Understanding the recent IBC (Amendment) Ordinance, 2017

by Rajeswari Sengupta and Anjali Sharma.

The Insolvency and Bankruptcy Code, 2016 (IBC) is a landmark reform for India. At its core are three principles. First, businesses can and will fail, and all failure is not fraud. The IBC provides a forum for the creditors to collectively resolve such failures. Second, insolvency resolution is a commercial decision best left to the creditors' collective wisdom. Creditors are better placed than the state or the judiciary to decide whether to resolve or liquidate a firm in distress. Finally, predictability in the resolution process and the resolution outcomes improves the overall credit ecosystem. The report of the Bankruptcy Law Reforms Committee (BLRC) which proposed the IBC clearly explains that such a principles-based approach would yield positive outcomes for the overall credit environment of the country.

One year after the notification of the law, an Ordinance to amend IBC has been promulgated. This Ordinance bars several categories of persons and entities from participating in the IBC processes. In our assessment, by doing so, it goes against each of the three core principles of the IBC. In this article we analyse the Ordinance from three perspectives:

1. Who does the Ordinance disqualify and from which IBC processes? Does the disbarment extend beyond the promoters of the firms in IBC?
2. What is the likely impact of the Ordinance on the IBC?
3. What is the likely impact of the Ordinance on the incentives of the various concerned parties?

Q1. Who does the Ordinance disqualify? From which IBC processes?

The Ordinance introduces a new section 29A in the IBC. This section identifies eight categories of participants and bars them from participating in three IBC processes. It bars them from being a *resolution applicant* and submitting resolution bids for firms that are in IBC. Second, it bars them from making any bids in the IBC liquidation process. Finally, it bars them from being associated with the debtor firm while an IBC resolution plan is being implemented.

A critical feature of the disbarment is the extent of its coverage. Not only does the Ordinance bar the eight categories of participants, it also bars all persons connected with them (section 29(i)). The definition of *connected person* is fairly wide. As per the Ordinance, it includes promoters, holding and subsidiary companies, associate companies, persons in management, persons in control as well as *related parties*. It is unclear which definition of *related parties* will be applicable to assess this disbarment. The term *related party* is defined in three separate laws, each with varying degrees of coverage:

1. Under section 188 of the Companies Act, 2013.
2. Under the Clause 49 of the Listing Agreement laid down by SEBI.
3. Under section 2(24) of the IBC itself where related parties in relation to the corporate debtor are laid down.

The IBC definition of *related party* is the widest. It includes directors, partners, key management personnel, entities with common directors, advisors, entities associated with policy making, subsidiaries, holding companies, associate companies, shareholders with 20% or more voting rights, and entities that provide or receive managerial or technical assistance.

The eight categories of persons being disbarred are themselves extensive in coverage. These categories are sourced from several laws ranging from the Banking Regulation Act, the SEBI Act, the Indian Penal Code (IPC), and the IBC itself. Laws from foreign jurisdictions also form the basis of one such category. We take a closer look at these categories of disbarment, their possible coverage, and the requirements which form the basis of these disqualifications.

1. **Undischarged insolvent (section 29A(a)):** Given that the IBC is the insolvency law in force, this category finds its basis in the IBC itself. It effectively excludes all entities that are in the IBC process, and their related parties such as promoters, managers and associate companies, from making resolution bids or participating in liquidation. With this clause in place, only third parties not connected to the firm in IBC can participate in the IBC resolution process. However, the other clauses of the Ordinance include even the third parties in the list of exclusions.

2. **Persons convicted for any offence punishable with imprisonment for two or more years (section 29A(d)):** This category finds its basis in the Criminal Procedure Code (CrPC) as well as other laws which have penal provisions for imprisonment of two years or more. For instance the Income Tax Act, the Negotiable Instruments Act, and the Prevention of Money Laundering Act all have such provisions for a range of offences. The manner in which this clause has been drafted does not require the person to be awarded an imprisonment of two years or more. It requires only that the offence they have been convicted of have this penalty available as an option. Often the imprisonment penalty in these laws ranges from three months to two or three years. The intent of this clause may have been to disbar persons who have been convicted of serious offences from IBC proceedings, but its drafting overreaches and disbars a far larger group of participants.

   This clause creates uncertainty about any IBC bids from persons who may be under investigation for such offences. The Committee of Creditors (CoC) may be biased against such bids due to the risk of future convictions. This clause also has the potential of being abused by vested interests who may use it to create negative biases against competitors' bids.

3. **Wilful defaulters (section 29A(b)):** This category finds its basis in the wilful defaulter guidelines of the Reserve Bank of India (RBI). There are inherent problems in the process using which some defaulters are classified as 'wilful'. The process is conducted entirely by committees of banks' senior management, who in this case are *nemo iudex in causa sua* or judges of their own cause. Even though the consequences of being classified a wilful defaulter are steep, there is no appeal mechanism available in the RBI norms. In some cases, the classification as wilful defaulter has been successfully challenged in High Courts.

   The RBI norms bar wilful defaulters from accessing bank credit. SEBI has barred them from a wide range of activities in the capital markets- from raising capital, to holding Board positions, to setting up capital market intermediaries such as mutual funds or brokerages. Reports suggest that as of March 2017, banks had classified 8,915 accounts amounting to Rs. 0.92 trillion of loans as wilful defaults.

   Since a wilful defaulter is shut out from formal financial institutions and markets, market dynamics would naturally prevent them from submitting any credible bids in the IBC resolution process. Even if a wilful defaulter is able to submit a bid, the CoC in IBC has the power the reject such a bid. Given that commercial incentives were already stacked against any bids made by wilful defaulters, it is unclear why the need was felt to amend the law to exclude these entities explicitly.

4. **Any person with a loan that has been NPA for one year or more (section 29A(c)):** This category finds its basis in the micro-prudential regulations that RBI imposes on banks under the Banking Regulation Act, 1949. When loan accounts become overdue for more than 90 days, banks are required to classify them as non-performing assets (NPAs). A borrower whose loan remains an NPA for 12 months or more, is barred by this Ordinance from submitting IBC resolution bids. A person may have one or more loans from banks and if even one of them fulfills this condition, then she is barred from bidding in IBC.

   This criterion creates uncertainty for participants in the stressed asset market who may have invested in a defaulting firm or wish to buy NPAs from banks. Unless they get clarity that these actions will not disbar them from the IBC process, they will be disincentivised from making such investments.

   A recently released Credit Suisse report points to the likely extent of exclusion that may occur on account of this category of disbarment. It finds that more than 50% of the stressed debt in the corporate sector (Rs 7.3 trillion) is with firms whose interest coverage ratio (ICR) has been less than one for two years. An ICR of less than one over such a long period suggests that many of these firms did not have the wherewithal to pay the interest on their borrowings and are likely to be NPA for more than 12 months in the banks' books.

   The Indian corporate sector has been in distress from 2010 onwards. For a large part of this period, banks under the umbrella of various restructuring schemes initiated by the RBI allowed corporate distress to remain hidden and unresolved. In the last two years, as part of RBI's Asset Quality Review (AQR) process many of these corporate loan accounts got classified as NPAs. Barring them from the IBC process puts the blame for unresolved distress squarely on these companies and their promoters, and lets the banks and the RBI off the hook despite their role in encouraging the 'extend and pretend' course of action and delaying resolution of corporate distress.

5. **Persons disqualified as directors (section 29A(e)):**
   This category finds its basis in section 164 of the Companies Act, 2013 (CA2013) which lays down the criteria for director disqualification. In October 2017, in a crackdown on shell companies, the Ministry of Corporate Affairs disqualified around three lakh persons from acting as directors. This action was taken under section 164(h)(a) of CA2013, which disqualifies a director of a company that has not filed financial statements or annual returns for three years in a row. There is no appeal mechanism available in CA2013 for a person disqualified as a director.

6. **Persons barred by SEBI from the securities markets (section 29A(f)):** This category finds its basis in the penal provisions of the SEBI Act, 1956. This disqualification criterion lacks clarity. The SEBI Act empowers SEBI to issues two types of orders through which participants are barred from accessing the securities markets: interim orders and final orders. Interim orders are *ex-parte* orders that are issued when investigation against the concerned entities is still ongoing. In these cases the concerned parties do not have the remedy of appeals to the Securities Appellate Tribunal (SAT) available to them. In its current form, the Ordinance bars both types of participants from the IBC process: those against whom an investigation is ongoing, and those against whom a final order has been made by SEBI.

7. **Persons who have given a guarantee to a creditor in respect to a corporate debtor in IBC (section 29A(h)):** This clause does not have any legal basis. Its simply bars any person who has extended an enforeceable guarantee to a creditor in respect of a company in IBC from submitting bids under IBC. Effectively, it makes the act of giving a guarantee an offence which is penalised under IBC.

   For a long time, banks in India have followed the practice of taking guarantees from promoters, major shareholders and associate companies for giving loans to companies. If such a company became distressed and ended up in IBC, it is unclear why these parties should be excluded from the resolution process. If these guarantors fail to fulfill their guarantee, IBC can be triggered against them. Similar concerns also arise for parties that have provided credit enhancement facilities, which are nothing more than guarantees.

8. **Persons from foreign jurisdictions (section 29A(j)):**
   This category offers the least clarity, in terms of coverage and intent. It bars from the IBC bidding process any person who falls in categories 1 to 7 as per the laws of foreign jurisdictions.

   The drafting of this clause suggests a wide disqualification, even for foreign participants. For instance, it suggests that a person or a company in India who may have an NPA account of more than one year in a bank in the UK is barred from submitting IBC resolution bids for any company in India. Likewise, a person or a company in the UK, who has given a guarantee for a UK company which goes into insolvency as per UK laws, cannot submit a resolution bid for a company under IBC in India.

To sum up: *if a person satisfies any of the above criteria or if a person is connected to an entity who satisfies any of the above criteria, then she cannot make a resolution bid or participate in liquidation proceedings in IBC.*

The initial discussion around this Ordinance focused on the disbarment of promoters of firms that are undergoing IBC proceedings from the resolution process of their own firms. However, in its current form the Ordinance bars them from any IBC resolution or liquidation, not just of their own firm. It also bars from the IBC bidding process, promoters of firms that are not in IBC, but who fall in any one of the eight categories.

Q2. What is the likely economic impact of this Ordinance on IBC?

In our view, this Ordinance will impact the IBC in four ways:

1. **Procedural impact:** The Ordinance introduces substantial procedural uncertainty in the resolution process and opens it up to disputes and litigation. For instance, it is unclear if this Ordinance will apply prospectively or retrospectively. Will it apply to the cases that are already in IBC? Similarly, will it apply to borrowers whose loans were NPA greater than 12 months as at the date of the Ordinance, or after?

   It complicates the role of the Resolution Professional (RP) or the Liquidator. These insolvency professionals now have the task of determining the eligibility of applicants as per this Ordinance.

   The Ordinance also puts a strain on the 180 (or 270) day timeline of the IBC. In case potential resolution applicants dispute their disbarment, the entire IBC process has to be put on hold till such dispute is adjudicated upon. If this Ordinance is applied to the current IBC cases many of which are already well underway, then the IPs may have to seek bids from new applicants eligible under the Ordinance and discard existing offers that may have been made by persons falling in any of the eight disbarment categories. The timeline of 180 (or 270) days may not be sufficient for the IPs to go through the bid-seeking process all over again.

2. **Economic impact on resolution**: The Ordinance effectively disqualifies vast sections of the corporate world,
   both in India and abroad, from participating in the IBC bidding process. In doing so, it significantly reduces the number of likely resolution plans that maybe submitted in any IBC case in an already gloomy landscape. The lack of competition among the narrow pool of eligible bidders will depress the financial value of any resolution plan that is eventually submitted to the CoC. The smaller the value of the eligible resolution plans, the greater will be the haircuts that the financial creditors, including banks, will be forced to accept. If the Ordinance is retrospectively applied, it will affect the current crop of 402 cases in IBC, including the 12 big cases that the RBI had identified earlier this year. These 12 cases are in the distressed sectors of steel, power, infrastructure, engineering-procurement-construction etc. for which recovery rates are expected to be low. With this Ordinance, the recovery rates in these cases will be even lower than initially expected. It is likely that many of these will end up in liquidation due to lack of sufficient bids.

3. **Economic impact on liquidation:** In the worst case scenario of no viable resolution bid submitted during the 180 (or 270) days of IBC, the firm in question will go into liquidation. Liquidation recovery rates are in any case lower but the Ordinance further aggravates it by signficantly reducing the pool of prospective buyers in liquidation as well.

   Presumably the driving force behind the Ordinance is to keep the promoters of the IBC firm at bay in order to prevent them from buying back the firm at a lower price. In India, third parties may find it difficult to acquire and manage promoter-controlled businesses without the cooperation of promoters. This is because such businesses may be operating on the basis of a large number of unwritten, informal contracts between the promoters and other parties. These maybe difficult for the RP to formalise within the 180 (or 270) day period of the IBC resolution process.

   Even if an eligible, external bidder makes a bid for acquiring a firm in IBC, it will apply discounts to the risks it faces on account of these informal contracts. In many cases these risks may be large enough to deter any third party bids. The exclusion of the promoters by the Ordinance may in fact negatively impact the outcome. In such circumstances, liquidation of the firm becomes highly likely.

   Large scale liquidations destroy organisation capital of firms. They are bound to have a detrimental effect on jobs, corporate sentiments and the overall economic growth of the country. In other words, the repercussions of the Ordinance may extend far beyond mere promoter exclusion.

4. **Impact on IBC principles:** By substantially shrinking the universe of eligible resolution applicants as well as potential buyers in liquidation, the Ordinance violates the core principles of the IBC.

   The IBC is based on the premise that all business failure is not fraud. The Ordinance by its very design goes against this principle. By disqualifying from the IBC bidding process any defaulter who has had an NPA account for one year or more, or who has given a guarantee, it views business failure and fraud with the same lens. A person may have faced adverse economic shocks such as a business cycle downturn or a commodity price shock as a result of which the firm owned or managed by her may have been unable to repay a loan for more than a year. This is different from a fraudulent or an unscrupulous promoter who may have been siphoning off assets from her own firm and hence has rendered it insolvent by her own actions. The Ordinance treats both these categories on par. In doing so and by disqualifying genuine bidders, it runs the risk of committing what is called a Type I error in statistical analysis.

   Another core principle of the IBC is that the resolution outcome is best left to the creditors' collective wisdom. Accepting or rejecting a resolution plan is a commercial decision and the creditors are best-placed to evaluate such a plan. The IBC gives the CoC complete discretion to reject any resolution plan that they may consider unviable or unsuitable. The creditors should have the right to choose a plan based on how much value they will recover in the process. By interfering with this process and by deciding who all are now eligible to submit their bids, the Ordinance risks jeopardising the very outcomes intended by IBC.

   An ultimate test of the success of IBC is the recovery rate. As the preamble to IBC clearly states, the primary objective of the law is maximisation of value of assets of the debtor firm undergoing the insolvency and bankruptcy proceedings. Fulfilling this objective requires a competitive bidding process such that there is a fair price discovery mechanism. The Ordinance thwarts this process by removing a large number of potential bidders from the applicant pool. By doing so, the Ordinance may end up lowering the recovery rate in the IBC resolution process. This creates uncertainty in the credit environment of the country. Creditors are encouraged to offer better terms and conditions when they are assured of a certain outcome upon the default of a firm. In an environment of persistently low recovery rates, IBC may not result in the desired outcome of an improved credit culture.

Q3. What is the likely impact of the Ordinance on the incentives of concerned parties?

The Ordinance, by its sweeping nature, is likely to affect the incentives of several stakeholders, both within and outside of IBC proceedings. Here we conjecture about the change in incentives of three main parties:

Promoters and borrowers

The Ordinance shuts out a large fraction of the promoters from the IBC bidding process, not just the wilful defaulters. Once disqualified from submitting bids for their own firms, the promoters have little incentive to co-operate with the RPs and share relevant information using which the RPs can seek potential bids.

In fact, as a firm becomes stressed, the Ordinance creates incentives for its promoters to indulge in high risk behaviour or asset stripping, even is it means running their firms to the ground. This is because the promoters know that with the amended IBC in place, they have no chance to buy back their firm once it enters into IBC.

The Ordinance disqualifies defaulters with an NPA account of one year or longer. This clause creates disincentives for firms that have inherently risky business models to seek bank financing. Since banks are the largest source of finance in India, this may create barriers to firm growth.

In the long run the Ordinance may affect the spirit of entrpreneurship in the country. The essence of IBC is to facilitate quick exits of failed firms and to accept failure as a natural outcome of entrepreneurship. With the Ordinance in place, the amended IBC will lead to promoters losing their firms even if the firms were in genuine distress.

Banks

The Ordinance gives incentives to the banks to delay NPA recognition for as long as possible.

By disqualifying a large number of persons, the Ordinance will lower the amount that the banks as the main financial creditors in most of the IBC cases expect to recover. This may result in the banks not recognising accounts as NPA so that the promoters can submit their bids in the IBC resolution process. The more the number of resolution plans submitted to the CoC, the higher will be the recovery rate in the competitive bidding process. It is possible that banks may also pressurise the promoters to pay up their dues but there is also a cost of provision that comes with early classification. If, as a result of the Ordinance, banks can benefit from higher recovery rate and also avoid provisions, they may have a greater incentive to delay NPA recognition.

Further, given that the Ordinance may adversely affect the recovery rate in the IBC process, banks may no longer have the incentive to trigger IBC to begin with. This Ordinance puts at risk even the out-of-court settlements with the eight categories of disbarred participants. For instance, if a plan that involves one of the eight categories of participants is negotiated out-of-court, and IBC subsequently gets triggered by a third party, the negotiated plan cannot be implemented and the RP has to seek fresh resolution bids.

Government

Most of the banks in the CoC are public sector banks, especially in the big cases undergoing IBC proceedings. By affecting the recovery rate that these banks may expect to achieve, the Ordinance may also affect the incentives of the government as the majority shareholder in these banks. The government maybe incentivised to encourage public sector firms (PSUs) to bid in the IBC resolution process so that the deals go through at relatively higher prices and the PSU banks do not face large haircuts. This may create an illusion of success in the IBC process but it will result in increased government ownership in the stressed industries which is not an efficient outcome.

If the inevitable outcome of the Ordinance is an increase in the number of liquidation cases, then also the government maybe incentivised to step in and instruct the PSU firms to bid in order to prevent large scale liquidations and resultant job losses.

Conclusion

Given its wide coverage, it is not clear whose interest the Ordinance is trying to protect or who the Ordinance is trying to punish. It is difficult to ignore the role of the promoter in any Indian business. If the promoter is allowed to bid for her firm as part of the IBC resolution process, there may not be any other bidder because there is a big asymmetry of information that favours the promoter. If, on the other hand, the promoter is completely shunned, then there may not be sufficient number of bids and the firm may go into liquidation.

One way to resolve this conundrum maybe to bar promoters from participating in the IBC bidding process in their full capacity while permitting them to make deals with third parties such as private equity funds, who would be the primary bidders. The share of the promoters maybe capped at a certain threshold in the resolution plan submitted to the CoC by the fund. This could be a reasonable compromise wherein the promoters get some value out of the auction process. They are not able to fully buy back their firms at a discounted price neither are they completely pushed aside. This may also ensure that the firm does not get liquidated and organisational capital is not lost.

Once such a condition is put in place in the amended IBC, there is no rationale for barring all the other categories of persons in the sweeping manner as done by the Ordinance. The IBC process in essence is a commercial one and the Ordinance to amend the IBC should not be driven by moral considerations.

Rajeswari Sengupta and Anjali Sharma are researchers at Indira Gandhi Institute of Development Research, Mumbai. The authors would like to thank Ajay Shah and Josh Felman for useful discussions