Constitutional Validity of the Provisions of Insolvency and Bankruptcy Code

Dr. Sujatha S Patil

Abstract

In India, the legal and institutional machinery for dealing with debt default has not been in line with global standards. The recovery action by creditors, either through the Contract Act or through special laws such as the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, has not had desired outcomes. Similarly, action through the Sick Industrial Companies (Special Provisions) Act, 1985 and Companies Act, 1956 & 2013 have neither been able to aid recovery for lenders nor aid restructuring of firms. Laws dealing with individual insolvency, the Presidential Towns insolvency Act, 1909 and the Provincial Insolvency Act. 1920, are almost a century old. This has hampered the confidence of the lender. When lenders are unconfident, debt access for borrowers is diminished. In this backdrop Parliament enacted Insolvency and Bankruptcy Code, 2016 by consolidating all existing laws into single law. After enactment of this Code the question arose pertaining to couple of provisions of Code are conflicting with articles of the Constitutions. This research paper will focus on how the constitutional validity of various provisions of the Code has been challenged before various High Courts and the Supreme Court. Further the papers put forth how the issues related to constitutionality are justified by the Courts.

- Dr. Sujatha Patil, Associate Professor & Principal of Law, School of Business and Law, Navrachana University, Vadodara

1. Introduction

The Code was enacted in 2016 following decades of recommendations suggesting improvements to the previous insolvency regime, which was fragmented, fraught with delays and resulted in poor recoveries for creditors.[1] The scheme of the Code marked a sea change from the previous regime. In respect of corporate entities, the Code introduced a creditor-in-control regime (with a focus on empowering financial creditors), a time-bound resolution process and reduced scope for judicial intervention, and established institutions such as the Insolvency and Bankruptcy Board of India, insolvency professionals and information utilities. Since the implementation of this new regime, the constitutional validity of various provisions of the Code has been challenged before various High Courts and the Supreme Court.

2. Analysis of Couple of Provisions of IBC

One ground on which the validity of the Code was challenged was that the process for initiation of the corporate insolvency resolution process was not consistent with the principles of natural justice. In ***Sree Metaliks Ltd. v. Union of India,***[2] the constitutionality of section 7 was challenged on the ground that the provision does not provide the corporate debtor an opportunity to be heard before an application to initiate an insolvency resolution process against it is admitted. The petitioner argued that since the provisions of the Code are silent on the right of the corporate debtor to be heard, the right to hearing should be read into the provision. The Court relied on section 424 of the Companies Act, 2013, to hold that even though the Code is silent on the right of hearing of the corporate debtor, "*where a statute is silent on the right of hearing and it does not in express terms, oust the principles of natural justice, the same can and should be read into in."* Accordingly, the Court held that the Adjudicating Authority is obliged to give reasonable opportunity to be heard to the corporate debtor.

The Calcutta High Court also delved into the question of constitutionality of certain provisions of the Code. In ***Akshay Jhunjhunwala and Anr. v. Union of India,***[3] the validity of sections 7, 8 and 9 was challenged. It was argued that the differentiation made between the operational and financial creditors by these provisions does not have a rational or intelligible basis and is therefore, liable to be struck down. The Calcutta High Court relied on the Report of the Bankruptcy Law Reforms Committee, wherein the Committee had opined that "*members of the creditors committee have to be creditors both with the capability to assess viability, as well as to be willing to modify terms of existing liabilities in negotiations. Typically, operational creditors are neither able to decide on matters regarding the insolvency of the entity, nor willing to take the risk of postponing payments for better future prospects for the entity... for the process to be rapid and efficient, the Code will provide that the creditors committee should be restricted to only the financial creditors.*" Given this, the Court held that *"the Bankruptcy Committee gives a*

[1] Bankruptcy Law Reforms Committee, The Interim Report of the Bankruptcy Law Reforms Committee (2015)
[2] SreeMetaliks Ltd. v. Union of India, Writ Petition 7144 (W) of 2017. Decision date- 07.04.2017
[3] AkshayJhunjhunwala and Anr. v. Union of India, Writ Petition No. 627 of 2017. Decision date- 02.02.2018

rationale to the financial creditors being treated in a particular way vis-à-vis an operational creditor in an insolvency proceeding with regard to a company. The rationale is a plausible view taken for an expeditious resolution of an insolvency issue of a company. Courts are not required to adjudge a legislation on the basis of possible misuse or the crudities or inequalities that may be perceived to be embedded in a legislation. The rationale of giving a particular treatment to a financial creditor in the process of insolvency of a company under the Code of 2016 cannot be said to offend any provisions of the Constitution of India."

In ***Shivam Water Treaters Pvt. Limited v. Union of India,***[4] the Supreme Court requested the Gujarat High Court to refrain from entering the debate relating to the "validity of the Insolvency and Bankruptcy Code, 2016 or the constitutional validity of the National Company Law Tribunal." However, it did not bar the petitioners from challenging the same before the Supreme Court under Article 32.

Thereafter, the constitutional validity of various provisions of the Code was challenged before the Supreme Court. In its judgment in ***Swiss Ribbons Pvt. Ltd. v. Union of India***,[5] the Supreme Court held that the judiciary should exercise restraint while examining the constitutional validity of economic legislation since "in complex economic matters every decision is necessarily empiric and it is based on experimentation or what one may call trial and error method and therefore, its validity cannot be tested on any rigid prior considerations or on the application of any straitjacket formula."[6] In this background, the Court upheld the constitutional validity of all the provisions challenged before it.

A large number of the challenges before the Court were against the provisions that treated financial creditors and operational creditors distinctly. First, the Court observed the distinction between financial debt and operational debt in the following terms "a financial debt is a debt together with interest, if any, which is disbursed against the consideration for time value of money. It may further be money that is borrowed or raised in any of the manners prescribed in Section 5(8) or otherwise, as Section 5(8) is an inclusive definition. On the other hand, an 'operational debt' would include a claim in respect of the provision of goods or services, including employment, or a debt in respect of payment of dues arising under any law and payable to the Government or any local authority."[7] It further relied on the Final Report of the Bankruptcy Law Reform Committee, the Notes on Clause 8 of the Insolvency and Bankruptcy Bill, 2015 and the Report of the Insolvency Law Committee, to broadly lay down the distinctions between financial and operational creditors as "most financial creditors, particularly banks and financial institutions, are secured creditors whereas most operational creditors are unsecured, payments for goods and services as well as payments to workers not being secured by mortgaged

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[4] Shivam Water Treaters Pvt. Ltd. v. Union of India, SLP No.1740/2018. Decision date- 25.01.2018

[5] Swiss Ribbons Pvt. Ltd. &Anr. v. Union of India, Writ Petition (Civil) No. 99 of 2018. Decision date- 25.01.2019

[6] Ibid.

[7] Ibid.

documents and the like."[8] The Court also distinguished between the nature of agreements entered into with financial creditors and operational creditors, where the former generally lends for working capital or on a term loan and involves a larger quantum of money as compared to the latter where the agreement mostly relates to the supply of goods and services. Therefore, the Court held that the distinction between the two is based on intelligible differentia with a rational nexus to the objectives that the Code seeks to achieve. Secondly, the Court highlighted that the most significant difference between financial and operational creditors is that "financial creditors are, from the very beginning, involved with assessing the viability of the corporate debtor. They can, and therefore do, engage in restructuring of the loan as well as reorganization of the corporate debtor's business when there is financial stress, which are things operational creditors do not and cannot do."[9] This was relied on, along with the legislative and case law developments that guarantee fair and equitable treatment to operational creditors, to hold that the provisions giving only financial creditors the right to vote as part of the committee of creditors are valid. Thirdly, the Court also analysed if the difference in the process for triggering the corporate insolvency resolution process by operational creditors and financial creditors was arbitrary. The Court held that since financial creditors have to prove that there is "default" on the basis of solid documentation, or information in an information utility that is easily verifiable, it was justifiable that they were not required to provide a demand notice to the corporate debtor. This is contrary to the requirement imposed on an operational creditor to provide a demand notice to the corporate debtor, who only "claims a right to payment of a liability or obligation in respect of a debt which may be due".[10] Finally, the validity of section 53 of the Code was challenged on the grounds that it was discriminatory towards operational creditors. The Court held that give the relative importance of the two types of debts, particularly the importance of repayment of financial debts for promoting capital availability in the economy, a legitimate interest was being protected by section 53 of the Code.

Various challenges were also raised against the validity of section 29A. The validity of this section was challenged on the grounds that first, it had retrospective application. The Court held that since a resolution applicant does not have a vested right in being considered as such in the resolution process, the section cannot be held to be retrospective. Secondly, it was argued that section 29A(c) holds unequal's as equals by treating promoters who did not act with malfeasance on par with those who had. The Court held that section 29A was intended to apply to persons other than criminals or those who had been malfeasant, and this was justified by the legislative purpose of the section. Thirdly, it was argued that placing a bar on persons disqualified under section 29A from purchasing any assets of the corporate debtor in liquidation as well would be contrary to the purpose of maximizing the value of the assets of the corporate debtor. This contention was rejected on the ground that the legislative purpose would continue to apply even

[8] Ibid.

[9] Ibid.

[10] Ibid.

in liquidation. Fourthly, it was argued that the period of one year prescribed in section 29A for the disqualification to apply was arbitrary and without basis.

The Court held that it was legislative policy that a person who is unable to service its own debt beyond the grace period of one year, is unfit to be eligible to become a resolution applicant, and "this policy cannot be found fault with. Neither can the period of one year be found fault with, as this is a policy matter decided by the RBI and which emerges from its Master Circular, as during this period, an NPA is classified as a substandard asset." Fifthly, it was argued that the disqualification of relatives of persons who are disqualified in section 29A was arbitrary. The Court held that "The expression "related party", therefore, and "relative" contained in the definition Sections must be read noscitur a sociis with the categories of persons mentioned in Explanation I, and so read, would include only persons who are connected with the business activity of the resolution applicant." Finally, it was argued that the exemption of MSMEs from section 29A was arbitrary. The Court held that it was not arbitrary since "the rationale for excluding such industries from the eligibility criteria laid down in Section 29A(c) and 29A(h) is because qua such industries, other resolution applicants may not be forthcoming, which then will inevitably lead not to resolution, but to liquidation."[11]

The Court also examined the validity of section 12A that was challenged as being violative of Article 14, largely since the withdrawal of a petition under section 12A requires the approval of ninety per cent of the Committee of Creditors. The Court emphasized that an insolvency proceeding is a proceeding in rem and not a lis between parties. Consequently, and as also explained in the report of the Insolvency Law Committee "all financial creditors have to put their heads together to allow such withdrawal as, ordinarily, an omnibus settlement involving all creditors ought, ideally, to be entered into. This explains why ninety per cent, which is substantially all the financial creditors, have to grant their approval to an individual withdrawal or settlement." Further, if the committee of creditors arbitrarily rejects an application for withdrawal, their decision can be set aside by the Adjudicating Authority or the Appellate Authority. Given this, the court also upheld the validity of this provision.

Provisions of the Code were also challenged on the grounds that the information stored in private information utilities should not be the conclusive evidence of default, and that these utilities are not governed by proper norms. The Court took note of the Insolvency and Bankruptcy Board of India (Information Utilities) Regulations, 2017 and held that "the aforesaid Regulations also make it clear that apart from the stringent requirements as to registration of such utility, the moment information of default is received, such information has to be communicated to all parties and sureties to the debt. Apart from this, the utility is to expeditiously undertake the process of authentication and verification of information, which will include authentication and verification from the debtor who has defaulted.

[11] Ibid.

This being the case, coupled with the fact that such evidence, as has been conceded by the learned Attorney General, is only prima facie evidence of default, which is rebuttable by the corporate debtor, makes it clear that the challenge based on this ground must also fail."It was also argued that by giving adjudicatory powers to a non-judicial authority, that is, the resolution professional, the Code violates the basic aspects of dispensation of justice and access to justice. This contention was also rejected by the Court on the grounds that "the resolution professional is really a facilitator of the resolution process, whose administrative functions are overseen by the committee of creditors and by the Adjudicating Authority."[12]

The Court also dealt with challenges to the appointment of members of the National Company Law Tribunal ("**NCLT**") and the National Company Law Appellate Tribunal ("**NCLAT**") which are the Adjudicating Authority and Appellate Authority for corporate debtors, respectively, under the Code, the location and number benches of the NCLAT and the Ministry which would exercise administrative control over the NCLT and NCLAT.[13] While the Supreme Court passed directions regarding the administrative control over the NCLT and the establishment of circuit benches of the NCLAT, it upheld the validity of the NCLT and NCLAT.

3. *Conclusion*

The provisions of the Code pertaining to initiation of the corporate insolvency resolution process, voting in the committee of creditors, distribution in liquidation, withdrawal of the corporate insolvency resolution process, disqualification from submitting a resolution plan, information utilities and powers of the resolution professional have been held valid.

As per my observation in one of the case, 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

[12] Ibid.

[13] One ground of challenge was regarding the appointment of members of NCLT and NCLAT, which was contended to be contrary to the judgment in *Madras Bar Association v. Union of India.* Rejecting the contention of the petitioner, the Court held that in compliance with the directions of the Court in the abovementioned judgment, a selection Committee was formed for the appointment of members of the NCLT. Further, advertisements were issued inviting applications for Judicial and Technical members of the Tribunal. The petitioners then argued that since the NCLAT has only one bench in New Delhi, the appellate remedy is rendered "inefficacious", for the people from other states who could have earlier, before the NCLAT was made the appellate forum, easily approached the High Courts in their respective States. Thus, the NCLAT lacks the "*convenience and expediency*" that the Highs Courts provided and runs contrary to the dictum in *Madras Bar Association*. However, the Attorney General assured the Court that Circuit Benches will soon be established to comply with the directions of the Court in *Madras Bar Association*. Thus, in furtherance of this assurance, the Court directed the Union government to establish these Circuit Benches within 6 months from the date of judgment. In addition to this, in regards to the issue of the NCLT/ NCLAT functioning under administrative control of the Ministry of Corporate Affairs instead of Ministry of Law and Justice as mandated by the decision in *Madras Bar Association*, the Court directed that the Union Government must comply with the same.

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.