PREFACE

SICKNESS AND INSOLVENCY OF COMPANIES: A CRITICAL ANALYSIS OF INSOLVENCY LAWS IN INDIA
PREFACE

An essential feature of the market economy is the birth and death of firms. While some firms will be economically viable: they will generate more cash than is required to pay the liabilities incurred to run the enterprise, some firms will fail.¹ In the aftermath of the Global Financial Crisis, business failure is becoming increasingly common in India (as in other parts of the world). The earnings of several Indian businesses have been adversely affected in many sectors. Moreover, financial distress faced by the parent companies of multinational groups in other parts of the world can quickly spread to their affiliates in India. Many prominent Indian and foreign businesses ‘went under’ during the crisis and several others could still be facing the risk of insolvency.²

When a business fails, it has adverse implications for various stakeholders including the shareholders, creditors, employees, suppliers and customers. Insolvency of large businesses could also have a ripple effect on the economy, affecting the solvency of many other businesses. It is widely believed that in order to address such extensive financial distress, the economy requires a highly efficient corporate insolvency regime that (i) separates viable companies from the unviable ones, and (ii) reorganises the former to the extent feasible and liquidates the latter (before any significant depletion in the value of the business), minimising losses for all stakeholders in the process. A well designed insolvency framework will give certainty to the company and all the economic actors that enter into contractual relationships with it regarding the outcomes that can be reasonably expected in case of failure.³

Insolvency of a company may be defined in terms of economic distress or financial distress. While the former relates to its ability to efficiently produce and sell goods and services, the latter signifies its capacity to service debts. It is widely recognized that as long as a failing company remains economically viable it should be first subject to a reorganization or rescue

¹ Finance Research Group, Indira Gandhi Institute of Development Research, “Economic thinking for bankruptcy reform”.
³ Ibid.
process (and not liquidation). Unlike liquidation, where the company is closed down, reorganisation is a process of “organizational rebirth” where the “debts are renegotiated, costs are cut and the firm may be shrunk, in order to return to profitable operations”. 4 Such reorganisation could also involve change of owners or management. It is important to point out that although a company’s economic viability differs from its financial health (which is primarily related to its level of indebtedness), there could be a strong link between the two, i.e. a company’s financial health could be a strong indicator of its economic viability. It may be noted that reorganization is not the only efficient rescue mechanism for saving a financially distressed company. The business could also be sold on a going concern basis (and proceeds distributed to the creditors) followed by liquidation of the residual entity (especially, when there is a ready market for that business). Some scholars argue that such approaches afford the possibility of avoiding protracted negotiations with various stakeholders and other costs associated with the reorganization process. 5

Resolving insolvencies efficiently can help in meeting several policy objectives. Some such objectives are analysed below:

A. CREDITOR PROTECTION

Protection of creditors is widely recognized as one of the main goals of corporate insolvency law. Such protection is required for efficient functioning of capital markets and availability of capital for investment. 6 In the absence of a collective procedure in the form of a corporate insolvency regime, the creditors may have incentives to run on the company’s assets in the event of insolvency or even a doubt thereof. In other words, each creditor may want to initiate separate recovery proceedings for the same assets, leading to conflicts, disorderly distribution, delays and depletion in value of the company. According to a commonly held view, the main purpose of corporate insolvency law is to support the collection efforts of the creditors (who have property rights in the assets of the firm outside of the insolvency regime) by providing a mandatory and collective procedure where the assets are distributed among the stakeholders in an orderly manner. 7

---

7 Supra n.2
Most insolvency regimes allow creditors some degree of control over such collective procedure. By providing adequate protection to creditors in insolvency, the law incentivizes them to continue providing capital to the businesses and lowers the cost of debt capital for the companies in general. Further, by promising secured creditors some control in the process (for initiation, etc.), they may be incentivized to monitor the company better, which could in turn encourage managers “to follow more conservative investment policies that reduce the chance of bankruptcy”. 8

A. PROMOTING ECONOMIC GROWTH

Allocative efficiency requires that the resources in an economy be put to their most efficient use. The economic goal of allocative efficiency is maximization of social welfare. 9 An effective corporate insolvency law can help this process by enabling reallocation of ‘inefficiently utilized resources’ and ‘ousting of inefficient participants’ from the market. 10 A robust corporate insolvency regime can help foster growth and innovation by enabling efficient allocation of resources (from failing or failed companies to efficient companies). Empirical research on this issue has shown that this continuous process of reallocation of resources (which is enabled by insolvency law) plays an important role for aggregate productivity and output growth in an economy. 11

B. PROMOTING CORPORATE BOND MARKETS

Corporate bonds (transferable debt instruments) are seen as a reliable and efficient source of raising finance in many countries. Studies show that bonds can lower the cost of raising finance for companies by competing with other sources of finance like bank loans, equity finance, etc. The recent Global Financial Crisis has shown that a market for bank loans may not be available at all times and alternative sources of finance need to be put in place to prevent widespread liquidity crunch when the banks are under distress.

---

9 A Ogus, Regulation: Legal Form and Economic Theory (1994)
Moreover, since bonds have a fixed term of maturity, companies issuing bonds have more
time (and associated flexibility) to repay. Nevertheless, bonds are generally perceived as
risky instruments by the investors in India, given India’s weak creditor protection
infrastructure (which includes an ineffective corporate insolvency regime). At present, in
India, bond investors plan for near zero recovery on default. This drives up the required
rate of return in the eyes of the bond holder to the point where very few companies find it
practical to issue bonds.\footnote{12}

Theory predicts that improved creditor rights could assist with the development of bond
markets.\footnote{13} There is also some empirical evidence to support that better enforcement of
creditor rights helps in the development of bond markets.\footnote{14} Burger and Warnock, in their
analysis of bond markets in 49 countries, find that for those countries that have also
issued foreign currency bonds, the size of local debt markets are larger when countries
have better rule of law and better creditor rights.\footnote{15} Although the corporate insolvency
system is only one part of the credit infrastructure, it may be argued that if the rights of
the creditors (bond holders) are better protected in the event of insolvency, it could go a
long way in developing a robust bond market in India.\footnote{16}

C. PROMOTING CREDIT MARKETS IN GENERAL\footnote{17}

The patterns of firm financing over the last two decades shows that: (i) Indian firms use
equity financing more than debt financing; (ii) banks are still the largest source of credit,
even though bank-led credit has remained stagnant; (iii) there has always been much
more secured than unsecured credi;

\begin{footnotes}
\footnote{12}{Supra n.1}
predicts: (a) in general, improvements in creditor protection (particularly protection in insolvency) should
facilitate the availability of external finance: “Rules and regulations that protect creditors and are properly and
efficiently enforced lead to larger credit market and lower interest margins. This idea has been formalized by
Townsend (1979), Aghion and Bolton (1992), and Hart and Moore (1994, 1998)” (A Galindo and A Micco,
“Creditor Protection and Credit Volatility” (Working Paper), summarising some of this theory); and (b) the
availability of capital in the form of securities (bonds, stock) rather than in the form of bank debt will also be
sensitive to the quality of investor protection: see for example F Modigliani and E Perotti, “Security Markets
versus Bank Finance: Legal Enforcement and Investors' Protection”}
\footnote{14}{Narjess Boubakri & Hatem Ghouma, Control/ownership structure, creditor rights protection, and the cost of
debt financing: International evidence, Journal of Banking & Finance (2010); JD Burger & FE Warnock, Local
Warnock”)}
\footnote{15}{Supra n.1}
\footnote{16}{Supra n.2}
\footnote{17}{Supra n.1}
\end{footnotes}
many of these features derive from the lack of an effective bankruptcy process. There is lack of clarity on bankruptcy processes and outcomes in India. Poor recovery rates, coupled with pressure on asset quality can lead to decreased lending by banks. The Reserve Bank of India’s Financial Stability Report (December 2014) reports that the consolidated balance sheets of scheduled commercial banks for 2013-14 show a decline in the growth of credit for the fourth consecutive year. The Report cites “persistent pressure on asset quality leading to increased risk aversion among banks” as one of the factors for the decline in growth of credit. A properly functioning insolvency system could resolve these issues to a large extent by facilitating the rehabilitation of companies where viable, thereby relieving the pressure on assets held by lenders. Where corporate rehabilitation proves to be unviable, by providing for swift liquidation of unviable companies, an effective insolvency system will maximise returns to lenders. This shall, in turn, contribute to the development of a robust market for credit.

D. PROTECTING OTHER STAKEHOLDERS

Creditors are not the only stakeholders in a company. Its shareholders (promoters and other investors), employees, suppliers and customers also have significant economic interests in the company and need to be adequately protected in the event of insolvency. The protection of shareholders and employees assumes special importance in this regard.

a. PROMOTERS/SHAREHOLDERS While it is widely believed that shareholders are residual claimants and do not need to be protected in an insolvency, the importance of protecting their interests has been recognized in certain situations – particularly in a reorganization. Insolvency defines the risk that the promoters and investors subject themselves to when they decide to promote a business. A robust corporate insolvency regime promotes entrepreneurship by providing a reasonably certain indication of the maximum downside risks and costs that the promoters and investors expose themselves to at the time of starting a venture. The costs of insolvency proceedings (which are directly proportional to the time required for resolving insolvencies) also assume importance in this regard. It has been observed that “firms are more likely to enter and receive start-up financing if

18 Supra n.2
19 Ibid.
20 Ibid.
21 Cirmizi, Klapper & Uttamchandani
bankruptcy proceedings are less costly…”\textsuperscript{22} Further, the reorganization or rescue provisions of an insolvency regime are often designed to limit losses for all the stakeholders. In a reorganization or rescue procedure, making payouts to the promoters or the shareholders, or giving them some control over the process, may incentivize them to initiate the process in time and co-operate with the other stakeholders.\textsuperscript{23}

b. EMPLOYEES

Suppliers of labour also need to be adequately protected in insolvency. This is particularly true for businesses deriving their value from the goodwill created by the skills and services of employees. Moreover, most employees are not in a position to ask for higher wages at the time of entering into their employment contracts in exchange for the risk of not being paid in the event of insolvency. Job losses associated with insolvency, if not dealt with adequately, can have many adverse implications for the economy. Protecting employees effectively should thus be one of the objectives of any corporate insolvency regime, at least in relation to accrued wage claims. However, it is important to point out that the interests of employees are arguably better addressed through labour laws and social security measures and that companies should not be allowed to remain alive for the only purpose of preventing unemployment.\textsuperscript{24}

E. ENHANCING INVESTOR CONFIDENCE

Reforming the insolvency system will have some benefits for liquidation of solvent companies as well. Many shareholder-agreements for investment transactions (involving foreign and domestic investors) in Indian companies provide for voluntary liquidation of the company as one of the exit alternatives for the investors or as a consequence of a termination event (termination events are grounds on the basis of which a shareholder agreement can be terminated by all or any of the parties). The ability of shareholders to cause the liquidation of a company in the event of breach of obligations by the other shareholders can serve as a disciplining mechanism for all the shareholders (and the management). However, the effectiveness of such a remedy depends on the efficacy of the liquidation regime. If the liquidation regime is efficient, it can go a long way in promoting investor confidence by giving strength to such liquidation provisions in shareholder-agreements. Such efficiency

\textsuperscript{23} Supra n.2
\textsuperscript{24} Ibid.
could also help commercial certainty on the occurrence of a liquidation event (by enabling parties to weigh legal risks in advance and price them into contracts accordingly).\textsuperscript{25}

An ideal insolvency regime needs to strike the right balance between the interests of all the stakeholders by a reasonable allocation of risks among them. An efficient corporate insolvency system should (i) have clear hierarchy of payments upon insolvency, (ii) have an efficient system for transferring failed reorganizations to liquidation, and (iii) allow sufficient control to the creditors without giving them the leeway to manipulate.\textsuperscript{26} The hierarchy of payments should be specific so as to enable a swift disposal of cases. If a company cannot be reorganized or the business rescued (by a sale) within a stipulated period, the company should be transferred to a liquidation process swiftly. Further, in order to incentivize creditors to participate in the reorganization/liquidation process, the insolvency system should allow the creditors sufficient control over the process. The court or the administrator should be required only to oversee the proceedings to ensure that there is no manipulation by the creditors. It should be acknowledged that (as noted above), allowing too much protection for creditors may have some trade-offs with pre-filing efficiencies by enticing firms to delay their bankruptcy filings.\textsuperscript{27}

The law on the statute book cannot be the sole basis for an effective corporate insolvency regime. It also requires an effective institutional structure for it to be successful. In spite of being similar (in substance) to the corporate insolvency laws of certain western countries, Indian law does not compare well with those countries on the effectiveness scale. This indicates that a well-designed system in itself may not lead to the desired outcomes. The decision-making institutions of an insolvency system (courts, liquidators and administrators) play a vital role in the success or failure of a system.\textsuperscript{28}

Moreover, for the insolvency law to be useful, it must be applied in tandem with other laws such as the debt recovery laws, tax laws and labour law. The debt recovery laws, if effective, can discourage solvent debtors from abusing the reorganization process. Threat of seizure (for both forms of debt) may encourage debtors to pay their debts in time and not file for

\textsuperscript{25} Ibid.
\textsuperscript{27} Sefa Franken, Creditor- and Debtor-Oriented Corporate Bankruptcy Regimes Revisited, European Business Organization Law Review (2005) (hereinafter referred to as “Franken”).
insolvency when they are not facing any serious financial distress. Tax incentives for outside buyers can be used as an effective tool for saving businesses and facilitating reorganizations. Labour law can enable entrepreneurs to efficiently restructure viable businesses while providing due protection for employees. Lastly, an effective insolvency regime promotes early initiation of proceedings so that the viable businesses can be separated from the unviable ones at the earliest opportunity and the maximum value of a given business can be preserved.29

Therefore understanding the closure down of business is as important as undertaking how to start one. Accordingly an attempt is made to give an overview of the legal framework governing insolvency in India.

a. **RESEARCH HYPOTHESIS**

The present insolvency regime in India is deficient as it is neither preventive nor effective in achieving the intended goal of corporate growth and protecting the rights of the creditors in insolvent companies. So an urgent reform is needed.

b. **RESEARCH OBJECTIVE**

In this context the researcher took this area to study the major reforms in insolvency in India. In this regard the government has proposed an array of reforms like setting up of NCLT and coming up with the new Company Act, 2013, IBC, 2016, which is likely to reform the liquidation process and would make the liquidation process more fast, efficient and less rigid which might go a long way in protecting the rights of creditors. In order to prevent the companies from slipping into sickness and insolvency, the Companies Act, 2013 has introduced certain measures like class action suit, SFIO, whistle blower, rotation of auditors and corporate criminal liability. These provisions of the Companies Act, 2013 are preventive in nature as they will make the management of the company transparent and accountable and thus may prevent the company from becoming sick and getting pushed into liquidation. In order to suggest reforms in insolvency law in India, the researcher will

---

try to find out as to what the part of the UNCITRAL Model Code on Insolvency can be incorporated in India and would like to do a comparative study of insolvency laws of United Kingdom with that of India and a few other countries.

c. **RESEARCH QUESTION**

Four research questions arise for the consideration.

- What is the viability of present insolvency regime in India?
- Whether the concepts introduced for the first time in Companies Act, 2013 are adequate to secure the rights of stakeholders?
- Whether the setting up of NCLT will help to unclog the legal system and fast-track corporate rehabilitation?
- What reforms can be carried out to resolve the existing issues plaguing insolvency regime in India?

d. **RESEARCH METHODOLOGY**

The researcher has relied on a blend of Doctrinal and empirical method of research. She has visited the offices of Official Liquidator (OL) attached to Kolkata High Court and Registrar of Companies (ROC), West Bengal and interviewed some practitioners of Insolvency laws as a part of empirical study. As a part of doctrinal study the researcher has done a comprehensive study of both primary as well as secondary resources. For this she dwelt upon text books, provisions in the Acts, law journals, as well as web sources, legal databases etc. for her research work. The various primary resources of study, referred by her include enacted piece of legislation, judicial precedents etc. The secondary resources include works of various eminent authors’ text books, law journals, news papers etc.
e. **SCOPE OF STUDY**

The focus of the research is existing legislative measures and practices to protect the interest of stakeholders in India and new legislative piece in the form of IBC, 2016 and new provisions introduced for the first time in the Companies Act, 2013, enhancing stakeholders confidence. In order to suggest reforms the researcher has carried out a comparative study of insolvency system in India and UK and a few other countries.