CAPITAL INFUSION AND DISTRIBUTION OF ASSETS IN A COMPANY: COMPANY LAW AND INSOLVENCY AND BANKRUPTCY CODE 2016

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INTRODUCTION

The Company Act 2013 is one of the biggest legislations and indeed very hard to grab because of the dynamism in corporate world. This legislation changes with every new development. Insolvency and Bankruptcy is one such development.

Insolvency and Bankruptcy Code (IBC) is an important legislation due to various reasons but one amongst them is the inter relationship of the said law with the Companies Act.

If Companies Act 2013 were to be seen independently, then the law contains provisions for, from the incorporation to the winding up of a company. The law is a substantive as well as procedural legislation. The act deals with the different facets of the company from its management, audit, mergers, and meetings till the closure of company business as winding up.

A company undoubtedly needs funds to initiate business and further to run business. A very famous saying among businessmen is "If one wants to do business, do with others people's money and not with yours"

Under Companies Act 2013, provisions are made for both (a) public and (b) private company to raise funds, however the modality certainly varies. If a company is listed, capital can be raised from equity finance and debt finance. In a case where the company is a private company the capital can be floated through the route of private placement. Thus the ways or modes may be different but participation of outside party is facilitated to raise funds and carry on the business. If a person invests in a company through equity finances instruments, he is a shareholder or owner of the company to the extent of his share. On the other hand if a person is investing in company through debt finance instruments then he will be a creditor of the company and as such is eligible for fixed returns.[1]

The Insolvency and Bankruptcy Code 2016 is enacted for the purpose of maximization of value of assets. Now the question arises: assets of whom, then the answer is assets of the company. Another question on the way is what constitute the assets of the company and how they will be appropriated so as to fetch the maximum value and address the interest of all the stakeholders.

The interrelationship of classification of assets and then realization of assets so as to fetch maximum value has to be assessed while reading both statutes together. Companies can raise capital in two ways, through debt or equity. Debt must be paid back regardless of the firm's financial situation, but it generally costs less to obtain after tax incentives. Equity gives up ownership but does not need to be paid back.[2]

The author in the present article has tried to summarize different modes of capital inclusion in a corporate along with the relevant laws applicable on the various financial instruments. This article delves into the issues or challenges which the Insolvency legislation is facing in India due to dynamics of investments. Part I of the article deals with several instruments recognized in India through which capital may be infused in any corporate.

Part II of the article deals with provisions of the Insolvency code with special focus on realization of assets.

Part III deals with challenges in the interpretation and balancing of rights of various stakeholders. Part IV concludes.

FINANCIAL INCLUSION IN A COMPANY

A company invariably needs finance to run the show. The finance can be raised in various ways. As Philip curve shows an apparently statistical relationship between inflation and

[1] Bahrati V pathak, Indian Financial Syaytem.
[2] Available at https://www.investopedia.com/terms/c/convertiblepreferredstock.asp

unemployment[3]. If the flow of finance is regular and continuous the company, will grow and expand, which will ultimately lead to generation of employment opportunities and strengthen the economy of a country. As in financial theory and so in macroeconomic theory, the guiding room was an ideal world with perfect liquidity.[4]

There are three concepts:

One is capital, second is finance and the last one is investment. Capital is source of funds, while investment is deployment of funds. Capital is shown in the liabilities side of the balance sheet, but Investment will be on the asset side of the balance sheet.[5] As per financial terminology Capital is a term for financial assets or their financial value as well as the tangible factors of production including equipment used in environments such as factories and other manufacturing facilities and investment is An investment is an asset or item acquired with the goal of generating income or appreciation. Capital account represents the paid up capital of share, reserve and surplus.[6] Capital is a word carrying different meanings in itself[7].

Finance is a study of money. The study of, nature, components and essentials of money are covered under study of finance.[8] When we talk of finance, a company can procure finance from within the country as well as outside the country. Whenever Finance is procured it will be termed as raising credit in economics and as Ralph Hawtrey states, "credit has inherent instability".

IMPORTANCE OF THIS STUDY

Whenever a topic is researched, first step is to know its scope or ambit. The scope can be traced by its importance. A credit has two sides as one's cash inflow will be another person's cash outflow. Now credit allures one to spend more, then one spend will induce somebody somewhere simultaneously to spend more on production. The inherent instability and

[3] Perry Mehrling, "The new Lombard Street: How the fEd became the dealer of last resort", Princeton University press, Pg 88
[4] *Ibid* Pg 90
[5] Available at https://www.enotes.com/homework-help/difrence-betwwn-invesment-capital-405980
[6]Available at https://www.enotes.com/homework-help/difrence-betwwn-invesment-capital-405980
[7] Paul L. Davies & Sarah Worthington, "Gower Principles of Modern Company Law", 10th Ed, Pg 256.
[8] Vasant Desai, "the Indian Financial system and development" Pg 9

continuous flow has raised immediate necessity to have an authority or regulator who can regulate the market of credit so that the flow is continuous and inherent instability will not fickle the market so as to have an adverse effect on the economy. With this notion in mind the concept of central bank came and in India we call it Reserve Bank of India (RBI in short hereinafter). In India the market is divided in form of money market and capital market to raise finance.

a. **Money market**: This market is further divided into organized and unorganized money market. Unorganized market here does not involve illegal or any unlawful activity. The word unorganized only relates to regulation of market. The market of lending money which does not fall under ambit of RBI is called as unorganized.[9] Money in India is a successor of barter system. The RBI is a regulatory authority on Banking Financial Institutions and non-banking financial institutions. These Financial institutions lend money to company in form of loan which is known a credit. The credit in turn can be secured by some security in form of movable or immovable property or both at one time or different times. This is called as a secured credit and vice versa is an unsecured credit. Now as the finance is changing every day, the modes of lending credit have taken new folds in form of consortium lending where more than one bank join together and collectively extend credit.[10]
b. **Capital Market:** The word Capital with reference to company has limited interpretation. Capital is the total value of assets contributed by its *shareholders.* Thus money received by a company in any way for investment in business operations constitutes its capital.[11] One always takes the value of assets in consideration rather than its form, because during course of time assets will change its form according o the changing needs of company. According to F. Livingston defined the capital market as "In a developing economy, it is the business of the capital market to facilitate the main stream of command over capital to the point of the highest yield. By doing so it enables

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[9] Available at http://www.economicsdiscussion.net/essays/essay-on-the-indian-money-market/18073 . The essay discuss about discuss about the Indian Money Market: 1. Structure of Indian Money Market 2. Characteristics and Defects of Indian Money Market**.**
[10] https://www.lexology.com/library/detail.aspx?g=97bda548-e1f9-42e4-ba3d-73633083715f
[11] Paul L.Davies & Sarah Worthington, "Gower Principles of modern Company Law", Sweet &Maxwell(2016) @nd Edition, Pg 256.

control over resources to pass into hands of those who can employ them most effectively thereby increasing productive capacity and spelling the national dividend".[12]

INSTRUMENTS OF MONEY MARKET

The money market as already stated is unorganized also. In unorganized market mainly shroffs and money lenders operate. As it is unorganized, framing out a structure or tools is beyond the scope of this article. As far as organized money market is concerned, the various constituents of this market is stated herewith.

- **(i) Call Money Market[13]**
- **(ii) Treasury Bill Market[14]**
- **(iii) Commercial Bill Market[15]**
- **(iv) Certificate of Deposit (CD) Market[16]**
- **(v) Commercial Paper Market[17]**

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[12] Available at http://shodhganga.inflibnet.ac.in/bitstream/10603/33042/11/11_chapter%201.pdf

[13] Call money is money loaned by a bank that must be repaid on demand. Unlike a term loan, which has a set maturity and payment schedule, call money does not have to follow a fixed schedule, nor does the lender have to provide any notice of repayment. In India, scheduled Banks re permitted to carry out these transactions.

[14] Normally, the treasury bills should be issued so as to meet temporary revenue deficit over expenditure of a Government at some point of time. But, in India, the treasury bills are, nowadays, considered as a permanent source of funds for the Central Government. http://www.economicsdiscussion.net/essays/essay-on-the-indian-money-market/18073

[15] It is a kind of bill which is normally drawn by one merchant firm on the other and they arise out of commercial transactions. The purpose for issuing a commercial bill is simply to reimburse the seller as and when the buyer delays payment.

[16] Certificate of Deposit (CD) is a negotiable money market instrument and issued in dematerialised form or as a Usance Promissory Note against funds deposited at a bank or other eligible financial institution for a specified time period. CDs can be issued to individuals, corporations, companies (including banks and PDs), trusts, funds, associations, Non-Resident Indians (NRIs) may also subscribe to CDs, but only on non-repatriable basis, which should be clearly stated on the Certificate. Such CDs cannot be endorsed to another NRI in the secondary market. https://rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=8171

[17] Commercial Paper (CP) is an unsecured money market instrument issued in the form of a promissory note. https://m.rbi.org.in/scripts/FAQView.aspx?Id=25

INSTRUMENTS OF CAPITAL MARKET

Financial instruments that are used for raising capital resources in the capital market are known as Capital Market Instruments. [18] The capital market is divided further in two: Primary market and Secondary market. The Primary market where the initial public offering or IPO takes place and secondary market is a market where further raising of capital, purchase and sale of securities takes place. The various capital market instruments used by corporate entities for raising resources are as follows:

(i) Preference shares[19]
(ii) Equity shares[20]
(iii) Convertible preference shares[21]
(iv) Warrants[22]
(v) Debentures[23]
(vi) Bonds[24]
(vii) Mutual fund[25]
(viii) Derivatives[26]

The point to be noted here is that Capital market can be either equity market or debt market.

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[18] *Ibid* Note 13
[19] Preference shares more commonly referred to as preferred stock, as shares of a company's stock with dividends that are paid out to shareholder before common stock dividends are issued.
[20] Equity shares represents equity stake currently held on the books by shareholders.
[21] These shares has guaranteed dividend, but does not grow like others. Thus it gives an option where the dividend can be linked to share price appreciation.
[22] Warrant is a derivative that confers the right but not the obligation to buy or sell a security –normally equity at a certain price before expiration.
[23] It is a long-term security yielding a fixed rate of interest, issued by a company and secured against assets. The debenture holder is termed as a creditor in company.
[24] Bond is fixed income investment in which an investor loans money to an entity which borrowsthe funds for a defined period of time at a variable or fixed interest rate.
[25] This can be – equity or debt. The money collected and pooled from various investors. The money can be invested in various securities, bonds etc.
[26] A derivative is a contract between two or more parties whose value is based on an agreed-upon underlying financial asset (like a security) or set of assets. Derivatives can be : future contracts, forward contracts etc.

POSITION OF CREDITOR

The above enumerated are the instruments by which money will be infused in a company. A person will be a creditor or an investor as per the instruments through which he will infuse his money. Like if a person invests through money market, Debentures, Bonds, debt mutual fund then he will be a creditor or an investor. One another subdivision in creditors is, secured creditor or unsecured. Generally in business world capital infusion, if, done by financial institutions like Bank will be secured , however the investment through Debentures will be unsecured.

The issue to be addressed here that in case the company is liquidated then how is one's money placed in liquidation process. The famous term for this process is waterfall mechanism which means that in case the company is getting wound up or liquidated then how I will recover back my money and at what position my interest will be placed.

The distribution of assets of company is divided in modes of winding up: winding up under Companies Act and liquidation under Insolvency and Bankruptcy Code. The NCLAT in case of Birender Kumar vs M/s Adel Landmarks[27] reiterated the position as given under Section 94a of Companies Act 2013.

WINDING UP OF A COMPANY UNDER COMPANIES ACT 2013

Where a company has no longer funds to function, or in case the company has funds but does not want to function then the process to end the legal existence of company, is called winding up. Once a company goes into liquidation, the difference between the rights of shareholders and creditors is difficult to draw. We can put this in simple words as both have financial interests only at this juncture.[28]

There are two types of winding up: Compulsory Winding up and Voluntary Winding Up.

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[27] Company Appeal (AT) (Insolvency) No. 39 of 2018
[28] Paul L.Davies & Sarah Worthington, "Gower Principles of modern Company Law", Sweet &Maxwell(2016) @nd Edition, Pg 1151-1152

As far as voluntary winding up is concerned, after enactment of Insolvency and Bankruptcy Code 2016, the said winding up is governed under the said code only[29].

The other type of winding up: compulsory winding up is governed by Indian Companies Act 2013 and Insolvency and Bankruptcy code 2016. In the latter code the word liquidation is used at every place and not winding up.

[29] Section 59: Voluntary Liquidation of corporate persons: 59. (1) A corporate person who intends to liquidate itself voluntarily and has not committed any default may initiate voluntary liquidation proceedings under the provisions of this Chapter.
(2) The voluntary liquidation of a corporate person under sub-section (1) shall meet such conditions and procedural requirements as may be specified by the Board.
(3) Without prejudice to sub-section (2), voluntary liquidation proceedings of a corporate person registered as a company shall meet the following conditions, namely:— (a) a declaration from majority of the directors of the company verified by an affidavit stating that— (i) they have made a full inquiry into the affairs of the company and they have formed an opinion that either the company has no debt or that it will be able to pay its debts in full from the proceeds of assets to be sold in the voluntary liquidation; and (ii) the company is not being liquidated to defraud any person; (b) the declaration under sub-clause (a) shall be accompanied with the following documents, namely:— (i) audited financial statements and record of business operations of the company for the previous two years or for the period since its incorporation, whichever is later; (ii) a report of the valuation of the assets of the company, if any prepared by a registered valuer; (c) within four weeks of a declaration under sub-clause (a), there shall be— (i) a special resolution of the members of the company in a general meeting requiring the company to be liquidated voluntarily and appointing an insolvency professional to act as the liquidator; or (ii) a resolution of the members of the company in a general meeting requiring the company to be liquidated voluntarily as a result of expiry of the period of its duration, if any, fixed by its articles or on the occurrence of any event in respect of which the articles provide that the company shall be dissolved, as the case may be and appointing an insolvency professional to act as the liquidator: Provided that the company owes any debt to any person, creditors representing twothirds in value of the debt of the company shall approve the resolution passed under sub-clause (c) within seven days of such resolution.
(4) The company shall notify the Registrar of Companies and the Board about the resolution under sub-section (3) to liquidate the company within seven days of such resolution or the subsequent approval by the creditors, as the case may be.
(5) Subject to approval of the creditors under sub-section (3), the voluntary liquidation proceedings in respect of a company shall be deemed to have commenced from the date of passing of the resolution under sub-clause (c) of sub-section (3).
(6) The provisions of sections 35 to 53 of Chapter III and Chapter VII shall apply to voluntary liquidation proceedings for corporate persons with such modifications as may be necessary.
(7) Where the affairs of the corporate person have been completely wound up, and its assets completely liquidated, the liquidator shall make an application to the Adjudicating Authority for the dissolution of such corporate person.
(8) The Adjudicating Authority shall on an application filed by the liquidator under sub-section (7), pass an order that the corporate debtor shall be dissolved from the date of that order and the corporate debtor shall be dissolved accordingly.
(9) A copy of an order under sub-section (8) shall within fourteen days from the date of such order, be forwarded to the authority with which the corporate person is registered.

GROUNDS OF COMPULSORY WINDING UP

Section 271 of Companies Act 2013 elaborates the grounds.[30] Among these the important ground is: just and equitable grounds. This clause is interpreted in various English as well as Indian cases. The winding up order on this ground can only be ordered when the court is of opinion that no alternative remedy is available to the petitioners or the petitioner have not acted unreasonably in pursuing the said winding up petition.[31] It was clearly held that the Petitioners have to make out a case for winding up of the company on just and equitable grounds. If the facts fall short of the case set out for winding up on just and equitable grounds no relief can be granted to the Petitioners. On the other hand the party resisting the winding up can demonstrate that there are neither just nor equitable grounds for winding up and an order for winding up would be unjust and unfair to them.[32]

PROCESS OF LIQUIDATION UNDER INSOLVENCY AND BANKRUPTCY CODE 2016

The code is framed for financial creditor and operational creditor. The Insolvency code split creditors in operational creditor and financial creditor.[33] The Insolvency resolution can be

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[30] **271. Circumstances in which company may be wound up by Tribunal-** A company may, on a petition under section 272, be wound up by the Tribunal,-
(a) if the company has, by special resolution, resolved that the company be wound up by the Tribunal;
(b) if the company has acted against the interests of the sovereignty and integrity of India, the security of the State, friendly relations with foreign States, public order, decency or morality;
(c) if on an application made by the Registrar or any other person authorised by the Central Government by notification under this Act, the Tribunal is of the opinion that the affairs of the company have been conducted in a fraudulent manner or the company was formed for fraudulent and unlawful purpose or the persons concerned in the formation or management of its affairs have been guilty of fraud, misfeasance or misconduct in connection therewith and that it is proper that the company be wound up;
(d) if the company has made a default in filing with the Registrar its financial statements or annual returns for immediately preceding five consecutive financial years; or
(e) if the Tribunal is of the opinion that it is just and equitable that the company should be wound up

[31] See *Virdi v Abbey leisure Ltd [1990]B.C.L.C 342 and Marescav BrookfieldDevelopment & ConstructionLtd[2013]EWHC3151* (CH)
[32] See *Hanuman Prasad Bagri & Ors vs Bagress Cereals Pvt. Ltd. & Ors on 27 March, 2001, https://indiankanoon.org/doc/255185/*
[33] Part II Section 2(7) of the code "financial creditor" means any person to whom a financial debt is owed and includes a person to whom such debt has been legally assigned or transferred to"
Section 2(20) "operational creditor" means a person to whom an operational debt is owed and includes any person to whom such debt has been legally assigned or transferred.

initiated by the financial creditor[34], operational creditor[35] or a corporate debtor itself[36] by making an application to the Adjudicating Authority. The Adjudicating Authority upon admission of the application declares a moratorium, issues a public notice and the resolution professional will be appointed. The moratorium on the debtor prohibits any institution or continuation of any proceedings against the debtor, mandates maintenance of status quo of the assets by the debtor including prohibition on any transferring, encumbering, alienating or disposing of such assets and requires the creditors to refrain from enforcing any security interest.[37]

The resolution professional constitutes a committee of the creditors and conducts the meetings of the creditors committee. The creditors committee has the power to decide and approve the final solution by majority vote in the negotiations. The majority vote requires approval of 75% of the creditors committee weighted by the aggregate financial liabilities. It is to be noted that in the creditors committee the financial creditors shall have voting rights whereas the operational creditors shall be represented in order to present their views and suggestions on the resolution process. Since, the viability of the debtor's business is to be assessed in discussion with the debtor such debtor will also attend the meetings of the creditors committee.

A resolution plan will be chalked out by the creditors and afterwards the Adjudicating Authority will pass the resolution and close the proceedings. Afterwards the resolution plan will be implemented which will be binding on all the stakeholders.

Likewise for individuals also repayment plan will be drafted and if in case the execution of repayment plan fails, the insolvency process will be initiated. The bankruptcy trustee is responsible for administration of the estate of the bankrupt and for distribution of the proceeds on the basis of the priority. The insolvency resolution professional may be appointed as the bankruptcy trustee, after due confirmation from the Board.

[34] See Section 7 of the Code
[35] See Section 9 of the Code
[36] See Section 10 of the code
[37] See Section 14 of the code.

ORDER OF DISTRIBUTION OF ASSETS

The order of priority under the IBC is similar to the order for distribution under a winding up under the Companies Act, but with a couple of significant differences. Unsecured financial creditors have greater primacy under the IBC, and now take ahead of both crown debts, that is, debts owed to government, and other unsecured creditors.[38] The consideration for this kind of preference is certainly uncertain as:

- Which type of financial creditor is given preference as when the committee of creditors is formed: both secured and unsecured can be a party of the committee and vote is taken cumulatively and independently?
- Unsecured creditors are preferred upon crown debts but Institutional lenders have priority over individuals invested through bonds and debentures, the reason is unclear as all the creditors and all take part in lifting economy in some or the other way.
- No doubt Debenture holders and Bond holders are covered under the definition of "Financial Debt". But the priority is given to secured creditors who already have security for their investment while distributing assets overlooking the interest of other financial creditors.

CONCLUSION

The legislative intent and rational of distribution of assets is unclear. Moreover both legislations have difference in other aspects of winding up or liquidation like fees of liquidator, authority to fix fees. One plausible reason can the object and purpose of both legislations. However, it is strongly urged to be clear and specific as both legislations meet when a corporate is dissolved.

[38]Available at http://blog.mylaw.net/liquidation-ibc-order-priority-signals-shift-economic-rationale/