the process of insolvency resolution will only result in the diminution in the value of the assets of the corporate debtors. The Ordinance has deprived the willing Corporate Debtors of an opportunity at insolvency resolution.

13. ***What are the possibilities for getting resolution applicants for insolvency proceedings initiated for defaults occurring prior to 25.03.2020?***

In the preamble to the Ordinance it is stated that it is difficult to find adequate number of resolution applicants to rescue the corporate persons who may default. If this is the thought behind the Ordinance, it is difficult to comprehend how the corporate

debtors, against whom insolvency proceedings might be initiated for defaults that occurred before 25.03.2020, would find resolution applicants. The chance that these companies might head into liquidation is quite high. The only possible silver lining is that valuations are likely to become cheaper and business with deep pockets and resources may see a bigger picture for future.

14. ***Should the increase in default threshold be revisited?***

In a cash flow regime of insolvency determination, the default threshold is an important tool. The default threshold acts as an indicator of solvency i.e. when a business is unable to meet a cash outflow of INR 1 lakh it indicates that the business is no longer solvent. The increase in the threshold in the backdrop of a lockdown was to ensure that a small default would not push the business into insolvency. It is definitely logical to push up the insolvency threshold when there are systemic cashflow issues in the economy.

It is also important to understand that the test of solvency should be applied to the businesses in an equitable manner. Now that the businesses have been protected from defaults that occur on or after 25.03.2020 there is a definite need to revisit the increase in default threshold. It is no longer equitable to retain the increased threshold. It is clear that it is not the objective of the government to protect the business that were insolvent much before 25.03.2020.

The mischief created by the continued existence of the increased threshold can be understood through the following example: Company A defaults in payment of debt of INR 50 lakhs on 01.12.2019 and the creditor files an application for initiation of insolvency proceedings. The NCLT on hearing the application admits the application and initiates the insolvency resolution process of Company A. Another Company B defaulted in payment of debt of Rs. 50 lakhs on 01.12.2019 but the creditor because of ongoing talks with Company B decided to delay the application to NCLT. Now the lockdown was announced on 25.03.2020 and the increase in threshold to INR 1 crore was also announced around the same time. The creditor will not be able to file an application before the NCLT as the default amount is below the increased threshold. There is no doubt that Company A and Company B both fail the solvency test prescribed by the Code on the date of default and the reason for their insolvency has nothing to do with the lockdown. Two companies who have defaulted in payment of debt of the same amount on the same date are being tested for insolvency using two different scales.

15. ***Does the Ordinance offer protection to continuing defaults?***

A question which remains unanswered is the case of a continuing default which continues after the suspension period. Whether the default that occurred during the suspension period be considered for computation default amount?

The default amount has attained significance because of the increase in the threshold to INR 1 crore. Now to answer the question, it is possible to simply conclude that since proviso to section 10A states that no insolvency application shall ever be filed for default occurring during the suspension period, the amount pertaining to the default that occurred during the suspension period cannot be considered for calculation of default amount.

On the contrary, it is possible to argue that the protection under section 10A operates only in a situation where the default is restricted to the suspension period. The protection cannot be extended to a default that occurs after the culmination of the suspension period.

In other words, if a default occurs after the suspension period, the question that can arise is whether there is no embargo on including the default that occurred during the suspension period for the purposes of the solvency test? In other words, whether the amount pertaining to default that occurred during the suspension period should be considered in computing the default amount for the purposes of threshold? In this context it is pertinent to note that Section 4 provides for the default threshold (solvency test) and Section 6 grants the right to a creditor or the corporate debtor to file an insolvency petition. The non obstante clause in section 10A covers only section 7, 9 and 10 it does not cover section 4 and 6. Clearly, Courts are likely going to be busy addressing these issues.