HOUSEHOLD DEBT AND THE PRESENT INSOLVENCY LAW REGIME

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INTRODUCTION

Personal bankruptcy laws protect a fraction of an individual's assets from seizure by unsecured creditors in case of default. An increase in the level of bankruptcy protection diminishes the collateral value of assets, and can therefore reduce borrowers' access to credit.[i] In the month of May 2016, India adopted a regime for personal insolvencies and bankruptcies as part of a comprehensive new Insolvency and Bankruptcy Code. The Code's provisions for individual debtors have not yet gone into force, and the regulatory agency charged with implementing it has recently constituted an advisory committee, which has drafted some proposed regulations and rules and will presumably advise the agency on potential reforms. The advisory group's project of review and counsel will inevitably spur more public discussion and debate about the purpose and function of personal insolvency and bankruptcy law in India. This paper aims to contribute to that discussion by describing India's new personal insolvency and bankruptcy regime in some detail, with respect to household debt, debt recovery and insolvency.

Factors that contribute to insolvency and the implications for the household vary significantly; we know that consumers are taking on more debt and more consumers can be characterized as insolvent. We are aware that our lifestyles are changing and consumption by households have increased and continues to increase at a level like never before. This is not only with respect to consumption of goods and services, but also real estate. This is owed, without a doubt, to the increased level of the disposable income of the average Indian.[ii] We are also aware that consumers are now increasingly reducing their debt, but this was due to the decrease in the overall credit rates. Consumers have also shifted from traditional credit card debt and personal

loan to less expensive home equity loans and lines of credit which are classified as home mortgage debt.[iii]

The Insolvency and Bankruptcy Code,2016 has the potential to transform aspects of Indian society related to consumer and household borrowing, especially regarding the stigma associated with financial distress and debt relief. Yet, there is a significant possibility that the regime will, at least initially, function primarily as a creditor's remedy and provide suboptimal insurance for individual and household debtors. If so, this would reduce the regime's utility in helping individual debtors recover from financial distress and would exacerbate some of the social costs of consumer over-indebtedness. It could also distort the development of consumer financial markets in India by promoting the expansion of lending without effectively insuring against systemic household over-indebtedness.

The insolvency regime that is set forth is a broad, comprehensive reform set forth in the Insolvency and Bankruptcy Code of 2016. The Code consolidates pre-existing elements of a bankruptcy and insolvency system. It pre-empts other legal regimes within its scope and designates exclusive jurisdiction for insolvency and bankruptcy cases in the National Company Law Tribunals for corporate cases and Debt Recovery Tribunals for personal cases. The Code's substantive regime is designed to reduce and constrain the role of courts and judges within the system by, among other things, simplifying rules on eligibility; allocating most procedural functions to insolvency professionals; setting strict deadlines for most actions required of those professionals and judges; and generally encouraging negotiation among parties. [iv] It is important to note that household insolvency goes beyond concerns over increasing debt levels and bankruptcy filings. Insolvency, like debt, has carrying charges of direct and indirect costs. For consumers who are delinquent, late fees and other collection costs simply add to liabilities that are already not being reduced. Although the intent of a bankruptcy filing is to give people a "fresh start," filing fees, loss of assets, inability to use credit for a period of time, and the stigma of having declared bankruptcy cannot be ignored. These represent direct costs for the use and abuse of credit. There are also indirect personal, emotional, and psychological costs which are beyond the scope of this paper.

An initial interim report of the Bankruptcy Law Reforms Committee that was charged by the Indian Parliament to propose and draft the new Code briefly noted the need for changes to the personal insolvency laws to address the financial distress of micro, small, and medium

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enterprises, most of which are sole proprietorships or benefit from personal financial guarantees.[v] Thus, unlike the provisions for corporate debtors under the new Code, the provisions for personal insolvency and bankruptcy do not appear to have been driven by acute or particular economic or social conditions in India. This is noteworthy because countries that have adopted or reformed their consumer insolvency regimes in recent decades have tended to so in the wake of consumer financial crises or dramatically expanding consumer financial markets.[vi] The Insolvency and Bankruptcy Code, thus appears to represent a rare instance of a country adopting or modernizing a personal insolvency or bankruptcy regime at the relatively early stages of the development of a consumer financial market, before one is necessary. This is because our market is not as forward as that of the West. Doing so avoids costs of responding too late, after consumer financial markets have overheated. It may also have a beneficial effect on the development of those markets in the first place. Especially since the recent global financial crisis of 2008-10, there is arguably an emerging consensus that a personal insolvency or bankruptcy regime is “a significant market institution and ground rule for credit markets.”[vii].If properly designed and operated, such a regime can help promote a stable market for consumer credit, making creditors more willing to lend and individuals more willing to borrow, disciplining both, reducing the social costs of consumer financial distress and perhaps the amount of household over-indebtedness in the economy as well.[viii] The bankruptcy chapter of the new Code promises to provide some meaningful debt relief to such debtors, but they must first go through the insolvency process, which requires a plan of repayment subject to creditor approval, during which the debtor is allotted only a minimum budget, and which formally ensures only a minimum level of relief or protection. It is possible, therefore, that a significant portion of debtors in financial distress will not voluntarily use the new insolvency and bankruptcy regime and that it will primarily be employed as a debt collection tool for creditors. If so, the scope of the insurance function of the new system may not end up providing sufficient relief to individual debtors who become mired in debt, may not promote risk-taking entrepreneurial activity, and may not provide a meaningful safety valve to developing consumer financial markets.[ix]

THE NEW SUBSTANTIVE FRAMEWORK

The substantive framework of India's new Insolvency and Bankruptcy Code effectively pre-empts a web of pre-existing laws that had provided for liquidation and restructuring of business entities and assets and for insolvency cases involving individual and household debtors.[x]The Companies Act of 1956, which provided for resolution of failing corporations, was one of the most important components of the pre-existing insolvency regime. It had been amended in 2013 to provide a mechanism for rescuing firms and restructuring their debt, but the relevant provisions were not subsequently notified and put into force; the 2013 amendments also created the National Company Law Tribunal and Appellate Tribunal, which replaced the Company Law Board and the Board for Industrial and Financial Reconstruction.[xi]Other important components of the pre-existing regime include the Sick Industrial Companies Act of 1985, which provided for restructuring of industrial companies;[xii] the Recovery of Debts Due to Banks and Financial Institutions Act of 1993, which gives financial institutions advantageous rights to recover collateral from defaulting debtors – individuals as well as business debtors – and which created the Debt Recovery Tribunals for this narrow purpose;[xiii] and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act of 2002, which, among other things, provides for self-help enforcement by secured creditors against collateral, with appeals to the Debt Recovery Tribunal.[xiv]

The provisions in the new Code for individuals and households replace two colonial era insolvency laws, the Presidential Towns Act and the Provincial Towns Act. Until and unless the Code's provisions are notified, these Acts are still technically in force. An individual debtor or the debtor's creditors can initiate a case under these laws to have the debtor deemed formally insolvent in a civil court of general jurisdiction or a subordinate court within the civil court system. Pursuant to the Acts, an individual debtor can, at least in theory, obtain some measure of debt relief. To do so, the court must determine that the debtor has committed an "act of insolvency," such as acting to defeat or delay one's creditors, transferring all or most of one's assets, asserting to creditors that one is not going to pay an obligation, having property sold in execution of a court decree, or failing to respond to a creditor's notice of insolvency. Courts are required to dismiss cases if they determine that the debtor has the capacity to repay his or her debts. Furthermore, under this pre-existing regime, courts have significant discretion in providing for the discharge of debt and in staying other actions affecting a debtor or the debtor's

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property. Thus, under those laws, debtors in an insolvency proceeding can still be subject to other debt recovery laws.

The personal bankruptcy chapter of the Code authorizes a Debt Recovery Tribunal to liquidate a debtor's non-excluded assets, to pay as much of the debtor's debt as possible, and to discharge the unpaid balance of certain debts. The Code provides that bankruptcy is available for individuals under three circumstances: where a debtor's application for insolvency was rejected by a Debt Recovery Tribunal because the debtor filed fraudulently; where a Debt Recovery Tribunal rejects the debtor's repayment plan; and where a debtor's repayment plan ends before complete.[xv]A case must be filed within three months of one of these circumstances.[xvi] A debtor or one or more of the debtor's creditors can apply to initiate a bankruptcy proceeding with a Debt Recovery Tribunal.[xvii] As with insolvency cases, the filing party can propose an insolvency professional,[xviii]and the Tribunal must within a week notify the Board of the proposed insolvency professional or, if the filing party does not propose one, request that the Board do so.[xix] The Board has 10 days to approve a proposed individual or nominate one if it rejects the proposed individual or if the filing party has not proposed one.[xx] An interim moratorium operates upon the filing of a bankruptcy case,[xxi] and the Debt Recovery Tribunal must pass a bankruptcy order or dismiss the application within two weeks of the approval of the proposed insolvency professional by the Board.[xxii] The Code does not provide any additional standards or requirements for issuing a bankruptcy order, so the Tribunal is presumably limited at this stage to confirming that the basic eligibility requirements are satisfied. Upon a bankruptcy order, an "estate of the bankrupt," which is eventually to be distributed among the debtor's creditors, vests in the insolvency professional[xxiii] who, in this context, is called the bankruptcy trustee. The estate is comprised of "all property belonging to or vested in the bankrupt at the bankruptcy commencement date."[xxiv] It does not include "excluded assets," property held by the bankrupt as a trustee, money due to workmen, or any other assets designated by the central government and financial regulators.[xxv]Excluded assets include tools, equipment, books, and vehicles of personal or business use; basic household goods, furniture, and equipment; certain personal ornaments of religious significance; life insurance policies or pension plans; and a dwelling unit up to a value to be determined by the Board.[xxvi] These exclusions do not defeat existing encumbrances.[xxvii] Disposition of property by a debtor during the pendency of a bankruptcy is "void," but a bona fide purchaser cannot be

divested of the property.[xxviii]Property acquired during bankruptcy is part of the estate unless it is an excluded asset.[xxix]

In a bankruptcy case, the insolvency professional's role as "trustee"[xxx] appears to be a more central and active role than such professionals generally play in personal insolvency cases. As noted above, the debtor's estate vests in the trustee once the trustee is appointed.[xxxi] He or she convenes a meeting of creditors, [xxxii] administers the debtor's estate,[xxxiii] and subsequently applies for a discharge of certain debts. In administering a bankruptcy case, the trustee must "investigate the affairs of the bankrupt; realise the estate of the bankrupt; [and] distribute the estate of the bankrupt."[xxxiv] Among other things, the trustee has power to hold property, make contracts, sue, sell assets of the estate, exercise rights of redemption for secured property, and collect on debts owed to the debtor. [xxxv]Some actions by the trustee require approval of creditors, such as carrying on the debtor's business to wind it up; bringing or defending legal actions related to the estate; using property of the estate as collateral; or appointing the debtor to manage property in the estate or carrying on the debtor's business.[xxxvi] The debtor has a duty to assist the trustee in his or her performance of these functions.[xxxvii]The trustee must apply to the Debt Recovery Tribunal for the debtor's discharge within one year of the commencement of the case or seven days after approval for a discharge by the creditors committee, whichever is earlier.[xxxviii] The discharge does not apply to debts incurred by fraud or "excluded debts."[xxxix]Creditors must vote to release the trustee after he or she has administered and distributed the bankrupt's estate.[xl]

CONCLUSION

If, in the future, household indebtedness becomes a crisis or near-crisis for whatever reason or sets of reasons, the operation of the personal insolvency and bankruptcy regime could become more acutely systemically significant. It could serve as a safety net to expediently allocate losses, unclog the financial system, and lessen the negative effects of the crisis, such as reduced consumption in the real economy. But, again, this function will likely depend in large part on debtors actually using the system under such circumstances. If at such a moment, debtors are widely reluctant or unable to utilize the regime, this would undermine the safety valve function of the regime, causing it to fail to perform its unique role in promoting the longer-term stability

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of the financial system. Thus, in assessing the future vulnerability and stability of the financial system and its exposure to the household finance sector, it is necessary to consider whether enough individual debtors might utilize the insolvency and bankruptcy regime when it is systemically important that they do so. Given the design of the regime and the foreseeable practical barriers for many individuals who might benefit from the regime, there are reasons to be concerned that many debtors may not do so. Creditors would presumably force some debtors into insolvency in a systemic financial crisis, but in a financial or economic downturn creditor may themselves be hesitant to trigger a wave of insolvencies. However, recently, the NCLT decision in ***Nikhil Mehta v. AMR Infrastructure***[xli] ruled that a purchaser of real estate, under an 'Assured-return' plan, would qualify as a 'Financial Creditor' for the purposes of the Insolvency and Banking Code ("IBC") and therefore, entitled to initiate insolvency process against the builder, in case of non-payment of such 'Assured/Committed return'. This, judgment gives us the understanding that the regime under the Insolvency and Bankruptcy Code is moving towards the protection of not just powerful creditors such as various financial institutions but also individuals both as creditors and debtors. This very Code can be a powerful tool for the development of our consumer financial market which in its very core is the strongest market for a country with the population of 1.2 billion people.

ENDNOTES

[i] Available at https://www.economics.utoronto.ca/index.php/index/research/downloadSeminarPaper/70664 (last accessed 03.09.2020 18:35 hours)

[ii] Available at https://www.ceicdata.com/en/india/nas-20112012-national-and-personal-disposable-income/nas-20112012-gross-national-disposable-income (last accessed 03.09.2020 18:40 hrs)

[iii] Available at https://pdfs.semanticscholar.org/01d7/3dd6554d910e9f5ee1ff5ef25b4c2665c594.pdf (last accessed 03.09.2020 18:46 hrs)

[iv] Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design, available at http://dea.gov.in/sites/default/files/BLRCReportVol1_04112015.pdf ("As with legal entities, what is visualized for individuals is to enable a negotiated settlement between creditors and debtor[s] without active involvement of the court.").

[v] Interim Report of the Bankruptcy Law Reform Committee, February 2015, available at http://www.finmin.nic.in/sites/default/files/Interim_Report_BLRC_0.pdf (last accessed 22.09.2020 05:31 hrs)

[vi] Countries across Europe and elsewhere -- including Hong Kong, South Korea, Israel, and Indonesia -- have adopted or reformed their personal insolvency regimes under such circumstances in the last two decades include. IAIN RAMSAY, PERSONAL INSOLVENCY IN THE 21ST CENTURY: A COMPARATIVE ANALYSIS OF THE US AND EUROPE, 3-6 (HART, 2017); JASON KILBORN, COMPARATIVE CONSUMER

BANKRUPTCY, 5-6 (CAROLINA, 2007); JOHANNA NIEMI-KIESILAINEN, IAIN RAMSAY & WILLIAM C. WHITFORD, EDS., CONSUMER BANKRUPTCY IN GLOBAL PERSPECTIVE (2003) JSTOR.
[vii] Discussing the IMF's post-crisis embrace of consumer bankruptcy reforms and the World Bank's Report on the Treatment of the Insolvency of Natural Persons, 2014, available athttps://siteresources.worldbank.org/INTGILD/Resources/WBInsolvencyOfNaturalPersonsReport_01_11_13.pdf). (last accessed 22.09.2020 05:46 hrs), Available at https://siteresources.worldbank.org/INTGILD/Resources/WBInsolvencyOfNaturalPersonsReport_01_11_13.pdf (last accessed 22.09.2020 05:51 hrs)
[ix] Available at http://piketty.pse.ens.fr/files/Pistor2013.pdf (last accessed 21.09.2020 17:31 hrs)
[x] Aparna Ravi, The Indian Insolvency Regime in Practice: An Analysis of Insolvency and Debt Recovery, Indira Gandhi Institute of Development Research working paper, 2015, available at http://www.igidr.ac.in/pdf/publication/WP-2015-027.pdf. (last accessed 21.09.2020 17:46 hrs)
[xi]http://www.mondaq.com/india/x/500200/Corporate+Commercial+Law/National+Company+Law+Tribunal+NCLT+replaces+Company+Law+Board+CLB+from+June+2016 (last accessed 21.09.2020 18:25 hrs)
[xii] Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design, available at http://dea.gov.in/sites/default/files/BLRCReportVol1_04112015.pdf (last accessed 21.09.2020 12:10 hrs)
[xiii] Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design, available at http://dea.gov.in/sites/default/files/BLRCReportVol1_04112015.pdf (last accessed 21.09.2020 16:31 hrs)
[xiv] Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design, available at http://dea.gov.in/sites/default/files/BLRCReportVol1_04112015.pdf (last accessed 21.09.2020 07:30 hrs)
[xv] IBC, § 121, IBC, § 100, 115, 118. It is not entirely clear from the Code whether a debtor might be eligible for bankruptcy if creditors do not vote to approve his or her repayment plan; this would presumably be precluded if Debt Recovery Tribunals only consider whether to approve or reject plans that have already been approved by creditors. The resolution professional must submit a report on creditors meetings regardless of whether the creditors approve the debtor's plan or not. Section 114 of the Code does not expressly prohibit the Tribunal from approving a plan that has not been approved by creditors, but the general structure and logic of the insolvency provisions does not seem designed to allow such a circumstance.
[xvi] IBC, § 121
[xvii] IBC, § 121.
[xviii] IBC, § 122(2), 123(4)
[xix] IBC, § 125
[xx] IBC, § 125.
[xxi] IBC, § 124.
[xxii] IBC, § 126
[xxiii] IBC, § 128(1)(a)
[xxiv] IBC, § 155
[xxv] IBC, § 155
[xxvi] IBC, § 79(14)
[xxvii] IBC, § 79(14)
[xxviii] IBC, § 158
[xxix] IBC, § 159
[xxx] IBC, § 125
[xxxi] IBC, § 154
[xxxii] IBC, § 132-35
[xxxiii] IBC, § 136
[xxxiv] IBC, § 149
[xxxv] IBC, § 151-52
[xxxvi] IBC, § 153.
[xxxvii] IBC, § 150.
[xxxviii] IBC, § 138
[xxxix] IBC, § 139
[xl] IBC, § 137, 148.
[xli] Company Appeal (AT) (Insolvency) No. 7 of 2017; Judgment delivered on 21st July, 2017. *The judgment has been followed by the NCLAT recently in Anil Mahindroo & And v. Earth Iconic Infrastructure (P) Ltd (Date of Decision 02.08.2017) to the same effect.*

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