

Misuse of Moratorium Under the Insolvency and Bankruptcy Code, 2016: A Threat to the Going Concern Principle

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Abstract

The Insolvency and Bankruptcy Code (IBC), 2016, was enacted by the Government of India to consolidate and amend the laws relating to insolvency and bankruptcy, with the aim of promoting ease of doing business and protecting the interests of all stakeholders. One of the key features of the IBC is the moratorium, which provides a temporary suspension of certain legal actions against a company undergoing insolvency proceedings. While this provision was introduced to provide the debtor a breathing space and to ensure that the company's assets are preserved during the resolution process, there is a growing concern about its misuse. The misuse of the moratorium has significant implications on the going concern principle, which is a fundamental assumption in accounting and corporate governance. This paper explores the misuse of the moratorium under the IBC, its impact on the going concern principle, and the potential remedies to address these concerns.

Introduction

The Insolvency and Bankruptcy Code (IBC), 2016, was designed to provide a time-bound process for the resolution of insolvencies and to address the growing concerns of stressed companies in India. One of the main provisions of the IBC is the moratorium under Section 14, which imposes a temporary ban on the institution of suits, execution of judgments, and other legal proceedings against the corporate debtor during the corporate insolvency resolution process (CIRP).

The moratorium was intended to serve a positive purpose: to protect the company's assets from being depleted during the resolution process, thereby increasing the chances of a successful resolution. However, the growing number of instances where companies have misused this provision raises significant concerns. The strategic use of the moratorium to delay legal actions or avoid liabilities can jeopardize the financial stability of the company, and more importantly, undermine the going concern assumption on which companies rely for the preparation of their financial statements.

This paper delves into the misuse of the moratorium provision under the IBC and its implications on the going concern assumption, a cornerstone of corporate financial reporting. It will also analyze the risks and challenges associated with this misuse and propose potential reforms to mitigate its negative impact.

Moratorium Under the IBC

Legal Framework

Section 14 of the Insolvency and Bankruptcy Code, 2016, provides for the imposition of a moratorium at the initiation of the Corporate Insolvency Resolution Process (CIRP). The section is clear in its intent to

protect the corporate debtor by ensuring that:

- No suits or legal proceedings are initiated or continued against the corporate debtor.
- No transfer, encumbrance, or disposal of the corporate debtor's property takes place without the approval of the insolvency resolution professional (IRP).
- No action is taken for the recovery of any debts, claims, or demands from the corporate debtor.

The moratorium period lasts until the completion of the resolution process or until the Adjudicating Authority (NCLT) terminates the process. It is designed to preserve the status quo of the debtor's assets and operations, thereby preventing any actions that might undermine the company's ability to recover through the resolution process.

Objective of the Moratorium

The primary objective of the moratorium is to provide a window of time in which the corporate debtor can restructure or resolve its financial difficulties without the threat of asset liquidation or other legal encumbrances. During this period, the company is expected to focus on the formulation of a resolution plan that will allow it to continue as a going concern, thereby ensuring that value is maximized for all stakeholders.

However, the effectiveness of the moratorium can be undermined if it is misused. This misuse occurs when the moratorium is employed strategically to delay or avoid creditor claims or legal proceedings, rather than facilitating a genuine corporate restructuring.

Misuse of the Moratorium

Delaying Tactics

One of the most common forms of misuse of the moratorium is the use of the provision as a delaying tactic. In many cases, debtors may initiate the CIRP at a time when they are aware of their inability to repay creditors, with the aim of stalling enforcement actions such as asset seizure or litigation. The moratorium temporarily prevents creditors from exercising their rights, which can be used to buy time for the debtor to come up with a resolution plan. In such cases, the debtor may not have any intention of genuinely restructuring the business or reaching an amicable resolution with creditors.

This tactic leads to a situation where the financial distress of the company is prolonged unnecessarily, and the assets of the company, instead of being protected, continue to deteriorate, further diminishing the prospects for a successful resolution.

Avoidance of Legal Liabilities

Another significant concern is the misuse of the moratorium to avoid legal liabilities, particularly in cases where the debtor has been involved in fraudulent or illegal activities. The moratorium prevents creditors and other stakeholders from initiating legal action to recover debts, enforce judgments, or file suits against the debtor. In situations where a company faces criminal or civil liabilities, the moratorium can be misused to shield the company from legal consequences.

This is particularly dangerous in cases where the debtor has engaged in fraudulent activities, such as misappropriating funds, inflating asset values, or engaging in other forms of financial misconduct. The moratorium prevents creditors and regulators from taking action against such individuals, allowing them to escape accountability and further jeopardizing the interests of stakeholders.

Abuse by Promoters

In some instances, the promoters of the company may use the moratorium as a shield to retain control over the company's assets and operations. During the CIRP, the management of the company is typically taken

over by the insolvency resolution professional (IRP), but in some cases, promoters may attempt to regain control by manipulating the moratorium. This manipulation can result in the continuation of mismanagement, further exacerbating the company's financial difficulties and hindering the resolution process.

This abuse undermines the objective of the IBC, which is to ensure that distressed companies are restructured or liquidated in an orderly and transparent manner. The misapplication of the moratorium provision can prolong the insolvency process and result in the depletion of the company's assets, making the resolution process more challenging and costly.

The Going Concern Principle and Its Importance

The going concern principle is a fundamental accounting concept that assumes that a company will continue to operate for the foreseeable future unless there is evidence to the contrary. This assumption is crucial for financial reporting, as it allows for the deferral of liabilities and the capitalization of assets that will be realized in the future.

The going concern principle provides a framework for valuing assets and liabilities in a way that reflects the company's ongoing operations. If the principle is compromised, the financial statements of a company may fail to provide an accurate representation of its true financial position.

In the context of the IBC, the going concern principle becomes particularly important. The objective of the insolvency process is to ensure that the corporate debtor continues as a going concern, thus preserving its value and providing the best outcome for creditors and other stakeholders. However, if the moratorium is misused, it can hinder the ability of the company to continue its operations and undermine the going concern assumption.

Impact of Misuse on the Going Concern Principle

The misuse of the moratorium can have several detrimental effects on the going concern principle:

1. **Asset Depletion:** One of the main consequences of a protracted insolvency process due to the misuse of the moratorium is the depletion of the company's assets. The longer the process is delayed, the less likely it is that the company can recover its financial position, diminishing its ability to operate as a going concern.
2. **Diminished Stakeholder Confidence:** The misuse of the moratorium may lead to a loss of confidence among stakeholders, including creditors, employees, and investors. If creditors are unable to take legal action or recover their debts due to the moratorium, their confidence in the company's future prospects will decrease. This loss of trust can further undermine the going concern assumption.
3. **Operational Disruptions:** Delays in the resolution process often result in disruptions to the company's operations. Employees may leave, suppliers may refuse to provide goods or services, and customers may turn to competitors. These disruptions can significantly impact the company's ability to function as a viable business and thus threaten the going concern assumption.
4. **Distorted Financial Statements:** Financial statements based on the going concern assumption may become misleading if the company's financial position deteriorates due to the prolonged effects of the misuse of the moratorium. If the company's future operations are uncertain, the financial statements may not accurately reflect the company's true financial health, leading to potential misinterpretation by stakeholders.

Potential Solutions and Recommendations

To mitigate the misuse of the moratorium and its impact on the going concern principle, several reforms and measures can be considered:

- 1. Stricter Scrutiny by the Insolvency Professionals (IPs):** The insolvency resolution professionals play a key role in managing the moratorium process. Stricter guidelines and oversight by regulatory bodies can help prevent the misuse of the moratorium by ensuring that the CIRP process is not delayed unnecessarily and that the debtor is genuinely attempting to resolve its financial difficulties.
- 2. Transparency in Financial Reporting:** Greater transparency in the financial reporting of companies undergoing insolvency proceedings can help ensure that the going concern assumption is not misrepresented. Regular audits, disclosures, and independent assessments can provide stakeholders with a clearer understanding of the company's financial position and its ability to continue operations.
- 3. Enhanced Role of Creditors:** The creditors' committee should play a more active role in monitoring the progress of the CIRP and in ensuring that the moratorium is not being misused to delay or avoid legitimate claims. Strengthening the rights and powers of creditors can help prevent the abuse of the insolvency process.
- 4. Judicial Oversight:** More robust judicial oversight by the National Company Law Tribunal (NCLT) and appellate authorities can ensure that the moratorium is not being misused. Courts should be empowered to intervene in cases where there is clear evidence of abuse, and appropriate sanctions should be imposed on companies that misuse the moratorium.

Conclusion

The moratorium provision under the Insolvency and Bankruptcy Code, 2016, serves an important function in providing a temporary shield for distressed companies. However, when misused, it can have serious consequences for the going concern principle and the long-term viability of the company. Delaying tactics, avoidance of legal liabilities, and abuse by promoters can erode stakeholder confidence, deplete assets, and distort financial reporting.

To address these challenges, it is crucial to implement stricter oversight and regulatory reforms, enhance transparency in financial reporting, and ensure active participation from creditors. By doing so, the integrity of the insolvency resolution process can be safeguarded, and the going concern principle can be better protected, ultimately ensuring that the IBC fulfills its intended purpose of promoting efficient and effective corporate restructuring.