Pre-Packaged Insolvency Resolution Process for MSMEs

The much-awaited Pre-Packaged insolvency under the IBC regime has been introduced through an ordinance in the form of Pre-Packaged Insolvency Resolution Process (PPIRP) for MSMEs. This newly inducted Chapter IIIA of the IBC is in line the concept of debtor-in-possession. The minimum threshold debt to initiative PPIRP of MSMEs has been kept at Rs 10 lakh. Besides, the PPIRP Rule 2021, makes it mandatory to have Udyam Registration Certificate, among other eligibility criteria. In this backdrop, the author presents an analysis of the newly enacted PPIRP. ***Read on to know more…***

Devendra Mehta
The author is a professional member of IIIPI. He can be reached at devendra.mehta@gmail.com

Introduction

In the budget speech of FY 2021-22, the Finance Minister Ms. Nirmala Sitharaman, had made two major policy announcements that had an impact on the larger insolvency ecosystem in the country. The first was creation of an Asset Reconstruction Company (Bad Bank) and an Asset Management Company, that was to consolidate and take over the existing stressed debt and then manage and dispose of the assets to Alternate Investment Funds and other potential investors for eventual value realization[1]. The second was the introduction of an alternate methods of debt resolution and special framework for Micro Small and Medium Enterprises (MSMEs)[2].

In the post budget press briefings, several comments were made by senior members of the Government on the Bad Bank, though we still do not have its final contours. On the other hand, without much fanfare, the Ministry of Law and Justice, Government of India, efficiently and quietly,

[1] Budget 2021-22, Speech of Nirmala Sitharaman, Minister of Finance, February 1, 2021 – Para 75

[2] Idem – Para 82

rolled out the framework for MSMEs by way of an Ordinance[3] on 4th April 2021. The Regulation[4] and Rules[5] too were notified on 9th April 2021.

Common law countries tend to have creditor centric insolvency systems. India, being a common law country, was no exception and thus veered its Insolvency and Bankruptcy Code, 2016 (IBC) as a creditor-in-possession system. Nevertheless, jurisdictions that have aggressively moved from a creditor-in-possession system to a debtor-in-possession system have been receiving rave reviews from the global investor and financial community for ease of restructuring. As an example, Singapore's Insolvency, Restructuring and Dissolution Act[6] 2018, has been modelled on the lines of Chapter 11 of the US Bankruptcy Code and the country has successfully positioned itself as a restructuring hub in Asia.

"Thus, clearly Chapter III-A of IBC will be dealing with bulk of the enterprises in the country of which some may be listed on stock exchanges. It is to be noted that section 54A(2)(g) requires a special resolution by corporate debtor for initiating PPIRP."

Thus, the first steps by IBBI are in the right direction by introducing Chapter III-A i.e., Pre-Packaged Insolvency Resolution Process (PPIRP) in the IBC that internalizes the concept of debtor-in-possession. However, at several places the creditor-in-possession legacy flows into the concepts articulated in Chapter III-A, which may limit its widespread adoption. IBBI has been very proactive in incorporating feedback from the insolvency ecosystem and it is hoped that when the ordinance makes its journey to Parliament in the form of Bill some of these minor aberrations would be removed.

What is MSME?

Before discussing PPIRP, let us define MSMEs. According to section 54A (1) of IBC it is a corporate debtor classified as a Micro, Small and Medium Enterprise under sub-section (1) of section 7 of Micro, Small and Medium Enterprises Development Act, 2006. The aforesaid section in-turn, vests power in Central Government to notify the criterion for classifying a MSME. The criterion was recently revised by the Government of India in its *Atmanirbhar* package on 13th May 2020 and the Gazette[7] notification was made for the same on 26th June 2020. Reserve Bank of India (RBI) too came up with detailed guidelines[8] based on the Gazette notification on 2nd July 2020. Accordingly, MSME as per definition, at the upper end, are enterprises with plant & machinery up to 50 crores and turnover up to 250 crores. It is to be noted that written down value of plant and machinery at the end of previous year is to be considered (not original cost) and definition excludes land, buildings, furniture & fittings. As a rough rule of thumb, if we consider value of land, building, furniture, and fixtures to be equivalent to that of plant & machinery, MSMEs at the upper limit will have an asset base of about 100 crores. Also, more than 99% of companies in India have a turnover of 250 crores[9] or less and in case of MSMEs the turnover criterion does not include export sales.

Thus, clearly Chapter III-A of IBC will be dealing with bulk of the enterprises in the country of which some may be listed on stock exchanges. It is to be noted that section 54A(2)(g) requires a special resolution by corporate debtor for initiating PPIRP. Thus, the minority shareholders of the corporate debtor will be fully aware of the PPIRP. To obviate any price volatility, that may be detrimental to minority shareholders, it would be ideal if a mechanism can be worked in conjunction with Securities and Exchange Board of India (SEBI) for securities that may be subject to PPIRP.

As per the PPIRP Rules 2021, an application for initiating the process may be made in respect of a corporate debtor classified as a MSME under sub-section (1) of section 7 of

[3] The Gazette of India, CG-DL-E-04042021-226365, The Insolvency and Bankruptcy Code (Amendment) Ordinance 2021
[4] The Gazette of India, CG-DL-E-10042021-226500, The Insolvency and Bankruptcy Board of India (Pre-Packaged Insolvency Resolution Process) Regulations, 2021
[5] The Gazette of India, CG-DL-E-09042021-226474, The Insolvency and Bankruptcy (Pre-Packaged Insolvency Resolution Process) Rules, 2021
[6] Republic of Singapore, Government Gazette, Acts Supplement No 38, Friday, November 9, 2018
[7] The Gazette of India, CG-DL-E-26062020-220191, Ministry of Micro, Small and Medium Enterprises Notification
[8] RBI/2020-2021/10, FIDD.MSME & NFS.BC.No.3/06.02.31/2020-21
[9] Ministry of Finance, Press Release, Release ID 1518550, https://pib.gov.in/PressReleasePage.aspx?PRID=1518550

the MSMEs Development Act, 2006. The law also mandates MSMEs to attach a copy of the latest Udyam Registration Certificate with the application form among others. Furthermore, the applicant MSME should be a Company or Limited Liability Partnerships (LLP). The law does not include Sole Proprietorship, Partnerships and Hindu Undivided Family forms of MSMEs under PPIRP.

What are Prepacks?

Prepack is a colloquial term and jurisdictions thus define the concept differently in their own special context. Broadly, a pre-pack is a reorganization plan that corporate debtor prepares with the assistance of an insolvency professional/administrator/advisors and has a buy-in of its creditors for preparation of plan. The plan may be put in place either before or after declaration of insolvency. The basic idea is to simplify the process and minimize the costs of insolvency.

> **Given the litigation prone history of IBC, Government, should act in a magnanimous and bold manner and allow applications to be filed under Section 54C irrespective of the fact that an application under section 7, 9 or 10 is pending on the date of ordinance.**

The PPIRP has been detailed in Figure 1. Appended is an analysis of certain aspects of PPIRP that either require further deliberation and clarity or aspects that insolvency professionals may encounter in a practical context.

Who can initiate[10]

PPIRP can be initiated by a corporate debtor who has not undergone either PPIRP or insolvency resolution process for a corporate debtor (CIRP) in three years preceding the PPIRP initiation date, is not currently undergoing CIRP, no order for liquidation is passed under section 33 of IBC and is eligible to submit plan under section 29A. Also, financial creditors of the corporate debtor, not being its related parties, representing not less than sixty-six percent in value of the financial debt due to such creditors, must have approved such an initiation proposal. In case the corporate debtor does not have any financial creditors, not being its related parties, under Regulation 14(8) the applicant shall convene a meeting of operational creditors, who are not related parties of the corporate debtor.

The criterion for initiation is fair and mirror the ones of most advanced insolvency jurisdictions. The requirement of eligibility under section 29A too are lenient as corresponding amendment has been made to section 240A of IBC. Section 240A now reads that the provisions of clause (c) and (h) of Section 29A shall not apply to the resolution applicant in respect of corporate insolvency process or pre-packaged insolvency resolution process of any micro, small and medium enterprises.

However, in case a meeting is called under Regulation 14(8) it will be difficult to muster requisite strength and thus a lower threshold, of say fifty-one percent, present and voting should be provided for. Currently, it is not clear from regulation as to what the threshold is, in case of operational creditors, under Regulation 14(8).

Admission of application

According to section 11A, if an application under section 54C is pending, or is filed within 14 days of filing an application under section 7,9 or 10, the adjudicating authority will give priority to application under section 54C.

However, if an application under section 7, 9 or 10 is pending on the date of Ordinance or an application under section 54C is filed after 14 days of an application under section 7,9 or 10 the adjudicating authority will first dispose of applications under section 7, 9 or 10. The aforesaid clause has a potential for endless litigation. What happens if corporate debtor agrees to a settlement with an operational creditor pending admission on the date of ordinance and thereafter files under section 54C – it will waste precious time of National Company Law Tribunal (NCLT). Pleas would be made before adjudicating authority that a special resolution cannot be passed in 14 days. Article 14 applications will be filed in Supreme Court claiming inequality before law.

Given the litigation prone history of IBC, Government, should act in a magnanimous and bold manner and allow applications to be filed under Section 54C irrespective of

[10] Chapter IIIA IBC, Section 54A

the fact that an application under section 7, 9 or 10 is pending on the date of ordinance. Similarly, it should extend the 14 days period suitably to say 60 days. The other organs of the Government are taking similar steps in light of the second wave of Covid; recently Ministry of Finance extended the emergency credit line guarantee scheme (ECLGS) yet again, this time to SMA1 category borrowers[11].

Such a change would also read harmoniously with the Preamble of the Ordinance, "Whereas it is considered expedient to provide an efficient alternative insolvency resolution process for corporate persons classified as micro, small and medium enterprises under the Insolvency and Bankruptcy Code, 2016, ensuring quicker, cost effective and value maximising outcomes for all the stakeholders, in a manner which is least disruptive to continuity of their businesses and which preserve jobs". In the current second wave of Covid-19, with a dearth of resolution applicants, Section 7 and 9 application if pursued are a sure path to liquidation for MSMEs. Even in normal times, normalised for defunct companies, liquidations far exceeded resolutions under CIRP, and we continue to be in exceptional times.

Debtor in possession

Section 54H states that management of the corporate debtor shall vest in Board of Directors and the corporate debtor shall exercise and discharge their contractual or statutory rights. However, Regulation 50 provides that corporate debtor shall not undertake transactions above a threshold and any other matters decided by the committee of creditors (COC) and not covered under section 28.

Several clauses under section 28 should ideally be kept outside the purview of COC in a debtor in possession scenario, namely, delegation of authority to any other person, make any change in management of corporate debtor, make changes in appointment or terms of contract of personnel, make changes in appointment and terms of statutory auditor or internal auditor. It is also hoped that COC will not impose restrictive conditions that may go against the spirit of debtor in possession.

[11] Finance Ministry widens emergency credit line guarantee scheme scope to SMA-1 loans- The New Indian Express dated 17th April 2021.

Avoidance, fraudulent or wrongful trading

Chapter III-A delves into avoidance, fraudulent or wrongful trading transactions at number of places. Section 54C(3) (c) for initiation of PPIRP requires a declaration from corporate debtor of the aforesaid transactions. Section 54F(2)(h) requires the resolution professional to file application for such transactions and section 54F(3)(f) requires resolution professional to collect information on them. In case PPIRP is terminated under section 54N or PPIRP is converted to CIRP under section 54O, the proceedings initiated for such transactions continue.

> **"Avoidance and fraudulent transactions should only be applicable under section 54J (2) where during PPIRP, the affairs of corporate debtor have been conducted in fraudulent manner, or there has been gross mismanagement and the management is vested in the resolution professional."**

In an ideal world for a debtor in possession framework, avoidance and fraudulent transactions should not be considered as one allows debtor-in-possession with some degree of implicit trust. Singapore's Insolvency, Restructuring and Dissolution Act 2018 have two rehabilitative procedures namely the "supercharged scheme" which is debtor in possession and "judicial management" which is creditor in possession. The provisions relating to impeachable transactions are not applicable to supercharged scheme. In similar vein, thus the avoidance and fraudulent transactions should only be applicable under section 54J (2) where during PPIRP, the affairs of corporate debtor have been conducted in fraudulent manner, or there has been gross mismanagement and the management is vested in the resolution professional.

Nevertheless, considering the exigencies of India, if we want to persist with avoidance and fraudulent transactions, the time prescribed is too short to arrive at a meaningful conclusion. Regulation 41 prescribes thirty days to form an opinion on transactions covered under section 43, 45, 50 or 66, forty-five days to decide and sixty days for application to adjudicating authority. Any detailed study

of financials, including a forensic audit, in such tight timelines will not do any justice to the assignment and impose extra costs.

An alternate could be to let financial creditors decide which corporate debtor should be investigated for such impeachable transactions. Financial creditors usually have a wealth of data about corporate debtor gleamed from monthly and quarterly reports. In case of delinquent debtors, they may have a "forensic" report irrespective of the nomenclature given to such a report. Where the financial creditors identify such a corporate debtor, the exercise for impeachable transaction should be started by resolution professional pre-admission to PPRIP. This would give enough time to reach a fair and just conclusion on such transactions.

Section 54B (3) states that the fee payable to the insolvency professional in relation to the duties performed under the section shall form part of the PPIRP costs if the application for initiation of PPIRP is admitted.

Resolution Plan

The corporate debtor submits the base resolution plan under section 54K, which may be revised on request of committee of creditors (COC). If the plan does not impair operational creditors and is in conformity with subsections (1) and (2) of section 30, the COC may approve the base resolution plan.

In case the aforesaid base plan is not approved by COC, the resolution professional will invite new plans from prospective resolution applicants and lay down criterion and basis for evaluation. The resolution professional will present to COC such plans that meet the criterion and confirm to requirements of section 30(2). Regulation 48 prescribe mechanism to better competing plans and is based on a Swiss challenge. The COC may choose the plan if it is significantly better than the base plan and in case none of the plans is chosen the resolution professional shall file for termination of PPRIP.

It is pertinent to note that under section 54K (14), if the resolution plan provides for impairment of any claims owed by corporate debtor, the COC may require the promoters of corporate debtor to dilute their shareholding or voting or control in corporate debtor. In case the resolution plan does not provide for such dilution, the COC must record reasons for the same. The aspect of equality before law will rear its head again vis-à-vis the resolution plans. Whereas plan of corporate debtor is not required to impair operational creditors, no such requirement exists for plan from any other resolution applicant. Thus, for an apple-to-apple comparison the resolution professional may have to specify a criterion for invitation of plans, of not impairing operational creditors. Moreover, COC will be cagey in recording a reason for non-dilution of promoter. As we are dealing with a smaller asset base, and thus as a corollary with limited number of lenders for each corporate debtor, such a condition may result in increase in one-time settlement outside of PPRIP.

Fees of Insolvency Professional

Lastly, I will be failing in my duty to my fellow brethren if I do not mention the peculiar way clauses related to fee have been prescribed.

Section 54B (3) states that the fee payable to the insolvency professional in relation to the duties performed under the section shall form part of the PPIRP costs, if the application for initiation of PPIRP is admitted. Regulation 8 specifies that corporate debtor shall maintain a separate bank account with such amount to meet the fee of resolution professional and expenses incurred by him for conducting the process. Section 54(4) (c) provides that in case of rejection of resolution plan by AA, the PPIRP costs, if any, shall be included as part of liquidation costs.

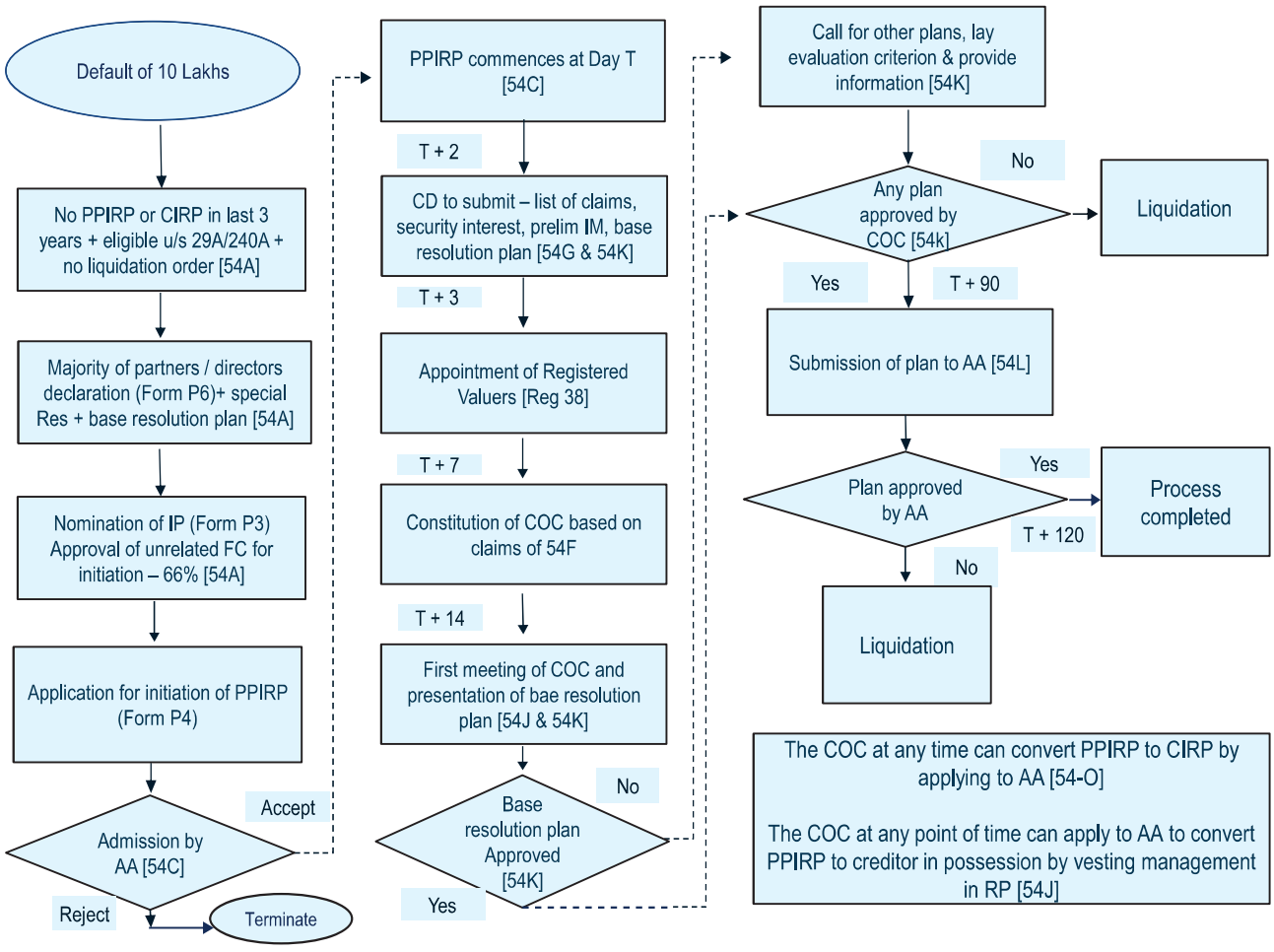
Section 54N(4)(b) provides that in case of termination of PPIRP, the PPIRP costs, if any, shall be included as part of liquidation costs. Section 54-O(2)(c) provides that in case of initiation of CIRP, the PPIRP costs shall be included as part of insolvency resolution process costs for CIRP. Unlike section 54B (3), for other fee related sections, no separate bank account is prescribed. In certain situations, thus the fee may become extremely backend. It is to be noted that due to the inherent definition of MSMEs, the insolvency professionals with large set-up may not be

inclined to take up such assignments. Thus, back ended fee would be a burden for insolvency professionals with a small set-up.

Conclusion

The initiative by IBBI to move to a debtor in possession model with creditor oversight is to be commended. Simple eligibility requirements, structured duties of resolution professional pre and post admission, fair timelines, availability of moratorium, and just & fair approach to resolution plan considering that operational creditors will in-turn be MSMEs too are concepts that will make PPIRP a success. If the anomalies detailed above are clarified, these baby steps will enable IBBI to roll out pre-packs for all corporates irrespective of their size.

PPIRP Process



Square Brackets denote relevant sections of the Insolvency and Bankruptcy Code 2016