SPEEDING UP SOLVENCY:
BANKRUPTCY REFORM IN INDIA
**Director’s Welcome**

*Every year, the India Business Initiative (IBI) at the Chazen Institute for Global Business organizes a research symposium/conference on key economic issues confronting India and the rest of the world. The conference typically takes place in January of each year in a major city such as Mumbai or New Delhi.*

In 2018, the symposium was on climate policy. Professors Geoff Heal and Patrick Bolton presented their research and participated in panel discussions with experts from India, including Mr. Jairam Ramesh, who is the Minister in charge of climate policy in India under the Congress administration, and professionals from the power industry.

This year the topic was insolvency and bankruptcy reform. The Indian parliament passed the enabling legislation in 2016, and since then significant amendments have been made through public hearings and discussions. This reform is arguably the most potent structural reform undertaken by the India government since independence. In one swoop, the rights of creditors have been dramatically elevated, altering the way in which business owners, banks, and investors think about corporate finance. Professor Ed Morrison of Columbia Law School and I drew on our research and participated in panel discussions and fireside chats with experts from India, drawn from the Ministry of Corporate Affairs, banks, law firms, and corporate borrowers.

To see coverage of this year’s forum, plus previous year’s events, go to [http://tinyurl.com/IBICazen](http://tinyurl.com/IBICazen).

The reform has the potential to increase foreign investment in India, and dramatically increase the efficiency with which financial distress in resolved. In the next section I offer a brief description of the evolution of bankruptcy reform in India.

**EVOlUTION OF BANKRUPTCY REFORMS IN INDIA**

An efficient bankruptcy code is vital to the smooth functioning of credit markets and capital allocation. The Insolvency and Bankruptcy Code (IBC), which came into effect in December 2016 is perhaps one of the major structural reforms in the Indian corporate sector. The introduction of this new code essentially supersedes the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI Act) of 2002, and the Reserve Bank of India’s asset restructuring proposals. IBC also replaces the fragmented approach to dealing with financial distress that existed prior to 2016, including the Sick Industry Companies Act, SARFAESI Act, debt recovery tribunals, etc. This new reform will squarely address the need to reduce the nonperforming assets in the public sector banks in India.
Bankruptcy Reform in India: Conference Summary

The objective of the Code (identified in the preamble) is as follows:

“...to maximize the value of assets, to promote entrepreneurship, to promote availability of credit, and to balance the interests of all the stakeholders. Each provision of the Code was drafted keeping these principles in mind, and the introduction of this legislation was done with the aim of replacing the existing framework for insolvency which was visibly inadequate, ineffective, and wrought with delays.”

Until the passage of this reform, bankruptcies could drag on for years: World Bank data show creditors in India recover just 26.4¢ on the dollar after 4.3 years; in the U.S. it’s 82.1¢ on the dollar in just one year. Under the new bankruptcy code, cases must be resolved within 270 days—otherwise the firms are pushed into liquidation. This represents an unprecedented transfer of rights and bargaining power to the creditors and a corresponding diminution of the rights of the so-called “promotor-shareholders” of companies, who in the past could run massive arrears with creditors with impunity.

Since the passage of the law, the Insolvency and Bankruptcy Board of India (IBBI) and the chief regulator, the National Company Law Tribunal (NCLT), have been set up to develop a complete ecosystem to deal with financial distress. In addition, the profession of insolvency professionals is being developed, as are information utilities.

After the IBC’s introduction there is some preliminary empirical evidence. On the basis of cases referred under the IBC until November 2018, there have been 66 resolutions and 260 liquidations: 74% of these liquidations were associated with “gone concerns”—not “going concerns.” The average time taken has been 300 days—a sharp fall from 4.5 years average in the past! But perhaps the most stunning fact is that in 4,000 cases, creditors withdrew the cases, as promotor-shareholders offered attractive restructuring to creditors. This shows that the IBC has strategically shifted the bargaining power in favor of the creditors. The potential loss of control is a sufficient threat that the promotor-shareholders pay off the dues to avoid the bankruptcy process itself. Nearly, 2.03 trillion rupees were settled in this way (a sort of “prepackaged resolution”). This figure will dramatically improve the recovery rate to lenders, which do not enter into the official statistics of the World Bank, which evaluates only the cases processed through the bankruptcy system, not the ones that were withdrawn due to restructuring.

The IBC transfers the control to the creditors upon the invocation of bankruptcy process. Both the operating creditors and financial creditors can invoke the law.

In summary, the IBC reform has the potential to alter the shape of credit markets and increase corporate investments in India. It also curtails the incentives to take excessive leverage.

The India Business Initiative was pleased to host this year’s forum in Mumbai. What follows are the comments of many of our distinguished panelists, each of whom comes from a different perspective. We hope you will find their observations illuminating.

Suresh Sundaresan
Director, India Business Initiative
Chase Manhattan Bank Foundation Professor of Financial Institutions
Columbia Business School

KEY AMENDMENTS

The following key amendments have been made since the passage of the law to improve its effectiveness.

- IBC now allows promotors of small and medium companies to bid for their enterprises which are undergoing the Corporate Insolvency Resolution (CIR) process provided they are not willful defaulters.

- In order to reduce the “holdout” problems, lenders can decide turnaround or liquidation by a 66% vote, down from 75%. This will speed up the resolution process.

- Other key amendments attempt to widen the pool of bidders for distressed assets.
2019 CONFERENCE PHOTOS


2. Journalists gather around Rajnish Kumar, CEO of State Bank of India.

3. Edward Morrison offers the US perspective.

4. Injeti Srinivas, Secretary to the Ministry of Corporate Affairs, Government of India, chats with reporters after his keynote address.

5. Rajnish Kumar, CEO of the State Bank of India, offered his perspective during a keynote speech.

6. Attendees network with Narendra Mukumbi of Shree Renuka Sugars Ltd (left), Rahul Kanodia of Datamatics Global Services Ltd, (second from left) and Suresh Sundaresan of Columbia Business School (second from right).

7. Attendees at the pre-event reception.

8. Kaustubh Kulkarni of JSW Steel makes a point during the panel discussion.

9. Panel participants (left to right) Suresh Sundaresan, Narendra Murkumbi, Kaustubh Kulkarni, Yash Rana, Suharsh Sinha, and Edward R. Morrison.

10. Suresh Sundaresan poses a question to Narendra Murkumbi.

11. Hemant Das (left) and Chaitanya Kalipatnapu (center) of Eruditus Executive Education chat with Joshua Safier of Columbia Business School.

VIEW THE VIDEO
Panel discussion on “India’s Insolvency and Bankruptcy Code: The Business Perspective”: https://tinyurl.com/IBI-Panel
Any law faces a three-pronged test to determine if it is successful: Is the law a better standard than what came before? How well can the law be implemented? Does it impact behavior?

We now have just over a year of outcomes to look back on and, as with any major reform, the strength of the resolve and the underlying commitment regarding the Insolvency and Bankruptcy Code (IBC) of 2016 are still being tested. But by any measure, this very modern insolvency framework passes the litmus test.

India proved that we don’t believe in an incremental approach to creating a bankruptcy statute. We want to leapfrog to be among the best in the world.

We have realistic expectations. Many issues still have to be accepted and clarified, and the country’s institutions will have to mature.

Some of the key intents of the IBC are crystalizing:

- You cannot have an easier process. Any creditor can trigger a bankruptcy investigation. A cash flow and not a balance sheet test is used to determine insolvency. Inability to pay debts is sufficient. It’s an onerous responsibility. The debt that becomes due has to be promptly paid.

- The act protects the borrower’s ability to operate while the proceedings play out. Whatever contracts needed for a company to be a going concern must be maintained. Whatever contracts that are burdensome or excessively skewed can be extinguished.

- Still, the balance of power has shifted from the previous regime, in which the borrower remained in control of operations. Financial creditors are in charge—shareholders had their day and cannot exercise any approval rights over a resolution plan. [Although they are entitled to the same liquidation value], operational creditors also cannot participate in drafting the plan.

The exclusion of operational creditors from the resolution plan is seen as a deficiency of our system. But the preamble of the law says the intent is to maximize the value of assets for all [parties]. In the 66 cases that have been resolved, operational creditors have recovered 47 percent of their claims, and financial creditors have received 45 percent.

- The process is time bound. The Corporate Insolvency Resolution Process is to be completed within 180 days and if necessary extended by another 90 days. The Reserve Bank of India too mandates banks to move quickly. If a non-performing asset is not resolved within 180 days, the bank has to file for insolvency proceedings.

Even though the value of liquidations is currently five times that of resolutions, we expect to see more successful resolutions as debtors wade through the backlog.

In fact, the biggest story that’s not captured by the statistics is that the lending and borrowing culture in India is changing. We are seeing mediations between debtors and lenders. An estimated 4,500 cases have been settled by mediation compared to 66 reported resolutions. This dispute settlement is happening outside the system.

Establishing a pathway to bankruptcy that provides transparency, competition, and rigor to the process makes doing business in India more binding.
WE NEED FASTER RESOLUTION

The IBC is one of the most significant reforms to have happened in the course of reform in India. In any market economy, the first principle is the survival of the fittest. In the absence of the code, the relationship was entirely in favor of the borrowers. Once you’ve dispersed the money, it is your turn to chase the money. It was not unusual to hear borrowers tell banks, “The loan is your problem. You have to find the solution, not us.”

The new framework is not now completely in favor of creditors, but it’s balanced. Now borrowers face a real danger that they could actually lose their enterprise. This was unthinkable two years ago.

The very fact that lenders have a remedy is sufficient to bring discipline. [Since IBC was implemented] we have seen hesitation not only on the part of creditors but also borrowers. One of the main problems before was companies asked for too much credit. Now, when borrowing is at the discussion stage, companies ask for financing of 65/45 debt/equity, not around 85/15, and explore the possibility of deleveraging at a high level. Banks are enhancing due diligence.

When the Committee of Creditors works on a resolution plan, it’s not the financial security of creditors alone that has to be maximized. Ultimately, it is who is the best person to preserve the value of the enterprise. If buyers are involved, are they serious enough to run the company for another 10, 20, 30, 50 years?

I don’t have a single example of a board turning down decisions made by a committee of creditors.

But this is not the end of the story. The law is new. All parties are in a learning stage. The people who represent the bank were never so empowered to make decisions. As an organization, how do we give them confidence to make right decisions that will come before boards?

And there is the issue around augmenting India’s legal infrastructure. One bench cannot handle all the appeals. It is important to have an adequate number of courts.

Today most of the litigation is around Section 29A [which prohibits related parties from bidding for assets]. In my view, this section is being stretched too far and causing procedural delays. Once the resolution plan is approved, nobody should be allowed to make changes. Otherwise nobody will take the bidding process seriously.

And there is a need for stiff penalties against bidders who are not serious.

As we progress, I’m sure the Supreme Court of India will make announcements and we will have more clarity around the contentious issue of 29A and B. I can say with confidence that whatever decisions are reached will help strengthen this important piece of legislation. We can move faster. At least the IBC provides a remedy.

Without lending by banks the country cannot prosper. But we need faster resolution.
Troubles with the Judiciary

The NCLT [National Company Law Tribunal], the judiciary, is a critical link in the IBC process and it is vital that the functioning of the NCLT does not in any way compromise the operation of the IBC. The greatest example is in January, the State Bank of India put its loan in Essar Steel up for sale in the secondary market, even though the bank was going to get an 85 percent recovery from the bid made by ArcelorMittal. The fact that the largest public sector bank was looking to divest its stake in Essar Steel shows that it had little faith in the matter being resolved by the NCLT.

NCLT judges come with a socialist mindset, prevalent in the days under the old act. At the end of the 180-day process, if there’s been no progress, the company is supposed to be liquidated. But the judges feel that liquidation is the worst possible outcome, which means loss of jobs, loss of income, further provisioning for banks. Because of that, zombie companies are being kept artificially alive with plans that are not commercially viable.

My view is that the bankruptcy code is a conduit to realizing the true economic value of a firm as opposed to enhancing the value of a firm. If the committee of debtors feels a company should be liquidated, we should not infantilize the thought process of creditors and give them what in their view is commercially correct.

The second issue is a tendency to legislate. The job of the judiciary is to interpret the law but not to create law. But we have seen judges change important provisions. For example, the code requires that operational creditors be given their liquidation value. The NCLT in the Binani Cement case held that result unfair, saying small creditors should recover value at par with the banks. If it was unconstitutional, the judge could strike the law down, but the NCLT cannot make a policy call on how the legislation should be.

“Zombie companies are being kept artificially alive with plans that are not commercially viable.”

—SUHARSH SINHA

Also there have been cases where the NCLT has interfered with the mechanics of a resolution plan approved by lenders. For instance, it said in an order that you should not be paid debt over 15 years, but 10 years—or something to that effect. Don’t pay at a coupon of 8 percent, but at 8.5 percent etc.

Then there’s the capacity issue at the NCLT. There are 11 benches and a few more are being set up. But some are more burdened than others, basically reflecting the heat map of commercial India. There needs to be more judges in these jurisdictions.

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Partner
AZB & Partners

THE LEGAL EXPERT

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Then there’s the capacity issue at the NCLT. There are 11 benches and a few more are being set up. But some are more burdened than others, basically reflecting the heat map of commercial India. There needs to be more judges in these jurisdictions. Secondly, there is only one appellate tribunal. There needs to be more. Essentially the decisions are getting stuck. Lastly, we need dedicated benches of the NCLT focusing only on bankruptcy. It’s important that the judges understand the dynamics of resolution plans. •
I've experienced the IBC both as a controlling shareholder and as someone who has bid for assets under IBC. So it's been interesting to see the perspective from both sides.

I have been an entrepreneur since graduating from university in 1994. Most recently I founded and headed Shree Renuka Sugars, which was acquired by a global company as part of a debt resolution in March 2018, but the whole deal was structured outside the IBC.

We all grew our companies rapidly in a more optimistic time of liquidity and a big surge in commodity prices. In 2008 banks across the world closed the taps of liquidity and a lot of leverage had to be resolved post-2015.

Today, there is a lot more clarity than when the IBC law was new in 2016. When we started our deleveraging procedures, not a single case had been resolved from start to finish. But going forward, I think for every case that goes into IBC, two cases will be resolved outside it.

The process is clearly overloaded, but I believe the IBC is right in its concept. It gives managers a boundary. If you cannot stay within that boundary you will lose your company.

I have issues with the time allowed. The stringent 180-day timeline probably destroyed value that could have been recovered in some of these situations. You need to give companies a year.

You’ve effectively had a stay for the last four months as companies have gone to the supreme court to clarify legal issues. People have bought time somehow.

A big factor in terms of value maximization has been sector policy. The best example has been in the steel sector where regulations allowed new foreign investors to acquire assets at a fairly decent valuation. It’s been a great outcome for banks.

Shree Renuka benefited a little as we completed our process outside IBC. The government of India came out with several policy measures to support the sugar sector. That helped to hold our valuation. [Singapore-based Wilmar Sugar Holdings converted convertible debt to equity last March, and subsequently invested additional equity into the business.]

As a potential acquirer, we are looking at assets both inside the resolution process as well as the liquidation process of going concerns. We still have little precedence regarding issues such as what happens with tax, licensing, and allotments of resources. For example, a cement company has a limestone concession. Does that transfer along with the sale?

It’s going to take time to settle more legal issues before people become confident. What would really help unlock value is legal precedent, which will probably come in a year or two.

“"I have issues with the time allowed. The stringent 180-day timeline probably destroyed value that could have been recovered.”"

—NARENDRA MURKUMBI
As partner at a US-based law firm representing global investors in India, most recently with the bid for Bhushan Steel, I’d like to make three observations brought about by the IBC as it affects foreign investors.

- Some foreign investors are buying debt in the secondary market and using that as a foothold to work with the distressed company either through the IBC process or outside of it, to improve their leverage and their valuation as a result.

- The process is a hostile situation, not common in Asia, and that puts investors at an information disadvantage. Promoters are not dying to share a lot of information and may not even be around.

- Promoters increasingly fearful of losing their company are proactively approaching existing lenders to find a resolution and approaching new investors to bring in fresh capital to deleverage their company. Traditional private equity clients are finding opportunities at more attractive valuations.

That said, there are more regulations for a foreign investor coming into India than just about any other country I’ve seen in Asia. And different industries are highly regulated. Recovery procedures in some industries are very significantly different than in others.

I would say, having worked on Indian matters since 1997, the IBC has been a major step forward. Statistics on debt collection and timing have improved radically.

And imperfections aren’t surprising. The US code was adopted in 1978 and continues to evolve through bankruptcy court judgments. We will see that in India as well.

I would encourage the regulators not to rush into making amendments but to discuss regulatory changes with the marketplace, whether through open forums or more targeted discussions with particular groups. Very often there are unintended consequences when you make amendments without input.

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—YASH RANA
Let the Money In

The steel industry has undergone the largest consolidation/restructuring/resolution under the IBC process. The fact that 20% of the Indian steel industry is getting resolved or will be resolved over the next six months is a big deal. That’s a great achievement under the IBC.

My perspective as head of JSW Steel, the largest steel producer in India, is as a participant who has tried to acquire a lot of companies that have become available in the IBC process.

My feeling is the code is moving in the right direction. But we have learned numerous lessons. When we started, we thought the process would be straightforward. You call for bids and the highest bidder would acquire the asset. We forgot that, by nature, India can be litigative.

Bidders learned they are in a competitive landscape. Maximization of value doesn’t mean for one lender. The resolution plan is structured to make the unit sustainable for the future as well as for lenders.

When you start doing due diligence on an asset, bidders realize bankruptcy proceedings are no different from a very hostile takeover situation. These promoters are being forced to give up their companies. To get full access to data, to be fully aware of what lies ahead, is a challenging process.

Then there’s financing. The ability of any Indian company to get financing for an acquisition has historically been limited to India. Today’s financial system is going through a bit of a churn. The country’s assets are consolidating in fewer hands, so those fewer number of groups need more money. But regulation restricts banks from lending more money to the same corporate groups. They don’t have fresh capital unless the Indian government infuses money into public sector entities. So the financing capacity has actually been reduced lately.

Foreign financial players were putting a significant amount of capital in, but even that is now more limited because regulations prohibit them from taking more than a specific exposure. Unless the funding space opens up, the ability to resolve those assets will be restricted at some point.

One of the arguments was that nobody invests in Indian distressed debt because there wasn’t an effective mechanism to retrieve your investment. That has changed with the IBC.

—KAUSTUBH KULKARNI

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Group Head, M&A and Strategic Financing
JSW Steel

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The US Bankruptcy Code is now 40 years old. Although the statute has not changed much for corporate bankruptcy since 1978, we’ve seen a sea-change in bankruptcy practice, especially in large corporate reorganizations. I suspect that we will see similar evolution in India. Even if the text of the IBC remains the same during the next few decades, bankruptcy practice in India will change substantially, at least if the experience of the United States is any guide.

40 YEARS OF THE US BANKRUPTCY CODE

If we look back over the past 40 years of experience under the US Bankruptcy Code, and if we focus on bankruptcy filings by large corporations, here are some of the changes we see:

- **Speed:** The process became much faster. In 1980, the typical bankruptcy case took 3.5 years. Today, a large corporate reorganization takes 5 months.
- **Planning and prepacks:** Corporations “plan” for bankruptcy and use the process to nail down a deal that was negotiated prior to filing the bankruptcy case. So-called prepackaged and prenegotiated cases accounted for about 0% of cases in the early 1980s and now account for about 50% of cases.
- **M&A strategy:** The bankruptcy process is used to consummate deals. It is where distressed M&A is concluded. In the early 1980s, it was rare to see a firm sold off as a going concern in bankruptcy. Now that occurs in at least one-third of cases.
- **A market for debt (“vulture” investing):** The bankruptcy process is highly competitive, with specialized investors (especially distressed debt hedge funds) buying the debts of banks (and other lenders) and challenging the proposals of firms and other creditors in bankruptcy.

For example, the US defaulted and distressed debt market grew in size from about $200 billion in the early 1980s to about $414 billion recently (the market grew to about $2 trillion in 2008, just as the financial crisis was peaking).

- **Bankruptcy’s rarity:** Business bankruptcy filings are rare in the United States. Among businesses generally (regardless of size), there are fewer than 15 bankruptcy filings for every 100 business deaths. The speed and predictability of the US bankruptcy process, which occurred over a 40-year period, has made it easier for firms and their creditors to negotiate deals outside of bankruptcy. It’s easier to reach a deal outside of bankruptcy when the outcome in bankruptcy is predictable.

The US experience, I think, boils down to at least one takeaway message: An effective bankruptcy process requires a balance of (a) clear rules and (b) flexible administration by expert regulators. Rules should spell out creditor priorities and corporate boundaries, timelines for making key decisions (e.g., interim financing), and conditions under which bargaining will be stopped and dissenters forced to accept the will of the majority. At the same time, investors need a flexible system that allows all parties to use the bankruptcy rules to challenge potentially inefficient or inequitable proposals by the
firm’s managers or its major financial creditors (e.g., secured creditors). For example, in the US, creditors can influence key bankruptcy decisions—such as the covenants included in interim financing (“debtor-in-possession loans”), whether current managers are replaced, whether assets or contracts are retained or sold off, whether the firm pursues litigation against related entities (such as a parent company)—by filing objections to proposed decisions and forcing the bankruptcy judge to hold expensive and lengthy hearings to evaluate those decisions. This flexibility has benefits and costs. On the benefit side, flexibility provides avenues through which creditors can prevent waste, self-dealing, and inefficient decisions in bankruptcy. On the cost side, flexibility could be used by creditors to “hold up” the bankruptcy process solely to extract a better “deal” from the other parties. Thus, an effective bankruptcy process must have expert judges and other administrators who can identify and stop situations where creditors are exercising “hold up” power.

In other words, clear rules increase the incentives of lenders to make loans to corporations and to buy the debt of distressed firms because it’s easier for banks and other investors to predict their recoveries when rules are clear. Flexible administration has the same effect—increasing credit to borrowers and making distressed debt more liquid—because investors can use that flexibility to influence the bankruptcy process in ways that maximize firm value and creditor recoveries, subject to oversight by judges and administrators.

CLEAR RULES

Judged along the first dimension—clear rules—the IBC seems to be a model of clarity in many respects, including the process for initiating a case, timelines for completing the case, and the infrastructure (the NCLT, the IBBI, and resolution professionals) for running the process. Although clarity in these domains is important to investors and borrowers, critical uncertainty remains in several areas of Indian law.

First, rules must be clear both in and outside of bankruptcy because bankruptcy laws work in tandem with non-bankruptcy laws (e.g., contract law, secured lending law, leasing law) to provide stability and certainty to commercial activity. Let me illustrate this point using the United States as an example: The US bankruptcy law is debtor friendly, as everyone knows, but our bankruptcy law is a special set of rules that apply only when a firm starts the bankruptcy process. Until that process is started, the laws governing debt collection laws are extremely creditor friendly. For example, it’s relatively easy to obtain a judgment against a defaulting debtor and foreclose on its assets. In states such as California and Texas, for example, 50% of residential foreclosures are completed within 18 months. In New York, a contract dispute is typically resolved within about a year.

My understanding is that, in India, it takes much longer to resolve contractual disputes and collect debts. Indeed, the IBC seems to be a response to the high costs of using the civil litigation system by operational creditors. To date, nearly 50% of IBC cases have been commenced by operational creditors, many of whom seem to be simply seeking to resolve a contract dispute. Many cases are withdrawn soon after the contract disputes are resolved. The IBC is therefore doing “double duty,” at least as compared to the US system. In the United States, non-bankruptcy laws (contract laws, secured lending laws, etc.) provide a ready device for resolution of contract disputes between a firm and a counterparty (“one-on-one disputes”). Bankruptcy law, by contrast, is a special device for situations where a firm has become insolvent, is suffering multiple defaults, and needs a collective proceeding to resolve these mass defaults. In India, by contrast, the IBC seems to serve as a device for resolving both (a) one-on-one disputes and (b) mass defaults. The IBC therefore serves a function (one-on-one disputes) that, in the United States and many other countries, is served by non-bankruptcy laws. This double-duty problem seems, to me, to place a substantial burden on the bankruptcy process in India. I wonder whether, 40 years from now, reforms in non-bankruptcy law will reduce that burden and allow the bankruptcy courts to focus exclusively on the traditional domain of bankruptcy law—the resolution of mass defaults.

Turning away from non-bankruptcy law and focusing on the IBC itself, there are several troubling areas of uncertainty. One is the treatment of operational creditors. They have little or no voice during the bankruptcy process. Although the IBC has been amended to elevate the priority of operational creditor claims, and although the NCLAT has taken steps to prevent discrimination against operational creditors, I worry that the...
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—EDWARD R. MORRISON

An investor can acquire 35% (or more) of financial creditor debt and, as a result, obtain the power to block resolution plans, even when those plans are value-maximizing.

FLEXIBLE ADMINISTRATION

So far I’ve been talking about the certainty of legal rules. The past 40 years in the United States suggest that flexible administration is an equally important element of a successful bankruptcy law. Along this dimension, I wonder whether we will see changes going forward in India.

Here is one example: Is the 270-day deadline too short for a large number of firms? In the United States, practitioners talk about two types of bankruptcies—planned cases and “free-fall” cases. Planned cases involve firms whose distress is well recognized: the resolution plan is crafted even before the bankruptcy filing is made. These cases—often called “prepacks” or “prenegotiated cases”—can take two or three months but sometimes take much longer, especially when negotiations are unexpectedly complex. The other type of case—“Free fall”—involves firms that have suffered unexpected setbacks due to operational problems, catastrophes, poor planning, or an impasse in negotiations with creditors (or some combination of the foregoing). These firms enter bankruptcy suddenly and can take many months or even years to resolve. Free-fall cases account for perhaps 40% of cases. Thus, in the United States, a substantial proportion of cases require more (much more) than 270 days to conclude a restructuring.

In the future, will the IBC’s 270-day deadline be stretched, perhaps frequently and substantially? My understanding is that, under Indian law, it is difficult to implement a prepackaged plan of reorganization. If so, a key ingredient that ensures speed under U.S. law is often unavailable in India. Perhaps unsurprisingly, then, we are already seeing many breaches of the deadline. The Essar Steel case is still ongoing, over 600 days after it began. An IBBI report indicates that, as of September 30, 2018, 238 cases were still pending more than 270 days after initiation of the case. To be sure, lawmakers were likely aware that the 270-day deadline is too short for many cases. They may have opted for an unrealistic deadline in order to make clear that the IBC is a sharp break from the past, when the average bankruptcy cases took 4.3 years to conclude, according to World Bank data. Nonetheless, I worry that, because the 270-day deadline seems unrealistic, it will be breached so often that it becomes a rule in name only, especially in large cases.

Another example is the role of promoter shareholders. Under current law, there are complex (and evolving) limits on their ability to participate in the resolution process. In the coming years, might they be given greater opportunity to participate? In the United States, promoter shareholders are generally thought to have the best information about the firm’s current and potential value (this is especially true in small-business cases). It is for this reason that US law gives promoter shareholders the power to start the bankruptcy case and the exclusive right to propose a resolution plan during the first few months. If promoter shareholders were freely permitted to propose resolution plans under the IBC, they might sometimes propose the most attractive plans, i.e., plans that impose smaller haircuts on creditors than any resolution plan proposed by other parties. The Essar Steel bankruptcy may be such a case. In the future, will the IBC evolve in ways that reduce the constraints on participation by promoter shareholders?

Finally, I wonder whether the IBC will become more flexible in dealing with creditor conflict. I have two kinds of creditor conflict in mind. Here is one: Under US law, we worry about creditors (especially distressed investors) who acquire “blocking positions” that prevent a majority from voting for a plan. That can happen under the IBC too, because an investor can acquire 35% (or more) of financial creditor debt and, as a result, obtain the power to block resolution plans, even when those plans are value-maximizing. Under United States law, courts use “cram down” to overcome blocking positions. Even if a sizable minority is opposed to a plan, these “hold out” creditors can be forced to accept a plan if it can be shown that these creditors will be paid in full (eventually) or that no one junior to these creditors is receiving any value under the plan. Might the IBC evolve in ways to handle
such “hold out” creditors? Some evolution has already occurred. In 2018, the IBC was amended to reduce the voting threshold for key decisions by the committee of creditors, including the decision to accept a resolution plan. Prior to 2018, a resolution plan required consent from committee members holding at least 75% of financial debt. Now members holding 66% of debt can approve the plan. By reducing the voting threshold, the IBC has made it harder to obtain a “blocking position” (previously, holding over 25% of financial debt gave you a blocking position; now you need to hold over 34% of the debt). This is an important start, but it’s still possible to obtain a blocking position and stymie an efficient plan. What is the future of cram-down in India?

Here is another type of creditor conflict: A firm may have senior and junior financial creditors. The senior creditors have higher payment priority. Because of this, the senior creditors may favor a quick resolution plan that pays the claims of senior creditors but may pay little or nothing to junior creditors. Senior creditors favor such a plan because they get paid in full quickly. If senior creditors hold 60% of the financial creditor debt, they can impose this plan on the junior creditors, even though a better plan might be possible if the resolution process was slowed down long enough for other resolution plans to be put forward. In the years ahead, might the IBC develop ways to prevent senior creditors from harming junior creditors in this way? To be sure, recent legal developments have begun to address this problem. The NCLT has held that the creditors committee cannot seek liquidation without first inviting bids (via an “expression of interest”) from potential buyers (“potential resolution applicants”). Additionally, recent amendments to the IBC make clear that potential buyers must be given at least 30 days to submit bids. These legal developments are a good start. It will be interesting to see whether additional tools and techniques are developed to address creditor conflict in the years ahead.

CONCLUSION

In the previous paragraph, I pose several questions about the future of the IBC. I ask these questions because much academic research indicates that it’s very important to pay close attention to the details of a country’s bankruptcy code, especially its relationship to other non-bankruptcy laws. Together, bankruptcy and non-bankruptcy laws determine the extent to which a nation’s laws are “debtor friendly” or “creditor friendly.” It’s not obvious that one is better than the other. “Creditor friendly” laws increase returns to creditors and lower the costs of credit, but these laws also expose entrepreneurs to the risk of liquidation when their businesses enter distress. Faced with this risk, entrepreneurs may take on less debt, grow more slowly, and engage in other strategies that reduce the risk of distress and liquidation (such as hoarding cash and other liquid assets that can be used to pay creditors). These actions can slow economic growth.

The optimal balance between “creditor friendly” and “debtor friendly” laws is not yet known. I am therefore not arguing that the IBC (or the US Bankruptcy Code) has gone too far in one direction or the other. My goal in this essay is only to draw attention to features of the IBC that may need greater study going forward. 
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