



THE IMPLEMENTATION OF PRE-PACK INSOLVENCY: WILL IT PREVAIL OVER CIRP TO FOSTER THE GROWTH OF MSME's

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Abstract:

With the advent of COVID-19, many small-scale businesses suffered due to nation wide lockdown. Those who are not able to discharge their liability are anticipating Insolvency Applications filed against them by the creditors. As we move closer towards normalcy, the Insolvency Board is planning to enact a new mechanism known as "Pre-Pack Administration". The model is introduced to protect and balance the rights of the Debtor-Creditor relationship and to reduce the burden from the judiciary. The paper seeks to analyse whether the pre-pack model would be able to protect small-scale business better than Corporate Insolvency Proceedings.

Keywords:

Pre-Pack, Speedy Resolution, MSMEs, Corporate Insolvency Resolution Process, Value Maximisation.

Introduction:

It has almost been a year since the nation entered into a "Lockdown", a complete closure of all the activities except the healthcare and food sector. Everything came to a halt, business cycles were disturbed, people lost their livelihood, Business houses went bankrupt and every individual surviving through the pandemic was scared for his/her life. Survival through the year was given more importance than anything else. However, what did not stop was the spread of the Novel Coronavirus and it resulted in the lockdown being extended. The disruption caused due to the extended lockdown was even bigger but now it was the new normal. People accepted the change and moved on wearing masks and using sanitizers cause eventually bread is to be earned. Therefore, when a nation of 1.3 billion people was locked down people were finding it difficult to earn their livelihood. For the first couple of months several small and medium size companies were unable to carry out their business activities and had to bear a huge loss. It was anticipated that such a situation might lead to large-scale filing of Insolvency Proceedings against business entities who defaulted on discharging their debts¹. This might hamper the corporate sector of India and thus urgent reforms were needed in the Insolvency and Bankruptcy Code to safeguard Corporates affected by COVID-19. In order to prevent such possibilities, the Government of India quickly moved various ordinances immediately after imposing a lockdown in the Country.

Before moving to the reforms brought by the Government in the Insolvency and Bankruptcy regime to help enterprises overcome this pandemic situation, it is important to understand the objective and purpose of the Code. The objective of the Code² is to enact laws pertaining to the restructuring of the insolvent companies by passing

¹ Dr. M.S Sahoo, *Insolvency Law in the Times of COVID-19*, Insolvency and Bankruptcy Board of India (April 01, 202011:15 PM), <https://www.ibbi.gov.in/uploads/resources/19f5dd1867e29b404046912df2b065f8.pdf>.

² Insolvency and Bankruptcy Code, 2016.

appropriate resolution plans, seek to maximise the value of the assets, to promote entrepreneurship amongst the people and to make the credit available to the corporates. Analysing the objective of the Code, it is clear that this code was brought by the Government to promote corporate growth in India by demotivating liquidation of companies. Liquidation should always be the last option available to the stakeholders and they should seek to revive the company in most cases. Keeping in mind the objective and the purpose of the code, the Government of India has brought many reforms to protect, especially small and medium enterprises.

The government of India took various legal measures after several countries like the United Kingdom, Australia and the U.S.A initiated solvency recourse³. In order to respond to COVID-19 the government has taken certain precautionary measures like Moratorium on Bank loan repayment, Infusion of funds in the Banking sector to provide funds to distressed firms⁴. Increasing the threshold limit of minimum default to file an application from 1 lakh to 1 crore⁵ to prevent micro and small scale industries from being punished in the pandemic. The Debt on small enterprises is not usually in crores. The intention to increase the threshold from 1 Lakh to 1 crore was to protect small businesses from the Insolvency Applications filed against them. One of the major steps amongst all the amendments was to suspend the filing of Insolvency Proceedings amid COVID-19 initially was brought for 6 months from the 25th March 2020 but was extended till 25th March 2021⁶. While analysing the amendment post pandemic, the core objective of the Government is to protect the enterprises from the discharging their liability in a stressed market environment.

One such reform in the Insolvency Regime was introducing “**Pre-Pack Insolvency**”.

The Insolvency Board released a report on Pre-Pack Insolvency after various scholars from around India deliberate on the subject matter. The report was finally released on 8th January 2021⁷.

Will the Pre-pack foster the growth of MSMEs:

Before analysing the subject matter it is important to understand how much COVID-19 has affected the MSMEs. With little reserves and a heavy debt on the shoulders, it was difficult for MSMEs to tackle the nation wide lockdown and sustain for a longer duration in the market. The average contribution of MSME from 2014-2019 has been around 30% of total India's GDP. That is nearly 1/3rd of the total GDP, and thus it is considered to be the backbone of our country. MSME has been the most affected sector in the Indian Industry. According to the International Labour Organisation, around 400 million workers in the informal economy are at the risk of losing their potential job and entering into the poverty zone⁸.

Now the real question is, will the implementation of Pre-Pack Insolvency foster the MSMEs?. According to the Black Law Dictionary Pre-Pack Administration is defined as “an arrangement under which the sale of all or part of a company's business or assets is negotiated with a purchaser prior to the appointment of an administrator, and the administrator effects the sale immediately on, or shortly after, his appointment”. In simple terms means an informal option adopted by the creditor and the debtor to come to a resolution plan and immediately moving the said plan to NCLT for its approval.

The total number of Corporate Insolvency Proceedings filed in NCLT in the month of 2019 itself was 1802⁹. With the advent of IBC,2016 there has been a steep rise in the number of applications filed in NCLT. One can imagine the situation post COVID-19 when the entire nation was locked and small enterprises were finding it difficult to raise capital to discharge their debts. Considering the above mentioned problem, there was an urgent need to introduce a mechanism which will not only help MSME tackle COVID-19 but also help them regain their position in the market after the Insolvency Proceedings are over.

³ Cyril Shroff & Dhananjay Kumar, *Indian Insolvency Law responds to the COVID-19 pandemic*, Cyril Amarchand Mangaldas Blogs (April 1, 2021, 1:26 PM), <https://corporate.cyrilamarchandblogs.com/about/>.

⁴ Policy Environment, Reserve Bank of India (April 1, 2021, 2:30 PM), <https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/5POLICYENVIRONMENT52C8F7F3A9734DDC9B6EE6C22232CF3D.PDF>.

⁵ Pallav Palit, Lalitendra Gulani, Shreya Bhojnagarwala, *Increased IBC Default Threshold – Prospective or Retrospective?*, Law Street India (April 2, 2021, 11:05 AM), <http://www.lawstreetindia.com/experts/column?sid=509#:~:text=Now%20the%20threshold%20which%20the,1%20crore%20rupees%20by%20notification>.

⁶ Gurmukh Choudhri, *Section 10 A Of The Insolvency & Bankruptcy Code, 2016 / Dispensable Or Indispensable?*, Mondaq (April 1, 2021, 2:43 PM), <https://www.mondaq.com/india/insolvencybankruptcy/1038454/section-10-a-of-the-insolvency-bankruptcy-code-2016-dispensable-or-indispensable>.

⁷ See Report of the Sub-Committee of the Insolvency Law Committee on Pre-packaged Insolvency Resolution Process, <https://www.ibbi.gov.in/uploads/whatsnew/34f5c5b6fb00a97dc4ab752a798d9ce3.pdf>.

⁸ ILO Monitor: *COVID-19 and the world of work. Second edition*, International Labour Organization (April 2, 2021, 4:31 PM), https://www.ilo.org/wcmsp5/groups/public/---dreports/---dcomm/documents/briefingnote/wcms_740877.pdf.

⁹ IBC: *A Code for Corporate Governance*, Insolvency and Bankruptcy Board of India (April 2, 2021, 4:46 PM), <https://www.ibbi.gov.in/uploads/whatsnew/e4e03c8ac9dc4441c79718f12283e8c8.pdf>.

The Pre-Pack model was introduced so as to wind-up the entire process of Insolvency Proceedings as soon as possible. It seeks for a rapid resolution of the Insolvency Plan. This will lead to retention of maximum value of the assets the company owns. It is a well established fact that the value of assets depletes by wear and tear, thus it becomes necessary for a company to adjudicate the matter as soon as possible for the normal functioning of the company. Had this been the other way round where MSMEs had to comply with the Corporate Insolvency Resolution Proceedings, it would have taken 180/270/330¹⁰ days to wind-up the whole process this might become a stressed asset for a company. Distressed assets have a very little time, one needs to get rid of such assets as quickly as possible. With speedier resolution, the market value of such assets are not affected, thus giving the company maximum value out of the sale. This will minimise the chance of winding-up of the company significantly. It has been observed that in the U.S.A the pre-pack insolvency takes merely two to four months to complete the whole resolution process¹¹. Such a speedy mechanism helps the company to settle the dispute quickly and with less cost as compared to formal CIRP. Time taken to complete CIRP under Insolvency and Bankruptcy Code is 180/270/330 days¹². With such a prolonged period taken to complete the process, it leaves little but no room for small enterprises to bounce back on their normal condition.

Another advantage of Pre-pack which can lead to the growth of MSMEs is the fact that ownership is not handed over to the Resolution Professional¹³. Most start-ups are based on innovation and creativity. The owner of the company knows the business of the company better than anyone else. Thus, they are considered to be the most capable people to manage and plan the growth of any company. The formal option of CIRP mandates the Resolution Professional to take over the management of the company facing Insolvency¹⁴. At times, the professional might not possess enough knowledge and skills to run the business. This might hamper the growth of a company while undergoing Insolvency Proceedings.

One of the most important issues addressed by the Pre-Pack is the cost incurred¹⁵. Corporate Insolvency Proceedings are generally time-consuming and incur a huge cost on the company undergoing CIRP. The Pre-Pack insolvency is designed in such a way that it will incur very little cost on the Insolvency Proceedings thus proving a cost-efficient mechanism for the MSME companies. The absence of IPR/RP in the Insolvency Proceedings makes it way cheaper than the formal CIRP. Section 5(13) of IBC, 2016 along with Regulation 31 of the Insolvency and Bankruptcy Board of India Insolvency Resolution Process for Corporate Persons) Regulations, 2016 has defined what is 'Insolvency Resolution Cost'. There are four costs out of nine which pertain to IPR/PR. This makes the entire CIRP unfavourable for MSMEs to proceed with Formal Insolvency Proceedings.

The very fact that courts are not involved in the entire proceedings is one of the ways through which the start-up company can save-up on their cost. Dragging the judiciary into the proceedings makes it lengthy and time consuming. It also leads to the creation of more and more stressed assets, which ideally should not be the case. The start-up company should always focus on getting the insolvency proceedings done as soon as possible¹⁶ and thus adopting the pre-pack model will help the start-up to preserve their innovation and grow in the market in the near future. This is probably the most important factor for a company to choose pre-pack insolvency as compared to the normal insolvency proceedings.

The pre-pack providing speedy resolution and being cost efficient can prove to be beneficial for the start-ups as they always seek to reduce the cost and increase profits. Given the structure of a start-up company is not so intricate it will be easy for both the Corporate Debtor and Financial/Operational Creditor to decide on restructuring the stressed assets and thinking of ways to clear the default. The intricacies of formal CIRP may not be suitable for companies with simple structure and low profits. The Pre-Pack mechanism offers MSME a more suitable way of settling down the debt.

The report of the Pre-pack also suggested an alternative to safeguard the rights of MSMEs and that is to build more benches of NCLT to reduce the burden on the court¹⁷. Though these two points are quite different, they are indirectly related to each other. Post COVID-19 it is also anticipated that with the rapid downfall of businesses in India and with normalcy being restored, the tribunals might receive Quantities of Insolvency Applications. Infact with a steep rise in the cases of application, the

¹⁰ Insolvency and Bankruptcy Code 2016 § 12.

¹¹ Norman N. Kinel, *The Ever Shrinking Chapter 11 Case*, Restructuring Global View (April 3, 2021, 5:15 PM), <https://www.restructuring-globalview.com/2018/08/the-ever-shrinking-chapter-11-case/>.

¹² *Supra* note 10.

¹³ *Supra* note 7.

¹⁴ Insolvency and Bankruptcy Code 2016 § 23.

¹⁵ *Supra* note 7.

¹⁶ Jo Windsor & Rebecca Jarvis, *A guide to "Pre-Pack" sales*, LinkLaters LLP (April 3, 2021, 5:34 PM), <https://www.linklaters.com/pdfs/mkt/london/A13446736.pdf>.

¹⁷ *Supra* note 7.

judiciary will take more time to pronounce the order. The delay in pronouncing the judgment might depreciate the value of assets over time. And with less value for the same asset, the company may find it difficult to discharge the liability and might end up getting liquidated. The Pre-Pack mechanism helps the court to tackle the anticipation. Thus, by establishing more number of NCLT benches and proper implementation of Pre-Pack, the work on the judiciary's shoulders will be evenly distributed and the judiciary will be able to pass orders in time.

The last stage of Pre-Pack refers to 'getting approval from NCLT once the pre-pack resolution has been decided'¹⁸. Getting the approval from the tribunal makes the pre-pack binding on the Creditor and the Corporate Debtor. The above mentioned provision has been taken from the USA Insolvency Code. Once the pre-pack plan is sanctioned by the tribunal, it is not subjected to any kind of alteration. Such a step ensures that neither party to pre-pack shall take any undue gain of non-compliance. It also reposes confidence in the investors¹⁹.

Another prospect of Pre-Pack which has been observed in the UK and USA model is Retaining of Jobs. The reports on Insolvency stated that commencement of CIRP puts the company in an unhealthy position leading to loss of potential customers and investors. With company's commencing pre-pack at a very early stage (possibly prior to creating a distressed asset) it helps in cost cutting of the company and leads to preserving the jobs. Various studies carried by the report suggested that many companies who opted for pre-pack in the United Kingdom were able to retain 100% of its employment. Only around 4% of the pre-pack showed no retention of employment because of the fact that the businesses had already been shut-down prior to commencement of the Insolvency Proceedings²⁰.

Conclusion:

While analysing the analytical jurisprudence of Pre-pack insolvency it is evident that pre-pack has proved to be a helping hand for companies who are on the brink of getting liquidated/ facing insolvency proceedings. With its own pros and cons, the mechanism needs to be balanced from the Debtor-Creditors point of view. In the United Kingdom itself, one-third of the administration involves pre-pack mechanisms²¹. This stat proves that the Pre-pack model even with its own cons, if implemented successfully can do justice to the Debtors Company.

The analogy of Pre-Pack is the same as what arbitration is to Litigation. With the growing market in such a fast-moving economy, there is a need for a mechanism to hasten the resolution process to bring back the company to its original state of business. While the Indian Laws strives towards bringing amendments to cater for the need of the Industries, The Pre-pack model suggested by the Insolvency Board might inculcate the model in the legislation like that of the United Kingdom and the U.S.A²².

While COVID-19 continues to haunt small businesses, the government might propose a tax rebate/exemption for MSMEs. Increasing the threshold limit of capital requirement in the definition of MSME will bring more number of enterprises in the domain of MSMEs. The step will render benefits to the maximum number of enterprises who are in need of it.

¹⁸ K.R. Srivats, *Now, a pre-packaged insolvency process for MSMEs*, Business Line (April 5, 2021, 5:52 PM), <https://www.thehindubusinessline.com/companies/msme/now-in-india-a-pre-packaged-insolvency-process-for-msmes/article34242211.ece>.

¹⁹ Otihjya Sen, Shreya Prakash & Debanshu Mukherjee, *Designing a Framework for Pre-Packaged Insolvency Resolution in India / Some Ideas for Reforms*, Vidhi (April 4, 2021, 6:00 PM), <https://vidhilegalpolicy.in/wp-content/uploads/2020/02/Report-on-Pre-Packaged-Insolvency-Resolution.pdf>.

²⁰ *Supra* note 7.

²¹ *Supra* note 16.

²² Dr. Binoy J. Kattadiyil & Prashant Kumar, *FUTURE PATH FOR PRE-PACKAGED INSOLVENCY RESOLUTION IN INDIA*, 9 *INTERNATIONAL JOURNAL OF MULTIDISCIPLINARY EDUCATIONAL RESEARCH* 19, 23 (2020).