

The Code: A Behavioural Perspective

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"Law is defined as a task of social engineering designed to eliminate friction and waste in the satisfaction of unlimited human interests and demands out of a limited store of goods in existence."

Roscoe Pound²

According to Marxist theory,³ the legal system of a society constitutes one of the components of its 'superstructure' being influenced and in-turn influencing the base or substructure of a society comprising of '*the forces and relations of production through which the necessities of life are produced*'. The design of law in a particular society is dependent upon the collective thinking of the society in terms of what is a desirable and what is a not-so-desirable action. The structure of incentives and deterrents in the law is dependent on this collective thinking which then encourages socially desirable actions and penalises non-desirable actions. It, in some sense, puts fetters on freewill of individuals and their behaviour in the interest of harmonious social existence. Roscoe Pound, a distinguished American legal scholar and educator, posits law as an applied science serving as a tool for resolving individual and social problems. He called 'jurists' as 'social engineers' tasked with maintaining a balance between the competing interests in a society. Social engineering is based on the perception that laws are used as a means to shape society and influence people's behaviour. Thus, according to Pound's theory of 'social engineering', law is an attempt to mold the behaviour of humans. Its effectiveness can be judged by the behavioural changes it is able to bring about. The same sentiments are echoed by Friedman who suggested that '*legal rules are to be judged by the structure of incentives they establish and the consequences of people altering their behavior in response to those incentives.*'⁴

While law seeks enforcement of a certain kind of behaviour in a society, economics, in particular behavioural economics, helps explain an economic agent's choice behaviour from the menu of choices presented to him. The evolution of the law and economics movement, established the paradigm style for the economic analysis of law. This approach to law theorises that legal rules are best analysed and understood in light of standard economic principles. Gary

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² Pound Roscoe (1942). Social Control through Law. *Journal of Philosophy*, 39 (20), pp. 559-560.

³ The Marxist theory suggests that a capitalist society consists of the base (or substructure) and superstructure. The substructure which includes the forces and relations of production through which the necessities of life are produced, determines society's other relationships and ideas to comprise its superstructure, including its culture, institutions, political power structures, laws, rituals, and state.

⁴ Friedman D. David (2000). *Law's Order: What Economics Has to Do with Law and Why It Matters*. Princeton University Press, 2000.

Becker⁵, referring to such principles, postulates that '*...human behavior can be viewed as involving participants who maximize their utility, from a stable set of preferences and accumulate an optimal amount of information and other inputs in a variety of markets.*' Appropriately designed legislation and efficient enforcement can provide incentives to agents to choose what is the best, or the most desirable, outcome, or, in the language of economics, the most efficient outcome. The study of law and economics involves determining the implications of such utility maximising behaviour of individuals for the entire economic ecosystem. To achieve this, it is necessary to understand the economic behaviour of economic agents under different circumstances. The Insolvency and Bankruptcy Code, 2016 (Code) serves as a good example to understand the interplay between law and economics.

The Code has been hailed as one of the most important economic legislation in recent times, having reformed the much-needed exit mechanism for corporates, to start with, and having addressed an important aspect of ease of doing business in the country. The law, being preventive in nature, is also being touted as having brought about a cultural shift in the dynamics between lenders and borrowers, and promoters and creditors. The Code has made an impact in the way repayment of debts are being viewed and treated by promoters and management of the defaulting firms. The first signs of distress now serve as early warnings for management to take corrective actions to avoid defaults. One can posit that the Code is emerging as a behavioural law aiming to draw various stakeholders of the entity in distress to work together, in a non-adversarial manner, towards laid down objectives of the law viz.

'...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...'⁶

This article explores the interplay between this law and aspects of behavioural economics in an attempt to elucidate upon the choice architecture the law offers in order to drive the stakeholders in the system towards envisaged outcomes. It examines the Code with the lens of economic behavioural principles to assess how it is using these principles to 'socially engineer' a particular behaviour amongst the key players in the insolvency and bankruptcy framework. In particular, being inspired by Chapter 2 of the Economic Survey 2018-19,⁷ the article focuses on various 'behavioural nudges' in the Code which are steering the stakeholders in an insolvency process towards overall utility maximising outcomes.

INFORMATION ASYMMETRIES IN CREDIT MARKETS AND NEED FOR AN INSOLVENCY LAW

Ease of access to credit is the cornerstone of economic development of any country. An established body of literature points to the positive influence of well-functioning credit markets on economic performance. The willingness of banks and investors to support new businesses is, to an extent, a function of the rules that govern the procedures when they fail, i.e. the ease of exit of capital. Effective insolvency regimes, while coming into play at the end of the business life cycle, have an overwhelming impact on the commencement of the cycle, ensuring the willingness of banks and investors to lend and that of entrepreneurs to enter the market

⁵ Becker S. Gary (1976). *The Economic Approach to Human Behavior*. University of Chicago Press Books.

⁶ Long title of the Code.

⁷ Economic Survey, Ministry of Finance. Government of India, 2018-19.

taking some amount of risk. The Cork Committee, which was tasked to redraft the UK Insolvency Law in 1982, succinctly noted the importance of effective insolvency regimes in the following words: *'It is important to recognize that the world in which we live and the creation of wealth depends upon a system founded on credit and that such a system required as a correlative, an insolvency procedure to cope with its casualties.'*

An effective insolvency regime stipulates provisions for dealing effectively with the financial distress of corporates; entrepreneurs (operating in the form of sole proprietorships or partnerships) and other individuals without business. Rescue processes through the apparatus of insolvency law involves participation by different economic agents viz. the creditors, debtors, employees, Government etc., fostering a fair and equitable distribution of funds of the defaulting entity. This process, crucially, hinges on mutuality of information between these agents. However, credit markets are often plagued by information asymmetries. This means that one of the parties to a credit has superior knowledge about the underlying product and associated risks. This situation leads to two potential concerns. One is 'adverse selection' as the creditor charges an interest rate commensurate with the average risk-profile of all the debtors in the market as it has difficulties, in view of incomplete information, in correctly assessing the risk of lending to a debtor or for a purpose. The high-risk borrowers find the rate to be attractive and borrow willingly, while the low risk borrowers exit the market, leaving behind a high-risk 'lemons'⁸ market. The second concern is 'moral hazard' as the debtor, who has superior information, changes his behaviour after the credit is availed, while the creditor suffers the consequence of changed behaviour of the debtor. A creditor usually resorts to secured lending to partially address both the concerns instead of meritocratic lending.

Thus, when the 'game' is set, i.e. an insolvency process of a corporate debtor (CD) is triggered, there are asymmetries in information available to each of these stakeholders. Which card a player will play and how the insolvency process will progress will depend upon the information available to the players, each's utility maximizing behavior and how their moves interplay with each other. The mechanics of this game raise fundamental questions concerning the nature of the insolvency process. These range from an enquiry into whether the Code guides players towards any particular outcome to whether it seeks to provide incentives and choices, drawing upon certain behavioral aspects of the agents, and eventually drives them towards that outcome? The collective nature of insolvency and bankruptcy proceedings envisaged by the law requires it to be facilitative in correcting these problems of information asymmetries and molding the behavior of the economic players in the resolution process to ensure its success. When a debtor is unable to pay its debts as they become due, the diverse interests of a range of stakeholders come into play. These stakeholders include the debtor; the owners and management of the debtor; the creditors, secured or unsecured; employees of the debtor, guarantors of debtors and suppliers of goods and services to the debtor in default. The legal regime of insolvency and bankruptcy law in an economy, provides a mechanism to deal with this default in a manner so as to provide collective satisfaction of all these players. Largely, the law would also need to ensure a balance not only between the different interests of these stakeholders, but also between these interests and the larger relevant social, economic and

⁸George A. Akerlof (1970). The Market for "Lemons": Quality Uncertainty and the Market Mechanism. *The Quarterly Journal of Economics*, Vol. 84, No. 3, pp. 488-500.

political considerations that the entity in default would require to be addressed. Some aspects of behavioural economics can help throw some light on how the various players in a corporate insolvency resolution process may behave. This is discussed in the next section.

ASPECTS OF BEHAVIOURAL ECONOMICS

The basic assumption of neoclassic economic analysis is that economic agents are 'rational' in their choices, i.e. their decision-making process is based on making choices that result in an optimal level of benefit or utility. However, individuals are not always 'rational' in their behavior. Behavioural economics draws on psychology and economics to explore why people sometimes make irrational decisions, and why and how their behaviour does not follow the predictions of economic models. The field of behavioural economics takes cognisance of the fact that individuals often make irrational choices subject to cognitive biases, emotions, and social influences.⁹ The theory suggests that in practice individuals interpret situations and based on the same, take decisions, under influence of their individual belief systems, societal practices and cultural norms. Some of these biases may play out in an unconscious and automated manner. These have been elaborated in following paras.

Individuals may actually rely too heavily on one piece of information, usually the first piece of information found, serving as an 'anchor', when taking decisions. This is what is termed as 'anchoring bias'. Further, they would like to rely on only those material which confirm to their pre-conceptions, ignoring any other contrary information, thus being subjected to what is called the 'confirmation bias'. Another example of a cognitive bias is called the 'loss aversion bias', i.e. the tendency of individuals to prefer avoiding losses as opposed to commensurate gains. Yet another form of a cognitive bias is the 'failure bias', under which individuals seem to be influenced by failures of a particular action that they see around them as opposed to success stories which can lead to false conclusions.

These are only a few examples of some of the cognitive biases that afflict an individual's decisions in his day to day life. However, being mindful of the effects of these biases and the time of their occurrence, along with utilising certain techniques available in behavioral economics, one can go a long way in mitigating any of their adverse consequences and actually use these biases to influence the behavior in a socially optimal manner.

Behavioural law and economics explores the implications of actual, as opposed to hypothesised human behavior for the law. Behavioural economics provides a number of principles that can be used to positively use these cognitive biases in order to influence the behavior of individuals towards desirable outcomes.

Nudge Theory

A relatively new area of behavioural economics is the 'nudge theory' suggesting that instead of taking the path of providing incentives to encourage a particular behaviour, one can help influence the choice architecture of individuals by providing delicate policy shifts or 'nudges' in particular directions, taking a cue from the patterns of functioning of human psychology. In other words, Nudge theory is essentially an indirect approach, which seeks to modify situations for people, arguing that if we wish to alter people's behaviour in a particular direction, it can be

⁹ Loewenstein, G. and Sutherland, R. (2014). An Introduction to Behavioral Economics. The Behavioral Economics Guide.

more effectively done by encouraging positive choices rather than trying to restrict undesirable behavior with some kind of sanctions.

The idea of 'nudging' falls between the two extremes of a *laissez-faire* economic policies which suggests that an individual's preferences are better known to the person himself and the concept of 'revealed preference' which is essentially defined by what one chooses. While conventional economic policy provides 'economic' solutions (e.g. taxes, incentives, regulation) to issues arising out of market failures such as information asymmetries, 'nudges', in contrast, provide behavioural solutions to problems that can be seen to have originated from human decision made under the influence of cognitive biases.

The principles of 'nudge theory', first articulated by James Wilk around 1995, were, in some sense, rediscovered by Thaler and Sunstien¹⁰ in their renowned book *Nudge: Improving Decisions About Health, Wealth, and Happiness* in 2008. They suggested that human behaviour can be influenced without any coercion as 'libertarian paternalism', viz. the idea that it is legitimately possible for private and public institutions to be able to affect behaviour of individuals while also respecting their freedom of choice. The principles of nudge theory suggest creating a choice architecture with such features that influence the decisions of people without changing their incentives or payoffs. The right 'nudge' can, therefore, produce the desired outcomes. In the words of Thaler and Sunstien, 'A nudge is any aspect of the choice architecture that alters people's behavior in a predictable way without forbidding any options or significantly changing their economic incentives.'

INSOLVENCY AND BANKRUPTCY CODE AND BEHAVIOURAL NUDGES

The choice architecture of the Code, though perhaps not envisaged *ex-ante*, in terms of behavioural principles can, *ex-post*, be seen as following these principles and hence yielding some visible behavioural changes in the debtor-creditor relationship. In the following paras, an attempt is made to relate each of these principles with the architecture of the Code to see how this law is using the behavioural principles, taking advantage of cognitive biases of individuals, 'nudging' the stakeholder(s) to achieve the objectives of the Code.

The National Company Law Appellate Tribunal (NCLAT), in its judgment dated 14th November, 2018 in the matter of *Binani Industries Limited v. Bank of Baroda & Anr.*,¹¹ held that the first order objective of the Code is resolution of the entity in distress. The second order objective is maximisation of value of assets of the firm and the third order objective is promoting entrepreneurship, availability of credit and balancing the interests. This order of objectives is sacrosanct. Further, in *Swiss Ribbons Pvt. Ltd. & Anr. v. Union of India & Ors.*,¹² the Supreme Court (SC) held that the primary focus of the legislation is to ensure revival and continuation of the firm by protecting it from its own management and from death by liquidation. In an attempt to emphasise upon the policy shift in law, the SC also observed that with the enactment of the Code the defaulter's paradise is lost and, in its place, the economy's rightful position has been regained.¹³ This is, perhaps, an enunciation of the biggest evidence of outcome from 'nudge' in the form of a bar/an embargo being placed upon the erstwhile

¹⁰ Thaler, R. H., & Sunstein, C. (2008). *Nudge: Improving Decisions about Health, Wealth, and Happiness*. New Haven, CT: Yale University Press.

¹¹ Company Appeal (AT) No. 82,123,188,216 & 234 -2018

¹² (2019) 4 SCC 17

¹³ *Ibid.*

defaulting promoters' of the CD from making a backdoor entry through bidding. The Code lays down a built-in mechanism in which the first order objective or default choice is resolution and thus stakeholders automatically 'opt-in' for resolution of the CD in the very first instance. Liquidation follows if resolution fails. This default choice is given to all the stakeholders. Thus, the Code is 'leveraging default rules', which is a behavioural principle given the 'anchoring bias' of individuals, by providing default choices to the economic agents, such that the default choice maximises their own welfare and that of the society as a whole.

The Code enables the best outcomes for all stakeholders by requiring them to first attempt a resolution of the entity in distress and creating a collective process where the value of the firm is preserved by not allowing creditors to recover at the very first instance. The Code, in other words, works on the basic principles of the insolvency and bankruptcy law, viz. incentivising socially optimal behavior of the stakeholders of the entity in distress in a manner which causes least loss and disruption to each of them. This would happen when the resolution process is time bound, fair and equitable, ensuring highest recovery to cost ratio. Also, it is paramount to take into consideration *ex-ante* efficiency which is an incentive-based device aimed at prompt filing of applications triggering insolvency resolution process. Without timely initiation of and pursuit of *ex-ante* mechanisms, *ex-post* mechanism is rendered nugatory. The Code relies on the behavioral principle of 'making it easy to choose', i.e. it provides easy to comprehend options with reduced administrative impediments to choosing. The Code affords convenient choices in the form of providing a two-way solution to the stakeholders. Firstly, it provides them with the automatic choice of resolution and simultaneously, it serves them a choice to exit by providing a withdrawal mechanism. The Code also provides an option of voluntary liquidation in instances where both debtor and creditor are of the opinion that the entity should not continue as a going concern.

The Code establishes a linear, collective process of resolution which is binding on the debtor, creditor and all other stakeholders thereby making it the 'go-to' option to resolve insolvency of a CD. It provides creditors a chance to assess the viability of the CD. Read with the RBI circular¹⁴ of June 7, 2019, which provides a framework for early recognition, reporting and time-bound resolution of stressed assets, the Code is an easy option to choose for the purpose.

For an effective resolution, assembling the assets of the CD is a principal task. In this respect, the Code provides enough protection to the assets of the CD. During the process of resolution, a 'moratorium' on proceedings against the CD is afforded, providing a 'calm period' for a resolution to be explored. While such a 'stay' is secured, no assets of the CD can be invaded upon or attached by any authority. Also, when an order for liquidation of a CD has been passed, no legal proceeding can be instituted by or against the CD. Moreover, during liquidation, the liquidator is expected to take into custody or control all the assets, property, effects and actionable claims of the CD. The applicability of moratorium and the overriding powers of the Code have been one of the most debated provisions of the Code. It is a useful shield to the against individual enforcement actions by the financial creditor (FCs). In the matter of Swiss Ribbons, the SC observed that '*...the moratorium imposed by Section 14 is in the interest of the corporatedebtor itself, thereby preserving the assets of the corporate debtor during the resolution process.*'

¹⁴ Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions, 2019 issued on June 7, 2019.

Another principle of 'nudging' human behavior is 'leveraging loss aversion' of individuals, which suggests designing of incentives to reward good behaviour *ex-ante*. Loss aversion is an important concept encapsulated in the expression 'losses loom larger than gains'¹⁵. It is said that the pain of losing is psychologically about twice as powerful as the pleasure of gaining. The Code, through its process design, which divests the promoters of the rights on their company as soon as a corporate insolvency resolution process (CIRP) is initiated, has effectuated fear amongst them, thus maneuvering them towards avoiding defaults. There have been instances where CDs have paid the default amount after filing of CIRP application or have repaid their debts immediately after receipt of notice from an creditors. The CIRP process under the Code is a non-adversarial and Court approved process giving it a sense of comfort for both creditors and debtors. Thus, the law has become preventative in nature so that real damages can be avoided by simply signaling to the market participants that the consequences of non-compliance might be heavy and that good credit behavior will be rewarded.

Taking a cue from 'failure bias' of individuals, the third principle talks about 'emphasising social norm' to enhance good behaviour by focusing on influencers that people can relate to. Our ancient scriptures have guidance to offer in respect of the borrowing behaviour, saying:

अग्निशेषम् ऋणशेषम् शत्रुशेषम् तथैव च ।
पुनः पुनः प्रवर्धत तस्मात् शेषम् न कारयेत् ॥

Meaning, 'If a fire, a loan, or an enemy continues to exist even to a small extent, it will grow again and again; so do not let any one of it continue to exist even to a small extent.'

Thus, the guidance is to repay your loans. Subsistence of default results not only in individual harm but of the economy. Reducing the possibility to become an insolvent begins with sound financial preparation. However, honest business failures cannot be ruled out. Thus, the Code looks upon such honest business failure as a normal and legitimate part of the functioning of the market economy. It strives to address the stigma associated with financial failure by providing a structured and swift mechanism to resolve it. In this regard, the provisions pertaining to fast track insolvency resolution pave the way for promotion of the burgeoning entrepreneurial and investment sentiment in India. Accelerated resolution attracts investors and, in this way, the Government of India, as a part of the Start-up India Initiative, is facilitating an easy option for smaller firms to exit and start afresh.

Further to overcome the 'failure bias', the next principle suggests that the Government/regulator should 'disclose outcomes' which are the realised benefits of good behavior which others can look up to as examples to follow. Measurable desired outcomes of the Code have come to fore over the past two years with a number of CIRPs yielding resolution, wherein realisation by FCs in comparison to the liquidation value of the CD has been almost 188 per cent. Further, both FCs and operational creditors (OCs) are realising almost equivalent proportions of their admitted claims, indicative of balanced outcomes under the Code. Active disclosure of these outcomes has imparted greater credibility to the Code and encouraged greater recourse to it. Further, the Adjudicating Authorities has played a vital role in the

¹⁵Daniel Kahneman, D. and Tversky, A. (1979). Prospect Theory: An Analysis of Decision under Risk, *Econometrica*, Vol. 47, No. 2, pp. 263-291

emergence of rich jurisprudence around the Code. They have been successful in setting up a behavioural insight through the interpretations that has developed with their decisions.

Mere disclosure of desirable outcomes would not be effective unless the same is reinforced so as to alter the behavioural pattern of the stakeholders. Need for 'reinforcing desirable outcomes' repeatedly is what the next principle of behavioral economics suggests. In furtherance to this, the Government and IBBI have been regularly engaging with various stakeholders in the context of the new legal framework for insolvency and bankruptcy regime in the country, making them aware of the details of the processes. The positive outcomes of the same are being informed through various communication channels, hence reinforcing its merits.

As noted earlier, individuals suffer from 'confirmation bias'. To use this to nudge a behavioral change, the behavioural principle, viz., 'making messages match mental models' i.e. training people to shift to new rules of thumb, can come in handy. Heuristics or mental shortcuts are often used by people as simple rules of thumb to help them take decisions. Given the growth of Code's jurisprudence and the way in which the Code has evolved as a problem solver to debtors and creditors in the society, it is expected that taking recourse to the provisions of the Code for resolving insolvency will be the new thumb rule.

CONCLUSION

Taking recourse to the Code is absolutely voluntary. Where one exercises its voluntary options in favour of the Code, the fall out is compulsory for all other stakeholders. Therefore, it is one of the parties to the insolvency process and not the State who imposes an outcome on all other players. This can be viewed as one of the most powerful 'nudge' requiring all stakeholders to exhibit their best behaviour, firstly to prevent triggering of an insolvency and if triggered, to ensure that interests of all stakeholders are taken care of.

Behavioural principles have strengthened the efficacy of principles of governance and economics. The relation between law and economics is that of complementarity, wherein the 'justness' of law and 'efficiency' of economics come together into a state of equilibrium. In fact, law can be said to be an enabler of economic activities. If the current order is less enabling, then the economy and its agents cannot perform to their full potential, leading to inefficient allocation of scarce resources. The objective is to encourage regulation that is designed to be efficient, accessible to all and simple to implement. Law or rather regulation making has gone one step further to imbibe the behavioural principles into achieving the desired economic outcomes, leading to maximisation of social welfare. The Code tests positive on all these fronts and is slowly and progressively 'nudging' its way towards achieving its statutory objectives.
