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Flaws in the Bankruptcy Code

Among other concerns, the Code fails to prescribe an inclusive voting rule for the Creditors' Committee

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To start with a market metaphor: policy wonks, journalists, lawyers, bureaucrats and sundry other stakeholders are 'bullish' on the Insolvency & Bankruptcy Code, 2016 (Code) that was recently passed by the Lok Sabha. The Code has been variously credited as being game-changing, excellent and as being able to save the lenders. This piece will 'play the bear' as it were and argue the case for a sceptical view of the Code.

Firstly, the Code empowers both the corporate debtor and the creditors to initiate corporate resolution process on the trigger of default. On the initiation of bankruptcy, an Insolvency Resolution Professional (IRP) will assume control of the corporate debtor's management, displacing the incumbents. But merely enabling stakeholders to move does not mean they will be motivated to move.

Let's break this down. Would creditors be motivated to move? The value (amount) of debt creditors (operational creditors in particular) may individually hold may simply not be large enough to justify invoking the corporate resolution process. Concededly, secured financial creditors (banks) are likely to have greater skin in the game and therefore greater motivation to move.

However, as Douglas Baird points out in his seminal work on the initiation problem in bankruptcy (*The Initiation Problem in Bankruptcy, International Review of Law & Economics, 1991*), creditors tend to specialize and lack a sense of overall day-to-day health of the corporate debtor. So, even if the creditors move the bankruptcy process, there is a risk the corporate debtor is admitted in the hospital too late for its own good.

Counter-intuitively, the only stakeholders that have adequate information about the solvency risk of a firm are the management. But because the probability of the management surviving in bankruptcy under the current Code is zero, it is unlikely they will move the insolvency resolution process at all.

The model that Chapter 11 of the US Bankruptcy Code employs is instructive and appears better in this regard. Under Chapter 11, the management retains its job during the bankruptcy process but the creditors and the Court are empowered to appoint a trustee. The Court can also appoint an examiner to investigate the affairs of the debtor. In other words, while the management retains control in bankruptcy, they manage "in the shadow of a trustee" and as such, the risk that they will indulge in asset stripping during the process appears substantially mitigated.

On the other hand, though, this model creates incentives for the management to move the insolvency resolution process at the earliest. Moreover, the commentary to the Code itself notes the need to distinguish corporate failure from corporate malfeasance. As such, a blanket rule replacing the management with IRP also appears internally incoherent.

Secondly, borrowing from the United Kingdom, the Code proposes to catalyze an industry of IRPs that will be regulated by a Board. Thinking through an economic prism, an IRP acts as an agent of creditors as a class and its presence ensures the inter-creditor agency costs are minimized. Empirical studies conducted on the UK bankruptcy regime, however, reveal that while adoption of the IRP model resulted in higher realizations, they also correspondingly increased costs of bankruptcy and thus did not materially improve creditor recoveries (goo.gl/HhR36U). In the light of this evidence, the adoption of the IRP model warrants careful scrutiny. Moreover, the emergence of a well-functioning IRP market will be critical to the success of the Code. Evidence from the UK, however, appears to suggest that antitrust concerns can arise owing to secured creditor-resolution professional nexus (goo.gl/ROpH4Z).

There are other ways of mitigating the inter-creditor agency costs that arise in the context of bankruptcy. For example, the Code could make the Creditor Committee more representative. Unfortunately, the Code explicitly excludes operational creditors from the Creditors Committee, a class that also includes vendor counterparties. The Code also fails to prescribe an inclusive voting rule for the Creditors' Committee; as things stand, a proposed resolution plan requires 75% in value of creditors to sign off for it. This creates the risk of the minority creditors being disenfranchised. (It is easy to imagine banking consortiums dominating smaller creditors, for instance).

Corporate democracy requires that each class of creditors under the proposed resolution plan vote separately on it. Merely enabling them to attend the creditor committee meetings as "observer" as the bill (as passed by the Lok Sabha) has sought to do appears inconsistent with corporate democracy. Illustratively, Chapter 11 provides class voting to ensure that the sanction of the resolution plan is truly representative. Likewise, even though the UK follows the 75% in value voting rule, the Rules permit only the unsecured creditors (secured creditors vote to the extent of their under-securedness; see Rule 2.24) to vote on the Proposal.

Finally, the Code provides a hard deadline of 180/270 days for completion of corporate insolvency process, failing which, the Code mandates the "Adjudicating Authority" to order liquidation (Section 33 (2) of the Code). Proponents of the Code have eulogized this feature. Negotiating under the shadow of liquidation may lead parties to not conduct a wide enough market search for the ailing corporate debtor and will likely result in going-concern fire sales (translating into creditor under-recoveries). Worse, a hard deadline will push otherwise salvageable companies into liquidation, disrupting markets and affecting jobs and livelihoods.

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