Theoretical Framework of Behavioural Law – IBC

A Study

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Abstract

The Insolvency and Bankruptcy Code, 2016 (IBC) is a behavioural law that is based on a comprehensive theoretical framework in formulating its objectives. The Maximisation of Assets Value, Going Concern Concept, eliminating the non-insolvency creditors from protection, promoting entrepreneurship development, and ultimately balancing the interests of stakeholders. The theoretical framework has origins in each of the objectives as mentioned earlier and the same are addressed in this paper. The paper also focuses on an inclusive approach to addressing corporate insolvency resolution in the interest of all the stakeholders. It addresses how the theory has the dynamics of the market as the determinant factor in the entire process of resolution. The role of the judiciary is comprehensively addressed in the insolvency legal framework with differing theoretical frameworks. Furthermore, they substantiated the impact of certain issues, viz., Information asymmetry, holding problems, conflict of interest in value estimation and investment incentives and debt overhang, the transformation of India's credit culture and deeming provisions in the Indian insolvency law and how they are utilised prudently. Therefore, IBC and its ecosystem are built with a substantial theoretical framework to address the critical issues of insolvency resolution and bankruptcy.

Introduction

The Insolvency and Bankruptcy Code, 2016[1] (IBC) is a market-driven behavioural law that balances the interests of stakeholders with a strong theoretical background. The IBC is designed by the Bankruptcy Law and Reforms Committee, 2015[2] (BLRC) drawing lessons from the lessons from the pre-IBC era in India and also borrowing several theories and models from abroad from several countries. The Four Pillars of IBC with a strong ecosystem ensures ease of doing business. **Anuradha Guru and Medha Shekar**[3]. In the interest of a better ecosystem of effective corporate restructuring, unviable units must be permitted to exit. Accordingly, to Joseph Schumpeter[4], ease of entry and exit provides a great boost to entrepreneurship in the ecosystem. IBC provides a platform and systematic mechanism for the same.

Accordingly, the paper has the following objectives:

1. To comprehend what is the theoretical framework of Bankruptcy Reforms
2. To understand, why do we require the theoretical framework?
3. To discuss the efficacy of these theoretical frameworks in addressing the issues of Bankruptcy Reforms

We can comprehend the theoretical framework of bankruptcy legal framework broadly into two dimensions - a) Traditionalist and (b) Proceduralist theories. The same can be addressed: a) What and why of the Bankruptcy legal framework; b) how does the theoretical framework and to what extent address these questions? Douglas G. Baird (1998)[5] addressed these theoretical aspects. Korobkin (1993)[6] focused on an inclusive approach in addressing corporate insolvency resolution intending the interests of all the stakeholders. Their approach focuses on the going concern concept in corporate reorganization and avoiding liquidation.

The approach of traditionalists is fundamentally focused on eliminating the non-insolvency creditors from protection. The process is intended to include only insolvent creditors as stakeholders for protection. They may include non-insolvency creditors provided that it enhances the maximization of value of assets, (Alan Schwart.,1998)[7]. This theory has the dynamics of the market as the determinant factor in the entire process of resolution. Their effort is to prevent premature liquidation to explore the possibilities of coordination among creditors. The theory considers that fairness or equality of distribution, i.e. interests of employees or other stakeholders cannot be a part of insolvency law, and perhaps could be outside the legal framework. Their philosophy is based on fairness and equity of the stakeholders could promote the reorganization and avoid liquidation.

Similarly, the role of the judiciary in the insolvency legal framework differs in both philosophies. The transparency and integrity in the process and minimization of conflicts among the stakeholders are envisaged in the judgement by Traditionalists. The result is weighed based on the facts of each case with the discretion of the judges, rather than on the commercial wisdom of the creditors.

The review of Ted Janger (2001)[8] on the works of Baird's works gives excellent findings. To trace the works of Baird, he focused on the answers to three axioms to draw broad distinctions among the philosophies of both Traditionalists and proceduralists. These anxious include (i) Is it the purpose of the Bankruptcy legal framework to provide rehabilitation to sick companies; (ii) Should we expect the judiciary to exercise its judgment to change the non-bankruptcy entitlements to provide rehabilitation; (iii) Are we banking up on the rationality and capabilities of the judiciary in drawing distinctions between likely success and failure of the prospective candidates in the rehabilitation or reorganization.

As we have comprehended, a firm becoming insolvent has two options: (i) Out of Court pre-packed restructuring; and (ii) Formal Resolution of disputes through legal and judiciary. The formal bankruptcy legal framework and procedures focused on balancing the interests of stakeholders. Balancing is required as their interests are based on conflict and perverse incentive structures, basically due to information gaps. However, the cost and benefits of this option are another major issue. It also involves several avoidable processes.

There are certain issues to be addressed in this regard, viz (a) Information Asymmetry; (b) Holdout problem; c) Conflict of Interest in Value Estimation; d) Investment Incentives and Debt Overhang.

Information Asymmetry

There are substantial information gaps on several aspects of bankruptcy between insiders viz., promoters and equity shareholders and outsiders viz., debt holders & creditors this is known. This leads to the fact that the outside is less informed or many times unable to make a distinction between which is a firm with vision, value and viability and which is not. This is vital for decision-making as it might distort decisions. There will be variations among the perception of them as to package based on to what extent the adverse or favourable insider information is available to the debt holders.

The major barrier to effective negotiation is the presence of asymmetric information in an informal way as pointed out by BLRC[9]. Therefore, a formal insolvency resolution process provides a source of vital information to creditors and the courts.[10] In addition, the judicial process in formal resolution drives and shows a way for consensus among stakeholders, though information asymmetry exists among them.[11]

As envisaged in the BLRC, the IBC in its CIRP and legal & regulatory framework provides for ''information finding'' and ''information revelation'' and ultimately ensures symmetry of information among the creditors and debtors and other parties who take part in the resolution process. In the CIRP mechanism, the Insolvency Professional takes responsibility and control from promoters for ensuring the process of attenuating asymmetric information issues. The BLRC envisages that information on business and viability shall be made available to all the parties in the resolution process.

It is observed that the Committee of creditors finds material information in the form of an Information Memorandum from the source of Insolvency Professional. Furthermore, IP makes inspections and takes information on preferential, undervalued extortionate and fraudulent transactions. He compiles information, analyses and also files progress reports to the Adjudicating Authority. IP also provides information about Corporate Debtor with the Resolution Applicants to enable them to appraise the projects and come out with viable resolution plans based on authentic information. Finally, all the Resolution Plans received are placed before the Committee of Creditors (CoC) for their consideration and ranking of project plans. This vital information will drive the CoC to take up resolution or liquidation as they consider appropriate. This process under IBC enables balancing the interests of stakeholders. BLRC envisaged a suitable provision in the legal framework to avoid obscure or opacity of corporate debtors. The IBC thus enables Insolvency Professionals (IP) to seek interference by Adjudicating Authorities (AAs) against preferential, undervalued, extortionate, or fraudulent transactions identified by IP.

Hold-out Problem

Where there are several groups of creditors, there could be a problem with holdouts or free rides. In this process, one group of creditors enjoy the benefits without cost or refuse to participate in the reorganization process. It is observed in the corporate restructuring plan that where his holdout strategy fails, he would look for free riders once the resolution is successful. These problems of coordination are addressed in bankruptcy procedures and AAs virtually coordinate the issues in their judgement.[12] These are all the issues addressed at different levels in the ecosystem and ultimately by AA.

The IBC is designed based on BLRC recommendations which provide a Corporate Insolvency Resolution Process (CIRP) mechanism to avoid free riders. The role of IPs, CoC, AAs and other agencies all collectively incentivise all the stakeholders and provide a coordination process at all levels. The legal and regulatory framework at every level focused on transparency and preventing hold out or free ride. The balance of interest and motivation to participate is the hallmark of IBC. The participation of creditors is ultimate and critical in the entire process. The Operational creditors can participate in CoC meetings but cannot vote but it does help in the coordination process.

The CoC deliberations make use of a mechanism for coordination among the creditors to strike a balance of interest among the stakeholders. CoC arrived at a consensus of 66 per cent as against the 75 per cent requirements earlier. This move is to avoid the situation of holdouts and facilitate the balance of interest. The creditors are focused on just a resolution plan, not their recovery. Their synergistic effect will be successful if the plan is approved, and corporate restructuring is done. Their efforts help to recover their dues in the waterfall procedural process and mechanism. The BLRC noted that a sound legal framework provides procedural certainty about the process of negotiation, in such a way that it reduces problems of common property.

Conflict of Interest in Value Estimation

The value of assets indicates differences among stakeholders in the distressed state. The major reason for such a variation relates to (i) private information asymmetry; and (ii) more so due to perception of conflict of interest. The bias among the claimants is due to their estimate of the value of the firm based on their respective perceived incentives. Similarly, management has biased estimates.[13]

The conflicts of interest originate because of their perceived biases. This contributes negatively to resolution outside a formal resolution process. The CoC takes measures for coordination. The valuation of Valuers under IBC is vital and professional. The results and outcomes of all the stakeholders are based on their estimation. This is realistic and scientific. The formal insolvency procedures under the code provide a path to an acceptable solution. However, due to conflict of interest among the shareholders and bondholders, could lead to inefficient investment decisions by the management outside IBC, and the apprehension of the managers will be different. They may hold the upside potential of an investment and prefer lower payoffs in states of bankruptcy. This

makes bondholders compromise with unfavourable terms. This would benefit shareholders, creating greater residuals in the process.

Investment Incentives and Debt Overhang

The managers' visualization of a gloomy picture sometimes works against the interest of higher payoffs in the states of bankruptcy. They focus on higher residuals to shareholders with a strategy, which may fail. BLRC also identified that conflict is a rise among creditors and debtors in preserving the time value of their investment. This conflict is the source of apprehension that creditors would prefer to close the issue quickly for alternative opportunities. In contrast, CD prefers to wait and look for higher residual value which they might realize in the process. It is certainly a complex situation.

The IBC code offers upper priority to later lenders as the insolvency may benefit new investors. This is envisaged to mitigate the debt overhang. This strategy will also address the problem of under-investment.[14] Literature suggests that the following measures for debt overhang and the reducing under-investment problem viz (a) creditors can forgive a part of their debt, renegotiate it or give up their seniority to reduce the debt burden (although these offer only a partial solution); (b) shortening debt maturity; (c) matching the maturities of the firm's assets and liabilities; and (d) covenant restrictions in the debt contract that preserve the value of senior debt such as restricting the financing policy, maintaining the seniority, limiting leverage ratios, etc.

IBC effectively addresses under investment issue vide sec. 29A by taking away control from managers and prescribing their ineligibility in the submission of resolution plans. As a result, any vested interest elements which may translate into under-investment problems are effectively stalled by the IBC. This allows creditors to virtually take charge of the firm from the Corporate Debtor (CD) through the Resolution Plan (RP) as this will ensure the quality of the plan. The creditors can identify a resolution. Which has the potential to address the revival. In the process, creditors can choose to go for a few haircuts on their own or restructure their loan contracts by tweaking maturities or inserting contract covenants to resolve the debt overhang problem of the CD. This is possible because of the creditor-in-control feature of the code. This process allows the creditors to assess the viability of the CD objectively and incentivizes them to consider the resolution of the CD for their own good. This, in a way, is a breakthrough based on a behavioural perspective.

Transforming India's Credit Culture by Madhavi Goradia Divan[15]

The IBC has made remarkable progress despite constraints. These constraints include several rounds of challenges in the courts. The IBC was aimed at creating an economic ecosystem to enable ease of doing business. The main purpose was to create conditions conducive to credit generation internally and invite investments globally. This necessitated to creation of a culture of deterrence against default. This is the philosophy with values. Unsecured creditors cannot be motivated when they do not look for secured assets. The CIRP under IBC is a powerful tool in the hands of an unsecured creditor. The small creditors' security by way of prompt payment can attract the investment market. Those who opposed the IBC laid misplaced emphasis on the relatively large number of companies that went into liquidation in the early stages of the IBC. These were the companies which were under BIFR for a long term, which successfully took the units to the death knell.

Surbhi Kapur in his work "Deeming Provisions in the Indian Insolvency Law Summarises".[16]

Deeming provisions while frequently resorted to by the Courts must be utilized prudently. As regards deeming provisions or delegated legislation, usually, a question arises as to whether it is judiciously invoked or is it excessively used. but it facilitates understanding of the law, it enables effective functioning and provides justice. This arrangement expects that it enables, social and economic benefits to flow, with greater clarity and certainty. This system enables the communication of the intent of the adjudicator and the legislators very effectively.

Legislative drafting is not a form-filling exercise. Any legal analysis involves a dexterous interpretation of the different components of a piece of law enacted by the legislative body of a

country. While judicial deference to the legislative intent is the interpretive norm, any legislative action is subject to the power of judicial review.

Conclusion

The ease of doing business requires addressing issues of bankruptcy reforms from multi-dimensions. IBC and its ecosystem substantially addressed its objectives with the comprehensive theoretical framework. Each of the objectives and related issues are integrated with the theoretical inputs to draw a logical conclusion. The Legal, Perspective, behavioural perspective, socio-economic perspective, and strategic perspective have their footing in theoretical inputs to fructify the outcome of IBC. The IBC is successful with its theoretical framework in providing a process and mechanism for balancing the interests of stakeholders.

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