31

COVID-19 Pandemic: Non-Traditional Resolution Mechanisms for Resolving Businesses

Shashank Saksena

Nonfinancial firms and households across many economies entered the era of COVID-19 induced crisis with historically high levels of leverage on the support of relatively easy financial conditions.[1] While the massive policy support response (both fiscal and monetary) has helped in mitigating the negative impact of COVID-19 crisis, continuation of easy financial conditions has led to further increase in leverage in the nonfinancial sector in both advanced and emerging market economies. There is robust empirical evidence that a rapid accumulation or high level of nonfinancial sector leverage has often preceded financial and economic downturns. The blend of easy financial conditions and quick increase in aggregate credit tends to reduce downside risk to economic activity in the short term but increases it in the medium term.[2] The firms in the developing countries appear to be in a state of financial stress which indicate that firm insolvencies would rise with decline in revenues continuing. COVID-19 pandemic-induced negative shocks to earnings have worsened the financial resilience of firms, with small businesses being severely affected. A recent study giving the survey data of more than 1,00,000 businesses in developing countries shows that 39% of micro and small businesses are in arrears or expect to fall into arrears in the next six months.[3] While the immediate policy response to flatten the curve of insolvency cases was designed to avoid the insolvency ecosystem from being overburdened with cases, it is important to keep in mind to monitor the response of longer-term functioning of insolvency ecosystems as both the cases of liquidations and restructurings, including those arising from the economic disruption of COVID-19, increase.

APPROACHES TO INSOLVENCY SYSTEMS

While there are demands to provide a calibrated financial support (both direct and indirect) to facilitate recovery and reconstruction of financially stressed businesses, that is not the main focus of this article. Beyond financial support policy, what we are interested in detailing is as to how the policymakers should prioritise reforms to the enabling framework with an emphasis on addressing insolvencies of corporates and micro, small and medium enterprises (MSMEs). The well-developed insolvency frameworks usually have the elements of both court sanctioned and out-of-court workouts (OCWs) resolution mechanisms or a mixture of both (hybrid workouts). A taxonomy of the different approaches to insolvency systems is given in Table 1, which is adopted from the World Bank Note.[4]

Table 1:

Type of Procedure	Advantages	Disadvantages	Level of Distress	Key considerations for framework
Workouts				
1. Out of court Workouts: London approach; INSOL Principles	No legal or court involvement, cost-effective, flexible and expeditious	Risk of creditor holdouts and enforcement, avoidance transactions	Imminent insolvency	Availability of financial information, culture of cooperation among creditors and debtors, strong legal and contract enforcement
2. Enhanced: Istanbul Approach (as in Korea and Thailand) workouts	No legal or court involvement, fiscal and regulatory incentive, inter-creditor agreement to bind dissenting creditors	Incentives may prop up unviable firms, no debtor or excluded creditors involvement in workouts, fiscal costs, limited effectiveness for borrowers with one financial creditor	Imminent insolvency	A strong coordinating agency, cooperative financial institutions and strong debt and contract enforcement
3. Hybrid workouts pre-packaged bankruptcies (as in US, UK, France, Netherlands and India for MSMEs)	Combines flexibility and speed of contractual reorganisation with formal court process to preserve value and reduce stigma	Unfair to minority creditors, court may refuse reorganisations	Imminent insolvency	High Court capacity, financial information availability, enabling legal framework
Formal Insolvency				
1. Preventive hybrid workouts: pre-insolvency scheme and safeguard procedure (Germany and France)	Moratorium, court monitoring, creditor cram-down, debtor-in-possession	Unfair to minority creditors, court may refuse reorganisations and could be costly	Imminent insolvency	High Court capacity and insolvency professionals, legal framework, debt enforcement

2. Judicial reorganisation (as in France, US, India and UK)	Preservation of value, strong enforcement, substantial court and insolvency practitioner oversight	Costly and lengthy, disruptive, invite stigma, process is driven by court and insolvency practitioners	Insolvency	High Court capacity and insolvency professionals, legal framework, debt enforcement
3. Liquidation (As in UK, Korea and India)	Orderly exit, value preservation	Low creditor recovery, lengthy and non-transparent auction procedure	Insolvency	High Court capacity and insolvency professionals, legal framework, debt enforcement

Usually, the developed insolvency and restructuring frameworks include a sanctioned (usually by a judicial authority) debt restructuring process as one of the tools to resolve financial distress of businesses. There is a greater reliance by countries now on hybrid processes which combine the characteristics of both OCWs and formal insolvency proceedings in the expectation of increased workload of formal court mechanisms post withdrawal of COVID-19 pandemic support measures. The common features of these processes are the following:

- The restructuring plan is discussed outside of the formal bankruptcy proceedings;
- There is a time-limited moratorium on enforcement actions against the debtor;
- The debtor can access the process in the case of imminent insolvency;
- The 'cross-class cram down' is possible on dissenting creditors;
- There is no court-assessment when the procedure begins;
- The process permits the debtor-in-control regime, sometimes assisted by a neutral third party;
- New financing is protected from avoidance actions.

Many countries have reformed and strengthened their insolvency systems by introducing new fast-track insolvency (restructuring and liquidation) procedures, specifically for MSMEs. Therefore, it would be instructive to review the country experience and facilitative regulatory framework to assess the effectiveness of such hybrid resolution frameworks as the pre-packaged insolvency framework has been recently introduced in India also for MSMEs. Under a hybrid debt resolution procedure, the court intervention is required only at critical points—usually, at the beginning, to prevent creditor action against the debtor, and at the end, to confirm the agreement concluded between the debtor and the creditors—but in between the process progresses without any judicial intervention. This is the approach adopted by the EU in its 2019 European Restructuring Directive following the experiences of some members during the euro area crisis, and the UK in its recent insolvency reform as part of the 2020 Corporate Insolvency and Governance Act. The reduction in judicial intervention is expected to economise on limited judicial resources and increase efficiency of the debt resolution process. A simple and most efficient hybrid restructuring procedure is reckoned as the pre-packaged reorganisation plan. After creditors and the debtor informally negotiate and agree on a plan, a reorganisation procedure is unlocked just to confirm the pre-packaged reorganisation plan. This procedure results in huge time reductions and minimal use of the resources of the judicial authorities. It was found that, in the US the ordinary reorganisation procedures during the period from 2011 to 2018 continued for 504 days, while pre-packaged reorganisations lasted only 77 days, on average.[5]

The objective of the reform of resolution system of any country should be to provide for easy and quick liquidation of nonviable businesses— irrespective of size—so that their capital can be saved and reallocated quickly to the competing uses in the economy. Countries could introduce reforms to rationalise their liquidation regimes. The use of new technology offers encouraging opportunities for the organisation of online auctions of assets (the recent examples include such systems introduced in Italy, Greece, and Ukraine).[6] Such reforms require not only enabling legal provisions, but also the introduction of new technology and capacity building of judicial and private players. Other reforms could enable acquisition of alternative assets by creditors in exchange for their debt claims. For those medium and small enterprises, which often have no major assets, the most important objective of the insolvency process could be to provide a debt discharge to 'honest but unfortunate' entrepreneurs, so that they can go into other economic ventures. An analysis of the data from the World Bank's Doing Business 2016 report indicates a relationship between the design and operation of insolvency procedures and recoveries in insolvency. The data demonstrates that reorganisation proceedings produce higher recovery rates than foreclosure, receivership, or liquidation.[7] Moreover, reorganisation proceedings are positively correlated with greater amounts of domestic credit provided by the financial sector. Strong insolvency and creditor rights (ICR) regimes are instrumental in improving loan repayment and decreasing borrowers' risk-taking behaviour. When the borrowers face stronger creditor rights they tend to diversify acquisitions, invest in high recovery assets, reduce cash-flow risk, and deleverage their balance sheets.[8] The evidence suggests that, *ceteris paribus*, reforming ICR systems could help reduce non-performing loan (NPL) occurrence. Few inquiries have been made into the impact of alternative enforcement mechanisms on NPL levels. However, the available evidence in India suggests that out-of-court mechanisms for the enforcement of creditor rights might help reduce bank losses from NPLs.[9] Considering the beneficial impact of reduction of NPLs on economic growth and financial stability, countries could either (i) target reduction in NPLs through active strategy of early recognition, recovery and resolution (through reform of ICR regimes) or (ii) foster higher loan growth. The 2016 study of 100 countries covering the period between 1997 and 2014 found that countries that actively tried to reduce NPLs (category (i)) achieved a higher economic growth than countries (in the control group) that failed to take any action to reduce their NPL levels; a 3% to 4% increase in GDP growth and a 13% increase in investment growth.[10]

OUT OF COURT WORKOUTS IN INDIA

A brief discussion follows about the variety of OCW and hybrid OCW in vogue in India. This will then be contrasted with the similar frameworks available in other jurisdictions as also with some international principles to derive policy recommendations. The World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes (WB-ICR Principles) and the United Nations Commission on International Trade Law Legislative Guide on Insolvency Law (the Legislative Guide) are construed as Insolvency and Creditor Rights Standard (ICR Standard) which is recognised as one of the Financial Stability Board Key Standards for Sound Financial Systems. The ICR Standard is recognised as the international consensus on best practices for evaluating and developing national insolvency regimes, including enhancing creditor rights. This provides best practice benchmarks for guaranteeing that ICR regimes can enable the survival of viable but distressed businesses, help diminish the risk associated with lending to such businesses, and ease the exit of nonviable, insolvent businesses.[11] The ICR Standard combines the WB-ICR Principles and the Legislative Guide. The relevant principles of ICR Standards would be examined from the perspective of assessing efficient OCW and hybrid OCW mechanisms.

The Reserve Bank of India (RBI) released the Prudential Framework for Resolution of Stressed Assets vide circular dated June 7, 2019 (Prudential Framework) which is a principle-based framework for debt resolution with bright-line tests for desired outcomes. Prudential Framework is the *de facto* OCW available to lenders and borrowers of banks and non-banking financial companies (NBFCs). The Prudential Framework was extended to enable the lenders to implement a resolution plan in respect of eligible corporate exposures without change in ownership, and personal loans, without classifying them as non-performing but subject to certain conditions. Borrowers classified as standard, but not in default for more than 30 days with any lending institution as on March 1, 2020 were eligible for resolution under the Prudential Framework. The Prudential Framework could be invoked till December 31, 2020. To facilitate revival of MSMEs adversely affected by COVID-19, lenders were permitted to restructure the loans of MSME borrowers in default but not classified as NPLs and to whom the aggregate exposure of lenders were ₹ 250 million or less, without classifying the restructured exposures as non-performing. In view of the resurgence of COVID-19, RBI has announced the Resolution Framework 2.0 dated May 5, 2021, subsequently revised on June 4, 2021, which permits lending institutions to restructure personal loans as well as loans to individuals for business purposes, MSMEs and other small business with aggregate exposure up to ₹ 500 million, without classifying the exposures as non-performing upon implementation subject to the conditions specified therein. The facility, available in respect of eligible borrowers which had not been restructured under earlier restructuring schemes, can be invoked up to September 30, 2021.

India has recently introduced the pre-packaged insolvency resolution process (PPIRP/pre-pack) through an ordinance amending the Insolvency and Bankruptcy Code, 2016 (Code/IBC) - Insolvency and Bankruptcy Code (Amendment) Ordinance, 2021, in order to provide a consensual, expeditious, cost-effective, semi-formal and less disruptive framework for insolvency resolution of MSME corporate debtors (CD) in distress. The MSMEs having a unique nature of business and representing a sizeable portion of India's labour force are critical for India's economic growth. Pre-pack framework provides for initiation by the MSME CDs eligible to submit a resolution plan, with the approval of 66% of unrelated financial creditors and special resolution of its shareholders. The framework envisages a consensual approach wherein the creditors and the CD reach a mutual understanding about the course of action for insolvency resolution before the formal initiation of the process. It provides for debtor-in-possession model wherein the management stays in control of the CD during the process but to prevent moral hazard situations, features of creditor-in-control model, where all major decisions are approved by the committee of creditors (CoC), and resolution professional acts as the process manager, who not only facilitates the process but also oversees it, are also incorporated. The pre-pack is largely an informal process as it empowers stakeholders to resolve the stress of a CD as a going concern, with minimum intervention of the Adjudication Authority. It would be a time bound process with 120 days for completion. For better value discovery of the assets of the CD, the Swiss Challenge method has been envisaged and on approval of the resolution plan for the CD, the regulatory benefits available in case of a normal corporate insolvency resolution process (CIRP) are also applicable in case of pre-pack process.

WB-ICR Principle B3 encompasses the essential criteria for establishing an enabling legislative framework in a country—one that is favourable to directing negotiations and undertaking analysis to preserve sustainable businesses. Such a framework may include[12] (i) availability of accurate and reliable information; (ii) incentives to invest in or recapitalise viable, financially distressed enterprises; (iii) a range of restructuring tools that the stakeholders can use to achieve their goals; (iv) appropriate tax treatment that enable debt restructurings; (v) effective debt enforcement and insolvency procedures; and (vi) removal of regulatory impediments in associated laws.

WB-ICR Principle B4 on informal workouts recognises that informal restructurings take place in the 'shadow of the law'-that is, they do not usually follow a legislative or regulatory framework because they are private, contractual arrangements that occur outside the domain of courts. However, the WB-ICR Principle B4 encourages the use of voluntary dispute resolution tools to help facilitate such negotiations. Further, the Legislative Guide recommendations 160-168 cover procedural features, such as, commencement of expedited reorganisation proceedings, application requirements, commencement, the effect and notice of commencement, and the confirmation, effect and failed implementation of a confirmed restructuring plan. The purpose of these recommendations is to make provisions relating to insolvency procedures that combine voluntary restructuring negotiations and acceptance of a plan with an expedited procedure conducted under the insolvency law for court confirmation of that plan. Many countries have adopted hybrid procedures which combine both the informal negotiated restructuring and formal court-sanctioned procedures.

WB-ICR Principle B5 emphasises the importance of promotion of any guidelines or code of conduct by the financial sector authorities on how to conduct informal workouts. Some countries have introduced memoranda of understanding between the central bank and the bankers' association to ensure that there is strong promotion of principles among the key financial sector players. Other countries have adopted more formal hybrid models which are backed by statutory mandates.

Thus, the first requirement for an effective insolvency regime (WB-ICR Principle B3) is that there should be an environment that enables restructuring of debt and enterprise and encourages participants to engage in consensual arrangements. This includes laws and procedures that ensure access to timely, reliable, and exact financial information on the distressed enterprise, encourage lending to, investment in, or recapitalisation of viable but financially distressed businesses and flexibly accommodate a comprehensive range of restructuring activities, involving asset sales, discounted debt sales, debt write-offs, debt reschedulings, debt and enterprise restructurings, and exchange offerings (debt-to-debt and debt-to-equity exchanges). The operational and legal framework for Prudential Framework and pre-pack subsumes these principles. The first and foremost ICR Standard which is relevant to any effective OCW is an efficient debtor information and early warning system which allows both debtors and creditors to anticipate an impending financial stress, recognise the extent of the problem and take early and timely debt resolution measures. There is no scarcity of financial information of debtors as there are multiple financial information agencies in India. Creditors in India generally use central repository of information on large credits (CRILC) for large exposures, obtain credit scores and reports from credit rating agencies (CRA), Ministry of Corporate Affairs' portal for charges on company's assets and also check central registry of securitisation asset reconstruction and security interest (CERSAI) for checking for any previous mortgage charges on immovable properties of the prospective borrowers. Under IBC, the information utilities (IUs) have been envisaged to reduce the information asymmetry between the creditors and debtors. IUs are envisaged to be holders of record of default and financial information of CDs and creditors. Recently, the sole registered IU, National E-Governance Services Limited has launched a digital loan document execution platform which will act as a repository of all loans given to debtors by the partner financial institutions. It is expected that it will reduce the disputes regarding the loan disbursement and dues between the creditors and debtors. Account aggregators (AAs) aim at bringing disparate customer asset information in a consolidated manner on a single platform. By reducing paperwork, AA allows speedier access to consented data of individual customers and small businesses, allowing lenders to assess a potential borrower's credit risks and process more loan applications faster, without compromising due diligence and safety. Going forward, the integration of the system of AAs, Trade Receivables Discounting System (TReDS), financial information systems, digital lending platforms, digital payments and digital identity and consent mechanisms would be expected to not only eliminate the informational asymmetry between the borrowers and lenders, but would also increase the transparency of the financing processes and reduce the transaction costs without compromising on safety and privacy of customers of financial services. Therefore, there is so much financial information available that there is a need to establish a master financial information system which could integrate and synthetically produce consolidated financial information of debtors from disparate databases. In this connection, technological innovations in the form of open digital public infrastructure, as mentioned above, could transform the functioning of financial systems and may also improve the informational efficiency of financial markets.

WB-ICR Principle B4 and the Legislative Guide recommendations 160-168[13] are adequately subsumed in the Prudential Framework and pre-pack. As mentioned above, the RBI encourage the use of voluntary dispute resolution tools to help facilitate such negotiations in the form of the Prudential Framework. This framework operates in the shadow of the legal framework of IBC and the anecdotal evidence suggests that IBC has forced responsible behaviour on the part of defaulting promoters who now dread losing control over their own businesses. By fastening personal liability on directors for wrongful transactions and disqualifying defaulting promoters from participating in the CIRP, the IBC has also contributed to embracing of higher standards of corporate governance by debtors. It is felt that the IBC has been successful in effecting an attitudinal change encouraging defaulting debtors to voluntarily settle their outstanding dues with creditors. As per the information provided in the report of the Standing Committee on Finance on the subject 'Implementation of Insolvency and Bankruptcy Code (IBC)-Pitfalls and Solutions' submitted to Parliament on August 3, 2021[14], about 17631 corporates have withdrawn applications for CIRP before admission with realisable value of ₹ 5,46,763 crore. This amount is much more compared to the approved resolution plans of 404 corporates with a realisable value of ₹ 2,54,431 crore. So, going forward, more CDs would be incentivised to go for a negotiated settlement of their disputes outside the formal CIRP by using alternative debt resolution mechanisms. Further, it may be stated that the procedural provisions relating to eligibility conditions, application requirements, commencement, effect of commencement, notice of commencement, confirmation of the plan and its effect, and failure of implementation of a confirmed plan contained in recommendations 160-168 of the Legislative Guide are subsumed in the pre-pack provisions.

The guidelines by the financial sector authorities (RBI, in case of Prudential Framework) on how to conduct informal workouts provide adequate guidance on workout procedures and good risk-management practices (WB-ICR Principle B5), supported by norms that facilitate effective internal procedures and practices supporting the prompt and efficient recovery and resolution of distressed assets. The prudential norms[15] for provisioning, income recognition, additional finance, change in ownership and regulatory forbearance all seek to create an effective OCW procedure and ensure meaningful restructuring of distressed assets. Further, IBC has adequate provisions to stipulate standards of good governance of CDs and effective anti-abuse provisions to nudge the management to preserve the value of business during the debt resolution process and any violation attracts deterrent penalty. There are other safeguards such as taking over of the management of the CD by CoC in certain cases of abuse of the resolution process by the debtor-in-possession. Therefore, to preserve the sanctity of the process, it is essential that good corporate governance principles for the CD (both listed and unlisted entities) may continue to be prescribed, imposed and monitored by the relevant regulatory authorities under law.

CONCLUSION

To summarise, in view of the above analysis, it may be stated that the alternative debt resolution mechanisms, whether in the form of a purely voluntary OCW mechanisms in the form of Prudential Framework or a hybrid procedure in the form of pre-pack generally conform to the WB-ICR Standard, which is the emerging international norm for effective insolvency resolution frameworks. However, the functioning of the alternative dispute resolution mechanisms may be improved further if the operational and technological improvements for relevant ICR Standard are effected as suggested above. While the alternative debt resolution mechanisms may be useful in resurrecting a financially viable, but distressed business, transparent and targeted support to solve the financial stress of businesses may be required in the form of grants, fresh financing, and subsidies[16] to aid the process of restructuring and recovery.

NOTES

[1] Global Financial Stability Report, April 2021, International Monetary Fund.
[2] Tobias, Adrian, Federico Grinberg, Nellie Liang, and Sheheryar Malik, (Forthcoming), "The Term Structure of Growth-at-Risk", American Economic Journal: Macroeconomics.
[3] Apedo-Amah Marie Christine, Besart Avdiu, Xavier Cirera, Marcio Cruz, Elwyn Davies, Arti Grover, Leonardo Iacovone, Umut Kilinc, Denis Medvedev, Franklin Okechukwu Maduko, Stavros Poupakis, Jesica Torres, and Trang Thu Tran (2020), "Unmasking the Impact of COVID-19 on Businesses: Firm Level Evidence from Across the World", Policy Research Working Paper No. 9434, World Bank.
[4] World Bank Group (2021), "Supporting Firms in Restructuring and Recovery", EFI Insight, World Bank.
[5] J. Díez, Federico, Romain Duval, Jiayue Fan, José Garrido, Sebnem Kalemli-Özcan, Chiara Maggi, Soledad Martinez-Peria, and Nicola Pierri (2021), "Insolvency Prospects Among Small and Medium Enterprises in Advanced Economies: Assessment and Policy Options," *IMF Staff Discussion Note*, April.
[6] Supra Note 5
[7] World Bank Group (2016), A Toolkit For Out-of-Court Workouts, World Bank.
[8] Acharya, V.V., Y. Amihud, and L. Litov (2011), "Creditor Rights and Corporate Risk-Taking", Journal of Financial Economics 102, pp. 150–66.
[9] Campbell, J.Y., T. Ramadorai, and B. Ranish (2015), "The Impact of Regulation on Mortgage Risk: Evidence from India", American Economic Journal: Economic Policy, Vol 7(4), pp. 71–102.
[10] Balgova, M., M. Nies, and A. Plekhanov (2016), "The Economic Impact of Reducing Non-Performing Loans", EBRD Working Paper, 193. European Bank for Reconstruction and Development.
[11] World Bank Group (2021), "Principles for Effective Insolvency and Creditor/Debtor Regimes", World Bank.
[12] Supra Note 7, Part A.
[13] United Nations Commission on International Trade Law (2005), Legislative Guide on Insolvency Law, pp. 244-247.
[14] Report of the Standing Committee on Finance, "Implementation of Insolvency and Bankruptcy Code -Pitfalls and Solutions", August 3, 2021.
[15] RBI (2019), Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions 2019, 7 June.
[16] Supra Note 4