IBC: what it is and what it is not

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The Insolvency and Bankruptcy Code, 2016 (IBC/Code) is a noble law. Its long title reads: *"law relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximisation of value of assets of such persons, to promote entrepreneurship, availability of credit and balance the interests of all stakeholders, including..".*

Sole Objective

It is a law for reorganisation and insolvency resolution, that is, resolution of stress of corporate persons, partnership firms, and individuals. It envisages resolution in a time-bound manner for maximisation of value of assets of the stressed persons. Such maximisation of value promotes entrepreneurship, and availability of credit and balances the interests of all stakeholders. Thus, the sole objective of the Code is stress resolution of listed persons. If stress is resolved in the manner the IBC provides, like time-bound process, it yields several benefits, namely, maximises the value of the assets of the stressed person, promotes entrepreneurship and improves credit availability in the economy, and balances the interests of stakeholders. The objective is only one, while the benefits are many.

It is useful to recall the Tinbergen Rule, named after the first Nobel Laureate in economics sciences. The Rule prescribes a basic principle of policy efficacy that the policymakers should have at least one policy for each objective. There can be more than one policy to achieve one objective but having one policy to achieve more than one objective is troublesome. It is not easy to kill more than one bird with one stone, particularly when they are flying in opposite directions. There can be many policies for stress resolution. In fact, there are. One may resolve stress under the RBI's prudential framework, the Companies Act, 2016, or the IBC, or even outside any formal framework. Thus, IBC is one of the options available for resolution of stress. Resolutions under different frameworks yield different benefits: the benefits arising from resolutions under the IBC could be different from those accruing from resolutions under the Companies Act.

Two Ways of Resolution

In the case of a company, the Code provides for stress resolution in two ways, first by the rescue of the company through a resolution plan, failing which, by the closure of the company through liquidation. A company is under stress if it is not performing well, that is, the resources at the disposal of the company are underutilised. If the company has a viable business, it should be possible to revive it. The IBC provides for corporate insolvency resolution process (CIRP) that enables the market to find a feasible and viable resolution plan to revive the company. If such a plan is approved, the company gets a new lease of life, and resources are put to optimal use. If the company has an unviable business, the market is unlikely to find a resolution plan. In such a case, the company gets into the liquidation process which closes the company, releasing resources, including entrepreneurs, for optimal use elsewhere.

The Code enables the market to make the choice. The market usually chooses to rescue a company if its business is viable, or close it if it is unviable. In either case, the stress is resolved: the company either continues without any stress and uses the resources optimally, or disappears along with stress, releasing the resources for optimal use elsewhere. Both resolution plan and liquidation serve the same economic purpose: resolve stress by putting resources to optimal use. It does not matter whether stress is resolved by way of a resolution plan or liquidation. The IBC does not envisage stress resolution by a resolution plan only. Liquidation is equally efficacious in stress resolution. Since liquidation takes a little longer than a resolution plan to put the resource back to optimal use, the IBC requires the market to first explore the possibility of a resolution plan. The exploration need not continue long, the market could decide to commence liquidation as early as 30 days from the commencement of CIRP.

Thus, the IBC has only one objective, that is, stress resolution, and nothing else. Such stress resolution can happen in either of two ways, namely, resolution plan, and liquidation. The assessment of the working of the IBC must, therefore, consider whether the IBC is resolving stress and, if so, with what efficiency in terms of value retrieved, cost and time.

On Liquidations

Resolution of stress under IBC recasts the rights and entitlements of stakeholders. It even takes away the 'divine' right of the promoters to cling to the company. A promoter of a company, for example, which shifts to a resolution applicant through the resolution process under the Code, may cry foul of the IBC. It is not surprising that the IBC has several adversaries, who are out to malign the IBC for its failure to achieve something which it is not intended to or designed for. For example, some of them aver that the IBC process is yielding relatively more liquidations- only 678 CIRPs ended up with resolution plans while 2030 with liquidations till March 2023- and therefore, it is not good for the economy.

This is motivated and misleading. Liquidation is not bad as such. It is a legitimate means of resolution of stress. Considered even from the perspective of the adversaries, the numbers do not look that bad. 678 companies resolved by resolution plans had assets valued at Rs.1.70 lakh crore, while the companies referred to for liquidation had assets valued at Rs.0.64 lakh crore when they were admitted into CIRP. Thus, though in terms of number, three fourth of companies were resolved by liquidations, three fourth of distressed assets were resolved by resolution

plans in value terms. In fact, of the companies resolved by resolution plans one-third were either sick or defunct.

Further, rescue of 678 companies by resolution plans is only a part of the story. Over and above this, thousands of companies are rescued at different stages of the IBC process. For example, about a thousand companies were rescued by the withdrawal of applications after the commencement of CIRP. Thousands of companies are resolving distress in the early stages of distress. They are resolving when default is imminent, on receipt of a notice for repayment but before filing an application, after filing an application but before its admission, and even after admission of the application. Till March 2023, the stress of about 25000 companies was resolved after applications were filed for initiation of CIRP but before admission of the applications. If the universe of stressed companies is considered, the percentage of companies proceeding for liquidation is negligible, under 1%.

The incidence of liquidation under IBC is not different from that in advanced jurisdictions. In the USA, the stakeholders have the option of starting liquidation directly, without exploring a resolution plan. Of the insolvency proceedings initiated by them, about 60% start with liquidation. An attempt is made to rescue companies through a resolution plan in case of balance 40% of proceedings, of which some end up with liquidation. The sum of direct liquidations and liquidations on failure to have a resolution plan in the USA exceeds the liquidations under IBC.

It is important to note the kind of companies getting liquidated. Of the companies resolved by liquidation, three-fourths were either sick or defunct. At this stage, the value of the company is substantially eroded. The companies ending up with liquidation had assets, on average, valued at about 5% of the outstanding debt, when they entered the CIRP. If a company has been sick for years and its assets have depleted significantly, the market is likely to liquidate it. More companies would be rescued if stakeholders initiate the proceeding in the initial stages of stress. The companies which are getting rescued by resolution plans have assets, on average, valued at about 17% of the outstanding debt, when they entered the CIRP. IBC enables stakeholders to commence the process early and close it expeditiously for more rescues.

On Haircuts

Till March 2023, the creditors recovered only Rs.2.86 lakh crore against their claims of Rs.8.99 lakh crore through resolution plans. The recovery is about 32% of the claims, meaning a haircut of 68%. Therefore, the IBC has turned out to be a tool for haircuts, claim the enemies of IBC. This is equally motivated and misleading. The IBC is not intended to recover the dues of creditors. In fact, the law provides for and the Adjudicating Authority imposes huge penalties on the parties who trigger CIRP to recover their dues.

It must be noted that the companies, which have been rescued by resolution plans till March 2023, had assets valued, on average, at 17% of the amount due to creditors when they entered the IBC. This means that the creditors were staring at a haircut of 83% to start with. The IBC not only rescued these companies but also reduced the haircut to 68% for creditors. The haircut only reflects the extent of value erosion by the time the companies entered the CIRP. Despite the haircut, recovery under the IBC is the highest among all options available to creditors for recovery.

It is appropriate to see the haircut in relation to the assets available on the ground and not the claims of the creditors. Because the market offers a value in relation to what a company has on the table, and not what it owes to creditors. IBC maximises the value of the assets at the commencement of the process history. The realisable value of the assets available with the 678 companies rescued, when they entered the CIRP, was Rs.1.70 lakh crore. The resolution plans realised Rs.2.86 lakh crore, which is around 168% of the liquidation value of these companies. Any other option of recovery or liquidation would have recovered at best Rs.100 minus the cost of recovery/liquidation, while the creditors recovered Rs.168 under the Code. The excess recovery of Rs.68 is a bonus from the Code for the creditors while rescuing the companies.

It is axiomatic that a company coming to IBC does not have adequate assets to fully repay all its creditors. About two years ago, *Ghotaringa Minerals Limited, and Orchid Healthcare Private Limited* caught media attention. They together owed Rs.8,163 crore to creditors, while they had absolutely no assets when they entered the IBC process. Obviously, creditors had to take a 100% haircut. On the contrary, Binani Cements and MBL Infrastructure have yielded zero haircuts, in addition to rescuing the companies. The question arises why does IBC yield zero haircut in one case and 100% in another? It depends on several factors, including the nature of the business, business cycles, market sentiments, and marketing efforts. It, however, critically depends on at what stage of stress, the company enters the IBC, as much as at what stage a patient arrives in the hospital. The best hospital can do little if the patient reaches with a substantial haircut to his health. Similarly, if the company has been sick for years, the IBC may yield a huge haircut or even liquidation.

There are serious issues in the way haircut is being computed. It is typically total claims minus the amount of realisation divided by the amount of claims. This formulation does not tell the complete story. The amount of realisation often does not include the amount that would be realised from equity holding post-resolution, and through a reversal of avoidance transactions and insolvency resolution of guarantors. The amount of claim often includes NPA, which may be completely written off, and interest on such NPA. It may include loans as well as the guarantees against such loans. These deflate the numerator and inflate the denominator and therefore, project a higher haircut than it is. That is why the World Bank finds realisation of 71.6 cents on a dollar, implying a haircut of only 28%.

Assessing IBC

Motivated assessment is gaining some credibility in the absence of any systematic assessment of the working of the IBC in terms of its objective. There are a few non-motivated studies/ findings. They use parameters that are not necessarily reflective of the objective of the Code. For example, the World Bank Doing Business Report (DBR) tracks the outcomes of insolvency reforms. In terms of its resolving insolvency parameter, India's rank

improved from 136th to 52nd position in the first three years of implementation of IBC (DBR is not available for subsequent years). The DBR studies the time, cost, and recovery of insolvency proceedings to arrive at a score for resolving insolvency for an economy. For India, in the first three years, the overall recovery rate for creditors jumped from 26.0 to 71.6 cents on a dollar and the time taken for resolving insolvency came down significantly from 4.3 years to 1.6 years.

Considering the sole objective of the Code, one may consider six possible layers of outcomes of the IBC, as under:

(a) The growth, strength, and efficiency of the **insolvency ecosystem** consisting of insolvency professionals, insolvency professional agencies, registered valuers, registered valuer organisations, information utilities, Adjudicating Authority, Appellate Tribunal, IBBI, Government, Courts, etc.;
(b) The strength, efficiency, and efficacy of **processes**, namely, corporate insolvency resolution, corporate liquidation, voluntary liquidation, fresh start process, individual insolvency resolution, and bankruptcy. This reflects the use of the IBC process vis-à-vis other avenues for achieving the objectives.
(c) The growth and efficiency of **markets** such as markets for interim finance, resolution plans, liquidation assets, and insolvency services, along with cost efficiency, information efficiency, etc.;
(d) The impact **on businesses** on the cost of capital, capital structure, availability of credit, entrepreneurship, capacity utilisation, creative destruction, competition, and innovation, etc.;
(e) **Behavioural changes** amongst the debtors and creditors, trust of the creditors in debtors, meritocratic lending, non-observable impact, and proactive/ preventive impact of the Code; and
(f) The **overall impact** on employment and economic growth of the nation.

It is imperative to have a clearly defined framework of indicators to monitor and measure outcomes of the Code that are tracked and reported on a regular basis against the objective. This would facilitate informed public debate and encourage research in matters of policy design and implementation, while throwing up the concerns to be addressed.