PARINAM
LAW ASSOCIATES

Disease, Debts and Default- Revision of the threshold for default under the Insolvency and Bankruptcy Code, 2016

Part II of the Insolvency and Bankruptcy Code, 2016 ("**Code**") is titled Insolvency Resolution and Liquidation for Corporate Persons. Section 4 falls within the said Part II and deals with the applicability of Part II. Under Section 4 of the Code, the minimum default on part of the corporate debtors was Rs. 1,00,000/- (Rupees One Lac only). There was a proviso vide which the said limit could be revised, subject to maximum of Rs. 1,00,00,000/- (Rupees One Crore only) by the Central Government by passing a notification. On 24th March 2020, as part of the financial relief measures to save the Indian economy from the economic ripple effect of nationwide lockdown, Indian Finance Minister, Smt. Nirmala Sitaram announced that the limit was revised to Rs. 1,00,00,000/- (Rupees One Crore only). The Finance Minister *inter alia* stated that this measure was taken for the protection of Micro Small Medium Enterprises. ("**MSMEs**"). This was promptly followed by a Gazette Notification dated 24th March 2020 ("**said Notification**"). The Central Government in exercise of its powers under Section 4 of the Code increased the minimum threshold for default under the Code to Rs. 1,00,00,000/- (Rupees One Crore only). The Finance Minister also stated that in lieu of the lockdown and its effect the Central government was considering suspending the application of Section 7 (Initiation of corporate insolvency resolution process by financial creditor), Section 9 (Application for initiation of corporate insolvency resolution process by operational creditor) and Section 10 (Initiation of corporate insolvency resolution process by corporate applicant) and such a decision was imminent if the current scenario continued beyond April 2020. In this alert we explore the rationale and effect of the said Notification in the first part and the effect of the proposed suspension if implemented on both creditors and debtors in the second part.

1. Protection of MSMEs as Debtors vis-à-vis the rights of MSMEs and other small Creditors

The nationwide lock down imposed by the government to tackle the spread of COVID-19 is likely to affect citizens and businesses at large. If goods/services do not qualify as an "essential service" it is virtually impossible for that particular business to function normally, thereby jeopardizing the contractual obligations and a steady source of income in the current circumstances. It is likely that pre-empting such situations, the said Notification has been issued to prevent such parties from being dragged into the CIRP process for a relatively minor amount.

In her address to the nation, the Finance Minister stated that the said notification was issued keeping in mind the protection of MSMEs. However, the text of the said notification does not state so.

Further, it is yet to be seen if this is a temporary measure in light of the current situation or if it is of a permanent nature. There is evidence to suggest that the decision of the Central Government may have been fast tracked but was always in the works if the recommendations made by the Insolvency Law Committee in its reports in March 2018 as well as February 2020 ("**ILC Reports**") are reviewed.

The ILC Reports have credited MSMEs to be the bedrock of the Indian economy and have made several suggestions to exempt them from certain provisions of the Code. Further, the ILC Report released in February 2020, recommended that the minimum default in case of financial debt be raised to Rs. 50,00,000/- (Rupees Fifty Lacs only) and in the case of Operational debt be raised to Rs. 5,00,000/- (Rupees Five Lacs only). This was again done keeping in mind inter alia the rights of MSMEs as Operational Creditors

The said Notification makes no distinction between operational debts and financial debts. It simply states that the minimum default has been uniformly raised. Since it is stated that such measure has been taken to protect MSMEs, the notification is presumably silent on the rights of MSMEs as operational creditors. Despite the enactment of the Micro, Small & Medium Enterprises Development Act, 2006, the lack of judicial infrastructure under the Act has diverted MSMEs towards taking action under the Code. The Code, in the absence of a pre-existing dispute ensures an effective and speedy remedy for realising debts which fall within the contours of the definitions under the Code. It is pertinent to mention here that not only MSMEs and other small creditors but also banks with their numerous resources have sought relief under the Code due the summary nature of proceedings. The ILC Reports have also recognised *that the Code has made debt enforcement more credible, especially for operational creditors that are empowered to initiate CIRP under the Code*. The viability of debt enforcement under the Code is further justified by the Appellate Authority's reluctance to stay the CIRP process in appeal without sufficient cause. Further, in the case of small creditors and MSMEs the Code has also proved as an effective measure for out of court settlements of admitted debts. While the current situation may demand measures like the said Notification, for such corrective measures to be effective it will be crucial that they remain at least until the economy can be safely said to have bounced back.

2. Proposed suspension of the operation of Section 7, Section 9 and Section 10 of the Code.

If the current situation extends beyond April 2020, the Finance Ministry may take steps to suspend the operation of Section 7, Section 9 and Section 10 of the Code temporarily with a view to combat the disruptions caused by COVID-19. Although, there has been no official notification pertaining to the same and the exact manner in which the suspension would be imposed hasn't been stated, in the section below, we have attempted to analyse the effect the same would have. A review of the same would demonstrate that a complete suspension may not be the ideal solution and the same could have serious ramifications for the creditors.

a. Section 7 (Initiation of corporate insolvency resolution process by financial creditor)

If Section 7 of the Code is suspended, banks and financial institutions to whom amounts are rightfully due may not be able to take advantage of the legislation which was primarily enacted with the motive of resolving looming bad debts. The effect of the same on the books of the lenders will also have to be seen since lenders would anyway be saddled with protracted recoveries in view of the pandemic. Moreover, the banks which fall within the purview of the Reserve Bank of India Circular dated 7th June 2019 will face severe adverse effects. As per the said circular the Reserve Bank of India grants banks a period of 210 days from the date of default to formulate a resolution plan for defaults above Rs. 2,000 Crores. Thereafter they are granted a period of 180 days to implement the said plan with a provisioning of 20 percent. In the event that the said plan is not implemented in 365 days the provisioning goes up to 35 percent. In the event the Government decides to suspend the operation of Section 7 of the Code the Reserve Bank of India will have to consider revising the provisioning norms to ensure that the Banks do not absorb a significantly larger liability.

b. **Section 9 (Application for initiation of corporate insolvency resolution process by operational creditor)**

Coupled with the said Notification and the proposed suspensions operational creditors will be left with no recourse but to pursue civil remedies for breach/default. This would add to the already overburdened judicial system with no other recourse for realisation of debt. This also leaves the fate of several employees, small companies and sole proprietors in a lurch who have been recognised as operational creditors under the Code.

c. **Section 10 (Initiation of corporate insolvency resolution process by corporate applicant).**

The suspension if put into effect seems the most counter-intuitive in the case of those who voluntary want to submit to the CIRP Process in view of the economic losses suffered due to the pandemic and the resulting lockdowns.

Conclusion

While the said Notification and the proposed suspension of provisions of the Code may have a prospective benefit, the retrospective and all-round effect is yet to be assessed. It is unclear as to whether and how the said Notification would impact ongoing proceedings before the Adjudicating Authority. What is the status of those Section 9 Petitions where notice has been issued and the statutory period of 10 days has lapsed? What about the dues of employees who have been recognised as operational creditors in a plethora of judgements but are unlikely to have claims above Rs.1,00,00,000/- (Rupees One Crore only)? There is also lack of clarity on the mechanism available to creditors whose debts are under Rs. 1,00,00,000/- (Rupees One Crore only) as they are now not only unable to approach the National Company Law Tribunal under the said Code but also lack adequate remedies under the prevalent company laws. This also could possibly open the said Notification to a constitutional challenge under Article 14 of the Indian Constitution in order to protect the rights of operational creditors.

The efforts by the Indian government are certainly laudable in attempting to protect companies likely to be severely affected however it is amply clear that clarifications will have to be issued to ensure the smooth operation of the said Notification and the effective implementation of the Code.

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