

From Chairperson's Desk

Resolvability: A 'Living Will' for Companies

A company should keep itself resolvable all the time and have a 'living will' on the shelf to guide its resolution should the need arise. It should vie for a higher resolvability index to command respect of the society and a premium from stakeholders.

I have, through this column, been reiterating that the life of a company is as precious as that of a human being. As Colin Mayer describes, the companies house, feed, clothe and employ us. By laying down norms that seek to minimise risks to life of a company and to rescue it when it experiences serious threat to its life, the Insolvency and Bankruptcy Code, 2016 (Code) has taken corporate governance to new heights. Let me explore one dimension of corporate governance, which can make rescue process faster and the possibility of rescue higher.

A high-rise building has several inherent risks. The caretakers (architects to residents) of the building anticipate risks, provide for risk prevention, and plan for risk mitigation. They plan, for example, for rescue of life and property as well as the building itself in case it catches fire. The community provides for a fire brigade, a stranger to the building, to come to its rescue. To ensure that the fire brigade reaches the site and starts rescue operations quickly, the caretakers take several measures, such as, the fire alarm alerts the fire brigade instantaneously, the access to the building is clear, and the building has functional emergency lighting and public announcement systems and an updated building evacuation plan. They further ensure clear escape routes, undisrupted water supply, and co-operation of residents to facilitate smooth and efficient rescue operations. The success of rescue operations depends on how rescuable the building is. The caretakers have incentive to keep the building rescuable, in the interest of their life and property and for the premium rescuable buildings enjoy in market. The law typically mandates certain minimum standards in this regard.

Similarly, a company faces several risks to its life. The immediate caretakers of the company, namely, promoters and managers, need to anticipate risks, provide for risk prevention and plan for risk mitigation. It is routine for a company to have stress periodically in a market economy. The caretakers need to plan for rescue of the company as well as its business from stress at the earliest. The Code provides for corporate insolvency resolution process (CIRP) to rescue a company in stress. CIRP assembles a team of rescuers - creditors and resolution applicants to work out a plan to rescue the company, and the Adjudicating Authority, Information Utilities, and Insolvency Professionals to facilitate the rescue process with fairness and transparency. The team is a stranger to the company. It appears on the scene when the company experiences stress and it is invited to rescue the company. Its success, however, depends on how rescuable the company is. Since CIRP rescues a company through a resolution plan, one often uses the term 'resolvable' in place of 'rescuable'. The term 'resolvability' gained momentum amidst global financial crisis of 2008 in the context of the resolution of large financial firms, who are, in many countries, required to have institutional ability to resolve stress.

Creditors have experimented different remedies, in case of default,

against the person and or his property. As these remedies, including collateral and personal guarantees, proved inadequate, they shifted focus to ability of the company, represented by business potential and management capability, to repay the loan. Several laws in recent decades strengthened their rights to recover loans and provided specialised forums to enforce such rights. Though focused on recovery and not so much on resolution, the recovery under these laws has not been inspiring; limited at best to the liquidation value of the assets available with the company. With the availability of CIRP, creditors have shifted focus again, in case of default, from the possibility of recovery to the possibility of resolution, whereby the company survives while they realise their dues from third parties. As the data indicate, the creditors are realising on average nearly 200% of liquidation value through resolution plans under CIRP, as the company continues with business, most often, with higher efficiency on a larger scale. The probability of resolution, which usually exceeds the probability of recovery, coupled with higher realisations and revival of the company, makes CIRP an attractive option for creditors.

The key purpose of keeping a company resolvable is to increase competition among resolution applicants that increases the likelihood of resolution in case of need. The likelihood is more if the company has value, and such value is free from encumbrances, is visible to a discerning eye, and easily realisable by any resolution applicant. It is less if value resides in informal, off-the record arrangements; personal relationships of promoters; disputed titles, complicated structures, and contingent contracts; or avoidance transactions. Similarly, an early commencement of CIRP and its quick closure improves the possibility of resolution. If initiation is resisted and / or the process is protracted, for reasons other than merit, the value diminishes making resolution difficult.

The resolution regimes are expected to incorporate the 'Key Attributes of Effective Resolution Regimes for Financial Institutions' to reduce the possibility of failure and enable resolution of financial institutions in an orderly manner. Similarly, to reduce the possibility of stress and to improve the likelihood of resolution, a real sector company may consider having a sort of living will, updated at regular intervals, that provides a guided path for resolution and carries:

- (a) an updated corporate structure with nature of relations and dealings with related parties;
- (b) updated and reliable books with complete information about the assets and liabilities of the company, that avoids disputes relating to default and claims;
- (c) an updated and authentic information memorandum on the shelf, which the resolution professional can pull out and share with stakeholders to enable them to work out a resolution plan;

- (d) a statement of material contracts, assets and liabilities, with brief details of disputes, encumbrances and litigations;
- (e) a statement of ongoing proceedings, if any, of alleged contraventions of provisions of law by the company and its management;
- (f) a user-friendly guide to ensure smooth and frictionless shifts of management and control from the board of directors to the interim resolution professional and then to the resolution professional and finally to the successful resolution applicant, without any disruption to business;
- (g) a manual for co-operation with the resolution professional in taking over the company and to keep it as a going concern for maximisation of value;
- (h) a back-up strategy for critical dependencies to keep the company as a going concern;
- (i) a plan to ensure timely and appropriate communication with the stakeholders;
- (j) a declaration that it has / has not been subject to any avoidance transaction during the relevant period;
- (k) an estimate of potential loss to the creditors from the date CIRP should have commenced;
- (l) a confirmation that it has provided and authenticated financial information with an information utility;
- (m) a description of the circumstances when the company on its volition would like to initiate a resolution process and suitability of different resolution options for the company;
- (n) a statement whether the caretakers are eligible under section 29A; and
- (o) a few possible resolution plans to serve as a model for potential resolution applicants.

The company stands to benefit the most if it is resolvable. If it is not resolvable, it is more likely to have a natural death in case of stress, and creditors would recover precious little through its liquidation. If it is resolvable, CIRP would rescue it, while ensuring decent realisation for creditors. A resolvable company would enjoy competitive advantage as compared to other companies in terms of better access to capital at lower cost, which may even avoid the need for resolution. A conscious effort to remain resolvable and preparation of a living will would enhance competitiveness and resilience of the company to withstand stress. The caretakers of the company would stand to gain as the company would not undergo CIRP, obviating the possibility of the company changing hands. In the unlikely event of CIRP, they, if eligible under section 29A, would most likely be the successful resolution applicant, having planned resolution options beforehand. Thus, keeping a company resolvable is a win-win for the caretakers, the company and creditors.

Resolvability, reflecting the readiness of a company to implement rescue strategies in a swift manner, is imperative as the intensity of competition and innovation increases in the economy. With growing acceptance of resolution as a tool for rescuing a company as well as in recovering the dues of creditors, more innovation in this realm is a certainty. An index should soon develop to measure the extent of resolvability of a company. Every company should vie for a higher resolvability index and the market should prefer to deal with a company which has higher index of resolvability, as it addresses 'what if' situations. This may entail some cost for the companies. Such costs are, however, likely to be insignificant as compared to rescuing the life of the company and the premium a rescuable company would enjoy in the market. The law may, in course of time, mandate certain minimum threshold of resolvability to prevent closure of viable companies and facilitate increased availability of credit and thereby promote growth.

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