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Bankruptcy code: a work in progress

If half of the 12 cases on distressed bank loans are solved, it'll build confidence in the system

When shareholders and lenders give capital to a business, they believe it will succeed and give them returns. Handling failure well is an equally important part of the business ecosystem. That had been found wanting in India till the new bankruptcy law kicked in. A year after the first insolvency case was admitted by courts, the bankruptcy framework still remains a work in progress.

India needed a modern framework to replace the ineffective and loophole-ridden set of insolvency laws that led to inordinate delay in cases. The new code marked a big shift in the balance of power between debtors and creditors. Banks, and other creditors, no longer need to be at the mercy of big borrowers. The framework sets a clock of 270 days for resolution and defaulters could no longer hide behind a maze of state laws to avoid paying their dues.

The Supreme Court ruling in the case of Innoventive Industries, the first case to be tried under the new law, said that the insolvency code took precedence over state laws. Government data showed that 2,434 fresh bankruptcy cases have been filed and 2,304 cases of winding up companies have been transferred from various high courts in the past year. Of these, 2,750 cases have been disposed. There is little data on the kind of resolution, recovery rates and costs. However, it is clear that the law is yet to fully demonstrate its effectiveness and is facing teething troubles as seen from the frequent changes in rules, the recent ordinance and amendment bill. The first case under the new framework had a less than satisfying outcome and highlighted loopholes. Lenders to Synergies Dooray Automotive recovered 6 paise to the rupee. The resolution has been challenged. There are allegations the company gamed the system by placing a proxy in the committee of creditors which takes the final call on resolution plans.

Indeed, concerns that devious promoters will get a backdoor entry to control firms at a steep discount prompted the government to issue an ordinance in November amending the code. It barred promoters of firms that hadn't paid up their dues and related entities from participating in the bidding for assets of a distressed company under the resolution process.

On one hand, it reinforced the signal that promoters have no divine right to control firms if they don't repay loans. However, the unintended consequence may be that banks may see a fall in recovery rates because of fewer bidders. The amendment bill, which

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was passed earlier this month, gives promoters some leeway to bid if they pay the overdue amount. The bill also exempted banks, asset reconstruction firms and those specialising in acquiring distressed assets from the definition of related entities.

Still, there are many areas where clarity is required, especially where the insolvency law comes in conflict in other laws. The government has already set up a committee to identify areas which require attention and is moving quickly to resolve these issues.

One example is the applicability on minimum alternate tax (MAT) on the portion of debt written off under a resolution plan because that could be seen as income. Last week, the Central Board of Direct Taxes granted an exemption. Other examples of conflicts include de-listing of listed shares, equity reduction and the applicability of competition law. Getting approvals from different regulators might lead to a delay in timelines.

Coming to the application of the law, as mentioned earlier, the apex court ruling on Innoventive Industries was welcome support. The court's intervention in the case of Jaypee Infratech Ltd led to a change in rules. Homebuyers were recognised as a category of creditors. Still, researchers have pointed out cases of judicial overreach. There are examples where cases have been dismissed because the court got into analysing the balance sheet of debtors and ruling that it was healthy enough. In some others, they have allowed a settlement even after a case was admitted, which is not explicitly allowed under the code.

That said, one area where the code has proved useful is for operational creditors like vendors, employees and service providers. A study of 515 cases by the Indira Gandhi Institute for Development Research shows that these operational creditors have been successful in recovering their dues using the threat of the bankruptcy court.

This year is crunch time for the code. Twelve big cases — accounting for a quarter of distressed bank loans — will reach their deadlines for resolution. Banks have filed (or are in the process of filing) cases against another 25 big accounts identified by the Reserve Bank of India (RBI). If even half of these are successfully resolved, it will build confidence in the new framework.

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