The Indian Insolvency and Bankruptcy Bill: A Squandered Opportunity

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2 June 2016

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This Version: June 2016

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Abstract:

In this perspective article, the author analyses the eventual efficacy of recently passed Insolvency and Bankruptcy Bill in India. The author ascertains that the Bill in its current form encourages liquidation at the cost of financial restructuring. An opinion is established based on secondary research that the Bill fails to provide adequate representation to certain key stakeholders. The author highlights a lack of clarity in the Bill regarding the appointment of executants. Certain lacunae in the Bill that may impede its overall effectiveness are explicitly identified. The issue of conflicts between various stakeholders is debated in the context of current Bill. The author draws upon cross-country experiences to suggest remedial measures that address current impediments in the successful implementation of the Bill.

Keywords: Insolvency and Bankruptcy Bill, India, Insolvency Resolution Professionals

1. Introduction

In an environment where NDA government has failed to get key bills approved in the Rajya Sabha, it is saddening to note that the government has lost an opportunity in the recently passed Insolvency and Bankruptcy Bill (the "Bill"). This Bill was one of a small number of legislations where the government was able to build a political consensus and muster enough votes to ensure safe passage.

Insolvency and Bankruptcy is an entry covered in the seventh schedule under concurrent list in the Indian constitution allowing both State and Centre governments to develop the legislative framework[i]. Prior to Insolvency Bill, the regulatory environment in India for managing bankruptcies was extremely complex and messy. At least six different regulations[ii], often at odds with each other in terms of process and intended objectives, governed the management of insolvency process. It was hardly surprising that bankruptcies lingered for ages in such a regulatory environment seriously impairing the claims of numerous stakeholders that are part of insolvency proceedings. The average time to resolve an insolvency proceeding in India at 4.3 years was far higher than the time taken in the developed economies (see Table 1). In fact, in a World Bank study, India ranked 186th on the list of 200 nations where data was available[iii] (see Table 2). The process of closing businesses (dissolution of companies), even on a voluntary basis, was a cumbersome process requiring court supervision and approval. Capital providers (Banks, Bondholders, and Financial Institutions) were adversely impacted by elongated timelines and their grievance did attract significant media attention in the recent times owing to large scale NPA crisis. However, the adverse impact of prolonged insolvency proceedings on employees and operational creditors (goods and service providers) went often unnoticed.

The process for a comprehensive bankruptcy reform was initiated with the setting up of Financial Sector Legislative Reforms Commission, led by Justice Srikrishna in 2011. In 2014, Ministry of Finance instituted the Bankruptcy Legislative Reforms Committee, led by T. K. Viswanathan. The Viswanathan committee submitted a two-volume report in 2015. The economic rationale and design features of a new legislative framework were covered in the first volume and the draft bill was laid out in the second volume. A modified version of this bill, incorporating public comments, was tabled in the Parliament in late 2015. After the bill was tabled, the Joint Parliamentary Committee was set up and the Joint Parliamentary Committee submitted its report which included a new draft of the law.

2. Concerns with the current Bill

It was imperative in such a scenario that a comprehensive and effective single framework is promulgated that safeguards interest of all stakeholders. The current insolvency Bill, despite its long drafting history, falls woefully short on the following six counts.

A. *Liquidation Preference*

The new Bill has a marked preference to liquidations versus reorganization thereby defeating the stated objective of maximizing asset value. The Bill mandates that a specialized personnel appointed to manage insolvency resolution process completes this exercise within 180 days. A timeframe of six months (or nine months including an extension) is grossly inadequate to prepare a robust revival plan that is agreed upon by a super-majority of creditors[iii]. Even in developed economies like the United States with experience of tackling economic, harmonisation and legislative challenges involved in the bankruptcy process for over thirty years[iv] , an eighteen months period[v] is provided to evaluate the viability of corporate restructuring and reorganization.

Such arbitrarily decided resolution period of six months without any consideration to the size of a firm, its recent financial performance, asset coverage, the number of creditor claims or severity of default will lead to a hastily arranged liquidation proceeding resulting in significant impairment of intrinsic enterprise value.

It is also important to consider that Indian economy is still largely a 'bank-oriented economy' rather than a 'market-oriented economy' and a large amount of corporate debt is owned by Banks. In a market-oriented economy, creditors often have the option to participate in the liquidation process thus ensuring optimal price discovery and arresting transfer of value. It is extremely unlikely though, given current regulatory and accounting environment for banks that the banks will be able to bid for liquidated assets. In a fire-sale liquidation process, the value will be appropriated by vulture firms from banks (and ultimately taxpayers). Aghion et al. (1992) question the conclusion that a competitive auction will inevitably lead a firm to be sold at the highest price. They posit that auctions work well if raising cash for bids is easy and there is plenty of competition among several well—informed bidders. However, even in the most advanced Western economies, these conditions will often not be met, and they believe that such conditions are even less likely to be satisfied in developing economies like Eastern Europe. If research findings of Aghion et al. hold true, Public Sector Banks, unsecured creditors, workmen, and minority shareholders will suffer the most in liquidation via cash-auction approach.

B. *Limited or No Representation to Key Stakeholders*

Workmen and operational creditors do not enjoy the same status as financial creditors in the new Bill. In the event of an alleged default, the financial creditor can initiate the insolvency proceedings without intimation to the debtor. In a similar instance, an operational creditor is required to deliver a demand notice and a corporate debtor can stall insolvency proceeding by merely disputing the veracity of such claim. It is almost certain that a debtor will dispute the legitimacy of a claim when facing the spectre of insolvency proceedings and consequently operational creditors (typically micro and small enterprises lacking financial and legal wherewithal) will continue to suffer inordinate delays in the recovery process.

Workmen have no representation in the insolvency resolution process and are at the mercy of creditors committee with disparate interests. Workmen dues are prioritized only for a period of twenty four months. Wages and dues of contract workers are prioritized for an even smaller period of twelve months. The Bill assumes that financial creditors, who may very well be secured creditors with sufficient asset cover and no risk exposure, are the only appropriate decision makers for creditors committee. This inaccurate assumption may lead to adverse consequences for workmen. For example, consider a company with assets of Rs. 100, total liabilities of Rs. 75 but with interest coverage of less than 1 due to temporary and transitory cash-flow disruption. If such a company defaults on its debt obligation, creditors will pursue the path of liquidation as they will have a full recovery of debt and their financials will appear better with reduced NPAs. Their immediate economic interests will disregard the appreciation for long-term viability of the company. The challenge faced by displaced workmen, particularly those who have attained a certain age and will find reskilling challenging, hasn't received any consideration in the Bill. Graham et al. (2013), using data from the Census Bureau's Longitudinal Employer Household Dynamics Program, suggest that one year after bankruptcy, the magnitude of the decline in annual wages is 30% of pre-bankruptcy wages. The principle of equity would mandate that a weaker stakeholder is offered more protection by law than a stronger stakeholder, but the Bill embodies a contrary rationale.

The Bill envisages an extremely limited role of government in ensuring a fair and orderly resolution process. In the United States, the U.S. trustee plays a major role in monitoring the progress of a bankruptcy case and supervising its administration[vi]. The confidence of market participants in integrity and transparency of bankruptcy process is extremely essential for a well-functioning equity and debt capital market. La Porta et al. (1997), in their seminal work on inter-linkage between law and capital structure, have underlined the importance of shareholder and creditor rights in influencing the development of financial systems and establishing funding preferences for a country. Undue favouritism shown by laws to either creditor or equity participant can artificially skew the financing preferences and raise overall cost of capital for businesses. Finally, the limited participation of union and state governments in the bankruptcy process and creditors committee is even more questionable when their claims from liquidation estate are prioritized below claims of unsecured creditors. Recent cases[vii] in India provide enough evidence that defaulting firms often fail to remit their statutory dues and taxes for an extended period prior to default. Absence of active government participation in creditors committee will definitely hamper ability to recover maximum possible amount for taxpayers' benefit.

C. *Qualifications for Key Executants Envisaged by Bill*

The key executants envisaged in the Bill to manage insolvency process are an Insolvency Resolution Professional ("IPR") and a Liquidator. IPR is responsible for managing the company, appointing and coordinating creditor's committee proceedings, entering into contracts on the behalf of the company, securing interim financing for the company and completing many other critical tasks with substantial financial and strategic implications. It is glaring therefore that the Bill does not specify minimum qualifications necessary for the appointment of Insolvency Resolution Professional ("IPR"). The lack of minimum qualifications or past experience becomes critically important as IPRs can be nominated by either a creditor or a corporate debtor itself. Lack of clarity on qualifications necessary for IPR appointment may lead to the appointment of IPRs with vested interests or IPRs that are in cahoots with the creditor or corporate defaulter. Since IPRs assume the role of management at the commencement of insolvency proceedings, it is absolutely essential that IPRs have character and qualifications that ensure impartial attention to the interest of all stakeholders and not only financial creditors or corporate debtor. Claessens and Clapper (2002) suggest that creditors in a market-based economy benefit more from aspects of bankruptcy law aiming to overcome collective action problems among creditors. They also suggest that there may be more scope for conflicts between the role of banks as creditors and equity holders in a bank-based system. Their research findings support my case for the appointment of an able and impartial IPR to ensure an impartial and efficient bankruptcy resolution process.

The Bill does not mandate any past experience or minimum recovery criteria for appointment as Liquidator. A capable liquidator can make correct decisions regarding the quantum of asset sale (bulk sale or smaller packages), sale strategy (private versus public) and auction technique and bidding mechanism (English Auction versus Dutch Auction, fixed versus moving bid increments) and maximize proceeds for liquidation estate. Liquidator's experience and expertise in managing complex liquidation process by structuring appropriate disposal strategy is critical for the success of bankruptcy process.

D. *Minimum Threshold for Default Amount*

The Bill does not specify any minimum threshold for defaulted debt either as a percentage of total debt or otherwise. This can result in a situation where a financial creditor commences insolvency proceedings even if less than one percentage of total obligations of corporate are in default. It is also disconcerting to note that the Bill allows a financial creditor to commence insolvency proceedings even if the debtor is making a regular payment on his debt but the debtor has defaulted on the debt availed from another creditor. This incongruity is particularly problematic in instances where the debtor has secured a waiver from the creditor who was directly impacted by the debt default. It is customary to have a minimum threshold clause in debt covenants along with a cure period provision in cross-default situations. The Bill in its current form allows debtors to override such provisions and create nuisance value of catastrophic magnitude for the debtor and its shareholders. A debtor against whom insolvency proceedings have publicly commenced will face massive challenges in running its enterprise in 'ordinary course'. The firm's ability to secure any new financing will be impaired, its ability to secure goods and services from suppliers will be curtailed, the morale of employees will be adversely impacted, prospective buyers will delay or cancel their planned purchase, and the loss of goodwill in the marketplace will have prolonged repercussions. Eckbo and Thorburn (2009) rightly opine that a poorly designed code exacerbates rather than attenuates costly conflicts among security-holders and risks destroying company value by misallocating control over corporate resources. Considering such grave consequences, it is shocking to note that the Bill failed to include a minimum threshold amount.

E. *Disclosure of Interest and Intent of committee members and other executants*

The Bill does not mandate that creditors forming part of creditors committee and IPR disclose their interests and intent to other committee members and debtor. Bankruptcy laws in many developed nations demands full disclosure of all instances may give rise to actual or potential conflicts of interest[viii]. The fact that committee members may have a conflict of interest can result in a lack of adequate representation of all stakeholders. Committee members with conflicted interest may dominate the committee proceedings and entertain high-risk strategies at the cost of other stakeholders. Harner and Griffin (2011), based on their study of 296 chapter eleven bankruptcy cases[ix] in the United States, suggested that cases with single creditor committee are more likely to result in a plan of liquidation. These cases were also more likely to provide distributions of less than fifty percent of claim value to unsecured creditors.

F. *Fraudulent Asset Conveyance*

The Bill fails to adequately address fraudulent conveyance of assets and doesn't bring cross-border assets of defaulters within its ambit. The "look back" period for fraudulent conveyance is limited to one year for unrelated parties and two years for related parties. Keeping in mind our recent experience with wilful default in case of more than 3000 accounts (Table 3), clearly establishing the premise that business failures and bankruptcies are often planned events In India, a longer look back period is needed. Liquidator and Trustee have neither been mandated nor empowered to look for cross-border assets of defaulting parties, thereby impeding full recovery potential for stakeholders.

3. Conclusion

Bankruptcy Law is an important tool for a well-functioning society and an ideal bankruptcy process must provide justice to all stakeholders. Distribution of claims needs to be impartial for all stakeholders including creditors, workmen, taxpayer and the debtor. A hasty liquidation of an enterprise with long-term economic viability, especially when liabilities exceed assets, will lead to losses for both secured creditors and unsecured creditors. Reorganization in such instances can generate future cash-flows that will inure to creditors, protect workmen employment, and generate tax revenue for the government. Unfortunately, the Bill in its current form has some serious lacunae and is unlikely to meet the desired objective of balancing the interests of all the stakeholders and maximization of debt recovery.

The government needs to address these shortcomings in the Bill at priority by way of an amendment. The timeframe for resolution plan approval needs to be significantly extended from current 180 days. The revised timeline should not be similar across defaulting firms and must incorporate a classification based on total assets, the severity of default and number of creditor claims. Creditors committee should have mandatory representation from employees. The *bonafide* of any disputes regarding a claim of an operational creditor should be established by Adjudicating Authority[x]. Union government should take an active participation in the insolvency proceedings and protect the integrity of bankruptcy resolution process by instituting a program similar to The United States Trustee Program. Detailed criteria, including minimum qualifications, need to be laid down for the appointment of key executants like IPRs and Liquidators. The government needs to specify a minimum threshold of default amount that will trigger initiation of insolvency proceedings. Members of creditors committee and other external executants should be mandated to provide a sworn declaration clearly specifying their interests and perceived or real conflicts that may arise from their participation in the process. The rules and procedures regarding fraudulent conveyance of assets need to be strengthened. Finally, a mechanism for ascertaining cross-border assets needs to be incorporated. Otherwise, the Bill will fail to increase ease of doing business, will not accelerate GDP growth as contemplated and will only result in higher cost of equity capital for businesses.

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Table 1: Descriptive data statistic on insolvency timelines for 200 countries

Mean	2.6
Standard Error	0.1
Median	2.5
Mode	2.0
Standard Deviation	1.1
Sample Variance	1.2
Kurtosis	0.5
Skewness	0.7
Range	5.8
Count	200
Largest(n)	6.2
Smallest(n)	0.4

Data Source: World Development Indicators, World Bank, Doing Business project (http://www.doingbusiness.org/)
Last Updated Date: 02-05-2016

Table 2: List of bottom 20 countries ranked on time to resolve insolvency

Rank	Country Name	Time in Years (2011 -2015 data)
200	Sao Tome and Principe	6.2
199	Cambodia	6
198	Micronesia, Fed. Sts.	5.3
197	Ecuador	5.3
196	Vietnam	5
195	Suriname	5
194	Niger	5
193	Myanmar	5
192	Gabon	5
191	Burundi	5
190	Central African Republic	4.8
189	Turkey	4.5
188	Kenya	4.5
187	Iran, Islamic Rep.	4.5
186	India	4.3
185	Kuwait	4.2
184	Syrian Arab Republic	4.1
183	Venezuela, RB	4
182	Slovak Republic	4
181	Oman	4

Data Source: World Development Indicators, World Bank, Doing Business project (http://www.doingbusiness.org/
Last Updated Date: 02-05-2016

Table 3: Suit-filed accounts of Rs. 25 Lacs and above as on 31-Mar-2016

		Rs. 1 Crore & Above (Willful Default)		**Rs. 25 Lacs & Above (Willful Default)**	
Category of Credit Grantor (CG)	**Total No. of CGs**	**No. of CGs**	**No. Of Records**	**No. of CGs**	**No. Of Records**
FOREIGN BANKS	17	12	291	5	12
NATIONALISED BANKS	16	3	460	13	2881
PRIVATE SECTOR BANKS	20	9	1096	11	625
SBI AND ITS ASSOCIATE BANKS	7	5	639	2	187
Grand Total	**60**	**29**	**2486**	**31**	**3705**

Endnotes:

[i] Entry 9 in List III - Concurrent List, Article 246 –Seventh Schedule to the Constitution
[ii] Companies Act, 1956; Sick Industrial Companies (Special Provisions) Act, 1985; Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI) Act, 2002; Recovery of Debts due to Banks and Financial Institutions Act, 1993; The Presidency Towns Insolvency Act, 1909; and Provisional Insolvency Act, 1920.
[iii] The Bill mandates that all decisions of the committee of creditors shall be taken by a vote of not less than
seventy-five per cent of voting share of the financial creditors
[iv] The current United States bankruptcy code was enacted in 1978 which generally became effective on October 1, 1979. The current code completely replaced the former Bankruptcy Act of 1898, also referred as Nelson Act.
[v] Refer 11 USC § 1121(b) of US Bankruptcy Code.
[vi] Bankruptcy Factsheet – US Department of Justice , https://www.justice.gov/ust/bankruptcy-fact-sheets/us-trustees-role-chapter-11-bankruptcy-cases
[vii] Refer Karnataka High Court Judgment in Kingfisher Airlines v/s CIT, ITA No. 165 of 2012
[viii] Rule 2019(a) of the Federal Rules of Bankruptcy Procedure in United States provides that any entity or committee representing more than one creditor or equity security holder and, unless otherwise directed by the court, every indenture trustee, must file a verified statement with the court disclosing their interest.
[ix] A chapter of the US Bankruptcy Code that provides for reorganization, usually involving a corporation or partnership. A chapter 11 debtor usually proposes a plan of reorganization to keep its business alive and pay creditors over time.
[x] Adjudicating Authority in the Bill means National Company Law Tribunal constituted under section 408 of the Companies Act, 2013