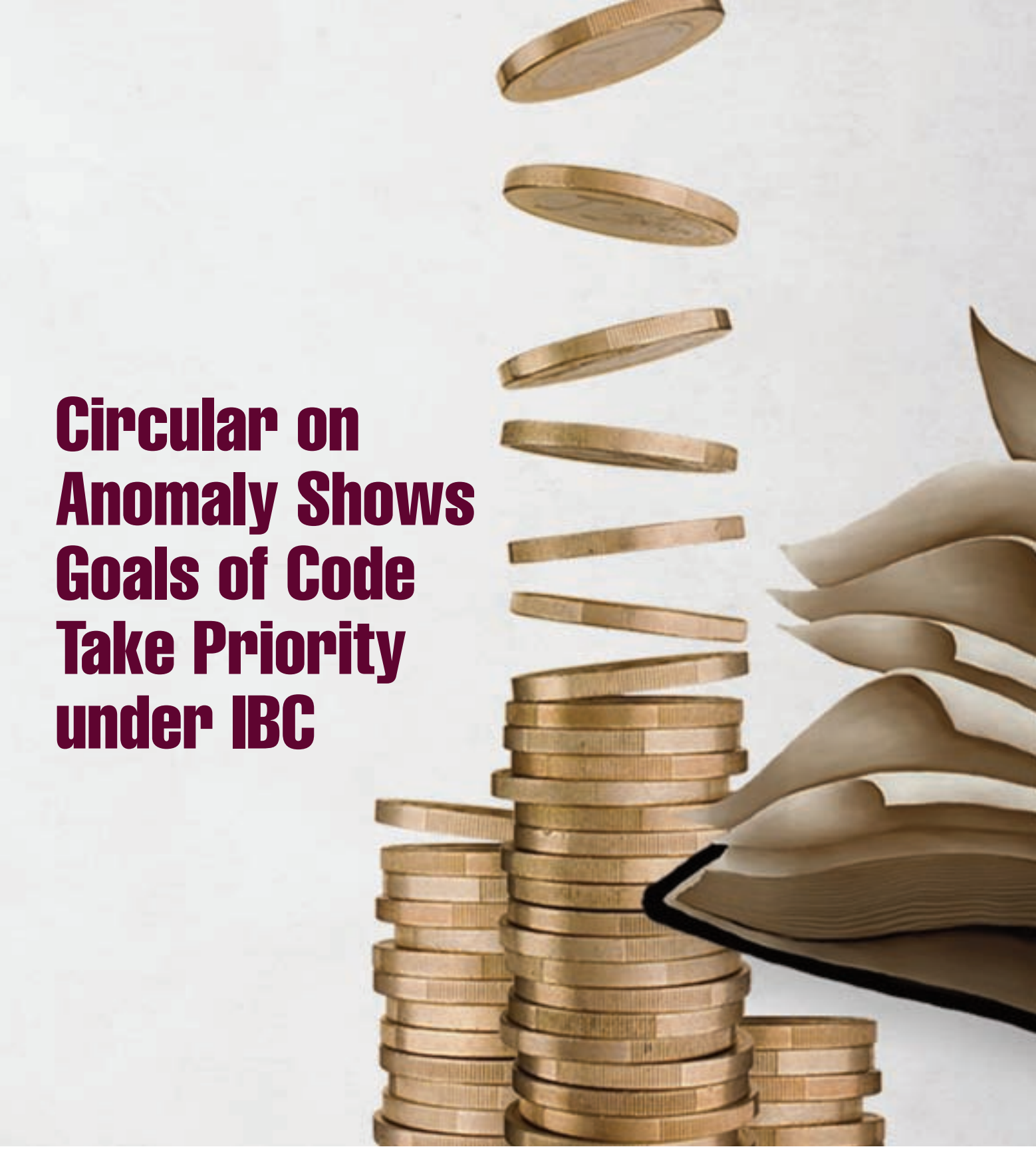
Circular on Anomaly Shows Goals of Code Take Priority under IBC



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The Insolvency and Bankruptcy Code, 2016 (IBC), implements a "creditor-in-possession" regime that vests decision making powers of the insolvent company with a "committee of creditors" (CoC), astutely recognizing that financial creditors will be better motivated than the previous managers to preserve the asset base of an insolvent company.

Despite shifting such control to the CoC, the provisions of the IBC and its regulations create an anomalous situation in which a provision of the Companies Act, 2013, could make a resolution plan agreed by the CoC subject to approval by shareholders of the insolvent company. While section 238 of the IBC states that the IBC will have overriding effect over the provisions of any other law, section 30(2)(e) of the IBC mandates that a resolution plan must be in conformity with the provisions of any law in force.

Under section 31 of the IBC, a resolution plan that does not comply with section 30(2)(e) may be rejected by the National Company Law Tribunal (NCLT). Further, regulation 39(6) of the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016, expressly dispenses with shareholder approvals that may be mandated by the constitutional documents of a company, the shareholder agreements, joint venture agreements, and other such documents, but does not dispense with shareholder approvals that are required under the Companies Act.

Recognizing this anomaly, the Ministry of Corporate Affairs (MCA) issued a circular on 25 October, clarifying that shareholder approval will not be required for resolution plans that have been approved by the NCLT. Thus, it may be useful to elaborate on the scheme and provisions of the IBC that can support an interpretation that allows shareholders' interests to be bypassed in favour of the decision made by the CoC.

During the corporate insolvency resolution process (CIRP) the management of the insolvent company, i.e. the "corporate debtor" (CD), vests with the interim resolution professional and then the resolution professional (RP), who is confirmed by the CoC. As per section 25(1) the RP's mandate is to "preserve and protect" the continued business operations of the CD, i.e. run the insolvent company as a going concern. Under section 28, the RP must obtain the approval of the CoC for actions aimed at affecting the capital structure, ownership or management of the CD or the rights of the creditors.

Thus, in the CIRP stage, all decision making powers vest with the CoC on account of the unsuccessful management of the CD by the promoters, directors and majority shareholders. For a private and closely held company, where the promoters are the majority shareholders, it makes no sense to allow any decision making power to vest with the shareholders once the corporate entity has defaulted in loan repayment and a CIRP has been initiated.

In any case, it would be consistent with the provisions of the IBC that during the CIRP, the RP merely oversees the assets of the company and manages its business as a going concern. Such routine administrative decisions ideally should not require shareholders' approval.

Once a resolution plan is decided, any strategies for restructuring the CD's debts, selling its assets, etc., would require shareholder approval. At this stage, the anomalous provisions of the IBC pose a challenge. The circular issued by the MCA states that the requirement of shareholder approval is deemed to have been complied with once the NCLT approves a resolution plan. Hence, once the resolution plan is placed before the NCLT, the NCLT must satisfy itself that the resolution plan is in compliance with all laws in force.

Recently, in light of the controversial insolvency proceedings against Jaypee Infratech, it has also been mandated that the resolution plan should contain a declaration to the effect that the interests of all stakeholders have been considered. Based on this, the NCLT's approval for a resolution plan is binding on the CD and its employees, members, shareholders, creditors, guarantors and all other stakeholders involved.

It may also be argued that any resolution plan, as approved by the CoC and the NCLT must show compliance with requirements that are focused more on regulation of the insolvent company, in terms of its corporate structure, than on how well it accommodates its stakeholders' financial interests, as the latter has already been taken into account by the CoC in the resolution plan.

Thus, it is clear that during the CIRP, the RP will not be making decisions that require shareholder approval, and that after the resolution plan is placed before the NCLT, the NCLT will assess whether the plan accommodates all interests at stake before approving it.