The Costs of Insolvency Professionals - A Challenge for Trade Creditors

*By Poornima Hatti and Aparna Ravi**

In the last few weeks, there has been a lot of attention on banks initiating insolvency proceedings against large corporates, particularly in light of the RBI's press release of June 13 directing banks to file insolvency resolution applications against specific debtors in default. However, as the report of the Bankruptcy Law Reform Committee makes clear, the Insolvency and Bankruptcy Code, 2016 (the "Code") is intended not just for banks and financial institutions, but for all types of creditors, including trade creditors and even employees who have not been paid their salaries. In assessing how the Code is doing so far, it is therefore important to consider the issues being faced by a range of creditors.

Under the Code, a creditor may file an application for commencement of the insolvency resolution process against a corporate if there has been a payment default of at least Rs. 1 lakh. To date, a number of trade creditors who are owed large payments by corporates for goods or services have filed or considered filing applications under the Code in cases where they would have previously filed applications for winding up in the High Courts (an option that no longer exists). However, for smaller trade creditors and employees, there is a significant practical obstacle that needs to be overcome if they choose to file an application – the costs of an insolvency professional.

One of the most significant changes introduced by the Code was a new class of insolvency professionals who replaced the court-appointed liquidators of the earlier regime. An insolvency professional needs to be appointed for every case which is admitted under the Code, where he would be tasked with facilitating the resolution process and managing the debtor's business on behalf of creditors. If a resolution cannot be achieved and the company goes into liquidation, an insolvency professional would be appointed as liquidator.

How do the costs of an insolvency professional work? The intention is for these fees and expenses to ultimately be paid out of the insolvent debtor's estate. The costs of an insolvency professional get priority in the liquidation waterfall and any corporate resolution plan that is agreed between creditors and debtor must necessarily make provision for the payment of the insolvency professional. The costs of a resolution professional need to be approved by the creditors' committee. These provisions are similar to those in other parts of the world, including the UK and US, where the costs of the insolvency process are paid out in priority to most other costs, and rightly ensure that insolvency professionals do not face the risk of non-payment for a service they are providing.

However, the Code does not specify how the costs of an insolvency professional are to be borne in the early stages of a proceeding. The regulations on the corporate insolvency resolution process state that the costs of the resolution professional will be decided and initially borne by the creditor or debtor who initiates the corporate insolvency resolution process. If these costs are later ratified by the creditors' committee, the creditor or debtor who filed the application will be reimbursed.

While market practice around the fees of insolvency professionals is yet to develop, in our experience, most insolvency professionals tend to charge a significant chunk of their fees upfront, first when they consent to act as a resolution professional, and second when the application is admitted. This means that any creditor who files an application under the Code faces the prospect of having to fund the costs of a resolution professional upfront with the risk that the creditors' committee may or may not ratify these costs as a later stage. The time period between filing an insolvency application and the first meeting of the creditors' committee could, even with the stringent timelines under the Code, be a few months. While this may not be a daunting prospect for financial creditors with deep pockets, it would be for an employee or a small trade creditor. Such creditors also have the added disadvantage that they would not be part of the committee of creditors (which is open only to financial creditors) that decides whether or not to ratify the insolvency professional's fees.

This is not to say that the fees being charged by insolvency professionals are unjustified. Given their wide-ranging responsibilities and liabilities under the Code, it is understandable that their fees will be significant and it is likely that with time insolvency professionals will develop fee structures suitable to different types of debtors and creditors. However, two measures can be taken to mitigate the impact for small creditors of having to bear the burden of the initial costs of insolvency resolution. First, the regulations should allow the creditors' committee very limited grounds for not ratifying the initial costs of the resolution professional. As the creditors' committee can, in any event, choose to appoint a new resolution professional, it must be required to ratify and share the initial costs of the professional. Not doing so would be penalising the creditor applicant for initiating a process from which all creditors stand to benefit.

Second, the institution of the court-appointed official liquidator of the prior regime was, even if hugely inefficient, a public resource which relieved creditors from having to bear enormous costs for initiating winding up petitions. In the wake of it is abolition, a solution must be found for trade creditors and employees to fund the initial costs of an insolvency professional between the time of making an application and the appointment of a creditors' committee, either through a publicly available fund or a service akin to legal aid for the insolvency profession. The resources needed to provide for such interim funding are not likely to be very high as ultimately the costs of the insolvency professional will be paid out of the debtor's estate.

Finding effective solutions for the costs of insolvency professionals is not a problem unique to India. The UK has had to review the fees charged by insolvency practitioners on a number of occasions. The UK Insolvency (Amendment) Rules that came into effect in October 2015 now require insolvency practitioners to provide upfront a summary of estimated costs, the work to be undertaken and, where an hourly rate is proposed, an estimate of the time required. The estimates serve as a cap on the insolvency practitioner's fees which can subsequently be changed only with the consent of creditors. These amendments were a response to evidence of the spiralling costs of insolvency practitioners and the finding that creditors, particularly unsecured creditors, appeared to have little control over these costs. In India too, the cost structure of insolvency professionals needs to be addressed to strike a balance between providing sufficient incentives for the profession to develop while ensuring that these costs do not serve as a disincentive for trade creditors to use the Code.

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