



**Insolvency and Corporate  
Governance:  
Linkages and limitations**

# Insolvency memorable quotes

- ◆ *“Sick companies but no sick promoters”*
- ◆ *“KKN” – cronyism, collusion and nepotism*
- ◆ *“promoter-bank nexus which has led to crony capitalism and attendant NPA/credit misallocation problem as ever-greening suited some borrowers and **some lenders** under the earlier framework”*
- ◆ *“No divine right of promoters”*



# Insolvency and corporate governance:

- Linkages
  - Weak corporate governance causes insolvency
  - Weak insolvency provisions
- “Ordinary course” provisions
- “Above and beyond” provisions and Limitations
  - Section 29A
  - Dual governance problem

# The linkages: bad corporate governance leads to insolvency?

Insolvency and corporate governance are part of a continuum in the life of a corporate entity (Nestor, 2002)

- Corporate governance weaknesses of a going concern and a company in insolvency:
  - Independence and functioning of board of directors... borrowing powers...overleverage
  - Related party transaction related controls...value extraction... avoidance measures in insolvency
- Indonesia- 1997 ( Wood, Blustein, Lindgreen et al; Enoch et al)
  - Directors made liable for corporate debts
  - “trading while insolvent”



# Linkages: effect of weak insolvency law on governance mechanisms

- Effects could run the other way as well
- Weak, un-credible insolvency mechanisms
  - Excessive leverage
  - Complex group structures- lack of transparency
  - Cross guarantees mask risk
  - Minority shareholder expropriation
- Korea, 1997
  - chaebols had excessive leverage
  - multiple listed group companies
  - Cross guarantees



# Insolvency law provisions on corporate governance: “Ordinary Course”

- Directors accountability
  - Wrongful trading penalties
  - Breach of fiduciary duties to creditors “in the zone of insolvency”
- Antecedent recovery powers
  - Preferring/ defrauding creditors
  - Transactions with related parties
  - Extortionate credit transactions
- India pre IBC:
  - Judgements in directors liability
  - Voidable transactions only at liquidation
- UK
  - Judgements
  - IP Service “deterrent effect”



## **“Insolvency law provisions on corporate governance: “Above and beyond”**

- Provisions not strictly related to objectives of insolvency law
- Solve problems of corporate governance independent of / ancilliary to insolvency law
- Other remedies (statutory / contractual) available
- Likely to cause distortionary / tactical behavior
- Have unintended consequences



# “Above and beyond provisions”: UK proposals

- Penalties and personal liability for directors of a parent company who sell a subsidiary company which is in “financial distress” –
  - “if they conduct a sale which harms the interests of the subsidiary’s stakeholders, such as its employees or creditors, where that harm could have been reasonably foreseen at the time of the sale. “
  - if subsidiary turns insolvent within 2 years of sale
  - if interests of creditors have been “adversely affected” between date of sale and date of purchase.
  - harm that should have been foreseen has occurred, with creditors suffering losses.
- Issue of incomplete contract, misrepresentation and fraud
- Contractual remedies- reps, warranties and indemnities available reasonably enforced
- LMA documents would ordinarily require consents of creditors prior to sale in any event.





# “Above and beyond provisions”: UK proposals

- Additional powers to buttress existing provisions on antecedent recovery- broadly formulated to “determine whether the transactions, however structured, were undertaken to unfairly put a particular party in a better position on insolvency than other creditors and apply to the court to take legal action against the party or parties in order to claw back money for other creditors. “
- Ordinarily- the test is that the company was technically insolvent on the date of the transaction or became insolvent as a result of the transaction.
- ***New test: Instead of a direct insolvency test, the Government believes the test should be that the value extraction scheme must have unfairly put the beneficiary in a better position than other creditors in a subsequent formal insolvency (liquidation/administration) than would otherwise have been the case.***
- Could this potentially include super priority financing?
- Consulting questions do recognize that
- Covenants in loan agreements would ordinarily protect lenders.



# “Above and beyond provisions” Section 29 A

- “No divine right of promoters”
  - *Earned right*
- Prevent phoenixing, strategic bankruptcies
- Tactical behaviour
  - *Eg. Binanci Cements, Numetal Essar*
- Unintended Consequences:
  - Protracted litigation, interminable delays
  - Restrictions on PE and other strategic investors *Eg. Accelor Mittal*
- Alternative remedies:
  - Use other governance provisions!
  - Notify individual insolvency for promoters for guarantee default.



# “Dual corporate governance problem”: limitation

- “Dual balance-sheet problem”
- “*Dual governance problem*”
  - Regardless of how causality runs, addressing only one part of the governance problem *i.e.* borrowers will yield limited results
  - Banks are the ***enforcement mechanism*** for governance incorporate borrowers
  - Bank governance reform is the logical mirror image reform that must be undertaken if any corporate governance provisions “ordinary course” or “unorthodox” are to succeed.

