

Insolvency and Bankruptcy: Economic, financial and legal perspectives

Rajeswari Sengupta (IGIDR)

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Outline

- ▶ Need for a sound insolvency system
- ▶ Elements of a sound insolvency system
 - ▶ Economic thinking and principles of an insolvency system
 - ▶ Economic outcomes of an insolvency system
- ▶ The present framework in India and related problems
 - ▶ Evolution of the bankruptcy framework
 - ▶ Legal and Economic outcomes
 - ▶ Reforms in Indian bankruptcy
 - ▶ Errors in reform policy
- ▶ The BLRC approach
 - ▶ Principles of design
 - ▶ Design of the Insolvency and Bankruptcy Code (IBC)
 - ▶ Institutions under IBC
 - ▶ How is IBC different?
- ▶ IBC output so far

Some definitions

- ▶ **Default:** when a borrower fails to repay his dues.
- ▶ **Insolvency:** the state where a borrower is generally acknowledged to be unable to repay his bills as and when they become due and payable.
- ▶ **Rehabilitation / Reorganisation / Restructuring / Revival:** financial or operational re-engineering that can be done that will allow a borrower to eventually repay.
Here, the enterprise continues to exist.
- ▶ **Bankruptcy:** when it is established that the borrower can never repay.
Here, the enterprise has to be shut down.
- ▶ **Liquidation:** the process by which the bankrupt enterprise is shut down.

Part I: Need for an insolvency resolution regime

I. Fostering entrepreneurship

- ▶ Entrepreneurs need freedom at 3 stages of a business- to start a business (free entry), to continue the business (free competition) and to discontinue the business (free exit).
- ▶ New firms can be born continuously, they do business as long as they can function efficiently, and they vacate the space when they fail.
- ▶ *Creative destruction*: Resources get allocated to efficient uses and economy as a whole benefits.
- ▶ A sound insolvency resolution regime is essential to enable failed firms to exit.
- ▶ A mechanism that allows failed firms to exit enables innovation and growth.
- ▶ Otherwise resources stay locked up in inefficient uses and this harms the economy.

II. Fostering credit markets

- ▶ For debt financing, creditor rights need to be protected.
- ▶ If creditors are unable to recover their dues in a timely manner, they become averse to extending credit and cost of credit goes up.
- ▶ It becomes harder for debtors to get access to credit.
- ▶ Credit enables large projects to be undertaken.
- ▶ A sound insolvency resolution regime is essential to facilitate development of a deep credit market.
- ▶ It provides certainty to parties in a debt contract about expected outcomes.
- ▶ *Ex-ante*, enables creditors to take better credit decisions.

Part II: Elements of a sound insolvency resolution system

The layout of any bankruptcy law

- ▶ Purpose of law: incentivise socially optimal behaviour on the part of economic agents at all times.
- ▶ Economic agents in a bankruptcy process : creditors / lenders and debtors / borrowers.
- ▶ What is optimal in insolvency and bankruptcy?
Minimise the loss to all parties concerned.
- ▶ Key features and outcomes of a good insolvency and bankruptcy framework?
 - ▶ Swift resolution – delayed responses and actions tend to lead to larger losses from the contract.
 - ▶ Smaller losses and higher recovery.
 - ▶ Repeated participation from both creditors and debtors who have faced a situation of insolvency and bankruptcy.
 - ▶ Deep credit markets.

Underlying economic thinking for a well-designed bankruptcy law

- ▶ Creditors put money into debt investments today in return for the promise of fixed future cash flows.
- ▶ But the returns expected on these investments are still uncertain.
- ▶ At the time of repayment, the debtor may make repayments as promised, or he may default and does not make the payment.
- ▶ When this happens, the debtor is considered insolvent.

Underlying economic thinking for a well-designed bankruptcy law

- ▶ Failure of business is a normal thing.
- ▶ There can be two types of failure:
 1. Financial failure: Short-term cash flow stress even though the business model is generating revenues.
 2. Business failure: A breakdown in the business model of the enterprise, and it is unable to generate revenues to meet payments.
- ▶ Financial failure: Enterprise is viable. Financial rearrangement can earn the creditors a higher economic value than shutting down the enterprise.
- ▶ Business failure: Cost of financial arrangement required to keep the enterprise going will be higher than the future expected cash flows. Enterprise is unviable or bankrupt and is better shut down.

Underlying economic thinking for a well-designed bankruptcy law

- ▶ A sound bankruptcy process is one that helps decide whether the entity is facing financial failure and business failure.
- ▶ This is important to allow both debtors and creditors to realise the maximum value of the business in insolvency.
- ▶ Objective of a bankruptcy process: create a platform for negotiation between creditors and external financiers.

Underlying economic principles of a well-designed bankruptcy law

- ▶ In failure, limited liability should be respected.
 - ▶ Limited liability company is a contract between equity and debt.
 - ▶ As long as debt obligations are met, equity owners have complete control, and creditors have no say in how the business is run.
 - ▶ When default takes place, control is supposed to transfer to the creditors; equity owners have no say.
- ▶ Speed of resolution is important so that capital and labour can be put back to work quickly.
- ▶ Insolvency and bankruptcy resolution should be an economic decision; not a judicial decision.

Underlying economic thinking for a well-designed bankruptcy law

- ▶ A combination of limited liability and strong insolvency process allows firms to undertake risky ventures while protecting creditors' rights. The bargain:
 1. Firms' shareholders accept disclosure
 2. They agree to work with lenders in insolvency
 3. In return their liability gets capped
- ▶ The rise of limited liability needs to be accompanied by (a) strong recovery laws, and (b) strong insolvency law.

Part III: Outcomes of a sound insolvency process

The economic outcomes of insolvency reform

- ▶ Breadth and depth of credit markets:
Where lenders can enforce repayment, there is: (1) higher credit access, (2) at lower price, (3) with longer maturity, (4) lower collateral requirement , and (5) from a greater number and variety of lenders.
- ▶ Commercial confidence and predictability.
When insolvency systems function, lenders can price risk more accurately and manage it more effectively.
- ▶ Balance in commercial relations.
More responsible behaviour by debtors and creditors. Improved corporate governance.
- ▶ Efficient allocation of resources.
The possibility of exit promotes entrepreneurship. Effective exit provides a safety valve for corporate distress.

Part IV: The India situation - What is wrong with the present framework?

What we see in India

- ▶ Weak capacity to separate theft from business and genuine business failure.
- ▶ Theft by promoters is a crime; business failure is not.
- ▶ Catchphrase “poor companies, but no poor promoters” gaining popularity to apply to all business failure: divine right of promoters.
- ▶ No collective action procedure.
- ▶ Capital and labour get interminably stuck.
- ▶ Lack of access to debt capital for projects with intangible capital.

What we see in India

- ▶ When a company defaults, 3 kinds of legal procedures are available:
 1. Debt enforcement by creditor(s)
 2. Reorganisation or restructuring of the business
 3. Liquidation of the company
- ▶ Debt enforcement: Individual creditors attempt to recover the debt due to them by enforcing collateral.
- ▶ Corporate insolvency procedures: collective action by creditors to assess viability of the business and take necessary action that affects right of all stakeholders.

How the bankruptcy framework evolved

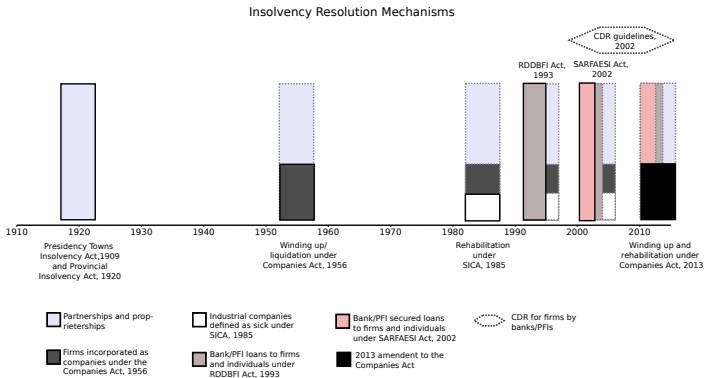


Figure: Prepared by Anjali Sharma, FRG

Enforcement

| Creditor | Debtor |
|--|---|
| Contract creditors | Firms; Individuals; Possessory security |
| Banks and Specified FIs | Firms; Individuals; Secured/ Unsecured |
| Banks and Specified FIs for secured NPLs | Firms; Individuals; Non-possessory security |
| State dues | Firms; Individuals |
| Workmen dues | Firms |

Insolvency

| Creditor | Debtor |
|--|---|
| Creditor with dues above defined value | Companies |
| All creditors | Registered Partnerships; Individual partners |
| Banks and Public FIs | Sick Industrial Companies |
| All creditors | Individuals |

| Creditor | Contract creditors | Banks, FIs, NBFCs, ARCs | Banks |
|---------------|--|--|---|
| | Statutory: Companies Act, 1956 Compromise/Arrangement Forum: High Court | Non-statutory: Individual restructuring; CDR; 5/25; SDR Forum: RBI guidelines Lenders' forum | Asset Sale to ARCs Forum: RBI guidelines |
| Debtor | Companies → | | |

Work out

Economic and Legal outcomes

Enforcement framework outcomes

- ▶ Average time to enforce contracts (WBDB) - 4 years, can go up to 20 years.
- ▶ DRTs: 1.7 lakh cases worth Rs. 3.7 trillion referred in 2015. 83,000 pending cases. Recovery rate - 14%.
- ▶ SARFAESI: 12.5 lakh cases worth Rs. 4.7 trillion in 2015. Recovery rate - 24%.

Insolvency framework outcomes

- ▶ Winding up: 9.5 lakh active companies in India in 2014. Around 60,000 - 70,000 new companies added every year. Only around 300 - 400 new winding up cases in High Courts. Around 4,800 cases pending. Average time to wind-up: 4-5 years. Some cases even 25 years.
- ▶ Rehabilitation via BIFR: 5,900 cases over three decades. Only one BIFR bench. Average time taken 5.8 years. 65% of BIFR referrals found not sick. Scheme sanctioned only in 10% cases.

Work out

- ▶ CDR: 655 cases referred between 2002 - 2015.
- ▶ Of these 65% between 2010 - 2014, when regulatory forbearance was given.
- ▶ Sanctioned in 530 cases, total debt of Rs. 4 trillion (around 7% of banking sector advances).
- ▶ Successful exit in 16% cases. 38% failed exits and 46% ongoing.
- ▶ 15 SDR cases (till December 2015) with debt of Rs. 0.8 trillion. 11 cases are from CDR and 2 from CDR group companies.
- ▶ 14 ARCs. Banks' stressed advances - 11% of assets. Sale to ARCs - 0.8%.
- ▶ *Extend and pretend* rather than *resolution*.

Problem on legal outcomes: high uncertainty

- ▶ Legal framework: complex, fragmented.
No concept of time value of money.
- ▶ Insufficient institutional capacity: courts, professional services, information systems. No capacity to deal with the demands of a growing economy.
Laws such as RDDBFI and SARFAESI did not improve recovery.
- ▶ Unclear priority between laws and between fora.
Conflicts are decided by litigation. Lack of clarity causes delays.
- ▶ Arbitrage: differential access, varied procedures.
Forum shopping. Stacked in favour of banks and FIs.

Low predictability of resolution, high pendency, high cost, poor recovery.

Problem on legal outcomes: high uncertainty

- ▶ Trigger is either too early or too late
 - ▶ SICA: 50% of net worth
 - ▶ Winding Up: Default worth INR 500
 - ▶ SARFAESI: 90 days of NPA declared
- ▶ No collective action process.
- ▶ Distribution waterfall is complex and uncertain.

Problem 1 on economic outcomes: broken insolvency framework

| | India | U.S.A. | U.K. | Singapore | Canada |
|---|-------|--------|-------|-----------|--------|
| Resolving Insolvency (Rank) | 136 | 5 | 13 | 27 | 16 |
| • Time (Years) | 4.3 | 1.5 | 1 | 0.8 | 0.8 |
| • Recovery rate (cents per \$) | 25.7 | 80.4 | 88.6 | 89.7 | 87.3 |
| Getting Credit (Rank) | 42 | 2 | 19 | 19 | 7 |
| • Credit to non-financial sector (% of GDP) | 59.5 | 149.8 | 156.3 | 144.8 | 203.9 |
| • O/w bank credit (% of total) | 93.5 | 33.4 | 57.0 | 85.4 | 51.1 |

Source: World Bank: Doing Business, 2015;

BIS: long series on total credit to non-financial sectors, 2015

Under-developed credit markets.

Problem 2 on economic outcomes: limited access to debt finance for firms

| As % of total | 1991-92 | 2009-10 | 2012-13 |
|---------------------|---------|---------|---------|
| Equity | 22.6 | 34.9 | 37.2 |
| Retained earnings | 10.6 | 21.0 | 6.8 |
| Fresh issuance | 12.0 | 13.8 | 30.4 |
| Depreciation | 17.6 | 9.7 | 3.6 |
| Borrowing | 35.3 | 29.5 | 21.6 |
| Banks | 17.1 | 17.8 | 15.2 |
| Bonds | 7.9 | 3.9 | 0.9 |
| Inter-corporate | 1.3 | 2.3 | 3.3 |
| Foreign | 5.5 | 3.2 | 0.7 |
| Current liabilities | 24.4 | 24.2 | 37.7 |
| D:E | 1.56 | 0.85 | 0.58 |
| Secured | 54.9 | 60.3 | 63.8 |
| Unsecured | 45.1 | 39.7 | 34.4 |

Source: CMIE Prowess

Low debt-financing, undue reliance on secured debt, bank dominance

Problem 3 on economic outcomes: banking sector stress

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|-----------------------------|------|------|------|------|------|------|
| Advances (Rs. trillion) | 40.8 | 48.0 | 55.3 | 62.8 | 68.8 | 73.2 |
| GNPA (%) | 2.5 | 2.4 | 3.4 | 4.2 | 4.7 | 7.6 |
| Restructured advances (%) | 5.0 | 5.8 | 5.8 | 6.0 | 6.4 | 3.9 |
| Total Stressed advances (%) | 7.5 | 8.2 | 9.2 | 10.2 | 11.1 | 11.5 |

Source: RBI

Real sector stress translates into banking stress. Precipitated by the lack of exit choices.

Part V: Reforms of Indian bankruptcy

Previous reform efforts

| Year | Committee | Key recommendation | Outcome |
|------|--|--|---|
| 1964 | 24th Law Commission | Merge Presidency and Provincial Insolvency Acts | Amendments to the Provincial Insolvency Act, 1929 |
| 1981 | Tiwari Committee (GOI) | Mechanism to deal with industrial sickness | SICA, 1983. BIFR and AAIFR set up. |
| 1991 | Narasimham Committee I (RBI) | Special tribunal for recovery claims of financial institutions | RDDBFI Act, 1993. DRT and DRAT set up. |
| 1998 | Narasimham Committee II (RBI) | ARCs to deal with banking NPAs | SARFAESI Act, 2002 |
| 1999 | Justice Eradi Committee (GOI) | Setting up of NCLT/NCLAT. Reorganisation to be merged in Companies Act. Repeal of SICA | Companies (Amendment) Act, 2002. Not notified |
| 2001 | L. N. Mitra Committee (RBI) | A comprehensive bankruptcy code | - |
| 2005 | Irani Committee (GOI) | Amendment to winding up under the Companies Act, inclusion of reorganisation | Companies Act, 2013. Insolvency chapters not notified |
| 2008 | Raghuram Rajan Committee (GOI) | Improvements to credit infrastructure and the insolvency framework | - |
| 2014 | Bankruptcy Law Reforms Committee (GOI) | Replacing extant laws with a single consolidated Insolvency and Bankruptcy Code | IBC, 2016. |

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¹ Source: "Evolution of the insolvency framework for non-financial firms in India", Sengupta et al, 2016 ▶

Errors in reforms policy

- ▶ Focused on a narrow problem for a limited group of credit market participants.
Example 1: SICA only for industrial companies that are sick.
Example 2: DRTs and SARFAESI only for banks and some financial institutions.
Example 3: ARCs only for NPAs of banks.
- ▶ No action on comprehensive reform proposals.
Example: Mitra Committee, Rajan Committee.
- ▶ Focus on strengthening laws, not implementation.
Example: DRT recovery rate 14%. Pendency 2-3 years. Cases worth Rs. 3.8 trillion pending.

Part VI: The approach adopted by the Bankruptcy Law Reforms Committee (BLRC)

Insolvency and Bankruptcy Code, 2016: Design principles

1. A systemic reform, a unified code. Multiple laws replaced by a single, comprehensive law.
2. Clarity of control between equity and debt. Respect for limited liability.
3. Facilitates viability assessment of the enterprise by private individuals. This protects organisational capital, in a sensible way. Failure is a possibility, viability a commercial decision.
4. A commercial decision taken by creditors. The judiciary's role is to ensure legal processes are followed.
5. A collective decision making process.
6. Symmetry of information between creditors and debtors.
7. Time-bound process to better preserve economic value.

Insolvency and Bankruptcy Code, 2016: The Institutional infrastructure

- ▶ The Code provides for three new institutions to support the resolution process.
 1. Private competitive industry of regulated *information utilities*: provide indisputable evidence.

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 3. A *regulator* to ensure malleability and to monitor better insolvency and bankruptcy outcomes:
 - ▶ Shorter time to resolve
 - ▶ Higher recovery rates
 - ▶ Deeper and liquid credit markets – both secured and unsecured, from private and public markets

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 - ▶ Deeper and liquid credit markets – both secured and unsecured, from private and public markets
- ▶ Courts which are involved only in ensuring procedural correctness.

Insolvency and Bankruptcy Code, 2016: The process

- ▶ When an enterprise is in distress IBC has the process to
 - ▶ resolve insolvency as Step 1, and
 - ▶ resolve bankruptcy as Step 2.
- ▶ The Step 1 process to resolve insolvency is called the Insolvency Resolution Process (IRP).
- ▶ IRP is a combination of trigger, process and limits.

IRP: Trigger

- ▶ Anyone with an undisputed credit claim can trigger: operational creditor, financial creditor, debtor.
- ▶ Benefits:
 - ▶ Difficult to create a carefully coordinated effort to hide distress.
 - ▶ Comforts creditors about future performance on their credit contracts.
 - ▶ Makes for an easier environment for creditors to then lend more readily.

IRP: Process features

- ▶ An automatic moratorium on any fresh claims on the firm - a calm period where firm is kept as a going concern to assess solvency.
- ▶ Debtor loses control. A regulated insolvency professional (Resolution Professional) is in charge. May displace management, if necessary.
- ▶ The Committee of Creditors (CoC) is responsible for all commercial decisions related to the firm.
- ▶ Litigation against the outcome (of resolution or liquidation) has to be on failure of procedure, and not the business decision.

IRP: Limits

- ▶ Limit of Rs.100,000 of dues to trigger IRP.
- ▶ No limit on who can trigger.
- ▶ Limit on decision time: outcome must be decided in 180 days.
- ▶ No limit on who can offer resolution plans and what can be in the resolution plans.
- ▶ Limit on by when financial creditors can put in claims to be part of the CoC.
- ▶ No limit on who can submit credit claims.

Liquidation - trigger

- ▶ Liquidation:
 - ▶ Failure of the CoC to reach an agreement during the period stipulated above or
 - ▶ A decision of the CoC to proceed with liquidation during the IRP or
 - ▶ Failure of the debtor to adhere to terms of the resolution plan approved by the adjudicator.
- ▶ IBC specifies a clear waterfall of priorities under liquidation.

Liquidation - waterfall

1. Costs of IRP (including any interim finance raised) and liquidation.
2. Secured creditors AND workmen dues (capped up to 24 months from the start of liquidation).
3. Employees' salaries (capped up to 12 months from the start of liquidation).
4. Financial debts of unsecured creditors.
5. Central or State Government dues pertaining to 2 year period prior to the start of liquidation AND unpaid dues of secured creditors after security enforcement.
6. Any remaining debt
7. Preference shareholders
8. Equity shareholders

How is IBC different?

- ▶ Distinction between financial and operational creditors
- ▶ Trigger: Operational creditor, financial creditor, debtor
- ▶ Moratorium
- ▶ Debtor not in control in IRP
- ▶ Commercial decisions by CoC
- ▶ Insolvency resolution through managed, time-bound negotiations
- ▶ Distribution waterfall clarity in liquidation

Part VII: Way Forward/IBC output so far

Implementation: Cautious optimism

- ▶ Passing the law is the beginning.
- ▶ Enacting the new law or getting a higher score in the Doing Business rankings are not the end-goal.
- ▶ Effective implementation needs setting up the pillars of infrastructure explicitly provided for in the law.
- ▶ Adequate capacity building is needed.
- ▶ Important to have a well equipped and trained judiciary to deal with cases under the new law.

Implementation: Where are we on this project now?

- ▶ IBC was passed as law on May 13, 2016 in both houses of Parliament.
- ▶ The adjudication forum for insolvency and bankruptcy of registered companies are the NCLT and NCLAT.
- ▶ The implementation of the law was started at the Ministry of Corporate Affairs.
- ▶ Already hundreds of cases under IBC proceedings.

Implementation: What do we know from publicly available data?

- ▶ The insolvency dataset at Finance Research Group (IGIDR)
- ▶ Hand-collected data
- ▶ Study of the final orders passed by each of the 10 NCLT benches and NCLAT, data on IBBI website and media reports.
- ▶ Sample period: December 01, 2016 to December 31, 2017 (continuously updated)
- ▶ Pre-identified fields of information are captured to answer questions on the functioning of the IBC.

Dataset at

https://ifrogs.org/releases/Chatterjeeetal2017_nclt.html

Who uses the IBC?

| | |
|---|-----------|
| No. of petitions filed by creditors | 407 |
| No. filed by operational creditors | 259 |
| No. filed by financial creditors | 113 |
| No. of petitions filed by debtors | 76 |
| Petitions for which information not available | 5 |
| <hr/> Total number of petitions | <hr/> 488 |

Table: Who uses the IBC?

| | |
|-------------|-----------|
| Employees | 16 |
| Vendors | 131 |
| Others | 18 |
| Not known | 94 |
| <hr/> Total | <hr/> 259 |

Table: Cases filed by operational creditors

Duration of cases

| Stages | Number | Average time (in days) |
|----------|--------|------------------------|
| T0 to T1 | 55 | 18 |
| T1 to T2 | 159 | 20 |
| T0 to T2 | 82 | 36 |

Table: Average time taken for disposal of petitions

T0: Date of filing

T1: Date of first hearing

T2: Date of final disposal

Big tests for IBC

- ▶ Questions going forward:
 - ▶ What will be the recovery rates in the first bunch of *fresh* cases?
 - ▶ Whether 180 day timeline will be adhered to?
 - ▶ How will liquidation proceed?
 - ▶ How vulnerable will the law be to litigation?
 - ▶ Will a supporting ecosystem develop? When?

Thank you.

Research work on Indian bankruptcy:
<http://www.ifrogs.org/POLICY/blrc.html>
rajeswari.sen@gmail.com