

IBC: Landmark step towards better economy; here's what its constitutional validity means for lenders, businesses

Published: February 4, 2019 5:03 PM

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By Vikas Kumar and Surbhi Jaju

The Insolvency and Bankruptcy Code 2016 (the 'Code') provides the creditors with a comprehensive solution for recovery of dues from willful defaulters. While this legislation has been facing teething issues and inconsistencies from its inception, the proactive approach of the government in amending this liquidation law from time to time has led to its significant implementation.

Like any fresh legislation, issues pertaining to the constitutional validity of the Code have been raised by various stakeholders time and again. It has

been alleged that the Code violates Article 14 of the Constitution of India and is discriminatory in nature. In a plethora of applications made to various National Company Law Tribunals ('NCLT(s)') and High Courts, the operational creditors have claimed that the classification of creditors as operational creditors and financial creditors is manifestly arbitrary and there is no intelligible differentia applied by the legislators in making such a demarcation.

Furthermore, another provision that led to massive hue and cry was the bar put on promoters from bidding for their own company. The Code forced the sale of the Company to new bidders and was argued to be against the fundamental right of the promoters. Additionally, the exclusion of the relative of an ineligible person under Section 29A, who is otherwise qualified to be the resolution applicant was considered extremely capricious.

Responding to a series of petitions that had challenged the constitutional validity of various provisions of the Code, the Supreme Court ('Court') in the case of *Swiss Ribbons Private Limited and Anr v. Union of India and Ors* upheld the validity of the Code in its entirety laying rest to several issues which arose due to the departure of the Code from previous insolvency laws.

The Court made several observations in response to the arguments put forth by the petitioners. Analysis drawn by the Court pertinent to their ruling is as follows –

Classification of creditors

The petitioners had contended that the classification between the financial creditors and operational creditors makes no real difference in terms of the object to be achieved by the Code. Further, the petitioners had argued that even if the Court believes that there exists a logical distinction between the two types of creditors, the operational creditors are discriminated and treated with hostility.

The Court observed that there is an existing intelligible differentia between the two creditors. The key observations made by the Court are – (i) financial creditors are secured creditors and operational creditors are unsecured creditors as payment for goods to the operational creditors is not secured by mortgage documents; and (ii) repayment of debt to a financial creditor is organized under various schedules and default in payment attracts penalty and a similar scenario does not exist for operational creditors;

The Court also analyzed the role played by the two set of creditors in furtherance of the Code. Basing of its observation, the Court said that the absence of operational creditors in the CoC is not violative of their rights. The viability and feasibility of the business of the corporate debtor are extensively assessed by the financial creditors while providing the debt and they are in a better position to evaluate the resolution plan as compared to the operational creditors which explains their presence in the CoC.

In view of the preservation of the corporate debtor as a going concern, while ensuring maximum recovery for all creditors being the underlying intention of the Code, there exists a substantial difference between the financial creditors and operational creditors.

The validity of Section 29A

Furthermore, contentions against the validity of Section 29A were heard by the Court. It was stated that (i) vested rights of promoters to participate in the recovery process of a corporate debtor have been impaired by retrospective application of Section 29A; and (ii) the relatives of the promoters who are within the eligibility criteria are barred from participating in the resolution process.

The Court observed that there exist no vested rights of participation in any resolution applicant and the same can be connoted to the widespread rejection of resolution applications made by such resolution applicants due to lack of feasibility. With respect to the participation of the relative of an

ineligible person, the Court pointed that if it is not shown that such 'related person' is connected with the business of the activity of the resolution applicant, he cannot be excluded under Section 29A(j). Therefore, Section 29A is constitutionally valid and is applicable in its entirety.

Section 12-A upheld

The relevant contention against Section 12A was that approval of ninety percent of the CoC is required to allow withdrawal of a petition made under Section 7 or 9 of the Code. The Court observed that this threshold has been substantiated in the Insolvency Law Committee Report as withdrawal is a major decision and requires significant deliberation. Also, the Code assigns the NCLT with the role to finalize such withdrawal. This is indicative of the CoC not having the ultimate decision and therefore, Section 12A passes the constitutionality test.

Conclusion

Conclusively, Justice Nariman while penning the verdict stated that 'the experiment contained in the Code passes the constitutional muster'. The judgment reiterates the contribution of the Code in increasing the flow of financial resource to the commercial sector in India as a result of repayment of financial debts. It also promotes ethical practices and is considered as a landmark step towards a better economy enhancing the rate of recovery of debts in the country.

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