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Client Alert

Insolvency risk arising from the COVID-19 pandemic

The COVID-19 pandemic is creating an evolving and growing list of challenges. Amongst others, one likely challenge is that of economic recession. The disruptions in supply chain, reduced demand, cash flow issues, job losses etc. will put additional pressure on businesses. With lockdown being imposed, the severity of factors such as crunch in cash flow, supply chain disruptions etc. will increase exponentially, which could lead to the risk of insolvency for companies.

The managements of companies would need to address and mitigate the business risks that have arisen due to the pandemic. With the increase in financial distress, it may not be long before companies start defaulting on the payments, thereby putting themselves at the risk of being subject to insolvency proceedings.

The Insolvency and Bankruptcy Code, 2016 ("**IBC**") is the umbrella legislation in India relating to insolvency and liquidation of corporate persons.

With increased financial distress, large conglomerates, or companies forming part of such conglomerates, may have the cushion with respect to meeting capital requirements. However, micro, small and medium enterprises (MSME) may find the situation more challenging. Payment defaults towards financial and/or operational creditors could lead to a situation where such creditors would assess whether to enforce security (if available) or initiate insolvency proceedings against the corporate debtor.

To meet the liquidity challenge, State Bank of India ("**SBI**") has set up an emergency credit line for its borrowers to help them tide over the crisis triggered by the COVID-19 pandemic. As per the information available, SBI, through its departmental circular, has stated that "*With a view to provide some degree of relief to the borrowers whose operations are impacted by Covid-19, it is decided by the Bank to make available additional credit facilities to the eligible existing borrowers by way of ad-hoc facilities i.e. COVID 19 EMERGENCY CREDIT LINE (CECL) to tide over the crisis situation. CECL will be in force upto 30.06.2020.*"

The Government of India has formed a "COVID-19 Economic Response Task Force" headed by the Finance Minister. The purpose of this task force is to assess the impact of the pandemic on the economy and suggest economic relief measures.

Several financial packages have been announced in the past few days, and more are forthcoming.

The Finance & Corporate Affairs Minister, Nirmala Sitharaman, on March 24, 2020, announced several important relief measures taken by the Government of India in view of the COVID-19 outbreak. Accordingly, the Ministry of Corporate Affairs, vide a notification[1] dated March 24, 2020, specified INR 10,000,000 as the minimum amount of

[1] *https://ibbi.gov.in/uploads/legalframwork/48bf32150f5d6b30477b74f652964edc.pdf*

default for the purpose of initiation of insolvency proceedings under section 4 of the IBC. It may be noted that before the said notification, the minimum amount of default for the purpose of initiation of insolvency proceedings was INR 100,000. This measure would prevent triggering of insolvency proceedings against some cash-strapped companies.

Further, Ms. Sitharaman, also mentioned that if the current situation continues beyond April 30, 2020, then the Ministry of Finance may consider suspending sections 7, 9 and 10 of the IBC for a period of six (6) months so as to stop companies at large from being forced into insolvency proceedings in such force majeure causes of default.[2] In other words, the suspension of sections 7, 9 and 10, would mean that financial and operational creditors would be prevented from initiating corporate insolvency proceedings against corporate debtors during the suspension period.

On March 27, 2020, Reserve Bank of India ("**RBI**") announced several measures[3] to alleviate financial stress, build confidence, and keep the financial system sound and functioning. Several liquidity measures were announced to address and ease COVID-19 related liquidity constraints. Additional measures were announced to mitigate the burden of debt servicing brought about by the COVID-19 pandemic and ensure the continuity of viable businesses and provide relief to borrowers. These measures include moratorium on term loans, deferring interest payments on working capital, easing of working capital financing, etc. Based on these announcements by RBI, banks are expected to announce details of the measures as implemented by them soon.

While these measures are supportive of business and a step in the right direction, the full impact of the COVID-19 outbreak on companies is likely to be clear only in the coming months.

Companies suffering or anticipating financial distress may consider engaging with their creditors and other stakeholders to carve out the strategy going forward to ensure continuity of business.

The following options may be explored by companies to mitigate the potential risk of insolvency:

a. review of the existing contracts to consider the following two factors: (i) whether default in payment or an insolvency event has (or could be) triggered; and (ii) whether 'force majeure' is applicable and enforceable;
b. contracts under negotiation must include clauses that provide for measures to be taken during periods of restricted liquidity or economic uncertainty;
c. review of the balance sheet/cash flow position with financial and legal advisors, so that solvency concerns can be detected at an early stage; and
d. holding meetings with the stakeholders to strategize ways to fulfil contractual obligations.

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[2] *https://pib.gov.in/PressReleaseIframePage.aspx?PRID=1607942*
[3] *https://www.rbi.org.in/Scripts/bs_viewcontent.aspx?Id=3847*

About Chadha & Co.

Chadha & Co. is a leading corporate and commercial law firm based in New Delhi, India. The Firm has a specialized inbound practice in advising domestic and foreign corporations doing business in India on all Indian laws and regulations that are relevant to their business.

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