

## IBBI's Fifth Annual Day Lecture

by

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### 'From No Exit to Easy Exit: A Case Study of IBC'

I am honoured that I have been invited to deliver IBBI's Fifth Annual Day Lecture. I am neither insolvent, nor bankrupt. Nor am I an insolvency professional. Therefore, it follows that my relationship with IBBI is not directly professional. I certainly do possess an indirect professional interest, since anything that furthers the cause of economic reforms in India is of professional interest to me. But since IBBI was set up on 1<sup>st</sup> October, 2016, I have also had a personal interest in IBBI, thanks to my association with Dr. M.S. Sahoo. In the last five years, IBBI has been led by Dr. Sahoo and the Chairman has been IBBI's face to the rest of the world. My best wishes to Dr. Sahoo for whatever he chooses to do next, practice law, write books. As he exits, and it has been an easy exit, my best wishes to the incoming Chairman too.

2. There is a famous Sanskrit shloka. It is attributed to "Chanakya Niti", but I have not been able to find it in any "Chanakya Niti" text. It belongs to the category of what is Sanskrit is called "Subhashitam", meaning good saying. It runs as follows:

लालयेत् पञ्च वर्षाणि दश वर्षाणि ताडयेत् /  
प्राप्ते तु षोडशे वर्षे मित्रवदाचरेत् //

*[IAlayEth pancha varSHANi dasha varSHANi thAdayEth /  
prApthE thu SHOdashE varSHE puthram mithravadh AcharEth //]*

Let me translate this now.

“Nurture a son for the first five years. Strike and punish him for the next ten years. When he attains the age of sixteen years, treat him like a friend.”

3. I have translated the Sanskrit word ‘*mitram*’ as friend. That’s not incorrect, though ‘*mitram*’ is more like colleague. ‘*Sakha*’ is friend. I hope the allusion is sufficiently clear. Infant mortality rates in India are high and so are under-5 mortality rates. But over time, both have declined. IBBI has survived the status of being an infant and has also survived the state of being an under-5 child. It has been nurtured sufficiently for the first five years. The time has arrived to also strike and punish it, within reason.

4. Birth is entry. Death is exit. Medical treatment does its best to facilitate birth and postpone death. But eventually, death is inevitable. That is how life and evolution proceeds. This may seem like a repugnant metaphor to use in the context of government policy and capital market efficiencies. Repugnant or not, if one thinks with the brain and not with the heart, there is a grain of truth in the metaphor. 2021 is being remembered as the 30<sup>th</sup> year since the reforms of 1991. What are reforms? Each person uses his or her own prism to define reforms. Whichever prism or lens one uses, reforms are about efficiency and competition. Perfect competition, in the sense used by economists, requires a certain set of assumptions to exist and it is also true that those assumptions rarely exist in real life. Be that as it may, one of those key assumptions is free entry and exit. If one exists, but not the other, we do not have competition and reforms are incomplete. Since 1991, and since May 2014, there have been several measures to introduce and facilitate free entry.

Thanks to the World Bank, doing business is a buzzword for the wrong reasons now. However, Department for Promotion of Industry and Internal Trade (DPIIT) has a parallel ease of doing business ranking for States and that continues to be a buzzword, for the right reasons. Any enterprise, and enterprise doesn't necessarily mean corporate enterprise, faces three kinds of impediments in three stages of its life cycle – entry, functioning and exit. Since 1991, in discussions on reform, an exit policy has often been described as an exit policy for labour. That is a misnomer. An exit policy is primarily an exit policy for enterpriser. Nothing is as certain as death and taxes. This quote is often attributed to Benjamin Franklin. Benjamin Franklin did use the expression in one of his letters, but there are others who have used the expression before him. To use the life and death metaphor, government policies must facilitate ease of entry (the primary focus of 1991 reforms, at least for industry), ease of functioning (the thrust of DPIIT's initiative) and also exit. I repeat, exit is not about Chapter V-B of the Industrial Disputes Act. It is about the exit of enterprises in a broader framework. Most enterprises have a product life cycle, a shelf life. If not most, some certainly do. All enterprises cannot have an elixir of life and be immortal. Faced with competition, changes in technology, changes in the external environment and changes, or lack of changes and adaptability internal to the organization, some enterprises will die and become extinct. That's the way markets work and drive efficiency. Adopting an idea from Karl Marx, Joseph Schumpeter referred to this as creative destruction, an expression also known as Schumpeter's gale. As with life, destruction leads to creation.

5. I have titled this talk, 'No Exit to Easy Exit'. By easy exit, I am obviously referring to the enactment of the Insolvency and Bankruptcy Code in 2016. I have done a bit of caricaturing. It wasn't as if there were no exit provisions

before 2016. I will come those in a moment. But they weren't easy exit provisions. As determinants of growth, economists use the expression factor inputs, referring to land, labour and capital markets. For India to develop and prosper, all three must function efficiently. And do note, I am using the expression 'capital markets' in an economist's sense, not with the loose nuance that is sometimes used. Why do we want enterprises to exit? This is a rhetorical question that warrants no answer. I think it is worth spending a moment on the etymological roots of the two words, insolvency and bankruptcy, the reason we are assembled here today. Insolvency means an inability to repay one's debt. Bankruptcy means you broke the bench, also because the individual (not quite an enterprise then) was unable to pay debts. There were two separate expressions because bankruptcy provisions applied to traders, while insolvency provisions applied to those who were not traders. The antecedents go back to a time when the concept of limited liability had not evolved. In general, limited liability provisions were introduced in the 19<sup>th</sup> century. Notions of both insolvency and bankruptcy pre-dated it. Therefore, there was no distinction between the assets and liabilities of an enterprise and an entrepreneur. If the enterprise failed, it was the entrepreneur who was treated as insolvent or bankrupt. This meant criminal provisions were invoked. Think of the debtors' prisons described in the novels of Charles Dickens – Pickwick Papers, David Copperfield, Little Dorrit, even A Tale of Two Cities. Why was Charles Dickens so interested in debtors' prisons, except for the obvious fact of they being around in the Victorian age? Except for those who are interested in English literature, many people may not be aware that John Dickens, Charles Dickens' father, was in one of these debtors' prisons and this left a deep impression on the son. There is a tangential issue about dysfunctional criminal provisions existing in much of our legislation and the

need for weeding them out. Think of a piece of legislation all of us are familiar with, the Negotiable Instruments Act of 1881. Given the vintage of this statute, one can understand why Section 138 provides for imprisonment in the case of unpaid debts. Before the new Code, think of statutes like the Presidency Towns Insolvency Act of 1909 or the Provincial Insolvency Act of 1920. These were a Pandora's box of problems, which is why they were rarely invoked, even by creditors. Pandora's box may be the wrong image to use. At least, Pandora's box had hope. These two statutes did not possess even that. I mentioned them as yet another instance of pointless imprisonment provisions.

6. Rarely do we read our old texts on governance. If I ask someone to mention an ancient Indian text on governance, the probability is pretty high that Kautilya's 'Arthashastra' will be mentioned. However, governance concepts also exist in texts we don't normally associate with governance. I have in mind the Mahabharata, familiar to all of us. Everyone present here knows that the Mahabharata is divided into eighteen sections, known as Parvas. I particularly have in mind Shanti Parva, the Parva about peace, where Bhishma is lying down on his bed of arrows and is instructing Yudhishtira and his brothers. Bhishma advances the following argument. Guilty of a crime, a relatively wealthy person must never be imprisoned, since this will be at the cost of the public exchequer. Instead, a relatively wealthy person should be asked to pay a monetary fine, with imprisonment reserved for the relatively poor, who cannot afford to pay. You may, or may not, agree with the implicit value judgement, but you will be forced to agree that the logic is irrefutable. Advocates of the law and economics movement would have approved. I was reminded of this incident because IBBI and efficient capital markets have this dynamic efficiency in mind. This is one of the pillars of what has come to be called institutional economics.

7. I have already made out a case for enterprises to exit. Whether we like it or not, economic evolution implies survival of the fittest. Any forcible prevention of this leads to survival of the fattest. Think of the assorted Central Public Sector Enterprises (PSEs) that are sought to be privatized now. Many are loss-making and many have eroded all net worth. The point is that almost all loss-making PSEs which have eroded net worth were not public sector enterprises to start with. They were sick private sector enterprises that weren't allowed to exit and were nationalized. There are several such instances from the 1960s and 1970s, when this reached a peak. But there are also other examples from Independent India. The nationalization was done to protect a few limited jobs. The point is that this led to capital being locked up and becoming unproductive. By turning an asset into a liability, it is no different in nature from hiding one's cash under one's bed, driving it out of circulation and thereby making it unproductive.

8. Resources are scarce, in any economy. That's the reason the first-year under-graduate definition of economics is couched in terms of opportunity costs, a concept we often tend to forget. Those resources must be deployed where they are most productive. The market performs this allocative task, provided exit is not impeded. Dynamic efficiency is impeded when we artificially create barriers to exit. A market does not function in isolation, in a vacuum. It is not an agricultural mandi. A market is a conceptual structure used by economists, where buyers and sellers interact. The foundation for markets is based on law and the legal system. Markets are embedded in a legal infrastructure, a fact narrow perspectives on economics and policy often tend to miss. That legal system, or legal infrastructure, has three layers – statutes, administrative law (the set of orders and regulations) and swift dispute resolution. There are some propositions that should be self-evident.

- (i) Enterprises will fail and should be allowed to fail. If everyone passes in an examination system, the examination system will be reduced to a joke.
- (ii) A failed enterprise must be punished and allowed to exit.
- (iii) An enterprise failing is not the same as an entrepreneur failing, an important distinction that pre-modern insolvency and bankruptcy legislation failed to appreciate. I mentioned the expression factor inputs, used by economists, earlier and referred to three factor inputs – land, labour and capital. In the standard listing, there is a fourth, entrepreneurship. Entrepreneurship is defined as the trait of risk-taking, a rare phenomenon and one that economists understand the least. Without entrepreneurship, the other three factor inputs cannot function. I repeat, success cannot be encouraged without encouraging failure. Risk-taking ability is such a rare attribute that the individual must be allowed to move on, abandoning the old ship of the failed enterprise and moving on to a new ship.
- (iv) Why has the enterprise failed? A distinction is sometimes drawn between economic failure and financial failure. Economic failure is permanent. There is no option but to wind down functioning and wind up the company. There will be an assorted basket of creditors who have claims on whatever remaining assets the defunct enterprise possesses. There must be a legal mechanism to aggregate these debts and distribute and apportion the remaining assets among the various creditors and claimants. This frees locked up capital and converts unproductive liabilities into productive assets. A country like India is bound to be capital scarce, relatively speaking. If scarce capital is locked

up in unproductive ways, the economy is starved of credit. In the case of financial failure, matters aren't that dramatic or traumatic. The ship need not be sent to a ship-breaking yard. There can be a restructuring exercise, with the assorted creditors and claimants paid off, before the enterprise takes to the seas again.

- (v) The processes for all that has been cited above must be transparent, credible and swift.

9. I mentioned both debtors' prisons and Kautilya earlier. The manuscript of Kautilya's "Arthashastra" was lost and only references remained. It was rediscovered by Professor Shamashastry in 1905 and subsequently translated by him into English. In the Shamashastry edition, Chapter 11 is on recovery of debts. Since I have referred to various creditors and claimants, I feel like quoting what Kautilya had to say. *"Excepting the case of a debtor going abroad, no debtor shall simultaneously be sued for more than one debt by one or two creditors."* I also find Chapter VIII of Manu Samhita interesting. This is about dispute resolution and the kinds of cases, in order of priority, the king (the counterpart of the government then) should give attention to. Number one in the priority list of disputes to be tackled and tried was non-payment of debt. Incidentally, in that day and age, Manu also spoke of a creditor recovering his dues by force, without recourse to a court of law. In this day and age, such methods continue to exist, but let us pretend they don't. But let me refrain from treading too much into the past. This is about the present and the future. Legislation has evolved and moved on in other countries, as it has in India, away from personal insolvency and bankruptcy provisions, towards corporate insolvency and bankruptcy. In the West, be it Britain, the United States or the EU, commencing in the 19<sup>th</sup> century (not of course for the EU), legislation and



processes have moved on, away from the horrors of debtors' prisons. What decade can we date the current legislation to? Depends on the geographical area and the country. Perhaps the 1970s for USA, the 1980s for Britain and the 1990s for EU. With 2016 as a benchmark, India is not too far behind.

10. There were sundry other initiatives before 2016. I have already mentioned the personal insolvency laws, dating to the first decades of the 20<sup>th</sup> century. That apart, there were provisions under the 1872 Indian Contract Act and the 1956 Companies Act. There were specific statutes too – the 1985 Sick Industrial Companies (Special Provisions) Act; the 1993 Recovery of Debts and Bankruptcy Act, and the 2002 Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest Act. For our present purposes, post-mortem of this edifice is pointless. They have been discussed *ad nauseam* in the literature. Suffice to say, the edifice was subject to rigor mortis. Or perhaps I should more poignantly say, there wasn't much rigour in actual instances of mortis. We were confronted with a litany of woes – multiple provisions, Union as well as State; multiple for a, with no harmonization between powers and rights of creditors and debtors; no finality in decisions, with provisions for review and conflicting case law; lack of expertise on the part of those entrusted with making decisions; gaming of the system by errant debtors who could delay decisions; and lack of an effective deterrent mechanism. With the expertise this audience possesses, you can add to this litany of laments. This phenomenon of lack of standardization and harmonization finds an echo in other areas of the law too, not merely insolvency and bankruptcy.

11. When an incipient disease assumes acute proportions, it manifests itself through severe symptoms. Arguably, for a while, the growth of the financial

sector was disproportionately high, compared to the real sector. As a growth template, with indiscriminate lending, of doubtful efficacy, there were bound to be mounting NPAs (non-performing assets), assuming huge proportions when the business cycle went into a downturn. The going was good, but only as long as it lasted. I do not need to cite the seriousness of the NPA problem by giving actual numbers. Every cloud has a silver lining and the so-called twin balance sheet problem became a catalyst for the over-due standardization and harmonization through the enactment of IBC, Insolvency and Bankruptcy Code, in 2016, five years ago. In our sacred texts, auspicious births are recognized by gods from heaven beating on celestial drums and showering down flowers from the firmament. It is not my intention to suggest that the gods are in the West and we Indians are mere mortals, endorsed by recent events, where the World Bank has not covered itself with glory in its cross-country doing business rankings. Nevertheless, the fact remains that India jumped in the 2020 rankings. Those are aggregate measures. The jump in rankings is even more impressive if one zeroes in on the resolving insolvency head. It shouldn't be surprising that in 2018, India won a Global Restructuring Review award for the most improved jurisdiction in matters connected with restructuring and insolvency. Ditto for the 2020 Global Innovation Index, particularly the sub-head of ease of resolving insolvency. Global and Western approbation is not the end. It is not even a means to an end. At best, it is a welcome by-product. IBC and IBBI, Insolvency and Bankruptcy Board of India deserve approbation in their own right, for what they have achieved, and for what they promise to achieve.

12. Approbation, or condemnation, has a metric to gauge success, irrespective of whether that metric is explicitly stated or not. Before using any metric, some caveats are in order. As everyone present here knows and as I

have myself mentioned earlier, IBC was enacted in May 2016. But today's IBC is not the same as the one enacted in 2016, there have been amendments. IBBI has been described as a start-up. It is that and IBC is an example of make in India. Despite parallels existing in other countries, IBC and IBBI are unique. There is nothing quite comparable anywhere in the world. Should I gauge success on the basis of some metric linked to the corporate insolvency process? Perhaps I should. But let us remember the mandate isn't only that. Strengthening the insolvency process is one part, there is also a mandate of strengthening the insolvency eco-system. Let's not forget that IBBI has regulatory oversight over insolvency professionals and allied activities. It regulates the market. It regulates the profession. It regulates utilities. And it also has a responsibility to develop them. It is a regulator, but it is not a bankruptcy and insolvency adjudicator. Unlike regulators in other sectors or in other countries, this regulator does not enforce its decisions. For a company or a limited liability partnership firm, the relevant adjudicator happens to be the National Company Law Tribunal (NCLT), and of course, the National Company Law Appellate Tribunal (NCLAT). There has been criticism of the NCLT process, with valid reason. On the broad canvas, if one is gauging how IBC has performed, one cannot delink NCLT and its procedures from that evaluation. But that is a subject matter for another day. Similarly, for individuals and partnerships, the relevant tribunal is the Debt Recovery Tribunal. If you think about it objectively, both the NCLT/NCLAT and the Debt Recovery Tribunal are hangovers from an earlier system. They represent legacies. In an ideal world, it might have been better for the adjudicator to be crafted on a clean slate, *de novo* and shorn of legacies. For instance, had it been a clean slate, it might have been easier to introduce professional case management, curb long vacations or use technology to eliminate the human

interface at the time of listing of cases. But as I said, that's not the subject matter for today, though these are important issues. IBC and IBBI cannot be expected to solve the banking sector's NPA problem on its own.

13. To reiterate an earlier point, IBC and IBBI are instances of what is called work in progress. One learns as one goes along. There is criticism and one tweaks. It is desirable that this tweaking occurs, on the basis of feedback. I regard this as a positive, not a negative. Accordingly, there have been amendments to the 2016 IBC. For instance, it is because of amendments that we now have a strict 330-day timeline for corporate insolvency. This became necessary because the system was being gamed. As a moot point, would the gaming have been possible had a *de novo* adjudicator evolved its own procedures, instead of using standard court procedures? As yet another example of an amendment, a pre-packaged resolution process has been introduced for micro, small and medium enterprises. While these amendments are welcome, this causes a statistical problem, familiar to everyone who works on empirical studies. When there are changes, how does one statistically control to ensure what economists refer to as *ceteris paribus*? This problem becomes sharper because of Covid, a pandemic the likes of which the world has not witnessed since the days of the Spanish flu, roughly one hundred years ago. In passing, India has weathered the storm rather well, including measures of vaccination, especially if one normalizes for population. Nonetheless Covid and the resultant lockdown knocked everything for a six and the business environment wasn't quite normal. In evaluating the progress of a child who has just turned five, what does one do if the child has not been to Anganwadi or a creche for a year and no health, height and body weight, measurements have been taken. I am referring of course to the temporary suspension of IBC during Covid.

14. Let me make an additional point, with a bearing on the way we look at the performance of any law. A lawyer's typical approach to a statute is short-term, static and compensatory in nature. Let us think of some civil matter, not criminal. I have harmed your rights in some way. The function of law is to grant you compensation for your loss. At least, that's the way most jurists and lawyers will think of the issue. An economist tends to look at the matter with a longer-term, dynamic efficiency objective in mind. The law's primary function is not to compensate you for your loss. The primary function is deterrence, preventing others from indulging in such wrong deeds in the future. Think of the way we judge the police or anti-terrorist organizations. For the former, we think of FIRs and conviction rates. Crimes prevented by the police, or anti-terrorist organizations, do not enter the picture because no data exist on those, at least not in the public domain. When we travel by car on the road, we see the barricades that slow us down. We do not perceive the preventive and deterrent role of the barricades. IBC actually represents the interface between law and economics. That's the reason I mentioned these examples. IBBI's mandate covers behavioural change and inducing these, providing incentives and disincentives. This is an intangible, difficult to measure and quantify. But that doesn't mean we should forget about it and only use metrics connected with recovery, simply because it is more convenient to do so.

15. That being said, we do have some data, particularly on corporate insolvency resolution. Unless I am wrong, in a proper sense, we have it for the period till March 2020. I will not bore you with numbers. Let IBBI do that through its website and publications. There are liquidation values and resolution plans. In looking at such metrics, let us also remember that once brought into the IBC process, there were also cases that were voluntarily and

mutually settled by opting out of the IBC process. Standard metrics do not usually capture that. Even if goes along with that short-coming, the Indian recovery numbers do not compare unfavourably with figures for similar institutions in other countries or alternative recovery forums within India. That comment was about metrics connected with corporate insolvency. We also have indicators about voluntary liquidation. Individual insolvency and bankruptcy proceedings kicked in much later, right at the end of 2019, by which time, Covid also kicked in.

16. Before IBC and IBBI, *de facto*, there was no exit, even though, *de jure*, there may have been some exit. IBC and IBBI have made it easy exit, though there is certainly scope to make it easier still. The child has survived and grown. It is not under-weight, or below the expected height. There is no stunting. But it is time for the child to grow and develop into an adult. We will do our best to ensure this by chastising it.

Thank you IBBI for having invited me.