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

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<th>Year</th>
<th>DRTs</th>
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Source: RBI Statistical Tables Relating to banking
# Pre-IBC Insolvency Frameworks

## Recovery Rates

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## Outcomes under CDR

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<th>Category</th>
<th>Cases referred since inception</th>
<th>Total cases approved for referral to CDR</th>
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<td>Cases referred since inception</td>
<td>656</td>
<td>474,351</td>
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<tr>
<td>Total cases approved for referral to CDR</td>
<td>531(81%)</td>
<td>403,535</td>
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<tr>
<td>Cases exited successfully</td>
<td>111 (21%)</td>
<td>84,677 (21%)</td>
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<tr>
<td>Cases withdrawn/ exited on failure</td>
<td>298</td>
<td>1,84,581 (46%)</td>
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<tr>
<td>Live cases</td>
<td>121</td>
<td>1,32,948</td>
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Source: CDR Cell (year unknown)
SDR: 15 cases (till December 2015) with debt of Rs.0.8 trillion. 11 cases are from CDR and 2 from CDR group companies.
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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

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<td>Time (years)</td>
<td>4.3</td>
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1% of GDP

2% of total

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<td><strong>Getting credit rank</strong></td>
<td>42</td>
<td>2</td>
<td>19</td>
<td>19</td>
<td>7</td>
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<tr>
<td>To non-financial sector $^1$</td>
<td>59.5</td>
<td>149.8</td>
<td>156.3</td>
<td>144.8</td>
<td>203.9</td>
</tr>
<tr>
<td>O/w bank credit $^2$</td>
<td>93.5</td>
<td>33.4</td>
<td>57</td>
<td>85.4</td>
<td>51.1</td>
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BIS: long series on total credit to non-financial sectors, 2015

$^1$% of GDP  
$^2$% 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
1. A unified legal regime governing bankruptcy in India
   - entity-agnostic
   - respecting the nuances of individual insolvency
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4. Creditor-driven decision making
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 into pieces and put these up to auction.
Unified legal regime governing insolvency

Entity-agnostic

- all persons incorporated with limited liability, except financial service providers
  - statutory corporations
  - co-operative societies
Unified legal regime governing insolvency

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- all individuals and unincorporated partnerships.
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Trusts?
Equalising the right to trigger

- Debtors can trigger on committing default
  - Fresh start process for indigent individual debtors.

- 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.
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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.\(^3\)

\(^3\)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):\(^4\)
  - Avg. recovery rates for operational creditors: 47.45%
  - Avg. recovery rates for financial creditors: 45.84%
- Counterfactual: expensive mechanisms for class-voting.

\(^4\)IBBI data
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How do we think about home buyers?

[^4]: IBBI data
Creditor-driven decision making

1. Management displaced on commencement of the CIRP, and affairs of the firm handed over to an insolvency resolution professional.
2. Key decisions during corporate insolvency resolution process to be taken by a vote of creditors’ committee.
3. Creditors’ committee decides what resolution plan gets approved.

▶ Does the IBC have a built-in re-organisation bias?\(^5\)

\(^5\)Supreme Court judgements in Arcelor Mittal and Swiss Ribbons
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.
- Section 30(2)(b) of the IBC.\(^6\)

\(^6\)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

- Low recovery rates
- Complexity
- Moral hazard risks
- Are we achieving the intent?\(^7\)

\(^7\)Ex: Section 12A withdrawal and settlement
## Legacy issues

1. **Section 29A and its implications**
   - Low recovery rates
   - Complexity
   - Are we achieving the intent?\(^7\)
   - Moral hazard risks

2. **Home buyers as financial creditors.**
   - Will their vote matter?
   - Law of unintended consequences
   - Will RERA or consumer protection laws solve this better?
   - Can we assure a floor recovery?
   - Moral hazard risks

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\(^7\) Ex: Section 12A withdrawal and settlement
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

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   ▶ Swiss Ribbons Pvt. Ltd. and Anr. v. UOI and Ors. (2018)
   ▶ “Liquidation as a going concern”

2. Group insolvency
   ▶ Procedural co-ordination v. substantive consolidation
Section 30(2)(b) of the IBC: priority of payments in a resolution application. 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.

\(^8\)IBC (Amendment) Act, 2019
Thank you
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