
BEYOND DISPLACEMENT IN INSOLVENCY PROCESS: EVALUATING PROMOTERS' ROLE BY SHADOW CONTROL UNDER INSOLVENCY AND BANKRUPTCY CODE, 2016

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ABSTRACT

The Insolvency and Bankruptcy Code of India, 2016 (IBC) marked the introduction of a completely new approach towards corporate insolvency which was controlled by the creditors rather than the old system of debtor-centric. One of the primary goals behind Corporate Insolvency Resolution Process (CIRP) is that of substituting the existing management as its goal entails the withdrawal of control from the hands of the former and putting it in the hands of an independent Resolution Professionals who functions under Committee of Creditors supervision. However, this theory seems far from reality.

The present paper reviews the legal structure that determines the displacement of management in the context of the IBC and critically analyzes how promoters maintain control over corporate entities in the course of the CIRP. It focuses on the statutory powers that the RP and CoC have, judicial interpretation of promoter involvement in corporate affairs, and the institutional weaknesses that allow for shadow governance. This research gives special attention to information asymmetry, employees' loyalty circles, related parties' deals, legal battles initiated by promoters, selective information disclosure, and time delays in procedures as factors of shadow control.

By means of analyzing statutory norms, judicial precedents, and practices of insolvency proceedings, it becomes clear that the formal displacement of managerial functions may not necessarily result in the real displacement of operational control over a company. Shadow control jeopardizes creditors' autonomy, misleads their value-maximizing goal, and risks the legitimacy of the resolution procedure itself. As a finding, the paper offers reforms that can promote the independence of RPs while ensure transparency, enhance forensic procedures, & implement strict compliance rules.¹

Keywords: Insolvency and bankruptcy Code, 2016 (IBC), Corporate Insolvency Resolution Process (CIRP), Committee of Creditors (CoC).

¹ Umakanth Varottil, *The Insolvency and Bankruptcy Code in India: A Comparative Analysis*, 10 NAT'L L. SCH. INDIA REV. (2018).

I. Introduction

The genesis of the IBC, in turn, is connected with the inefficiency of the current Indian legislation regulating the issue of insolvency. Prior to the introduction of the law, the legislative framework included a number of laws, overlapping with each other. Such overlaps were often exploited by the debtor firm for postponing the proceedings. Consequently, a "de facto debtor-in-possession regime" emerged wherein the promoter continued managing the insolvent company, while the creditors were able to recover only 20-25% of the claim through proceedings. At the same time, the Board for Industrial and Financial Reconstruction functioning under SICA stood for the bureaucratic inertia, so the process of insolvency resolution could be stopped until the value of the company became zero. Thus, the enactment of the IBC signified a revolutionary shift from cumbersome procedure to the efficient solution to maximize the value of the asset as well as improve the climate of credit.²

CIRP is the crux of the IBC Act, and it is triggered when the corporate debtor fails to repay its debts amounting to or exceeding ₹1 crore. The CIRP may be triggered by any financial creditor, operational creditor, or even by the corporate debtor itself through Section 7, 9, or 10 respectively.³ The moratorium is invoked under Section 14 when admitted by the NCLT⁴. It puts a legal quarantine on the assets of the firm by stopping any outside efforts against the assets in order to resolve things collectively. Control passes directly into the hands of the Interim Resolution Professional who runs the affairs of the firm as a continuing concern under the guidance of the Committee of Creditors. This process is time-bound up to 180 days or up to 330 days including the period during which legal challenges can be raised.

Even with the IBC stipulating that there should be a change in management, it cannot be denied that the nature of business in India has a tendency towards promoter-oriented business management because the essence of the business comes from the promoters themselves. Thus, the existence of an inherent conflict of interest when the CIRP procedure takes place is brought about because even though it is the Resolution Professional who has the right to do so, he lacks sectoral expertise. Promoters are able to exert shadow control by way of using their influences in many ways, which could range from information denial, employee bullying, or simply

² Luca Enriques & Tobias Tröger, *The Law and Economics of Information Disclosure in Insolvency*, 17 EUR. BUS. ORG. L. REV. 123 (2016).

³ The Insolvency and Bankruptcy Code §§ 7–10, No. 31, Acts of Parliament, 2016 (India).

⁴ The Insolvency and Bankruptcy Code § 14, No. 31, Acts of Parliament, 2016 (India).

getting inside the company via connections.

Purpose of the Study

Purpose of the study is to understand shadow control mechanisms and the effect of shadow control on insolvency procedure. The present study shall examine the law regarding the process of changing the management and the powers vested in the Resolution Professional and Committee of Creditors. Furthermore, this study would define and describe the types of shadow control in India. Moreover, this research will examine the weaknesses of the Corporate Insolvency Resolution Process, which lead to shadow control even after changing the management.

II. Statutory Framework under IBC

CIRP is a multi-staged process that aims at striking a balance between efficiency and equity. The process is initiated on the “insolvency commencement date” which is the date when the NCLT admits the application filed. There are two immediate consequences of the initiation of the process. First, there will be a moratorium imposed under Section 14.⁵ Such a structural alteration aims to ensure that promoters do not make off with the company’s property or conduct any preferential dealings while resolving the matter. The rationale behind the statute as endorsed by the Supreme Court in *Swiss Ribbons Pvt. Ltd. v. Union of India*⁶, The purpose is to ensure that control passes to professionals who will make an objective assessment of viability, uninfluenced by the self-interest problems that plague founder-controlled governance during times of distress. The moratorium serves as a controlled breathing space where the assets of the corporation debtor will be safeguarded from being picked off bit by bit, thus ensuring a more holistic solution that benefits all concerned parties instead of a mad scramble by various creditors.

The role of the Resolution Professional comes into play as the connecting link between the troubled organization and its creditors. The Resolution Professional acts as an officer of the court and carries considerable fiduciary responsibilities. Under Section 17 of the IBC, the Resolution Professional is empowered with the management of the corporate debtor’s business, and the officers and directors of the firm are duty-bound to answer to the Resolution

⁵ The Insolvency and Bankruptcy Code § 14, No. 31, Acts of Parliament, 2016 (India).

⁶ *Swiss Ribbons Pvt. Ltd. v. Union of India*, (2019) 4 SCC 17 (India).

Professional.⁷ The role of the Resolution Professional comes into play as the connecting link between the troubled organization and its creditors. The Resolution Professional acts as an officer of the court and carries considerable fiduciary responsibilities. Under Section 17 of the IBC, the Resolution Professional is empowered with the management of the corporate debtor's business, and the officers and directors of the firm are duty-bound to answer to the Resolution Professional.⁸ However, the RP's practical effectiveness is frequently undermined by suboptimal cooperation from the suspended management, which leads to significant delays in preparing the Information Memorandum and inviting resolution plans, ultimately consuming a substantial portion of the statutory resolution timeline.

The Committee of Creditors, or CoC, is the manifestation of the creditor-in-control concept, which comprises all financial creditors of the company. The CoC can make important commercial decisions such as the acceptance or rejection of a resolution plan, replacing the Resolution Professional, and opting for liquidation. The commercial sense of the CoC has been considered the ultimate decision maker in the CIRP process by the Supreme Court in *K. Sashidhar v. Indian Overseas Bank*⁹ unequivocally stating that this wisdom is beyond the purview of judicial scrutiny of the NCLT or NCLAT. Power is derived from a voting mechanism whereby each decision requires a two-thirds majority of the CoC's proportional interest in the aggregate amount of debt owed. This is a dual-edged sword in which the very entity designed to remove the promoters from any influence becomes an avenue by which their interests can be maintained should they successfully get friendly creditors into the CoC.

The displacement of the management marks an essential break with the existing insolvency scheme, meant to make sure that people who are at fault for their inability to repay a loan are no longer involved in making decisions about how to conduct business. This process is supposed to bring about credit discipline as promoters realize that they stand to lose everything if they mishandle their debts. Yet, despite the fact that the promoter is officially displaced by the RP, in practice, he often continues to exercise informal influence over operations and the decision-making process. The theoretical displacement of the promoter thus does not always result in his actual replacement, and the resulting vacuum provides fertile ground for shadow governance. To close this gap, however, requires not only legislative changes but institutional

⁷ The Insolvency and Bankruptcy Code § 17, No. 31, Acts of Parliament, 2016 (India).

⁸ The Insolvency and Bankruptcy Code §§ 18, 25, No. 31, Acts of Parliament, 2016 (India).

⁹ *K. Sashidhar v. Indian Overseas Bank*, (2019) 12 SCC 150 (India).

development, particularly in the form of developing professional competence within the field.

III. Understanding of "Shadow Control"

Shadow control refers to the power exerted by individuals on the management of the organization without formally designating any individual to any particular role within the board of the company. The above phenomenon is supported by legal philosophy of 'shadow directors' who are defined as persons, whose directions the directors of the business organization used to follow in the course of conducting their activities. The above helps to ensure that the people exercising powers in organizations should be held responsible for the same.

Shadow control is very rampant among the corporate families in India where promoters exercise control through informal directions without going through the process of passing formal resolutions from the board of directors. From the philosophical point of view, the doctrine of substance over form justifies the issue of shadow control where persons exercising power should be answerable irrespective of the law.

The promoters retain their control indirectly in a variety of ways, some of which take advantage of structural weaknesses in the CIRP structure. The first method employed by the promoters is the one based on information asymmetry, they deprive the RP of access to accounts, tallies, and even the operational login details so that they remain dependent on them for the survival of the business. The second method relates to the psychology of the employee and promoter loyalty; since there is a tendency among the employees and managers to consider the promoters as their employers, they go behind the back of the RP to seek instructions. The third method involves taking advantage of the related-party structure whereby the promoters can make use of associated or subsidiary firms to enclose their assets or channelize their cash flows away from the corporate debtor before it is seized.¹⁰

Manifestations of shadow control can be easily observed in forensic audits, or whenever there is resistance on the part of the RP from the RP's efforts to exercise their control. One such manifestation involves the practice of subservience where the board of directors, despite being suspended from their roles, do not take any initiative without receiving tacit approval from the

¹⁰ *Synergies-Dooray Automotive Ltd. v. Edelweiss Asset Reconstruction Co., Company Appeal (AT) (Insolvency) No. 202 of 2017 (NCLAT 2018) (India).*

former promoters.

In the case of *ArcelorMittal India Pvt. Ltd. v. Satish Kumar Gupta*, the Supreme Court of India has used the concept of lifting the corporate veil to determine the true controllers of corporate entities by finding out the actual minds of those controlling through the intricate shareholding structure. Another manifestation includes the use of litigation tactics aimed at exhausting the statutory process within the stipulated 330 days. In particular, the promoters might file several petitions against the RP in relation to claim verification or asset valuation. The result would be a situation where the CIRP exceeds the time limit and only promoters would have interest in the business¹¹.

Moreover, soft obstruction techniques, including partial and non-reconcilable disclosure of financial documents, stating that physical properties are in the possession of third parties, and pretending that the access codes to digital devices have been lost, are commonly encountered by resolution professionals but hardly ever penalized under Section 19(2) of the IBC, which creates a notable loophole exploited by shadow controllers to retain their actual control over failing businesses despite being legally ousted from their positions.

IV. Judicial Understanding and Interpretation of the Concept

The Indian judiciary has been integral to defining the limits of promoter involvement in the Corporate Insolvency Resolution Process under the IBC. With the IBC evolving into an effective process, the judiciary had to intervene many times in deciding when the displaced management of a company could interfere in the corporate insolvency resolution process and the exact point where such interference would amount to improper interference.

*Swiss Ribbons Pvt. Ltd. vs Union of India (2019)*¹² is a seminal judgment delivered by the Supreme Court of India that validated the constitutionality of the IBC while defining its principles and purpose of the IBC and establishing the rationale behind adopting a creditor-controlled regime under the law. In the said case, it was deliberately differentiated between the debtors-in-possession regime of the erstwhile BIFR and a creditors-in-control regime of the IBC. It was clarified that displacement of the promoter management was essential and not

¹¹ World Bank, *Doing Business 2020: Resolving Insolvency* (World Bank Grp. 2020).

¹² *Swiss Ribbons Pvt. Ltd. v. Union of India, (2019) 4 S.C.C. 17 (India)*.

punitive as its ultimate aim was maximizing the value of the business.

In *ArcelorMittal India Pvt. Ltd. vs. Satish Kumar Gupta (2019)*¹³, where the Supreme Court was able to penetrate multiple shareholding systems to find out the individuals controlling the corporate debtor. The Supreme Court stated that the insolvency courts did not have to follow the formal organisational structure but could rely on the true nature of the transaction, thereby laying down a principle under which insolvency tribunals had the right to look at the substance of the transaction. This led to a legal doctrine whereby resolution applications could be disallowed if the applicants tried to conceal their affiliation with the defaulting promoter.

Gaps Identified by Courts

In spite of the progressive trend in insolvency jurisprudence in India, the judicial institutions have recognized loopholes in the legislative framework, making shadow control possible. The first loophole recognized in the statute is the inefficacy of the enforcement regime under Section 19(2), which mandates that personnel at the corporate debtor must assist the RP. Though this provision is included, the judiciary has highlighted the absence of a time frame for the requirement to be fulfilled, a lack of penalty gradation, and the RP's own remedy of seeking the tribunal's direction, which is a lengthy process susceptible to delays.

Furthermore, the NCLAT has commented in several cases that the statutory bar against promoters from filing a resolution plan under Section 29A¹⁴, despite being comprehensive, has created new challenges. Promoters have challenged their disqualification under Section 29A using interlocutory applications, wasting valuable time for the resolution process. It is worth noting that while the disqualification regime under Section 29A is necessary, the courts have remarked that there are insufficient measures to counteract promoters' delaying tactics¹⁵.

V. Regulatory and Framework Challenges

(i) Undermining Creditor Control

Under the creditor control doctrine of the IBC, it is expected that the Committee of Creditors,

¹³ *ArcelorMittal India Pvt. Ltd. v. Satish Kumar Gupta*, (2019) 2 S.C.C. 1 (India).

¹⁴ *ArcelorMittal India Pvt. Ltd. v. Satish Kumar Gupta*, (2019) 2 S.C.C. 1 (India).

¹⁵ *Jindal Steel & Power Ltd. v. Arun Kumar Jagatramka*, Company Appeal (AT) (Insolvency) No. 221 of 2018 (NCLAT July 24, 2018) (India).

being an independent entity working for the common purpose of recovering money and maximizing value, would act as a good check on both the corporate debtor and its erstwhile promoters. Structurally, this doctrine appears reasonable, but in reality, the promoters often gain control over the CoC through debt assignment by related parties and the build-up of operational creditor claims through proxy companies¹⁶.

In addition to infiltration, another major issue is information asymmetry. Since most CoC members are usually bank officials, rather than domain experts, they depend significantly on the Information Memorandum and the RP's assessment while considering the proposals. In cases where the RP lacks sufficient information, the CoC, while making business-critical decisions, depends solely on a distorted picture of the true worth of the debtor company. Consequently, the information gap not only depresses the bids but also ensures that the promoters, who possess the confidential information, get an undue competitive edge over other resolution applicants.

(ii) Information Asymmetry

The most insidious and yet least tangible method of exercising shadow control during CIRP is probably through informational asymmetry. Regardless of his abilities, the Resolution Professional finds himself operating within an organization whose internal workings, contracts, and assets have always been the sole domain of the promoters, sometimes for several decades. This informational disadvantage cannot be entirely bridged even through the use of legal powers to obtain information, especially when the departing management has an interest in maintaining such an informational advantage¹⁷.

(iii) Misuse of Process

A common issue that arises is how the CIRP process has become a tool for strategic behavior on the part of promoters, who not only have the motive but also the means to do so. One such misuse of the process is the use of litigation as a tool for delay, whereby promoters make interlocutory applications at all stages in order to challenge the RP's decisions with regard to claim validation, valuation, and resolution plans¹⁸.

¹⁶ Insolvency and Bankruptcy Code, No. 31 of 2016, §§ 21, 24 (India).

¹⁷ Embassy Property Developments Pvt. Ltd. v. State of Karnataka, (2020) 13 S.C.C. 308 (India).

¹⁸ ArcelorMittal India Pvt. Ltd. v. Satish Kumar Gupta, (2019) 2 S.C.C. 1 (India).

VI. Recommendations and Reforms

(i) Strengthening Resolution Professional Independence

A strategy to address the vulnerabilities in the design of the CIRP process must be multi-faceted and consider aspects of legislative framework as well as capacity. An appropriate reform must begin with the independent functioning of the RP. In its current structure, the process of nomination of the RP in practice involves selection of the RP by the same financial creditors, whose representatives form the CoC, thereby introducing a conflict of interest which negates the objectivity of the RP as a neutral administrator of the process. The RP must be chosen through a transparent process by the NCLT from a rotation pool of certified RPs with documented sectoral expertise maintained by the IBBI¹⁹.

Simultaneously, the IBBI must mandate certain forensic audit standards for every CIRP over a certain amount of admitted debt. Instead of making the extent of forensic audit process contingent upon the capacity and will of the RP, a standardized forensic audit process ensures that the examination of related party transactions, asset transfers, and off-balance sheet transactions is carried out systematically in every case²⁰.

(ii) Tighter Compliance Mechanisms

The enforcement gap in Section 19(2)²¹ needs to be bridged by enacting necessary legislation to provide time-based sanctions against corporate debtors' staff failing to cooperate with the RP. It cannot be expected that approaching the NCLT for directions in this regard will help since it is not an appropriate solution due to its slowness and cumbersome nature. An alternative can be the introduction of the deemed compliance concept whereby the failure to provide certain information within the stipulated time period shall lead to a statutory presumption of fraud shifting the burden of proof to the other party²².

Regarding the independence of CoC, it has to be ensured that all participating parties have no interest in the corporate debtor's affairs. To this end, the IBBI can ask creditors wishing to become a part of the CoC to disclose whether they have some connection with the

¹⁹ Insolvency and Bankruptcy Code, No. 31 of 2016, § 25(2)(j) (India).

²⁰ Insolvency and Bankruptcy Board of India (Insolvency Professionals) Regulations, 2016, reg. 7(2)(h) & Code of Conduct (India).

²¹ Insolvency and Bankruptcy Code, No. 31 of 2016, § 19(2) (India).

²² Insolvency and Bankruptcy Code, No. 31 of 2016, § 60(5) (India).

promoter/associates of the corporate debtor. In case any creditor does so, he should be debarred from participating in the CoC proceedings related to his conflict of interest issue²³.

VII. Conclusion

This paper has focused on one of the most critical yet often overlooked aspects of the Indian Insolvency regime – the discrepancy between the official de jure transfer of control away from the promoters as required by the IBC and the unofficial de facto retention of their influence via shadow control systems²⁴. It is clear that such discrepancy is an integral part of the overall CIRP process structure stemming from three key weaknesses: information asymmetries associated with a change of management, restrictions imposed by the current status quo of the RP position, and insufficient enforcement tools against willful obstruction.

It is important to note that the issues raised above, from capture of the CoC to proxy bidding, selective disclosure, and manipulation of liquidation proceedings, have a common property of being most potent in an informationally incomplete and uncoordinated environment²⁵. As such, the proposed remedies are targeted mainly at the improvement of the informational structure of the problem at hand, via forensic requirements, enhanced independence and statutorily-mandated penalties for non-cooperation.

²³ Insolvency and Bankruptcy Code, No. 31 of 2016, § 5(24) (India).

²⁴ Insolvency and Bankruptcy Code, No. 31 of 2016, §§ 43–51, 66 (India).

²⁵ Committee of Creditors of Essar Steel India Ltd. v. Satish Kumar Gupta, (2020) 8 S.C.C. 531 (India).