ACCOMODATING PRE-PACKS IN THE INDIAN INSOLVENCY REGIME

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ABSTRACT

The Insolvency and Bankruptcy Code, 2016 was enacted to establish a uniform, comprehensive legal framework to govern the matters of Bankruptcy in India. Since its inception, it has been hailed as being creditor-friendly. One of the reasons for the same is that the Code leans in favour of extensive monitoring of the Insolvency Resolution Process by the Courts. Though good in its intentions, this leaves no scope for informal arrangements which may be desirable in certain circumstances. Such an approach is based on the assumption that Indian market is not mature enough for informal Bankruptcy resolution.

It is against this backdrop that this paper seeks to study Pre-Packs, a popular mode of informal/quasi-formal bankruptcy resolution prevalent in many jurisdictions over the world. Such arrangements existing in the US and UK are chosen as the primary subject matter of scrutiny. The paper evaluates the viability of Pre-Packs as an alternative Insolvency Resolution mechanism in terms of both corporate rescue and satisfaction of creditors' claims as against the formal bankruptcy procedure. The criticisms against such arrangements are also discussed. The paper then

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analyses the present Indian Insolvency Regime to determine the feasibility of Pre-Packaging in India. A comparison is made between the legislative intention and judicial trend to show that such pre-packs ought to be given legal recognition. Finally, it illustrates how the Insolvency Code can be amended so as to accommodate such pre-packed arrangements in India.

1. INTRODUCTION

A bankruptcy resolution process ideally aims to enable both the parties, i.e. debtors and creditors to realize maximum value of the insolvent business' assets. Often, this is not possible as both the sides have conflicting aims. Creditors, as soon as they get a whiff of bankruptcy, tend to close their investment and explore other opportunities. To resolve such conflicts, there is a need for a sound regulatory framework, which should ideally bring in 'procedural certainty' and ensure a smooth negotiation process by maximum dissemination of information to both sides. [1]In India, the Insolvency and Bankruptcy Code,[2] is the governing legislation on matters such as Corporate Insolvency, Partnership and LLP Insolvency and Individual Bankruptcy. It was enacted to thoroughly overhaul the erstwhile fragmented framework of Insolvency Resolution which was congested with multiple recovery mechanisms under multiple legislations before multiple Courts. For the same reason, ease of doing business in India was deplorable which is evidenced by a 2014 World Bank Report

[1] REPORT OF THE BANKRUPTCY LAW REFORMS COMMITTEE VOLUME I: RATIONALE AND DESIGN 22 (Nov. 22, 2015).
[2] Insolvency and Bankruptcy Code, 2016, No. 31, Acts of Parliament, 2016.

that stated that the average time to recover from bankruptcy in India is 4 years as opposed to 0.8 years in Singapore and 1 year in London.3 Therefore, the IBC was enacted to bring the Indian Insolvency Regime at par with the well-developed bankruptcy regimes of other countries.

However, the existing framework emphasizes on extensive supervision by Courts. The reason cited for this is, in the former haphazard framework, debtors were often able to get away without paying the creditors' sufficiently. However, analysing the judicial trend for over more than a year after the IBC came into force, one finds that pre-packaging may not be a gruesome addition to the present framework.

The aim of this Paper is to explore the viability of introducing 'Pre-packs', an established mechanism of Insolvency Resolution in many jurisdictions, to India, after perusing the existing models in U.K and U.S. and weighing its pros and cons. Pre-packaged bankruptcy arrangements have come to play an important role in bridging the gap between the formal and informal insolvency regimes in various jurisdictions across the world. Generally, it serves as a mode of contingency or recovery planning, in anticipation of Bankruptcy.[4] U.K and U.S are chosen for the present study as the foundations upon which their insolvency regime rests are sharply contrasting. U.K maintains a pro-creditor approach while the U.S leans towards a pro-debtor approach. In the concluding section, the

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3 *Time to Resolve Insolvency, Doing Business Project*, THE WORLD BANK, https://data.worldbank.org/indicator/IC.ISV.DURS (last visited Feb. 23, 2017).

4 Vanessa Finch, *Prepackaged Administrations: Bargains in the Shadow of Insolvency or Shadowy bargains* J.B.L. 568, 569 (2006).

authors propose reforms to the existing Indian regime so as to recognize pre-packs which should be a middle ground between Formal and Informal Bankruptcy Procedure (for e.g., out-of-court settlement). This is in consideration of the concern that the existing Indian market is not mature enough to completely do away with Court supervision.

2. PRE-PACKAGED BANKRUPTCY ARRANGEMENTS IN UNITED STATES

The legislation that covers the matters of Bankruptcy in the US is the Bankruptcy Reform Act of 1978[5] in which Chapter 11, specifically deals with reorganization. US bankruptcy regime leans towards corporate rescue in as much as that the important objective of Chapter 11 is to 'expeditiously and effectively separate the past problems in a business from its future prospects to enable the debtor to continue the business in as many cases as possible after reorganization with protection of the estate and creditors.[6]

Pre-packaged bankruptcy is a combination of private workout and legal bankruptcy.[7] In a conventional bankruptcy case, the debtor files a bankruptcy petition, then negotiates a reorganization plan and solicits votes. An automatic stay of all lawsuits[8] and other proceedings to enforce any pre-petition obligation of the debtor[9] comes into force upon the filing

5 Bankruptcy Reform Act, 11 U.S.C., §§ 1101-1174 (1978).
6 J.S. Moore & V.P. Slusher, *Bankruptcy Code Section 363 Sales: Trends and Opportunities*, NORTON BANKR. L. ADVISER, no. 9, 2007.
7 JEFFREY JAFFE ET AL., CORPORATE FINANCE 841 (10th ed. 2012).
8 11 U.S.C. § 362(a)(1) (2000).
9 11 U.S.C. § 362(a)(3); Section 362(a)(6) ; Sections 362(a)(4)–(5) (2000).

of the petition. The purpose of this stay is to provide the debtor with breathing room during the reorganization negotiations.[10]

In a pre-packaged plan, the applicant negotiates a plan and solicits votes before filing of a Chapter 11 petition.[11]There is simultaneous filing of Chapter 11 petition and plan of reorganization limiting the Court's role to setting a date for approval of disclosure statement and the reorganization plan.[12]

The first major case of pre-packaged bankruptcy was that of Crystal Oil Company. The company filed for bankruptcy on 1st October, 1986. Three months later, the total indebtedness of the firm was reduced from $277 million to $129 million. Creditors received combinations of convertible notes, common stock, and convertible preferred stock in exchange for giving up their claims. [13]The company was able to emerge from bankruptcy within such a short period of time because reorganization was finalized by way of private agreement before a petition was filed for bankruptcy under Chapter 11.

Section 1102 (b) (1) of the U.S. Bankruptcy Code permits the official committee to be comprised of members organized by the creditors themselves before the commencement of the case, provided, they are fairly chosen and are representative of different kinds of claims. Section 1121

10 H.R. REP. NO. 95-595, at 340 (1977); S. REP. NO. 95-989, 54–55 (1978).
11 *In Re*, Pioneer Finance Corp., 246 B.R. 626 (Bankr. D. Nev. 2000).
12 LAW AND PRACTICE OF RESTRUCTURING IN THE U.K. AND U.S. 205 (C. Mallon et al. eds., 2011).
13 John McConnell, *The Economics of Prepackaged Bankruptcy* 4 J. APPLIED CORPORATE FINANCE, no. 2, 1991, at 93, 94.

(a) provides that a debtor may file a plan for reorganization simultaneously with its petition for a voluntary bankruptcy case. These provisions are the evidence of Congressional recognition of the fact that negotiations between a debtor and its creditors outside of a bankruptcy court can actually assist in the ultimate goal of bankruptcy law which is to reconcile the interests of debtors and creditors in a mutually satisfactory way.[14]

Before entering into negotiations, creditors typically execute agreements such as waiver or forbearance agreements to modify or waive their rights to collect debts. This is to avoid any creditor from initiating formal bankruptcy proceedings amidst the negotiations. U.S. Courts have upheld such agreements which signalled concerted action, even if they were challenged by a dissenting minority. An illustrative case is *In Re, NRG Energy Inc.*,[15] where, a debtor had begun negotiations with certain creditors for a pre-packaged bankruptcy plan. Certain other creditors, who were not party to the negotiations, filed an involuntary bankruptcy petition against the debtor before a pre-packaged plan could be filed. In response, the debtor sought to have the bankruptcy court abstain from exercising its jurisdiction over it, or in the alternative, to dismiss it. The Court ruled in favour of the debtor and emphasized that the debtor had already entered into substantial negotiations with the creditors which had enabled him to take substantial steps toward filing its own negotiated restructuring.

14 *supra* note 12, at 206..
15 294 B.R. 71 (Bankr. D. Minn. 2003).

3. PRE-PACKS IN THE UNITED KINGDOM

In the United Kingdom, pre-packaged administration is the mechanism where, an administrator works with the management prior to his formal appointment to work out a resolution plan in confidence. The resolution plan which may provide for sale of all or some of the company's assets is affected immediately after the appointment of the administrator.[16]

Pre-packs are a result of the promotion of rescue culture as opposed to debt collection during insolvency. The reforms introduced by Enterprise Act 2002,[17] such as a system of out-of-court entry into administration, have made way for the higher incidence of pre-packs.[18] Increased costs to be paid to professionals, demands of ransom payments by suppliers who have monopoly, etc. have been observed to be certain flaws of the formal insolvency regime that may have led to this steady growth of pre-packs in the U.K. According to a leading study, there was a considerable amount of increase in pre-pack administrations in the U.K. between 2001 and 2004.[19] A 2009 Report stated that a third of the administrations in the U.K were pre-packs.[20] The 2012 Insolvency Service

16 INSOLVENCY SERVICE, STATEMENT OF INSOLVENCY PRACTICE 16 (2016).
17 Enterprise Act 2002, c.40 (Eng.).
18 GERARD MCCORMACK, CORPORATE RESCUE: AN ANGLO-AMERICAN PERSPECTIVE 72 (2008).
19 SANDRA FRISBY, A PRELIMINARY ANALYSIS OF PRE-PACKAGED ADMINISTRATIONS 15 (2007).
20 INSOLVENCY SERVICE, REPORT ON THE OPERATION OF STATEMENT OF INSOLVENCY PRACTICE 5 (2009).

Report states that the percentage of pre-packs increased from 25 % in 20111 to 29% in 2012.[21]

4. WHY CHOOSE PRE-PACKS?

The U.S. pre-pack is described as a 'hybrid form of reorganization'[22] as it combines the transparency and the need for creditor consent in a Chapter 11 procedure with the flexibility of an out-of-court workout.[23] A study observed that pre-packaged bankruptcies come with the advantages of a formal bankruptcy and are more efficient.[24] Further, empirical studies suggest that, private restructuring is generally the preferred method of dealing with debtor default in the U.S.[25]

4.1. DECREASED COSTS AND INCREASED SPEED

In U.K, a pre-pack is generally observed to offer the best chance to rescue a business, preserve goodwill and employment, maximize realization and generally speed up the insolvency process.[26] Resorting to pre-packs enables the distressed companies to avoid significant expenses

21 INSOLVENCY SERVICE, 2012 ANNUAL REVIEW OF INSOLVENCY PRACTITIONER REGULATION 4 (2013).
22 E. Tashjian et al, *Prepacks, An Empirical Analysis of Prepackaged Bankruptcies*, 40 J. FINANCIAL ECON., no. 1, 1996, at 135, 138-39.
23 J.K. Mateti & R.S. Vasudevan, *Resolution of Financial Distress: A Theory of the Choice Between Chapter 11 and Workouts*, 9 J. FINANCIAL STABILITY 196 (2013).
24 J.J. McConnell et al., *Prepacks as a Mechanism for Resolving Financial Distress: The Evidence*, 8 J. APPLIED CORPORATE FINANCE, no. 4, 1996, at 99,102.
25 G. Kilson et al., *Trouble Debt Restructuring: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FINANCIAL ECON. 315, 335 (1990).
26 INSOLVENCY SERVICE, ENTERPRISE ACT, 2002 – CORPORATE INSOLVENCY PROVISIONS: EVALUATION REPORT 147 (2008).

and relatively complicated formal bankruptcy process.[27] It minimizes the time a company will spend in insolvency and thus increase the chance of rescuing its business as they open up the scope for debt restructuring at a stage when the company's business may still be viable.[28]

Therefore, decreased costs and increased speed in emerging from bankruptcy are, certain factors which prompt the resort to pre-packaged bankruptcy.

4.2. REPRESENTATION OF THE EXISTING MANAGEMENT

In India,[29] and in the U.K, the Corporate Debtor's management is out of the picture once the insolvency proceedings are initiated.[30] It is unreasonable to entirely exclude the Management from the scene in cases where corporate distress was not a result of fault or fraud of the Management. Their non-participation may even result in deterioration of the value as they are the most acquainted with the business and may be in a better position to plan its revival. However, it has to be noted that this may not be the situation at all times as the company's distress might have been brought about by mismanagement itself. In such cases, creditors may be put at greater risk, if the debtor-in-possession model is followed.[31]

27 BO XIE, COMPARATIVE INSOLVENCY LAW: THE PRE-PACK APPROACH IN CORPORATE RESCUE 323 (2016) .
28 *Id.* at 323.
29 Insolvency & Bankruptcy Code, 2016, § 21.
30 Insolvency Act, 1986, c.45, sch. B1, [59]-[61] (U.K.).
31 John Armour, *The Rise of the 'Pre-Pack': Corporate Restructuring in the UK and Proposals for Reforming*, *in* RESTRUCTURING COMPANIES IN TROUBLED TIMES: DIRECTOR AND CREDITOR PERSPECTIVES 29 (R.P. Austin et al. eds., 2012).

Moreover, increased role of management would decrease the role played by Insolvency Professionals and thereby bring down the Insolvency Resolution Process costs as well.[32]

4.3. LESS DEPRECIATION OF VALUE OF ASSETS AND DISRUPTION IN BUSINESS

Pre-packs can be a good option of informal insolvency resolution in companies whose business is reputation based or Intellectual Property based.[33] The value of such businesses can drastically diminish even at the hint of a formal insolvency.[34] Formal insolvency declaration often drags down the value of the goodwill.[35] Negative publicity as a result of stigma attached to being insolvent, in this way jeopardizes the objective of realization of maximum value of the company's assets.[36] Further, other entities would be reluctant to continue/commence business with the Corporate Debtor and this adversely affects the prospects of the Debtor for a rebirth even more.[37] This problem is aggravated in situations where the

32 J. Armour et al., *The Costs and Benefits of Secured Creditor Control in Bankruptcy: Evidence from the U.K.*, 10-13, Univ. of Cambridge Centre for Business Research, Working Paper No. 332, 2009, *available at* papers.ssrn.com/sol3/papers.cfm?abstract_id=912302.
33 MCCORMACK, *supra* note 18, at 72.
34 Martin Ellis, *The Thin Line in the Sand – Pre Packs and Phoenixes*, 3 RECOVERY (2006).
35 Tracy Chan, *Schemes of Arrangement as a Corporate Rescue Mechanism: The Singapore Experience*, 18 INT'L INSOLVENCY REV. 42 (2009).
36 P. Walton, *Pre-Packaged Administrations – Trick or Treat*, 19 INSOLVENCY INTEL. 113, 115 (2006).
37 G. Meeks & J.G. Meeks, *Self-Fulfilling Prophecies of Failure: The Endogenous Balance Sheets of Distressed Companies*, 45 ABACUS 22, 25 (2009).

Corporate Debtor has entered into contracts that contain terms to the effect that it will stand terminated on the commencement of formal insolvency proceedings.[38] In such a scenario, pre-packs may be the best option as they are both, beneficial to the creditors and can give the business a second chance.[39] There is no scope for goodwill deterioration because by the time the public comes to know of the insolvency, the plan to save it would already have been conjured.[40] However, it has to be noted that, these costs cannot entirely be avoided and can only be reduced.[41]

Pre-packs cause relatively less disruption to the business and there is a higher degree of certainty of its continuation. In *DKLL Solicitors v. HM Revenue Customs*, the High Court of Justice (Chancery Division) upheld a pre-packed sale of a solicitors' business on the ground that the pre-packaged sale minimized disruption to clients and was the best way to protect jobs.[42]

4.4. BALANCES CREDITORS' INTERESTS WITH CORPORATE RESCUE

Pre-packs aim at selling the distressed business as a going concern and its pre-determined nature offers a high level of certainty to creditors.[43]Further, the secured creditors enjoy a greater degree of control

38 Armour, *supra* note 31, at 13.
39 A. Bloom & S. Harris, *Prepackaged Administrations –What Should be Done Given the Current Disquiet*, 19 INSOLVENCY INTEL. 122, 122 (2006).
40 *In Re*, DKLL Solicitors [2007] E.W.H.C. (Ch.) 2067 (Eng.).
41 J. Armour & S. Deakin, *Norms in Private Insolvency: The "London Approach" to the Resolution of Financial* Distress, J. Corp. L. Stud. 21, 23 (2001).
42 [2007] E.W.H.C. (Ch.) 2067 (Eng.).
43 Xie, *supra* note 27, at 90.

in such arrangement. For the same reason, they are sometimes considered to be more attractive than a protracted formal insolvency process. [44]

4.5. MINIMIZED CHANCES OF HOLD-OUT

In a pre-packaged bankruptcy, the company enters into an agreement of compromise or sale of the company with the large creditors leaving out the smaller creditors' claims.[45] This minimizes the chances of a holdout by minority creditors. It is further minimized when combined with the protection offered by the formal bankruptcy procedure by way of which dissenting creditors can be bound by the terms of reorganization agreement if it garners the support of the required majority.[46] Therefore, pre-packs can provide a cost-effective and expeditious way for the majority creditors to bind the minority. In U.S, the unsecured and minority creditors are not party to the negotiations as they have no real economic interest in the company. But they are free to use the challenges that are ordinarily brought against conventional bankruptcy cases.

5. INCORPORATING PRE-PACKS IN INDIA

The growing popularity of insolvency resolution, through pre-packs, has led to the recognition of similar procedures in other countries such as Accelerated Financial Safeguard procedure (*Procédure de*

44 MCCORMACK, *supra* note 18, at 72.
45 T.J. Salerno & C.D. Hansen, *A Prepackaged Bankruptcy Strategy*, 12 J. BUSINESS STRATEGY 36 (1991).
46 K.A. Mayr, *Enforcing Prepackaged Restructurings of Foreign Debtors under the U.S. Bankruptcy Code*, 14 AM. BANKR. INST. L. REV. 469, 497 (2006).

Sauvegar de Financière Accélérée) in France,[47] Protective Shield Proceedings (*Schutzschirmverfahren*) in Germany,[48] Legge Fallimentare of Italy[49] etc. Before analysing the judicial decisions that incline towards party-autonomy, it is pertinent to peruse the preparatory works of IBC to understand whether pre-packs were ever considered at some point.

The Interim Bankruptcy Law Reforms Committee has discussed the prospect of introducing pre-packaged corporate rescue in India.[50] However, it opined that the Indian market is currently not sufficiently developed to allow sales with zero intervention by NCLT. Nevertheless, there is scope for hope as the Report has waved a green flag for encouraging NCLT-supervised schemes of arrangement after consultation with the stakeholders.[51] The Report states that such pre-packs may be approved by NCLT within 30 days of filing after confirming that the scheme satisfies certain requirements. BLRC was of the view that further consultation may be required with the stakeholders before allowing such pre-packed sales as part of Schemes of Arrangement without involving all the requirements relating to creditor meetings, after taking note of the criticism such plans have received for not taking into account the interests of all stakeholders.[52] It was of the opinion that, separate rules be

47 Code De Commerce [C.Com.] [Commercial Code] art. L.628-1 L.628-7 (Fr.).
48 Gesetzzurweiteren Erleichterung der Sanierung von Unternehmen [ESUG] [The Law on the Facilitation of the Restructuring of Enterprise], Dec. 7, 2011, Das Bundesgesetzblatt [BGBI] at 2582 I 2011 (Ger.).
49 Leggefallimentare, 16 marzo1942, n.267, G.U., Apr. 6, 1942, n.81 (It.).
50 INTERIM REPORT OF THE BANKRUPTCY LAW REFORMS COMMITTEE 2 (Feb., 2015).
51 BLRC Report, *supra* note 1, at 79.
52 *Id.*

introduced to provide an impetus to such schemes while also protecting the interests of the stakeholders sufficiently.

Further the makers of IBC have opined that scheme of arrangement have been relatively successful and can be an effective tool for debt-restructuring in India as restructurings can be achieved less formally and less expensively.[53] However, no efforts were made to explore its potential as a full-fledged debt restructuring mechanism under the Insolvency Regime. It is to be noted that scheme of arrangement has the hues of a pre-packaged bankruptcy arrangement. [54]

The BLRC Report has reiterated the nine broad objectives of an insolvency law regime, as stated by UNCITRAL, which includes maximization of value of assets, striking a balance between liquidation, and reorganization etc.[55]Speed has been recognized to be the essence for the working of the Bankruptcy Code. [56]It was also noted that the liquidation value of the assets tends to go down with time and that sale of the company as a going concern would fetch a better realization.[57]The entire scheme of the Code has been summarized by the Hon'ble Supreme

53 *Id.*, at 78.
54 UmakanthVarottil, *The Schemes of Arrangement as a Debt Restructuring Tool in India: Problems and Prospects*, NUS - Centre for Law & Business, Working Paper No: 17/02, 2017, *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2943855.
55 U.N. Comm'n on Int'l Trade Law (UNCITRAL), Legislative Guide to Insolvency Law, Part I, 10 – 14, *available at* www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf (last visited Mar. 3, 2018).
56 BLRC Report, *supra* note 1, at 15.
57 *Id.*

Court in *Innoventive Industries Ltd. v. ICICI Bank Ltd.*,[58] wherein it observed that:

> *The scheme of the Code therefore is to make an attempt, by divesting the erstwhile management of its powers and vesting it in a professional agency, to continue the business of the corporate body as a going concern until a resolution plan is drawn up, in which event the management is handed over under the plan so that the corporate body is able to pay back its debts and get back on its feet.*

From the above observations, it can be concluded that the underlying scheme of IBC and the objectives of Pre-packs are not at polar extremes.

` The IBC is being hailed as being pro-creditor in its nature.[59] This inevitably means that there is little scope for participation of corporate debtors. Once the application is admitted, there is no opportunity for the corporate debtor to make a representation in stages such as, appointment of Insolvency Resolution Professional (IRP), finalizing Resolution Plan etc. Even though the members of the suspended Board of Directors can participate in the meetings of Committee of Creditors,[60] they have no voting rights, thus reducing their role to mere spectators. As the IRP takes over the management and control of the Corporate Debtor entirely, even

58 Civil Appeal No: 8337-8338/2017, ¶ 33, (Aug. 31, 2017).
59 UmakanthVarottil, *Supreme Court reaffirms creditor-friendly nature of Insolvency Law*, INDIA CORP. LAW (Sep. 1, 2017), https://indiacorplaw.in/2017/09/supreme-court-affirms-creditor-friendly-nature-insolvency-law.html.
60 Insolvency & Bankruptcy Code, 2016, § 24(3)(b).

day-to-day activities of the company would require creditors' meeting and approval.

Insolvency Resolution is almost always a costly affair. However, the formal insolvency process in India offers 'little scope for further injection of capital or small-scale sale of assets', during the period of insolvency by reason of the moratorium that is placed.[61] The option to resort to pre-packaged bankruptcy gives the corporate debtor/creditor to start off early so that the company remains sufficiently liquid throughout the entire period of negotiations.

Further, Rule 8 of Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules prohibits withdrawal of an application once it has been admitted, leaving no scope for the parties to settle afterwards. Some recent judicial decisions strike a rather discordant note. The Supreme Court, in its decision in *Lokhandwala Kataria Construction (P) Ltd. v. Nisus Finance and Investment Managers LLP*, allowed a settlement between the parties.[62] However, it is doubtful whether this can be treated as a precedent. as the settlement was allowed in exercise of Supreme Court's powers under Article 142 with respect to the facts of the particular case. [63]In another case, while allowing a settlement between the parties, the Supreme Court observed thus:

61 *Id.*, § 14.
62 [2017] 140 C.L.A. 215 (N.C.L.A.T.).
63 Goda Raghavan, *No level playing field*, THE HINDU (Aug. 12, 2017), www.thehindu.com/opinion/op-ed/no-level-playing-field/article19476401.ece (last visited Apr. 8, 2018).

> *We are of the view that instead of all such orders coming to the Supreme Court as only the Supreme Court may utilize its powers under Article 142 of the Constitution of India, the relevant Rules be amended by the competent authority so as to include such inherent powers. This will obviate unnecessary appeals being filed before this Court in matters where such agreement has been reached.*[64]

This issue has been discussed by the Report of the Insolvency Law Committee which concluded that such settlements post admission may be allowed if 90% of the Committee of Creditors approves it. [65]Such a high threshold may make it impossible to ever reach a settlement even in the cases where it is the most appropriate recourse. This points at the need for the authority to adjudge the viability and propriety of settlement in the interests of business rescue even when the threshold is not satisfied.

Moreover, if such post-petition settlements can have legal validation, pre-petition settlements such as pre-packs should be considered next.

Apart from the fact that there is no legal recognition of informal insolvency resolution, these are some hindrances which stand in the way of informal insolvency resolution between the management and the creditors indicative of 'extensive intervention of Bankruptcy Laws in the relations between creditors and the Corporate Debtor'. This is not consistent with the modern economic approach by which the relevant

64 Uttara Foods & Feeds Pvt. Ltd v. Mona Pharmachem, Civil Appeal No. 18520 of 2017.

65 REPORT OF THE INSOLVENCY LAW COMMITTEE 73, ¶2 9.2 (Mar. 28, 2018).

entities should have at least some freedom to contract their way out of insolvency.[66]

Recently, the NCLT-Kolkata Bench suggested an out-of-court settlement in the matter of Binani Cements insolvency.[67] However, the SC refused to allow such a settlement.[68] Such a contradictory approach stems from the lack of legal backing for informal bankruptcy settlements.

These judgments indicate that it is indeed desirable to recognize the autonomy of the parties by allowing settlements with one or some of the many creditors. However, this is also dangerous in the absence of provisions to secure the dissenting creditors' claims. Therefore, there is a need to modify the existing Insolvency Regime so as to accommodate such settlements even before the initiation of Bankruptcy proceedings, in the form of pre-packs, while sufficiently taking care of the interests of other creditors.

6. CONCERNS RELATED TO THE PRE-PACK APPROACH

It has to be noted that the authors' aim is not to suggest that pre-packs must necessarily be preferred to the court-driven insolvency

66A Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J., 1807, 1851 (1998).

67 *NCLT suggests out-of-court settlement between Binani Cement and Creditors* BLOOMBERG QUINT (Mar. 27, 2018), www.bloombergquint.com/insolvency/2018/03/27/nclt-suggests-out-of-court-settlement-between-binani-cement-and-creditors (last visited Apr. 8, 2018).

68 Arpan Chaturvedi & Vishwanath Nair, *Binani Cement Matter Back in NCLT as Supreme Court Unimpressed by Petition to Terminate Insolvency*, BLOOMBERG QUINT (Apr. 13, 2018), www.bloombergquint.com/business/2018/04/13/binani-industries-withdraws-plea-for-binani-cement-insolvency-settlement-from-supreme-court (last visited Apr. 30, 2018).

process. This is because pre-packs suffer from certain flaws. Moreover, the viability and success rates of pre-packs show that it may even not be the best option at all times.[69] Some scholar's herald pre-packaged administrations as an effective rescue mechanism while others view it with scepticism because they consider it as a means by which the mighty can bypass statutory provisions.[70] Therefore it is relevant to this discussion to examine the major criticisms the existing pre-pack systems in U.S. and U.K have received lest they should not replicate in India.

Firstly, pre-packaged plans have received criticism because it lets the business to be sold off to the corporate insiders.[71] In pre-pack negotiations, the control and management of the company continues to be in the hands of the erstwhile Board and the entire process is also driven by the existing management. This opens up the possibility of connected-party sales to the existing management, promoters, and the like. In U.K, concerns have been raised that pre-packs have given rise to unpleasant practices such as the one where the existing management buys back the business at prices lower than the market value.[72]

Secondly, in pre-packs, there is almost always a possibility of some creditors being left out without asserting their claims or were not

69 Sandra Frisby, *The Second-Chance Culture and Beyond: Some Observations on the Pre-Pack Contribution*, 3 LAW & FIN. MKT. REV. 242 (2009).
70 VANESSA FINCH, CORPORATE INSOLVENCY LAW: PERSPECTIVES AND PRINCIPLES 215 (2d ed. 2009).
71 Walton, *supra* note 36, at 114.
72 J. Moulton, The *Uncomfortable Edge of Propriety – Pre-Packs or Just Stitch-ups?*, 2 RECOVERY (Autumn) (2005).

provided with an opportunity to vote.[73] In the negotiation stage, the creditor's ability to participate is directly related to the ability to gain access to information.[74] Presently, in U.K, secured creditors have access to information by way of terms or warranties in the loan agreements.[75] They may be in an advantageous position because of this and hence a plan which serves their interests best might be the end result.[76] On the other hand, general unsecured creditors may not have the same access to information.[77] This may leave them out of the picture. This problem is particularly acute in U.K, as opposed to U.S. because, the entire process is unsupervised by the Courts while in the U.S, the Court can determine whether sufficient information was disclosed to all the creditors.

Thirdly, lack of objectivity, inclination towards the management, abuse of powers, and lack of accountability to creditors etc. are some of the major criticisms that the administrators have received for their role in pre-pack administrations in the U.K.[78] However, with the development in corporate governance and risk monitoring practices, stakeholders are at a better position to have timely information about the present and possible risks that the company will face.[79] The guidelines issued in U.K, such as, the Statement of Insolvency Practice to regulate the conduct of

73 Mark Plevin et al., *Pre-packaged Asbestos Bankruptcies – A Flawed Solution*, 44 S. Tex. L. Rev. 889, 903 (2003).
74 Vanessa Finch, *The Recasting of Insolvency Law*, 68 MOD. L. REV. 713, 722 (2005).
75 Finch, *supra* note 4, at 517.
76 Xie, *supra* note 36, at 76. .
77 Frisby, *supra* note 19, at 28.
78 S. Davies Q.C., *Pre-pack – He who pays the piper calls the tune*, SUMMER Recovery 19 (2006).
79 Finch, *supra* note 74, at 719.

administrators aim to ensure that the process is transparent and that a fair value is obtained.[80]

Fourthly, some critics have raised apprehensions that, in pre-packaged bankruptcies, the market may not be properly tested[81] in order to choose the best possible rescue mechanism and some interested parties may not be made aware of the sale.[82] As the negotiations happen in secrecy, whether the assets are sold at its maximum attainable value in the absence of market forces is doubtful. Further, in U.K it has been observed that administrators often settle for lower prices just to secure a buyer.[83]

Fifthly, the efficacy of pre-packs as an alternative informal insolvency arrangement, continues to be questioned. There are certain situations where the evidence has convinced a court that only a pre-pack can lead to wealth maximization,[84] but there is no convincing evidence that this is always the case. *Clydesdale Financial Services Ltd. v. Smailes* is an illustration where, the court ordered the replacement of the pre-pack administrator to carry out an independent assessment of the valuation of the business.[85]

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80 L. Conway, *Pre-pack Administration Procedure*, House of Commons-Briefing Paper No: 5035, 3 (Jan., 2017).

81 P. Walton et al., *Pre-Pack Empirical Research Characteristic and Outcome Analysis of Pre-Pack Administration – Final Report to Graham* Review, University of Wolverhampton (May, 2016)

82 VANESSA FINCH, CORPORATE INSOLVENCY LAW: PERSPECTIVES AND PRINCIPLES 81 (2d ed. 2008).

83 Davies Q.C., *supra* note 78, at 4.

84 *In Re*, Kayley Vending Ltd. [2009] E.W.H.C. (Ch.) 904 (Eng.).

85 Peter Walton, *When is pre-packaged administration appropriate? A Theoretical Consideration*, 20 NOTT. L.J. 11, 15 (2011).

Finally, pre-packs may not a viable option when there are a large number of creditors with sharply contrasting interests.[86] In those cases, formal bankruptcy procedure must be resorted to as there is little scope to reach an agreement.[87] Creditors in severely distressed cases, would wish to maximize their recovery and therefore the best option would be formal insolvency proceeding.[88]

7. PROPOSALS FOR REFORM

While countries such as U.K. and Singapore are moving forward to adopt a system that has the hues of the U.S. Chapter 11 Reorganization, India is taking a step back by insisting on extensively creditor-friendly and court-driven process of bankruptcy resolution.[89] This may seem to be inconsistent with one of the main objectives of the new reforms – *i.e.* rescuing the business of the entity as far as possible. This is likely to be detrimental to the emergence of start-ups in the country because the insolvency regime that completely takes away the business out of the control of its management even when the latter is not at fault is not likely to go down well with the new entrants.

In U.K, as pre-packs are not regulated by any legislation, suggestions have been made as to how the existing monitoring regime should regulate the pre-pack negotiations as well. Professional guidance,

86 S. Chatterjee et al., *Resolution of Financial Distress: Debt Restructurings via Chapter 11, Prepackaged Bankruptcies and Workouts*, 25 FINANCIAL MANAGEMENT 5, 7 (1996).
87 Armour, *supra* note 31, at 14.
88 *Id.*, at 13.
89 Varottil, *supra* note 55, at 34.

filing of a report at the end of negotiations to the monitoring body etc., are some of those suggestions.[90] Along these lines, the authors put forth that, the present legal regime governing insolvency and bankruptcy be amended adequately to accommodate pre-packaged bankruptcy settlements between creditors and the Corporate Debtor. How the regime governing pre-packaged bankruptcy should come about is explained below.

The IBC must be amended so as to give powers to the appropriate authority to approve, reject, and even modify a pre-packaged bankruptcy plan arrived at as a result of negotiations between the Corporate Debtor and its creditors, after satisfying itself that the pre-pack complies with certain conditions.

The relevant authority to be vested with the powers of approving or rejecting a pre-packaged bankruptcy should be the Insolvency and Bankruptcy Board of India (IBBI) for two reasons; firstly, the large number of pending IBC cases before the various benches of NCLT and; secondly, because IBBI is the authority which regulates the IRPs and hence can set the standards which the IRP has to comply with during the negotiations.

Unlike how a merger or combination with value above a prescribed threshold requires approval of the CCI, the authors are of the view that, at least at the present stage, every pre-packaged bankruptcy plan must necessarily get the sanction of the IBBI.

90 Finch, *supra* note 4, at 585.

The Corporate Debtor should necessarily appoint an Insolvency Resolution Professional from the pool of professionals regulated by the IBBI, to act as a mediator of the negotiations. This is in consonance with the model called 'integrated co-determination model of control' proposed by Hahn.[91] He has proposed that the negotiations of restructuring should commence without ousting the existing management and, a trustee should be appointed to the Board to oversee the process. Non-appointment of IRP should be a ground for rejection of the proposed plan.

Further, the corporate debtor should be able to bind the creditors under a forbearance agreement during the negotiations without any legal hindrance so that the holdout problem and litigation by dissenting creditors during the negotiations can be avoided.

The IBBI should lay down detailed guidelines regarding the standards to be followed by IRP while discharging duties as an administrator during the pre-pack negotiations. The duties would include ensuring that there is dissemination of information to the negotiating parties, valuation of assets by an independent valuer,[92] professional advice on the viability of continuation of business and on the restructuring plan etc. The IRP should be independent, objective, and impartial. The proposed plan should also necessarily consist of statement of reasons by

91 D Hahn, *Concentrated Ownership and Control of Corporate Reorganisations*, 4 J. CORP. L. STUD. 117, 147 (2004).

92 TERESA GRAHAM, GRAHAM REVIEW INTO PRE-PACK ADMINISTRATION: REPORT TO THE RT HON VINCE CABLE MP 48 (June, 2014).

the IRP for revival of the business.[93] Non-compliance with these standards should be considered sufficient grounds for objection to the proposed plan.

On the conclusion of negotiations, the plan is to be inspected by the IBBI to ensure that the conditions such as disclosure of information to creditors are met with. There should be a period of 30 days for a creditor or any other relevant person to file objections to the proposed plan. This is to ensure that unsecured and other creditors who were not party to the negotiations, can make their representations and have their claims satisfied.

Further, the parties concerned should submit an action plan for the next 12 months on how they intend to revive the business along with the pre-packaged plan.[94] Sales to related parties, existing management, promoters etc. should be permitted subject to the conditions that the terms of the transaction are ordinary and that the assets are valued at a fair market price by an independent valuer.[95] On satisfaction of these conditions, the IBBI may approve the pre-pack. In the event of rejection of the pre-pack by IBBI, CIRP or liquidation should commence. Further, if the business becomes distressed again any time in the next 12 months, there should not be an opportunity to choose pre-packs over CIRP.

What the authors have suggested is that, the system should be modified to recognize pre-packs under such circumstances where they may be successful in rescue of the business. The above proposed model

93 Insolvency Act, 1986, c 45, sch. B1, [49] (U.K.).
94 Graham, *supra* note 93, at 62.
95 Armour, *supra* note 31, at 16.

ensures that there is necessary court supervision to avoid subversion of creditors' interests and seeks to clearly define procedural requirements for a pre-pack thus enabling eligible managements to enter into such arrangements with the necessary legal recognition. Recognition of pre-packs would be a step towards promotion of speedy recovery of small businesses from bankruptcy. However, caution should be exercised so that such reforms do not eventually result in increased costs and delay induced by procedural technicalities.