

# The Insolvency and Bankruptcy Code: economic rationale, the law and some recent developments

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# Structure of the talk

- ▶ Why do/did we need a bankruptcy framework?
- ▶ Goals of the IBC
- ▶ Design principles
- ▶ Contextualising some recent developments to design principles

Some history and trivia ...

# Pre-IBC insolvency frameworks

## Recovery rates

Year	DRTs	SARFAESI
2012-13	14.19	27.17
2013-14	9.58	26.55
2014-15	6.95	16.33
2015-16	9.24	16.48

Source: RBI Statistical Tables  
Relating to banking

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## Outcomes under CDR

Cases referred since inception	656	474,351
Total cases approved for referral to CDR	531(81%)	403,353
Cases exited successfully	111 (21%)	84,677 (21%)
Cases withdrawn/ exited on failure	298	1,84,581 (46%)
Live cases	121	1,32,948

Source: CDR Cell (year unknown)

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- ▶ BIFR: 6,991 references made. 760 schemes approved. 1,303 cases referred for winding up. 1,297 cases pending.

# Takeaways

1. Fragmented legal framework. Largely focused on re-organisation.
2. Some creditors were more equal than others. Not all creditors had a seat at the table or the power to trigger.
3. Legal uncertainty.
4. Opaqueness and endless timelines.



## Pre-IBC outcomes

	India	US	UK	Singapore	Canada
<b>Resolving insolvency rank</b>	136	5	13	27	16
Time (years)	4.3	1.5	1	0.8	0.8
Recovery rate	25.7	80.4	88.6	89.7	87.3

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<sup>1</sup>% of GDP

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<b>Getting credit rank</b>	42	2	19	19	7
To non-financial sector <sup>1</sup>	59.5	149.8	156.3	144.8	203.9
O/w bank credit <sup>2</sup>	93.5	33.4	57	85.4	51.1

Source: World Bank: Doing Business, 2015;

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

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<sup>2</sup>% of total

No way to fix the system through incremental changes.

# Why not just have a debtors prison?

- ▶ Countries which encourage risk taking fare better
- ▶ Access to equity capital, limited liability, clean bankruptcy process will encourage more firms to innovate and try risky business ventures.
- ▶ Britain invented limited liability, and the bargain was:
  1. The firm accepts disclosure
  2. Both lender and borrower work within the bankruptcy process
  3. In return the firm gets limited liability.
- ▶ Limited liability means the shareholder gets to drive around in his personal Mercedes Benz while the firm is in default.

## Goals of IBC

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5. Role of judiciary restricted to oversight of due process
6. Institutions to support the bankruptcy process of firms and individuals

## Design principles

# What is the contract between debt and equity?

- ▶ Equity owners have control
- ▶ If they pay on their debt on time, all is well
- ▶ When they default, equity gets expropriated and control transfers to the creditors.
- ▶ The creditors will decide whether to sell it as a going concern or to carve it up to pieces and put these up to auction.

# Unified legal regime governing insolvency

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- ▶ all persons incorporated with limited liability, except financial service providers
  - ▶ statutory corporations
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Trusts?



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- ▶ Creditors can trigger if a corporate debtor has committed default of more than Rs. 100,000
- ▶ Creditors can trigger if an individual debtor who has not applied for fresh start commits a default
  - ▶ in case of a partnership firm, all or majority of the firm must apply.
- ▶ Trigger rights in case of a cross-default.

# Collective action process

A debtor may be insolvent because of:

1. Financial failure: a persistent mismatch between payments by the enterprise and receivables into the enterprise, even though the business model is generating revenues, or
  2. Business failure: a breakdown in the business model of the enterprise, and it is unable to generate sufficient revenues to meet payments.
- ▶ Collective action process and calm period to allow creditors to identify which one is it.
  - ▶ Settlement once collective action is triggered.
    - ▶ Core idea of transparency.

# Time-bound decision making

- ▶ The 180 day period, coupled with the threat of liquidation, in the collective action process solves the incentive problem.
- ▶ A one-time extension of 90 days, for reasons to be recorded in writing.
- ▶ Automatic liquidation disincentivizes protracted negotiation.

Timeline now extended to 330 days.<sup>3</sup>

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<sup>3</sup>IBC Amendment Act, 2019

## Collective action process: seat on the table

- ▶ Costs of including operational creditors into the creditors committee
- ▶ Anti-liquidation bias
- ▶ Incentives of financial creditors to be fair
- ▶ 66 completed resolution processes (as in December 2018):<sup>4</sup>
  - ▶ Avg. recovery rates for operational creditors: 47.45%
  - ▶ Avg. recovery rates for financial creditors: 45.84%
- ▶ Counterfactual: expensive mechanisms for class-voting.

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How do we think about home buyers?

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# Role of judiciary (the legislature and the regulator!)

Role of judiciary, legislature and regulator excluded from commercial decision-making.

- ▶ Creditors are best placed to take commercial calls that affect their own rights.
- ▶ Statutory bodies and judges are ill-equipped to make these calls.
- ▶ Decision of the NCLAT in *Standard Chartered v. Satish Kumar Gupta* (2019)
- ▶ Section 30(2)(b) of the IBC.<sup>6</sup>

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<sup>6</sup>Added by the Insolvency and Bankruptcy Code (Amendment) Act, 2019

# Institutions

- ▶ Insolvency professionals and insolvency professional associations
- ▶ Information utilities
- ▶ Judiciary

Contextualising key developments to the economic rationale and design principles.

# Legacy issues

## 1. Section 29A and its implications

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Low recovery rates

Complexity

Are we achieving the intent?<sup>7</sup>

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Moral hazard risks

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<sup>7</sup>Ex: Section 12A withdrawal and settlement

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## 2. Home buyers as financial creditors.

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Will their vote matter?

Law of unintended consequences

Will RERA or consumer protection laws solve this better?

Can we assure a floor recovery?

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Moral hazard risks

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# Judicial and executive roles in a bankruptcy framework

1. Does the IBC have a built-in re-organisation bias?
  - ▶ Swiss Ribbons Pvt. Ltd. and Anr. v. UOI and Ors. (2018)
  - ▶ “Liquidation as a going concern”

# Judicial and executive roles in a bankruptcy framework

1. Does the IBC have a built-in re-organisation bias?
  - ▶ Swiss Ribbons Pvt. Ltd. and Anr. v. UOI and Ors. (2018)
  - ▶ “Liquidation as a going concern”
2. Group insolvency
  - ▶ Decision of NCLT in Videocon Ltd. (2009): implications for limited liability.
  - ▶ Procedural co-ordination v. substantive consolidation



# Judicial and executive roles in a bankruptcy framework

Section 30(2)(b) of the IBC: priority of payments in a resolution application.<sup>8</sup>

Operational creditors must receive amount set out by the IBBI, which should not be lower than:

1. liquidation value; or
2. share of the resolution proceeds if they were to be distributed as per the liquidation waterfall.

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<sup>8</sup>IBC (Amendment) Act, 2019

Thank you  
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