

## **Insolvency & Bankruptcy Code: A catalyst to Business and Investment in India**

### **I & B Code vis-à-vis Ease of Doing Business**

The Insolvency & Bankruptcy Code has proved to be one of the key legislative reforms that has, and continues, to aid India's path to self-reliant India on a high growth trajectory. The ease of resolving insolvency has significantly boosted the confidence of investors providing them with a well-defined medium to enforce their rights. The enactment of I & B Code along with other key reforms such as simplified GST regime has enabled India to emerge as 'Make for World' platform and have credited to surge in Foreign Direct Investment to the tune of \$74.5 billion (20% increase from previous year) in 2019-20.<sup>1</sup>

Each year's rank in the ease of doing business index usually reflects stakeholders' perception of reforms undertaken up to the month of May of the previous year. For instance, the 2020 rank, released last year, had captured these reforms undertaken in the year through May 2019. The positive influence of the enactment of the I & B Code on the investor community is evident from the fact that within three years of its enactment, Out of 21,136 applications filed, 9,653 cases involving a total amount of approx. Rs.3,74,931.30 Cr have been disposed off at pre-admission stage while 2838 cases were admitted into CIRP. In the 161 resolved cases, the realizable amount is Rs. 1,56,814 crore.<sup>2</sup>

Criteria	Before Enactment of I & B Code in India	After Enactment of I & B Code in India
Recovery Rate	26%	71.6%
Time taken for closure of case	4.3 years	1.6 years
Cost of resolution	9%	1%

Before implementation of the I & B Code, it was very burdensome for secured creditors to seize companies in default of their loans - foreclosure proceedings lasted almost five years, making efficient recovery almost impossible. The I & B Code introduced the option of reorganisation (Corporate Insolvency Resolution Process) for corporate entities as an alternative to liquidation or other mechanisms of debt enforcement, reshaping the way

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<sup>1</sup> Source: Highlighted in Prime Minister's speech dated 6<sup>th</sup> January, 2020.

<sup>2</sup> Year End Review, Press Information Bureau, 2019

insolvent firms could restore their financial well-being or close down. Companies now have effective tools to restore financial viability, and creditors have access to better tools to successfully negotiate and have greater chances to revert the money loaned at the end of insolvency proceedings.<sup>3</sup>

Having said this, ease of doing business is one thing, but what draws the attention of investors and businessmen is whether such ease of doing business helps in **economic growth through value creation and resolution of bad debts**? There are various instances testament of this. In the resolution process of Essar Steel India Limited, the amount of claims released by creditors was 82.91%. In the acquisition of Jaypee Infratech Limited, the 7<sup>th</sup> biggest defaulter, by NBCC (India) Limited, the amount of claim released was more than 100 percent (100.20%). This percentage of claim released might not be feasible in every case and the creditors are compelled to take haircuts, but the Code has most certainly provided possibilities for successful resolution and realization of debts (71.6% being the recovery rate) which wouldn't have been possible through any other legislation or restructuring mechanism, as is evident from here:

Medium	Recovery percentage (FY 2018)	Recovery percentage (FY 2019)
Lok Adalats	4%	5%
DRTs	5%	3%
SARFAESI	32%	14%
IBC	50%	43%

Further, swift, time-bound resolution or liquidation of stressed assets is critical for ameliorating the condition of 'twin balance sheet' problem, that is, when company gets distressed, its creditor banks get distressed impacting the credit growth, making it necessary to rescue the firm for value creation and improve NPA problem.

### **Resolution on a Commercial Basis:**

The I & B Code provides both the creditors and debtors the power to initiate proceedings. The main feature attributable to I & B Code is the commercial feasibility of insolvency resolution, wherein the commercial aspect is ring fenced from the judicial aspect and it limits the power of adjudicating authority to facilitate the insolvency process rather than adjudicating it on

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<sup>3</sup> Source: Ease of Doing Business Report, 2020.

merits. This results in a resolution that works on the market forces. The due importance to commercial wisdom ensures resolution from a market perspective than a long drawn judicial phenomenon. Despite getting haircuts, creditors are getting 200 percent of the liquidation value. This has only been possible because the enactment lets market forces of demand and supply play their role.

### **What is in Store for MSMEs?**

Setting start-ups in form of an MSME has never been safer in India, leading us to the next point of 'ease of operating small businesses' in India. Firstly, the minimum threshold to initiate insolvency proceedings has been raised to Rupees One crore (from Rupees One lakh), which largely insulates MSMEs. In pursuance of this, pre-packaged insolvency resolution process has been notified for debts above Rupees One Lakh and for defaults insolvency in respect of which was barred under Section 10A of the I & B Code. Pursuantly, the Central government has introduced an ordinance for a pre-packaged insolvency resolution process for micro, small and medium enterprises (MSME) under the I & B Code. The MSME sector got badly hit due to the CoViD-19 pandemic putting them in a stressed situation. The rationale for promulgating the I & B Code amendment ordinance has been to offer an alternative resolution mechanism to MSMEs that is quicker, cost-effective and value maximising outcomes for all the stakeholders, in a manner which is least disruptive to the continuity of their businesses and which preserves jobs. Pre-packaged insolvency is a hybrid, pre-planned process in which financially distressed company and its creditors reach an agreement for resolution of the company.

The USP of pre-pack is that it takes less time for conclusion, increasing the probability of revival of a firm, at a higher value. Since the process takes less time, the cost of process linked to time becomes less. Since the company continues with the existing management during pre-pack, it avoids the cost of disruption of business as it does not shift management to IRP to RP and then to successful Resolution Applicant and continues to retain employees, suppliers, customers, and investors. Further, unlike CIRP wherein despite the stipulated time frame, CIRP in several high-profile cases like Essar Steel and Bhushan Steel and Power got inordinately delayed, thanks to litigations, caused mainly by defaulting promoters, chances of frivolous litigation is minimum under pre-packs, because creditors and debtors will be at consensus prior to prepacks and thus issues regarding their rights, obligation and claims etc., can be resolved at prior stage which will save time and restructuring of companies and its growth with fresh perspective can start in no time. Pre-packs provide for 'debtor in possession' in which the debtor attempts to salvage value from assets after bankruptcy, and when it comes to small businesses,

they have been seen to possess more knowledge about their operations at the ground level and will be able to utilise more and more assets for better results and thus there will be less chances of liquidation of a company and thus it will ensure continuity of a business. Since the Pre-pack mechanism is relatively new and untested in the Indian market, we are yet to see how the market adapts to it.

### **Accelerating Investments through M&A Transactions**

The impact of I & B Code on M&A is immense which in turn aligns with the elemental jump in Ease of Doing Business rankings, since sale of distressed assets implies availability of business at reduced price leading to increment in local and foreign investment opportunities. As per the reports, till 2018, the M&A deals in distressed assets worth USD 14.3 billion were done in just 2 years of operations of the I & B Code. Most of the times even after rigorous due diligence has been conducted, litigation and financial issues still surface making it M&A transactions troublesome. Particular challenge posed while dealing with distressed assets due to the lack of information on these assets, a situation which is ameliorated by means of CIRP. The IRP/RP takes over the management of the company and is under mandate to provide certain information under Section 36(2) which has constitutes the subject matter for M&A due diligence also:

- i. Latest annual financial statements and audited financial statements for past 2 years- important for recognising PUFEE transactions
- ii. Assets and liabilities alongwith list of creditors and the respective amounts of debt including related party debts.
- iii. Details of guarantees, guarantors and stakeholders along with size of stake
- iv. Details of material litigations and investigations.
- v. Number of workers and employees alongwith their respective liabilities.

This, not being only a court-driven process, also constitutes a cost-cutting factor in due-diligence process. Further, the valuation of assets is carried out under a time-frame, making the process faster as compared to personal due diligence. This significance is enhanced by the fact that the Code leaves no room for the management of the company to sell of its distressed assets at a compromise price or divulge in any business that might cause deterioration of assets, by virtue of moratorium imposed barring disposal of any asset or transfer of legal rights by the investee. Out of the 12 highest defaulting accounts, 8 have been resolved through distressed M&A deals in India, that is, out of the outstanding debt of Rs.3.45 lakh crores of these accounts, Rs. 2.37 lakh crores has been resolved through distressed M&A investments. Most noteworthy

of these is acquisition of Essar Steel India Limited for US dollar 6 million, and that of Bhushan Steel for 7.4 billion. Such numbers/statistics boost the confidence of investors in investing through medium of I & B Code. Other attractions for investing in distressed assets are:

- i. Resolution Plan (takeover document) is approved by the Court and is legally binding, so investors are protected.
- ii. Licenses, permits, concessions etc. of target company remains intact.
- iii. Legal immunity is provided against criminal liabilities and PUFEE transactions of target company.
- iv. IBC prevails over all other laws, if there is inconsistency with other laws, investors will stand protected. Recent example being the prevalence of IBC over PMLA, where the assets of the company cannot be attached by the ED under PMLA if the company is under CIRP, and further by virtue of Section 32-A the prior criminal liabilities of company also stall extinguished.

### **How the CoViD-induced amendments affected M&A deals?**

Suspension of fresh insolvency proceedings has not affected the pending applications. In fact, as at the time of amendments, 2170 companies were up for resolution and 914 companies for liquidation. As predicted by the IBBI Chairperson MS Sahoo that there won't be any "white knights to rescue even viable companies", the statistics show that out of these companies only 42 companies were resolved in the first six months of FY-21. Hence, CoViD-induced M&A have definitely seen a decline. This has been further met by reluctance on part of investor to adhere to schedule of payments in the resolution plan, some resolution applicants (like Amtek auto case) even backed out from investing despite the plan being approved. The out-of-court M&As have seen a surge but same is not the case for I & B Code. The fate of these deals, despite of Code being back in its full form, is yet to be examined in light of the future fate of I & B Code due to surge in covid cases and impending lockdowns.

### **How I & B Code has changed India's credit culture**

#### ***Behavioural Change<sup>4</sup>:***

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<sup>4</sup> Source: IBBI Report on Monetary Management and Financial Intermediation

The I & B Code has brought about significant behavioural changes among the creditors and debtors thereby redefining debtor-creditor relationship. The inevitable consequence of a resolution process (the control and management of the firm move away from existing promoters and managers, most probably, forever) deters the management and promoter of the firm from operating below the optimum level of efficiency. Further, it encourages the debtors to settle default expeditiously with the creditor at the earliest, preferably outside the I & B Code. There have been many instances where debtors have been settling their debts on their own or settling immediately on the filing of an application with the National Company Law Tribunal before it is admitted:

Since the enactment of the Code in 2016, of the 18,892 applications that were dealt with, as many as 14,884 cases involving defaults of Rs.5.15 lakh crore were withdrawn by September, 2020 from various benches of the NCLT, before these applications were admitted by the Adjudicating Authority and 897 processes were closed mid-way by December, 2020. These figures indicate that almost 83 per cent of the CDs are getting resolved on the way, before the official commencement of CIRP under the Code on account of behavioural change among the defaulting debtors. Only 7 per cent of the CDs have undergone the entire process yielding either resolution or liquidation. Remaining 10 per cent of CDs are still undergoing the process.

I & B Code has shifted the process, from being debtor centric, to being creditor-centric. The Code has brought in better credit culture in borrowers as they are apprehensive of the initiation of insolvency, and resultantly, losing control over their assets. At the same time, the fear of insolvency proceedings, should not result in an atmosphere that demotivates young business owners. In fact the recent amendments in the corporate law legislations like that in Companies Act which seek to decriminalize certain corporate activities, and to reduce the penalties under other provisions would go a long way towards creating a business-friendly environment.

### ***Check on the Banks:***

Whenever the distress is not taken care of immediately, the value of that asset deteriorates. I & B Code helps the creditors recover whatever value there is. A lot of the current NPAs were legacy issues. In the absence of IBC, these would have continued to fester. The provisions of I & B Code ensure a check not only on promoters but also on banks. The approach of bankers had been to avoid a legal recognition of NPA accounts. Needless to say, the indolence portrayed

by banks has led to a major banking crisis. In fact, on a special investigation conducted by RBI, it was found that banks were concealing bad assets under the practice of forbearance, and followed their own methods. An accurate assessment of asset quality is an important responsibility of the RBI. Usually, the RBI conducted an Annual Financial Inspection to inspect the balance sheets of banks. However, owing to the mounting NPAs, and the feeling that some banks were underreporting their NPAs and postponing bad loan classification, the RBI came out with additional inspections on the balance sheets of banks to assess the genuineness of bank assets. The AQR was conducted in October, 2015. This was a special inspection where the sample size was much larger and most large borrower accounts were inspected. It revealed much higher level of asset quality deterioration, and that banks were concealing bad assets. In some banks, a loan that was non-performing was shown as performing. They were neither making adequate procedures for non-performing loans nor attempting to have projects put back on track.

I & B Code encourages timely and preventive action on the part of creditors, so that there can be redress at the earliest signs of distress, rather than prolong matters in a way where redress becomes impossible. The I & B Code enjoins the banks as creditors to enforce their contracts or renegotiate their contracts with their borrowers so that they are not in default in the first place. Bank books should reflect such renegotiation through asset classification and provisioning, and banks are required to report even a one day default and draw up resolution plans so that the borrower is not in default on the 180<sup>th</sup> day from the date of such default. One has to keep in mind that changes in credit culture take time. It's not an overnight phenomena. When you are trying to change the culture, those who were benefiting from the old culture will try to maintain *status quo*.

The general approach of bankers had been to avoid recognition of non-performance of accounts with stressed assets. Existing restructuring schemes by RBI were used for avoiding downgrade rather than resolving the asset, which is infamously called as 'borrower-banker nexus', implying that the banks indulged in the act of 'extending and pretending'. The I & B Code acts as a supervisory legislation to banks to refer specific cases of default against large borrowers for resolution, making it difficult for banks to neglect defaulters. The I & B Code creates Information Utilities, defined under section 3(21) read with section 210 of I & B Code which act as a ready electronic depository of the status of a loan. Financial creditors are required to submit financial information and information relating to assets in relation to which any security interest has been created in the manner and form prescribed. Such information is maintained by the IU and is made universally accessible under Section 214 of I & B Code. Such

information can be updated, modified, or rectified by any person in the required manner under section 216 of I & B Code.

Resultantly, the I & B Code has enabled the retrieval of higher value. Even though the resolution process does not create value, it ensures that if there is some value, the maximum is taken of it and the creditors get out with least damage. IMF and World Bank have praised the I & B Code regime in its Financial Sector Assessment Program 2017 quoting: India is moving towards a new state of the art bankruptcy regime. Making use of the recently enacted I & B Code, the RBI has identified several accounts that are non-performing and asked banks to follow up with NCLT for resolution/ insolvency in accordance with the time-bound process laid down in the Code. The move is expected to make a significant dent to the quantum of NPAs starting next year.

### **Ease of Exit for Companies**

India's legislative framework has been very stringent when it comes to entry and exit norms, with entry being licensed and exit next to impossible.

### **Result of Absence of 'Exit' Legislation:**

Back in the 1960s and 1970s, a large number of sick private sector enterprises were nationalised into public sector enterprises due to absence of a mechanism by which these enterprises could easily exit. Sooner than later, these public sector enterprises also became sick. The existence of an exit door for errant promoters was more or less non-existent. This ensured the promoters that they need not exit the firms irrespective of their performance and conduct. The 1991 reforms gradually liberalised entry in most of the sectors of the economy but 'exit' still posed a problem.

### **How IBC Has Helped:**

Implementation of I & B Code has led to the establishment of exit mechanism, which in turn has helped in eradicating crony capitalism from the economy. The Economic Survey 2019-20 shows that crony lending that led to wilful default, wherein promoters have collectively siphoned off wealth from banks. As of 2018, wilful defaulters owed their respective lenders nearly Rs. 1.4 lakh crore. I & B Code envisages a market mechanism to rescue firms in financial distress and to facilitate closure of firms in economic distress, in accordance with the processes



under the Code and rules and regulations made thereunder. Section 65 of the I & B Code further makes the exit scheme creditor-friendly by ensuring that the CIRP is initiated only on account of ‘inability to pay debts’ and for no unholy reason. Further, the provisions of Section 43-66 (avoidable transactions) resolves the issue of siphoning off of funds or any fraudulent transactions.

Particulars (As on Dec., 2020)	Rescued	Ordered for Liquidation
No. of Companies	308	1,112
Average time taken	441 days	328 days

Making the exit scheme a court-supervised process makes it a smooth and ‘blood-less’ change in management, with its eye on value maximisation, where the new management bestows upon itself to pay off the creditors of the corporate debtor when at the same time makes profit by investing in distressed assets at throw away prices. I & B Code has sent Indian corporates a message that either pay up your debts to the banks in a stipulated time frame or get ready to be liquidated or acquired. I & B Code has indeed set alarm bells ringing with almost every debt-stricken company trying its hand at debt restructuring or putting up distressed assets on sale, to either initiate its own CIRP or sooner or later their creditors will.