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India**

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**Indira Gandhi Institute of Development Research, Mumbai  
June 2016**

<http://www.igidr.ac.in/pdf/publication/WP-2016-018.pdf>

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## **Abstract**

*The current Indian framework for corporate insolvency resolution, is fraught with deficiencies in the laws, their procedures, their implementation as well as in the capacity of the institutions supporting them. The absence of a coherent and effective mechanism for resolving corporate insolvency has resulted in poor economic outcomes. The origin of the complex framework characterised by multiple, fragmented laws, can be traced back to the history of its evolution. In this paper, we describe the evolution of the corporate insolvency resolution framework, with the objective of linking it back to the policy directive of the time. We conclude that when policy adopts a piecemeal approach focusing on solving only a part of the complex problem, one at a time, it most often leads to inefficient outcomes on the overall objective. We end with a brief description of the Insolvency and Bankruptcy Code (IBC), 2016 which is most recent policy initiative in this field. The IBC is a clean, modern law that offers a simple, coherent answer to the insolvency resolution problems under current Indian conditions. Once implemented, the law will potentially change not only the manner in which insolvency is resolved in India but also the entire credit landscape of the country.*

**Keywords: Indian insolvency law, Restructuring, Winding up, Secured creditors, Debt recovery, Insolvency and Bankruptcy Code**

**JEL Code: G33, G34, K2**

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June 22, 2016

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# 1 Introduction

Since the economic reform process of the 1990s, there has been significant progress in the development of financial markets and services in India (Thomas 2005). However, this development has been skewed largely towards equity markets. Despite considerable policy initiatives, the development of debt markets has seen little progress (Table 1). While many factors have contributed to the lack of development of a debt market in India, one that clearly stands out as a large missing piece is the absence of a coherent and effective mechanism for resolving insolvency.

The limited liability company is a contract between equity and debt. Unlike an equity contract, where there are no promised returns to investors, in a debt contract, the borrower (or the *debtor*) promises a *return* as well as a *repayment of the original capital* to the lender (or the *creditor*) at a defined time in the future. All debt contracts contain a possibility that at the time of repayment, the debtor may not make the payment as promised and *defaults*.

**Table 1** Financial market development in India – 1996 to 2015

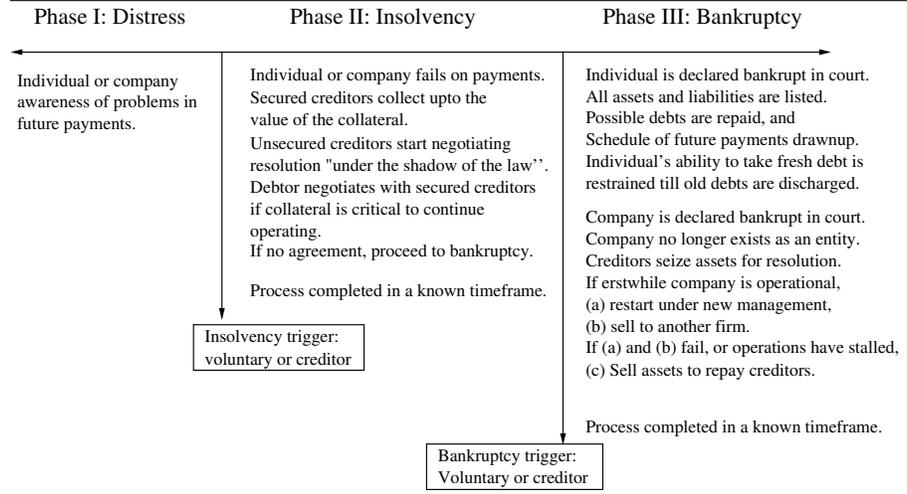
As % of GDP	1996	2008	2015
Equities	32.1	108.4	80.0
Government bonds	14.3	36.1	34.3
Corporate bonds	0.9	3.9	14.0
Bank assets	46.5	73.8	89.0

Source: SEBI, RBI, IMF World Economic Outlook

Non-payment by a debtor firm may be due to a short term cash-flow stress even when the underlying business model is generating revenues or due to a fundamental weakness in the business model because of which the business is unable to generate sufficient revenues to make payments. As long as the debt obligations are met, equity owners have full control and the creditors of the firm have no say in the running of the business. When the debtor defaults on payments, the control transfers to the creditors and the equity owners should have no further say. Upon default, the creditors have the incentive to be the first to recover their amounts. Consequently, a *race to collect* may ensue, with firm liquidation as the inevitable outcome. What should ideally happen is that the creditors and the debtor should negotiate a financial rearrangement to preserve the economic value of the business and keep the enterprise running as a going concern. If however the default is due to a business failure, then the enterprise should be shut down as soon as possible. The *insolvency and bankruptcy law* of the country provides a framework through which these decisions can be taken and hence it assumes great importance.

The insolvency and bankruptcy law of a country lays down a process by which firms in financial distress can seek a resolution or an exit. The three different states of distress, insolvency and bankruptcy are presented in Figure 1. When

**Figure 1** Distress, insolvency and bankruptcy in debt relationships



implemented efficiently, the law provides protection to the creditors in the event of a firm insolvency. It provides certainty to parties in a debt contract about the expected outcomes and this, ex ante, enables the creditors to take better credit decisions in the pre-insolvency stage. An insolvency law therefore impacts both pre-insolvency and post-insolvency actions of the debtors and the creditors and is a critical element of the financial environment of a country.

With a clear and coherent insolvency and bankruptcy law, there is lower contention between the creditor and the debtor, and financial distress can be resolved rapidly. Debtors can re-enter the enterprise arena quickly and with lower costs and creditors get incentivised to repeatedly provide credit. An empirical analysis of domestic bond market development in 49 countries around the world finds that the size of local debt markets is larger when countries have better rule of law and better creditor rights (Burger and Warnock 2006). The paper also shows that countries where creditors' incentives to lend are low, have poorly developed bank-based and market-based lending.

The current Indian framework for corporate insolvency resolution, is characterised by a complex system with fragmented laws accompanied by an inadequate institutional set-up. The origin of such a complex framework can be traced back in the history of its evolution. In this paper, we describe the evolution of the corporate insolvency framework, with the objective of linking it back to the policy directive of the time. We conclude that when policy adopts a piecemeal approach focusing on solving a part of a complex problem, one at a time, it most often leads to non-optimal outcomes on the overall objective.

## 2 The evolution of insolvency laws in India

### 2.1 The origins of Indian insolvency law

Insolvency law in India has its origin in the English law. In India, the need for a legal framework to deal with insolvency was first felt in the three Presidency towns of Bombay, Calcutta, and Madras where the British carried on trade. The earliest insolvency provisions can be traced back to sections 23 and 24 of the Government of India Act, 1800, Statute 9 enacted in 1828, the Indian Insolvency Act, 1848, and the Presidency-towns Insolvency Act, 1909. The Presidency-towns Insolvency Act, 1909 continues to be in force for Bombay, Calcutta and Madras and covers the insolvency of individuals, partnerships and associations of individuals.

Till the early 1900s, there was no insolvency law for the non-Presidency town areas. The 1907 Provincial Insolvency Act which was eventually replaced by the 1920 Provincial Insolvency Act was the first insolvency law for the other areas. It continues to be the insolvency law in force in areas other than the Presidency towns of Bombay, Calcutta and Madras and deals with insolvency of individuals, which may also include individuals as proprietors.

In 1964, the Law Commission of India<sup>1</sup> recommended combining the two laws to create a common insolvency law that would be applicable to the entire country. However, this was not implemented. Till today, the Presidency towns Insolvency Act, 1909 and the Provincial Insolvency Act, 1920 continue to be the relevant laws for insolvency resolution of individuals and associations of individuals.

### 2.2 The first law for corporate insolvency: The Companies Act, 1956

In the Indian Constitution enacted in 1950, the terms “Bankruptcy” and “Insolvency” were specified in the Concurrent List<sup>2</sup> However, incorporation, regulation and winding up of corporations<sup>3</sup> was under the Union List<sup>4</sup>. With these powers, the Parliament enacted the Companies Act in 1956. This Act governed all aspects of the functioning of companies, including their winding up.<sup>5</sup> The Act had no definition of the terms insolvency or bankruptcy and dealt only with

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<sup>1</sup>26th Report of the Law Commission of India

<sup>2</sup>As Entry 9 of List III of the Seventh Schedule. Both Center and State governments can make laws relating to this subject.

<sup>3</sup>Entry 43 and 44 of List I of the Seventh Schedule. There are some exceptions such as incorporation, regulation and winding up of cooperative societies, which is covered in List II of the Seventh Schedule.

<sup>4</sup>Subjects on which only Parliament can make laws

<sup>5</sup>The Act covered the process of winding up registered companies (in Part VII of the Act, covering Sections 425–560). It also covered the winding up of foreign companies, partnerships, societies and associations with more than seven members under Part X of the Act.

the 'inability to pay debts'. However, for all practical purposes, it was the only law available for dealing with corporate insolvency.

The High Courts constituted the adjudicating authority for winding up related matters under this law. Creditors with unpaid dues above a defined threshold<sup>6</sup> could petition the court for winding up a company. Winding up was preceded by liquidation, a process managed by an Official Liquidator (OL), appointed by the High Court. The OL was responsible for collecting the assets of the company, and managing the sale and the distribution of the proceeds in accordance with the priority defined in the Act. This Act, passed in the early periods of India's policy of industrialisation, prioritised workmen dues and dues to the government over secured creditors' dues.

The Companies Act, 1956 contained certain provisions through which the company or its creditors could seek to reorganise it.<sup>7</sup> However, these were general provisions and not specific to insolvency or bankruptcy situations.

In 2013, there were approximately 14 lakh registered companies in India of which only 9.5 lakh were active.<sup>8</sup> In contrast, on an average, between 2008 and 2010, not more than 6,500 cases of winding up were registered with the High Courts. Only about 250-350 cases were added every year and about 300-600 completed every year. This highlights the low use of the Companies Act procedures for dealing with corporate insolvency. It also points to a lack of capacity at the High Courts to deal with case volumes. Anecdotal evidence suggests that winding up under the Act, on an average, takes around five to eight years to complete and in extreme cases even 25-30 years.

The Companies (Amendment) Act, 2003 proposed significant changes to the insolvency related provisions of the Companies Act, 1956. However these could not be notified due to legal challenges. In 2013, the new Companies Act was passed. Most of the provisions of the 2013 Act are in line with those proposed under the Second Amendment in 2002. Implementation challenges with respect to the corporate insolvency provisions continue even with the new Companies Act, 2013. As a result the provisions of the Companies Act, 1956 continue to be in force.

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<sup>6</sup>Rs. 1 lakh

<sup>7</sup>Sections 390, 390A and 391. Any creditor or member of a company could approach the court with a scheme of arrangement or a compromise. The court would order a meeting of the creditors to consider the scheme. If three fourths of the creditors agreed to it, the court could enforce it on the remaining creditors. The court enabled this action without judging the merit of the scheme.

<sup>8</sup>Data from Ministry of Corporate Affairs Annual Report

### 2.3 Strengthening debtor’s rights: Sick Industrial Companies Act (SICA) 1985

From 1956 to 1985, the Companies Act was the only law dealing with corporate insolvency. The early policies of the government after independence involved the development of manufacturing industries in the economy which required significant investments. As was typical in several emerging economies, the government made these investments through large development finance institutions (DFIs), which were set up with the objective to encourage industrial development. In return for credit, the DFIs were given a seat on the board of these firms. This was expected to give these creditors a direct control on the management of these firms. In turn, this resulted in poor allocation of economic capital. There is evidence that large firms with banks as creditors and the latter on the boards, have higher leverage, lower investment and tend to be in greater financial distress. This turned out to be true in India as well (Bubna and Gopalan 2012).

By the early 1980s, the problem of sickness among the industrial companies had become widespread. From 1981 to 1985, the number of sick industrial units rose from 26,758 to 119,606.<sup>9</sup> In 1980, an empowered committee (Tiwari Committee) was set up to recommend legislative and administrative remedies to the problem of industrial sickness. As an outcome of this, the Sick Industrial Companies Act (SICA) was passed in 1985 with the objective of identifying “sickness” in industrial companies and reviving them. The Act was supported by the setting up of a new legal forum, the Board of Industrial and Financial Reconstruction (BIFR) and the Appellate Authority for Industrial and Financial Reconstruction (AAIFR).

SICA was the first law which focused solely on restructuring of companies. However, its coverage was narrowly defined to include only “industrial companies” that were deemed “sick”.<sup>10</sup> The Act put the onus of reporting sickness on the *board of the firm*. Once sickness was reported, the Act provided an automatic stay on all suits, claims and proceedings against the company. This procedure differed from that in the Companies Act, where a stay was not automatic and was granted at the discretion of the High Court. SICA also empowered the debtor company to control its assets and operations even after being adjudged sick. Over time, the law developed a distinct rehabilitation bias (Zwieten 2015). Key provisions of the Act were interpreted and reinterpreted by judges in an attempt to rescue companies that were bankrupt and hence destined for liquidation, and to protect some types of stakeholders (especially employees) in the interim period.

An additional challenge with SICA was that there was only one bench of the BIFR, in Delhi. As enterprises grew manifold in number all over the the country, the lack of capacity at the BIFR became a bottleneck. Further, if the BIFR

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<sup>9</sup>Economic Survey 1987-88, Ministry of Finance

<sup>10</sup>Industrial companies and sickness were defined under the Act, though the definition of sickness was amended over time.

judged the company to be sick, it recommended winding up. But the winding up order as per the Companies Act, 1956, was issued by the High Court. Often, winding up recommendations by the BIFR were re-opened by the High Courts afresh and many a time, even reversed, thereby causing inordinate delays and associated loss in firm value.

An analysis of BIFR cases between 1987 to 2014 shows that a total of 5,800 cases were reported to the BIFR. 53% of these cases were either dismissed or abated, 22% of the cases were recommended for liquidation, in 9% of the cases a rehabilitation plan was implemented and the remaining 15% cases remain pending in BIFR. The average time taken for the closure of a case is around 5.8 years. This highlights fact that eligible companies often used BIFR as a mechanism to seek protection from their creditors. It also points to the capacity challenge at BIFR in dealing with case volumes.

The 2003 Amendment of the Companies Act sought to repeal SICA. However, due to legal challenges this Amendment could not be notified.

### **3 Policy focus on strengthening creditors' rights**

In the decade of 1990, there was a general acknowledgement of the failure of insolvency resolution process under the Companies Act, 1956 and the SICA, 1985. Procedures under both these Acts were plagued with significant delays and did not lead to productive outcomes. In order to rectify this several committees were set up between 1991 and 2008 to reform the framework for corporate insolvency resolution. Table 2 lists the numerous government committees that have worked on this subject, for many decades. A noticeable feature of this reform push was the attempt to strengthen the “individual” recovery rights of banks and financial institutions, the dominant lenders at the time, rather than all creditors in general.

As an outcome of the policy reform push of the 1990s and early 2000s, laws focusing solely on strengthening the recovery rights of the banks and public financial institutions were brought about. A consequence of this, and of the general failure of the collective resolution mechanisms under Companies Act, 1956 and SICA, 1985, is that credit in India continues to be dominated by secured lending and reputation based lending by banks. This thwarts the development of alternative sources of credit such as corporate bond market and in turn makes it difficult for new firms and firms without collateral to access credit.

#### **3.1 The RDDBFI Act, 1993**

The recommendations of the High Level Committee on the Financial System (Narasimham Committee I, 1991) led to the enactment of the Recovery of Debts

**Table 2** Government committees on bankruptcy reforms

Year	Committee	Outcome
1964	24th Law Commission	Amendments to the Provincial Insolvency Act, 1929.
1981	Tiwari Committee (Department of Company Affairs)	SICA, 1983.
1991	Narasimham Committee I (RBI)	RDDDBFI Act, 1993.
1998	Narasimham Committee II (RBI)	SARFAESI Act, 2002.
1999	Justice Eradi Committee (GOI)	Companies (Amendment) Act, 2002, Proposed repeal of SICA.
2001	L. N. Mitra Committee (RBI)	Proposed a comprehensive bankruptcy code.
2005	Irani Committee (RBI)	Enforcement of Securities Interest and Recovery of Debts Bill, 2011. (With amendments to RDDDBFI and SARFAESI Acts).
2008	Raghuram Rajan Committee (Planning Commission)	Proposed improvements to credit infrastructure.
2014	Bankruptcy Law Reforms Committee (Ministry of Finance)	Insolvency and Bankruptcy Code (Replacing extant laws with a single consolidated code)

due to Banks and Financial Institutions Act, 1993 (RDDDBFI, 1993). The committee highlighted that the banks and DFIs found it difficult to recover their dues from borrowers using the Civil Court system. It recommended the setting up of specialized tribunals that would speed up these recoveries. Accordingly the RDDDBFI Act paved the way for setting up of the Debt Recovery Tribunals (DRT) and the Debt Recovery Appellate Tribunals (DRAT). The DRTs and the DRATs, were intended to be specialised tribunals that would facilitate expeditious recovery of debt from the defaulters by banks and a defined set of financial institutions.<sup>11</sup>

The DRTs were given the power to order recovery through sale of the debtor's assets and also to imprison or detain the debtor. DRTs were the first court of appeal for aggrieved debtors, but any appeal to the DRT could only be made after depositing 75% of dues beforehand with the DRATs.

While the DRTs were set up for speedy adjudication of matters pertaining to the recovery of dues, they suffered from several weaknesses. This included the lack of resources available to the tribunals, which in turn led to delays in deciding cases beyond the prescribed time frame of six months. DRT recovery rates in 2012 and 2013 were at 17% and 14% respectively of the amounts involved.<sup>12</sup> Further, since this law did not apply to creditors other than banks and specified financial institutions, the DRTs created a special class of creditors with greater recovery rights. This limited the confidence of other types of creditors to enter

<sup>11</sup>The DRTs are one member tribunals that have sole jurisdiction over matters related to the recovery of dues to banks and specified financial institutions, with the exception of the Supreme Court. Appeals against the orders of the DRT were to be heard in the Debt Recovery Appellate Tribunals (DRATs).

<sup>12</sup>Source: RBI Report on Trends and Progress of Banking in India, 2008 – 2013.

into the debt market, and limited the size of these markets.

### 3.2 The SARFAESI Act, 2002

The second Narasimham Committee (Narasimham Committee II, 1998) on Banking Sector Reforms raised concerns around the rising non-performing assets (NPAs) of the banking sector. The Committee's recommendations led to the enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI, 2002) Act in 2002.

The Act provided sweeping powers to the banks and financial institutions to recover against non-performing secured loans. Since the DRTs had not proved to be as effective in enabling recovery as expected, the SARFAESI Act provided an alternative route for recovery. The Act allowed banks and FIs to take possession of the collateral security without court intervention. Its intent was to reduce the growing size of NPAs at banks and large public financial institutions. After its implementation, the number of new cases filed with DRTs went down by almost 40% (Rajan, 2008).

The Narasimham Committee I and II also recommended setting up of Asset Reconstruction Companies (ARCs). Banks could offload their bad debts at a discount into the ARCs for the purpose of resolution. Accordingly, SARFAESI 2002 paved the way for the creation of Securitisation Companies/Asset Reconstruction Companies (SC/ARC). These financial firms are specialized institutions that buy NPAs from the banks, for the purpose of recovering and resolving them.

SARFAESI vested extraordinary enforcement powers, but only with certain class of secured creditors, i.e. the banks. In addition, enforcement actions under the SARFAESI Act took precedence over BIFR proceedings in the High Courts, if agreed upon by 60% of the creditors in value. This meant that rehabilitation under SICA or winding up under the Companies Act, could be delayed or even abated using SARFAESI enforcement.

The performance of SARFAESI in enabling recovery of banks' secured dues was at first promising, but has worsened over time. The recovery rate declined from 61% in 2008 to 21.9% in 2013. The sale of NPAs by the banks to the ARCs has also remained stagnant.<sup>13</sup>

## 4 Banking regulation and corporate insolvency

In 2001, the RBI set up the Corporate Debt Restructuring (CDR) process as an out-of-court mechanism between the debtor and the creditor banks to negotiate

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<sup>13</sup>These figures have been compiled from the *RBI Report on Trends and Progress of Banking in India*, for 2008 to 2013.

new terms on their existing loans. The CDR mechanism is based on the ‘London Approach’ which is founded upon the principles of collective and coordinated efforts to rescue a defaulting firm that has multiple creditors. Comprehensive guidelines for the CDR mechanism were first issued in 2008, and subsequently augmented in 2012 and 2013. The key feature of the CDR process was that the RBI would permit lower provisioning on loans made to companies that were restructured under this mechanism.

As of March 2016, out of 655 applications, 530 cases were approved for CDR.<sup>14</sup> The aggregate debt outstanding of these companies is approximately Rs. 4.03 trillion.

In 2014, RBI introduced the Joint Lenders’ Forum (JLF) mechanism, to facilitate the adoption of a comprehensive banking system-wide view of loans made to a company. In 2015, it introduced the Strategic Debt Restructuring (SDR) mechanism which enables banks to convert their debt to a firm to equity and execute a change in the management of the firm.

CDR, JLF and SDR are all mechanisms through which RBI has allowed the banks to recover their dues from corporate borrowers. Since all these mechanisms are accompanied by some amount of regulatory forbearance on NPA provisioning, over time these have become the preferred mechanisms for collective recovery of corporate dues.

## 5 Legal and economic outcomes

The evolution of the laws for corporate insolvency resolution as described above, has resulted in a complex and fragmented environment for both creditors and debtors. The reforms that have sought to strengthen creditors’ rights, give benefit only to the banks and a subset of FIs. Non-bank creditors can only enforce debt recovery action using the Civil Courts. Collective action by these lenders can only be under the provisions of SICA, 1985 and the Companies Act, 1956.

Among debtors, there are limitations on the firms that get covered under the two main laws, Companies Act, 1956 and SICA, 1985. A large number of small, unregistered enterprises with less than seven members may not get covered under the Companies Act, 1956 or 2013. SICA, 1985, is only applicable to a subset of “sick industrial companies”.

In a landscape dotted with multiple laws and special provisions, there is a lack of clarity on what holds precedence in a given situation. In India, this has been a subject of significant litigation. This has also given rise to the concept of “forum shopping”, where both the creditor and the debtor firm can opt for the judicial mechanism that suits their individual needs, at the cost of

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<sup>14</sup>Source: [www.cdrindia.org](http://www.cdrindia.org)

maximising the economic value of the business (Ravi, Aparna 2015). Added to this complexity, is the dearth of timely mechanisms that are consistently available to all categories of creditors to resolve the insolvency of all categories of debtor firms.

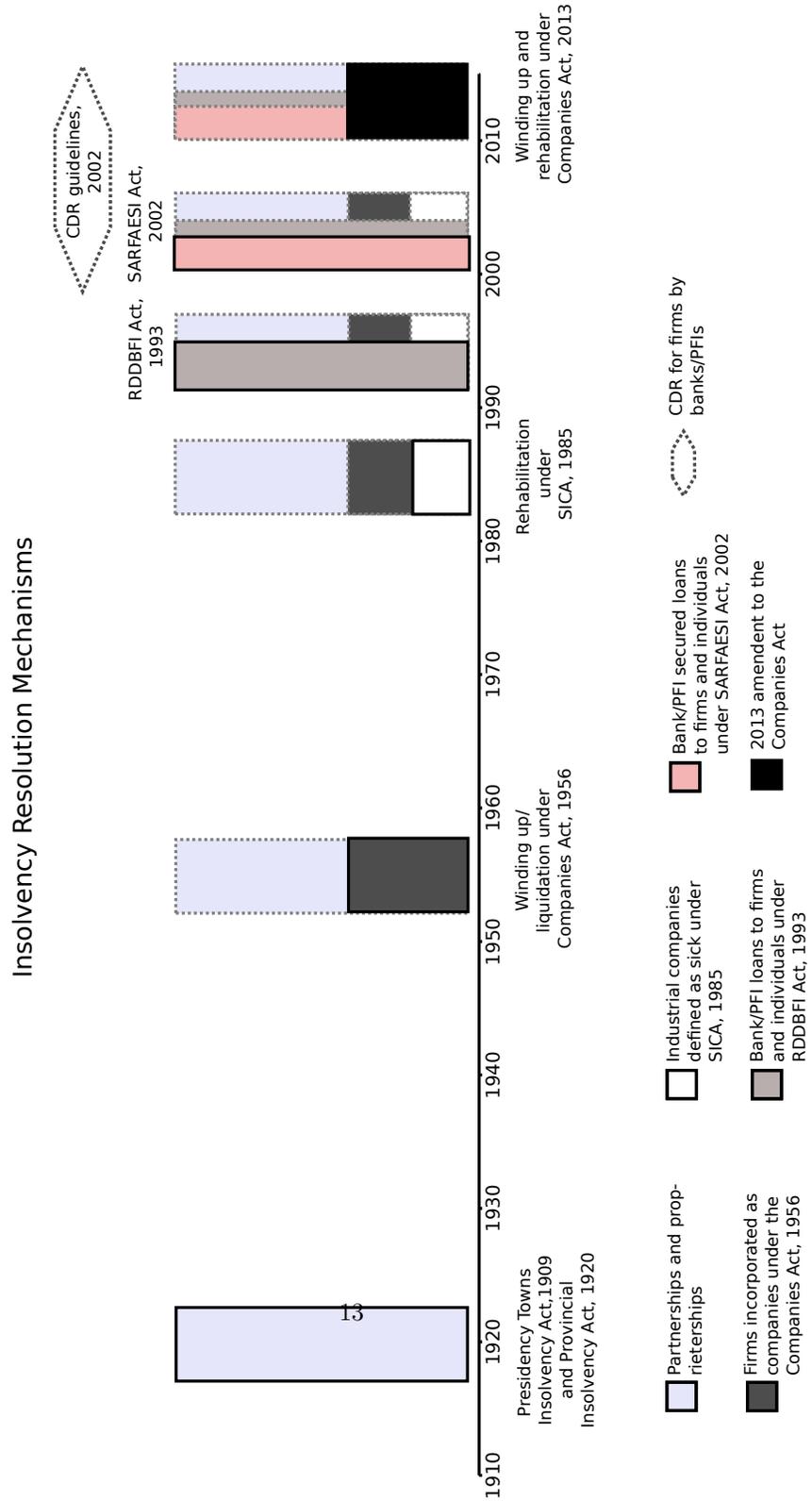
Figure 2 attempts to capture this scenario, where each column represents the fragmentation of the laws across entities (horizontally), and across creditors (vertically). It starts from a single law in 1920 to two laws in 1956, with Companies Act for all registered entities and the Insolvency Acts of 1909 and 1927 for partnerships and proprietorships. It ends in 2013 with two Acts across entities, but with three separate laws to initiate debt recovery.

The current insolvency resolution framework is characterised by deficiencies in the definitions of the laws, their procedures, their implementation as well as the capacity and capability of the institutional frameworks supporting them. A typical winding up process under the Companies Act, 1956 takes anywhere between 3-15 years leading to a complete erosion of the value of assets of the company.

## 5.1 Problems in legal outcomes

- There is no common framework for all firms.
- The trigger for filing a petition differs across different laws.  
For example, Companies Act, 1956 considers the incidence of default as the trigger while SICA, 1985, accepts a balance sheet trigger of negative networth.
- There is no clarity on whether there is a moratorium on actions against and by the debtor after a petition has been filed in court.
- There are no procedural timelines defined in any of the laws. Even where the timelines are defined, these are not adhered to (for example, RDDBFI, 1993).
- The supporting infrastructure of dedicated benches in courts and tribunals or the official liquidators do not yet have the required capacity to support a diverse set of creditors.
- The law does not encourage interim-financing for debtors that have filed for insolvency resolution.
- Banks and specified FIs have superior enforcement rights under debt recovery laws.
- There is no clarity on the interaction of the various insolvency laws and debt enforcement laws between themselves as well as with other major laws, for example, the Industrial Disputes Act and Transfer of Property

**Figure 2** Evolution of insolvency resolution mechanisms in India



**Table 3** Sources of funds aggregated for all non-financial firms

	1991-92	2009-10	2012-13
Equity	22.60	34.87	37.21
Retained earnings	10.56	21.05	6.85
Fresh issuance	12.04	13.82	30.36
Depreciation	17.64	9.69	3.56
Borrowing	35.32	29.48	21.57
Banks	17.14	17.83	15.20
Bonds	7.87	3.94	0.96
Inter-corporate	1.28	2.28	3.32
Foreign	5.51	3.22	0.74
Current liabilities	24.42	24.19	37.65
D:E	1.56	0.85	0.58

Source: CMIE Prowess

Act. The dependence on the courts for a resolution of the conflicts between these laws causes significant delays in the insolvency process.

- Out-of-court mechanisms used by banks, such as the CDR and SDR processes distorts the incentives in the credit process and skews the same towards large debtors and creditors.

## 5.2 Problems in economic outcomes

Figure 2 demonstrates the lack of a clear process for resolving insolvency. In such an environment there is also evidence that India has faced significant problems in developing credit markets. Given the state of corporate insolvency laws, at present bond investors plan for near-zero recovery upon default, which in turn drives up the required rate of return. This leads to few companies finding it cost effective to issue bonds. As a result, secured credit from banks and FIs continues to be the dominant source of debt financing for companies (Table 3). In fact, India is unique in that equity is a larger source of financing than debt for firms on average. While the debt-equity ratio tends to be around 3 for firms in developed economies, it is around 0.5 for Indian firms (Thomas 2005).

Table 3 shows that, out of 29.84 percent of total borrowings by Indian firms in 2009-2010, banks account for 17.83 percent. In absence of a well-functioning insolvency resolution framework, banks themselves continue to be vulnerable to poor recovery against loans when the debtor firms fail. The size of NPAs of banks has grown over the years along with their loan portfolios (Table 4).

Further evidence about the weaknesses in the legal framework for bankruptcy in India can be seen in the “Doing Business Survey” of the World Bank. Contracts take much longer to be enforced in India compared to countries like the U.S. and the UK, as can be seen in Table 5. India is ranked much lower than these countries on three sets of credit quality measures. In keeping with the literature,

**Table 4** NPAs of the banking system

	2008	2010	2013	2015
Gross Advances (Rs. cr.)	23,318	32,719	59,883	67,423
Gross NPA + restructured advances (%)	3.59	6.90	8.82	10.91

Source: Report on Trends and Progress of Banking in India

**Table 5** India's performance vis-a-vis other countries

	India	U.S.A.	U.K.	Australia	Singapore
<b>Getting Credit (Rank)</b>	28	3	1	3	3
• Index of legal rights strength (1...10)	8	9	10	10	10
• Private bureau coverage (%)	19.8	100	100	100	60.3
<b>Enforcing Contracts (Rank)</b>	186	11	56	14	12
• Time (Days)	1420	370	437	395	150
• Procedures (No.)	46	32	28	28	21
<b>Resolving Insolvency (Rank)</b>	121	17	7	8	4
• Time (Years)	4.3	1.5	1	1	0.8
• Recovery rate (cents per \$)	25.6	81.5	88.6	81.3	89.4
<b>Domestic Credit by financial sector (% of GDP)</b>	77.1	246.1	195.6	158.8	112.6

Source: World Bank Doing Business Report, 2014, World Bank World Development Indicators, 2014

the lack of legal protection for creditors visible in Table 5 is correlated with the poor development of the credit markets in India seen in Table 3.

## 6 Recent reforms

### 6.1 Bankruptcy Law Reforms Committee, 2014

In 2014, a significant effort at comprehensive bankruptcy reform was undertaken when the Ministry of Finance set up the Bankruptcy Law Reforms Committee (BLRC) under the Chairmanship of Dr. T. K. Viswanathan. The mandate of the BLRC was to recommend an Indian Bankruptcy Code, that would be applicable to all non-financial corporations and individuals, and would replace the existing framework. The Committee submitted its report and a comprehensive draft Insolvency and Bankruptcy Code (IBC) to the government in November 2015. In May 2016, the IBC was enacted in the Parliament. This implies that India now has a new insolvency law that would supersede the existing laws for all categories of debtors and creditors. The new law is yet to be notified by the government.

## 6.2 The Insolvency and Bankruptcy Code, 2016

IBC 2016 is different from the labyrinth of extant Indian laws dealing with corporate insolvency, both in principle and in the design of the resolution framework. It incorporates the recommendations of several past committees that were not taken into consideration earlier. It is a single, consolidated code for insolvency resolution of all entities unlike the existing laws such as Companies Act 1956 or SICA 1985, or SARFAESI 2002, that apply selectively to a certain group of debtors and creditors. It empowers all creditors – secured, unsecured, financial and operational to initiate insolvency proceedings. This is a significant departure from the existing framework. Unsecured financial creditors and operational creditors including the employees of the debtor firm have no rights to seek resolution of an insolvent firm under the prevalent laws.

IBC provides a forum for collective recovery and resolution. It gives opportunity to all key stakeholders to participate in the insolvency proceedings and collectively assess the viability of the defaulting firm. This is different from the individual recovery rights accorded to secured financial creditors by laws such as the SARFAESI, to the detriment of other creditors. Unlike SICA 1985 where restructuring proceedings can be initiated only when the firm has been reported “sick” which might be too late to recover any value, IBC 2016 enables the resolution process to start at the earliest sign of financial distress as reflected in a single default.

Once the resolution process begins, there is an automatic moratorium on all suits and claims against the debtor firm. This is to enable a calm period where other proceedings do not derail existing ones. While SICA 1985 has this provision as well, it permits the promoter/management of the debtor firm to retain control of the firm’s assets even in “sickness”. Often this led to pilferage and siphoning off of assets by the promoters/management, at the cost of the creditors. The debtor-in-possession regime promoted by SICA has been criticised by several committees in the past. IBC rectifies this by replacing the existing management during insolvency proceedings. A regulated insolvency professional will run and manage the firm as a going concern during the period of the insolvency proceedings.

IBC also stipulates finite time limits within which the debtor’s viability can be assessed. In the existing framework, judicial involvement in business decisions often causes inordinate delays in resolving insolvency. Under IBC the adjudicator’s main role is to see that the processes follow the law. All business decisions will be taken by a committee comprising all financial creditors. If the debtor firm is adjudged unviable and bankrupt, the firm goes into liquidation. IBC outlines a clear waterfall of priorities for the payment of dues to all claimants once the bankrupt firm’s assets are sold off.

In addition to the process improvements, IBC also proposes to set up new institutions to support the implementation of the law and ensure efficient outcomes.

These include a cadre of regulated insolvency professionals (or IPs) and IP agencies, regulated information utilities, an insolvency and bankruptcy regulator as well as a specialized tribunal to adjudicate upon insolvency related matters. It has been decided that individual insolvency cases will be referred to the DRTs and DRATs whereas the newly set up NCLT and NCLAT will deal with corporate insolvency matters.

With this framework, IBC seeks to achieve the objectives of low time to resolution, higher recovery rate and higher levels of debt financing across diverse sources.

## 7 Way forward for India

Aghion, Hart, and Moore 1994 document how the development of bankruptcy law “as a series of attempts to solve perceived immediate problems”, has led to “a widespread dissatisfaction with bankruptcy procedures throughout the world”. This accurately describes the manner in which insolvency laws came about in India. One flaw in the development of the legal framework for insolvency resolution is that it has addressed the interests of a single participant at every point in the evolution. There tended to be a bias towards certain constituencies, either the Indian business houses as the dominant debtors, or the banks and public financial institutions as the dominant creditors, or labour and state dues. These biases in development are reflected in the debt markets that are in place today.

Policy instead needs to develop to protect the interests of all parties involved in debt contracts. These include unsecured creditors, and operational as well as financial creditors such as banks or Non-Banking Finance Companies. The unsecured creditors form a strong emergent class of creditors to a wide range of debtors in India today. These include firms that produce services but do not have collateral such as the services sector or young firms. Debt markets that are restricted to a homogenous set of creditors are typically not able to provide credit to this broader mass of potential debtors. In such a market, debtors are limited in the diversification of their credit access, and creditors are limited in how well they can diversify their debt portfolio.

For a robust credit market to develop in India, there needs to be a single unambiguous law that covers insolvency of all classes of debtors and gives clarity to all classes of creditors about their rights when a debtor becomes insolvent. Creditors and the debtor have tangential preferences in insolvency. Creditors would prefer to liquidate the firm as quickly as possible to preserve existing economic value. Debtors would prefer to take on more risk within the enterprise in the hope of earning higher future revenues. While clarity on the individual rights of the debtor and the creditors is important, a good bankruptcy law should also incentivise collective action in assessing the economic value of the enterprise in

distress.

IBC 2016 is based on this principle of collective action and according rights to all the key stakeholders. Once implemented, the law will potentially change not only the manner in which insolvency is resolved in India but also the entire credit landscape of the country. It will pave the way for the development of alternative sources of credit that are crucial if India is to transition to a mature, market economy.

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