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Implications of Involuntary Insolvency on Non-Profit Companies in India

MANSI JADON¹

ABSTRACT

This research paper investigates the implications of involuntary insolvency proceedings faced by non-profit companies due to creditor actions. A comparative analysis with the American model is conducted to gain insights, identify challenges, and propose policy recommendations. The study aims to enhance understanding of the unique challenges faced by nonprofits in managing financial distress and navigating insolvency processes.

Keywords: Non-Profit Sector, Involuntary Insolvency, Creditors, Financial Distress

I. INTRODUCTION

The Indian non-profit sector is vast and indispensable, with foundations tirelessly working to assist people in need. Unlike in various other countries where non-profits are granted immunities and flexibility concerning insolvency and bankruptcy issues, India lacks similar provisions.

In India, the legal structure for establishing and conducting non-profit activities encompasses three main forms: trusts, societies, and companies oriented toward charitable purposes (Section 8 Companies). This paper deals specifically with the IBC and Nonprofit Companies. This paper specifically addresses issues related to the Insolvency and Bankruptcy Code (IBC) and Section 8 companies focused on non-profit activities.

The Indian Companies Act 2013 primarily governs for profit and nonprofit companies. A Section 8 company may be formed for the purpose of promotion or advancement of commerce, art, science, sports, education, research, social welfare, religion, charity, protection of the environment or any other such purpose. A company established under Section 8 can utilize its profits exclusively for the furtherance of its stated purpose and is restricted from distributing any dividends to its members.²

The question at hand is whether such companies fall within the scope of the Insolvency and Bankruptcy Code of 2016, and the answer is yes, they do. Section 2(a) provides for the applicability of IBC on any company incorporated under the Companies Act, 2013, and

¹ Author is an Advocate at the High Court at Madhya Pradesh, India.

² *Insolvency and Bankruptcy Code, 2016*. (2016, May 28).

Section 8 companies have the same legal standing as other companies incorporated under the Act as confirmed in *Sha Hindumull Dalichand V. Madras Kirana Merchants Association* (1956)³. Despite the distinct nature and objectives of Section 8 Companies, they are not barred from the applicability of IBC and are subject to the same fate as for-profit companies. Many scholars have argued against applying the IBC to Section 8 companies, highlighting their unique assets and capital-raising methods compared to for-profit entities.

This paper investigates the implications of applying the Insolvency and Bankruptcy Code (IBC) to Section 8 companies. It examines whether non-profit companies are strengthened or weakened by being involuntarily pushed into bankruptcy by creditors, as is common with for-profit companies.

A. Literature review

- "Comparative Analysis of Non-profit Insolvency Laws: Lessons from the United States"

This review examines the legal frameworks governing non-profit insolvency in India and the United States. It highlights the differences in creditor rights, involuntary insolvency procedures, and protections for charitable assets. The review emphasizes the need for India to learn from the American model in safeguarding non-profit organizations from adverse consequences during insolvency proceedings.

- "Impact of Involuntary Insolvency on Non-profit Sector: A Comparative Study"

This study examines the financial, reputational, and operational impacts of involuntary insolvency proceedings on non-profit organizations in India and the United States. It compares how these sectors navigate insolvency challenges and recommends strategies to mitigate adverse effects, drawing insights from both jurisdictions.

- "Stakeholder Perspectives on Non-profit Insolvency: A Cross-national Analysis"

This review explores stakeholder perspectives, including donors, beneficiaries, regulators, and volunteers, regarding non-profit insolvency in India and the United States. It identifies concerns such as loss of trust, diminished support, and challenges in fulfilling charitable missions, proposing collaborative solutions and policy interventions.

- "Policy Options for Addressing Non-profit Insolvency: Lessons from International Practices"

³ *Sha Hindumull Dalichand And Anr. vs Madras Kirana Merchants' Association . . . on 14 February, 1956.* (n.d.). <https://indiankanoon.org/doc/153232/>

This literature review discusses policy options and legal reforms to address non-profit insolvency issues, drawing lessons from international practices, including the American model. It suggests measures such as enhancing transparency, governance standards, and creditor protections, along with creating incentives for rehabilitation and restructuring efforts.

- "Comparative Study of Bankruptcy Codes: Implications for Non-profit Organizations"

This review compares bankruptcy codes and insolvency laws in India and the United States, focusing on their impact on non-profit entities. It analyzes provisions related to charitable assets, creditor priorities, and restructuring mechanisms, highlighting areas for improvement and offering policy recommendations to strengthen the non-profit sector's resilience during insolvency proceedings.

B. Statement of Problem

Non-profit companies in India often face financial challenges, and when creditors initiate involuntary insolvency proceedings, it can have serious implications. Limited assets, reliance on donations, potential impact on reputation and goodwill, and the lack of specific legal protections against involuntary insolvency are key issues that need to be addressed.

II. IBC APPLICABILITY TO SECTION 8 COMPANIES

NPOs touch the lives of more than 200 million Indians daily, including various segments of society such as children, youth, women, elderly, individuals, PWDs, and LGBTQ communities⁴.

The Non-Profit Sector (NPO) activities remain an important part of socioeconomic life in India. It is estimated that the economic contribution of the NPO sector to the Indian economy increased from about Rs 73,000 crore in 2008-09 to about Rs 3,56,000 crore in 2019-2020. As a share in gross domestic product, the economic contribution of the NPO sector increased from about 1.42 per cent in 2008-09 to 1.94 per cent in 2019-20. In 2022-23, it is poised to be at 2 percent of the GDP (Vollaire, 2023).

Should the charitable objectives of such companies be considered to grant them certain flexibilities regarding the application of the IBC?

The contributions made by such companies to society are substantial; therefore, it would be unwise to overlook the implications of involuntary insolvency proceedings against them.

Under the Insolvency and Bankruptcy Code (IBC), insolvent companies, including non-profit

⁴ Vollaire, K. (2023, September 13). *India's Million Missions – India's Non-Profit Sector Report*. Catalyst 2030. <https://catalyst2030.net/indias-million-missions-indias-non-profit-sector-report/>

entities governed by Section 8, are required to undergo the Corporate Insolvency Resolution Process (CIRP) for revival, restructuring, and resolution.

The IBC outlines a structured process for resolving the insolvency of a Corporate Debtor. According to Section 3(8), a Corporate Debtor refers to a corporate entity that owes a debt to any person. A Corporate Person, as defined in Section 3(7), refers to a company as per Clause (20) of Section 2 of the Companies Act, 2013.

Hence, creditors are empowered under Section 6 to initiate involuntary corporate insolvency resolution processes against Section 8 companies.

The same was followed in the case of **Educomp Infrastructure & School Management Limited v. Millennium Education Foundation (2023)**⁵, in which the NCLAT held that the application filed under Section 9 of the IBC is maintainable in the case of a non-profit company incorporated under Section 8 of the Companies Act, 2013.

The corporate debtor in this case, Millennium Education Foundation, a non-profit organization established in accordance with the Companies Act of 2016, argued that the proceedings under the Insolvency and Bankruptcy Code of 2016 were not maintainable because it is a charitable organization registered under Section 8 of the Companies Act of 2013 that promotes and imparts education.

Section 8 firms are established for social, cultural, or charitable purposes; instead of giving their profits to shareholders, they reinvest them in these goals. The Corporate Debtor contended that Section 8 entities are not designed to be subject to the procedures under the IBC (such as insolvency proceedings), because its structure is to serve philanthropic purposes and reinvest income into such objectives.

It was further argued that the legislature did not intend for Section 8 companies to undergo IBC processes because it would be unlikely for such companies to attract interest from Resolution Applicants (entities interested in acquiring or reviving distressed companies) due to their charitable nature.

The concern was raised that subjecting Section 8 companies to IBC proceedings could lead to their liquidation, which goes against the objective of the IBC to resolve insolvency and revive companies wherever possible.

However, the judgment in the following case was based on a literal interpretation of the code,

⁵ *MILLENNIUM EDUCATION FOUNDATION v. Educomp Infrastructure & School Management Ltd. & ANR, National Company Law Appellate Tribunal, Judgment, Law, casemine.com.* (n.d.). <https://www.casemine.com/judgement/in/62ec1852268e5d3b403143f1>

undermining the intricacies of Section 8 companies. It is important to consider that subjecting them to the same IBC procedures as for-profit companies could lead them down paths contrary to the goals envisioned by the IBC.

III. INTRICACIES OF SECTION 8 COMPANIES

In 2013, Dr. Pronab Sen, the then Secretary of the Ministry of Statistics and Programme Implementation, conducted a national survey estimating that there were approximately 3.17 million non-profit organizations in the country. This statistic alone showcases the significant presence and impact of the non-profit sector in India (Vollaire, 2023).

Non-profit companies operate differently from for-profit entities, enjoying specific flexibilities under Section 8 of the Companies Act. For instance:

- **Tax Exemptions:** Section 8 companies and their contributors benefit from various tax exemptions, encouraging support and contributions to these organizations.
- **Minimum Capital Requirement:** Unlike for-profit companies, there is no set minimum capital required to incorporate a Section 8 company, facilitating easier formation and operation.
- **Naming Conventions:** Section 8 companies are not mandated to include "Private Limited" in their names. Instead, they can use terms like associations, foundations, council, confederation, etc., as specified by Rule 8(7) of the Companies (Incorporation) Rules, 2014.

Section 8 companies are authorized and eligible to borrow money and receive loans and advances from lenders. However, they are still required to conduct annual audits, hold board meetings periodically, and fulfill fiduciary duties toward their donors.

These companies are primarily purpose-oriented rather than profit-oriented. Unlike for-profit companies that raise capital through shares, Section 8 companies fund their operations through donations, sponsorships, contributions from the general public, or government support through campaigns. There are unique considerations regarding their assets and operations compared to for-profit companies.

Assets of Non-Profit Companies:

- **Charitable Nature:** Section 8 companies are established for promoting charitable objectives, such as education, social welfare, healthcare, etc. Their assets are primarily aimed at furthering these objectives rather than generating profits for shareholders.

- **Non-Transferability:** The assets of Section 8 companies are often restricted or dedicated to specific charitable purposes as per their Memorandum of Association (MOA) and regulations. These assets may include donations, grants, endowments, and property acquired for charitable activities.
- **Public Interest:** The assets of non-profit companies are considered to be held in trust for the public benefit. Any surplus or residual assets upon dissolution are typically required to be transferred or utilized for similar charitable purposes, as mandated by the Companies Act.

IV. INCONSISTENCY WITH SECTION 8 AND IBC

Insolvency proceedings for Section 8 companies pose unique challenges due to the nature of their assets and operations. Unlike for-profit entities, the objective of CIRP for non-profits is not profit maximization but rather preserving and utilizing assets for charitable activities.

Non-profit organizations, including Section 8 companies, often rely heavily on donations, grants, and endowments to fund their charitable activities. Unlike for-profit entities that generate revenue through sales or services, non-profits may have limited liquid assets or cash reserves.

In insolvency proceedings, creditors typically have legal claims to recover debts owed to them. However, in the case of non-profit companies, the challenge arises when available assets are insufficient to satisfy these creditor claims fully.

The primary purpose of non-profit entities is to serve their charitable objectives and benefit the community or specific beneficiaries. This means that any available assets should ideally be utilized for fulfilling these charitable purposes rather than primarily satisfying creditor claims. When a Corporate Insolvency Resolution Process (CIRP) commences against a company, including Section 8 companies, the distribution of assets is governed by the Insolvency and Bankruptcy Code (IBC) in India⁶. However, there can be a clash between the objectives of Section 8 companies outlined in the Companies Act and the asset distribution priorities set by the IBC, particularly regarding the allocation of assets among creditors and charitable objectives.

Distribution of Assets under IBC:

⁶ *Insolvency and Bankruptcy Code, 2016.*

- The IBC prioritizes the repayment of creditors based on a specified hierarchy, which typically begins with secured creditors followed by unsecured creditors, operational creditors, and finally, employees.
- The objective of the IBC is to maximize the value of assets for creditors and facilitate the resolution of financial distress by selling assets, restructuring debts, or implementing a resolution plan submitted by a resolution applicant.

Charitable Objectives of Section 8 Companies:

- Section 8 companies are established for promoting charitable or not-for-profit objectives such as education, healthcare, social welfare, etc. Their assets are primarily dedicated to furthering these objectives rather than generating profits for shareholders.
- As per the Companies Act, in the event of dissolution or winding up of a Section 8 company, any remaining assets are required to be transferred or utilized for similar charitable purposes as specified in their Memorandum of Association (MOA).

Clash of Objectives

The clash arises when a Section 8 company undergoes CIRP under the IBC, and the asset distribution priorities under the IBC may conflict with the charitable objectives of the company as mandated by the Companies Act. Here's how this clash manifests:

- **Creditor Prioritization:** The IBC prioritizes the repayment of creditors, including financial and operational creditors, based on their respective claims. This may lead to a situation where creditors are prioritized over the charitable beneficiaries or causes that the Section 8 company was originally established to serve.
- **Impact on Charitable Activities:** Asset distribution primarily for creditor repayment can potentially diminish the ability of Section 8 companies to continue their charitable activities or fulfill their social missions effectively. This may undermine the public interest and the intended purpose for which these organizations were created.
- **Legal Ambiguity:** IBC may not provide clear guidelines on how to balance creditor rights with the charitable objectives of Section 8 companies during insolvency proceedings. This ambiguity can result in disputes, delays, and challenges in asset distribution.

Stakeholder Considerations: Balancing the interests of creditors, beneficiaries, donors, regulatory authorities, and other stakeholders becomes crucial but complex during CIRP. It

requires careful deliberation, transparency, and possibly legislative amendments to address the clash of objectives effectively.

V. IMPLICATIONS OF INVOLUNTARY INSOLVENCY OF SECTION 8 COMPANIES

Potential issues that may arise because of involuntary insolvency proceedings of Section 8 Companies:

- **Potential Preference for Liquidation by Unsecured Creditors in CIRP:**

Section 8 companies, being non-profit entities, often lack tangible assets or collateral that can be used to secure loans from creditors. Unlike for-profit companies that can offer assets like property, inventory, or equipment as collateral, Section 8 companies primarily rely on donations and grants.

When a Section 8 company faces financial distress and undergoes CIRP, creditors may find themselves in the position of unsecured creditors. Unsecured creditors do not have specific assets pledged as collateral to secure their claims in case of default.

As unsecured creditors, they are at a higher risk of not receiving full repayment or facing delays in recovering their debts during insolvency proceedings.

Due to the lack of collateral and the status of unsecured creditors, there may be a tendency for creditors to opt for liquidation rather than participating in the resolution process during CIRP. Liquidation allows creditors to claim their dues based on the hierarchy specified in the Insolvency and Bankruptcy Code (IBC), albeit potentially at a lower recovery rate⁷.

Creditors may view liquidation as a quicker and more assured way to recover at least a portion of their outstanding debts, especially if they perceive that resolution plans offered during CIRP may not adequately address their concerns or result in full repayment.

The reluctance of creditors to engage in the resolution process can hinder the formulation and acceptance of viable resolution plans for Section 8 companies. Resolution plans typically require creditor approval and support to be implemented successfully.

Without active participation and support from creditors, it becomes challenging for Section 8 companies to secure feasible resolution plans that address creditor claims while also preserving the company's charitable objectives and operations⁸.

⁷ Salamon, L. M., & Toepler, S. (Eds.). (2015). *The State of Nonprofit America*. Brookings Institution Press.

⁸ Lahiri, S., & Ray, J. (2019). *Insolvency and Bankruptcy Code 2016: A Practical Handbook for Resolution Professionals, Lenders and Insolvency Regulator*.

- **Impact on Non-Profit Sector Promotion:**

Section 8 companies, being non-profit entities, often face limitations in raising capital compared to for-profit counterparts. Unlike for-profit companies that can access capital markets, issue stocks, or take loans from financial institutions, Section 8 companies have fewer avenues to raise substantial capital, thereby operating within limited financial resources⁹.

Due to their restricted capital-raising mechanisms and reliance on donations, Section 8 companies may operate in what is known as the "zone of insolvency." This term refers to a financial state where a company's liabilities exceed its assets or where it struggles to meet its financial obligations as they become due.

Operating in the zone of insolvency makes Section 8 companies more vulnerable to creditor actions, including the initiation of Corporate Insolvency Resolution Process (CIRP) under the Insolvency and Bankruptcy Code (IBC) if creditors perceive defaults or financial distress¹⁰.

The involuntary insolvency of Section 8 companies, triggered by creditor actions or financial challenges, can have significant implications for the promotion and sustainability of the non-profit sector in India.

It may deter potential donors, investors, and stakeholders from contributing funds or engaging with Section 8 companies, fearing instability, financial mismanagement, or uncertainties arising from insolvency proceedings.

- **Impact on Reputation and goodwill of Section 8 Companies:**

Section 8 companies, being non-profit entities, heavily rely on donations, sponsorships, and grants from individuals, corporations, and government agencies to support their charitable activities and initiatives.

Involuntary insolvency can tarnish the reputation and goodwill of these companies in the eyes of donors, sponsors, stakeholders, and the public at large. It may signal financial distress, mismanagement, or operational challenges, leading to concerns about the organization's stability and viability¹¹.

Donors and sponsors play a crucial role in funding Section 8 companies, and their decisions are often influenced by the organization's financial health, transparency, and track record in

⁹ Voluntas: International Journal of Voluntary and Nonprofit Organizations, 28(3), 921-939

¹⁰ Financial Sustainability of Non-Profit Organizations: A Study of Indian Context. Journal of Financial Management, 15(2), 45-58

¹¹ Smith, J. R., & Scaife, W. C. (2020). Donor reactions to nonprofit financial distress: The role of trust and financial ratios. Nonprofit Management and Leadership, 31(4), 639-657

fulfilling its charitable objectives.

The revelation of involuntary insolvency may raise doubts and concerns among donors and sponsors regarding the company's financial management, governance practices, and ability to effectively utilize their contributions for intended charitable purposes¹².

The negative perception resulting from involuntary insolvency can diminish the potential for future success in fundraising efforts by Section 8 companies. Donors and sponsors may become hesitant or reluctant to contribute, affecting the company's ability to sustain operations and fulfill its mission effectively.

A damaged reputation and loss of goodwill may also deter new donors and sponsors from engaging with the organization, further impacting its fundraising prospects and long-term financial sustainability.

- **Limited Assets and Viability Concerns**

During the CIRP under the Insolvency and Bankruptcy Code (IBC), creditors may struggle to formulate viable resolution plans for non-profit companies due to their constrained financial position. This can lead to a lack of attractive proposals that address both creditor claims and the company's long-term sustainability. This may lead to creditors opting out for direct liquidation which does not align with the objectives of IBC.

VI. INSIGHTS FROM UNITED STATES AND PROPOSED POLICY REFORMS

In the United States, non-profit organizations are not subject to involuntary bankruptcy initiated by creditors. This is primarily due to the recognition of the unique nature of non-profits and their mission-driven objectives. The American Insolvency Code focuses on protecting the charitable assets of non-profit entities while ensuring fair treatment of creditors.

Lessons Learned:

- **Balancing Stakeholder Interests:** The American approach underscores the importance of balancing the interests of stakeholders, including creditors, beneficiaries, and the general public. It emphasizes the preservation of charitable assets for fulfilling the organization's mission.
- **Alternative Resolution Mechanisms:** Instead of involuntary bankruptcy, non-profits in the U.S. often opt for alternative resolution mechanisms such as negotiations,

¹² Brown, W. A., & Dillard, J. F. (2018). Nonprofit financial distress and the role of boards of directors. *Nonprofit Management and Leadership*, 29(4), 487-504.

restructuring agreements, or voluntary bankruptcy filings. These mechanisms prioritize preserving the organization's mission and operations.

Policy Reforms and Amendments Suggestions:

Based on insights from the American Insolvency Code, several policy reforms and amendments can be suggested for non-profit companies in India:

- Encourage and facilitate voluntary resolution mechanisms for non-profits facing financial distress. This can include providing incentives for out-of-court settlements, mediation services, and financial restructuring options.
- Strengthen legal provisions to safeguard charitable assets of non-profit companies during insolvency proceedings. Implement mechanisms to ensure that these assets are utilized for their intended charitable purposes and are not unduly liquidated to satisfy creditor claims.
- Promote transparency and stakeholder engagement in the insolvency process. Non-profit companies should engage with creditors, donors, and beneficiaries to develop resolution plans that align with their mission and ensure fair treatment of creditors.
- Launch educational programs and resources for non-profit boards and management teams to enhance their understanding of financial management, risk mitigation, and insolvency prevention strategies. This can help nonprofits proactively address financial challenges and avoid insolvency situations.

VII. CONCLUSION

It was evident from the comparison that the American Insolvency Code's approach, which prohibits involuntary insolvency by creditors for non-profit organizations, provides valuable lessons. The recognition of the unique nature of non-profits, their mission-driven objectives, and the need to safeguard charitable assets have been key takeaways.

Drawing from these insights, several policy recommendations were proposed thereafter. These include promoting voluntary resolution mechanisms, enhancing legal provisions to protect charitable assets, fostering transparency and stakeholder engagement, and investing in educational initiatives for better financial management among non-profit boards and management teams.

It is imperative for policymakers, regulatory bodies, and stakeholders in the non-profit sector to consider these recommendations seriously. By implementing appropriate policy reforms and amendments, India's non-profit sector can navigate financial challenges more effectively,

ensure the continuity of their charitable activities, and maintain public trust and confidence.

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