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# Value Destruction and Wealth Transfer under the Insolvency and Bankruptcy Code, 2016

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# Value destruction and wealth transfer under the Insolvency and Bankruptcy Code, 2016

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**Summary.** India experienced a major structural change with the enactment of the Insolvency and Bankruptcy Code, 2016. Since then, India's ranking under the Insolvency head in the World Bank Group's Doing Business report has sharply risen from 136 to 103. India was also awarded the Global Restructuring Review (GRR) Award for the *Most Improved Jurisdiction* in restructuring and insolvency regime. Yet, the Insolvency and Bankruptcy Code, 2016 has also raised two important concerns - the *value destruction* problem and *wealth transfer* problem. This article applies theoretical concepts from the law and economics literature on insolvency to identify the sources of these two problems in insolvency law. It then applies these theoretical concepts to the Insolvency and Bankruptcy Code, 2016 to identify two potential sources of the *value destruction problem* and four potential sources of the *wealth transfer problem* in the law. Indian policymakers need to revisit some of the fundamental legislative design choices embedded within the Insolvency and Bankruptcy Code, 2016 to successfully address these very sources of the *value destruction* and *wealth transfer* problems.

## 1.1 Introduction

India experienced a major structural change with the enactment of the *Insolvency and Bankruptcy Code*, 2016. Before this, it did not have any comprehensive modern statute on corporate insolvency.[1] Intermittent attempts were made at various points of time to develop a modern insolvency law framework.[2] In 2014 the Finance Minister made a budget announcement about the government's plan to usher in an entrepreneur friendly legal bankruptcy framework.[3] Later that year, the Bankruptcy Law Reforms Committee (BLRC) was set up.[4] In 2015, the BLRC submitted its report along with a draft legislation, which finally culminated into the enactment of the *Insolvency and Bankruptcy Code*, 2016.

Since the enactment of the *Insolvency and Bankruptcy Code*, 2016, India's ranking under the Insolvency head in the World Bank Group's Doing Business report has sharply risen from 136 to 103.[5] India was also awarded the GRR Award for the Most Improved Jurisdiction in restructuring and insolvency regime, surpassing even European Union and Switzerland.[6] However, at the same time, *Insolvency and Bankruptcy Code*, 2016 has also thrown up new challenges.[7]

Two such challenges are particularly important. *First*, there are concerns that companies entering formal insolvency under the *Insolvency and*

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[1] *Report of the Joint Committee on the Insolvency and Bankruptcy Code, 2015*. Lok Sabha, Apr. 28, 2016, p. 6.

[2] See e.g. R. Sengupta, A. Sharma, and S. Thomas. *Evolution of the insolvency framework for non-financial firms in India*. 2016. URL: `http://www.igidr.ac.in/pdf/publication/WP-2016-018.pdf` (visited on 04/26/2018), pp. 5-10; K. van Zwieten. "Corporate rescue in India: The influence of the courts". In: *Journal of Corporate Law Studies* 15 (2015), p. 1, pp. 2-5.

[3] Interestingly, the Finance Minister in his budget speech had only mentioned that an 'entrepreneur friendly legal bankruptcy framework will also be developed for SMEs to enable easy exit.' Finance Minister. *Budget Speech*. 2014. URL: `https://www.indiabudget.gov.in/budget2014-2015/ub2014-15/bs/bs.pdf` (visited on 03/31/2018), paragraph 106.

[4] *The report of the Bankruptcy Law Reforms Committee. Volume I: Rationale and Design*. Bankruptcy Law Reforms Committee, 2015, chap. 9.

[5] Reserve Bank of India. *Financial Stability Report*. Report. 2017, par. 53.

[6] Insolvency and Bankruptcy Board of India. *India wins the GRR Award for the Most Improved Jurisdiction*. June 28, 2018. URL: `http://ibbi.gov.in/webadmin/pdf/press/2018/Jun/Global%20Restructuring%20Review%20(1).pdf` (visited on 09/27/2018).

[7] In view of these challenges, the government constituted the Insolvency Law Committee (ILC) to recommend legislative and regulatory changes. *Report of the Insolvency Law Committee*. Insolvency Law Committee, 2018; to address some of these challenges, the IBC has already been amended twice through Presidential ordinances, followed up by Parliamentary laws. *The Insolvency and Bankruptcy Code (Amendment) Ordinance*. 2017; *The Insolvency and Bankruptcy Code (Amendment) Ordinance*. 2018.

*Bankruptcy Code*, 2016 often experience avoidable value destruction. For instance, a legitimate apprehension arises if insolvent companies with viable businesses on entry into formal insolvency are inadvertently pushed into liquidation instead of being successfully restructured or its business being sold as a going concern. In the context of *Insolvency and Bankruptcy Code*, 2016, this apprehension has been triggered due to the fact that more companies are being liquidated than successfully salvaged under the *Insolvency and Bankruptcy Code*, 2016.[8] Since the enactment of *Insolvency and Bankruptcy Code*, 2016 till September 30, 2018, out of the 1198 cases admitted to insolvency resolution process, 118 were closed on appeal or review, 52 yielded resolution, while 212 resulted in liquidation.[9] In other words, till end of September 2018, only 20% of the cases were successfully resolved, while 80% ended up in liquidation.[10] In one particular case, allegations were made that a viable company was pushed into liquidation.[11] Value destruction could also happen if entry into formal insolvency makes it more difficult to preserve the value of an insolvent company.

[8] As reported by Business Standard, according to data from IBBI, around 78 companies got liquidation orders since February 2017. Resolution plans have been approved by the National Company Law Tribunal (NCLT) in only 6 cases, and in another 4 cases, resolution plans have been submitted to the NCLT. Namrata Acharya. *IBC proceedings: 78 liquidation orders, a handful of resolutions*. Apr. 22, 2018. URL: `http://www.business-standard.com/article/economy-policy/ibc-proceedings-78-liquidation-orders-a-handful-of-resolutions-118042200726_1.html` (visited on 04/23/2018); See also Banikinkar Pattanayak. *Insolvency law: More firms going for liquidation than resolution; over 20 face closure*. Dec. 25, 2017. URL: `http://www.financialexpress.com/industry/insolvency-law-more-firms-going-for-liquidation-than-resolution-over-20-face-closure/988676/` (visited on 03/29/2018).

[9] IBBI. *Insolvency and Bankruptcy News: Automating the wheels of commerce*. Oct. 30, 2018. URL: `https://ibbi.gov.in/QUARTERLY_NEWSLETTER_FOR_JUL_SEP_2018.pdf` (visited on 12/17/2018).

[10] The trend has been similar earlier too. However, this could be because of legacy cases from the earlier regime. ENS Economic Bureau. *Lower value realisation due to liquidation of corporate debtors*. Sept. 22, 2018. URL: `https://indianexpress.com/article/business/banking-and-finance/lower-value-realisation-due-to-liquidation-of-corporate-debtors/` (visited on 09/27/2018).

[11] Arun Kumar Jagatramka, the Chairman and Managing Director of Gujarat NRE Coke Ltd criticised the bankers after NCLT ordered liquidation of his company. The insolvency proceeding was initiated by the company itself under section 10(1) of the Code. The workers proposed a resolution plan for a going concern sale of the company. However, the resolution plan could not be considered by the Committee of Creditors because the statutory time limit for approving the resolution plan was exceeded. Consequently, the company had to be liquidated by the NCLT as per the Code. Gopika Gopakumar. *Insolvency code: Gujarat NRE Coke CMD seeks more accountability from bankers*. Jan. 16, 2018. URL: `https://www.livemint.com/Companies/045S6mr9BoGeEAe5tI8AYL/Insolvency-code-Gujarat-NRE-Coke-CMD-seeks-more-accountabil.html` (visited on 03/29/2018); See also *Re: M/s. Gujarat NRE Coke Ltd.* 2018.

For instance, a company on admission into insolvency resolution process under *Insolvency and Bankruptcy Code*, 2016 reported severe strains on its working capital and decline in level of operations, impacting the carrying value of its assets.[12] Such cases have raised apprehensions about the potential risks of value destruction under the *Insolvency and Bankruptcy Code*, 2016.

*Second*, there are wide-ranging concerns that the *Insolvency and Bankruptcy Code*, 2016 unjustly discriminates against operational and trade creditors.[13] The constitutionality of the *Insolvency and Bankruptcy Code*, 2016 is currently facing legal challenges primarily on this ground.[14] The issue had gained prominence during insolvency of major real estate companies, where home buyers being unsecured creditors were left without any effective remedy.[15] Subsequently, some aggrieved home buyers filed a public interest litigation in the Supreme Court challenging the constitutionality of the preference given to financial creditors under the *Insolvency and Bankruptcy Code*, 2016.[16] Sim-

[12]See notes to unaudited financial statements of Videocon Industries Ltd. for the quarter ending June 30, 2018. Videocon Industries Limited. *Un-audited Financial Results for the Quarter ended 30th June, 2018 and Changes in Key Managerial Personnel of the Company*. Un-audited Financial Results. 2018.

[13]As discussed later in Chapter 1.2.1, under the Code only financial creditors have the right to vote on the future of the insolvent company - whether to liquidate it or not. Operational creditors do not have any say in this matter. According to a report in Business Standard, since resolution plans of most bidders are only taking care of secured financial creditors, unsecured operational creditors are planning to challenge this legal discrimination against them before the Supreme Court. Dev Chatterjee. *IBC: Bidders want clarity on haircut to be offered to operational creditors*. Mar. 29, 2018. URL: `http://www.business-standard.com/article/companies/ibc-bidders-want-clarity-on-haircut-to-be-offered-to-operational-creditors-118032500600_1.html` (visited on 03/29/2018).

[14]Multiple writ petitions challenging the constitutionality of this feature of the statute are currently pending before the Supreme Court of India. *Swiss Ribbons Pvt. Ltd. v. Union of India*. Dec. 13, 2018; A. Aryan. *Operational creditors should get a say, vote in insolvency process: SC*. Dec. 13, 2018. URL: `https://www.business-standard.com/article/companies/operational-creditors-should-get-a-say-vote-in-insolvency-process-sc-118121300923_1.html` (visited on 10/07/2018); an earlier writ petition on the same ground was dismissed by the Calcutta High Court observing that the Bankruptcy Law Reforms Committee (BLRC) had given a clear rationale for differentiating between financial and operational creditors, discussed in footnote 58 in Chapter 1.2.2.1. *Akshay Jhunjhunwala v. Union of India*. 2018.

[15]In one such case, the NCLT held that home buyers were neither financial creditors nor operational creditors. This caused much confusion about the status of home buyers under the Code. *Rubina Chandha v. AMR Infrastucture*. July 21, 2017; the ILC has now suggested that home buyers should be treated as 'financial creditors' owing to the unique nature of financing of real estate projects and the treatment of home buyers by the Supreme Court of India. see n. 7, par. 1.1-1.9.

[16]IDBI Bank initiated insolvency proceedings against Jaypee Infratech Limited ('Jaypee'), a real estate company. The NCLT issued an insolvency commencement

ilar concerns have arisen in the context of dissenting financial creditors too. But the decision of National Company Law Appellate Tribunal (NCLAT) in *Central Bank of India v. Resolution Professional of Sirpur Paper Mills Ltd. and Ors.* and a subsequent amendment to the regulations by Insolvency and Bankruptcy Board of India (IBBI) on October 5, 2018 have partially addressed the problem.[17] These cases essentially highlight the risks of wealth transfer across classes of claimants under the *Insolvency and Bankruptcy Code*, 2016.

This article aims to apply theoretical concepts from the law and economics literature on insolvency to identify the sources of these two contemporary challenges - the *value destruction problem* and the *wealth transfer problem*. It then applies these theoretical concepts to analyse the *Insolvency and Bankruptcy Code*, 2016 to precisely identify the unique legislative features which are responsible for these two problems in the Indian context.

This article is organised as follows: Part 1.2 provides an overview of the relevant features of the legislative scheme of the *Insolvency and Bankruptcy Code*, 2016. Based on this discussion, it develops the two challenges discussed above into two precise research questions and frames them within the context of the overall scheme of the *Insolvency and Bankruptcy Code*, 2016. Part 1.3 deals with the first challenge - the *value destruction problem*. It develops a theoretical framework to analyse the various types of this problem and the sources from which they could potentially emanate. Then it applies this theoretical framework to the *Insolvency and Bankruptcy Code*, 2016 to identify two potential sources of the *value destruction problem* in the *Insolvency and Bankruptcy Code*, 2016. First, the law entrusts the decision about the future of a *financial distressed* corporate debtor with a super-majority of financial creditors, whose payoffs may not necessarily be affected by the outcome of that decision. Therefore, they may not have the right incentive to preserve the value of the business of the corporate debtor. Second, by limiting the benefits of the cramdown provision only to post-insolvency restructuring, the law delays restructuring and enhances the risk of *value destruction* of the

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order and imposed a moratorium on any individual recovery action against the company. This order left the home buyers of Jaypee without any remedy, especially since during the moratorium they could no more utilise the remedies under the Consumer Protection Act, 1986. In this backdrop, the home buyers filed a public interest litigation before the Supreme Court arguing that the differential treatment between secured financial creditors and unsecured home buyers under the Code is violative of Article 14 of the Constitution of India that guarantees equality before law as a fundamental right. This matter is currently pending. Advocate for the petitioners. *Chitra Sharma v. Union of India*. Aug. 21, 2017. URL: `https://barandbench.com/wp-content/uploads/2017/09/Jaypee-Petition.pdf` (visited on 03/29/2018).

[17] *Central Bank of India v. Resolution Professional of Sirpur Paper Mills Ltd. and Ors.* Sept. 12, 2018, par. 9; The regulations which were one of the sources of the wealth transfer problem were deleted by IBBI on October 5, 2018. *Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) (Fourth Amendment) Regulations*. 2018.

corporate debtor. Part 1.4 deals with the second challenge - the *wealth transfer problem*. It develops a theoretical framework to analyse the various types of this problem and the sources from which they could potentially emanate. Then it applies this theoretical framework to the *Insolvency and Bankruptcy Code*, 2016 to identify four sources of the *wealth transfer problem* in the *Insolvency and Bankruptcy Code*, 2016. First, the law does not expressly provide for judicial supervision to ensure fairness in a resolution plan adopted by cramming down the minority financial creditors. Consequently, till October 5, 2018, a resolution plan that paid only the break-up 'liquidation value' to such dissenting minority financial creditors, would have been perfectly legal under the regulations and had to be approved by National Company Law Tribunal (NCLT). This created potential risks of *wealth transfers* from dissenting minority financial creditors through resolution plans. After October 5, 2018, in the absence of a specific valuation benchmark for dissenting financial creditors in the law or regulations, it remains to be seen what valuation benchmark could be successfully used in this regard. Second, the regulations before October 5, 2018, used the break-up 'liquidation value' instead of going concern 'liquidation value' as the benchmark for restructuring of a *financially distressed* company, reducing the valuation of the claims of the dissenting minority financial creditors in the restructured company. After October 5, 2018, in the absence of a specific valuation benchmark for dissenting financial creditors in restructuring cases, it remains to be seen what valuation benchmark could be successfully used in this regard. Third, the law incorrectly applies the 'liquidation value' benchmark used in restructurings to going concern sales for cash to third parties, creating opportunities for *wealth transfer* from operational creditors to junior claimants in such sales transactions. Fourth, the appointment process of registered valuers could create scope for strategic valuation favouring *wealth transfer* to majority financial creditors. Finally, Part 1.5 summarises the main learnings from Chapter 1.3 and Chapter 1.4 and concludes the article.

## 1.2 IBC 2016

### 1.2.1 Overview of legislative scheme

The *Insolvency and Bankruptcy Code*, 2016 classifies creditors into financial or operational, based on the nature of debt extended. 'Financial debt' is broadly defined to include credit extended against consideration for the time value of money including against payment of interest.[18] On the other hand, 'operational debt' has been defined as a claim in respect of provision of goods or services including employment and tax dues.[19] The IBBI has subsequently

[18] *Insolvency and Bankruptcy Code*. 2016, 5(8).
[19] Ibid., 5(21).

created another third category of creditors - 'other creditors' - who are neither financial nor operational creditors.[20] If a corporate debtor defaults on payment to any creditor, financial, operational or other creditor, the *Insolvency and Bankruptcy Code*, 2016 allows the corporate debtor itself or any of its financial or operational creditors to make an application before the NCLT to trigger the insolvency resolution process.[21] The application must also propose an insolvency professional to act as the interim resolution professional.[22]

Within fourteen days from the date of filing of the application, the NCLT has to decide whether to admit the application or not, based on a two-fold test.[23] First, depending on whether the applicant is a financial or operational creditor, NCLT has to follow the relevant statutory procedure to confirm that the corporate debtor has actually committed a payment default.[24] Second, NCLT has to confirm that there is no disciplinary proceeding pending against the proposed insolvency professional.[25] Once these prerequisites are confirmed, NCLT is required to admit the application and issue an order initiating the insolvency resolution process against the corporate debtor.[26] Simultaneously, NCLT must also declare a moratorium on any individual recovery action against the assets of the corporate debtor.[27] Within fourteen days of commencement of the resolution process, the NCLT is required to pass an order appointing an interim resolution professional to immediately take over the management of the corporate debtor.[28]

[20]The IBBI is the regulator under the Code. In the initial phase of implementation of the Code, insolvency of real estate companies raised unique concerns about status of home-buyers as financial or operational creditors. In view of the definitional ambiguity, IBBI amended the regulations to create a third category of creditors to cover those who are neither financial nor operational creditors. *Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations*. 2016, 9A.

[21]The term 'default' and 'debt' are broadly defined such that default to any creditor could be used to trigger insolvency resolution under the Code. However, 'other creditors' do not have a specific statutory right to trigger insolvency resolution. see n. 18, 3(11), 3(12), 7, 8, 9, 10.

[22]Ibid., 7(3)(b).

[23]Ibid., 7(4), 9(5).

[24]Ibid., §§ 7, 8, 9.

[25]Ibid., 7(5), 9(5).

[26]Ibid., 7(5)(a), 9(5)(i), 10(4)(a).

[27]See n. 18, 13(1)(a), 14; the NCLT is also required to cause a public announcement of the initiation of the corporate insolvency resolution process calling for submission of claims by claimants of the corporate debtor. see n. 18, §§ 13, 15.

[28]If the applicant had proposed an insolvency professional, the same professional would be appointed as the interim resolution professional. Such interim resolution professional is vested with the management of the affairs of the corporate debtor and the power of the board of directors stands suspended from the date of her appointment. Subsequently, in the first meeting of the Committee of Creditors, the interim

The resolution professional has various important tasks,[29] of which four are particularly relevant for the present discussion. *First*, she has to receive and collate all claims submitted by claimants against the corporate debtor and constitute a Committee of Creditors (CoC) of the corporate debtor.[30] The CoC comprises only of financial creditors.[31] Operational creditors do not have any representation or vote on the CoC.[32] The CoC may by 66% vote by value decide on the future of the corporate debtor - whether to continue it or not.[33] *Second*, the resolution professional has to prepare an information memorandum containing the overall financial position of the corporate debtor.[34] She must provide this information memorandum to each member of the CoC as well as each prospective bidder ('resolution applicant') of the corporate debtor.[35] *Third*, the resolution professional has to invite resolution plans from prospective resolution applicants interested in purchasing the business of the corporate debtor.[36] After a resolution applicant has submitted its resolution plan to the resolution professional, the 'creditor protection rules' require the resolution professional to examine and confirm if the plan provides for:[37] (a) repayment of the debts of operational creditors which shall not be less than the

resolution professional could either be appointed as the resolution professional or be replaced by a new resolution professional. see n. 18, 13, 16, 17(1), 22.

[29]Ibid., 25(2).

[30]The claimants would have submitted their claims pursuant to the public announcement made by virtue of the first order of the NCLT. ibid., 18(1)(b), 18(1)(c).

[31]However, a financial creditor who is also a related party to the corporate debtor does not have any right of representation, participation or voting in a meeting of the CoC. ibid., 21(2).

[32]Ibid., 30(4).

[33]See n. 18, 30(4); initially, 75% vote by value was needed. However, pursuant to the the recommendations of the Insolvency Law Committee (ILC) the voting share for approval of the resolution plan and other critical decisions was reduced from 75% to 66%. See see n. 7, paragraph 11.6.

[34]The information memorandum contains details of the assets and liabilities, annual financial statements, list of financial and operational creditors and corresponding credit amounts, material litigation and various other financial and operational information of the corporate debtor. see n. 20, 36(2).

[35]See n. 18, § 29; see also see n. 20, 36(1).

[36]See n. 18, 25(2)(h); a subsequent amendment to the law added section 29A, which prohibits a broad category of persons from applying as resolution applicants. The ILC observed that this provision could inadvertently include Asset Reconstruction Companies (ARCs), banks and alternate investment funds. This could therefore potentially prevent existing creditors from applying as resolution applicants for a debt restructuring under the Code. Although the ILC has suggested that pure play Financial Entities be exempted from this prohibition, currently this confusion persists. see n. 7, par. 14.3-14.4.

[37]The resolution professional is obliged to examine if the resolution plan conforms with various other mandatory statutory requirements as well as requirements that may be imposed by the IBBI through regulations. see n. 18, 30(2), 30(2)(f).

amount to be paid to the operational creditors in the event of liquidation;[38] (b) specific sources of funds to be used to pay 'liquidation value' due to dissenting financial creditors and provide that such payment is made before any recoveries are made by the financial creditors who voted in favour of the resolution plan.[39] Going by the interpretation used by the ILC,[40] these creditor protection rules apply the break-up 'liquidation value' benchmark to guarantee minimum protection to both operational creditors, who are not on the CoC, as well as dissenting financial creditors, who comprise the minority in the CoC.[41] If a resolution plan does not satisfy these creditor protection rules, the resolution professional cannot present it to the CoC for its approval.[42] *Fourth*,

[38] This is the current position under IBC. The word 'liquidation' here could either refer to a break-up sale, or a going concern sale of the corporate debtors' business to a third party, followed by liquidation of the corporate shell of the corporate debtor. see n. 18, 30(2)(b), 53; before October 5, 2018, the IBBI regulations also mandated that a resolution plan must identify specific sources of funds to pay the 'liquidation value' to operational creditors. The regulations defined 'liquidation value' as 'the estimated realizable value of assets of the corporate debtor, if the corporate debtor were to be liquidated on the insolvency commencement date'. see n. 20, 2(1)(k), 38(1)(b); the ILC in its report had however used break-up 'liquidation value' as the minimum amount to be paid to operational creditors in a resolution plan. See also see n. 7, par. 18.2-18.3.

[39] Please note that this was the legal position before October 5, 2018. This requirement was not there in the IBC, but was only specified in the regulations issued by IBBI. see n. 20, 38(1)(c); on September 12, 2018, the NCLAT struck down Regulations 38(1)(b) and (c) for being inconsistent with the IBC. see n. 17; subsequently, on October 5, 2018, IBBI amended these regulations and deleted Regulations 38(1)(b) and (c). see n. 17, p. 6; earlier, the ILC in its report had used break-up 'liquidation value' as the minimum amount to be paid to dissenting financial creditors in a resolution plan. see n. 7, par. 30.1.

[40] See ILC's opinion in footnotes 38 and 39. See also see n. 7, par. 18.2-18.3, 30.1.

[41] Commentators have highlighted ambiguities in the IBC 2016 regarding calculation of the break-up 'liquidation value'. Under section 52, a secured creditor in a liquidation proceeding has an option to relinquish security interest to the liquidation estate and receive proceeds under section 53, or to realise its security interest in accordance to non-insolvency law following the procedure under section 52. It is unclear if the resolution professional should take into account the preference of each secured creditor in liquidation scenario while calculating the 'liquidation value' for the purposes of creditor protection while reviewing the resolution plans. V. Sivaramakrishnan and D. Charan. *Cramming down under the Insolvency Code*. Jan. 5, 2018. URL: `https://www.vantageasia.com/cramming-insolvency-code/` (visited on 01/11/2018); moreover, neither the statute nor the regulation explicitly extends the creditor protection rules to the third category of creditors - 'other creditors' - that has been subsequently created by the IBBI. see n. 20, 38(1).

[42] It is however unclear how the resolution professional could do this without knowing in advance which financial creditors will dissent or what would be the preferences of each and every secured creditor in liquidation scenario. see n. 18, 30(3) and 52(1).

the resolution professional is under a legal duty to appoint two registered valuers within seven days of his appointment.[43] These two valuers are required to submit to the resolution professional an estimate of the 'fair value' and the 'liquidation value' of the corporate debtor in accordance with internationally accepted valuation standards.[44] If in the opinion of the resolution professional, these two estimates are significantly different, she may appoint another third registered valuer who shall submit another set of estimates.[45] The average of the two closest estimates of a value shall be considered the 'fair value' and 'liquidation value' of the corporate debtor.[46] The resolution professional is required to transmit these final estimated values to the CoC.[47] This information is expected to be useful to the CoC while determining the bids received from resolution applicants and thus aid in maximising the recovery value for the creditors.[48]

Within 180 days from the date of commencement of the insolvency resolution process, the CoC may by 66% vote by value approve a resolution plan proposed by a resolution applicant.[49] The resolution plan could propose either a going concern sale or a restructuring.[50] Once a resolution plan is approved

[43]See n. 20, p. 27.

[44]For definition of 'liquidation value', see footnote 38. 'Fair value' means 'the estimated realizable value of the assets of the corporate debtor, if they were to be exchanged on the insolvency commencement date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties acted knowledgeably, prudently and without compulsion'. ibid., 2(1)(hb), 35(1)(a).

[45]Ibid., 35(1)(b).

[46]Ibid., 35(1)(c).

[47]Ibid., 35(2).

[48]Lenders were of the view that fair or enterprise valuation should be taken into account so that bidding started from a higher point. This nudged IBBI to introduce the new regulation requiring 'fair value' and 'liquidation value' to be provided to the CoC. FE Bureau. *Stressed asset valuation: Both fair and liquidation values to be considered*. Feb. 8, 2018. URL: `http://www.financialexpress.com/economy/stressed-asset-valuation-both-fair-and-liquidation-values-to-be-considered/1057179/` (visited on 03/29/2018).

[49]See n. 18, 30(4); the CoC can extend the 180 days deadline by maximum of another 90 days at most. See also see n. 18, 12(1); in practice these time limits have been breached in multiple cases. V. Marwah and A. Sharma. *Watching The IBC: Lessons From The RBI-12 Cases*. Sept. 24, 2018. URL: `https://www.bloombergquint.com/insolvency/watching-the-ibc-lessons-from-the-rbi-12-cases#gs.Ww6hEA0` (visited on 10/07/2018); during this time, the resolution professional can raise interim finance subject to approval of the Committee of Creditors. Such interim finance are treated as part of the 'insolvency resolution process costs' and enjoy super-priority in the waterfall. See also see n. 18, 20(2)(c), 25(2)(c), 28(1)(a), 5(13) and 53(a).

[50]See n. 20, p. 37; as explained in Chapter 1.4.2.2, the law is unclear about the distinction between restructuring and going concern sale to third party. For instance, it is not evident why the resolution professional is under a mandatory obligation to

by the super-majority of the CoC, the resolution applicant must submit the plan to the NCLT for its approval.[51] The NCLT must approve the resolution plan if it is satisfied that the resolution plan meets the mandatory legal requirements (including the creditor protection rules) and that the plan was approved by a vote of not less than 66% of voting share of the financial creditors.[52] Once approved by NCLT, the resolution plan becomes binding on all stakeholders including the corporate debtor, its employees, members, creditors and guarantors.[53] However, if the NCLT rejects the resolution plan for non-compliance with mandatory legal requirements or if the resolution plan is not submitted before the NCLT within the statutory time limit, the NCLT is required to pass an order initiating the liquidation of the corporate debtor.[54]

invite resolution plans from third parties in a restructuring, although it is normal to do so in a going concern sale to third parties through auctioning. Similarly, it is unclear from where will cash be available to pay the dissenting financial creditors as required under the law, if the resolution plan proposes a restructuring that leaves the business with the company. See also see n. 20, 36A, 38(1)(c).

[51]See n. 18, 30(6).

[52]As per the text of the IBC, the obligation on NCLT to approve such a resolution plan is mandatory. The IBC does not give any discretion to NCLT to review whether the resolution plan is unfair to the dissenting minority creditors or non-voting operational creditors. For practical implications of this feature of the Code, see Chapter 1.4.2.1. see n. 18, 31(1), 30(2); this legal position is in conformity with the policy rationale adopted by the BLRC, which observed that in the past, laws in India have brought arms of the government (legislature, executive or judiciary) to decide on the future of a defaulting firm. The BLRC wanted to avoid any such discretion being given to any organ of the state including the judiciary. It was of the view that the appropriate disposition of a defaulting firm is a business decision, and only the creditors should make it. see n. 4, chap. 2; however, the IBBI has of late started emphasising the need for 'fairness and equity' and has observed that the CoC must not discriminate amongst creditors. It is unclear if the IBBI envisages a role for NCLT in ensuring such 'fairness and equity' while approving the resolution plan. IBBI. *Insolvency and Bankruptcy News: CoC Dharma*. Sept. 18, 2018. URL: `http://ibbi.gov.in/webadmin/pdf/whatsnew/2018/Sep/Newsletter_%20IBBI_April%20-%20June,%202018_2018-09-18%2019:28:22.pdf` (visited on 10/07/2018); recently, the NCLAT held that 'any resolution plan if shown to be discriminatory against one or other financial creditor or the operational creditor, such plan can be held to be against the provision of the I&B Code'. The implication of this decision on 'out-of-money' creditors is unclear. *Binani Industries Ltd. v. Bank of Baroda*. Nov. 14, 2018, par. 48.

[53]See n. 18, 31(1).

[54]Ibid., 33(1).

### 1.2.2 Research Questions

#### 1.2.2.1 Value destruction problem

The BLRC had envisaged that the assessment of viability of an insolvent firm should ideally be the outcome of collective negotiation among the claimants of the firm.[55] However, it acknowledged that such collective negotiations could lead to conflicts, causing destruction of value of the insolvent firm.[56] To avoid such value destruction, the BLRC tried to design a formal insolvency resolution process that would appropriately channel such conflicts to achieve a solution.[57] In designing this formal insolvency resolution process within the *Insolvency and Bankruptcy Code*, 2016, BLRC entrusted the power of viability assessment of an insolvent firm to a super-majority of its financial creditors instead of leaving it for collective negotiation among the different classes of claimants of the insolvent firm.[58] My research seeks to analyse whether entrusting financial creditors with the power to assess the viability of insolvent firms could potentially cause *value destruction*.

#### 1.2.2.2 Wealth tansfer problem

The BLRC was of the view that to preserve the organisational capital of insolvent firms, the insolvency process should facilitate creation of a platform for negotiation between creditors and external financiers.[59] Consequently, the regulations under *Insolvency and Bankruptcy Code*, 2016 seek to facilitate going concern sale of the business of the corporate debtor at 'fair value' during the insolvency resolution process and not merely recover break-up 'liquidation value'.[60] Yet, the creditor protection rules under the *Insolvency and Bankruptcy Code*, 2016 use the break-up 'liquidation value' as the benchmark for calculating the minimum amount to be paid to the operational creditors

[55] See n. 4, chap. 3.2.1.

[56] Ibid., chap. 3.2.2.

[57] Ibid., chap. 3.2.3.

[58] The BLRC deliberated on who should be on the creditors' committee, given the power of the creditors' committee to ultimately keep the entity as a going concern or liquidate it. The Committee reasoned that members of the creditors' committee should have the capability to assess viability, as well as the willingness to modify terms of existing liabilities in negotiations. Typically, operational creditors are neither able to decide on matters regarding the insolvency of the entity, nor willing to take the risk of postponing payments for better future prospects for the entity. Therefore, the Committee concluded that, for the process to be rapid and efficient, the law should provide that the creditors' committee should be restricted to only the financial creditors. ibid., chap. 5.3.1.4.

[59] Ibid., chap. 3.2.3.

[60] This is why the resolution professional is required to appoint registered valuers to determine the 'fair value' and accordingly inform the CoC to aid in the bidding process. see n. 20, pp. 27, 35.

and dissenting financial creditors under a resolution plan.[61] My research seeks to analyse the potential for abuse of these different valuation benchmarks to cause *wealth transfer* from one class of claimants to another in the absence of judicial supervision to ensure fairness of the resolution plan.

## 1.3 Value Destruction Problem

### 1.3.1 Theoretical framework

#### 1.3.1.1 Economic distress and financial distress

Making the appropriate decision about the future of a distressed company essentially hinges on correctly identifying whether the company is *economically distressed* or *financially distressed*.[62] If the net present value of the company is less than the total value of the assets of the company were they to be broken up from the business and sold separately (break-up 'liquidation value'), such a company is said to be in *economic distress*.[63] Since the assets of an *economically distressed* company are worth more piecemeal than kept together in the company's business, the claimants are better off by liquidating such a company and selling its assets on a piecemeal basis. In contrast, if the company is not *economically distressed* but is unable to service its debts, such a company is said to be in *financially distress*. In terms of valuation, when the total value of debt of a company exceeds its net present value, it is said to be *financially distressed*. The assets of such a company are more valuable if kept together as a functioning unit than they would be if sold off piecemeal. In other words, since a merely *financially distressed* company has *going concern surplus*, it should not be liquidated except through a process which preserves such surplus.[64]

[61] See n. 18, 30(2)(b); see n. 20, 38(1)(b), 38(1)(c); please note that the valuation benchmark for dissenting financial creditors was applicable till October 5, 2018. IBBI has amended its regulations to remove this requirement. see n. 17, p. 6.

[62] D.G. Baird. "Bankruptcy's uncontested axioms". In: *Yale L.J.* 108 (1998), p. 573, p. 580.

[63] M. Crystal and R.J. Mokal. "The Valuation of Distressed Companies - A Conceptual Framework". In: *International Corporate Rescue* 3 (1 and 2 2006), pp. 63, 123, Part II (Bases of Valuation).

[64] As discussed in Chapter 1.2.1, the word 'liquidation' could either refer to a break-up sale or simply entry into a liquidation procedure. The latter is not mutually inconsistent with preservation of going concern value. Such liquidation could entail a sale on going concern basis, cash proceeds could be distributed among claimants, and then the shell could be liquidated. In this article, the term 'liquidation' has been used primarily to refer to break-up liquidation, not going concern sale, unless explicitly mentioned otherwise. Similarly the term 'liquidation value' refers to break-up 'liquidation value', unless explicitly mentioned otherwise. ibid., Part II (Bases of Valuation).

#### 1.3.1.2 Basic objectives of insolvency law

A well-designed insolvency law should have at least two objectives. First, it must facilitate the correct determination of the type of distress a company is suffering from - *economic distress* or *financial distress*. Second, it must ensure that an *economically distressed* company is liquidated, whereas a *financially distressed* company is sustained either by restructuring it among existing claimants or by selling it to new investors. Only then can the insolvency law help achieve an *ex post* efficient outcome that maximises the total value of the proceeds - measured in money terms - for the claimants.[65] In contrast, an insolvency law that pushes merely *financially distressed* (but not *economically distressed*) companies into break-up liquidation is poorly designed because it destroys the organisational value of such companies.[66] Such potentially inefficient outcome of a poorly designed insolvency law is an instance of the *value destruction problem*.

#### 1.3.1.3 Sources of value destruction

The *value destruction problem* could arise if the insolvency law entrusts the decision regarding the future of the insolvent company to a class of claimants whose payoffs are not affected by the outcome of the decision. This could be either because the claimants are fully protected in any case or because they are not entitled to anything in the first place.[67] For instance, if the decision as to the future of the company is left to the fully secured creditors of the insolvent company, they have no incentive to recover any amount in excess of the face value of their debt. This is because, even if they recover an amount higher than the face value of their debt, the maximum amount they are entitled to is still the face value of their debt only. Therefore, if this decision is left to such secured creditors, they have an incentive to destroy value of the *financially distressed* company by selling it at a value less than the *going concern value* or to push it into immediate liquidation to realise the *liquidation value*.[68]

[65] P. Aghion, O. Hart, and J. Moore. "Improving bankruptcy procedure". In: *Wash. U. L. Rev.* 72 (1994), p. 849, p. 852.

[66] A living business with established customers, knowledgeable employees and so forth will bring a higher price as a unit than would the sale of each asset class separately, even assuming that those separate sales would obtain market value for each asset. J.L. Westbrook. "The Control of Wealth in Bankruptcy". In: *Tex. L. Rev.* 82 (2004), p. 795, p. 811.

[67] Aghion, Hart, and Moore, "Improving bankruptcy procedure", see n. 65, p. 859.

[68] O.D. Hart. "*Bankruptcy Procedure*". In: *Firms, Contracts, and Financial Structure*. Clarendon Press, 1995, p. 27; however, there could be countervailing factors like reputational costs in repeat lending, which may incentivise secured creditors not to automatically liquidate firms on payment default. For instance, there is strong evidence that UK banks do not opt for automatic liquidation on violation of debt contract. J. Franks and O. Sussman. "Financial Distress and Bank Restructuring of Small to Medium Size UK Companies". In: *Review of Finance* 9 (2005), p. 65, p. 91.

Insolvency law could also cause value destruction by delaying initiation of restructuring. Restructuring is meant to realise the *enterprise value* of the company by reorganising its capital structure.[69] The earlier the restructuring is initiated, the higher are the chances of preservation of the value of the business and its (remaining) *enterprise value*. If debts are not restructured early on, the corporate debtor may enter formal insolvency procedure, which may further depress the *enterprise value*.[70] Moreover, the lower the *enterprise value*, the lesser is the residual value for the equity holders, and the higher is their propensity to pursue high risk investment strategies at the expense of the creditors - the *asset substitution problem*.[71] Therefore, delayed initiation of restructuring could also destroy *enterprise value* of a company which is *financially distressed* or is likely to become *financially distressed*.

### 1.3.2 Value destruction under IBC

#### 1.3.2.1 Liquidation of merely *financially distressed* companies

The *Insolvency and Bankruptcy Code*, 2016 entrusts the decision regarding the future of the insolvent company to the CoC.[72] The CoC comprises only of financial creditors, who can approve a resolution plan by 66% vote by value.[73] Therefore, if 66% or more of the financial debt of a *financially distressed* company is held by fully secured creditors, the future of the company is essentially entrusted with such secured creditors. If these secured creditors are fully protected against the value of the security, they are likely to have little incentive to maximise the economic value of the business of the *financially distressed* company. Because even if the company is sustained and the *going concern surplus* is realised, the secured creditors are not entitled to any of that surplus. Instead, such secured creditors are likely to have a stronger incentive to immediately liquidate the *financially distressed* company and realise the *liquidation value*, thus destroying the *going concern surplus* of the company. The outcome will remain the same even if the secured creditors are partially protected by the value of their securities, as long as the liquidation value is higher than the present value of their expected returns from continuing the *financial distressed* company.

[69] For a more detailed discussion on this issue, refer to Chapters 1.4.1.1 and 1.4.1.2. See also Crystal and Mokal, see n. 63, Part II (Bases of Valuation).

[70] H. Eidenmuller and K. van Zwieten. “Restructuring the European Business Enterprise: the European Commission’s Recommendation on a New Approach to Business Failure and Insolvency”. In: *European Business Organisation Law Review* 16 (2015), p. 625, p. 655.

[71] M.C. Jensen and W.H. Meckling. “Theory of the firm: Managerial behaviour, agency costs and ownership structure”. In: *Journal of Financial Economics* 3 (1976), p. 305, p. 334; See also Eidenmuller and Zwieten, see n. 70, p. 655.

[72] See n. 18, 30(4).

[73] Ibid., 21(2).

To illustrate, let's consider a hypothetical example. Suppose a company has two types of creditors - secured financial creditors and unsecured operational trade creditors.[74] It owes \$100 to its secured financial creditors, \$30 to its unsecured operational trade creditors, and the liquidation value of the company is \$90. If the company is continued as a going concern for next 6 months, there is a 0.5 probability that it will be worth \$200 and a 0.5 probability that it will be worth \$40. In other words, if the company is continued for the next 6 months, the expected going concern value of the company would be \$ (0.5).(200) + (0.5).(40) = \$120.[75] Since the net present value (\$120) is higher than the liquidation value (\$90), the company is not *economically distressed*. It is only in *financial distress* because the total debt of the company (\$130) exceeds its net present value (\$120). Therefore, the value maximising choice would be to keep the company going, so that both the financial and operational creditors can recover a total of \$120 as against only \$90 if the company is liquidated. However, if things go well and after 6 months the company is actually worth \$200, the secured financial creditors will still get only \$100, the value of debt owed to them. On the other hand, if things go badly and after 6 months the company is actually worth \$40, they will get the entire \$40. Therefore, the expected return for secured financial creditors would be \$ (0.5).(100) + (0.5).(40) = \$70 - much lesser than the immediate liquidation value (\$90). Figure 1.1 summarises the returns to the creditors in the different states.

Evidently, if the future of the company is to be decided by the secured financial creditors only, they would always prefer to immediately liquidate the company for \$90 even though the value-maximising decision would be to continue it.[76] Therefore, in the factual matrix described above, the *Insolvency and Bankruptcy Code*, 2016 would fail to save a *financially distressed* (but not *economically distressed*) company from being liquidated, causing value destruction.[77]

This problem could possibly be avoided if the operational creditors and shareholders could pay off the majority secured financial creditors in exchange for the right to decide the future of the company - whether to liquidate or

[74]In this example, I am assuming that the secured creditors are a little under secured. If the secured creditors are fully or over secured, the effect described in this example will be even more profound.

[75]For convenience, we are assuming that the discount rate is 0. Therefore, the expected going concern value is also the net present value of the company.

[76]This is based on the assumption that there are no countervailing factors like reputation in repeat or relationship lending. Franks and Sussman, see n. 68, p. 91; this example is based on an example used by Aghion, Hart and Moore. Aghion, Hart, and Moore, "Improving bankruptcy procedure", see n. 65, p. 859.

[77]The above example relates to secured creditors who are a little under-secured. If they were fully secured, the effect would be even more profound.

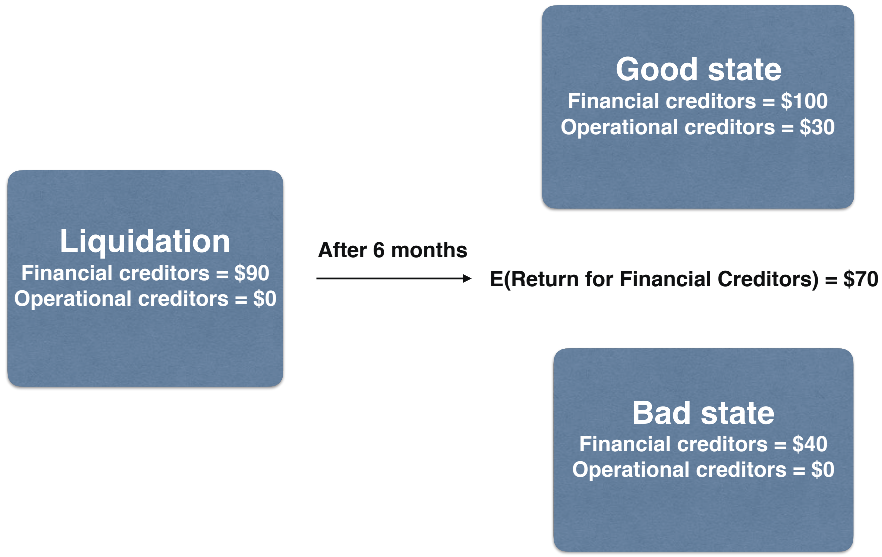


**Fig. 1.1.** Returns to creditors in different states

not.[78] However, under *Insolvency and Bankruptcy Code*, 2016, only financial creditors could be on the CoC. Therefore, operational creditors and shareholders could possibly influence the decision as to the future of the company by entering into an agreement with majority secured financial creditors requiring the latter to vote in a certain way on the CoC. In practice, such 'side agreements' may be difficult to enter into since coordinating with a vast group of heterogenous stakeholders - financial creditors, operational creditors and shareholders - could be extremely costly. Even if such agreements are practically feasible, enforceability of such inter-creditor agreements is yet to be tested before the NCLT and NCLAT.[79]

[78] Aghion, Hart and Moore referred to this arrangement a 'bribe' from junior creditors and shareholders to the senior creditors. Aghion, Hart, and Moore, "Improving bankruptcy procedure", see n. 65, p. 860.

[79] The NCLT in a recent decision has called for the development of a 'Standard Operating Procedure' for CoCs to determine the suitability and viability of resolution plans. In this backdrop, it is unclear to what extent 'side agreements' between financial creditors and other claimants intended to influence the outcome of the decision of a CoC would be enforceable under Indian laws. *Mr. Ajay Agarwal v. M/s. Ashok Magnetics Limited & Anr.* Nov. 9, 2018, par. 17.

#### 1.3.2.2 Delayed restructuring

Once the insolvency resolution process under the *Insolvency and Bankruptcy Code*, 2016 is triggered, the resolution professional with the approval of the CoC can engage in debt restructuring.[80] The main advantage of restructuring within the framework of the *Insolvency and Bankruptcy Code*, 2016 is that the law empowers the majority financial creditors (with at least 66% vote by value) to impose a restructuring plan on operational creditors as well as dissenting financial creditors - the 'cramdown' provision.[81] Such a potent cramdown option for restructuring is unavailable outside the *Insolvency and Bankruptcy Code*, 2016.[82]

However, the insolvency resolution process under the *Insolvency and Bankruptcy Code*, 2016 can be triggered only post-insolvency.[83] Therefore, restructuring under the *Insolvency and Bankruptcy Code*, 2016 is not possible pre-insolvency, when the corporate debtor is reasonably likely to default on its debt obligations and become *cash flow insolvent* in the foreseeable future.[84] Consequently, any attempt to restructure pre-insolvency will have to be outside the scope of the *Insolvency and Bankruptcy Code*, 2016, without the benefit of the cramdown provision.

Pre-insolvency debt restructuring could then potentially be executed through a scheme of arrangement under *Companies Act*, 2013.[85] However, unlike the *Insolvency and Bankruptcy Code*, 2016, the cramdown provision in *Companies Act*, 2013 is much less potent since it does not allow cross-class cramdown.[86] *Companies Act*, 2013 gives extensive discretion to the NCLT to modify the

[80] See n. 18, 28(1)(c); see n. 20, 37(f), 37(g) and 37(i).

[81] See n. 18, 28(1)(c), 30(4); see also see n. 20, 37(f), 37(g), 37(i).

[82] As discussed in the next paragraph, a scheme of arrangement provides a less potent cramdown option. *Companies Act*. 2013, § 230; a cramdown provision was also available under the Guidelines on Joint Lenders' Forum (JLF) and Corrective Action Plan (CAP) issued by RBI on February 26, 2014, and subsequently amended on May 5, 2017. However, this framework was repealed by RBI on February 12, 2018. Under the revised framework, there is no cramdown provision. *Resolution of Stressed Assets - Revised Framework*. Feb. 12, 2018.

[83] Insolvency resolution process can be triggered only after there has been a payment default by the corporate debtor. This is the case even when the corporate debtor itself is the applicant. see n. 18, §§ 7, 9, 10.

[84] In UK, schemes are often used instead of administration for debt restructuring precisely because the former provides a cramdown option pre-insolvency while the latter provides a cramdown option but only post-insolvency. J. Payne. "Debt restructuring in English law: lessons from the United States and the need for reform". In: *L.Q.R* 130 (2014), p. 282, p. 295.

[85] *Companies Act*, see n. 82, § 230.

[86] U. Varottil. *The Scheme of Arrangement as a Debt Restructuring Tool in India: Problems and Prospects*. 2017. URL: `https://law.nus.edu.sg/wps/pdfs/005_2017_Umakanth.pdf` (visited on 04/26/2018), p. 8.

scheme.[87] There are no specific timelines for approving a scheme. Further, unlike section 14 of *Insolvency and Bankruptcy Code*, 2016, the *Companies Act*, 2013 does not provide for an automatic statutory moratorium.[88] There are various additional procedural hurdles to restructuring through a scheme.[89] All these factors make debt restructuring through Companies Act 2013 far more difficult than through the *Insolvency and Bankruptcy Code*, 2016.[90]

The only other alternative to executing a pre-insolvency restructuring plan would be through private contracting. This would require consent of all the claimants - financial creditors, operational creditors, and shareholders - making it extremely difficult to negotiate in practice.[91]

Overall, under the current Indian legal framework, pre-insolvency restructuring is far more difficult to execute than post-insolvency restructuring. This disparity stems from the application of the *Insolvency and Bankruptcy Code*, 2016 to only post-insolvency restructuring. To this limited extent, by delaying restructuring to post-insolvency phase, the *Insolvency and Bankruptcy Code*, 2016 makes it difficult to preserve the value of a business which is on the verge of *financial distress* and enhances the risk of value destruction.[92]

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[87] *Companies Act*, see n. 82, 230(7).

[88] Under section 391(6) of the Companies Act, 1956, a limited moratorium was available whereby the court reviewing a scheme was entitled to 'stay the commencement or continuation of any suit or proceeding against the company' pending disposal of the scheme application. This provision is absent in Companies Act, 2013. It is not entirely clear whether the absence of the moratorium provision was a deliberate choice or an inadvertent omission. In any event, this is likely to adversely affect the choice of scheme by parties to effect a debt restructuring. Varottil, see n. 86, p. 24.

[89] For instance, any creditor with not less than 5% of the total outstanding debt has a legal right to raise an objection to the restructuring plan. *Companies Act*, see n. 82, 230(4).

[90] To date, schemes under Companies Act, 2013 have been used sparringly in India for debt restructuring, although they have been widely used for corporate restructurings like amalgamations, mergers and demergers. Given the application of the Insolvency and Bankruptcy Code, 2016 to post-insolvency restructuring only, it remains to be seen if scheme of arrangement under Companies Act, 2013 could become a viable device for pre-insolvency restructuring. Varottil, see n. 86; one recent example where the scheme route is being used for debt restructuring is the IL&FS case. Currently, the case is pending. M. Doshi. *Why IL&FS Picked This Route To Solvency*. Sept. 25, 2018. URL: `https://www.bloombergquint.com/business/why-ilfs-picked-this-route-to-solvency#gs.8UOHopA` (visited on 10/07/2018).

[91] If all creditors had to agree to the restructuring, that would have put significant hold-up rights into the hands of minority creditors, potentially allowing even very small creditors to derail the restructuring while they would have bargained for additional benefits or advantages. The cramdown provision helps overcome this problem. Payne, "Debt restructuring in English law: lessons from the United States and the need for reform", see n. 84, p. 284; See also Eidenmuller and Zwieten, see n. 70, p. 632.

[92] Eidenmuller and Zwieten, see n. 70, p. 631.

## 1.4 Wealth Transfer Problem

### 1.4.1 Theoretical framework

#### 1.4.1.1 Going concern sale and its limitations

A *financially distressed* company has *going concern surplus*, which should be preserved.[93] One way of preserving the *going concern surplus* of a *financially distressed* company is by selling its business at the *enterprise value*.[94] Such *enterprise value* may be much greater than *market value* of asset sale (and therefore, *liquidation value*) because a living business has organisational value which is lost if its assets are sold separately, even if they could be sold at *market value*.[95]

However, a *going concern sale* of a financially distressed company at *enterprise value* may not always be possible because of myriad reasons. First, the company could be in financial distress because of industry wide factors. Its competitors in that industry may not be in a position to offer the *enterprise value* to expand their businesses.[96] Second, industry wide factors may push other companies into financial distress, creating an oversupply of similar businesses in the market. This may create the risk of auctions at 'fire sale' prices, which may be equivalent to the liquidation value.[97] Third, auctions work well when there is adequate financing and competition among bidders. Countries with less developed capital markets naturally will be at a disadvantage. Even in countries with well-developed capital markets, if a very large company's business is put up for auctioning, it will be difficult to raise financing. The only solution is to raise money from some big institutional investors, who will be prepared to buy the business only at a discount because of the substantial risk they will be bearing.[98] Fourth, participating in an auction process involves transaction costs. But only the winner is able to recoup the costs. Consequently, even though there could be many potential bidders who could raise the financing, not all of them will participate. This may cause a lack of competition problem.[99]

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[93] Eidenmuller and Zwieten, see n. 70, p. 655.

[94] Crystal and Mokal, see n. 63, Part II (Bases of Valuation).

[95] As discussed earlier, a living business with established customers, knowledgeable employees and so forth will bring a higher price as a unit. Westbrook, see n. 66, p. 811.

[96] Crystal and Mokal, see n. 63, Part II (Bases of Valuation).

[97] Crystal and Mokal, see n. 63, Part II (Bases of Valuation); See also Eidenmuller and Zwieten, see n. 70, p. 636.

[98] P. Aghion, O. Hart, and J. Moore. "The Economics of Bankruptcy Reforms". In: *J.L. Econ. & Org.* 8 (3 1992), p. 523, p. 527.

[99] Ibid., p. 527.

#### 1.4.1.2 Restructuring

Because of the above mentioned reasons, sale of the *financially distressed* company as a going concern to new investors may not raise the *enterprise value* of the company. In such an event, instead of selling the company to new investors, the claimants of the financially distressed company would be better of by 'selling' the company to some or all of the existing claimants themselves.[100] This 'hypothetical sale' is commonly referred to as *restructuring* (or *reorganisation*).[101]

Restructuring could be implemented voluntarily if all the claimants could come to an agreement. However, this is difficult because of two reasons. First, when there is a dispersed set of claimants, the coordination cost is too high.[102] Moreover, a prolonged negotiation could be disadvantageous and impractical if the debtor is facing an acute liquidity crisis.[103] Second, there is a possibility that one or more claimants may hold-up the process to try and get a better deal for themselves. For instance, one or more claimants may withhold consent, file individual recovery action or petition for winding up of the company.[104] The situation is worse if the claimant holding-up restructuring efforts is an out-of-the-money claimant, who would not receive any payment or other consideration if the corporate debtor is liquidated instead.[105] State supplied insolvency laws are necessary to overcome these two specific problems - *co-ordination costs* and *hold-up costs*.

Insolvency law could facilitate restructuring by allowing a majority of claimants to impose a restructuring plan on a dissenting minority. This could be structured in different ways. For instance, insolvency law could allow a restructuring plan to be imposed only on dissenting claimants of a particular class if the majority of that class consents. It could also allow the restructuring plan to be imposed on whole classes of dissenting claimants - the cross-class cramdown provision.[106] Such provisions help reduce the coordina-

[100] Crystal and Mokal, see n. 63, Part V (A case study: My Travel Group Plc).

[101] D.G. Baird. "The Uneasy Case for Corporate Reorganizations". In: *The Journal of Legal Studies* 15 (1 1986), p. 127, p. 127.

[102] Crystal and Mokal, see n. 63, Part II (Bases of Valuation).

[103] J. Payne. "The role of the court in debt restructuring". In: *CLJ* 77 (1 2018), p. 124.

[104] Payne, "The role of the court in debt restructuring", see n. 103, p. 127; this problem has also been referred to as the 'motivation cost'. Crystal and Mokal, see n. 63, Part II (Bases of Valuation).

[105] This is the reason why English courts discount dissent of those without any economic interest in the corporate debtor. Payne, "The role of the court in debt restructuring", see n. 103, pp. 138-139.

[106] Payne, "The role of the court in debt restructuring", see n. 103, p. 128; British policymakers are currently considering introduction of such a cramdown provision for restructuring. *A review of the corporate insolvency framework. A consultation on options for reforms*. The Insolvency Service, May 25, 2016, par. 9.19-9.21.

tion and hold-up problems that make contractual restructuring difficult to achieve.

#### 1.4.1.3 Sources of wealth transfer

When insolvency law provides cramdown powers to facilitate restructuring, it raises the possibility of abuse, and in particular of *wealth transfer* from one class of claimants to another.[107] The *wealth transfer* problem could arise when insolvency law allows majority claimants to gain control over the restructuring of the corporate debtor.[108] The majority claimants being in control of the process may be able to advantage or disadvantage different groups of beneficiaries by structuring of the securities, contract rights or other property received by each.[109] They could even abuse this control to derive disproportionate private benefits by transferring wealth away from the dissenting minority claimants through the restructuring plan.[110] Adequate safeguards are therefore necessary to protect the interests of the dissenting claimants.[111]

Insolvency laws across jurisdictions usually provide this safeguard to dissenting minority claimants through judicial supervision.[112] The main objective of such judicial supervision is to ensure that a restructuring plan does

[107]Payne, "The role of the court in debt restructuring", see n. 103, p. 134.

[108]Control is the function of insolvency law. It concerns the management of the corporate debtor's assets during the recovery process after default. Westbrook, see n. 66, p. 800.

[109]Ibid., p. 800.

[110]There are other substantial private benefits of controlling corporate decision-making. For example, in exchange for 'yes' votes, majority creditors may receive side benefits from managers or major shareholders, such as early repayment, security interest, guarantee, or other business opportunities. H.C. Lee. "Efficient and Inefficient Debt Restructuring: A Comparative Analysis of Voting Rules in Workouts". In: *Cornell Int'l L.J.* 40 (3 2007), p. 661, pp. 665-666.

[111]British policymakers proposing a cramdown provision have discussed potential safeguards for creditors in the form of judicial supervision. see n. 106, paragraphs 9.24-9.28; even the Singaporean Insolvency Law Review Committee while recommending inclusion of a cramdown provision in the Companies Act, 1967, was conscious of this issue. Accordingly, it recommended that 'the court should require a high threshold of proof that the dissenting class is not going to be prejudiced by the cramdown'. *Report of the Insolvency Law Review Committee*. Insolvency Law Review Committee (Singapore), 2013, p. 156.

[112]In the US, Chapter 11 of the Bankruptcy Code relies heavily on the role of the court. This is also the policy in UK and Singapore. However, the 2016 EU draft Directive regarding restructuring processes, and the EU Recommendation on which it is based, both aim to minimise court involvement, although not remove it completely. Admittedly, judicial supervision has its disadvantages, but still it is considered better than leaving this issue to the sole discretion of the insolvency professional appointed by the senior lenders. Payne, "The role of the court in debt restructuring", see n. 103, pp. 125,133-134; for the policy in Singapore, see n. 111, pp. 155-156.

not make the dissenting creditors worse off than what they would have been in the event of liquidation of the corporate debtor.[113] The starting point for the court is to consider the counterfactual, namely what each creditor would receive if no restructuring could be agreed upon. In that case, the company could either be liquidated on break-up basis or its business sold as a going concern and the corporate structure could be liquidated.[114] Therefore, the court could use either the break-up 'liquidation value' or the going concern 'liquidation value' as the benchmark for determining how much should be paid to the dissenting creditors. If the court uses the break-up 'liquidation value', it would obviously provide lesser protection to the dissenting creditors of a merely *financially distressed* company, causing wealth transfer from them.[115] It has therefore been suggested that for corporate debtors in mere *financial distress*, a going concern 'liquidation value' is a more appropriate benchmark than a break-up 'liquidation value'.[116]

Wealth transfer could also happen if valuation of the corporate debtor is left to one particular class of creditors. Senior creditors have an incentive to undervalue the company's business, while junior creditors have an incentive to overvalue it. For instance, in a restructuring involving conversion of debt to equity, if the value of the company is lesser than the value of the senior claims, then senior creditors could have the right to all the equity since the junior creditors would be left with no economic interest. In contrast, if the value of the company is more than the value of the senior claims, then the junior creditors will also have to be offered equity in the company. Therefore, if the issue of valuation is left to either the senior creditors or the junior creditors, they could engage in strategic valuation, leading to wealth transfer from the other.[117] Even when this issue is subject to judicial supervision, courts need to be prepared to resist any attempt at strategic valuation and instead choose the valuation method best suited to curb the *wealth transfer* problem.[118]

Even in cases where the court feels it appropriate to use the going concern 'liquidation value', another critical question of valuation arises, namely,

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[113]For example, see *Proposal for a Directive of the European Parliament and of the Council. on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU*. European Commission, Nov. 22, 2016, p. 31.

[114]Since restructuring is a hypothetical sale, no actual sale of the business to third party takes place. The liquidation value on going concern basis is therefore used only for valuation purposes in this context. R.C. Clark. "The Interdisciplinary Study of Legal Evolution". In: *Yale L.J.* 90 (5 1981), p. 1238, p. 1252.

[115]As discussed earlier, restructuring is a 'hypothetical sale' to preserve the going concern value or enterprise value of a *financially distressed* company and not merely recover the break up 'liquidation value'. Crystal and Mokal, see n. 63, Part II ((Bases of Valuation)).

[116]Payne, "The role of the court in debt restructuring", see n. 103, p. 139.

[117]Crystal and Mokal, see n. 63, Part III (Sources of Valuation Uncertainty).

[118]Payne, "The role of the court in debt restructuring", see n. 103, p. 139.

how to determine the going concern value. Restructuring being a hypothetical sale to the claimants themselves, a proper market test may not be possible.[119] Therefore, it would be necessary to determine the going concern value based on valuation opinions from expert valuers. This process being subjective may generate disputes and litigation, making the valuation exercise time-consuming and messy.[120] These valuation problems have to be resolved by courts while protecting minority claimants against *wealth transfer* in a restructuring.

### 1.4.2 Wealth transfer under IBC

#### 1.4.2.1 Inadequate protection from abusive cramdown

The *Insolvency and Bankruptcy Code*, 2016 empowers majority financial creditors with 66% vote by value in the CoC to impose a resolution plan on the dissenting minority financial creditors as well as the non-voting operational creditors.[121] Such a resolution plan could *inter alia* modify any security interest, extend the maturity date, change interest rate or other terms of a debt due from the corporate debtor.[122] In view of this broad cramdown power given to the majority financial creditors, the *Insolvency and Bankruptcy Code*, 2016 provides three safeguards to protect the dissenting minority financial creditors as well as the non-voting operational creditors. First, the resolution plan must identify specific sources of funds to pay the 'liquidation value' due to dissenting financial creditors.[123] Second, the resolution plan must provide for repayment of the debts of operational creditors which shall not be less than the amount to be paid to the operational creditors in the event of liquidation.[124] Third, the 'fair value' and 'liquidation value' of the insolvent business calculated by the registered valuers appointed by the resolution professional is expected to mitigate problems of strategic valuation.[125]

It is important to note here that there is no explicit provision in the *Insolvency and Bankruptcy Code*, 2016 that empowers NCLT to review the fairness of the resolution plan,[126] as long as such plan provides the minimum

[119] As discussed in Chapters 1.4.1.1 and 1.4.1.2, restructuring is likely when *going concern sale* may not fetch the *enterprise value*.

[120] Payne, "The role of the court in debt restructuring", see n. 103, p. 140.

[121] See n. 18, 30(4), 31(1).

[122] See n. 20, 37(1).

[123] Please note this was the legal position before October 5, 2018. see n. 20, 38(1)(c); this provision was struck down by NCLAT on September 12, 2018 for being inconsistent with the IBC. see n. 17; subsequently, on October 5, 2018, IBBI amended these regulations and deleted Regulations 38(1)(b) and (c). see n. 17, p. 6.

[124] See n. 18, 30(2)(b).

[125] See n. 20, 2(1)(hb), 2(1)(k), 35(1)(a).

[126] Refer to the discussion in footnote 52 in Chapter 1.2.1. In contrast, 'fairness' of a scheme is a relevant consideration for English courts while exercising their discretion to grant sanction. *Companies Act*. 2006, 899(1); see also Payne, "The role of the court in debt restructuring", see n. 103, p. 138.

break-up 'liquidation value' to the dissenting financial creditors and the operational creditors.[127] The ILC during its recent review of the *Insolvency and Bankruptcy Code*, 2016 recorded stakeholders' concerns that the 'liquidation value' guaranteed to the operational creditors may be negligible as they fall under the residual category in the statutory waterfall.[128] The ILC deliberated on whether instead of 'liquidation value', a different benchmark like 'fair value', 'resolution value' or 'bid value' should be used as the floor to determine the value to be given to the operational creditors. However, none of them were deemed suitable.[129] Instead, the ILC went on to observe that many operational creditors get payments above the 'liquidation value' in the resolution plan.[130] Accordingly, the ILC concluded that the interests of operational creditors must be protected, not by tinkering with what minimum must be guaranteed to them statutorily, but by improving the quality of resolution plans overall by efforts of regulatory bodies (like IBBI and Indian Banks' Association (IBA)) - not the NCLT.[131] Evidently, Indian policymakers do not explicitly envisage any judicial supervision of the valuation method adopted in a resolution plan to prevent potential *wealth transfer* as long as the plan pays the break-up 'liquidation value' to non-voting operational and dissenting financial creditors.[132] This limitation in the creditor protection framework under the *Insolvency and Bankruptcy Code*, 2016 creates opportunities for *wealth transfer* through resolution plans.

[127]This protection to dissenting financial creditors is not available since October 5, 2018. Refer to footnote 123 in Chapter 1.4.2.1. However, there are other specific criteria that a resolution plan must satisfy including that it must not contravene any of the provisions of the law. But the law does not explicitly require a resolution plan to be 'fair'. see n. 18, 30(2), 31(1); however, the NCLAT has recently held that 'any resolution plan if shown to be discriminatory against one or other financial creditor or the operational creditor, such plan can be held to be against the provision of the IBC'. The implication of this principle in terms of a precise valuation benchmark is not clear. see n. 52, par. 48.

[128]See n. 7, par. 18.2.

[129]Ibid., par. 18.3.

[130]According to data from Reserve Bank of India, over 4300 insolvency resolution applications were filed before NCLT till November 2017. Out of these cases, the ILC merely cited two instances - the *Synergies-Dooray* case and the *Hotel Gaudavan* case - to conclude that there was no empirical evidence to show that operational creditors do not receive a fair share in the resolution process. Moreover, IBBI currently does not publish data on resolution plans and therefore, it is difficult to expect private stakeholders to adduce empirical evidence on this issue. see n. 7, par. 18.4-18.5; See also Reserve Bank of India, see n. 5, par. 3.27.

[131]While IBBI is the insolvency regulator, IBA is a private association of Indian banks. see n. 7, par. 18.4.

[132]Please note that the valuation benchmark applicable to dissenting financial creditors has been removed from the regulations since October 5, 2018. For details, please refer to footnote 39 in Chapter 1.2.

To illustrate, assume that a corporate debtor has entered insolvency resolution process under the *Insolvency and Bankruptcy Code*, 2016. It has a break-up 'liquidation value' of \$10 and two types of financial debts - Debt 1 and Debt 2 - having identical priority. The face value of Debt 1 is \$40 (34% by value approx) and its maturity is $T_1$; the face value of Debt 2 is \$80 (66% by value approx) and its maturity is $T_2$. Also, assume that the corporate debtor is likely to generate: (a) a sure cash flow of \$40 at $T_1$; and (b) a cash flow of \$80 or \$0, each with a probability 0.5 in $T_2$. Consequently, Debt 1 will be fully repaid with certainty in $T_1$ (expected return = \$40), while the expected return of Debt 2 in $T_2$ is \$(80)(0.5)+(0)(0.5) = \$40, which is lesser than its face value of \$80. As a result, the holder of Debt 1 has no reason to consent to a restructuring, given the conflict of interest between Debt 1 and Debt 2.

However, under the *Insolvency and Bankruptcy Code*, 2016, the holder of Debt 2 (being 66% by value) can adopt any resolution plan and impose it on the holder of Debt 1 as long as such resolution plan satisfies section 30(2). Assume that the holder of Debt 2 adopts a resolution plan that extends the maturity of Debt 1 from $T_1$ to $T_2$. We know that in good state, the corporate debtor will generate \$40+80 = \$120; in bad state, it will generate \$40+\$0 = \$40. Now since both Debt 1 and Debt 2 have same priority and maturity, holders of Debt 1 in good state will get \$(120)(0.34) = \$40.8 and in bad state, will get \$(40)(0.34) = \$13.6; holders of Debt 2 in good state will get \$(120)(0.66) = \$79.2 and in bad state will get \$(40)(0.66) = \$26.4. Therefore, expected return of Debt 1 will now be \$(0.5)(40.8)+(0.5)(13.6) = \$27.2, while expected return of Debt 2 will now be \$(0.5)(79.2)+(0.5)(26.4) = \$52.8. Table 1.1 captures the returns for holders of Debt 1 and Debt 2 respectively across good state and bad state both before and after restructuring.

| | **Pre-restructuring** *(D1, D2)* | **Post-restructuring** *(D1, D2)* |
|---|---|---|
| **Good State** | 40, 80 | 40.8, 79.2 |
| **Bad State** | 40, 0 | 13.6, 26.4 |
| *Expected Return* | 40, 40 | 27.2, 52.8 |

**Table 1.1.** Returns to holders of Debts 1 and 2

It is evident that the restructuring will reduce the expected return of Debt 1 by \$40-\$27.2 = \$12.8 and increase the expected return of Debt 2 by \$52.8-\$40 = \$12.8. Essentially, the resolution plan in this case would lead to a wealth transfer of \$12.8 from holders of Debt 1 to holders of Debt 2. Even after such wealth transfer, the holder of Debt 1 would get \$27.2, which is more than the amount it would have got in a break-up liquidation, that is, \$(10)(0.34) = \$3.4. Therefore, this resolution plan would satisfy the creditor protection rule requiring payment of break-up 'liquidation value' to dissenting financial creditors and still cause wealth transfer.[133] Moreover, since it would legitimately satisfy all the grounds in section 30(2), the NCLT is not empowered to refuse approval under section 31(1). This example illustrates why the *Insolvency and Bankruptcy Code*, 2016 may fail to prevent *wealth transfer* from the dissenting financial creditors to the majority financial creditors in a restructuring using a break-up 'liquidation value' benchmark.[134]

#### 1.4.2.2 Incorrect use of valuation benchmark

The *Insolvency and Bankruptcy Code*, 2016 overlooks a basic distinction between restructuring and going concern sales.[135] Restructuring, being a hypothetical sale of the corporate debtor's business to the claimants of the corporate debtor, some finite value has to be placed on the business of the corporate debtor. Otherwise, it would not be possible to calculate how much shares and other claims each claimant across each class of claimants of the corporate debtor should get in the newly restructured entity owning the business.[136] Therefore, restructuring requires a valuation benchmark, according to which the rights of each claimant in the restructured business has to be determined.[137] No such problem arises in a going concern sale for cash to a third party after proper marketing exercise. In such a sale transaction, after accounting for the expenses, the resolution professional can distribute the cash received to pay out the different claimants according to their priorities, until the money runs out.[138] Therefore, there is no need for a valuation benchmark to decide the rights of the claimants in a going concern sale.

Yet, the *Insolvency and Bankruptcy Code*, 2016 applies the same valuation benchmark to both restructuring and going concern sale.[139] Therefore, even in case of a true sale to a third party for cash at going concern value, the minimum amount to be paid out of that cash proceeds to the dissenting

[133]It is important to note here that the NCLAT has recently struck down this creditor protection rule on the ground that it is violative of the IBC 2016. The NCLAT held that no discrimination can be made between the financial creditors in the resolution plan on the ground that one has dissented and voted against the resolution plan or the other has supported and voted in favour of the resolution plan. see n. 17, par. 3.

[134]Please note that this was the legal position before October 5, 2018. For details, refer to footnote 39 in Chapter 1.2. This example is based on an example used by Lee. Lee, see n. 110.

[135]A resolution plan allows both possibilities. see n. 20, p. 37.

[136]Clark, see n. 114, p. 1252.

[137]Ibid., p. 1252.

[138]Ibid., pp. 1252-1253.

[139]Please note that the valuation benchmark applicable to dissenting financial creditors has been removed from regulations since October 5, 2018. For details, see footnote 39 in Chapter 1.2. For the legal position in this regard before October 5, 2018, see see n. 20, p. 38; see also see n. 18, 30(2)(b).

financial creditors and non-voting operational creditors under the resolution plan is to be determined according to the amount they would have received in a break-up liquidation. The remaining amount of sale proceeds could then be transferred to junior claimants.[140] Such resolution plans being in compliance with the *Insolvency and Bankruptcy Code*, 2016, the NCLT cannot refuse to sanction them to prevent the unfair *wealth transfer* from operational creditors to junior claimants.

To illustrate, assume that a corporate debtor has entered insolvency resolution process under the *Insolvency and Bankruptcy Code*, 2016. It has a going concern value of $130 and break-up 'liquidation value' of $110. The face value of debts owed to its financial creditors is $100 and to its operational creditors is $30. If the company is liquidated on break-up basis, then the financial creditors would get $100 and the operational creditors would get only $10. However, if the company is sold for cash to a third party at going concern value, then the financial creditors could get $100 and $30 will be left over. Applying the creditor protection rules under the *Insolvency and Bankruptcy Code*, 2016, the financial creditors could legitimately approve a resolution plan that provides only the break-up liquidation amount ($10) to the operational creditors and pays the remaining $20 to the shareholders, who feature below the operational creditors in the statutory waterfall.[141] This resolution plan would satisfy the creditor protection rule requiring payment of break-up 'liquidation value' to operational creditors and still cause wealth transfer from the operational creditors. As discussed earlier, the NCLT has no specific power to object to this resolution plan. This example illustrates why the *Insolvency and Bankruptcy Code*, 2016 may fail to prevent *wealth transfer* from the operational creditors in a going concern sale because of the 'liquidation value' benchmark.

Evidently, this is an incorrect use of the valuation benchmark. Restructuring and going concern sales are two completely different concepts. For instance, Chapter 11 of the *U.S. Bankruptcy Code*, 2012 deals with restructuring, which

[140] This is antithetical to the *absolute priority principle*, which requires most senior creditors to be paid off in full before anything could be given to the next most senior creditors and so on down the ladder. Aghion, Hart, and Moore, "Improving bankruptcy procedure", see n. 65, pp. 852-853; under the IBC 2016, the *absolute priority principle* is applicable to proceeds from the sale of liquidation assets. However, there is no specific statutory provision that extends this rule to the proceeds from a going concern sale through a resolution plan. see n. 18, 30, 31, 53(3)(i); for instance, as reported by the Economic Times, when Tata Steel purchased insolvent Bhushan Steel, the banks took a 37% haircut and yet the shareholders retained the residual interests. Sangita Mehta. *Tata Steel completes Rs 35,200 crore purchase of bankrupt Bhushan Steel*. May 22, 2018. URL: `https://economictimes.indiatimes.com/industry/indl-goods/svs/steel/tata-steel-completes-5-2-billion-purchase-of-bankrupt-bhushan-steel/articleshow/64224367.cms` (visited on 05/19/2018).

[141] See n. 18, 53(1).

uses the valuation benchmark.[142]. On the other hand, section 363 in Chapter 3 of the *U.S. Bankruptcy Code*, 2012 deals with going concern sales, which does not use any such valuation benchmark. The *Insolvency and Bankruptcy Code*, 2016 inadvertently fused both these features into the insolvency resolution process and consequently, applied the break-up 'liquidation value' benchmark to both.[143] As illustrated above, this creates unnecessary risks of *wealth transfer* in going concern sales under *Insolvency and Bankruptcy Code*, 2016.

The NCLAT in *Central Bank of India v. Resolution Professional of Sirpur Paper Mills Ltd. and Ors.* made an attempt to resolve this issue. In this case, the resolution plan for a going concern sale was approved by the NCLT. The plan provided the dissenting financial creditors an amount equal to that provided to the majority financial creditors. This particular aspect of the plan was challenged by one of the majority financial creditors before the NCLAT on the ground that it violates the creditor protection rule under Regulation 38(1)(c) of the *Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations*, 2016 since an amount more than 'liquidation value' was provided to the dissenting financial creditors under the resolution plan. The NCLAT rejected this argument and dismissed the appeal. It held that no discrimination can be made under *Insolvency and Bankruptcy Code*, 2016 between the financial creditors in a resolution plan on the ground that one has dissented and voted against the resolution plan or the other has supported and voted in favour of the resolution plan.[144] The tribunal also struck down the above regulation as *ultra vires* the *Insolvency and Bankruptcy Code*, 2016.[145] Subsequently, on October 5, 2018, the IBBI deleted Regulations 38(1)(b) and (c) of the *Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations*, 2016.[146]

This decision of NCLAT and the subsequent amendment of regulations by IBBI, do not resolve the problem of incorrect use of the valuation benchmark.

First, although Regulation 38(1)(b) (applicable to operational creditors) and Regulation 38(1)(c) (applicable to dissenting financial creditors) now stand deleted, the creditor protection rule applicable to operational credi-

[142] *U.S. Bankruptcy Code*. 2012 (henceforth cited as 11 U.S.C), 1129(a)(7)(A)(ii).

[143] Please note that the valuation benchmark applicable to dissenting financial creditors has been removed from regulations since October 5, 2018. For details, see footnote 39 in Chapter 1.2. For the legal position in this regard before October 5, 2018, see see n. 20, 38(1)(c).

[144] See n. 17, par. 3.

[145] The NCLAT struck down both Regulation 38(1)(b) applicable to operational creditors and Regulation 38(1)(c) applicable to dissenting financial creditors. It is submitted that this was the result of a wrong interpretation by NCLAT. The regulations only provided for a minimum value to be paid to the operational and dissenting financial creditors. Consequently, any higher amount paid to such creditors was not violative of these regulations. ibid., par. 9.

[146] See n. 17.

tors under section 30(2)(b) of *Insolvency and Bankruptcy Code*, 2016 is still in force. This statutory provision still uses the break-up 'liquidation value' benchmark for operational creditors.[147] Consequently, neither the decision of the NCLAT nor the amendment to the regulations may actually alter the valuation benchmark as far as operational creditors are concerned.

Second, although the NCLAT in *Central Bank of India v. Resolution Professional of Sirpur Paper Mills Ltd. and Ors.* was dealing with a going concern sale, the decision did not differentiate between going concern sales and restructurings. Subsequently, the IBBI deleted the valuation benchmark altogether from its regulations. Therefore, there is at present no applicable valuation benchmark for dissenting financial creditors in restructurings during the corporate insolvency resolution process. This is problematic since restructurings require a valuation benchmark, according to which the rights of each claimant in the restructured business has to be determined. For instance, section 1129(a)(7)(A)(ii) in Chapter 11 of the *U.S. Bankruptcy Code*, 2012 uses liquidation value as the minimum benchmark for restructurings. The recent *Companies (Amendment) Act*, 2017 in Singapore has also provided for valuation benchmark to ensure that a restructuring plan imposed on dissenting classes of creditors using the cramdown provision is fair and equitable.[148] Similarly, a critical issue in the ongoing insolvency law reforms in UK has been about the appropriate valuation benchmark to be used in restructurings.[149] Therefore, the present Indian position on this issue is at odds with the position adopted across advanced jurisdictions.

Third, the NCLAT in a subsequent decision in *Binani Industries Ltd. v. Bank of Baroda* held that 'any resolution plan if shown to be discriminatory against one or other financial creditor or the operational creditor, such plan can be held to be against the provision of the *Insolvency and Bankruptcy Code*, 2016'.[150] In the absence of any specific valuation benchmark in the law or regulations, this broad principle of non-discrimination could dilute the cross-class cramdown provision under *Insolvency and Bankruptcy Code*, 2016. Cramdown powers are necessary in restructurings to overcome potential hold-ups by dissenting claimants. The valuation benchmark provides a precise level of minimum protection to the dissenting claimants from poten-

[147] The section does not specifically mention that the valuation benchmark should be the break-up 'liquidation value'. However, as discussed in footnote 38, the ILC in its report has used break-up 'liquidation value' as the minimum amount to be paid to operational creditors in a resolution plan. see n. 7, par. 18.2-18.3.

[148] *Companies (Amendment) Act*. 2017, 211H(4).

[149] UK has proposed to use the 'next best alternative' valuation benchmark. Department of Business, Energy and Industrial Strategy. *Insolvency and Corporate Governance: Government response*. Report. 2018, par. 5.169-5.176.

[150] See n. 52, par. 48.

tial abuse of cramdown powers by the majority claimants.[151] In contrast, non-discrimination is a broad principle that could be misused by dissenting out-of-the-money minority claimants to engage in hold-ups to extract a better deal for themselves. Such misuse could dilute the efficacy of the cramdown provision under the *Insolvency and Bankruptcy Code*, 2016, and cause unnecessary litigation.

Fourth, although the principle of non-discrimination is the correct intuition, it is not a precise standard. For this principle to be implementable in practice, it has to be translated into an appropriate valuation benchmark, ideally codified in law as is the case currently in US and Singapore.[152] Therefore, Indian policymakers still need to decide whether the going concern 'liquidation value', the break-up 'liquidation value' or 'next best alternative' value is the appropriate valuation benchmark to ensure that non-discrimination in restructurings.

The Indian judiciary could potentially address this issue through judicial interpretation. However, this could be tricky given the lack of an explicit provision for judicial supervision of the fairness of a resolution plan.[153] In any case, Indian courts do not necessarily have a great track record of managing creditor oppression in the context of corporate insolvency, as is evident from the history of Board for Industrial and Financial Reconstruction (BIFR).[154]

#### 1.4.2.3 Strategic Valuation

The valuation of the insolvent company under the *Insolvency and Bankruptcy Code*, 2016 is done by registered valuers, appointed by the resolution professional, who in turn is appointed by the CoC.[155] Therefore, it is likely that these valuers would be influenced by the interests of the majority financial creditors on the CoC.[156] This could create scope for strategic valuation under the *Insolvency and Bankruptcy Code*, 2016 in favour of the majority financial creditors. If these financial creditors are secured, they have an incentive to depress the valuation in a restructuring, so that they can capture more equity in the restructured company. This could create further risks of *wealth transfer* to the majority financial creditors.

[151] Policymakers in Singapore discussed this issue in detail and finally agreed to introduce the cramdown provision in the statute along with necessary safeguards including valuation benchmark. see n. 111, pp. 154-156.

[152] 11 U.S.C, 1129(a)(7)(A)(ii); see n. 148, 211H(4).

[153] Refer to the discussion in foonote 126.

[154] Zwieten, see n. 2.

[155] Even if not formally appointed by the Committee of Creditors initially, an interim resolution professional can be replaced by 75% vote by value of the Committee. Therefore, for all practical purposes, the resolution professional will be answerable to the Committee. see n. 18, § 27.

[156] At the very least, it will impact on the perception that the valuation is unbiased. Payne, "The role of the court in debt restructuring", see n. 103.

## 1.5 Conclusion

India experienced a major structural change with the enactment of the *Insolvency and Bankruptcy Code*, 2016. Although it has vastly improved India's corporate insolvency framework, it has also raised two important challenges - the *value destruction problem* and *wealth transfer problem*. This article applied theoretical concepts from the law and economics literature on insolvency to identify the sources of these two problems in the *Insolvency and Bankruptcy Code*, 2016.

The article identified two potential sources of *value destruction* under the *Insolvency and Bankruptcy Code*, 2016. First, the law entrusts the decision about the future of a *financial distressed* corporate debtor with a supermajority of financial creditors, whose payoffs may not necessarily be affected by the outcome of that decision. Therefore, they may not have the right incentive to preserve the value of the business of the corporate debtor. Second, by limiting the benefits of the cramdown provision only to post-insolvency restructuring, the law delays restructuring and enhances the risk of *value destruction* of the corporate debtor.

The article identified four potential sources of *wealth transfer* under the *Insolvency and Bankruptcy Code*, 2016. First, the law does not expressly provide for judicial supervision to ensure fairness in a resolution plan adopted by cramming down the minority financial creditors. Consequently, till October 5, 2018, a resolution plan that paid only the break-up 'liquidation value' to such dissenting minority financial creditors, would have been perfectly legal under the regulations and had to be approved by NCLT. This created potential risks of *wealth transfers* from dissenting minority financial creditors through resolution plans. After October 5, 2018, in the absence of a specific valuation benchmark for dissenting financial creditors in the law or regulations, it remains to be seen what valuation benchmark could be successfully used in this regard. Second, the regulations before October 5, 2018, used the break-up 'liquidation value' instead of going concern 'liquidation value' as the benchmark for restructuring of a *financially distressed* company, reducing the valuation of the claims of the dissenting minority financial creditors in the restructured company. After October 5, 2018, in the absence of a specific valuation benchmark for dissenting financial creditors in restructuring cases, it remains to be seen what valuation benchmark could be successfully used in this regard. Third, the law incorrectly applies the 'liquidation value' benchmark used in restructurings to going concern sales for cash to third parties, creating opportunities for *wealth transfer* from operational creditors to junior claimants in such sales transactions. Fourth, the appointment process of registered valuers could create scope for strategic valuation favouring *wealth transfer* to majority financial creditors.

Indian policymakers need to revisit these fundamental legislative design choices embedded within the *Insolvency and Bankruptcy Code*, 2016 to successfully address the contemporary concerns regarding the *value destruction* and *wealth transfer* problems.

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