CHAPTER 1

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Insolvency Defined

Insolvency refers to the inability of any legal person to discharge all the debts as they become due. It is the state or condition of having more debts (liabilities) than total assets which might be available to pay them, even if assets were mortgaged or sold.¹

Insolvency takes place when certain things happen, some of which may comprise of: mismanagement of cash, inflation in cash expenses, or reduction in cash flow. The detection of insolvency is important; as the creditors are empowered and entitled to exercise specific rights against the insolvent individual or organization. For example, the liquidating assets of the insolvent party may be used to pay off the outstanding debts. Prior to proceeding with liquidation process, it is common for the insolvent entity to meet with the creditor in order to attempt to arrange an alternative payment method.

Bankruptcy

Bankruptcy is not exactly the same as insolvency. Technically, bankruptcy takes place when a court has determined insolvency, and given legal directions for it to be resolved. Bankruptcy is a determination of insolvency made by a court of law with resulting legal orders intended to resolve the insolvency.² When the debtor is unable to meet his/her standing obligations, then such a situation is regarded as insolvency.³ Bankruptcy is a legal manoeuvre in which an insolvent debtor seeks relief.

³ ibid.
Companies’ insolvency

In context of companies’ laws, the word “insolvency” has neither been used nor defined in India. Sec.433 (e) of Companies Act, 1956 deals with a company, which is “unable to pay its debts”, and as a result of which constitutes a ground for winding up of the company. Inability to pay its debts would be a situation in which, a company’s entire capital is lost in heavy losses and no accounts are formulated and filed and no business is carried out for a year.4

Section 271(1)(a) of 2013 Act relates to the winding up by Tribunal on account of lack of ability to pay the debts, has now been omitted by Section 255 of the Code5. The same is now dealt by the Insolvency and Bankruptcy Code, 2016 by Sections 7 to 9 of the Code, being initiation of corporate insolvency resolution process by financial and operational creditors.

An application to the adjudicating authority (National Company Law Tribunal) for initiation of corporate insolvency resolution process can be made only when there is a “default” in payment of debt by a corporate person. In this regard, it is to be noted that the term “default” has been defined in the Code to mean non-repayment of a debt, whether whole or in part, which has become due and payable by a corporate person. This would suggest that, now under the Insolvency and Bankruptcy Code, 2016, insolvency resolution proceedings can be triggered even against a financially solvent company which has made a default in payment of its debts, since the same would fall within the ambit of “default” under the Code.

REASONS BEHIND INSOLVENCY

The main reasons behind insolvency are primarily poor management and financial constraints. This is much more prevalent in smaller companies. Specifically, the reasons are:

• Market – Company did not recognize the need for change.

• Management – incompetency to acquire sufficient skills, unwise accounting, lack of information systems • Finance – loss of long term finance, over regulating or lack of cash flow.

• Knock on effect – i.e. from other insolvencies.

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4 Dictionary of Accounting Terms for: liquidation; Available at:www.allbusiness.com/glossaries/liquidation/4942579-1.html [accessed on February 2016]

5 Insolvency and Bankruptcy Code,2016
• **Lack of experience in commercial operations**: Business was carried out in a way to increase risk.

• **Ignorance of business practices**: proper knowledge of even the most basic business practices is important. For e.g. entering into a contract by the corporate body, without being aware of contractual obligations is often a grave mistake.

• **Deficient resources to cover the costs of creating the business viable**: In order to be viable, some businesses require capital and time, and in many cases the business enterprise just doesn’t have them.

• **Excessive expenditure, usually while trying to build business**: Throwing money at business development can be fatal.

• **Failure of clients to pay money owing or to follow through on business projects**: One of the most common of all reasons for business failure is being dragged down by another failing business.

• **Competition**: Many businesses seriously underrate their competition, which results in business failure.

• **Impractical business ventures**: Very common, high risk ventures generally include costs to businesses which put the business in debt.

• **Financial management**: Even good businesses can be sabotaged by bad financial management.

• **Credit situations**: Borrowing money on the basis of future revenue is a typical reason for business insolvency.

Such state of insolvency can be cured by taking measures including:⁶

- Reconstruction of debts
- Revival and rehabilitation of sick industries
- Companies restructuring (includes merger and amalgamation)

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However even after resorting to the means mentioned above if the company cannot be revived then only resort should be made for liquidation and the creditors may file for recovery of their debts.

INSOLVENCY LAWS IN INDIA

The Parliament has the power to make laws with respect to any of the matters listed in List I (Union List) and List III (Concurrent List) of the Seventh Schedule to the Constitution of India, 1950 (“Constitution”). States also have the power to enact laws on matters listed in List III, besides List II (State List). In case of repugnancy, or conflict between laws made by the Parliament and State Legislature on a matter relatable to List III, the parliamentary law prevails.\(^7\) This is unless the State has sought presidential assent for its law, in which case it prevails in that state only.\(^8\) ‘Bankruptcy and Insolvency’ is an item specified in Entry 9 of List III. Entry 43 of List I deals with ‘incorporation, regulation and winding up of trading corporations, including banking, insurance and financial corporations, but not including co-operative societies’ whereas Entry 44 of List I deals with ‘incorporation, regulation and winding up of corporations, whether trading or not, with objects not confined to one State, but not including universities.’ Further, Entry 32 of List II deals with ‘incorporation, regulation and winding up of corporations, other than those specified in List I…’ While the entries in List I do not raise any issues regarding the Parliament’s competence to pass a law on such entries, the power of the State Legislatures to enact a law on a matter under Entry 32 of List II does not, in any matter whatsoever, affect the Parliament’s power to enact a law under Entry 9 of list III.\(^9\) The current legal framework governing the winding-up of companies is contained in the Companies Act 1956. The provisions contained in Chapter XX of the CA 2013 relating to winding up of companies have not been notified yet. The winding up proceedings under the Companies Act 1956, are carried out voluntarily (members’ voluntary liquidation, which is a liquidation procedure for solvent companies, and creditors’ voluntary liquidation), or compulsorily by the High Court. It may be noted that insolvency of a company is only one of the grounds for compulsory winding up a company.\(^10\)

\(^7\) Article 254(1) of The Constitution of India
\(^8\) Article 245(2) of The Constitution of India
\(^9\) “INTERIM REPORT OF THE BANKRUPTCY LAW REFORM COMMITTEE” ;Available at:<http://www.finmin.nic.in/sites/default/files/Interim_Report_BLRC_0.pdf> accessed on 5th march 2017
\(^10\) Ibid.
Even though Article 19 (1)(g) of the Constitution of India provides ‘freedom to practice any profession or to carry on any occupation, trade or business to the citizens of India’, there are restrictions on closure of any industrial undertaking. Such restriction is justified on the ground that it is in ‘public interest to prevent unemployment’\textsuperscript{11}. As a consequence of such rule there is liberty to start any industrial activity, but there is no liberty to exit.

The insolvency of companies in India is regulated by multiple laws. These are:-

- Companies Act, 1956
- Companies Act 2013
- Sick Industrial Companies Act(SICA,1985)
- The Recovery Of Debts Due To Banks And Financial Institutions (RDDBFI Act,1993)
- INSOLVENCY AND BANKRUPTCY CODE, 2016
- THE SICK INDUSTRIAL COMPANIES (SPECIAL PROVISIONS) REPEAL ACT, 2003 (SICA REPEALING ACT)
- ENFORCEMENT OF SECURITY INTERESTS AND RECOVERY OF DEBT LAWS AND MISCELLANEOUS PROVISIONS (AMENDMENT) ACT, 2016

\textsuperscript{11}Article 19(1)(g) of the Constitution of India. It provides for FUNDAMENTAL RIGHT TO PRACTISE ANY PROFESSION OR TO CARRY ON ANY OCCUPATION, TRADE OR BUSINESS