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Pre-Pack Insolvency Resolution Process
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The advent of the Insolvency and Bankruptcy Code, 2016 ("**IBC**") has led to a transformative turnaround in the corporate distress resolution framework of India. It has given a new lease of life to a Company whose fate was earlier dependent upon a plethora of debt restructuring schemes introduced in the past, the failures of which often resulted in the Company being relegated to winding up proceedings or being stuck with a situation of sitting over unproductive assets whose value depreciated with time.

In the Indian context, most of the organizations are largely promoter driven and presently IBC under Section 29A bars the Company management and its related parties, responsible for pushing the Company into insolvency, to regain control over the business of such companies. This results in creating a situation of imbalance which can be best addressed through Pre-Pack schemes.

Pre-pack is a scheme where the debtor negotiates with the creditors to remain in the business and keep its operations as a going concern. For a situation where a Company is going into insolvency because of macroeconomic disturbances and not because of fault in the management, then it would be practical alternative to allow the promoter to resuscitate its Company as he is very much aware of the dynamics and operational difficulties. Pre-Packaged scheme being the latest step in the evolution of the statute aims at blending various corporate restructuring tools such as sale of assets of the debtor to another company, refinancing and interim financing, change in management etc. before the debtor goes into insolvency proceedings under IBC.

The Interim Report of The Bankruptcy Law Reform Committee, February, 2015 debated over the viability of the Pre-Pack scheme and opined that pre-pack schemes are not a workable mechanism for insolvency resolution as the Indian markets does not have infrastructure to allow 'out of court' restructuring without intervention of the court. However, thereafter, the Government as well as the Regulator i.e., IBBI looked into introducing Pre-Pack schemes, more so in light of Covid-19 pandemic which was compiled into a Report by the Sub-Committee of the Insolvency Law Committee on Pre-Packaged Insolvency Resolution Process dated 31.10.2020.

A pre-pack can be explained as a kind of restructuring plan, which is agreed to, by the debtor and its creditors prior to the insolvency filing and then sanctioned by the court on an expedited basis. The existing management normally remains in charge till the final agreement is agreed upon. The informality of the process is aimed at a faster resolution of the distressed corporations. It is a fusion of the formal and informal insolvency Process and may be applied even in advance than a default. The management of a Company is undoubtedly aware about the probable stress which a Company may face and thus, can propose a scheme at the inception which, most often than not, shall result in both preservation of value and maximization of asset values of a company.

Background

In the context of possible rise in corporate and individual insolvencies as an aftermath of the COVID-19 pandemic, the economies are presented with a challenge to keep themselves afloat. The World Bank and the International Monetary Fund have suggested various measures and the implementation of the same in a three-phased approach may help the economy transition smoothly towards the positive side of the graph. In the first phase, copious interim measures need to be taken to halt insolvency and debt enforcement activities. In the second phase, when a huge wave of insolvencies is anticipated, it may be addressed by transitional measures, such as special out-of-court workouts, to 'flatten the curve' of insolvencies. The third phase calls

for regular debt resolution tools to address the remaining debt overhang and support economic growth in the medium term.

In response to this, Governments have rolled out certain measures such as moratorium on loan repayments, sector specific forbearance, infusion of liquidity into the banking system to provide credit to financially distressed firms, relief in asset classification banking norms, flexibility in director's obligations to initiate insolvency proceeding and suspension of filing of insolvency proceeding by the creditors. The Government has increased the threshold of default for filing of an insolvency application from Rs. 1 lakh to Rs. 1 crore to protect the interest of the MSME's from being pushed into insolvency proceedings.

Pre-Packs in the above background gained prominence and the Ministry of Corporate Affairs released the draft on the proposed Pre-Pack scheme.

Highlights of the Draft Proposal as Released by Ministry of Corporate Affairs

The pre-pack scheme is an out of court settlement between the creditor and the debtor, where the debtor will play a far greater role as compared to Insolvency Process as provided under IBC. An application for a pre-pack can only be initiated by the Debtor, though the initiation would also require approval of a simple majority in value of the unrelated financial creditors. In case of absence of unrelated Financial Creditor, simple majority of shareholders' unrelated operational creditor, can approve the initiation with above mentioned requisite majority. The Draft scheme proposed by MCA also clarifies that no parallel proceeding under insolvency proceedings provided in IBC and Pre-pack can be initiated against the Company. Pre-packs support the debtor in possession in contrast to the creditor in control approach enshrined under the IBC. However just like insolvency proceedings under the IBC, the important decisions of the business of the Company require approval of the Financial Creditors.

The role of Resolution Professional is similar to the role of Insolvency Professional in Insolvency Proceedings under IBC to an extent and the Resolution Professional in pre-packs comes into picture after the initiation of the process. Pre-pack process is ought to be completed in 90 days and thereafter 30 days is given to the Adjudicating Authority to reject or approve the resolution plan. Before the resolution plan is submitted to the AA for its approval the same has to be approved by the CoC by a majority of not less than 66% and in case no resolution plan is accepted by the CoC, an increased threshold of 75% is required to liquidate the Company.

A widespread concern about pre-packs has been whether confidential nature of the process provides for sufficient transparency and enables value maximization by allowing a wide range of participants to submit bids. The Draft Scheme has provided for the concept of a 'Swiss challenge' to mitigate this shortfall. As per the Swiss challenge, the Company may submit the bids at first instance, but in case the bid submitted by Company impairs the rights of certain class of creditor (operational creditor), a third party may be allowed to submit its bid, which protects the interest of all the creditor. A second chance to the Company will also be provided to match up to the bids of the third party, in the event the same is not achieved, the bid submitted by third party will be approved.

Analysis of the Draft Proposal as Released my Ministry of Corporate Affairs

1. Treatment/Rights of Creditors other than Financial Creditor- The Pre-Pack in terms of recommendations of the sub-committee of Insolvency Law Committee which has been circulated in the public domain envisages a similar mechanism of settlement of dues of all creditors in terms of decision of the Financial Creditors with the requisite majority. Since Pre-Packs are largely informal mechanisms, the process of eliminating the claim of other Creditors appear to be harsh towards such creditors. Creditors other than Financial Creditors accordingly, can be considered as outsiders without their specific consent.
2. Process of appointment of Resolution Professional: The draft proposal provides that the choice of Insolvency Professional to act as Resolution Professional, and the terms of his appointment may have consent of majority unrelated Financial Creditor and such Insolvency Professional may be appointed as Resolution Professional by the Adjudicating Authority.

   The process of Resolution Professional's approval by the Adjudicating Authority at the threshold, may provide practical result with some delays owing to the fact that the Adjudicating Authorities are

overburdened. The Adjudicating Authority in the proposed model will be involved in two stages; first, at the time of appointment and secondly, for approval of the resolution plan. This itself would be counter-intuitive to the basic essence of the pre-pack process which provides minimal role of the Adjudicating Authority and ensure timely resolution.

Thus, the appointment of the Resolution Professional directly by the CoC with the consent of the requisite majority should be considered instead. When the resolution plan application is pending before Adjudicating Authority, the same would limit the role of Adjudicating Authority to a single application for approval of the Resolution Plan.

3. Transparency: The success of Pre-Packs shall greatly depend on the transparency with which the existing management works coupled with the role played by the Resolution Professional. The approach of both the creditor and the debtor to operate in the best interest of the company is required to be ingrained in the working of various stakeholders.
4. Bar of Section 29A: The draft envisages continuance of bar of section 29A in case of pre-packs. This proposition also deliberated upon, did not find favour amongst majority of members of the committee. This may restrict the pool of probable Resolution Applicant and also at times, disincentivize management driven Pre-Pack for companies.
5. Approval of the Adjudicating Authority/ NCLT: Under the draft Pre-pack, the Resolution plan does not attain finality, even after the consent of 66% of the Financial Creditors, until the Adjudicating Authority/ NCLT approves it. Such approvals are not only time consuming but also results in an element of uncertainty being cast on the process of the entire pre-pack scheme. Such an element of uncertainty gravely prejudices the success of a Pre-Pack.

Conclusion

Pre-Packs, to work more efficiently, pre-supposes co-operation among different classes of creditors and debtors. Unlike the Insolvency Proceedings under IBC, the promoters will continue to be in control of the business during the pre-pack discussion and if they fail to provide necessary information related to the scheme and valuation of the assets to the creditors (even though a criminal liability has been provided in the draft scheme), the pre-packs scheme would be hapless and would serve no purpose to the creditors, particularly operational creditors. As this arrangement usually works with the consultation of the management of the Company, it gives reverence to the interest of debtors and secured creditors before operational creditors. Consequently, the success of Pre-Packs has direct co-relation to the role played by the participants of the process- Management, Financial Creditor, Resolution Professional and the Adjudicating Authority. The entire economic business culture of both the Company and creditors are required to be aligned to fulfil the object of introducing pre-pack i.e., resolution at the nascent stage with value maximisation. The Pre-Packs are required to have adequate checks and balances throughout the process. The asymmetry of information i.e., titled towards the management, requires complete disclosure with strict consequences in cases of any wilful suppression. The related party and/or connected party sale/alienation of assets at deeply discounted prices warrants highest possible conducts of the Resolution Professional to meet the probable challenges. However, given the nature of Pre-Packs, the same can be a successful tool in the armour of the creditors to resolve financial stress of companies specifically group companies through a unified mechanism.