

Covid-19 - Insolvency and Bankruptcy Code amended to suspend initiation of insolvency proceedings for six months

25 June 2020

This analysis covers:

1	Introduction	2
2	Analysis	2
2.1	Prohibition on filing of insolvency applications for defaults during the Suspension Period	2
2.2	Determination of date of default	3
2.3	No distinction between Covid-19 and non-Covid-19 related defaults	3
2.4	Other remedies	3
2.5	Suspension of Section 10 (Voluntary Insolvency)	3
2.6	No other equally efficacious remedy available to operational creditors	4
2.7	Protection to directors/partners of a corporate debtor	4
3	Conclusion	4

1 Introduction

The global spread of Coronavirus (**Covid-19**) pandemic and consequent lockdowns have adversely impacted businesses in varied sectors across the economy. To overcome a highly distressed market scenario and address the credit exposures of various businesses, the Indian Government has introduced various economic relief packages and legal and regulatory measures, the latest being the amendments to the Insolvency and Bankruptcy Code, 2016 (**IBC**).

On 5 June 2020, the President promulgated the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2020 (**Ordinance**) with immediate effect. The objective of the Ordinance is to protect corporate entities that have witnessed a sudden halt in operations and consequently defaulted on their repayment obligations, from being dragged into insolvency.

The Ordinance introduces Section 10A to the IBC, which suspends the applicability of:

- a. Section 7 (insolvency application by a financial creditor);
- b. Section 9 (insolvency application by an operational creditor) and;
- c. Section 10 (voluntary insolvency application by the corporate debtor),

for a period of six months, on account of any payment defaults that occur on or after 25 March 2020 (**Suspension Period**). The Ordinance provides that the Suspension Period may be extended by Government notification, for a maximum period of up to one year.

The proviso to Section 10A bars any insolvency application from **ever** being filed, for any default occurring during the Suspension Period. The explanation to Section 10A clarifies that this provision does not apply to any default that occurred before the commencement of the Suspension Period, i.e., before 25 March 2020.

The Ordinance also amends Section 66¹ of the IBC to prohibit a resolution professional from filing an application under Section 66(2) against a partner or director of a corporate debtor in respect of a default that has occurred during the Suspension Period.

2 Analysis

2.1 Prohibition on filing of insolvency applications for defaults during the Suspension Period

For defaults that occur during the Suspension Period, Section 10A read with the proviso not only suspends the filing of insolvency applications but in fact extends the prohibition in perpetuity. The Ordinance does not provide any foundation for this perpetual prohibition.

In view of this, it could also be argued that no remedy under the IBC would be available to a creditor even in case of a continuing default i.e. a default which first occurred during the Suspension Period and is not cured

¹ New sub-section (3) under Section 66 of the IBC introduced by the Ordinance.

after the Suspension Period. Accordingly, unless there is a fresh default that occurs post the Suspension Period, a creditor may not be able to resort to a remedy under the IBC. This aspect may become a subject matter of litigation following the expiry of the Suspension Period.

2.2 Determination of date of default

From the perspective of the applicability of Section 10A, the determination of date of default by the Adjudicating Authority becomes a key factor. Creditors may have to deal with this aspect carefully to ensure that any subsequent insolvency filing is based on a default that occurred either before or after the Suspension Period, as the proviso to Section 10A seems to indicate that corporate insolvency applications can never be filed for a default which occurred during the Suspension Period. Where there are existing defaults during the Suspension Period (whether payment or otherwise) or fresh defaults occurring during the Suspension Period, Section 10A may guide lenders in taking a call as to whether or not to accelerate a facility during the Suspension Period. Some lenders may wish to reserve this remedy for after the expiry of the Suspension Period to demonstrate that the default in question leading to an IBC filing has occurred outside the Suspension Period. It will also be interesting to see if lenders appropriate monies repaid by the borrowers after the Suspension Period first towards default during the Suspension Period, and argue for fresh defaults post the Suspension Period, as loan documentation usually reserve the flexibility for such appropriation with the lenders.

2.3 No distinction between Covid-19 and non-Covid-19 related defaults

The preamble of the Ordinance refers to the impact of Covid-19 on business houses, financial markets and the economy. However, Section 10A does not expressly make any distinction between defaults that have occurred on account of Covid-19 and those due to other factors independent of Covid-19. Therefore, the underlying legislative intent is to shield corporate entities from insolvency proceedings, irrespective of the cause of default provided the default has occurred during the Suspension Period. This is understandable to some extent as requiring a nexus to Covid-19 may have been too subjective a criteria and may have been difficult for borrowers to prove.

2.4 Other remedies

The Ordinance does not impact remedies under other statutes such as security enforcement, recovery proceedings before the Debt Recovery Tribunal and also contractual restructuring. Similarly, the provisions relating to personal insolvency which have been recently notified are not impacted by the Ordinance. Therefore, personal insolvency proceedings under the IBC would continue to be available as an alternative remedy in respect of personal guarantors.

It may also be possible to proceed against corporate guarantors where the principal debtor's default occurs during the Suspension Period, provided that the invocation of the corporate guarantee and default thereunder arises after the Suspension Period. The analysis in this regard is expected to be driven by the facts of each specific case involving a corporate guarantee. In such a scenario, the interplay between the corporate guarantor and principal borrower's liability could become a contentious issue to be resolved by the NCLT/NCLAT.

2.5 Suspension of Section 10 (Voluntary Insolvency)

The Ordinance goes a step further than merely protecting corporate entities from creditors. It also suspends Section 10 of the IBC, which allows corporate entities to voluntarily file an insolvency application against

themselves, where a default has occurred. The rationale for this is not entirely clear. If a corporate debtor determines that notwithstanding Covid-19 and its impact, the best course of action is to subject itself to an insolvency proceeding, then the Ordinance should perhaps have allowed this flexibility.

2.6 No other equally efficacious remedy available to operational creditors

The operational creditors, particularly the Micro Small and Medium Enterprises (MSMEs) do not have the same array of remedies available as financial creditors. The only legal remedy now available to such operational creditors for any default that occurs during the Suspension Period would be to file a civil suit, which would ordinarily take years to reach any finality.

2.7 Protection to directors/partners of a corporate debtor

The objective behind the introduction of Section 66(3) is not entirely clear. Section 66 of the IBC enables the resolution professional to take action in respect of fraudulent or wrongful trading by the erstwhile management. Typically, this provision is invoked in situations involving delinquent conduct by the erstwhile management in the course of the company's affairs. The introduction of Section 66(3) seems to provide unwarranted protection to the erstwhile management in respect of such delinquent conduct that may occur during the Suspension Period.

3 Conclusion

The Ordinance provides respite to businesses affected by the Covid-19 outbreak and the consequent lockdowns while ensuring that the IBC proceedings against corporates where the payment default has occurred before 25 March 2020 can continue without any obstruction. However, the proviso (apart from the apparent conflict with the main provision) could be problematic in some instances, such as in the case of non-fund based facilities, where a bank guarantee is invoked during the Suspension Period. In such cases, the default in respect of the entire debt may have occurred during the Suspension Period and the creditor would never be allowed to file an insolvency application for such default.

There may be similar challenges for debt exposures that have a bullet repayment during the Suspension Period. To illustrate, the holder of an unlisted secured bond that had a bullet payout during the Suspension Period would never have access to the IBC if the argument on continuing default does not entitle the holder to file after the Suspension Period. Being an unlisted bond, the bondholder would not have access to other efficacious remedies for enforcement of security, such as under the SARFAESI regime, leaving a civil suit for recovery of money and enforcement of security, as the only remedy available to it.

Therefore, the impact of the provision appears to be considerably disproportionate in a few circumstances, to the limited objective of the Ordinance which is to provide respite to borrowers during the Suspension Period. There is a contrary view with respect to the real impact of Ordinance as financial debt defaults are expected to be lower due to moratorium on payment of principal loan amounts extended by RBI regulated entities coinciding with the Suspension Period.

Additionally, some unintended consequences may flow from the Ordinance. For example, the Ordinance does not carve out an exception for wilful defaults by corporate entities which may be unrelated to Covid-19 and this could create an environment where wilful defaulters may be able to take advantage of the Ordinance. Similarly, the introduction of Section 66 (3) allows the management to escape scrutiny in the

ANALYSIS

course of a resolution process that may be initiated at a later stage with respect to fraudulent transactions that may take place during the Suspension Period.

Finally, the restriction on a creditor's right under the IBC may constrain the affected creditors to opt for debt restructuring in terms of the Reserve Bank of India's circular dated 7 June 2019 on Prudential Framework for Resolution of Stressed Assets. However, this framework would only apply to those creditors who are regulated by the Reserve Bank of India. Additionally, the corporate debtors are likely to have greater bargaining power in the current scenario which may impact the efficacy of this alternative. In cases, where debt restructuring is not a viable option, the remedies may be limited to pursuing security enforcement measures, recovery proceedings before the Debt Recovery Tribunal or filing civil suits/arbitration (if applicable).

If you require any further information about the material contained in this newsletter, please get in touch with your Trilegal relationship partner or send an email to alerts@trilegal.com. The contents of this newsletter are intended for informational purposes only and are not in the nature of a legal opinion. Readers are encouraged to seek legal counsel prior to acting upon any of the information provided herein.