# CONTEMPORARY ISSUES ON THE LAWS OF INSOLVENCY & BANKRUPTCY


*Edited by*

A. B. Debasis Rout, Kaushiki Brahma and Mayank Tiwari

Along with Student Editors, Centre for Corporate Law, National Law University Odisha


*Foreword by*

Prof. (Dr.) M.S. Sahoo

Distinguished Professor, National Law University Delhi

NATIONAL LAW UNIVERSITY ODISHA

सत्ये स्थितो धर्मः

CCL


EBC

India's leading law information provider

# FOREWORD

The Insolvency and Bankruptcy Code, 2016 (Code/IBC) is a noble law since it endeavours to address stress of a person, be it a company, a limited liability partnership, a proprietorship, a partnership firm, or an individual. Its sole object is reorganisation, as stated in its long title. Such reorganisation has several benefits, namely, it promotes entrepreneurship, improves credit availability, maximises the value of assets of the person concerned, etc. These are not objectives; the objective is only one and it is reorganisation.

The Code provides for insolvency resolution of corporate persons (companies and LLPs) and individuals (personal guarantors, proprietorship and partnership firms and other individuals). This law is being implemented in phases. The provisions relating to corporate insolvency (resolution process, liquidation process and voluntary liquidation process), and individual insolvency dealing with resolution and bankruptcy process of personal guarantors to corporate debtors are currently in operation. The provisions relating to individual insolvency dealing with fresh start process, proprietorship and partnership firms and other individuals are yet to come into force. This foreword, therefore, limits to corporate insolvency, which has been in vogue for about five years, in terms of two dimensions of corporate life, namely, freedom to do business and corporate governance, which aim to rescue the precious lives of companies in distress.

## FREEDOM TO DO BUSINESS

An economy prospers when its limited resources are put to the best possible use. This happens when the self-interested firms have the maximum freedom to reshuffle resources among the competing uses continuously and seamlessly. Such freedom unleashes and realises the full potential of every firm and every resource in the economy. It is well established that economic freedom and economic performance have a remarkably high positive correlation. Countries having high level of economic freedom generally outperform countries with not-so-high level of economic freedom.

The economic history of India suggests that unshackling the economic freedom augments wealth creation. *Kautilya* advocated economic freedom by advising the King to remove all obstructions to economic activity. Traditionally, India followed a market model for wealth creation. She, however, deviated from this model for a few decades after independence only to return to the roots post economic liberalisation in 1991. The thrust of reforms since then has been provision of economic freedom for firms and building institutions to promote and protect such freedom and regulate such freedom only to address market failure(s). In other words, it has been the endeavour of our country to have conducive business regulations that ensure freedom for firms to do business.

A firm needs freedom broadly at three stages of a business - to start a business (free entry), to continue the business (fair competition) and to discontinue the business (free exit). The first stage enables allocation of resources to the most efficient use, the second stage enables efficient use of resources allocated, and the third stage enables release of resources from inefficient uses. Together they facilitate the most efficient use of resources and consequently optimum economic well-being. Economic reforms typically endeavour to provide economic freedom at these three stages.

The reforms in India in the 1990s focused on freedom of entry. It ushered in liberalisation, privatisation and globalisation. It dismantled the licence-permit-quota Raj when discretionary licence gave way to an entitlement of registration. It allowed firms meeting the eligibility requirements to raise resources, without requiring any specific approval from the State, to facilitate freedom of entry. The reforms in the 2000s focused on competition - creating a free and fair market. It moved away from control of monopoly of firms to promote competition among firms in the marketplace. Size or dominance, *per se*, was no longer considered bad; however, its abuse was. The reforms provided a level playing field and competitive neutrality and prohibited firms from restricting the freedom of other firms to do business.

India has been enacting a new genre of economic laws, which are expanding "*who, what and how to do*" list and repealing "*control*" enactments that restricted freedom, such as, the Capital Issues (Control) Act, 1947 and the Import and Export (Control) Act, 1947. She also repealed the Monopolies and Restrictive Trade Practices Act, 1969 to promote competition and scaling up of businesses. This expanded the contours of economic freedom and consequently the frontiers of development of the country. The outcome has been astounding. The average growth rate in the post reforms period since 1992 has been more than double of that in the pre-reforms period. Today, India is the fastest-growing, trillion-dollar economy. It is the fifth largest in the world and, in terms of purchasing power parity, the third largest.

**Freedom to exit**

After having commenced business, a firm in a market economy may fail to deliver, as planned, mostly on account of competition and innovation. The firm belongs to an industry where business is no more viable for exogenous reasons such as innovation. Most such firms have economic distress and are generally unviable. It is necessary to release the resources of these firms for other competing uses and the entrepreneurs to pursue emerging opportunities. Or the firm belongs to an industry where other firms in the industry are doing well, but the firm in question is not doing well for endogenous reasons such as inability to compete at marketplace. Most such firms have only financial distress and are generally viable. It is necessary to rescue these firms before it is too late.

Where a firm remains under stress for long, its balance sheet gets stretched. Such failure by many firms, particularly large ones, impacts the balance sheets of creditors, particularly banks. This reduces the availability of funds with the creditors, limiting their ability to lend for even genuinely viable projects, thus restricting credit growth. The impact is pronounced where some firms deliberately fail to repay loans. Thus, what emerged in the middle of this decade, popularly referred to as the *Twin Balance Sheet* problem, where both the banks and firms were reeling under the stress of bad loans, thereby, hindering the overall economic growth.

When a firm experiences financial or economic stress, the resources at the disposal are underutilised and the management/entrepreneur has failed. In the absence of an exit mechanism, either for the firm or the entrepreneur even when it is in deep distress, the Indian economy suffered the inefficiencies of several zombie entities in the system for so long. Given that the resources are scarce, and failures are routine in a dynamic market economy, India needed a codified and structured market mechanism to put the underutilised resources to more efficient uses continuously and free entrepreneurs from failure. The insolvency reforms, through the Code, provide a market mechanism for (a) rescuing a failing, but viable firm; and (b) liquidating an unviable one and releasing its resources, including entrepreneur(s), for competing uses, and thereby provide the freedom to exit, the ultimate freedom. It provides a market mechanism, for time-bound resolution of insolvency, wherever possible, and ease of exit, wherever required.

Prime Minister of India in his address at the Centenary Celebrations of Kirloskar Group on 6th January, 2020, underscored the importance of freedom of exit: "साथियों आजकल *Insolvency Bankruptcy Code (IBC)* की इतनी चर्चा होती है लेकिन यह सिर्फ इतना पैसा वापस आया उतना पैसा वापस आया यहां तक ही सीमित रहती है लेकिन वह उससे भी आगे है आप सभी यह बेहतर जानते हैं कि कुछ स्थितियों में धंधे से बाहर निकलना ही कई बार समझदारी माना जाता है ये जरूरी नहीं कि जो कंपनी सफल ना हो रही हो उसके पीछे कोई साजिश ही हो कोई गलत इरादा हो कोई लालच होए यह जरूरी नहीं है देश मे ऐसे उद्यमियों के लिए एक रास्ता तैयार करना आवश्यक था और *IBC* ने इसका आधार तैयार किया आज नहीं तो कल इस बात पर अध्ययन जरूरी होगा कि *IBC* ने कितने भारतीय आदमियों का भविष्य बचाया उन्हें हमेशा हमेशा के लिए बर्बाद होने से रोका।"

With the Code in place, India now provides the complete suite of economic freedom comprising freedom to start, freedom to continue and freedom to exit business.

The scheme of incentives and disincentives under the Code is bringing about significant behaviour changes on the part of every stakeholder, minimising the incidence of failure, default, and under-performance. Thousands of debtors are resolving stress in early stages of sickness, when the possibility of resolution of stress as well as recovery for creditors is much higher, avoiding the use of the Code. I have always believed, in the long run, the best use of the Code would be not using it at all. I also believe that if the resources, that are currently unutilised or underutilised or rusting for whatever reason, are put to more efficient uses through the processes under the Code, the growth rate may well go up by a few percentage points, other things remaining unchanged, particularly when it is accompanied by availability of credit and entrepreneurship arising from implementation of the Code. By liberating resources stuck up in inefficient and defunct firms for continuous recycling, the Code has changed the narrative from "Hopeless End" to "Endless Hope".

**Outcomes so far**

The journey on the path of "endless hope" so far has been extremely rewarding. From providing freedom of exit to rescuing companies in financial stress to releasing entrepreneurs and idle resources stuck up in inefficient uses to helping creditors realise their dues and, most importantly, bringing about a behavioural change amongst the debtors and creditors alike, the list of achievements is a long one. Let me briefly touch upon the salient outcomes from the implementation of the Code:

1. The primary objective of the Code is rescuing lives of companies in distress. Till March, 2022, the Code has rescued about 480 such companies through resolution plans, one third of which were in deep distress. However, it has referred 1609 companies for liquidation. The companies rescued had assets valued at Rs1.31 lakh crore, while the companies referred for liquidation had assets valued at Rs 0.56 lakh crore when they were admitted to CIRP. Thus, in value terms, around 70 percent of distressed assets were rescued. Of the companies sent for liquidation, three-fourths were either sick or defunct and of the companies rescued, one-thirds was either sick or defunct.

2. The realisable value of the assets available with the companies rescued, when they entered the CIRP, was only Rs 1.31 lakh crore. The resolution plans recovered Rs 2.34 lakh Crore, which is about 178 percent of the liquidation value of these companies. Any other option of recovery or liquidation would have recovered at best Rs 100 minus the cost of recovery/liquidation, while the creditors recovered Rs 178 under the Code. The excess recovery of Rs 78 is a bonus because of the Code.

3. Beyond revival of companies and realisations for creditors, the credible threat of the Code, that a company may change hands, redefined debtor-creditor relationship prompting resolutions in the shadow of the Code and substantial recoveries for creditors outside the Code, while improving performance of companies. The Supreme Court noted the success of the Code with the words: *"defaulters' paradise is lost"*, while upholding its constitutional validity. Many debtors today beg, borrow or steal to resolve stress at early stages, to avoid consequences of CIRP.

4. The Code has established the supremacy of markets and the rule of law in insolvency resolution, and professionalised the process of resolution while balancing the powers of suppliers of capital - debt and equity. It enables the stakeholders themselves to decide the matters for them instead of accepting a solution worked out by the State. Where the equity suppliers have failed to address the stress of a firm, the Code gives an opportunity to creditors to do so. The right of the promoters to cling on to the firm, irrespective of its conduct, is no more divine with several firms changing hands, despite valiant battles by some of them up to the Supreme Court.

5. The Code endeavours to close the various processes at the earliest. It prescribes timelines for some of them. The 480 resolution processes, which have yielded resolution plans by the end of March, 2022, took on average 450 days (after excluding the time excluded by the Adjudicating Authority) for conclusion of process. Similarly, the 1609 resolution processes, which ended up in orders for liquidation, took on average 412 days for conclusion. Further, 328 liquidation processes, which have closed by submission of final reports till March 31, 2020, took on average 456 days for closure. Similarly, 644 voluntary liquidation processes, which have closed by submission of final reports, took on average 422 days for closure.

The improvement in India's rank in World Bank's resolving insolvency parameter from 136$^{th}$ to 52$^{nd}$ position in three years, is testimony of the remarkable journey. The overall recovery rate for creditors jumped from 26.0 to 71.6 cents on the dollar and the time taken for resolving insolvency came down significantly from 4.3 years to 1.6 years. India is now, by far, the best performer in South Asia on the resolving insolvency component and does better than the average for Organisation for Economic Cooperation and Development high-income economies in terms of recovery rate, time taken and cost of a CIRP. The performance of the insolvency ecosystem has earned due recognition. India won the prestigious Global Restructuring Review Award for the "Most Improved Jurisdiction" in 2018.

## CORPORATE GOVERNANCE

The raison d'être of a company is that it must live, generate value, and share the value equitably among stakeholders. Corporate governance is the framework which enables a company to do so. In this sense, the IBC serves as a *"Code"* for corporate governance. Its first order objective is rescuing a company in distress. The second order objective is maximising value of assets of the company and the third order objective is balancing the interests of stakeholders. This order of objectives is sacrosanct, as underscored by the National Company Law Appellate Tribunal.

**Saving life**

The IBC endeavours to save the life of a company in distress. It empowers creditors, represented by a Committee of Creditors (CoC), to rescue a company, when it experiences a serious threat to its life. For this, the CoC has a *trishul*: (a) it can take or cause a haircut of any amount to any or all stakeholders required for rescuing the company; (b) it seeks the best resolution from the market, unlike earlier mechanisms that allowed creditors to find a resolution only from existing promoters; and (c) the resolution plan can provide for any measure that rescues the company. It may entail a change of management, technology, or product portfolio; acquisition or disposal of assets, businesses or undertakings; restructuring of organisation, business model, ownership, or balance sheet; strategies of turn-around, buy-out, merger, amalgamation, acquisition, or takeover; etc. The IBC provides a competitive, transparent market process, which identifies the person, who is best placed to rescue the company and selects the resolution plan, which is the most sustainable under the circumstances. It mandates consideration of only feasible and viable resolution plans, that too, from capable and credible persons, to ensure sustained life of the company. This releases the company from the clutches of promoters and management and puts it in the hands of a credible and capable management to avoid liquidation.

**Maximising value**

The IBC safeguards and maximises the value of the company and consequently, value for all its stakeholders. It enables initiation of resolution process at the earliest to preserve the value. It mandates resolution in a time-bound manner to prevent decline in the value. It does not envisage recovery, which maximises the value of the creditors on first-cum-first-serve basis. It does not allow liquidation, which maximises the value for stakeholders who rank higher in the waterfall, while destroying going concern value. Liquidation process commences only on failure of resolution process to revive the company.

The IBC facilitates resolution as a going concern to capture going concern surplus. It makes an insolvency professional run the company as a going concern, prohibits suspension or termination of supply of essential services, mandates continuation of licences, permits and grants; stays execution of individual claims, enables raising interim finances for running the company, insulates the resolution applicants from the misdeeds of the company under the erstwhile management, etc. It provides for a market mechanism where the world at large competes to give the best value for the company through a resolution plan.

Where value has been lost on account of irregular transactions, the IBC enables claw back of such value. It even mandates retrieval of value lost due to the failure to exercise due diligence. There is a twilight zone which begins from the time when a director knew or ought to have known that there was no reasonable prospect of avoiding the commencement of resolution process till the company enters resolution process. During this period, a director has an additional responsibility to exercise due diligence to minimise the potential loss to the creditors and he is liable to make good such loss. There is thus strong deterrence to prevent directors and promoters from causing loss of value to the company in the run-up to insolvency.

**Balancing interests**

A company has two main sets of immediate stakeholders: shareholders and creditors. If debt is serviced, shareholders have complete control of the company. When the company fails to service the debt, the IBC shifts control of the company to the creditors for resolving insolvency. By moving from *debtor-in-possession* to *creditor-in-control*, the IBC balances the rights and powers of shareholders and creditors vis-a-vis a company.

The CoC decides the fate of the company. There are, however, checks and balances to ensure that the resolution process yields fair and equitable outcomes for the various stakeholders. The IBC prescribes payment of a certain minimum amount to operational creditors and to dissenting financial creditors, payment to operational creditors in priority over financial creditors, a statement as to how a resolution plan has dealt with the interests of the stakeholders, etc. Though the ultimate discretion of what to pay and how much to pay to each class or subclass of creditors is with the CoC, its decision must reflect that it has taken into account maximising the value of assets of the company, and it has balanced the interests of the stakeholders.

### Proactive governance

The IBC contributes to governance of a company even before it gets into distress. There is a credible threat that if a company defaults, and consequently it gets into resolution process, in all probability, it would move away from the hands of current promoters/management for ever. Firstly, because the promoters may not be eligible to submit a resolution plan. Second, even if eligible, they may not submit the most competitive plan. This prevents use of resources below their potential before resolution, minimising the incidence of failure and default.

The IBC shifted the focus of creditors from the possibility of recovery to the possibility of resolution, in case of default. A company prefers to keep itself resolvable all the time, should a need arise, and the market prefers to deal with a company which is resolvable. A resolvable company obtains a competitive advantage vis-a-vis non-resolvable companies through reduced cost of debt. If value of a company lies in informal, off-the record arrangements or personal relationships among promoters or their family members, prospective resolution applicants may find it hard to trace and harness the value, making resolution of the company remote. A company prefers to have value, which is visible and readily transferable to resolution applicants. Similarly, a company keeps an updated information memorandum ready to enable expeditious conclusion of resolution process, if initiated. By incentivising a company to remain resolvable all the time, the IBC facilitates preparation of a sort of "*living will*" for the benefit of the company as well as the society at large.

## LIVES OF COMPANIES

Humans are mortals. In search of immortality, they created artificial persons, namely companies, which would carry on their legacy forever. *Kongo Gumi*, a Japanese construction company, lived 1,428 years before it succumbed to debt in 2006. There are a few thousand-year young companies around. These are, however, rare. The life of a company is in danger today than any time before. The average life of S&P 500 companies has reportedly reduced from 90 years to 18 years over the last century. 2015 research reveals that the average life of publicly traded companies, considering acquisitions, mergers, and bankruptcy, is about

10 years. Thus, a company having indefinite life now lives shorter than a human! This begs the question: Whose life is it anyway?

Companies are engines of growth. They are a hope of prosperity for the posterity. They often have an organisational capital over and above their liquidation values. Closure of a company destroys the hope and the organisational capital. Therefore, it is necessary to rescue a company from premature death, and nurse it back to normal life.

**Three enemies**

The life of a company has three enemies. First is the enemy within. A company is an amalgam of many stakeholders. Each stakeholder has a unique objective function, with a distinct set of rights, interests, and level of engagement with the company. The interests of one stakeholder may conflict with those of another and/or of the company. Stakeholders may work at cross-purposes, and even against the interest of the company. Some leave the company at the earliest sign of distress. Departure of a major shareholder may orphan the company. In their drive to maximise the upside for them while enjoying limited liability, shareholders may expose the company and other stakeholders to unlimited liabilities. The society bears the brunt of unlimited liability such as those arising from Bhopal gas tragedy, Satyam fiasco, etc.

Such conduct of stakeholders can benefit a set of stakeholders, often at the cost of another, the company, and the society. Persistent uneven sharing of losses and gains endangers the life of the company. Independent directors, key managerial personnel, regulation of related-party transactions, protection of minority interest, financial and secretarial audit, timely and accurate disclosures about material matters, taxes and subsidies, CSR - collectively referred to as corporate governance - endeavour to synchronise and balance the interests of stakeholders, subordinate the interests of immediate stakeholders to those of the company, and establish precedence of interests of the society over those of the company. Some jurisdictions have consolidated these norms through codes for corporate governance to protect companies.

The second enemy is unfair battles at the marketplace. For example, a company that does not have financial muscle to sell its product below cost, cannot survive in a market where a dominant company sells its product below cost. The competition law prohibits predatory pricing. A company cannot survive if its cost of capital is high as compared to another company that manipulates market for its securities. Securities laws regulate the capital market to prevent any kind of manipulation. A company that dutifully pays corporate tax on its profits cannot survive if another company in the same business dodges taxes. The rule of law ensures that all companies get a similar tax treatment. Generally, the State protects a company from such unfair battles.

The third and the most fatal enemy is competition and innovation. This is fair battle because it is the State policy to stimulate competition and innovation, and eliminate anticompetitive conduct at marketplace, for higher growth. A company loses life when it fails to compete with its peers in the industry for reasons such as poor organisation, inefficient management and malfeasance. It also loses life when its business becomes unviable for reasons such as innovation. Creative destruction often destroys more companies than it creates! Resilience and adaptation, R&D, risk management, sustainable business model, visionary leadership, preparedness for unknowns, etc., minimise threats. There is, however, no governance norm to have such strategies, though many have these on their own volition. To add salt to injury, with demand dwindling and supply chains hit around the Globe in the wake of the COVID-19 pandemic, many companies, which were doing well earlier, are reeling under stress. Some of them are at the brink of default, not because of market pressures, but because of *force majure* circumstances.

The law provides for layers of security to protect the life of a company. A board of directors appoints and supervises the executive management and replaces it in accordance with contractual arrangements, in case of failure. Shareholders elect directors to the board, monitor their performance and replace them in accordance with the provisions of the Companies Act, 2013, if they fail to perform. A promising set of shareholders may even replace the existing set through the market for corporate control. The creditors step in to rescue the company in accordance with the provisions of the Code when shareholders fail to protect its life. The CoC is duty bound to rescue a failing, but viable company, irrespective of whose company it is.

## APPRECIATION

While the Code provides for a time-bound resolution mechanism for businesses, specific, unprecedented questions often arise in its wake. It is, therefore, for this reason, that academic scrutiny is most warranted.

Academia, in its contemplations of the insolvency and bankruptcy laws, seeks to balance the interests of various stakeholders while highlighting the legislature's intention in enacting such provisions. Only when such theoretical contemplations are encouraged do we find novel solutions to long-standing matters that have plagued Indian businesses.

On that note, the "Contemporary Issues on the Laws of Insolvency and Bankruptcy" has extended an academic platform to professionals in the field to raise pertinent questions and seek solutions to bolster the country's insolvency and bankruptcy laws. The articles selected in this volume have contributions on topics ranging from cross-border insolvency, airline insolvencies in India, convergence between corporate governance and insolvency, personal and corporate guarantors' liabilities under insolvency regime.

The challenges in the insolvency and bankruptcy laws are complex and exciting. The authors worked on them with enthusiasm, tenacity, and dedication to develop new facets and provide solutions to the regulatory challenges under insolvency regime. In this age where businesses have transformed in scale and scope, the laws for their restructuring and dissolution must also be equally flexible. Initiating and maintaining academic discourse on the latest, significant, and novel areas of insolvency and bankruptcy is perhaps most crucial.

I am sure, it will be a great resource for practitioners, policy makers, researchers, academics, and students to understand in detail the change that is in the offing on account of the Code. I am certain that it will motivate more inquisitive minds to delve deeper into various aspects of the IBC from an interdisciplinary perspective, enriching the Indian literature on insolvency and bankruptcy in the days ahead. I compliment National Law University Odisha for this seminal work.

**Prof. (Dr.) M. S. Sahoo**

Distinguished Professor, National Law University Delhi

Former Chairperson, Insolvency and Bankruptcy Board of India