A domestic framework for group insolvency

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The limited liability bargain

- The limited liability bargain is:
  1. Shareholders get limited liability. In lieu of this they accept disclosure.
  2. Lenders accept that they must make informed credit decisions and monitor the loans they have made.
  3. When there is default, borrower and lenders agree to work within the bankruptcy process.
- This bargain is the basis of modern capitalism.

Business groups and lending

- Business groups are a unique construct in the limited liability landscape.
- When giving loans to entities in a business group, lenders may take into account group relationships or assets.
- However, lenders can ring-fence their credit risk by:
  1. Building contractual safeguards for their loans to business group entities.
     Loan covenants, security perfection, guarantees, contingent claims.
  2. Monitoring their loans to ensure that no adverse and malafide actions are taken by borrower entities.
  3. Using avoidance provisions of bankruptcy law to reverse adverse/malafide
     Avoidance of preferential, undervalued, fraudulent and extortionate transactions.
     actions of borrowers.

Business groups and lending

- Lenders cannot not claim ignorance about the existence of business group relationships when making credit decisions.
- Many laws and regulations pro-actively seek to enhance group level disclosures.
  (1) RBI norms on group exposure, (2) SEBI norms on group disclosures, (3) CA13 clauses on financial statement consolidation and related party disclosures.
- Lenders need to undertake their own due diligence.

Then..

- Is there any need for a legal framework for business group insolvency?

  No.

- Any attempt to force fit group level consolidation in insolvency will violate the limited liability bargain.
- It may create ex ante effects such as:
  1. It creates uncertainty for lenders at the point of extending credit, as contractual safeguards may lose relevance in bankruptcy.
  2. This may incentivise dominant lenders to lower credit and monitoring standards when lending to groups.
  3. It may disincentivise smaller lenders from lending to business group entities.
  4. It may choke off lending to business groups, or make the terms of lending unfavourable.

What about fraud?

- Fraud is an enforcement problem not a bankruptcy problem.
- A time bound insolvency process creates little or no incentive for discovery or adjudication of fraud.
- However, in the event a fraud is discovered, it must be proceeded against under the relevant law.
- Insolvency proceedings can continue in parallel to the fraud adjudication process as long as suitable disclosures are made to creditors and resolution applicants.
- Resolution applicants can deal with the uncertainty of the fraud adjudication process by: (1) valuation adjustments, (2) transaction structuring, or (3) contractual safeguards.

Case 1. IL&FS group

- A “group” with 300+ subsidiaries.
- Some entities regulated financial entities
- Many non-financial entities. Several of them project SPVs with ring fencing.
- Classification of entities into Red, Amber and Green suggests that not all of them insolvent.
- For insolvent non-financial entities – IBC. For the financial entities – need for a resolution mechanism to be created.
- No benefit in consolidating IL&FS entities in insolvency. In fact there may be costs:
  1. Increased complexity,
  2. Value in “good” entities used to pay-off creditors of “bad” entities. An undesirable outcome.
  3. Litigation and holdouts by parties whose interests are adversely affected

Case 2. The Jaypee group

- Jaypee Associates Limited (JAL) asked deposit funds to meet the dues to home buyers of Jaypee Infra Limited (JIL).
- Corporate veil pierced: liabilities of the corporation assigned to its shareholders. Done in “public interest”.
- In common law, the only basis for such action: if the corporate structure is artificial and fraudulent.
- This needs to be proven beyond doubt. Otherwise limited liability ceases to have meaning.
- Actions like siphoning and tunneling can be dealt through avoidance provisions and prosecution under relevant laws.

Lessons from these cases

- These cases do not point to any problem whose solution is a group level consolidation of insolvency.
- If anything, they suggest weak lender due diligence, and weak micro prudential regulation.
- These cases are from a period when India did not have a functioning insolvency law.

  Not all their challenges are commercial.
- These cases should not drive the thinking on the future of bankruptcy reform.

International experience

- Background note points out international examples of group insolvency frameworks.
- Its useful to organise them by legal system to understand:
  1. How are these placed in the context of the jurisdictions legal system for enterprises?
  2. How the law on books is being used in practice?
  3. How has enterprise in these jurisdictions evolved in response to legal provisions?
- More research and study needed before conclusions can be drawn.
- International experience does not automatically make a case for changes in domestic laws.
- Their relevance to the local setting, and their potential impact needs careful study.

But..

- Is there some merit in procedural coordination?
  Perhaps.

Two levels of procedural coordination

1. Same forum
   Cases of a group of entities are heard at the same adjudication forum.
2. Procedural coordination
   Some or all aspects of the insolvency resolution procedure for a group of entities are consolidated. Limited liability remains intact.

Defining a group

- Procedural coordination can happen between any set of entities that are under insolvency proceedings.

  Not necessarily a business group.
- Inter-dependent firms, with common creditors may seek procedural coordination.
- The current law neither permits nor prohibits this.

The need for a legal instrument

- Unclear whether a legal change is required to enable procedural coordination or a guidance may be sufficient.
- Important to remember that coordination can only be between companies already under insolvency proceedings.

  Cannot be used to bring otherwise solvent entities into insolvency proceedings.

If there is to be legal framework

1. Define which entities can seek procedural coordination. Suggestion: any group of entities already in insolvency.
2. Think through details:
   - 2.1 Who can initiate the coordination of proceedings?
   - 2.2 What should be the extent of coordination?
   - 2.3 For which types of processes – CIRP, liquidation, voluntary liquidation?
   - 2.4 At what stage of the insolvency process?
   - 2.5 Based on what trigger?
   - 2.6 Who finally decides whether coordination should happen?
   - 2.7 What should be the insolvency procedure once consolidation is effected?
   - 2.8 Once effected, should coordination be allowed to be undone?

1. Some suggestions on common forum

- Separate proceedings at the same NCLT bench – likely to create judicial clarity.
- A substantial creditor may be allowed to initiate – to ensure there is some possibility of acceptance

  For instance a creditor with more than 10% of the liabilities of *any of the entities*.
- Approval of majority of creditors of each entity a must.
- Key question: which NCLT bench?
  Suggestion: where the request for coordination is made.

2. Suggestions on procedural coordination

- Some aspects of insolvency proceedings are coordinated:
  - Common RP
  - Concurrent moratorium
  - Common data room for due diligence
  - Sharing of information across CoCs
  - Possibility of aggregate bids and/or separate bids
- Likely benefits: reduced information asymmetry.
- A substantial creditor may be allowed to initiate. Higher threshold than for common forum.

  For instance a creditor with more than 10% of the liabilities of *each of the entities*.

2. Suggestions on procedural coordination

- Approval of majority of creditors of each entity a must.
- Key question: what should be the extent of coordination?

  Lenders should be given the flexibility to decide.
  Coordination should not become a reason for delays.

Why creditor consent?

- Common forum or procedural coordination must require creditor consent as they affect the rights of creditors.
- For example:
  1. Creditors may have chosen a particular jurisdiction for their loan contracts and may not want that changed.
  2. Creditors may have differing views on the Resolution Professional (RP) and associated costs.
  3. Creditors may not want joint bidding.
- All these are commercial matters that only creditors should decide.
- Key question: should CoC be viewed as the representative of creditor views?

  Yes. Since this is the IBC design.

But..

- Will these conditions make coordination very difficult?
- Perhaps. For coordination that is sought only once insolvency has happened.
- But, lenders can take the coordination decision before filing for insolvency.
- Such coordination will be eminently feasible even with these conditions.

Overarching principles for procedural coordination

1. Group insolvency is not a concept that aligns with limited liability.
2. There is no case for substantial coordination in insolvency proceedings. There may be a case for procedural coordination.
3. Even procedural coordination can impact value and vary rights of creditors $\rightarrow$ creditors must have the power to decide.
4. This will ensure that coordination takes place only when:

   Gains from consolidation $>$ Costs of consolidation

The way forward

- Any policy action in regard to even procedural coordination needs careful consideration.
- Research needed to understand:
  1. Whether increased coordination and reduced information asymmetry create value in insolvency proceedings.
  2. The extent to which coordination can reduce insolvency process costs.
  3. The link between the size of creditors' debt in a firm and their preference for coordination.
  4. A more nuanced understanding of the international experience.
- The design of any framework for coordination should undergo extensive consultation.
- A guidance based approach, which empowers creditors to seek coordination may be preferable to a statutory mandate.

Thank you

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