The Pre-Pack Ordinance 2021 - The Challenges And Way Forward

BACKGROUND

The Central Government has on 4 April 2021, promulgated the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2021 (***the Ordinance***) which along with the Insolvency and Bankruptcy Board of India (Pre-packaged Insolvency Resolution Process) Regulations, 2021 constitutes the pre-packaged insolvency resolution process (***PIRP***) for micro, small and medium enterprises (***MSMEs***).

A pre-pack is a voluntary consensual restructuring process between the debtors and the creditors, prior to the formal insolvency filing and follows the debtor-in-possession model, making it distinct from the already existing framework under the Insolvency and Bankruptcy Code 2016 (***the Code***).

Through this article, the authors seek to critically examine the provisions of the Ordinance in light of the objectives for its promulgation and highlight the potential challenges that may arise in the implementation of pre-packs in India. The authors will also highlight possible means to overcome the resultant issues and enhance the much-needed pre-pack resolution process as it gains ground in the Indian insolvency regime.

COVID-19 AND PRE-DEFAULT STRESS

The Ordinance, which shall come into force at once is, modelled on the Report of the Sub-Committee of the Insolvency Law Committee on Pre-packaged Insolvency Resolution Process (***ILC Report***) which the Indian government had constituted to recommend a regulatory framework for PIRP.

The ILC Report, in para 3.27, recommended for the PIRP framework to include COVID-19 defaults, due to the pandemic induced economic slowdown. The Preamble to the Ordinance also sets out that it has been promulgated in light of the impact on the business operations of the MSMEs from the pandemic. On the other hand, the Ordinance, by adding a proviso to Section 4 of the Code, expressly excludes COVID-19 defaults. Thus, there stands a need to reconsider the proviso and provide for COVID-19 defaults.

Further, the ILC Report, in para 3.28, recommended pre-packs to be introduced in four phases:

Phase (i) - Default ranging from Rs.1 lakh to Rs. 1 crore and COVID-19 defaults,

Phase (ii) - Default above Rs.1 crore,

Phase (iii) - Default from Re.1 to Rs.1 lakh, and

Phase (iv) - Pre-default stress.

The newly added proviso to Section 4 of the Code essentially falls in phase (i), excluding COVID-19 defaults, and phase (ii). The pertinent issue that arises here is whether phase (iv) will be incorporated in the Code or has been left absolutely unattended. An MSME, which is aware of an incipient stress, and wishes to explore the PIRP mechanism, should have access to it through the phase of a pre-default stress. Phase (iv) that deals with the stage of pre-default stress is critical to be included in the framework at this stage, where MSMEs are struggling with the erratic lockdown measures.

RESTRICTED SCOPE

The Ordinance aims to provide for an efficient alternative insolvency resolution process to MSMEs in the form of pre-packs. Despite that, it restricts the scope of the Ordinance to a corporate debtor (***CD***) classified as a MSME under Section 7(1) of the MSME Development Act, 2006.It is worth noting that out of a total of 6.3 crore MSMEs, only around 4% are registered and eligible to take recourse under the PIRP scheme. This substantially impedes the availability of the mechanism to the entire class.

STRICT TIMELINES UNDER THE ORDINANCE

The Ordinance has been promulgated to ensure speedier resolution of the CD, particularly in light of the pandemic. The ILC Report in its recommendation for a 90+30 day timeline noted that shorter timelines encourage better pre-pack negotiation between the debtor and the creditors while longer timelines would deter the creditors from opting for the pre-pack route as against the corporate insolvency resolution process (***CIRP***). While a stricter timeline is indeed necessary to promote faster settlement and it reduces the burden on the tribunals, resolution under the Code takes longer than envisaged. Notably, the original CIRP timeline of 270 days under the Code, was revised and increased to 330 days in 2019 after the practical experience indicated that proceedings under the Code take an average of 340 days.

The Ordinance makes no provision for an extension of the PIRP. On the contrary, in the event the resolution plan fails to be approved within the stipulated timeline, the PIRP is bound to be terminated,[1] relegating the parties back to the CIRP mechanism. This will increase compliance and overall costs associated with the resolution process. Thus, a statutorily recognised and a limited extension of the time period of the PIRP is desirable to ensure that the resolution process does not become burdensome for the parties.

PIRP AND CIRP – THE PRECEDENCE CONFLICT

The Ordinance amends Section 11 of the Code to set a priority amongst the CIRP and the PIRP. The Ordinance identifies the following three scenarios:

1. When a CIRP Application under Section 7, 9 or 10 of the Code is filed after a PIRP application is filed, the NCLT must first admit/ reject the PIRP application.
2. When the PIRP application is filed *within* 14 days of the filling of the CIRP application under Section 7, 9 or 10 of the Code, the NCLT must first dispose of the application for a PIRP.
3. When the PIRP application is filed *after* 14 days of the filling of the CIRP application under Section 7, 9 or 10, the NCLT must first dispose of the CIRP application.

The Ordinance lays down a short and strict timeline for filling and initiating a PIRP, which may not come to fruition in practice. Nonetheless, it is relevant to consider that either the PIRP or the CIRP application can be disposed of by the NCLT in a manner that leads to the liquidation of the CD.[2] Consequently, in such an event, the CD will either have to undergo the resolution process under a different channel, leading to tedious and multiple litigations.

SUBMISSION OF THE RESOLUTIONPLAN.

The Code under Section 240 creates an exemption whereby, Section 29A (c) of the Code which bars existing promoters of the CD to submit a resolution plan, does not apply to MSMEs. However, under the present pre-pack scheme, the Committee of Creditors (***CoC***) must first consider the base resolution plan as submitted by the CD within 2 days of the PIRP commencement date.[3] Section 54K(2) of the Ordinance provides that this base resolution plan may also be revised once only upon the approval of the CoC. This is to ensure that the debtor is first to be put in charge of paving the way for the resolution of the entity.

In this light, it is crucial to note that the explanation to Section 54K (15) provides that a base resolution plan can be submitted by the CD *"individually or jointly with any other person."* The words 'any person' lay a large net for a broad category of entities to be covered under the provisions including one or more financial creditors, operational creditors and possibly related parties. It can potentially lead to favouritism amongst the members of the CoC, wherein a financial creditor is part of both the CoC and the group submitting the resolution plan. Furthermore, it could also lead the way for the entities expressly debarred under Section 29A of the Code, such as related parties or other connected persons, to submit resolution plans under the scheme.

ROLE OF RESOLUTION PROFESSIONALS

The Ordinance provides for an insolvency professional to be appointed as an RP in a pre-pack. Unlike in the case of a CIRP, in a PIRP, the management of the CD does not shift to the RP. The RP does not run the business of the CD as a going concern and does not take custody of its assets. The RP is only left with the responsibility of oversight and monitoring the affairs of the CD. With various cases having challenged the independence of the RP during a CIRP,[4] ensuring a fair and transparent role of RP in PIRP might prove challenging.

CONCLUSION

Considering the exigencies faced by small businesses during the COVID-19 pandemic, the Ordinance has expedited the introduction of the pre-pack resolution process for MSMEs. Despite being a source of relief for many small businesses, it does not meet some crucial needs of the current pandemic hit economy. In order to make a robust and effective PIRP for India, a statutory amendment to the Code clarifying the scope of the implementation of the present scheme is desirable. The Amendment should provide for inclusion of COVID-19 and pre-default stress, and should allow an extension of the resolution timeline. Furthermore, the amendment should clarify the stage for the initiation of the PIRP and CIRP in the event of liquidation of the entity, as well as define the scope of the monitoring power of an RP. It is also important to lay down strict and clear eligibility criteria for resolution plan applicants.

(Source: Taxmann.com)