Seven years of Indian bankruptcy laws: Six stylized facts

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Protection of equity and creditor rights has emerged as an important determinant in the development of the equity and debt markets in an economy, with implications for availability of capital at reasonable rates, and thereby for economic growth. Countries with poorer investor protections, measured by both the character of legal rules and the quality of law enforcement, have smaller and narrower capital markets. These findings apply to both equity and debt markets \cite{Porta1997}.

The defining feature of various securities is the rights that they bring to their owners (\cite{Hart1995, Porta1998}). National legal frameworks tend to be influenced largely by historical antecedents and inherited legal systems where countries have been liberated from foreign rule. In a study of legal rules covering protection of corporate shareholders and creditors, the origin of these rules, and the quality of their enforcement in 49 countries, La Porta et all document (i) the quality of law enforcement is the highest in Scandinavian and German civil law countries (ii) next highest in common law countries (iii) the lowest in French civil law countries. Th study underscores these results are not just a consequence of different income levels in countries with different laws. Yet it is widely recognized that law and the quality of its enforcement are potentially important determinants of what rights security holders have and how well these rights are protected. Since the protection investors receive determines their readiness to finance firms, corporate finance may critically turn on these legal rules and their enforcement.\cite{Porta1998}.

In the case of equity finance, shareholder rights include voting powers, periodic and continuous disclosures on corporate developments and templated financial statements to protect against surreptitious expropriation by management. For creditors, some of this protective legal cover includes recognition of security of the loan, and the ability to grab assets in case of a loan default.

Important aspects of the strength of creditor rights are the specific features of a country’s insolvency regime and its enforcement. Recent financial crises have further highlighted the importance of well- functioning insolvency systems to prevent and resolve corporate sector financial distress\cite{Claessens2002}. Literature has already highlighted the complex role of creditor rights in affecting not only the ex-post resolution of distressed corporations, but also in influencing ex-ante incentives and an economy’s dethegree of entrepreneurship more generally.

*Au contraire*, weak protection of creditor rights in insolvency is a key source of financial barriers (\cite{Porta1997, Shleifer1997, Demirgüc-Kunt 1998, Ponticelli2016}).

In what follows, we examine these issues in greater detail, the context being that a modern insolvency and bankruptcy law has been in operation for almost seven years. In Section 2, this paper reviews the literature around the co-evolution of law and finance, and specifically, the intent and content of modern bankruptcy laws in the context of protection of creditor rights. In Section 3, we review some conceptual issues regarding the efficiency of bankruptcy laws. Section 4 presents some stylised facts emerging out of data on resolution/liquidation proceedings over the last seven years. The following section concludes.

## 2. Economic foundations of modern bankruptcy laws

Although the Babylonian Talmund had a detailed discussion on division of the estate of a bankrupt person, it was not until the 1500's England that it was recognised that creditors’ rights had to be protected through special laws outside the common civil law. The first bankruptcy law passed in England in 1542, was titled "An Act against such persons who make bankrupts," explicitly recognising that since credit is the life blood of trade and commerce, a default in one link in the chain can have a cascading effect throughout the system.

That was not always the case. In fact, the evolution of Bankruptcy laws from Roman times to the first formal bankruptcy law in 1542, illustrates the changing perception of debtors from criminals to failed entrepreneurs. \cite{Radin1922} narrates the fate of “a duly adjudicated debtor in fifth century BCE, if he failed to pay the judgment or get it paid, might have been killed by his creditor or sold into foreign slavery, or, if there were several creditors, might have been cut into pieces by them in proportion to their (creditors’) shares.”

Early English law inherited this “criminality” view of defaulting debtors. Baird and Jackson(1990)\cite{Baird1990} describe early English laws as "viciously punitive from the perspective of the debtor.” Imprisonment for debt was the order of the day, and common law authorized "body execution," i.e., seizure of the body of the debtor to be held until payment of the debt. In other common law territories, punishments upon debtors included forfeiture of all property, “relinquishment of the consortium of a spouse,” imprisonment, and death.

As commerce expanded, terminal measures were sought to be replaced with remedial actions. Individual collection remedies, such as the common law execution, imprisonment and denial of consortium of spouse did not address the distinct problems presented by a debtor's multiple defaults. Carving out the body of a debtor doesn’t replenish the creditor’s pool of capital.

Also, trade and commerce necessitated multiple creditors or varying seniority and vintage. There were the secured creditors, who held valuable security in their possession for the credit granted; operational creditors included the trade creditors who would despatch raw material on credit, most often on verbal promises to pay on due date.

When multiple creditors are in the play for the estate of a debtor in default, a court-supervised procedure and a templated protocol of distribution of assets in the only way to maintain order in the distribution and to avoid a Titanic-like situation. There has to be an incontrovertible finding of seniority/vintage of the secured credit and a detailed public hearing inviting all operational creditors to file their claims. In essence, bankruptcy laws are designed to protect creditors’ rights not only against the corporate debtor but also between themselves.

Formally stated, bankruptcy is court-supervised process which provides a platform for financially distressed firms to resolve their debts due to its creditors, and occasionally governments. The main economic function of corporate bankruptcy is to reduce the cost of default by having a government-sponsored procedure that resolves all debts simultaneously \cite{White2007}.

In the context of the financial crises in the last 30 years, authors have noted an increased interest globally in the design of insolvency systems from a point of resource allocation, efficiency, and stability as well as equality and fairness; see \cite{Stiglitz2001, Hart2000} for reviews.

A game theoretic view of bankruptcy laws in the context of creditor protection is developed in Baird and Picker (1991)\cite{Baird1991}. Beginning with the traditional view of bankruptcy law that diverse general creditors of a firm face a collective action problem in case the debtor becomes insolvent, the general creditors now are the firm's residual owners. In this framework inherits from the criminality view of bankruptcy which admitted of seizure of the debtor’s assets. In this case, bankruptcy law is designed in the first instance to allow the co-owners (creditors) to act collectively, in the interest of realizing the maximum value of the asset for the common good of all.

Therefore, it is argued that bankruptcy serves principally to frame the negotiations between this senior creditor and the firm's erstwhile owner shareholder-managers. A bankruptcy proceeding is needed largely because these negotiations cannot be entirely the province of private contract.

Bankruptcy is best appreciated as a forum in which the pool of creditors on the one hand and shareholder-managers of the defaulting debtor negotiate with each other.

Bankruptcy's rules have a dual function: to enforce the agreement between these parties and to ensure that this agreement does not compromise the rights of any third parties. This has been justified on theoretical grounds \cite{Jackson1986) that collective action problems between the creditors may lead to inefficient loss of complementarities between the firm’s assets, as creditors seek their individual remedies against the specific assets charged to them. If secured creditors’ enforcement rights were not stayed in bankruptcy, then enforcement by multiple secured creditors would lead to inefficient liquidation \cite{Webb, 1991}.

Bankruptcy laws are the central pillar of creditor protection in that they require a coordinated resolution involving all creditors \cite{Langhofer2004}. This mandatory participation prevents individual debt collection remedies that tend to destroy asset value. Bankruptcy laws exist to resolve the conflict that arises among creditors when a debtor becomes insolvent. In the absence of a bankruptcy system, creditors generally find individual debt collection remedies privately optimal, even though a coordinated liquidation would maximize the value of the assets to be distributed to the creditors as a group. A bankruptcy law that mandates a collective process avoids this inefficient liquidation.

India has inherited the common law provisions in English The first bankruptcy legislation can be traced to the Government of India Act, 1800, wherein insolvency jurisdiction was conferred upon the Supreme Court at Fort William, Calcutta (now known as Kolkata) and Madras (now rechristened Chennai) and the Recorder's Court at Bombay (now: Mumbai). These courts were empowered to make rules and orders for granting relief to insolvent debtors on the lines intended by the Act of the British Parliament called the Lord's Act passed in 1759.

The first designated insolvency courts for relief of insolvent debtors were established by the Act of 1828 in the three Presidency towns of Calcutta, Bombay and Chennai.

The Indian Insolvency Act, 1848 retained the framework for relief of insolvent debtors established by the Act of 1828. The Provincial Insolvency Act, 1907 instituted a special insolvency jurisdiction, specifying the conditions under which a debtor could be adjudicated on his own petition or on a petition by a creditor.

Broadly, while Indian laws were written after English law, there is a distinct pro-debtor bias, in so far as it stressed surrender by the debtor of all his goods for the benefit of his creditors in return for immunity from court process and harassment. However, the Presidency town of Bombay had already adopted a provision--based on section 1(1)(g) of the English Act—with an unambiguous pro-creditor intention. The Law Commission Report (1908) recommended the Bombay legislation be adopted in all jurisdictions:

"the most effective way of instilling a healthy fear in the minds of dishonest judgment-debtors would be to enable the Court to adjudicate him an insolvent if he does not pay the decretal amount after notice by the decree-holder, by specifying a period within which it should be paid, on the lines of the Bombay amendment to the Presidency Towns Insolvency Act."

The move towards a modern bankruptcy law was initiated in 2014, when the Union Ministry of Finance established a [Bankruptcy Law Reforms Committee](https://ibbi.gov.in/uploads/resources/BLRCReportVol1_04112015.pdf) (BLRC) under the Chairmanship of T. K Viswanathan. The committee marked a significant departure from earlier efforts at legislation—pro-debtor or pro-creditor—when it centered its enquiry on the "Key economic question in the bankruptcy process." The Viswanathan Committee report's clear and unamiguous narrative highlights the primacy of preserving value in a stressed asset in the context of creditor protection. It is a very illuminating read on the intent behind the draft code, which subsequently was refined by the [Joint Parliamentary Committee on the Insolvency and Bankruptcy Code](https://eparlib.nic.in/bitstream/123456789/762113/1/jcb_2016_insolvency_bankruptcy_bill.pdf), 2015 (Chairperson: Mr. Bhupender Yadav).

The intention of Indian Parliament is clearly enunciated in the preamble of the Insolvency and Bankruptcy Code 2016:

"An Act to consolidate and amend the laws relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximisation of value of assets of such persons, to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders."

## 3. Objectives of Bankruptcy laws

The economic foundation of bankruptcy laws has been established. But to what objective? How is the economy, pool of creditors or debtor unable to pay her debts better off with bankruptcy laws? And how to evaluate the efficiency gains arising out of bankruptcy laws? These are questions that determine the co-evolution of law and finance in different economies.

It has been well documented that bankruptcy laws have impact on the development of the financial markets \cite{Levine1998}. Succurro (2012) provides empirical evidence that the investment share of GDP is higher in countries characterized by highly efficient bankruptcy system; the more efficient the insolvency procedures in terms of time, cost and recovery rate, the more readily available debt is and the higher the Investment/GDP ratio is. The investment share of gross domestic product is positively associated with the degree of sophistication of bankruptcy laws \cite{Succurro2012}.

Stiglitz (2001) approached this problem statement from a point of resource allocation, efficiency, and stability as well as equality and fairness \cite{Claessens2002}. Insolvency regimes include a number of features designed to balance conflicting viewpoints: protecting the rights of creditors and other stakeholders – essential to the mobilization of capital for investment and working capital and other resources – against protecting of rights of debtors, including protection against the premature liquidation of viable firms.

To recap, in the context of efficiency measures, the first overall objective of bankruptcy laws is the allocation of risk among participants in a market economy in a predictable, equitable, and transparent manner. The allocation of risk plays a critical role in providing confidence in the credit system and fostering economic growth for the benefit of all participants \cite{IMF1999}. For example, the protection afforded to a creditor to commence insolvency proceedings against a debtor as a means of enforcing its claim reduces the risk of lending and, thereby, increases the availability of credit and investment capital. Equally, an insolvency law also serves to allocate risk *inter se* among different creditors. For example, the special treatment afforded by statute to secured creditors vis-a-vis unsecured creditors protects the value of security, which may be particularly important for those debtors that, because of their credit risk, cannot obtain (or cannot afford) unsecured credit.

The second objective of an insolvency law is to protect and maximize value for the benefit of all interested parties and the economy in general. This objective is most obviously pursued during rehabilitation, where value is maximized by continuing a viable enterprise. But it is also a primary objective of liquidation procedures where rehabilitation has been judicially determined to be unviable.

It has been argued that the second objective is dominant during rehabilitation, where value is maximized by continuing a viable enterprise. But it is also a determining objective of procedures that liquidate enterprises that cannot be rehabilitated \cite{IMF1999}. This paper argues a two-way causality between the two objectives, in that the achievement of the second (value maximization) objective is often furthered by the fulfilment of the first (equitable risk allocation) objective.

This paper holds that the two objectives of value maximization and of equitable risk allocation are not sequentially causal, but two facets of a single objective of resolving distress in insolvent firms. They differ only in the time dimension. The objective of equitable risk allocation dominates the economics of a running firm, ensuring availability of credit at reasonable rates, whereas the objective of value maximization kicks in when the firm in unable to pay its debts. Bankruptcy laws, therefore, serve a critical purpose prior to and after the initiation of insolvency.

Elsewhere, the problem statement has been reformulated to identify the efficiency gains from bankruptcy laws at different points in the resolution/liquidation process. The literature identifies five distinct roles of bankruptcy law\cite{Smith2004}. These are: (1) to verify assets and liabilities, (2) to improve coordination among claimholders, (3) to protect third-party claimants, (4) to maintain asset value during bargaining, and (5) to alleviate the impact of liquidity constraints among claimants and potential acquirers.

Given the importance given to equity shareholder and creditor protection in all economies, as key pillars of economic development, the research interest has turned to evaluating the efficiency of bankruptcy processes in various economic regimes, across varying time periods.

There is no ultimate approach to the efficiency assessment \cite{Staszkiewicz2019}. A good bankruptcy law should achieve many, not always compatible, goals. A bankruptcy law has to decide what to do with the insolvent firms and how to compensate the creditors.

Thorburn proposes the reference point for efficiency can take the form of market value or market oriented procedures \cite{Thorburn2000}, time, cost, and recovery rate of the procedure \cite{Succurro 2012}, ability to strike a balance between debtors and creditors protection \cite{Franks1996, Porta2008}, or the behavioral changes of process actors.

The literature has made a useful distinction in various definitions of bankruptcy efficiency. Cornelli suggests a framework to analyze the efficiency properties of bankruptcy procedures, distinguishing between ex-ante and ex-post efficiency \cite{Cornelli1997}. Ex-post efficiency consists in maximizing the ex-post value of the insolvent firm, whereas ex-ante efficiency consists in maximizing the proceeds to creditors from the reorganization of the firm and providing incentives for the creditors to monitor the firm. If the choice of what to do with the firm can be regarded as *ex-post* efficiency, the effect on the incentives can be regarded as *ex-ante* efficiency. Camacho-Miñano et al. (2013) add another measure of ‘interim efficiency,’ as a measure of realization of the assets in the shortest time at the lowest achievable cost.

In this paper, we follow the Cornelli (1997) framework and the metrics in Succuro (2012) to get an initial assessment of the ex-post efficiency of Indian bankruptcy laws in the seven years of operation.

## 4. Some stylized facts