Ensure ‘equity’ in IBC resolution

thehindubusinessline.com/opinion/ensure-equity-in-ibc-resolution/article66223450.ece

December 4, 2022

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The IBC process of a listed company could result in liquidation of the company, or its continuation as a resolved company, with or without listing, based on the resolution plan. So far, 28 listed companies have ended in liquidation, 52 have been delisted and 23 continue to remain listed. In all circumstances, shareholders typically end up with almost nothing.

In a consultation paper floated recently, SEBI has suggested that as part of the resolution plan, the resolved company must offer the existing public shareholders (PSs) an opportunity to acquire shares up to 25 per cent of its fully diluted capital, on the same pricing terms as agreed upon by the acquirer. If the offer results in at least 5 per cent public shareholding, the company would remain listed. If not, the company shall be delisted.

The IBC process is triggered against a company merely on a default. The company need not necessarily be balance sheet insolvent. This is evident from the fact that of the 517 companies resolved by resolution plans till June 30, 2022, financial creditors (FCs) realised at least 100 per cent of their claims in 56 cases. There is, thus, a realistic possibility that some of these companies may have residual value in its equity. If the resolution plan wipes out the residual equity value, it amounts to an unfair transfer of value from the shareholders to the acquirer. Looked at from this perspective, SEBI’s proposal makes immense sense.

SEBI has statutory duty to protect the interests of investors in securities, both debt and equity. Any proposal to enhance protection for equity providers may adversely impact the interests of holders of debt securities. The requirement to offer shares to public shareholders (PSs) may create uncertainty regarding the extent of public subscription for shares, and whether the company would remain listed. Coupled with the likely dilution of control and management, and share in the fortune of the company, it may subdue realisation for creditors in some cases. On the other hand, it may help generate more resolution plans by supplementing funds from PSs.

Along with sharing of risk to the extent of public shareholding, it may improve realisation for creditors in some other cases. Thus the requirement of public offer may impact realisation for creditors either way. Similarly, some may consider continued listing as a blessing while others may consider it burdensome. There could be ways to lighten the burden. For example, a longer time frame could be considered to raise public float to 25 per cent.

Disadvantage creditors

Operational creditors (OCs) are also in the same boat as PSs. Whether the company is liquidated or resolved through a resolution plan, they get very little. Their unpaid claims are usually extinguished once the resolution plan is approved. The NCLAT has, recently in Excel Engineering, urged the government and the IBBI, to consider entitlement for OCs, based on the amount realised in the resolution plan over and above the liquidation value (LV). There is a merit in this suggestion. If the IBC process yields liquidation, both FCs and OCs would receive only LV as per waterfall.

Let the LV be distributed vertically among FCs and OCs, as per waterfall. Any excess of resolution proceeds over the LV belongs to all creditors and should be equitably shared. Let it be distributed horizontally among all creditors in proportion to their claims. Let us assume, LV is 100, while the company owes 900 and 100 respectively to FCs and OCs and resolution Plan offers 190 for creditors. Let FCs get LV of 100, and the excess 90 be distributed to FCs and OCs in the ratio of their remaining claims of 800:100, whereby FCs get 80 and OCs get 10.

The Bankruptcy Law Reforms Committee had reasoned that the limited liability company is a contract between equity and debt. As long as debt obligations are met, equity owners should have complete control. When default on debt takes place, control should shift to the creditors.

The IBC incorporates this design principle. However, PSs are not on the decision-making table when the equity owners run down the company. Similarly, OCs are not on the decision-making table when the FCs decide the fate of the company, including sharing of resolution proceeds among creditors. In fact, the concept of OCs seems to be an Indian innovation. Both are voiceless junior artists in the insolvency drama, while the fate of the company is either in the hands of promoter shareholders or the FCs. The proposals of SEBI and the NCLAT in respect of PSs and OCs respectively deserve consideration from this perspective also. Policymakers, however, need to ponder whether securities law or insolvency law is best placed for protecting the interests of PSs of a listed company admitted to insolvency resolution. Here, it is important to revisit the basics.

Moral hazard

A company is in financial distress if the total value of its debt exceeds its net present value. In such a scenario, shareholders have a perverse incentive to engage in risky strategies. If the strategy pays off, they benefit. If the strategy fails, the creditors bear the losses. To address this moral hazard inherent in the structure of a limited liability company, corporate insolvency law shifts the power to decide from its shareholders to its creditors.

The creditors could use corporate insolvency law to either restructure their claims on the company or get a third party to restructure the business as a going concern, or even liquidate it. In all cases, the manner of value distribution among various claimants (including equity shareholders) of the company is decided as per corporate insolvency law, which prevails over every other law. Therefore, the entitlement of PSs of a listed company undergoing the IBC process should be addressed through the insolvency law. Care should be taken to ensure that entitlements for OCs and PSs do not complicate legal structures.

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