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A Rocky Road to Resolution

Achievements and struggles of India's Insolvency Code

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In its first five years, the Insolvency and Bankruptcy Code has recorded some high-profile successes but also a failure to ensure a higher recovery of debt. Implementation has to improve if the code is to successfully balance the interest of all stakeholders.

In June 2021, the National Company Law Tribunal approved a resolution plan for the 13 entities that constituted the Videocon group, the first case under the Insolvency and Bankruptcy Code, 2016 (IBC) that resulted in a common resolution plan for companies belonging to the same enterprise group. The Videocon resolution would have typically been a time for celebrating the law's success in enabling a complex and efficient resolution that allowed for the group to be taken over through a common plan.

Yet, the Videocon resolution made the headlines for a very different reason. In approving the resolution plan submitted by Twin Stars Technologies, a company from the Vedanta group, Videocon's lenders accepted a haircut of nearly 98% on the dues owed to them. Since then, headlines such as "Want a 95% haircut? Take your debtor to IBC" have become common. (A 'haircut' refers to the proportion of the dues forgone by the lenders.)

In the five years since the IBC was enacted, it has been both heralded as a game-changing legislation and vilified for failing to deliver in terms of resolution and recovery of bad debt. On the one hand, policy makers, researchers, and some stakeholders have pointed to the significant successes of the IBC, including some high-profile resolutions and, importantly, changes in promoter behaviour. On the other hand, critiques have emphasised serious implementation challenges on the ground, a lack of capacity of the National Company Law Tribunals (NCLTs) that handle IBC cases, an absence of bidders for many assets, and a malfunctioning of the committee of creditors (CoCs). The fallout of the Covid-19 pandemic, which simultaneously resulted in increased financial distress and reduced capacity of the NCLTs (in part due to virtual hearings), has not made the IBC's journey any easier.

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In this article, I trace the meandering course that the IBC has taken since its inception, focusing on some key themes to try to make sense of the crossroads at which the legislation finds itself today. I also offer some thoughts on how one is to assess the successes or failures of an economic legislation such as the IBC, whose core goal is to balance the competing interests of different stakeholders in a situation where there is not enough left in the pot for everyone.

Origins

While there have been attempts at insolvency reform in the past, the trigger for enactment of the IBC, which began with the constitution of the Bankruptcy Law Reforms Committee (BLRC) in August 2014, appears to be a combination of concerns over the mounting non-performing assets (NPAs) of public sector banks and a drive to improve India's standing in the recently scrapped Ease of Doing Business Index of the World Bank.

The BLRC, whose report laid the framework for the IBC as originally enacted, focused on four major features. First, there was a significant focus on a time-bound process for insolvency resolution process, based in large part on the experience until then of companies taking over a decade to be liquidated or rehabilitated. Timely resolution or liquidation is particularly important as the value of distressed assets depletes rapidly with time. Delays also lead to significant uncertainty among creditors on the prospects of recovery, which, in turn, makes them less inclined to extend credit in the first place. Keeping in mind these factors, the IBC and the underlying regulations were framed such that most steps in the process were to be completed within stipulated timelines. The most important of these was the 180-day period within which a resolution plan must be approved. (This was subsequently extended to 330 days by amendments to the IBC.) If this does not happen, the debtor company goes into liquidation.

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Second, insolvency law is meant to be a collective process that aims, in the first instance, to find a resolution for the debtor company that would enable the business to continue as a going concern. In the process, regardless of who has initiated the insolvency application, all creditors share in the recoveries. If resolution fails (perhaps because the company is not financially viable or there is no buyer for the business), the debtor company goes into liquidation and its assets are distributed among the creditors based on a formula prescribed by law. The collective nature of insolvency resolution stands in contrast to debt recovery or security enforcement,[1] where the goal is for each individual creditor to recover its debt rather than the turnaround of the debtor company's business. The collective nature of the insolvency process also calls for a need to balance the interests of the various stakeholders that are affected by a company's insolvency – the financial creditors, the debtor company's suppliers and vendors (who fall into the bucket of operational creditors), and the employees.

Third, the IBC provides for a creditor-driven process. When the corporate insolvency resolution process commences, the board of directors of the debtor company is suspended and the company is run by a resolution professional, acting under the control of the CoC. The significant emphasis on the need for a creditor-driven process was based, in large part, on the experience with the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA), which was a debtor-in-control regime and was universally regarded as an abject failure. Worse, SICA was seen as providing a safe haven for debtor companies looking to siphon off their assets from creditors.

Related to the creditor-driven process was the idea that market forces, rather than the law or a government authority, were best placed to determine the fate of the debtor company. Whether a particular resolution plan goes ahead or not is left to the commercial wisdom of the CoC, subject to certain legal constraints (such as that a resolution plan should not contravene any law and must provide for payment of resolution costs and at least liquidation value to the operational creditors). It is for this reason that the IBC, particularly in its original enactment, is not prescriptive on the form that a resolution plan must take. The flip side of the emphasis on the commercial wisdom of the CoC was that the judiciary was seen as having a very limited role and minimal discretion over the resolution process. The role of the NCLT is not to question the substance of a resolution plan or the extent of a haircut, but only to ensure that it complies with the tenets of the IBC.

> [T]he IBC was an ambitious enactment that not only saw the birth of a new law but also of a new institutional architecture to go along with it.

The supremacy of the CoC in the resolution process was made abundantly clear in the Supreme Court's landmark November 2019 judgment in the insolvency resolution of Essar Steel Limited. Here, the Supreme Court clarified that the CoC had ample powers to decide on the terms of the resolution plan, including the distribution of payments to different stakeholders. The Supreme Court's judgment also states in unequivocal terms that the CoC owes no fiduciary duty to any particular class or group of creditors or stakeholders and that its role is to exercise a business decision "based on ground realities by a majority, which then binds all stakeholders, including dissentient creditors." As discussed below, these unfettered powers of the CoC have been called into question in recent times.

Finally, the IBC was an ambitious enactment that not only saw the birth of a new law but also of a new institutional architecture to go along with it. Often referred to as the three pillars of the IBC, the legislation provided for a new regulator (the Insolvency and Bankruptcy Board of India or IBBI), the development of insolvency professionals as a new class of professionals to run the resolution and liquidation processes, and repurposed the NCLT to hear insolvency cases. In the five years since the IBC has come into effect, much has been done to develop these pillars to enable them to support the implementation of the legislation.

I will come back to some of these drivers behind the IBC later on when I assess how this initial thinking has played out in the law's implementation. But before that, I want to touch on some important amendments that have been made to the IBC.

Failure or fraud? Section 29A

Since its enactment, the central government and the IBBI have been closely monitoring the progress of the IBC and have been taking steps to plug loopholes and perceived defects. There have, to date, been six sets of amendments to the IBC and numerous more amendments to the regulations. While several amendments have been passed to make clarifications or minor procedural changes, a

particularly significant amendment was the addition of the controversial Section 29A in November 2017.

Section 29A prohibits certain "undesirous" or "unscrupulous" persons from bidding for the assets of the debtor company and effectively bars the erstwhile promoters of the debtor company (and their related parties) from regaining control of the company at the end of the resolution process. This section was introduced in a climate of great suspicion on the intentions of promoters and their attempts to run their companies dry for personal gains, exemplified by the phrase "there are bankrupt companies, but no bankrupt promoters.". Against this backdrop, the idea that a promoter could allow his company to default on its debts, have a portion of the debts forgiven in the resolution process, and regain control of the company on a clean slate was perceived as inherently unfair.

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Section 29A has been watered down to a certain extent since it was first introduced, as experts were quick to point out that the language of the provision made its scope unintentionally broad. Subsequent amendments have also made certain sub-sections of Section 29A inapplicable to micro, small and medium enterprises (MSMEs). These changes make it easier for MSME promoters to submit resolution plans, a move necessitated by the premise that these companies are likely to attract few third-party resolution applicants. However, it remains one of the most controversial sections of the IBC today, and has also given rise to much litigation by competing resolution applicants challenging one another's eligibility to submit a resolution plan. In the wake of the Covid-19 pandemic, there were once again calls to do away with Section 29A in order to ease the resolution process, particularly in light of the lack of third-party bidders for many assets at the time.

The debate around Section 29A also revolves around the larger issue of distinguishing fraud or malfeasance from business failure. On the whole, the IBC is not punitive on the debtor company or its management and promoters, but is instead meant to provide a path for a smooth resolution or exit, taking into account the reality that business failure can occur for a number of reasons. It is, of course, possible (and to the cynical mind, likely) that fraud and malfeasance have contributed to a company's insolvency, in which case the IBC has separate provisions to deal with fraudulent or other questionable transactions that come to light during the resolution or liquidation process. Section 29A, by contrast, tends to deal with all promoters in one fell swoop, regardless of the factors behind a company's financial distress.

Homebuyers as financial creditors

Consumer creditors did not initially feature in the stakeholders that the IBC intended to consider. However, in August 2017, the insolvency resolution of real estate developer Jaypee Infratech, brought attention to a specific group of consumer creditors: homebuyers who had paid advances on their to-be-constructed homes but would have no say in the developer's insolvency resolution process. They were now faced with the prospect of having neither their homes delivered nor their money back. Sparking almost as much debate and controversy as Section 29A, the plight of homebuyers led to yet another amendment to the IBC. Taking into account the realities of the real estate sector in India and the fact that homebuyer advances constitute a significant portion of a developer's financing, the IBC now treats homebuyers of development projects as financial creditors.

Since then, homebuyers have participated in CoCs through their authorized representatives and are entitled to the same recoveries as banks and financial institutions under the IBC. The functioning of these CoCs has, however, run into implementation challenges given the differing interests and perspectives of the groups involved. These hurdles might be overcome with time. Yet, it leads to the larger question of whether the IBC is intended to also be a consumer protection legislation or if other laws, such as the Real Estate (Regulation and Development) Act, 2016 (RERA), might be better placed to protect the interests of homebuyers.

Individual insolvency and personal guarantors

While most of the focus of the IBC has been on corporate insolvency, an entire chapter of the law deals with insolvency and bankruptcy of individuals. Many of these provisions are yet to come into effect and the process of rolling out an insolvency law to deal with individuals across the country is going to be a mammoth task. However, in December 2019, the chapter on individual insolvency did come into effect for one category of individuals: personal guarantors who had extended guarantees to secure loans granted to their companies. This was a significant stepping stone for the IBC as it allowed banks and financial institutions to go after promoters in their personal capacity. The regulations around insolvency of personal guarantors were initially challenged on constitutional

grounds, but they have since been upheld by the Supreme Court. With this, several banks have filed applications against high profile promoters who have failed to honour their personal guarantees, including Anil Ambani of the Reliance Group, Kapil Wadhawan of Devan Housing Finance, Sanjay Singhal of Bhushan Power & Steel and, most recently, Venugopal Dhoot of the Videocon group.

Many of these companies have already gone through the resolution process, and banks are now beginning to use the personal insolvency law in an attempt to enhance their recoveries beyond what they received in the resolution plan.

Dealing with the pandemic

Like several other countries, India too made certain changes to the IBC to give companies some breathing space to deal with the devastating economic impact of Covid-19 on most businesses. The immediate changes were an increase in the default threshold to Rs. 1 crore from Rs. 1 lakh (a limit that remains in place today) for triggering the insolvency process and a suspension on the filing of IBC applications for defaults that occurred between 25 March 2020 and 25 March 2021. The suspension has since been lifted. However, a strange quirk in the language of the amendment has meant that IBC applications may never be filed for defaults that occurred during the suspension period.

A more long-term impact of attempting to tailor the IBC to deal with the new normal has been the introduction of a new type of resolution process, known as pre-packaged insolvencies or "pre-packs". A pre-pack allows the debtor and creditor to agree to a resolution in advance before making an insolvency application to the NCLT and, most importantly, allows the debtor to remain in control during the resolution process. In situations where there is consensus between debtor and creditor, pre-packs can save time and costs and also minimise the disruption caused to the debtor's business during insolvency, while having the same binding effect on all stakeholders as a plan approved under the IBC. At present, pre-packs under the IBC are only available to MSMEs and it remains to be seen if they will be adopted more widely.

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In the last 18 months, it has also become apparent that the formal insolvency process should not be the only mechanism for resolution of distress or dealing with NPAs. The Reserve Bank of India provides for non-statutory mechanisms for consensual resolution between banks and debtors and pre-packs themselves are indicative of the broader trend during the pandemic of exploring consensual resolutions outside the IBC process. The latest mechanism is the 'bad bank' idea which has been operationalised with the incorporation of the National Asset Reconstruction Company Limited (NARCL). The NARCL will acquire NPAs from banks aggregating to, in the first phase, about Rs. 90,000 crore. The NARCL, with the assistance of the India Debt Resolution Company Limited (IDRCL), is to then attempt resolution of these stressed assets, with any shortfall from liquidation or resolution being backed by a government guarantee that is to be valid for five years. Experts have raised various concerns with the bad bank proposal, which are beyond the scope of this article. Suffice to say that the bad bank and the IBC approach the same problem from different angles and, given the enormity of the task head, these options will all need to be pursued in parallel.

Assessing the IBC's impact

Based on data in the *IBBI Newsletter*, as of end June 2021, a total of 4,541 insolvency applications have been admitted by NCLT benches across the country since the IBC came into effect. Of these applications, 396 have ended with a resolution plan being approved, while 1,349 have been ordered for liquidation. The average time for a resolution plan to be approved was 482 days, while the average time for a liquidation order to be passed was 362 days. In terms of recovery rates, based on the 396 resolution plans approved up to 30 June 2021, the average recovery rate for banks and financial institutions was 36% of their claim amounts, while the recovery rate for plans approved in the last quarter (March to June 2021) was 25.46%.

What do these numbers tell us? First, several more companies that go through the insolvency process end up in liquidation rather than in resolution. This, by itself, however, does. not provide much insight as many of the companies in this bucket are legacy cases, which had defaulted several years before the IBC came into effect. Second, it is clear that adhering to the 330-day time line has been a challenge, though even with these extended timelines, resolution appears to be occurring much faster than in the pre-IBC era.

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These numbers, however, also do not give us a full picture as they suggest that approval of a resolution plan or the passing of a liquidation order signals closure. On the other hand, in order for the stakeholders to reap the benefits of a resolution plan, it needs to be implemented and this is where many resolution plans get stuck. Implementation typically requires approvals from other governmental authorities and very often resolution plans are appealed after their approval. Most recently, for example, the resolution plans of both Videocon and Jet Airways have been challenged in the appellate tribunals. Similarly, the passing of a liquidation order only signals the commencement of the liquidation process and not the completion of the distribution of assets.

As we assess how the IBC has fared, it is worth considering whether one should assess its impact based on process or outcomes. The law is clearly being used extensively and has yielded some resolutions, which suggests that the process laid down by the legislation is working, albeit imperfectly. But the outcome of resolution plans has often been far from satisfactory, both in terms of timelines for resolution and recoveries for creditors. At one level, the law alone cannot be faulted for these outcomes, which depend on numerous factors, including the availability of bidders for these assets and the behaviour of stakeholders in the resolution process.

It is also important not to judge the success of a legislation based on a handful of high-profile cases that yielded poor outcomes. Indeed, the data shows that haircuts are not universally as low as headlines make them out to be. Yet, if most insolvencies end in liquidation and resolution plans yield consistently low recovery rates, these cannot be ignored.

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The unsatisfactory outcomes of resolution plans is, at least partly, a result of the lack of bidders for these assets. This will always be driven by market factors and the quality of assets in insolvency However, efforts are under way to ease the resolution process and make it more attractive for prospective resolution applicants. The other driver of poor outcomes, which has come into focus of late, is the behaviour of the CoC during the resolution process. Concerns have surfaced over confidentiality breaches, delays in making decisions and not being focussed on the turnaround of the business or with balancing the interests of all stakeholders.

In response to these concerns, the IBBI has published a consultation paper seeking inputs on whether it would be prudent to introduce a code of conduct for members of the CoC, just as there is one for resolution professionals. This would be a welcome move and goes to show the perils of giving the CoC unfettered powers, without the corresponding requirements to act responsibly. If the IBC is to truly be a collective resolution process, it can only work if the CoC takes long term concerns and the interests of all stakeholders (including operational creditors and employees) into consideration.

Another area that requires significant work is capacity building at the NCLTs to deal with the growing number of IBC cases. A Parliamentary Standing Committee on Finance recently called out the Ministry of Corporate Affairs for failing to fill in vacancies at these tribunals, pointing out that there were only 29 NCLT members as against the sanctioned strength of 63 members. Most benches of the NCLT only sit for a couple of days a week as members divide their time between two, and sometimes even three, benches. This has led to many cases pending for admission for over a year and very significant delays in resolution. Finally, heeding calls from the Supreme Court, the central government has very recently cleared the appointments on 18 additional members for the NCLT. One would hope that this helps the NCLTs to hear and dispose of cases within the timelines contemplated by the law. But the bizarre events surrounding the central government’s attempt to cut short the tenure of AIS Cheema, acting chairman of the appellate tribunal, by a few days only goes to show that all is far from well with the appointments process.

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The quality of decisions taken by the NCLTs are also variable and often turn the clock back by questioning issues that are very clear in the law. In addition, these decisions have contributed to further litigation and a lack of finality of resolution plans. In the insolvency of Educomp Solutions, the Supreme Court recently took the NCLT to task for going beyond its mandate in allowing a resolution plan to be withdrawn after its approval by the CoC. The Supreme Court also, in this same decision, called out the working of the

adjudicating mechanisms as one of the primary reasons for the IBC not living up to its stated purpose of facilitating time-bound resolution. Against this backdrop, filling vacancies without delay, designing efficient case management mechanisms and training programmes for NCLT judges are urgently needed.

Amidst all of these critiques, we must not forget that one welcome consequence of the IBC is the change in behaviour of companies and their promoters. The ease with which the insolvency resolution process can be triggered and the resulting loss of promoter control once a company is admitted into the resolution process have led to companies taking their repayment obligations more seriously. Companies and promoters are less likely to be wilful defaulters and companies with genuine reasons for economic distress are more likely to reach out to their lenders at the first signs of distress. In this sense, one measure of the law's success are cases that do not come into the NCLT at all and we are seeing more cases being settled in the pre-IBC stage aided by the looming threat of falling into the IBC net. Yet, for outcomes to improve in terms of time, turnaround prospects and recovery rates, the implementation and capacity challenges need to be tackled.

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Justice Brandeis of the U.S. Supreme Court once wrote in a famous dissent on *stare decisis* that "in most matters it is more important that the applicable rule of law be settled than it be settled right."[2] This, of course, cannot apply to situations where fundamental rights might be at stake. But economic laws such as the IBC are ultimately about balancing interests of different stakeholders. There is probably no perfect way to achieve this balance, but once a scheme is decided upon, it gives some level of predictability and certainty to stakeholders. It is hoped that the IBC, through more consistent implementation and efficient disposals, could bring about such certainty.

Footnotes:

1 As exemplified by the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SARFAESI) or the Recovery of Debts and Bankruptcy Act, 1993.

2 Burnet v. Colorado Oil & Gas Co. (Justice Brandeis dissenting).