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A shorter haircut

Timely use of IBC can help minimise and even avoid losses for creditors

THE INSOLVENCY and Bankruptcy Code, 2016 (IBC) is a noble law because it relieves stress, be it of a company, a limited liability partnership, a proprietorship or partnership firm or an individual. However, the discussion here is limited to companies as provisions of the IBC relating to individuals, except in relation to personal guarantors to corporate debtors, are yet to come into force. It is based on generalisations though there are notable exceptions.

For reasons sometimes under the control of a company and at times beyond its control, it may experience stress, that is, is unable to repay the debt in time — implying that it has assets less than claims against it. Elementary economics tells us that when a company has inadequate assets, the claim of an individual creditor may be consistent with its assets while claims of all creditors put together may not. In such a situation, creditors may rush to recover their claims before others do, triggering a run on the company's assets. They recover on a first-come first-served basis till the assets of the company are exhausted, bleeding it to death. This is a negative-sum game.

The IBC provides for reorganisation that prevents a value-reducing run on the company. It aims to rescue the company if its business is viable or close it if its business is unviable, through a market process. In case of a rescue, the company is reorganised as a going concern. The claims of creditors are restruc-

tured, which may be paid to them immediately or over time. In case of closure, the assets of the company are sold, and proceeds are distributed to creditors immediately as per the priority rule. The IBC entrusts the responsibility of reorganisation to financial creditors as they have the capability and the willingness to restructure their claims. They are likely to rescue a company having a going concern surplus which aligns the interests of the company and of financial creditors, making it a positive-sum game.

Where the company does not have adequate assets, realisation for financial creditors, through a rescue, may fall short of their claims. Such shortage, in common parlance, is known as haircut. About a year ago, Ghotaringa Minerals Limited, and Orchid Healthcare Private Limited caught media attention. They together owed Rs 8,163 crore to creditors, while they had absolutely no assets when they entered the IBC process. There was no hair to be cut. In comparison, there are cases (Binani Cements) which have yielded a zero haircut, in addition to rescuing the company.

Perhaps the relevant question is: Why does the IBC process yield a zero haircut in one case and 100 per cent in another? It depends on several factors, including the nature of business, business cycles, market sentiments, and marketing effort. It, however, critically depends on at what stage of stress, the company enters the

IBC process. If the company has been sick for years, and its assets have depleted significantly, the IBC process may yield a huge haircut or even liquidation. The companies, which have been rescued through IBC till March 2021, had assets valued at, on average, 22 per cent of the amount due to creditors when they entered the IBC process. This means that the creditors were staring at a haircut of 78 per cent to begin with. One third of these were not even going concerns. The IBC process not only rescued these companies, but also reduced the haircut to 61 per cent for financial creditors.

A haircut is typically the total claims minus the amount of realisation/amount of the claims. But this formulation may not tell the complete story. The realisation often does not include the amount that would be realised from equity holding post-resolution, and through the reversal of avoidance transactions and the insolvency resolution of guarantors — personal and corporate. It also does not include realisations made in other accounts (recovery of about Rs 8,000 crore incidental to resolution of Essar). The amount of claim often includes NPA, which may be completely written off, and the interest on such NPA. It may include loans as well as the guarantee against such loans. These understate the numerator and overstate the denominator, projecting a higher haircut.

Should a haircut be seen in relation to claims of creditors or the assets available? The

former may not be realistic as the claims are often inflated. The latter may make better sense because the market offers a value in relation to what a company brings on the table, not what it owes to creditors. The IBC maximises the value of existing assets, not of assets which probably existed earlier.

The IBC enables and facilitates market forces to resolve stress as a going concern where resolution applicants, who have many options for investment, including in stressed companies, compete to offer the best value and such value matches the expectation of financial creditors, who have many options for recovery as well as resolution. If the best value offered by the market is not acceptable to creditors, the company is liquidated.

In addition to rescuing the company, the IBC realises, of the available options for creditors, the highest in percentage terms. It is a tool in the hands of stakeholders to be used at the right time, in the right case, in the right manner. They should use it in early days of stress, when value of the company is almost intact, and close the process quickly before value recedes further to minimise or even avoid haircuts. Post disposal of the pre-IBC legacy matters, as "recent" stress cases are dealt with, the haircuts would perhaps be pleasing to the eye.

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