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[2018] 1 IBJ (Art.) 109

Rights of bondholders under the Insolvency and Bankruptcy Code, 2016

In this article, the author makes an attempt to answer question as to whether bondholder can initiate proceedings under the Insolvency and Bankruptcy Code, 2016.

Introduction

Bonds are financial instruments issued by companies. Bond is a contract between an investor and an issuer. Companies issue bonds at fixed rate of interest to meet its financial requirements. Bonds are repayable after a stipulated time period and interest is generally payable on regular intervals or on cumulative basis as per the terms of issue. Usually, the bonds are also listed on stock exchanges and due to its tradability, bondholders can exit investment without a lock-in period. Trustees are appointed for the bonds and certain powers are delegated to them, which they can exercise on the decision of majority or specified number of bondholders. Bonds fetch more interest than fixed deposits and are less risky as compared to equity shares. At times, due to cash flow issues or the losses to the issuer, the repayment of bond or interest on it are delayed and default occurs.

No Action Clause

A **clause** is commonly found in documentation for a **bond** issue where a trustee structure is used. Typically, the **clause** permits only the trustee to take enforcement **action** against the issuer or guarantor of the **bonds**. On bonds becoming due and payable, trustee may institute such proceedings against the issuer as it may think fit. No bondholder may institute proceeding unless the trustees have failed to do so.

Trustees take action against the issuers on decisions of majority bondholders. This clause allows majority holders the power to decide on the irregularity of bonds. Minority bondholders may suffer due to this clause.

At times, trustees need expenditure to be borne by bondholders and bondholders already deprived due to defaults in bonds may not further fund the trustees.

Whether bondholder can initiate proceeding under the Insolvency and Bankruptcy Code, 2016 ('Code')

No action clause blocks the right of individual bondholders and individual bondholders cannot initiate actions against issuers on default. Globally,

individual bondholders are barred from institution of suits. However, for winding-up petitions, Indian courts have accepted the individual bondholders being the creditors.

In BLRC Report, it is mentioned as follows :

“While the existing framework for secured credit has given rights to banks, some of the most important lenders in society are not banks. They are the dispersed mass of households and financial firms who buy corporate bonds. The lack of power in the hands of a bondholder has been one (though not the only) reason why the corporate bond market has not worked. This, in turn, has far reaching ramifications such as the difficulties of infrastructure financing.

Under these conditions, the recovery rates obtained in India are among the lowest in the world. When default takes place, broadly speaking, lenders seem to recover 20% of the value of debt, on an NPV basis.

When creditors know that they have weak rights resulting in a low recovery rate, they are averse to lend. Hence, lending in India is concentrated in a few large companies that have a low probability of failure. Further, secured credit dominates, as creditors’ rights are partially present only in this case. Lenders have an emphasis on secured credit. In this case, credit analysis is relatively easy: It only requires taking a view on the market value of the collateral. As a consequence, credit analysis as a sophisticated analysis of the business prospects of a firm has shriveled.”

The BLRC report has further noted as follows :

“This system has numerous advantages for the securities markets as a whole, and for corporate bonds in particular. For all investors, it gives a frictionless mechanism for transmission of cash flows from issuers to beneficiaries. It removes the possibility of issuers who selectively default on payments to powerful investors while reneging on less powerful investors. It eliminates the delays associated with establishing the fact that default took place when a bondholder desires to force the entity into the insolvency resolution process:

the depositories would be able to rapidly produce definitive proof that the required amount of cash was not sent to them on the appointed date.”

Code was drafted considering the plight of individual bondholders

The Code grants no authority to the trustees of bonds or debentures to initiate the insolvency resolution process. While the term ‘Financial Creditor’ includes debenture holders and bondholders as stated above, the Code does not specifically entitle trustees to initiate the insolvency resolution process.

Under the Code, any Financial Creditor or Operational Creditor can initiate action against the Corporate Debtor on following events.

There is a default in payment and the amount of default is minimum Rs one lakh. In case of debenture or bondholders, individual bondholders are empowered to take action under the Code.

The term ‘financial debt’ includes any amount raised pursuant to any note purchase facility or the issue of bonds, notes, debentures, loan stock or any similar instrument. Financial Creditor is the creditor who owes any financial debts. Therefore, bondholders are Financial Creditors under the Code. No action clause does not bar individual bondholder to initiate action against the Corporate Debtor in case of default.

