

# IBC (Amendment) Bill, 2019: Implications for judicial review of resolution plans

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Shardul Shroff and Misha (2019) had earlier highlighted that excessive judicial discretion in corporate insolvency resolution is contrary to the express provisions of the Insolvency and Bankruptcy Code, 2016 (“IBC”). Indian policymakers have now recognized this problem. Accordingly, the **IBC (Amendment) Bill, 2019** (“2019 Bill”) has been passed by the Parliament.

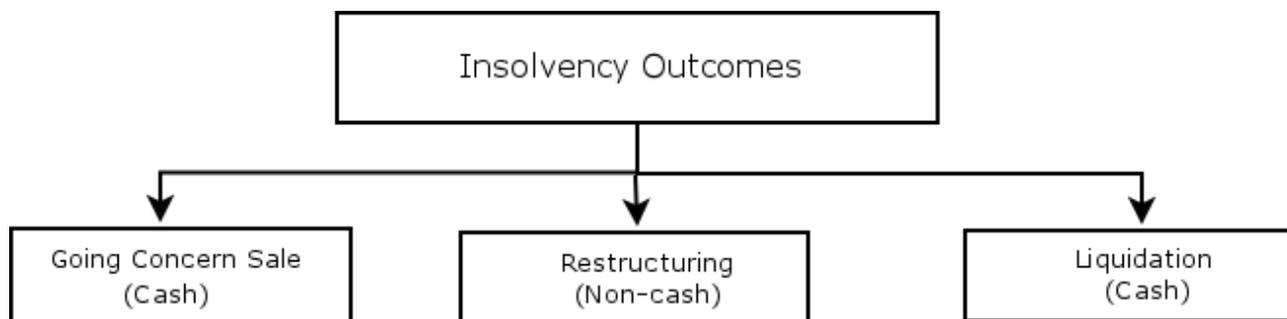
The immediate trigger for this reform was the National Company Law Appellate Tribunal (“NCLAT”) judgment dated July 4, 2019, in the resolution of Essar Steel Ltd. (“Essar judgment”). In this case, the NCLAT found ArcelorMittal’s resolution plan to be discriminatory. Accordingly, it went on to modify the plan such that the financial and operational creditors enjoy the same recovery rate. In the process, it obliterated the distinction between secured and unsecured creditors. Moreover, the NCLAT also held that the statutory waterfall under section 53 of IBC does not apply to distribution under a resolution plan. By disrupting the basic fundamentals of banking, this decision caused much concern in the Indian financial sector. Among others, the 2019 Bill has been brought in to address these concerns as well.

In this backdrop, we contextualize the amendments proposed by the 2019 Bill within a hypothetical theoretical framework to analyse their implications on the scope of judicial review of resolution plans

under IBC.

## Theoretical framework

An insolvency law should have two broad objectives. First, it must achieve the most efficient economic outcome for the insolvent business. This outcome could be going concern sale, restructuring, liquidation or a combination of these outcomes. Second, the value (cash/non-cash) received from the outcome must be distributed among the claimants of the company according to the waterfall provided in the insolvency law.



In a going concern sale, the business of the insolvent company is marketed for price discovery, that is, it is auctioned. Potential buyers submit their price bids in their respective resolution plans. Once the best price is discovered, that price signifies the precise value of the business. The successful buyer deposits this value in cash or its equivalent in an escrow account and takes over the business, immediately putting the assets to their best use. The resolution plan need not deal with how the deposited value would be distributed among the insolvent company's claimants.

The value deposited in the escrow could be separately distributed by the resolution professional among the claimants of the insolvent company as per the statutory waterfall. This scheme of distribution cannot be altered unless a claimant(s) affected by such alteration specifically consents to it. However, the resolution plan need not deal with any of these distribution issues. Therefore, the resolution plan cannot in any way *unfairly* discriminate against any claimant. Consequently, there is no need for judicial review of resolution plans to ensure *fair and equitable* distribution in a going concern sale for cash or its equivalent. The same logic applies to distribution in liquidation involving sale of assets for cash or its equivalent.

However, going concern sales through auctions are not always possible or desirable. For instance, during a recession, there could be no buyers in the market. Or even if there are buyers, there could be an oversupply of similar assets in the market due to industry wide factors, pushing down the price for such assets. In such circumstances, instead of a going concern sale to a new buyer through an auction, the claimants of the insolvent business may be better off by "selling" the business to some or all of the existing claimants themselves. In other words, the rights of the existing claimants to the pool of assets simply get redistributed or restructured. Such "hypothetical sale" is commonly referred to as *restructuring*.

In such a restructuring, there is no -auctioning of the insolvent business to potential outside buyers. As a result, there is no price discovery and the precise value of the insolvent business in cash or its equivalent is not evident. Therefore, the notional distribution of rights (that is, non-cash securities in the restructured company) among the claimants is conceptually very different from the distribution of value in cash or its equivalent in a going concern sale.

Unlike a going concern sale, the notional distribution of rights in a restructuring has to be determined by the resolution plan. This creates two unique problems. First, given the uncertainty regarding the value of the restructured business itself, there could be ambiguity about how much value should each claimant receive under the waterfall. Second, even if the value payable to each claimant is agreed upon, there could be ambiguity regarding the value of the rights (that is, non-cash securities of the restructured company) allocated to each claimant by the resolution plan. These unique problems create a peculiar risk in a restructuring - the rights distributed by the resolution plan may effectively give one or more classes of claimants a value lesser than what they are entitled to under the statutory waterfall. This is often referred to as “unfair discrimination”. To prevent such *unfair discrimination*, judicial review of resolution plans in restructuring transactions is necessary.

This conceptual distinction between sale and restructuring transactions is critical. Minority creditor protection mechanisms including judicial review is necessary primarily for restructuring transactions; not so much for sale transactions. For example, Chapter 11 of the US Bankruptcy Code deals with restructuring. **Section 1129** in this chapter requires a restructuring plan to provide every creditor at least the liquidation value. This safeguard is not applicable to sale transactions (for cash) under **section 363** of Chapter 3 of the US Bankruptcy Code. Evidently, the US law clearly recognises the difference between sale and restructuring transactions.

So far we have only dealt with neat categories of going concern sale and restructuring. However, in reality, resolution plans could propose transactions that may not squarely fall within these simple categories. For instance, some new investors may pay up cash to buy some equity or take on some debt of the restructured company, while existing lenders may swap some of their debt into equity of the restructured company. Such transactions would then be a hybrid exhibiting features of both a going concern sale for cash as well as that of restructuring for non-cash considerations. It is important to recognise that such transactions effectively help preserve the going concern value of the insolvent business. Therefore, in such transactions, each claimant of the insolvent company must get at least the amount of value (cash, non-cash or both) that it would have received had the company been sold off as a going concern for cash or its equivalent. In other words, even in such transactions, the distribution of value must follow the statutory waterfall. And this distribution function has to be performed by the resolution plan itself. Consequently, the risk of *unfair discrimination* may arise even in such transactions, rendering judicial review of resolution plans necessary for minority creditor protection.

## Shortcomings in IBC and the proposed solutions

The IBC, as initially envisaged, differed from this ideal theoretical framework primarily on two counts.

First, the statutory waterfall under section 53 of the IBC was initially envisaged only for distribution in liquidation. The *Essar judgment* held that section 53 cannot apply to distribution proposed by a Resolution Applicant. Consequently, in both sale or restructuring transactions, a resolution plan would have to follow a scheme of distribution different from the statutory waterfall, opening up flood-gates of *unfair discrimination* allegations.

The 2019 Bill attempts to address this problem. Section 30(2)(b) is proposed to be amended to make the statutory waterfall under section 53 applicable to distribution in resolution as well. This clarity should

reduce allegations of *unfair discrimination* in resolutions and help cut down on unnecessary judicial review in going concern sales.

Second, the IBC does not clearly recognise the conceptual difference between cash and non-cash transactions. Unlike US Bankruptcy Code, section 30(2) of IBC applies minority creditor protection mechanisms, meant primarily for restructuring (non-cash) transactions, to even sale (cash or its equivalent) transactions. This provision has been liberally interpreted by the NCLAT in *Binani Industries* to hold that every resolution plan must be *fair and equitable* – a vague judicially determined standard. Consequently, every resolution plan is now open to judicial review without any clear purpose. This has unnecessarily delayed many corporate insolvency resolutions. For example, the Essar resolution has been ongoing for almost 2 years, even after approval of a resolution plan by the CoC.

The 2019 Bill attempts to address this problem too. The proposed Explanation 1 to section 30(2)(b) explicitly clarifies that if a resolution plan follows the order of priority under section 53, it will satisfy the 'fair and equitable' standard. This explanation should narrow down the focus of judicial review to ensure distribution as per the statutory waterfall.

## Conclusion

Judicial review under IBC should be focused to ensure that distribution of value is as per the statutory waterfall under section 53. In going concern sales for cash or its equivalent, distribution of value among claimants based on the waterfall would be relatively unambiguous and should not require judicial review of resolution plans. In restructuring or other hybrid transactions involving non-cash consideration, notional distribution of non-cash value in form of rights to the restructured business (that is, its securities) is likely to be contentious, given that distribution will be provided by the resolution plan and/or the lack of price discovery. This could create opportunities for value extraction from minority to majority claimants through resolution plans in such restructuring or hybrid transactions. Judicial review of resolution plans may be necessary only to prevent such unfair value extractions in violation of the statutory waterfall. But once distribution among claimants as per the statutory waterfall is achieved, there is nothing further to be gained by subjecting each and every resolution plan to judicial review. The 2019 Bill has now modified the law to achieve this optimal outcome. Whether this outcome is achieved in practice will depend largely on how the judiciary interprets and implements these new provisions.

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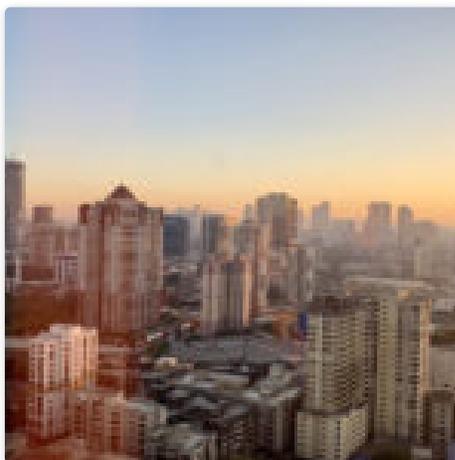
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