

Value destruction and wealth transfer under IBC

IBBI-IGIDR Conference

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Part I

Context

Motivations

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 - Operational creditors may have various grievances
 - One is **Wealth Transfer Problem (WTP)**

- Reviews law and economics literature on VDP and WTP
- Contrasts the provisions of IBC against this theory
- Identifies potential channels of value destruction and wealth transfer under IBC

Part II

Value destruction problem

- A firm unable to meet debt obligations could be in:
 - Financial distress: Total value of debt $>$ PV of assets
 - Economic distress: Break-up liquidation value $>$ PV
- Basic objective of insolvency law:
 - Correctly determine if a company is in financial or economic distress
 - If economically distressed business, then liquidate
 - If merely financially distressed, then sustain the business

Part III

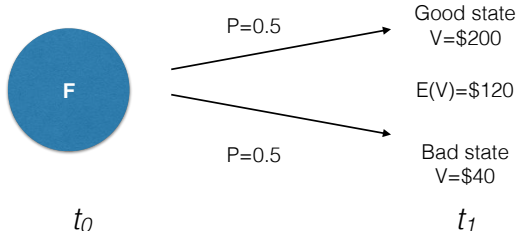
Sources of value destruction

Liquidation of viable companies

- Who decides the future of the insolvent business?
- If decision as to the company's future is left to claimants whose pay-offs are not affected by the outcome of the decision
- Secured FCs in CoC have no upside from the outcome of the decision
- Could prefer liquidation of merely financially distressed companies

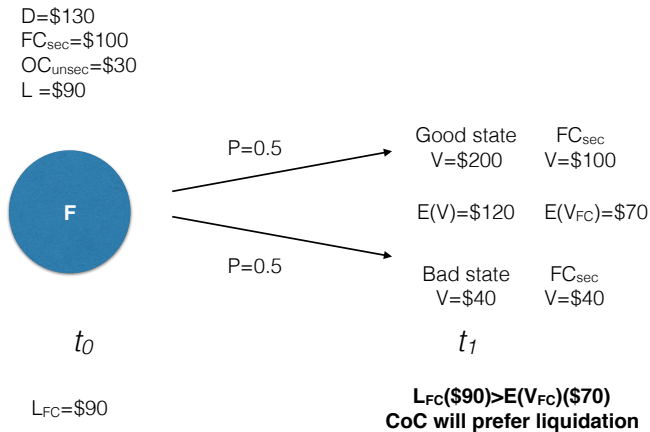
Example

$D = \$130$
 $FC_{\text{sec}} = \$100$
 $OC_{\text{unsec}} = \$30$
 $L = \$90$



$PV(\$120) > L(\$90)$ - no eco. distress
 $D(\$130) > PV(\$120)$ - only fin distress
Co should not be liquidated

What will CoC do?



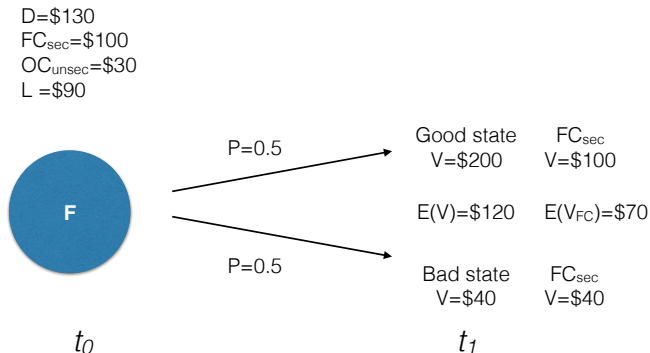
Part IV

Second source of value destruction

Delayed restructuring

- Restructuring saves going concern surplus
- Going concern surplus = $PV(\text{cont.}) - L$

Going concern surplus



$GCS = PV(\$120) - L(\$90) = \$30$
Surplus, if not liquidated

How to protect going concern surplus?

- 1 Going concern sale to new investors
 - May not always be possible
 - Industry wide crisis
 - Lack of well-developed capital markets
- 2 Restructure among existing claimants
 - 'Hypothetical sale' to existing claimants

Challenges to restructuring

- Two problems:
 - 1 Coordination cost - higher if more dispersed set of claimants
 - 2 Hold-up costs
- Solution - cramdown powers
 - 1 Intra-class
 - 2 Inter-class/cross-class

Delayed restructuring under IBC

- IBC restructuring is only post-default in CIRP
- Cramdown powers can be used only post-default
- Pre-default scheme u/CA is possible
- Scheme not been used in India
- JLF had a limited cramdown power
- Revised framework has no cramdown power
- When insolvency is likely in near future, restructuring is difficult
- This facilitates destruction of going concern value

Part V

Wealth transfer problem

Abusive cramdown

- Cramdown powers raise possibility of abuse
- Majority creditors controlling restructuring may extract wealth from the other claimants
- Judicial supervision is necessary to check this abuse
- Test: the plan must give minority creditors at least what they would have got in liquidation
- Liquidation could be of two types:
 - ① Break-up liquidation
 - ② Going concern sale of business + liquidation of corporate shell
- For financially distressed company being restructured, should use going concern liquidation value
- Break-up liquidation value will not capture going concern surplus

Wealth transfer under IBC

- No clear rationale for judicial supervision of the plan
 - No duty to check wealth transfer through resolution plan
 - 'Effective implementation' u/s 31(1) - confusing
 - NCLT interpreted to mean 'logical analysis of financial data'
- Break-up v. going concern liquidation value
 - ILC discussed this in its report
 - No changes made
 - Seems to suggest this issue not for judicial review

Part VI

Example of wealth transfer

Restructuring

Pre-restructuring

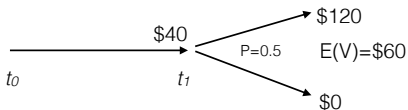
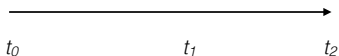
F. Debt 1 (\$40 -> 25%)

F. Debt 2 (\$120 -> 75%)

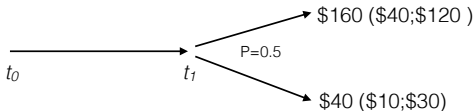


$L = \$10$

Maturity Period



Post-restructuring - maturity of D1 extended to t_2



Wealth transfer

	Pre-restructuring	Post-restructuring
	<i>(D1, D2)</i>	<i>(D1, D2)</i>
Good State	40, 120	40, 120
Bad State	40, 0	10, 30
<i>Expected Return</i>	40, 60	25, 75

Table: Returns to holders of Debts 1 and 2

Incorrect valuation benchmark

- Restructuring requires valuation benchmark
- Going concern sale to third party is a true sale - no benchmark needed
- IBC applies valuation benchmark to both
- GC sale - dissenting FC can be paid liquidation value
- May cause wealth transfer from dissenting FCs and OCs to junior claimants

Part VII

Conclusion

- Value destruction problem
 - Super-majority of FC may destroy value
 - Limiting cramdown post-default destroys value
- Wealth transfer problem
 - No clarity on purpose of judicial supervision
 - Break-up liquidation value wrong comparator
 - Liquidation benchmark should not apply to GC sales