Value destruction and wealth transfer under the Insolvency and Bankruptcy Code

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Abstract

India experienced a major structural change with the enactment of *Insolvency and Bankruptcy Code* in 2016. Since then, India's ranking under the Insolvency head in the World Bank Group's Doing Business report has sharply risen from 136 to 103. Yet, it has also raised two important concerns - the *value destruction* problem and *wealth transfer* problem. This dissertation develops the theoretical frameworks necessary to identify the sources of these two problems in an insolvency law. It then applies these theoretical frameworks to the Code to precisely identify the unique legislative features responsible for these two problems. Indian policymakers need to revisit these fundamental legislative design choices embedded within the Code to successfully address the contemporary concerns emanating from the *value destruction* and *wealth transfer* problems.

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1 Introduction

1.1 Background to the study

India experienced a major structural change with the enactment of *Insolvency and Bankruptcy Code* in 2016. Before this, it did not have any comprehensive modern statute on corporate insolvency.[1] Intermittent attempts were made at various points of time to develop a modern insolvency law framework.[2] In 2014 the Finance Minister made a budget annoucement about the government's plan to usher in an entrepreneur friendly legal bankruptcy framework.[3] Later that year, the Bankruptcy Law Reforms Committee (BLRC) was set up.[4] In 2015, the BLRC submitted its report along with a draft legislation, which finally culminated into the enactment of

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[1] See Lok Sabha, *Report of the Joint Committee on the Insolvency and Bankruptcy Code, 2015* (2016) p. 6.

[2] For detailed account of the evolution of the Indian corporate insolvency law regime, see generally R Sengupta, A Sharma and S Thomas, 'Evolution of the insolvency framework for non-financial firms in India' (*IGIDR Working Paper*, 2016) ⟨http://www.igidr.ac.in/pdf/publication/WP-2016-018.pdf⟩ accessed 26th April 2018; also see, K van Zwieten, 'Corporate rescue in India: The influence of the courts' (2015) 15 Journal of Corporate Law Studies 1.

[3] Interestingly, the Finance Minister in his budget speech had only mentioned that an 'entrepreneur friendly legal bankruptcy framework will also be developed for SMEs to enable easy exit.' See Finance Minister, 'Budget Speech' (*Union Budget*, 2014) ⟨https://www.indiabudget.gov.in/budget2014-2015/ub2014-15/bs/bs.pdf⟩ accessed 31st March 2018, paragraph 106.

[4] See Chapter 9, Annexures Bankruptcy Law Reforms Committee, *The report of the Bankruptcy Law Reforms Committee: Volume I: Rationale and Design* (2015) .

Insolvency and Bankruptcy Code in 2016.

Since the enactment of the *Insolvency and Bankruptcy Code*, India's ranking under the Insolvency head in the World Bank Group's Doing Business report has sharply risen from 136 to 103.[5] However, new challenges have also emerged.[6] Two such challenges are particularly important. *First*, there are concerns that more companies are being liquidated than successfully salvaged under the *Insolvency and Bankruptcy Code*.[7] In one particular case, allegations were made that a viable company was pushed into liquidation.[8] Such cases have raised apprehensions about the potential risks of value destruction under the *Insolvency and Bankruptcy Code*. *Second*, there are wide-ranging concerns that the *Insolvency and Bankruptcy Code*

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5 See Reserve Bank of India, *Financial Stability Report* (Report, 2017) pp 53.

6 In view of the suggestions received from various stakeholders, the government constituted the Insolvency Law Committee (ILC) to recommend legislative and regulatory changes. The ILC recently submitted its report. See Insolvency Law Committee, *Report of the Insolvency Law Committee* (2018) .

7 As reported by Business Standard, according to data from IBBI, around 78 companies got liquidation orders since February 2017. Resolution plans have been approved by the National Company Law Tribunal (NCLT) in only 6 cases, and in another 4 cases, resolution plans have been submitted to the NCLT. See N Acharya, 'IBC proceedings: 78 liquidation orders, a handful of resolutions' (*Business Standard*, 22nd April 2018) ⟨http://www.business-standard.com/article/economy-policy/ibc-proceedings-78-liquidation-orders-a-handful-of-resolutions-118042200726_1.html⟩ accessed 23rd April 2018; similar concerns have been reported by Financial Express. See B Pattanayak, 'Insolvency law: More firms going for liquidation than resolution; over 20 face closure' (*Financial Express*, 25th December 2017) ⟨http://www.financialexpress.com/industry/insolvency-law-more-firms-going-for-liquidation-than-resolution-over-20-face-closure/988676/⟩ accessed 29th March 2018.

8 Arun Kumar Jagatramka, the Chairman and Managing Director of Gujarat NRE Coke Ltd criticised the bankers after NCLT ordered liquidation of his company. The insolvency proceeding was initiated by the company itself under section 10(1) of the Code. The workers proposed a resolution plan for a going concern sale of the company. However, the resolution plan could not be considered by the Committee of Creditors because the statutory time limit for approving the resolution plan was exceeded. Consequently, the company had to be liquidated by the NCLT as per the Code. See G Gopakumar, 'Insolvency code: Gujarat NRE Coke CMD seeks more accountability from bankers' (*LiveMint*, 16th January 2018) ⟨https://www.livemint.com/Companies/045S6mr9BoGeEAe5tI8AYL/Insolvency-code-Gujarat-NRE-Coke-CMD-seeks-more-accountabil.html⟩ accessed 29th March 2018; also see *In Re: M/s Gujarat NRE Coke Ltd* (2018) 146 SCL 63 (NCLT).

unjustly discriminates against unsecured operational and trade creditors.[9] The constitutionality of *Insolvency and Bankruptcy Code* has already been challenged once on this ground, although unsuccessfully.[10] The issue gained further prominence during insolvencies of major real estate companies, where home buyers being unsecured creditors were left without any effective remedy.[11] Subsequently, some aggrieved home buyers filed a public interest litigation in the Supreme Court challenging the constitutionality of the preference given to financial creditors under the *Insolvency and Bankruptcy Code*.[12] More such legal challenges by unsecured operational credit-

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[9] As discussed later in Chapter 2.1, under the Code only financial creditors have the right to vote on the future of the insolvent company - whether to liquidate it or not. Operational creditors do not have any say in this matter. According to a report in Business Standard, since resolution plans of most bidders are only taking care of secured financial creditors, unsecured operational creditors are planning to challenge this legal discrimination against them before the Supreme Court. See D Chatterjee, 'IBC: Bidders want clarity on haircut to be offered to operational creditors' (*Business Standard*, 29th March 2018) ⟨http://www.business-standard.com/article/companies/ibc-bidders-want-clarity-on-haircut-to-be-offered-to-operational-creditors-118032500600_1.html⟩ accessed 29th March 2018.

[10] The Calcutta High Court dismissed the writ petition observing that the Bankruptcy Law Reforms Committee (BLRC) had given a clear rationale for differentiating between financial and operational creditors, discussed in foonote 41 in Chapter 2.2.1. See, *Akshay Jhunjhunwala v Union of India* (2018) 1 CLJ 418 (Calcutta High Court).

[11] In one such case, the NCLT held that home buyers were neither financial creditors nor operational creditors. This caused much confusion about the status of homebuyers under the Code. See *Rubina Chandha v AMR Infrastucture* Company Appeal (AT) (Insolvency) No. 08/2017; the ILC has now suggested that homebuyers should be treated as 'financial creditors' owing to the unique nature of financing of real estate projects and the treatment of homebuyers by the Supreme Court of India. See, (n 6) p. 15-18.

[12] IDBI Bank initiated insolvency proceedings against Jaypee Infratech Limited ('Jaypee'), a real estate company. The NCLT issued an insolvency commencement order and imposed a moratorium on any individual recovery action against the company. This order left the home buyers of Jaypee without any remedy, especially since during the moratorium they could no more utilise the remedies under the Consumer Protection Act, 1986. In this backdrop, the home buyers filed a public interest litigation before the Supreme Court arguing that the differential treatment between secured financial creditors and unsecured home buyers under the Code is violative of Article 14 of the Constitution of India that guarantees equality before law as a fundamental right. This matter is currently pending. See Advocate for the petitioners, 'Chitra Sharma v. Union of India' (*Paper Book*, 21st August 2017) ⟨https://barandbench.com/wp-content/uploads/2017/09/Jaypee-Petition.pdf⟩ accessed 29th March 2018.

ors are likely in the near future.[13] These cases essentially highlight the risks of wealth transfer across classes of claimants under the *Insolvency and Bankruptcy Code*.

This dissertation aims to provide the theoretical frameworks necessary to identify the sources of these two contemporary challenges - the *value destruction problem* and the *wealth transfer problem*. It then applies these theoretical frameworks to the *Insolvency and Bankruptcy Code* to precisely identify the unique legislative features which are responsible for these problems.

1.2 Chapter arrangement

This dissertation is organised into four chapters. The first chapter provides an overview of the relevant features of the legislative scheme of *Insolvency and Bankruptcy Code*. Based on this discussion, it develops the two challenges discussed above into two precise research questions and contextualises them within the overall scheme of the *Insolvency and Bankruptcy Code*. The second chapter deals with the first challenge - the *value destruction problem*. It develops a theoretical framework to analyse the various types of this problem and the sources from which they could potentially emanate. Then it applies this theoretical framework to *Insolvency and Bankruptcy Code* to identify the unique legislative features which are responsible for the *value destruction problem* in the *Insolvency and Bankruptcy Code*. The third chapter deals with the second challenge - the *wealth transfer problem*. It develops a theoretical framework to analyse the various types of this problem and the sources from which they could potentially emanate. Then it applies this theoretical framework to *Insolvency and Bankruptcy Code* to identify the unique legislative features

[13] See Chatterjee (n 9).

which are responsible for the *wealth transfer problem* in the *Insolvency and Bankruptcy Code*. The fourth chapter summarises the main learnings from the second and third chapter and concludes the dissertation.

2 Insolvency and Bankruptcy Code, 2016

2.1 Overview of legislative scheme

The *Insolvency and Bankruptcy Code* classifies creditors into financial or operational, based on the nature of debt extended. 'Financial debt' is broadly defined to include credit extended against consideration for the time value of money including against payment of interest.[1] On the other hand, 'operational debt' has been defined as a claim in respect of provision of goods or services including employment and tax dues.[2] The Insolvency and Bankruptcy Board of India (IBBI) has subsequently created another third category of creditors - 'other creditors' - who are neither financial nor operational creditors.[3] If a corporate debtor defaults on payment to any creditor, financial, operational or other creditor, the *Insolvency and Bankruptcy*

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1 See section 5(8), Insolvency and Bankruptcy Code 2016.

2 See section 5(21) Insolvency and Bankruptcy Code 2016.

3 The IBBI is the regulator under the Code. In the initial phase of implementation of the Code, insolvencies of real estate companies raised unique concerns about status of home-buyers as financial or operational creditors. In view of the definitional ambiguity, IBBI amended the regulations to create a third category of creditors to cover those who are neither financial nor operational creditors. See Regulation 9A, Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016.

Code allows the corporate debtor itself or any of its financial or operational creditors to make an application before the National Company Law Tribunal (NCLT) to trigger the insolvency resolution process.[4] The application must also propose an insolvency professional to act as the interim resolution professional.[5]

Within fourteen days from the date of filing of the application, the NCLT has to decide whether to admit the application or not, based on a two-fold test.[6] First, depending on whether the applicant is a financial or operational creditor, NCLT has to follow the relevant statutory procedure to confirm that the corporate debtor has actually committed a payment default.[7] Second, NCLT has to confirm that there is no disciplinary proceeding pending against the proposed insolvency professional.[8] Once these prerequisites are confirmed, NCLT is required to admit the application and issue an order initiating the insolvency resolution process against the corporate debtor.[9] Simultaneously, NCLT must also declare a moratorium on any individual recovery action against the assets of the corporate debtor.[10] Within fourteen days of commencement of the resolution process, the NCLT is required to pass an order appointing an interim resolution professional to immediately take over the manage-

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4 The term 'default' and 'debt' are broadly defined such that default to any creditor could be used to trigger insolvency resolution under the Code. However, 'other creditors' do not have a specific statutory right to trigger insolvency resolution. See sections 3(11), 3(12), 7, 8, 9 and 10, Insolvency and Bankruptcy Code 2016.

5 See section 7(3)(b), Insolvency and Bankruptcy Code 2016.

6 See sections 7(4) and 9(5), Insolvency and Bankruptcy Code 2016.

7 See sections 7, 8 and 9, Insolvency and Bankruptcy Code 2016.

8 See section 7(5) and 9(5), Insolvency and Bankruptcy Code 2016.

9 See sections 7(5)(a), 9(5)(i) and 10(4)(a), Insolvency and Bankruptcy Code 2016.

10 See sections 13(1)(a) and 14, Insolvency and Bankruptcy Code 2016; the NCLT is also required to cause a public announcement of the initiation of the corporate insolvency resolution process calling for submission of claims by claimants of the corporate debtor. See sections 13 and 15, Insolvency and Bankruptcy Code 2016.

ment of the corporate debtor.[11]

The resolution professional has various important tasks,[12] of which four are particularly relevant for the present discussion. *First*, she has to receive and collate all claims submitted by claimants against the corporate debtor and constitute a Committee of Creditors (CoC) of the corporate debtor.[13] The CoC comprises only of financial creditors.[14] Operational creditors do not have any representation or vote on the CoC.[15] The CoC may by 75% vote by value decide on the future of the corporate debtor - whether to continue it or not.[16] *Second*, the resolution professional has to prepare an information memorandum containing the overall financial position of the corporate debtor.[17] She must provide this information memorandum to each

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[11] If the applicant had proposed an insolvency professional, the same professional would be appointed as the interim resolution professional. Such interim resolution professional is vested with the management of the affairs of the corporate debtor and the power of the board of directors stands suspended from the date of her appointment. Subsequently, in the first meeting of the Committee of Creditors, the interim resolution professional could either be appointed as the resolution professional or be replaced by a new resolution professional. See sections 13, 16, 17(1) and 22 Insolvency and Bankruptcy Code 2016.

[12] See section 25(2), Insolvency and Bankruptcy Code 2016.

[13] The claimaints would have submitted their claims pursuant to the public annoucement made by virtue of the first order of the NCLT. See sections 18(1)(b) and (c), Insolvency and Bankruptcy Code 2016.

[14] However, a financial creditor who is also a related party to the corporate debtor does not have any right of representation, participation or voting in a meeting of the CoC. See section 21(2), Insolvency and Bankruptcy Code 2016.

[15] See section 30(4), Insolvency and Bankruptcy Code 2016.

[16] See section 30(4), Insolvency and Bankruptcy Code 2016; the ILC recently recommended that the voting share for approval of the resolution plan and other critical decision should be reduced from 75% to 66%. See Insolvency Law Committee, *Report of the Insolvency Law Committee* (2018) paragraph 11.6.

[17] The information memorandum contains details of the assets and liabilities, annual financial statements, list of financial and operational creditors and corresponding credit amounts, material litigation and various other financial and operational information of the corporate debtor. See Regulation 36(2), Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016 (n 3).

member of the CoC as well as each prospective bidder ('resolution applicant') of the corporate debtor.[18] *Third*, the resolution professional has to invite resolution plans from prospective resolution applicants interested in purchasing the business of the corporate debtor.[19] After a resolution applicant has submitted its resolution plan to the resolution professional, the resolution professional is legally obliged to examine and confirm if the plan provides for:[20] (a) repayment of the debts of operational creditors which shall not be less than the amount to be paid to the operational creditors in the event of liquidation;[21] (b) specific sources of funds to be used to pay 'liquidation value' due to dissenting financial creditors and provide that such payment is made before any recoveries are made by the financial creditors who voted

[18] See section 29, Insolvency and Bankruptcy Code 2016; also see Regulation 36(1), Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016 (n 3).

[19] See section 25(2)(h), Insolvency and Bankruptcy Code 2016; a subsequent amendment to the law added section 29A, which prohibits a broad category of persons from applying as resolution applicants. The ILC observed that this provision could inadvertently include Asset Reconstruction Companies (ARCs), banks and alternate investment funds. This could therefore potentially prevent existing creditors from applying as resolution applicants for a debt restructuring under the Code. Although the ILC has suggested that pure play Financial Entities be exempted from this prohibition, currently this confusion persists. See paragraphs 14.3-14.4, (n 16).

[20] The resolution professional is obliged to examine if the resolution plan confirms to various other mandatory statutory requirements as well as requirements that may be imposed by the IBBI through regulations. See sections 30(2) and 30(2)(f), Insolvency and Bankruptcy Code 2016.

[21] The word 'liquidation' here could either refer to a break-up sale or a going concern sale of the corporate debtors' business to a third party followed by liquidation of the corporate shell of the corporate debtor. See sections 30(2)(b) and 53, Insolvency and Bankruptcy Code 2016; the regulations however mandate that a resolution plan must identify specific sources of funds to pay the 'liquidation value' to operational creditors. The regulation defines 'liquidation value' as 'the estimated realizable value of assets of the corporate debtor, if the corporate debtor were to be liquidated on the insolvency commencement date'. See Regulations 2(1)(k) and 38(1)(b), Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016 (n 3); the ILC in its recent report has however used break-up 'liquidation value' as the minimum amount to be paid to operational creditors in a resolution plan. See paragraphs 18.2-18.3, (n 16).

in favour of the resolution plan.[22] Going by the interpretation used by the Insolvency Law Committee (ILC),[23] these provisions apply the break-up 'liquidation value' benchmark to guarantee minimum protection to both operational creditors, who are not on the CoC, as well as dissenting financial creditors, who comprise the minority in the CoC.[24] If a resolution plan does not satisfy these 'creditor protection rules', the resolution professional cannot present it to the CoC for its approval.[25] *Fourth*, the resolution professional is under a legal duty to appoint two registered valuers within seven days of his appointment.[26] These two valuers are required to submit to the resolution professional an estimate of the 'fair value' and the 'liquidation value' of the corporate debtor in accordance with internationally accepted valuation

22 This requirement is not there in the statute, but only in the regulations. See Regulation 38(1)(c), Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016 (n 3); the ILC in its recent report has used break-up 'liquidation value' as the minimum amount to be paid to dissenting financial creditors in a resolution plan. See (n 16) paragraph 30.1.

23 See ILC's opinion in footnotes 21 and 22. Also see paragraphs 18.2-18.3 and 30.1, (n 16).

24 Commentators have highlighted ambiguities in the Insolvency and Bankruptcy Code regarding calculation of the break-up 'liquidation value'. Under section 52, a secured creditor in a liquidation proceeding has an option to relinquish security interest to the liquidation estate and receive proceeds under section 53, or to realise its security interest in accordance to non-insolvency law following the procedure under section 52. It is unclear if the resolution professional should take into account the preference of each secured creditor in liquidation scenario while calculating the 'liquidation value' for the purposes of creditor protection while reviewing the resolution plans. See V Sivaramakrishnan and D Charan, 'Cramming down under the Insolvency Code' (*Asia Business Law Journal*, 5th January 2018) ⟨https://www.vantageasia.com/cramming-insolvency-code/⟩ accessed 11th January 2018; moreover, neither the statute nor the regulation explicitly extends the creditor protection provision to the third category of creditors - 'other creditors' - that has been subsequently created by the IBBI. See Regulation 38(1), Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016 (n 3).

25 It is however unclear how the resolution professional could do this without knowing in advance which financial creditors will dissent or what would be the preferences of each and every secured creditor in liquidation scenario. See section 30(3) and 52(1), Insolvency and Bankruptcy Code 2016.

26 See Regulation 27 Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016 (n 3).

standards.[27] If in the opinion of the resolution professional, these two estimates are significantly different, she may appoint another third registered valuer who shall submit another set of estimates.[28] The average of the two closest estimates of a value shall be considered the 'fair value' and 'liquidation value' of the corporate debtor.[29] The resolution professional is required to transmit this final estimated values to the CoC.[30] This information is expected to be useful to the CoC while determining the bids received from resolution applicants and thus aid in maximising the recovery value for the creditors.[31]

Within 180 days from the date of commencement of the insolvency resolution process, the CoC may by 75% vote by value approve a resolution plan proposed by a resolution applicant.[32] The resolution plan could propose either a going concern sale

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[27] 'Fair value' means 'the estimated realizable value of the assets of the corporate debtor, if they were to be exchanged on the insolvency commencement date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties acted knowledgeably, prudently and without compulsion'. See Regulations 2(1)(hb) and 35(1)(a), Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016 (n 3).

[28] See Regulation 35(1)(b), Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016 (n 3).

[29] See Regulation 35(1)(c), Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016 (n 3).

[30] See Regulation 35(2), Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016 (n 3).

[31] Lenders were of the view that fair or enterprise valuation should be taken into account so that bidding started from a higher point. This nudged IBBI to introduce the new regulation requiring 'fair value' and 'liquidation value' to be provided to the CoC. See FE Bureau, 'Stressed asset valuation: Both fair and liquidation values to be considered' (*Financial Express*, 8th February 2018) ⟨http://www.financialexpress.com/economy/stressed-asset-valuation-both-fair-and-liquidation-values-to-be-considered/1057179/⟩ accessed 29th March 2018.

[32] See section 30(4), Insolvency and Bankruptcy Code 2016; the CoC can extend the 180 days deadline by maximum of another 90 days at most. See section 12(1) Insolvency and Bankruptcy Code 2016; during this time, the resolution professional can raise interim finance subject to approval of the Committee of Creditors. Such interim finance are treated as part of the 'insolvency resolution process costs' and enjoy super-priority in the waterfall. See sections 20(2)(c), 25(2)(c), 28(1)(a), 5(13) and 53(a) Insolvency and Bankruptcy Code 2016.

or a restructuring.[33] Once a resolution plan is approved by the super-majority of the CoC, the resolution applicant must submit the plan to the NCLT for its approval.[34] The NCLT must approve the resolution plan if it is satisfied that the resolution plan meets the mandatory legal requirements (including the creditor protection rules) and that the plan was approved by a vote of not less than 75% of voting share of the financial creditors.[35] Once approved by NCLT, the resolution plan becomes binding on all stakeholders including the corporate debtor, its employees, members, creditors and guarantors.[36] However, if the NCLT rejects the resolution plan for non-compliance with mandatory legal requirements or if the resolution plan is not submitted before the NCLT within the statutory time limit, the NCLT is required to pass an order initiating the liquidation of the corporate debtor.[37]

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[33] See Regulation 37, Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016 (n 3); as will be explained later, the law is unclear about the distinction between restructuring and going concern sale to third party. For instance, it is not evident why the resolution professional is under a mandatory obligation to invite resolution plans from third parties in a restructuring, although it is normal to do so in a going concern sale to third parties through auctioning. Similarly, it is unclear from where will cash be available to pay the dissenting financial creditors as required under the law, if the resolution plan proposes a restructuring that leaves the business with the company. See Regulation 36A and 38(1)(c), Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016 (n 3).

[34] See section 30(6), Insolvency and Bankruptcy Code 2016.

[35] The obligation on NCLT to approve such a resolution plan is mandatory. The law does not give any discretion to NCLT to review whether the resolution plan is unfair to the dissenting minority creditors or non-voting operational creditors. See section 31(1) and 30(2), Insolvency and Bankruptcy Code 2016; this legal position is in confirmity with the policy rationale adopted by the BLRC, which observed that in the past, laws in India have brought arms of the government (legislature, executive or judiciary) to decide on the future of a defaulting firm. The BLRC wanted to avoid any such discretion being given to any organ of the state including the judiciary. It was of the view that the appropriate disposition of a defaulting firm is a business decision, and only the creditors should make it. See Executive Summary, Bankruptcy Law Reforms Committee, *The report of the Bankruptcy Law Reforms Committee: Volume I: Rationale and Design* (2015) .

[36] See section 31(1), Insolvency and Bankruptcy Code 2016.

[37] See section 33(1), Insolvency and Bankruptcy Code 2016.

2.2 Research questions

2.2.1 Value destruction problem

The BLRC had envisaged that the assessment of viability of an insolvent firm should ideally be the outcome of collective negotiation among the claimants of the firm.[38] However, it acknowledged that such collective negotiations could lead to conflicts, causing destruction of value of the insolvent firm.[39] To avoid such value destruction, the BLRC tried to design a formal insolvency resolution process that would appropriately channel such conflicts to achieve a solution.[40] In designing this formal insolvency resolution process within the *Insolvency and Bankruptcy Code*, BLRC entrusted the power of viability assessment of an insolvent firm to a super-majority of its financial creditors instead of leaving it for collective negotiation among the different classes of claimants of the insolvent firm.[41] My research seeks to analyse whether entrusting financial creditors with the power to assess the viability of insolvent firms has any potential implications on value destruction.

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[38] See (n 35) paragraph 3.2.1.

[39] See (n 35) paragraph 3.2.2.

[40] See (n 35) paragraph 3.2.3.

[41] The BLRC deliberated on who should be on the creditors' committee, given the power of the creditors' committee to ultimately keep the entity as a going concern or liquidate it. The Committee reasoned that members of the creditors' committee should have the capability to assess viability, as well as the willingness to modify terms of existing liabilities in negotiations. Typically, operational creditors are neither able to decide on matters regarding the insolvency of the entity, nor willing to take the risk of postponing payments for better future prospects for the entity. Therefore, the Committee concluded that, for the process to be rapid and efficient, the law should provide that the creditors' committee should be restricted to only the financial creditors. See (n 35) paragraph 5.3.1(4).

2.2.2 Wealth transfer problem

The BLRC was of the view that to preserve the organisational capital of insolvent firms, the insolvency process should facilitate creation of a platform for negotiation between creditors and external financiers.[42] Consequently, the *Insolvency and Bankruptcy Code* seeks to facilitate going concern sale of the business of the corporate debtor at 'fair value' during the insolvency resolution process and not merely recover break-up 'liquidation value'.[43] Yet, the creditor protection norms under the *Insolvency and Bankruptcy Code* use the break-up 'liquidation value' as the benchmark for calculating the minimum amount to be paid to the operational creditors and dissenting financial creditors under a resolution plan.[44] My research seeks to analyse the potential abuse of these different valuation benchmarks in the form of *wealth transfer* from one class of claimaints to another in the absence of judicial supervision to ensure fairness of the resolution plan.

[42] See (n 35) paragraph 3.2.3.

[43] This is why the resolution professional is required to appoint registered valuers to determine the 'fair value' and accordingly inform the CoC to aid in the bidding process. See Regulations 27 and 35 Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016 (n 3).

[44] See Regulations 38(1)(b) and 38(1)(c), Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016 (n 3).

3 Value Destruction Problem

3.1 Theoretical framework

3.1.1 Economic distress and financial distress

Making the appropriate decision about the future of a distressed company essentially hinges on correctly identifying whether the company is *economically distressed* or *financially distressed*.[1] If the net present value of the company is less than the total value of the assets of the company were they to be broken up from the business and sold separately ('liquidation value'), such a company is said to be in *economic distress*.[2] Since the assets of an *economically distressed* company are worth more piecemeal than kept together in the company's business, the claimants are better off by liquidating such a company and selling its assets on a piecemeal basis. In contrast, if the company is not *economically distressed* but is unable to service its debts, such a company is said to be in *financially distress*. In terms of valuation, when the total value of debt of a company exceeds its net present value, it is said

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[1] See DG Baird, 'Bankruptcy's uncontested axioms' (1998) 108 The Yale Law Journal 573, p. 580; 'Value of a company' here refers to the value of the company's business.

[2] See Part II (Bases of Valuation), M Crystal and RJ Mokal, 'The Valuation of Distressed Companies - A Conceptual Framework' (2006) 3(1 and 2) International Corporate Rescue 63, 123.

to be *financially distressed.* The assets of such a company are more valuable if kept together as a functioning unit than they would be if sold off piecemeal. In other words, a *financially distressed* company has *going concern surplus*, which should not be liquidated except through a process which preserves such surplus.[3]

3.1.2 Basic objectives of insolvency law

A well-design insolvency law should have at least two objectives. First, it must facilitate the correct determination of the type of distress a company is suffering from - *economic distress* or *financial distress.* Second, it must ensure that an *economically distressed* company is liquidated, whereas a *financially distressed* company is sustained either by restructuring it among existing claimants or by selling it to new investors. Only then can the insolvency law help achieve an *ex post* efficient outcome that maximises the total value of the proceeds - measured in money terms - for the claimants.[4] In contrast, an insolvency law that pushes merely *financially distressed* (but not *economically distressed*) companies into break-up liquidation is poorly designed because it destroys the organisational value of such companies.[5]

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3 As discussed in Chapter 2.1, the word ‘liquidation’ could either refer to a break-up sale or simply entry into a liquidation procedure. The latter is not mutually inconsistent with preservation of going concern value. Such liquidation could entail a sale on going concern basis, cash proceeds could be distributed among claimants, and then the shell could be liquidated. In this dissertation, the term ‘liquidation’ has been used primarily to refer to break-up liquidation, not going concern sale, unless explicitly mentioned otherwise. Similarly the term ‘liquidation value’ refers to break-up ‘liquidation value’, unless explicitly mentioned otherwise. See Crystal and Mokal (n 2) Part II (Bases of Valuation).

4 See P Aghion, O Hart and J Moore, ‘Improving bankruptcy procedure’ (1994) 72 Washington University Law Review 849, 852.

5 A living business with established customers, knowledgeable employees and so forth will bring a higher price as a unit than would the sale of each asset class separately, even assuming that those separate sales would obtain market value for each asset. See, JL Westbrook, ‘The Control of Wealth in Bankruptcy’ (2004) 82 Texas Law Review 795, p. 811.

Such potentially inefficient outcome of a poorly designed insolvency law is referred to as *value destruction problems.*

3.1.3 Sources of value destruction

The value destruction problem could arise if the insolvency law entrusts the decision regarding the future of the insolvent company to a class of claimants whose payoffs are not affected by the outcome of the decision. This could be either because the claimants are fully protected in any case or because they are not entitled to anything in the first place.[6] For instance, if the decision as to the future of the company is left to the fully secured creditors of the insolvent company, they have no incentive to recover any amount in excess of the face value of their debt. This is because, even if they recover an amount higher than the face value of their debt, the maximum amount they are entitled to is still the face value of their debt only. Therefore, if this decision is left to such secured creditors, they have an incentive to destroy value of the *financially distressed* company by selling it at a value less than the *enterprise value* or to push it into immediate liquidation to realise the *liquidation value.*[7]

Insolvency law could also cause value destruction by delaying initiation of restructuring. Restructuring is meant to realise the *going concern value* or *enterprise value* of the company by reorganising its capital structure.[8] The earlier the restruc-

[6] See Aghion, Hart and Moore, 'Improving bankruptcy procedure' (n 4) p. 859.

[7] See OD Hart, '*Bankruptcy Procedure*' in *Firms, Contracts, and Financial Structure* (Clarendon Press 1995) p. 27; however, there could be countervailing factors like reputational costs in repeat lending, which may incentivise secured creditors not to automatically liquidate firms on payment default. For instance, there is strong evidence that UK banks do not opt for automatic liquidation on violation of debt contract. See J Franks and O Sussman, 'Financial Distress and Bank Restructuring of Small to Medium Size UK Companies' (2005) 9 Review of Finance 65, p. 91.

[8] For a more detailed discussion on this issue, see Chapters 4.1.1 and 4.1.2. Also see Crystal and Mokal (n 2) Part II (Bases of Valuation).

turing is initiated, the higher are the chances of preservation of the value of the business and its (remaining) *enterprise value*. If debts are not restructured early on, the corporate debtor may enter formal insolvency procedure, which may further depress the *enterprise value*.[9] Moreover, the lower the *enterprise value*, the lesser is the residual value for the equity holders, and the higher is their propensity to pursue high risk investment strategies at the expense of the creditors - the *asset substitution problem*.[10] Therefore, delayed initiation of restructuring could also destroy *enterprise value* of a company which is *financially distressed* or is likely to become *financially distressed*.

3.2 Value destruction under IBC

3.2.1 Liquidation of merely *financially distressed* companies

The *Insolvency and Bankruptcy Code* entrusts the decision regarding the future of the insolvent company to the CoC.[11] The CoC comprises only of financial creditors, who can approve a resolution plan by 75% vote by value.[12] Therefore, if 75% or more of the financial debt of a *financially distressed* company is held by fully secured creditors, the future of the company is essentially entrusted with such secured creditors.

9 See H Eidenmuller and K van Zwieten, 'Restructuring the European Business Enterprise: the European Commission's Recommendation on a New Approach to Business Failure and Insolvency' (2015) 16 European Business Organisation Law Review 625, p. 655.

10 See MC Jensen and WH Meckling, 'Theory of the firm: Managerial behaviour, agency costs and ownership structure' (1976) 3 Journal of Financial Economics 305, p. 334; also see Eidenmuller and Zwieten (n 9) p. 655.

11 See section 30(4) Insolvency and Bankruptcy Code 2016.

12 See section 21(2) Insolvency and Bankruptcy Code 2016.

If these secured creditors are fully protected against the value of the security, they are likely to have little incentive to maximise the economic value of the business of the *financially distressed* company. Because even if the company is sustained and the *going concern surplus* is realised, the secured creditors are not entitled to any of that surplus. Instead, such secured creditors are likely to have a stronger incentive to immediately liquidate the *financially distressed* company and realise the *liquidation value*, thus destroying the *going concern surplus* of the company. The outcome will remain the same even if the secured creditors are partially protected by the value of their securities, as long as the liquidation value is higher than the present value of their expected returns from continuing the *financial distressed* company.

To illustrate, let's consider a hypothetical example. Suppose a company has two types of creditors - secured financial creditors and unsecured operational trade creditors.[13] It owes $100 to its secured financial creditors, $30 to its unsecured operational trade creditors, and the liquidation value of the company is $90. If the company is continued as a going concern for next 6 months, there is a 0.5 probability that it will be worth $240 and a 0.5 probability that it will be worth $40. In other words, if the company is continued for the next 6 months, the expected going concern value of the company would be $ (0.5).(240) + (0.5).(40) = $140.[14] Since the net present value ($140) is higher than the liquidation value ($90), the company is not *economically distressed*. It is only in *financial distress* because the total debt of the company ($130) exceeds its liquidation value ($90). Therefore, the value maximising choice would be to keep the company going, so that both the financial and operational

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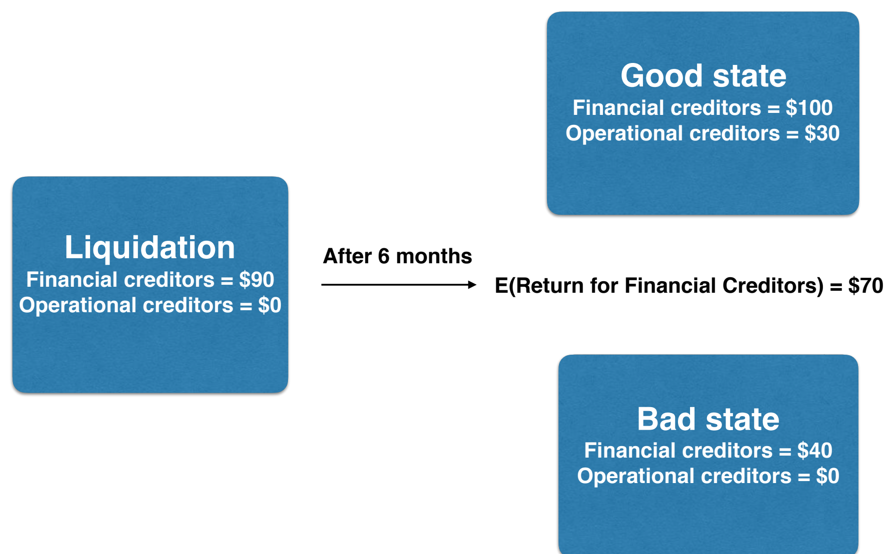
13 In this example, I am assuming that the secured creditors are a little undersecured. If the secured creditors are fully or over secured, the effect described in this example will be even more profound.

14 For convenience, we are assuming that the discount rate is 0. Therefore, the expected going concern value is also the net present value of the company.

creditors can recover the full amount owed to them (that is, \$130) and the company can generate a going concern surplus (\$140-130=\$10). However, if things go well and after 6 months the company is actually worth \$240, the secured financial creditors will still get only \$100, the value of debt owed to them. On the other hand, if things go badly and after 6 months the company is actually worth \$40, they will get the entire \$40. Therefore, if the secured financial creditors decide to keep the company going, their expected return would be \$ (0.5).(100) + (0.5).(40) = \$70 - much lesser than the immediate liquidation value (\$90). Figure 3.2.1 summarises the returns to the creditors in the different states.



Evidently, the secured financial creditors would always prefer to immediately liquidate the company for \$90 even though the value-maximising decision would be to continue it.[15] Therefore, in the factual matrix described above, *Insolvency and*

[15] This is based on the assumption that there are no counterveiling factors like reputation in repeat

Bankruptcy Code would fail to save a *financially distressed* (but not *economically distressed*) company from being liquidated, causing value destruction.[16]

3.2.2 Delayed restructuring

Once the insolvency resolution process under *Insolvency and Bankruptcy Code* is triggered, the resolution professional with the approval of the CoC can engage in debt restructuring.[17] The main advantage of restructuring within the framework of *Insolvency and Bankruptcy Code* is that the law empowers the majority financial creditors (with at least 75% vote by value) to impose a restructuring plan on operational creditors as well as dissenting financial creditors - the 'cramdown' provision.[18] Such a potent cramdown option for restructuring is unavailable outside *Insolvency and Bankruptcy Code*.[19]

However, the insolvency resolution process under *Insolvency and Bankruptcy Code* can be triggered only post-insolvency.[20] Therefore, restructuring under *Insolv-*

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or relationship lending. See, Franks and Sussman (n 7); this example is based on an example used by Aghion, Hart and Moore. See Aghion, Hart and Moore, 'Improving bankruptcy procedure' (n 4) 859.

[16] The above example relates to secured creditors who are a little under-secured. If they were fully secured, the effect would be even more profound.

[17] See section 28(1)(c) Insolvency and Bankruptcy Code 2016; also see regulations 37(f), (g) and (i) Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016.

[18] See sections 30(4) read with 28(1)(c) Insolvency and Bankruptcy Code 2016; also see regulations 37(f), (g) and (i) Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016 (n 17).

[19] As discussed in the next paragraph, a scheme of arrangement provides a less potent cramdown option. See section 230, Companies Act 2013; a cramdown provision was also available under the Guidelines on Joint Lenders' Forum (JLF) and Corrective Action Plan (CAP) issued by RBI on February 26, 2014, and subsequently amended on May 5, 2017. However, this framework was repealed by RBI on February 12, 2018. Under the revised framework, there is no cramdown provision. See Resolution of Stressed Assets - Revised Framework 2018.

[20] Insolvency resolution process can be triggered only after there has been a payment default by

ency and Bankruptcy Code is not possible pre-insolvency, when the corporate debtor is reasonably likely to default on its debt obligations and become *cash flow insolvent* in the foreseeable future.[21] Consequently, any attempt to restructure pre-insolvency will have to be outside the scope of *Insolvency and Bankruptcy Code*, without the benefit of the cramdown provision.

Pre-insolvency debt restructuring could then potentially be executed through a scheme of arrangement under *Companies Act*.[22] However, unlike *Insolvency and Bankruptcy Code*, the cramdown provision in *Companies Act* is much less potent since it does not allow cross-class cramdown.[23] *Companies Act* gives extensive discretion to the NCLT to modify the scheme.[24] Further, there are various additional procedural hurdles to restructuring through a scheme.[25] All these factors make debt restructuring through *Companies Act* far more difficult than through *Insolvency and Bankruptcy Code*.[26] The only other alternative to executing a pre-insolvency restructuring plan would be through private contracting. This would require consent

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the corporate debtor. This is the case even when the corporate debtor itself is the applicant. See sections 7, 9 and 10 Insolvency and Bankruptcy Code 2016.

[21] In UK, schemes are often used instead of administration for debt restructuring precisely because the former provides a cramdown option pre-insolvency while the latter provides a cramdown option but only post-insolvency. See J Payne, 'Debt restructuring in English law: lessons from the United States and the need for reform' (2014) 130 Law Quaterly Review 282, p. 295.

[22] See section 230 Companies Act 2013.

[23] See U Varottil, 'The Scheme of Arrangement as a Debt Restructuring Tool in India: Problems and Prospects' (*NUS Working Paper*, 2017) ⟨https://law.nus.edu.sg/wps/pdfs/005_2017_Umakanth.pdf⟩ accessed 26th April 2018, p. 8.

[24] See section 230(7), Companies Act 2013.

[25] For instance, any creditor with not less than 5% of the total outstanding debt has a legal right to raise an objection to the restructuring plan. See proviso to section 230(4), Companies Act 2013.

[26] To date, schemes under Companies Act, 2013 have been used sparringly in India for debt restructuring. Given the application of the Insolvency and Bankruptcy Code to post-insolvency restructurings only, it remains to be seen if scheme of arrangement under Companies Act, 2013 could become a viable device for pre-insolvency restructuring. See, Varottil (n 23).

of all the claimants - financial creditors, operational creditors, and shareholders - making it extremely difficult to negotiate in practice.[27]

Overall, under the current Indian legal framework, pre-insolvency restructuring is far more difficult to execute than post-insolvency restructuring. This disparity stems from the application of *Insolvency and Bankruptcy Code* to only post-insolvency restructuring. To this limited extent, by delaying restructuring post-insolvency, *Insolvency and Bankruptcy Code* makes it difficult to preserve the value of a business which is on the verge of *financial distress* and enhances the risk of value destruction.[28]

[27] If all creditors had to agree to the restructuring, that would have put significant hold-up rights into the hands of minority creditors, potentially allowing even very small creditors to derail the restructuring while they would have bargained for additional benefits or advantages. The cramdown provision helps overcome this problem. See Payne, 'Debt restructuring in English law: lessons from the United States and the need for reform' (n 21) p. 284; also see Eidenmuller and Zwieten (n 9) 632.

[28] See Eidenmuller and Zwieten (n 9) 631.

4 Wealth Transfer Problem

4.1 Theoretical framework

4.1.1 Going concern sale and its limitations

A *financially distressed* company has going concern surplus, which should be preserved.[1] One way of preserving the *going concern surplus* of a *financially distressed* company is by selling its business at the *going concern value* (also known as the *enterprise value*).[2] *Going concern value* may be much greater than *market value* of asset sale (and therefore, *liquidation value*) because a living business has organisational value which is lost if its assets are sold separately, even if they could be sold at *market value.*[3]

However, a *going concern sale* of a financially distressed company at *enterprise value* may not always be possible because of myriad reasons. First, the company

[1] See H Eidenmuller and K van Zwieten, 'Restructuring the European Business Enterprise: the European Commission's Recommendation on a New Approach to Business Failure and Insolvency' (2015) 16 European Business Organisation Law Review 625, p. 655.

[2] See M Crystal and RJ Mokal, 'The Valuation of Distressed Companies - A Conceptual Framework' (2006) 3(1 and 2) International Corporate Rescue 63, 123, , Part II (Bases of Valuation).

[3] As discussed earlier, a living business with established customers, knowledgeable employees and so forth will bring a higher price as a unit. See JL Westbrook, 'The Control of Wealth in Bankruptcy' (2004) 82 Texas Law Review 795, p. 811.

could be in financial distress because of industry wide factors. Its competitors in that industry may not be in a position to offer the *enterprise value* to expand their businesses.[4] Second, industry wide factors may push other companies into financial distress, creating an oversupply of similar businesses in the market. This may create the risk of auctions at 'fire sale' prices, which may be equivalent to the liquidation value.[5] Third, auctions work well when there is adequate financing and competition among bidders. Countries with less developed capital markets naturally will be at a disadvantage. Even in countries with well-developed capital markets, if a very large company's business is put up for auctioning, it will be difficult to raise financing. The only solution is to raise money from some big institutional investors, who will be prepared to buy the business only at a discount because of the substantial risk they will be bearing.[6] Fourth, participating in an auction process involves transaction costs. But only the winner is able to recoup the costs. Consequently, even though there could be many potential bidders who could raise the financing, not all of them will participate. This may cause a lack of competition problem.[7]

4.1.2 Restructuring

Because of the abovementioned reasons, sale of the *financially distressed* company as an ongoing concern to new investors may not raise the *enterprise value* of the company. In such an event, instead of selling the company to new investors, the

[4] See Crystal and Mokal (n 2) , Part II (Bases of Valuation).

[5] See Crystal and Mokal (n 2) , Part II (Bases of Valuation); also see Eidenmuller and Zwieten (n 1) p. 636.

[6] See P Aghion, O Hart and J Moore, 'The Economics of Bankruptcy Reforms' (1992) 8(3) Journal of Law, Economics, & Organization 523, p. 527.

[7] See Aghion, Hart and Moore, 'The Economics of Bankruptcy Reforms' (n 6) p. 527.

claimants of the financially distressed company would be better of by 'selling' the company to some or all of the existing claimants themselves.[8] This 'hypothetical sale' is commonly referred to as *restructuring* (or *reorganisation*).[9]

Restructuring could be implemented voluntarily if all the claimants could come to an agreement. However, this is difficult because of two reasons. First, when there is a dispersed set of claimants, the coordination cost is too high.[10] Moreover, a prolonged negotiation could be disadvantageous and impractical if the debtor is facing an acute liquidity crisis.[11] Second, there is a possibility that one or more claimants may hold-up the process to try and get a better deal for themselves. For instance, one or more claimants may withhold consent, file individual recovery action or petition for winding up of the company.[12] The situation is worse if the claimant holding-up restructuring efforts is an out-of-the-money claimant, who would not receive any payment or other consideration if the corporate debtor is liquidated instead.[13] State supplied insolvency laws are necessary to overcome these two specific problems.

Insolvency law could facilitate restructuring by allowing a majority of claimants to impose a restructuring plan on a dissenting minority. This could be structured in different ways. For instance, insolvency law could allow a restructuring plan to be imposed only on dissenting claimants of a particular class if the majority of that class

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8 See Crystal and Mokal (n 2) Part V (A case study: My Travel Group Plc).

9 See DG Baird, 'The Uneasy Case for Corporate Reorganizations' (1986) 15(1) The Journal of Legal Studies 127, p. 127.

10 See Crystal and Mokal (n 2) Part II (Bases of Valuation).

11 See J Payne, 'The role of the court in debt restructuring' (2018) 77(1) The Cambridge Law Journal 124, p. 127.

12 See Payne, 'The role of the court in debt restructuring' (n 11) p. 127; this problem has also been referred to as the 'motiviation cost'. See Crystal and Mokal (n 2) Part II (Bases of Valuation).

13 This is the reason why English courts discount dissent of those without any economic interest in the corporate debtor. See, Payne, 'The role of the court in debt restructuring' (n 11) p. 138-139.

consents. It could also allow the restructuring plan to be imposed on whole classes of dissenting claimants - the cramdown provision.[14] Such provisions help reduce the coordination and hold-up problems that make contractual restructuring difficult to achieve.

4.1.3 Sources of wealth transfer

When insolvency law provides cramdown powers to facilitate restructurings, it raises the possibility of abuse, and in particular of *wealth transfer* from one class of claimants to another.[15] The *wealth transfer* problem could arise when insolvency law allows majority claimants to gain control over the restructuring of the corporate debtor.[16] The majority claimants being in control of the process may be able to advantage or disadvantage different groups of beneficiaries by structuring of the securities, contract rights or other property received by each.[17] They could even abuse this control to derive disproportionate private benefits by transferring wealth away from the dissenting minority claimants through the restructuring plan.[18] Adequate safeguards are therefore necessary to protect the interests of the dissenting

[14] See Payne, 'The role of the court in debt restructuring' (n 11) p. 128; British policymakers are currently considering introduction of such a cramdown provision for restructuring. See The Insolvency Service, *A review of the corporate insolvency framework: A consultation on options for reforms* (2016) paragraphs 9.19-9.21.

[15] See Payne, 'The role of the court in debt restructuring' (n 11) p. 134.

[16] Control is the function of insolvency law. It concerns the management of the corporate debtor's assets during the recovery process after default. See, Westbrook (n 3) p. 800.

[17] See Westbrook (n 3) p. 800.

[18] There are other substantial private benefits of controlling corporate decision-making. For example, in exchange for 'yes' votes, majority creditors may receive side benefits from managers or major shareholders, such as early repayment, security interest, guarantee, or other business opportunities. See, HC Lee, 'Efficient and Inefficient Debt Restructuring: A Comparative Analysis of Voting Rules in Workouts' (2007) 40(3) Cornell International Law Journal 661, p. 665-666.

claimants.[19]

Insolvency laws across jurisdictions usually provide this safeguard to dissenting minority claimants through judicial supervision.[20] The main objective of such judicial supervision is to ensure that a restructuring plan does not make the dissenting creditors worse off than what they would have been in the event of liquidation of the corporate debtor.[21] The starting point for the court is to consider the counterfactual, namely what each creditor would receive if no restructuring could be agreed upon. In that case, the company could either be liquidated on break-up basis or its business sold as a going concern and the corporate structure could be liquidated.[22] Therefore, the court could use either the break-up 'liquidation value' or the going concern 'liquidation value' as the benchmark for determining how much should be paid to the dissenting creditors. If the court uses the break-up 'liquidation value',

[19] British policymakers proposing a cramdown provision have discussed potential safeguards for creditors in the form of judicial supervision. See (n 14) paragraphs 9.24-9.28; even the Singaporean Insolvency Law Review Committee while recommending inclusion of a cramdown provision in the Companies Act, 1967, was conscious of this issue. Accordingly, it recommended that 'the court should require a high threshold of proof that the dissenting class is not going to be prejudiced by the cramdown'. See Insolvency Law Review Committee (Singapore), *Report of the Insolvency Law Review Committee* (2013) .

[20] In the US, Chapter 11 of the Bankruptcy Code relies heavily on the role of the court. This is also the policy in UK and Singapore. However, the 2016 EU draft Directive regarding restructuring processes, and the EU Recommendation on which it is based, both aim to minimise court involvement, although not remove it completely. Admittedly, judicial supervision has its disadvantages, but still it is considered better than leaving this issue to the sole discretion of the insolvency professional appointed by the senior lenders. See Payne, 'The role of the court in debt restructuring' (n 11) p. 125,133-134; for the policy in Singapore, see generally (n 19).

[21] See European Commission, *Proposal for a Directive of the European Parliament and of the Council: on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU* (2016) page 31, paragraph 30.

[22] Since restructuring is a hypothetical sale, no actual sale of the business to third party takes place. The liquidation value on going concern basis is therefore used only for valuation purposes in this context. See RC Clark, 'The Interdisciplinary Study of Legal Evolution' (1981) 90(5) The Yale Law Journal 1238, p. 1252.

it would obviously provide lesser protection to the dissenting creditors of a merely *financially distressed* company, causing wealth transfer from them.[23] It has therefore been suggested that for corporate debtors in mere *financial distress*, a going concern 'liquidation value' is a more appropriate benchmark than a break-up liquidation value.[24]

Wealth transfer could also happen if valuation of the corporate debtor is left to one particular class of creditors. Senior creditors have an incentive to undervalue the company's business, while junior creditors have an incentive to overvalue it. For instance, in a reorganisation involving conversion of debt to equity, if the value of the company is lesser than the value of the senior claims, then senior creditors could have the right to all the equity since the junior creditors would be left with no economic interest. In contrast, if the value of the company is more than the value of the senior claims, then the junior creditors will also have to be offered equity in the company. Therefore, if the issue of valuation is left to either the senior creditors or the junior creditors, they could engage in strategic valuation, leading to wealth transfer from the other.[25] Even when this issue is subject to judicial supervision, courts need to be prepared to resist any attempt at strategic valuation and instead choose the valuation method best suited to curb the *wealth transfer* problem.[26]

Even in cases where the court feels it appropriate to use the going concern 'liquidation value', another critical question of valuation arises, namely, how to determine

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[23] As discussed earlier, restructuring is a 'hypothetical sale' to preserve the going concern value or enterprise value of a *financially distressed* company and not merely recover the break up 'liquidation value'. See, Crystal and Mokal (n 2) , Part II ((Bases of Valuation)).

[24] See Payne, 'The role of the court in debt restructuring' (n 11) p. 139.

[25] See Crystal and Mokal (n 2).

[26] See Payne, 'The role of the court in debt restructuring' (n 11) p. 139.

the going concern value. Restructuring being a hypothetical sale to the claimants themselves, a proper market test may not be possible.[27] Therefore, it would be necessary to determine the going concern value based on valuation opinions from expert valuers. This process being subjective may generate disputes and litigation, making the valuation exercise time-consuming and messy.[28] These valuation problems have to be resolved by courts while protecting minority claimants against *wealth transfer* in a restructuring.

4.2 Wealth transfer under IBC

4.2.1 Inadequate protection from abusive cramdown

Insolvency and Bankruptcy Code empowers majority financial creditors with 75% vote by value in the CoC to impose a resolution plan on the dissenting minority of financial creditors as well as the non-voting operational creditors.[29] Such a resolution plan could *inter alia* modify any security interest, extend the maturity date, change interest rate or other terms of a debt due from the corporate debtor.[30] In view of this broad cramdown power given to the majority financial creditors, *Insolvency and Bankruptcy Code* provides three safeguards to protect the dissenting minority financial creditors as well as the non-voting operational creditors. First, the resolution plan must identify specific sources of funds to pay the 'liquidation value'

[27] As discussed in Chapters 4.1.1 and 4.1.2, restructuring is likely when *going concern sale* may not fetch the *enterprise value*.

[28] See Payne, 'The role of the court in debt restructuring' (n 11) p. 140.

[29] See sections 30(4) and 31(1), Insolvency and Bankruptcy Code 2016.

[30] See Regulation 37(1), Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016.

due to dissenting financial creditors.[31] Second, the resolution plan must provide for repayment of the debts of operational creditors which shall not be less than the amount to be paid to the operational creditors in the event of liquidation.[32] Third, the 'fair value' and 'liquidation value' of the insolvent business calculated by the registered valuers appointed by the resolution professional is expected to mitigate problems of strategic valuation.[33]

It is important to note here that there is no explicit provision in the *Insolvency and Bankruptcy Code* that empowers NCLT to review the fairness of the resolution plan, as long as such plan provides the minimum break-up 'liquidation amount' to the dissenting financial creditors and the operational creditors.[34] The ILC during its recent review of the *Insolvency and Bankruptcy Code* recorded stakeholders' concerns that the 'liquidation value' guaranteed to the operational creditors may be negligible as they fall under the residual category in the statutory waterfall.[35] The ILC deliberated on whether instead of 'liquidation value', a different benchmark like 'fair value', 'resolution value' or 'bid value' should be used as the floor to determine the value to be given to the operational creditors. However, none of them were deemed suitable.[36] Instead, the ILC went on to observe that many operational credit-

[31] See Regulation 38(1)(c), Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016 (n 30).

[32] See section 30(2)(b) Insolvency and Bankruptcy Code 2016.

[33] See Regulation 2(1)(hb), 2(1)(k) and 35(1)(a) Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016 (n 30).

[34] There are specific criteria that a resolution plan must satisfy including that it must not contravene any of the provisions of the law. However, the law does not require a resolution plan to be fair. Therefore, the NCLT has no power to refuse a resolution plan merely because it is unfair. See sections 30(2) and 31(1) Insolvency and Bankruptcy Code 2016.

[35] See Insolvency Law Committee, *Report of the Insolvency Law Committee* (2018) paragraph 18.2.

[36] See (n 35) paragraph 18.3.

ors get payments above the 'liquidation value' in the resolution plan.[37] Accordingly, the ILC concluded that the interests of operational creditors must be protected, not by tinkering with what minimum must be guaranteed to them statutorily, but by improving the quality of resolution plans overall by efforts of regulatory bodies (like IBBI and Indian Banks' Association (IBA)) - not the NCLT.[38] Evidently, Indian policymakers do not envisage any judicial supervision of the valuation method adopted in a resolution plan to prevent potential *wealth transfer* as long as the plan pays the break-up 'liquidation value' to non-voting operational and dissenting financial creditors.[39] This limitation in the current creditor protection framework under the *Insolvency and Bankruptcy Code* creates opportunities for *wealth transfer* through resolution plans.

To illustrate, assume that a corporate debtor has entered insolvency resolution process under the *Insolvency and Bankruptcy Code*. It has a break-up 'liquidation value' of $10 and two types of financial debts - Debt 1 and Debt 2 - having identical priority. The face value of Debt 1 is $40 (25% by value) and its maturity is T_1; the face value of Debt 2 is $120 (75% by value) and its maturity is T_2. Also, assume that the corporate debtor is likely to generate: (a) a sure cash flow of $40 at T_1;

[37] According to data from Reserve Bank of India, over 4300 insolvency resolution applications were filed before NCLT till November 2017. Out of these cases, the ILC merely cited two instances - the *Synergies-Dooray* case and the *Hotel Gaudavan* case - to conclude that there was no empirical evidence to show that operational creditors do not receive a fair share in the resolution process. Moreover, IBBI currently does not publish data on resolution plans and therefore, it is difficult to expect private stakeholders to adduce empirical evidence on this issue. See (n 35) paragraphs 18.4 and 18.5; also see paragraph 3.27, Reserve Bank of India, *Financial Stability Report* (Report, 2017) .

[38] While IBBI is the insolvency regulator, IBA is a private association of Indian banks. See (n 35) paragraph 18.4.

[39] 'Liquidation value' here is different from 'fair value' which, as discussed above, is going concern liquidation value. Therefore, 'liquidation value' here refers to break up liquidation value.

and (b) a cash flow of \$120 or \$0, each with a probability 0.5 in T_2. Consequently, Debt 1 will be fully repaid with certainty in T_1 (expected return = \$40), while the expected return of Debt 2 in T_2 is \$(120)(0.5)+(0)(0.5) = \$60, which is lesser than its face value of \$120. As a result, the holder of Debt 1 has no reason to consent to a restructuring, given the conflict of interest between Debt 1 and Debt 2.

However, under *Insolvency and Bankruptcy Code*, the holder of Debt 2 (being 75% by value) can adopt any resolution plan and impose it on the holder of Debt 1. Assume that the holder of Debt 2 adopts a resolution plan that extends the maturity of Debt 1 from T_1 to T_2. We know that in good state, the corporate debtor will generate \$40+120 = \$160; in bad state, it will generate \$40+\$0 = \$40. Now since both Debt 1 and Debt 2 have same priority and maturity, holders of Debt 1 in good state will get \$(160)(0.25) = \$40 and in bad state, will get \$(40)(0.25) = \$10; holders of Debt 2 in good state will get \$(160)(0.75) = \$120 and in bad state will get \$(40)(0.75) = \$30. Therefore, expected return of Debt 1 will now be \$(0.5)(40)+(0.5)(10) = \$25, while expected return of Debt 2 will now be \$(0.5)(120)+(0.5)(30) = \$75. Table 4.2.1 captures the returns for holders of Debt 1 and Debt 2 respectively across good state and bad state both before and after restructuring.

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

It is evident that the restructuring will reduce the expected return of Debt 1 by \$40-\$25 = \$15 and increase the expected return of Debt 2 by \$75-\$60 = \$15. Essentially, it would lead to a wealth transfer of \$15 from holders of Debt 1 to holders of Debt 2. Even after such wealth transfer, the holder of Debt 1 would get \$25,

which is more than the amount it would have got in a break-up liquidation, that is, $(10)(0.25) = $2.5. Therefore, this resolution plan would satisfy the creditor protection rule requiring payment of break-up 'liquidation value' to dissenting financial creditors and still cause wealth transfer. Moreover, since it can legitimately satisfy all the grounds in section 30(2), the NCLT cannot refuse approval under section 31(1). This example illustrates why the *Insolvency and Bankruptcy Code* may fail to prevent *wealth transfer* from the dissenting financial creditors to the majority financial creditors in restructurings using a break-up 'liquidation value' benchmark.[40]

4.2.2 Incorrect use of valuation benchmark

The *Insolvency and Bankruptcy Code* overlooks a basic distinction between restructuring and going concern sales.[41] Restructuring, being a hypothetical sale of the corporate debtor's business to the claimants of the corporate debtor, some finite value has to be placed on the whole business. Otherwise, there would be no way of telling where, down the ranks of claimants, it was fair to stop issuing shares and other claims in the newly organised entity owning the business. Therefore, restructuring requires a valuation benchmark, according to which the rights of each claimant in the restructured business has to be decided.[42] No such problem arises in a going concern sale for cash to a third party after proper marketing exercise. In such a sale transaction, after accounting for the expenses, the resolution professional can distribute the cash received to pay out the different claimants according to their

40 This example is based on an example used by Lee. See Lee (n 18).

41 A resolution plan allows both possibilities. See Regulation 37, Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016 (n 30).

42 See Clark (n 22) p. 1252.

priorities, until the money runs out.[43] Therefore, there is no need for a valuation benchmark to decide the rights of the claimants in a going concern sale.

Yet, the *Insolvency and Bankruptcy Code* applies the same valuation benchmark to both restructuring and going concern sale.[44] Therefore, even in case of a true sale to a third party for cash at going concern value, the minimum amount to be paid out of that cash proceeds to the dissenting financial creditors and non-voting operational creditors under the resolution plan is to be determined according to the amount they would have received in a break-up liquidation. The remaining amount of sale proceeds could then be transferred to junior claimants.[45] Such resolution plans being in compliance with the *Insolvency and Bankruptcy Code*, the NCLT cannot refuse to santion them to prevent the unfair *wealth transfer* from operational creditors to junior claimaints.

To illustrate, assume that a corporate debtor has entered insolvency resolution process under the *Insolvency and Bankruptcy Code*. It has a going concern value of \$130 and break-up 'liquidation value' of \$110. The face value of debts owed to its financial creditors is \$100 and to its operational creditors is \$30. If the company is liquidated on break-up basis, then the financial creditors would get \$100 and the

[43] See Clark (n 22) p. 1252-1253.

[44] See Regulation 38, Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016 (n 30); also see section 30(2)(b), Insolvency and Bankruptcy Code 2016.

[45] This is antithetical to the *absolute priority rule*, which requires most senior creditors to be paid off in full before anything could be given to the next most senior creditors and so on down the ladder. See, P Aghion, O Hart and J Moore, 'Improving bankruptcy procedure' (1994) 72 Washington University Law Review 849, p. 852-853; under the Insolvency and Bankruptcy Code, the *absolute priority principle* is applicable to proceeds from the sale of liquidation assets. However, there is no specific statutory provision that extends this rule to the proceeds from a going concern sale through a resolution plan. See sections 30, 31 and Explanation (i) to section 53(3), Insolvency and Bankruptcy Code 2016.

operational creditors would get only $10. However, if the company is sold for cash to a third party at going concern value, then the financial creditors could get $100 and $30 will be left over. Applying the creditor protection rules under *Insolvency and Bankruptcy Code*, the financial creditors could legitimately approve a resolution plan that provides only the break-up liquidation amount ($10) to the operational creditors and pays the remaining $20 to the shareholders, who feature below the operational creditors in the statutory waterfall. This resolution plan would satisfy the creditor protection rule requiring payment of break-up 'liquidation value' to operational creditors and still cause wealth transfer from the operational creditors. As discussed earlier, the NCLT has no specific power to object to this resolution plan. This example illustrates why the *Insolvency and Bankruptcy Code* may fail to prevent *wealth transfer* from the operational creditors in a going concern sale because of the 'liquidation value' benchmark.

Evidently, this is an incorrect use of the valuation benchmark. Restructuring and going concern sales are two completely different concepts. For instance, Chapter 11 of the U.S. Bankruptcy Code deals with restructuring, which uses the valuation benchmark.[46]. On the other hand, section 363 in Chapter 3 of the U.S. Bankruptcy Code deals with going concern sales, which does not use any such valuation benchmark. The *Insolvency and Bankruptcy Code* has inadvertently fused both these features into the insolvency resolution process and applied the break-up 'liquidation value' benchmark to both.[47] As illustrated above, this creates unnecessary risks of *wealth transfer* in going concern sales under *Insolvency and Bankruptcy Code*.

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[46] See section 1129(a)(7), US Code: Title 11 - Bankruptcy 2012.

[47] See Regulation 37(1), Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations 2016 (n 30).

The NCLT could potentially rectify this error through judicial interpretation. However, this could be tricky given the lack of an explicit provision for judicial supervision of the fairness of a resolution plan. In any case, Indian courts do not necessarily have a great track record of managing creditor oppression in the context of corporate insolvency, as the Board for Industrial and Financial Reconstruction (BIFR) history shows.[48]

4.2.3 Strategic valuation

The valuation of the insolvent company under *Insolvency and Bankruptcy Code* is done by registered valuers, appointed by the resolution professional, who in turn is appointed by the CoC.[49] Therefore, it is likely that these valuers would be influenced by the interests of the majority financial creditors on the CoC.[50] This could create scope for strategic valuation under *Insolvency and Bankruptcy Code* in favour of the majority financial creditors. If these financial creditors are secured, they have an incentive to depress the valuation in a restructuring, so that they can capture more equity in the restructured company. This could create further risks of *wealth transfer* to the majority financial creditors.

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48 See generally, K van Zwieten, 'Corporate rescue in India: The influence of the courts' (2015) 15 Journal of Corporate Law Studies 1.

49 Even if not formally appointed by the Committee of Creditors initially, an interim resolution professional can be replaced by 75% vote by value of the Committee. Therefore, for all practical purposes, the resolution professional will be answerable to the Committee. See section 27 Insolvency and Bankruptcy Code 2016.

50 At the very least, it will impact on the perception that the valuation is unbiased. See Payne, 'The role of the court in debt restructuring' (n 11).

5 Conclusion

India experienced a major structural change with the enactment of *Insolvency and Bankruptcy Code* in 2016. Although it has vastly improved India's corporate insolvency framework, it has also raised two important concerns - the *value destruction* problem and *wealth transfer* problem. This dissertation developed the theoretical frameworks necessary to identify the sources of these two problems in the *Insolvency and Bankruptcy Code*.

Applying the relevant theoretical framework, it identified two potential sources of *value destruction* under *Insolvency and Bankruptcy Code*. First, the law entrusts the decision about the future of a *financial distressed* corporate debtor with a super-majority of financial creditors, whose payoffs may not necessarily be affected by the outcome of that decision. Therefore, they may not have the right incentive to preserve the value of the business of the corporate debtor. Second, by limiting the benefits of the cramdown provision only to post-insolvency restructurings, the law delays restructuring and enhances the risk of *value destruction* of the corporate debtor.

Similarly, applying the relevant theoretical framework, the dissertation identified four potential sources of *wealth transfer* under the *Insolvency and Bankruptcy Code*. First, the law does not expressly provide for judicial supervision to ensure fairness

in a resolution plan adopted by cramming down the minority financial creditors, as long as the plan pays the break-up 'liquidation value' to non-voting operational and dissenting financial creditors. This creates potential risks of *wealth transfers* through resolution plans. Second, the law uses the break-up 'liquidation value' instead of going concern 'liquidation value' as the benchmark for restructuring of a *financially distressed* company, reducing the valuation of the claims of the dissenting financial creditors in the restructured company. Third, the law incorrectly applies the 'liquidation value' benchmark used in restructuring to going concern sales for cash to third parties, creating opportunities for *wealth transfer* from operational creditors to junior claimaints in such sales transactions. Fourth, the appointment process of registered valuers could create scope for strategic valuation favouring *wealth transfer* to majority financial creditors.

Indian policymakers need to revisit these fundamental legislative design choices embedded within the *Insolvency and Bankruptcy Code* to successfully address the contemporary concerns regarding the *value destruction* and *wealth transfer* problems.

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