Chapter 4

Corporate Insolvency Law in India: Provisions and Effectiveness

Yogendra Nath Mann
Dr. Gaur Hari Singania Institute of Management and Research, India

Kavindra Nath Mann
Bank of India Staff Training College, India

ABSTRACT

The 2008 financial crisis was followed by a global economic downturn, a credit crunch, and a reduction in cross-border lending, trade finance, and foreign direct investment, which adversely affected businesses around the world. The consequent increase in the number of firm insolvencies in the corporate sector highlights the need for commercial bankruptcy laws to liquidate efficiently unviable firms and reorganize viable ones, so as to maximize the total value of proceeds received by creditors, shareholders, employees, and other stakeholders. India’s weak insolvency regime, its significant inefficiencies, and systematic abuse are some of the reasons for the distressed state of credit markets in India today. The Code promises to bring about far-reaching reforms with a thrust on creditor driven insolvency resolution. It aims at early identification of financial failure and maximizing the asset value of insolvent firms. The Code also has provisions to address cross-border insolvency through bilateral agreements and reciprocal arrangements with other countries.

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INTRODUCTION

In legal terminology, Insolvency is the situation where the liabilities of a person or firm exceed its assets. In practice, however, insolvency is the situation where an entity cannot raise enough cash to meet its obligations, or to pay debts as they become due for payment. Properly called technical insolvency, it may occur even when the value of an entity’s total assets exceeds its total liabilities. Mere insolvency does not afford enough ground for lenders to petition for involuntary bankruptcy of the borrower, or force a liquidation of his or her assets.

The Difference Between Insolvency and Bankruptcy

Many people often mix up the terms “insolvency” and “bankruptcy,” assuming them to mean the same thing. However, these two words, though similar, actually have different meanings. Simply speaking, insolvency is a financial state of being – one that is reached when you are unable to pay off your debts on time. Bankruptcy, on the other hand, is a legal process that serves the purpose of resolving the issue of insolvency.

Insolvency

Insolvency is essentially the state of being that prompts one to file for bankruptcy. An entity – a person, family, or company – becomes insolvent when it cannot pay its lenders back on time. In general, this occurs when the entity’s cash flow is falls below its cash flow out. For individual debtors, this means that their incomes are too low for them to pay off their debts. For companies, this means that the money flow into the business plus its assets are less than its liabilities.

Typically, those who become insolvent will take certain steps toward a resolution. One of the most common solutions for insolvency is bankruptcy.

Bankruptcy

Bankruptcy is a legal declaration of one’s inability to pay off debts. When one files for bankruptcy, one obliges to pay off what is owed with help from the government. In general, there are two main forms of bankruptcy – reorganization and liquidation bankruptcy. Under reorganization bankruptcy, debtors restructure their repayment plans to make them more easily met. Under liquidation bankruptcy, debtors sell certain assets in order to make money they can use to pay off their creditors.
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