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POLICY BRIEF

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Insolvency and Bankruptcy Code

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1. Key Messages

- Previous legal provisions for insolvency in our country were not effective. The Insolvency and Bankruptcy Code is an attempt to deal with corporate and individual insolvencies in a manner that is both economically productive and humane.
- Over the past two years, the new Code has shown promise in resolving corporate insolvencies. However, there are major issues with the Code and its implementation.
- The part of the Code dealing with individual insolvency has not been operationalised at all. The rights and protections that Parliament offered to both individual debtors and their creditors are being held back by the executive.
- The Code unfairly discriminates against trade creditors, employees, and workmen by not allowing them a role in determining the fate of defaulting corporates.
- The judiciary is not able to keep up with the increased burden on it. Cases take much longer than the duration allowed by the Code, both for determining admission into the resolution process, and to exit out of the process. The recent amendment also asks the judiciary to take a call on the commercial decisions of the creditors.
- The regulator has set up high entry barriers that have prevented competition, both in the area of agencies for managing regulated professionals, as well as in the area of utilities providing information related to debt. Without these institutions, the operation of the Code may be stunted.

2. Background

The Parliament recently amended the Insolvency and Bankruptcy Code, 2016 (Code) for the second time, almost two years since it was first enacted. This is a good opportunity to review the successes and the failures of the Code.

2.1 Insolvency Regime

Somebody borrowed some money from you, but he doesn't pay you back. What do you do? In the ancient world, he would have to become your slave till the debt was paid off. Or, he would have been considered a criminal, and put in debtor's prison. But today, most societies have regimes that are more humane, and economically more productive, than either slavery or imprisonment.

Insolvency is not limited to individuals alone rather firms too, can become insolvent. In fact, in a competitive economy, most new firms are likely to end up as failures. If society punishes every failure harshly, people will not dare to try out new ideas. Only a society that is tolerant of risk-taking can evolve into a more prosperous society. To encourage risk-taking, society needs to put a system in place to handle failures. Insolvency is an early indicator of the failure of a firm. A rescue mechanism should be provided for those failures that are still viable, and a clear exit route is required for those firms that are unviable.

Insolvency regimes can shape the economy in many ways. A good insolvency regime is essential for enhancing productivity in the economy, both by protecting viable firms, and by recycling the assets of unviable firms (McGowan and Andrews 2016; Andrews and Cingano 2014). It can reduce the cost of capital (La Porta et al. 1997; Djankov, McLiesh, and Shleifer 2007), and promote the creation of new enterprises (Armour and Cumming 2006; Lee et al. 2011). So, it is essential for India to have an effective insolvency regime.

2.2 IBC: Better Late than Never

Our legal approach to enterprise failure was previously governed by the Companies Acts of 1956 and 2013, and by the Sick Industrial Companies (Special Provisions) Act, 1985. Individual default was dealt with through the Presidency Towns Insolvency Act, 1909, and the Provincial Insolvency Act, 1920. Debt recovery was sought to be facilitated through the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interests Act (SARFESI), 2002, and the Recovery of Debts due to Banks and Financial Institutions Act, 1993.

These laws were not very effective. Our recovery rate was estimated to be just 26.4%. For comparison, the rate for OECD countries is 71.2% (World Bank 2018). Lenders sought to counter these high losses by charging higher interest rates and fees. Consequently, all firms faced a higher cost of funds. Since legal proceedings could take a long time, insolvent firms would continue to occupy resources that could have been put to productive use elsewhere.

In 2014, the government set up the Bankruptcy Legislative Reforms Committee (BLRC). In its report, it conceived of a very different approach to dealing with default. Based on the law drafted by the BLRC, the Parliament passed the Code in 2016. It is a unified law that handles both corporate and individual insolvency. It also establishes a new regulator, the Insolvency and Bankruptcy Board of India (IBBI).

3. Impact

3.1 Corporate Insolvency

The Code treats a limited liability firm as a contract between equity and debt. Equity owners normally control the firm. However, if the firm is unable to pay its debts on time, then its Financial Creditors (FCs) or Operational Creditors (OCs)[1] can approach the for the admission of the debtor into the Corporate Insolvency Resolution Process (CIRP). Under the CIRP, once default is established, the control of the firm shifts to a Resolution Professional (RP) appointed by the creditors. This professional keeps the firm running, while inviting "resolution plans" from parties who may wish to purchase the firm as a going concern. The creditors vote on the resolution plans received, and selects one of them by a 66% majority. If this does not happen within a defined duration, the firm is liquidated and the proceeds distributed among the creditors.

This scheme places commercial decisions in the hands of the creditors, rather than in the hands of judges or bureaucrats. The role of the judiciary is limited to ensuring due process and legality.

About 701 petitions for admission into corporate insolvency resolution have been admitted as of March 31, 2018 (IBBI 2018b). Of these, 22 have been resolved, 87 have been liquidated, and 67 were closed on appeal/review.

Some of the major changes the Code has brought about are:

- **Changing incentives**

The greatest impact of the Code may be the change it has brought about in the behaviour of creditors and debtors. Under the Code, the promoters may lose control of their firm if it defaults. So, promoters are eager to avoid default and to work together with lenders to resolve issues (FICCI 2018).

- **Early recognition of default**

In the case of a default, time is of the utmost importance. The earlier the default is recognised, the greater the possibility to rescue the firm. Generally, when a debtor is in trouble, it defaults to its suppliers and employees

[1] Operational Creditors are those who have a claim against the debtor in respect of the provisions of goods or services. This includes workmen, employees, trade creditors, tax authorities, etc.

before it defaults to banks. The Code promotes early recognition of default by allowing not just financial institutions, but also trade creditors and employees to initiate the corporate insolvency process.

- **Predictability**

The process is time-bound: if the corporate debtor is not resolved within 270 days, it is liquidated. This provides consistency and predictability to all the stakeholders. This is very important, especially in the light of the fact that judicial processes in India are slow and unpredictable.

- **Evergreening**

Some debtors might be politically influential. They might be able to persuade their creditors not to initiate insolvency proceedings against them, and instead to 'evergreen' the loan. The Code reduces this possibility by expanding the universe of parties who can initiate the CIRP.

- **Individual Insolvency**

In the case of individual insolvency, the Code helps the creditors to recover as much of their debts as is humanely possible, while providing a clear path to discharge for the debtors. There is a provision for a "Fresh Start": small borrowers with few assets can get an immediate discharge. Other defaulting borrowers can create and follow a repayment plan after it is approved by the Debt Recovery Tribunal (DRT). If the individual is bankrupt, he can obtain a discharge after liquidating his assets (other than certain essentials).

4. Issues

4.1 Individual Insolvency not operationalised

The Code contains provisions not just relating to corporate insolvency, but also relating to individuals. The government has operationalised corporate insolvency alone. It has yet to notify the provisions relating to individuals and partnership firms.

Until these provisions are notified, individuals continue to be governed by British-era Acts. The Code contains important improvements over those Acts, such as quick processes, humane treatment of defaulters, a moratorium, as well as a "Fresh Start" provision to deal with small defaults by the poor. A modern insolvency framework is also required for individuals who are proprietors of small firms or partnership firms. Around 63 million such small and micro enterprises exist in the country that employs more than 109 million people (Ministry of Micro, Small, and Medium Enterprises 2018).

While the Parliament has granted the Central Government the power to notify specific sections of the Code, this power should not be construed as a carte-blanche to delay implementation indefinitely. By not operationalising a very important part of the Code for two years, the Government is frustrating the will of the Parliament.

4.2 Discrimination against Operational Creditors

The Code mandates that the fate of the corporate debtor will be decided by a committee of creditors. However, this committee consists only of FCs. The OCs, including suppliers, employees, and workmen, are generally excluded from voting in this committee.

Other countries do not employ such distinctions among creditors. The report had originally suggested this discrimination on the assumption that FCs would be willing to bear short-term losses for long-term gains. In the lights of the experience of the past couple of years, the validity of this assumption is questionable.

A more rational way to determine the membership of the committee of creditors is on the basis of whether the debt is secured or not. To the extent the secured debtors are assured of repayment, they do not need to be its members. The committee can then consist of all non-secured creditors, whether financial or operational.

In any case, since there is no rationale to continue discrimination against OCs in favour of financial firms, the Code must be amended to provide for fair treatment of OCs.

4.3 Judicial Delays

As of January 31, 2018, a total of 9073 cases were pending in NCLTs (Rajya Sabha 2018). Since then, many thousands of more cases would have been filed. NCLT judges are tasked by the Code to adjudge petitions for admission to CIRP in 14 days. Evidence suggests that these deadlines are being missed in most of the cases (Chatterjee, Shaikh, and Zaveri 2017).

NCLT judges are also asked to ensure that if a CIRP does not end in a maximum of 270 days, the debtor is liquidated. This deadline is also frequently missed (Dutt and Lele 2018). In the matters of insolvency, delays are especially costly since it leads to the dissipation of physical and organisational capital.

Part of the solution would be to set up more NCLT benches (Damle and Regy 2017). It is equally important to examine if the work-load of the NCLTs can be reduced (Datta and Regy 2017). For instance, NCLT benches often ask for frequent reports from the RP about the progress in the case. Such micro-management runs counter to the Code. This also adds to the work-load of the RP as well as of the NCLT.

4.4 Judiciary making Commercial Decisions

One of the most important features of the original Code was the separation of the commercial and judicial aspects of insolvency resolution. The Code provided for a market-determined process, in which the fate of the insolvent corporate was left to the commercial wisdom of the creditors. The judiciary’s role was limited to overseeing the process to ensure that no laws were violated and that due process was followed.

The recent Second Amendment burdens the judiciary with commercial decisions. Now, the NCLT has to satisfy itself that “the resolution plan has provisions for effective implementation”. This requires the judiciary to second-guess the effectiveness of a commercial decision which was proposed by the resolution applicant and which has been accepted by the creditors.

Putting the judiciary in this role is harmful to the resolution process. It opens the floodgates to unproductive litigation. It dilutes the basic principles of the Code, and increases uncertainty among all stakeholders.

4.5 Regulation of Professionals

This is one of the institutional innovations in the Code. The BLRC conceived of IPAs as a first-level regulator of IPs:

> Thus, the Committee believes that a new model of "regulated self-regulation" is optimal for the IP profession. This means creating a two-tier structure of regulation. The Regulator will enable the creation of a competitive market for IP agencies under it.
>
> …The IP agencies under the Board will, within the regulatory framework defined, act as self-regulating professional bodies that will focus on developing the IP profession for their role under the Code. They will induct IPs as their members, develop professional standards and code of ethics under the Code, audit the functioning of their members, discipline them and take actions against them if necessary.

The BLRC anticipated that competition among IPAs will lead to better standards and better enforcement. These expectations have been belied. IBBI's regulations obstruct competition by creating very high entry barriers. For instance, IBBI has mandated that all IPAs have to be Section 8 companies with a net worth of at least Rs 10 crore. This has discouraged the entry of private IPAs.

Only three IPAs exist, all offshoots of statutory professions.[2] As IBBI acknowledged in a discussion paper, these IPAs do not seem to compete with each other at all (IBBI 2018a). If IPAs are to play the role envisaged in the Code, IBBI has to reduce obstructions to competition in the area of IPAs.

4.6 Information about Debts

Another institutional innovation of the Code was the concept of Information Utilities (IUs). They were meant to provide accurate and incontrovertible information that could be used as evidence during the insolvency resolution process. Since timely and accurate information are so important to successful resolution, IUs would have been of great value.

Today, there is only one IU. In this area too, the expectation of BLRC that there would be a competitive industry has not been met. IBBI regulations require each IU to have at least Rs 50 crores of net worth, and prevent any single shareholder from holding more than 10 percent of the equity of an IU. IBBI also requires each IU to pay a fee of Rs 50 lakhs to the Board annually. These are onerous requirements, especially since this

[2] The three existing IPAs have been set up by the Institute of Chartered Accountants of India, the Institute of Cost Accountants of India, and the Institute of Company Secretaries of India.

is a new and unproven industry. Consequently, there is little interest in the private sector to set up IUs, and BLRC's vision is frustrated.

5. Way Forward

In this article, we have highlighted the learnings from two years of the Code. Some of these issues require changes to the Code. The Code should be amended to place OCs on an equal footing with the FCs. The obligation cast on NCLT judges to evaluate the commercial feasibility of the resolution plan is a mistake, and it should be removed from the Code.

But other issues are in the purview of the government or the regulator. They need to work together to operationalise the provisions of the Code relating to individual insolvency. The government needs to do better about estimating the work-load on NCLTs and providing sufficient resources to handle this load. The regulator needs to enable competition among and among IPAs and among IUs.

After almost 70 years of existence as an independent country, India finally has a modern insolvency regime. While it has shown itself to be workable and practical, its operation has been beset with many failures as well. These need to be fixed rapidly if our economy is to progress.

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