

Insolvency is a financial stringency i.e. when an individual or an organization/company is no longer capable to pay the debts he/it owes. Insolvency usually leads to insolvency proceedings, in which legal action can be taken against the insolvent, and assets may be liquidated to pay off the outstanding debts.

## When a Person / Entity can be Declared Insolvent

Before declaring an entity or a person as insolvent, a competent court defines two conditions –

- A person or entity should be debtor and
- He/it should had done any act of insolvency.

**Act of insolvency** means, when a person (debtor) shows that he is not able to pay his liabilities.

An order of adjudication must be passed by the court of law, before legally declaring any person insolvent. To pass an order of adjudication by the court of law, a petition should be filed by any of the creditor or creditors or by the debtor himself. Petition by the creditor may be filled only in following conditions;

- Debt should be at least for Rs. 500/- or more
- Within three months of petition, an act of insolvency should be done by debtors.

After filing the petition, the competent court will fix date of hearing and then it may declares that the debtor is insolvent or not. If insolvency of a person starts from an earlier date, and not from the date of adjudication passed by the court. This is known as **Doctrine of Relation Back**.

Under Presidency Towns Act, to conduct the insolvency proceedings, an official is appointed by the court is known as **Official Assignee** and in case of Provincial Insolvency Act, known as **Official Receiver**. The property of the insolvent vests in the official assignee or receiver to realize the assets and distribute the sale proceeds of the assets in the manner given below -

- Secured creditors will be paid in full.
- Remuneration and expenses of the official receiver.
- To Preferential Creditors.
- To unsecured creditors + partly secured creditors to the extent remain un-secured.

## The Order of Discharge

Order of discharge is an order issued by the court of law to the insolvent. Normally, this order releases the insolvent from all current and provable debts and liberates him from the legal obligations imposed on an insolvent. The order of discharge is issued on the basis of the report submitted by the official receiver and on the application of the insolvent.

## Interest

An interest @ 6% pa will be paid to the creditors for the period, after the order of adjudication, if any surplus remains, after full payment to the creditors.

## Voluntary Transfer

As per the Presidency Towns Insolvency Act, any property transferred by the insolvent without any consideration during the two years preceding the order of adjudication shall be void. Under the Provincial Insolvency Act, such transfer became inoperative, if made within two years of petition of the insolvency except followings –

- For consideration of marriage and made before and

- To purchase valuable consideration in good faith.

## Insolvency Law

The Insolvency Act in India is based on English Bankruptcy Act and following two acts are applicable on the Indian Territory –

- **The Presidency Towns Insolvency Act, 1909** – Applicable to Mumbai, Kolkata, and Chennai.
- **The Provisional Insolvency Act, 1920** – Applicable to the rest of India except Mumbai, Kolkata, and Chennai.

Above Insolvency Acts are applicable to any Individual, Partnership Firm, and Hindu Undivided Family only. Companies Act, 1956 applies to Joint stock companies and the term liquidation is used instead of Insolvency. In case of insolvency, a person is not able to pay his liabilities but in case of liquidation, company may be liquidated even it has the sufficient amount to pay its liabilities.

## Insolvency Accounts

Under the Presidency Towns Insolvency Act, insolvent has to submit following documents to the court of law –

- Statement of Affairs as on date of order and
- Deficiency Account.

No provision, for the submission of a Statement of Affairs under Provincial Insolvency Act. The form of Statement of Affairs as prescribed by the rule made under Presidency Towns Act is given below –

### **Statement of Affairs**

(As required by the Indian Insolvency Act)

### **In the Court of Justice**

In insolvency

To the insolvent – you are required to fill up carefully and accurately, this sheet and the several sheets, A,B,C,D,E,F,G, and H, showing the state of your affairs on the day on which the order of adjudication was made against you viz. the .....day of .....20.....

Such sheets, when filled up will constitute your Schedule and must be verified by Oath or Declaration.

Gross Liabilities (Rs.)	Liabilities (as stated and estimated by the debtor)	Expected To rank	Assets (as stated and estimated by the debtors)	Estimated to produce
	<p>Unsecured Creditors as per List A</p> <p>Fully Secured Creditors as per list B</p> <p>Less: Estimated value of Securities</p> <p>Less: Amount thereof carried to List C</p> <p>Balance thereof <i>contra</i></p> <p>Partly secured creditors as per List C</p> <p>Less: Estimated value of Securities</p> <p>Preferential Creditors as per List D (Creditors</p>		<p>Property as per List E, viz.</p> <ul style="list-style-type: none"> <li>▣ Cash at Bank</li> <li>▣ Cash in hand</li> <li>▣ Cash deposited with solicitor for cost of petition</li> <li>▣ Stock in trade</li> <li>▣ Machinery</li> <li>▣ Trade Fixture, Fitting, Utensils, etc.</li> <li>▣ Furniture</li> <li>▣ Life Insurance Policies</li> <li>▣ Other property</li> </ul> <p>Book debts as per list F, viz.</p> <p>Good</p> <p>Doubtful</p> <p>Bad</p>	

	<p>for rent, taxes, salaries and wages, etc.) payable in full as per <i>contra</i></p>		<p>Estimated to produce</p> <p>Bills of exchange or other similar</p> <p>Securities on hand as per List G</p> <p>Estimated to produce</p> <p>Surplus from securities in the hands of creditors fully secured (per <i>contra</i>)</p> <p>Deduct: Creditors for preferential rent, rates, taxes, wages, etc. (per <i>contra</i>)</p> <p>Deficiency as per explained in list H</p>	
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I /We .....make oath, solemnly affirm,  
and say, that the above statement and the  
several lists hereunto annexed marked  
A,B,C,D,E,F,G, and H are to the best of  
my/our knowledge and belief, a full and  
complete of my/our affairs on the date of  
the abovementioned order of adjudication  
made against me/us.

Affirmed----- at. ....this.....  
day of Sworn Before me.

.....  
(Signature)  
Commissioner

### Unsecured Creditors as per List A

Trade creditors, *stridhan* ornament and personal belongings etc. of lady) of Mrs., bills payable, bank overdraft, partly paid shares held, uncompleted contracts guarantees given for others, etc., wages, rent, salaries, etc.

### Loan from Wife

Loan taken from wife is usually treated like any other loan taken and makes wife creditor of the insolvent. In case, it is proved that loan is paid by wife out of amount received from insolvent, then be treated as the capital of insolvent.

### Interest

@ 6% interest will be paid to the creditors after the date of adjudication, if there is a sufficient balance left after the payments to creditors.

### Fully Secured Creditors as per List B

The creditors who have sufficient securities against their claims will be included in this list and after paying these creditors, balance amount will be shown on the asset side of the statement of affairs as available balance to distribute among other creditors.

### Partly Un-secured Creditors as per List C

Un-paid or unsatisfied amount of the partly secured creditors will be shown as expected to rank column as unsecured creditors, to be divided for unpaid amount.

### Preferential Creditors as per List D

Following creditors comes under the category of preferential creditors and such



## Preferential Creditors as per List D

Following creditors come under the category of preferential creditors and such creditors get preference over the unsecured creditors.

As per the law, following creditors come under category of the preferential creditors -

- Government and local authority.
- Salary and wages for the service rendered for four months preceding the date of the presentation of the insolvency petition.
- Under Presidency Town Insolvency Act, one month rent comes under the category of preferential creditors, but rent is not at all comes under the preferential creditors category as per the Provincial Insolvency Act.

The assets as shown in the statement of affairs of insolvent are classified into the four categories as follows -

- **Property as per List E** - Other than the bills receivable in hand and the assets as kept by creditors as fully and partly secured debts are comes under this list.
- **Property as per List F** - Following are the three categories of book debts -
  - Good
  - Doubtful Debts
  - Bad
- **Assets as per List G** - Bills of exchange and other similar securities comes under this list.

- **Assets as per List G** - Bills of exchange and other similar securities comes under this list.
- **Deficiency Account as per List H** - As name suggests, deficiency account means the deficiency, which the insolvent debtor is not able to pay.

### Important Points in Preparation of Statement of Affairs

- In case of an individual insolvent, no distinction will be made between the private assets and the business assets while preparing a Statement of Affairs. Personal assets are included in the Statement of Affairs to pay the business liabilities. In case of partnership firm, after paying personal liabilities from the personal assets of the partner, surplus if any, may be included in the statement of affairs of Partnership firm to pay the business liabilities.
- Value exceeding Rs. 300/- of tools, wearing apparel, bedding, cooking utensils, etc. will be included in the statement of affairs under the Presidency Towns Insolvency Act. Assets, as pledged against secured and partly secured creditors, may be shown in the statement of affairs only, if, became surplus after paying the fully and partly secured creditors.
- Fully secured assets are not shown in the 'expected to rank' column.
- Partly secured assets after paying partly secured debts will be shown in the column of 'expected to rank.'

- The bills discounted to be dishonored are included in the unsecured creditors as per the list A.

## Difference between Balance Sheet and Statement of Affairs

Following are the main differences between Balance Sheet and Statement of Affairs –

- The value of assets is shown as books value as well as releasable value in the statement of affairs; however, it is shown as only book value as in the case of Balance sheet.
- In the Statement of Affairs, prepaid expenses and goodwill are not included, whereas all fictitious assets are included in the Balance sheet.
- Statement of Affairs does not include capital, drawings, profit, or loss, interest on capital, whereas Balance sheet includes all such items.
- Balance sheet does not show the amount of deficiency as shown in the Statement of Affairs.
- Balance sheet is prepared at the end of accounting period, whereas Statement of Affairs is prepared on the date on which order of adjudication is passed.
- Statement of affairs is prepared as per the rule of Insolvency Act, whereas Balance sheet is a routine work to maintain the accounting record.

- Balance sheet of a firm does not include personal assets and liabilities, whereas Statement of Affairs includes the same as discussed above in this chapter.
- Statement of Affairs includes contingent liabilities, whereas in the Balance sheet, contingent liabilities are shown as footnote only.

## Deficiency Account (List H)

### Specimen of Deficiency Account List H

	Amount (Rs.)		Amount (Rs.)
<p>Excess of Assets over liabilities i.e. capital on .....</p> <p>Net profit arising from carrying on business after deducting usual trade expenses, income or profit from other source i.e.</p> <ul style="list-style-type: none"> <li>▣ Interest on capital</li> <li>▣ Excess of private assets over private liabilities</li> <li>▣ Profit on realization of any assets</li> </ul> <p>Deficiency as per statement of Affairs</p>		<p>Excess of Liabilities over assets</p> <p>Net Loss arising from carrying on business after deduction from profit, usual trade expenses</p> <p>Bad debts as per list F</p> <p>Expenses incurred since.....</p> <p>Other than usual trade expenses, viz.</p> <p>House hold expenses (Drawings)</p> <p>Other Losses -</p> <ul style="list-style-type: none"> <li>▣ Loss on realization of Assets</li> <li>▣ Loss through dishonor of discounted bills</li> </ul> <p>Speculation losses</p> <p>Losses through betting</p> <p>Excess of private liabilities over private assets, etc.</p>	

From the above, it is clear that debit side of the deficiency account shows capital account and credit side of the deficiency accounts shows losses and drawing and the difference of two sides is a deficiency as shown in the Statement of affairs Account.

## Insolvency of Partnership Firm

Insolvency of the partnership firm differs from the insolvency of any individual or HUF (Hindu undivided family). The assets of an individual are used to pay the business liabilities, but in case of partnership firm, assets of the partners are used to pay his personal liabilities first, and then balance, if any, may be utilized to pay the business debts. After paying the personal debts of a partner, surplus assets will appear in the Statement of Affairs and will be shown as **“Property as per List E.”**

In case, if personal asset of a partner is in possession of any creditor as security, still such creditor will get his dues first as unsecured creditor from the firm and then for the balance amount, he may sell the property, owned by him to recover his dues.