

RESOLUTION VS. LIQUIDATION UNDER IBC

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Abstract

Resolution over the liquidation of a bankrupt company is desirable as it better protects the interests of shareholders and employees. But, the number of liquidations have been reported to be three times of resolutions under Insolvency and Bankruptcy Code of India. Existing literature provides that bankrupt companies should be resolved or liquidated depending on their potential to contribute to the economic growth of a nation. This study attempts to determine whether outcomes of bankruptcy proceedings in India depend on the competence of companies or not. It also delves into other factors impacting the likelihood of survival of companies after bankruptcy proceedings. This study has used logistic regression and independent sample t-test for analyzing 115 responses of insolvency professionals on a questionnaire investigating reasons behind the outcome of resolution vs. liquidation. Additionally, it has also used phenomenological analysis to analyse the interviews of 10 insolvency professionals. Results reveal that the outcomes of bankruptcy proceedings are not being based on the economic efficiency of companies. However, if a company timely files for bankruptcy, it has 1.731 times the chances of resolution over liquidation. Phenomenology has unfolded the plight of insolvency professionals, incompetence of National Company Law Tribunal, and drawbacks of the supremacy of committee of creditors.

Keywords: Economic efficiency, liquidation, resolution, timeliness

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INTRODUCTION

Some scholars define insolvency as chronic ineptitude of the company to fulfill economic, financial and social responsibilities. Others define it as incompetence of the company to act proactively or react aptly to the internal and external forces of the environment. Referring to it as a ‘spiral of failure’, some authors associate insolvency with termination of payments. From the economic perspective, the company is said to be insolvent, if it had been exposed to a series of failures to repay debt or interest thereon or pay dividend or discharge social obligations and thus gets drawn under the bankruptcy proceedings (Levratto, 2013). Under IBC, where insolvency is considered as the short-term inability to pay off the due liabilities, bankruptcy is a longer-term view when company has reached at the brink of financial inability to discharge its liabilities using its assets (EY, 2017). In the context of IBC, Bhasin (2018) clarified that companies’ arrival to National Company Law Tribunal (NCLT) signifies bankruptcy.

The term bankruptcy is made up of two Latin words – ‘bancus’ meaning bench and ‘ruptus’ meaning broken (Cheng, 2012). Bankruptcy is the legal declaration of borrowings to be greater than the market value of assets. Bankruptcy is the determination of insolvency made by a court of law with resulting legal orders intended to resolve insolvency (Levratto, 2013).

Nation’s bankruptcy law depends upon the level of development and structure of the financial sector of the economy. Blazy, Chopard, and Fimayer (2008) propounded that the bankruptcy law of the nation is said to have attained ex-ante efficiency if it provides enough impetus to debtors, entrepreneurs, and lenders; and is claimed to have reified ex-post efficiency if financially distressed companies are resolved or liquidated depending upon their potential to create value for the economy. It is the ex-post efficiency that the present paper focuses on. Provided that IBC also aims to timely resolve or liquidate the companies depending on their competence, IBBI (2018) reported that of the 701 companies admitted under IBC, 22 companies have been resolved, 87 companies have been liquidated, and rest are still pending. This study attempts to analyse if economically inefficient or incompetent companies are being liquidated since the enactment of IBC. The present study relies on the quality of its asset base to classify a company as economically efficient (Basu, 2018).

Pochet (2002) supported that bankruptcy perturbs all the stakeholders including shareholders, banks, employees, state, customers, suppliers, and managers (Shilpa & Amulya, 2017). The degree of losses can be minimised if bankruptcy law is designed to favour resolution over liquidation. Verma (2018, June 7) exhibited that despite of the strongly held belief that it is better to resolve the company rather than liquidating it, December 2017 data of Corporate Insolvency Resolution Process (CIRP) under IBC unveiled liquidation orders for companies numbering as thrice of the number of companies resolved. PTI (2018, June 10) presented discontent of the Chairperson of Insolvency and Bankruptcy Board of India (IBBI), M S Sahoo, over the current state, who said that the central aim of the code is to protect the interests of all stakeholders and direct the actions to resolve and not liquidate the company, to maximize the value of corporate debtors. K R Jinan, member of NCLT Kolkata bench in an article by PTI (2018, June 10) was quoted to have explained that the implementation of IBC needs to be reviewed regularly for implementing it in a way to achieve its aim. Sahoo specified that more than 75% firms under the NCLT proceedings have been liquidated as a result of the voting results of CoC who found it tough to choose the suitable bidder. Sahoo affirmed that in order to deal with this issue, new ordinance amending IBC has reduced the required CoC voting percentage on resolution plans to 66% from 75% (PTI, 2018, June 10). It is in the best interests of the stakeholders to resolve a bankrupt company. The objective of the present study is to identify the factors which impact the final result of bankruptcy proceedings between resolution and liquidation. Such factors will enable maximum recovery for all the stakeholders.

REVIEW OF LITERATURE

This section is divided into three parts. The first part focuses on two possible outcomes of bankruptcy. The second part presents a review of factors influencing them. And third part details the Insolvency and Bankruptcy Code of India.

Outcomes of Bankruptcy

This part of the study deals with two mechanisms available to a company at the culmination of bankruptcy proceedings. Labardin (2013) presented one of the general bankruptcy laws as that of France, that after the company is assured that its assets fall

short to pay off the liabilities, it has three days to voluntarily file for bankruptcy, else creditors or the courts file the case. Once the case has been lodged, the company is supposed to furnish the balance sheet which is used as the basis for valuing assets and liabilities. Then a provisional receiver is appointed by the court for managing the operations of the company until the permanent receiver gets appointed contingent upon the discussion between the court and the creditors. The receiver then prepares the balance sheet depending on settlement vs. liquidation (Labardin, 2013).

White, LLP, Dallas, and Medford (2003) asserted that bankruptcy law can be said to have achieved its true goal if, with its enforcement, directors can save the interests of all the stakeholders. Stakeholders' interests other than of creditors are often not met when a corporate debtor is liquidated and not resolved. It has been found that the committee of creditors (CoC) does not approve resolution plans because either liquidation value seems to be higher than resolution value or the terms of resolution plans do not suit them (Verma, 2018, June 7). For the duration of more than 270 days permitted by IBC to decide upon the resolution plan, the CoC of Ferro Alloys Corporation Limited (founded in 1955) did not approve of any resolution plan providing one or other reason. The analysis revealed that Rural Electrification Corporation, with INR 8 billion at stake, being the 90% claimant of the debt, had the chance to recover a higher proportion of the claim from INR 7.5 billion which was the liquidation value of Ferro Alloys through piecemeal sale, over any resolution plan (Rakshit, 2018). Pochet (2002) supported that there is always a trade-off between relieving creditors and continuing the company.

France and Germany have their respective single legislation to provide for both reorganization and liquidation depending on the companies' circumstances (Pochet, 2002). The bankruptcy code of the USA came into being in 1978 (Donoher, 2004). Pochet (2002) further provided that the USA features two separate legislations – chapter 11 deals with reorganization and chapter 7 is used for liquidation. Japan and the UK bestow multiple legislations for reorganization, however, most frequently applied are 'civil rehabilitation' and 'administrative receivership' respectively. The successful reorganization necessitates automatic stay on the claims of secured creditors, which is granted by France, Germany, USA and Japan (subject to court's decision) but not by the UK. Germany's bankruptcy law is also debtor-oriented as it allows the present manager

to continue as a head but authorizes the creditors to choose the fate of the company. Germany supports reorganization but the procedure is not easy, thus the number of reorganizations are fewer (Pochet, 2002). The USA has derived its chapter 11 for reorganization from its bank crash history of 1929, when Glass Steagall Banking Act, 1933 and Chandler Act, 1938 were enacted to regulate the huge powers vested with the banks. Since then, the bankruptcy law in the USA has been designed to protect debtors and opts for resolution over the liquidation of economically viable companies. (Pochet, 2002)

Through IBC, India has also moved from the concept of debtor-in-possession to creditor-in-control model, following the UK regime (EY, 2017). Pochet (2002) emphasised that being Anglo-American countries, which follow shareholder-oriented models, the UK and India have instituted creditor-oriented bankruptcy models. In the USA, Japan, France, and Germany, being the followers of debtor-oriented models, resolutions are pursued more often (Pochet, 2002).

Factors affecting the outcomes of bankruptcy

When a low potential distressed company is saved, it is referred to as type I error and, when a high potential distressed company is liquidated, it is referred to as type II error (Blazy, Chopard, & Fimayer, 2008). Pochet (2002) reported that in France, due to intense competition among banks, even economically efficient companies have also been liquidated. Levratto (2013) emphasised on distinguishing between economically inefficient and economically efficient distressed companies.

Donoher (2004) proposed that companies should punctually file for bankruptcy for easier and maximum recuperation. M S Sahoo, Chairperson at Insolvency and Bankruptcy Board of India, in an article by PTI (2018, June 10), recommended to timely pursue bankruptcy filing for better chances of saving the company. Dutt and Gupta (2018) exemplified that the steel business of Usha Martin Limited, an Indian listed company, had accumulated the debt of INR 50 billion and to bring it down, a committee of independent directors of the company was timely formed to facilitate and monitor the decision of sale of steel business, which in turn saved the company. Proactive efforts can maximize recovery. Donoher (2004) explained that Chapter 11 for the reorganization of

the USA, does not even impose a solvency criterion for filing, i.e. even healthy companies file for better management of the debt.

Donoher (2004) stated that creditors receive the amount depending on the realization value of assets that they want to maximize by early filing. Both secured and short-term unsecured creditors pose threat to management by the sale of collateral and denial to additional lending, respectively. They find themselves safer with the court's involvement in settlement and thus push for expedient bankruptcy filing. Unsecured creditors are more worried about their recovery because they do not have assets to sell (Donoher, 2004). Institutional investors and block holders also push for early filing as per the findings of the study authored by Donoher (2004). Author (2004) provided that most of the companies dread from filing for bankruptcy and keep delaying it for bankruptcy costs, disgrace associated with it, the threat of risking future employment opportunities, and low success rate after bankruptcy.

The activism of operational creditors is also being seen as a force in resolving the company such as in the case of Alok Industries Ltd. (Basu, 2018). Scholars have added that corporate debtors who file for bankruptcy with a reasonable quality of assets and competent structure have a higher probability of resolution under bankruptcy regimes.

Insolvency and Bankruptcy Code, 2016 – Bankruptcy law of India

Sinha (2018) appreciated that IBC considers a company to be insolvent if it has failed to pay ₹1,00,000. IBC enactment has given huge respite to banks and other lenders as the winding-up process under Companies Act was extremely time-taking and inefficient. Author (2018) clarified that it has been made to happen for the first time in India (EY, 2017), that promoters have to be wary about excessive investments through over-leveraging as such a condition could lead to bankruptcy, post which they will lose control over the company. This is because IBC orders for automatic suspension of any control rights vested with the promoters or directors after the petition has been filed.

Under IBC, creditors are divided into operational and financial creditors. The CoC which is authorized to make all the decisions subject to the approval of NCLT is constituted of only financial creditors. The insolvency petition can be filed by either of the following- financial creditors, operational creditors (including

government/employees) or corporate debtor (MCA, 2016). Once the petition is admitted by NCLT (within 14 days from the date of petition), an interim resolution professional/resolution professional (IRP/RP) has to be appointed who takes over the powers of board and management to operate the company during corporate insolvency resolution process (CIRP). NCLT declares moratorium period which begins from the date of insolvency petition admission (insolvency application in other countries) till the end of 180 days (270 days if extended by NCLT). During the moratorium, certain activities are prohibited such as initiation of legal proceedings against corporate debtor, enforcement of security interest, transfer of assets, etc. Resolution applicants submit resolution plans which are subject to the approval of 66% of members of CoC in a meeting convened by RP. If till the deadline of 180 days (270 days), no resolution plan is accepted by CoC or accepted by CoC but not approved by NCLT, the company goes into liquidation.

For liquidation, resolution professional/liquidator calculates the liquidation estate, discharges the claims of creditors in accordance with section 53 of IBC, and dissolves the corporate debtor. Section 53 provides for the following order of payment: payment of insolvency resolution process and liquidation costs; payment towards secured portion of secured creditors (if not realized already u/s 52) and workmen dues; payment to unsecured creditors; payment towards government claims (were above in the hierarchy under Companies Act, 2013) and unsecured portion of secured creditors; preference shareholders; and lastly towards equity shareholders. Even if the resolution plan is approved, within 30 days of approval, operational creditors and dissenting financial creditors need to be disbursed the liquidation value. (IBBI, 2018; EY, 2017)

RESEARCH METHODOLOGY

This section covers the description of sample and data used for the study, details of the hypotheses, and tools used in the study.

Sample and Data

This study is based on primary data analysis. It is a survey-based research. It relies on both quantitative and qualitative analysis. The details are as follows:

Quantitative Analysis

A questionnaire was designed to be responded to by insolvency professionals. The final questionnaire was sent to 300 insolvency professionals. Data was received from 115 of them from May – June 2019. The questionnaire contained ‘21’ five-point Likert Scale statements ranging as ‘5’ for ‘strongly agree’, ‘4’ for ‘agree’, ‘3’ for ‘neutral’, ‘2’ for ‘disagree’ and ‘1’ for strongly disagree. Two categories of petitioners included operational (coded 0) and financial (coded 1) creditors. Lack of timeliness was asked through two statements in the survey: ‘petitions are filed when assets have lost their viability’ and ‘institutional investors fail to ensure timely filing under IBC’. Low activism was calculated as the summation of: ‘operational creditors lack activism in enforcing their rights’, ‘supremacy of financial creditors leads to decisions in their own favour’, and ‘IBC features unequal recovery for claimants’. The reliability of the questionnaire (Cronbach’s Alpha coefficient) is higher than 0.7. The validity of the questionnaire has been ensured by the development of statements based on the review of literature.

Qualitative Analysis

Telephonic interviews were conducted with 10 insolvency professionals. The respondents were approached through LinkedIn.

Hypotheses of the Study

Based on the extant literature that was studied to carry on the research, following null hypotheses and their corresponding alternate hypothesis have been derived and tested in this study:

H1: The result of bankruptcy proceedings does not differ based on categories of petitioners.

H2: Lack of timeliness in filing for bankruptcy is not likely to lead to liquidation.

H3: Low activism of operational creditors does not cause liquidation.

H4: Company with low quality of assets is not likely to result in its liquidation.

H5: Low demand of the company doesn’t take it to liquidation.

Tools Used

For quantitative analysis, logistic regression and independent sample t-tests were applied using SPSS 21. The dichotomous dependent variable was taken as ‘liquidated’ (coded 1) and ‘resolved’ (coded 0). For qualitative analysis, the tool of phenomenological analysis (Moustakas, 1994) was used.

DATA ANALYSIS

Quantitative Analysis

An independent sample t-test was first conducted to see which variables significantly differ for the grouping variable of resolution and liquidation.

Table 1. Significance of differences (R-L) as per independent sample t-tests (N = 115)

Variable	T	df	Sig. (bootstrap)	Mean difference
Category(1)	-	1	0.486	0.486#
Lack of timeliness	-2.147	113	0.034*	-0.30072
Low activism	0.334	113	0.739	0.047
Low demand	0.917	108.293	0.361	0.138
Low asset quality	-1.552	113	0.123	-0.261

Pearson chi-square values for categorical variable

*p < 0.05

Table 1 highlights that the outcome of resolution vs. liquidation is not different based on the category of the petitioner, activism of operational creditors, quality of asset base, and demand of assets. In addition to independent sample t-test, the following model is tested through logistic regression:

Result of bankruptcy proceeding = f (Category of petitioner, lack of timeliness, low activism of operational creditors, low demand of corporate debtor, low quality of asset base)

Assumptions

All the assumptions of absence of multi-collinearity, normality, absence of heteroscedasticity, linearity, absence of outliers and influential statistics (Field, 2013) were met.

Model Fit

At 5% level of significance, chi-square is significant, $\chi^2(4) = 14.252$, $p = .014$; therefore, model is a significant fit of the data. With the predictor variables, the model correctly classified 64.3% of the choices. Based on 0.155 (Nagelkerke), it can be said that the model is moderately fitting the data.

Interpretation of Variables

Table 2. Logistic regression predicting result of bankruptcy proceedings (N = 115)

Variable	B (S.E.)	Wald	Sig.	Exp(B)	Lower Exp(B)	Upper Exp(B)
Category(1)	-0.226 (0.409)	0.305	0.567	0.798	0.358	1.778
Lack of timeliness	0.549 (0.265)	4.307	0.042*	1.731	1.031	2.908
Low activism	-0.322 (0.277)	1.352	0.256	0.725	0.421	1.247
Low demand	-0.492 (0.260)	3.581	0.055 ⁺	0.612	0.368	1.018
Low asset quality	0.385 (0.253)	2.307	0.111	1.469	0.894	2.414

⁺ Significant at 10% level of significance

* Significant at 5% level of significance

Table 2 shows that a lack of timeliness in filing for bankruptcy causes a significant ($B = 0.549$, $p < 0.05$) impact on the result of bankruptcy proceedings. As a lack of timeliness increases, the likelihood that the company will be liquidated increases by 1.731 times. Wald statistic's column highlights the highest relative value of this variable. The confidence interval of Exp(B) does not include one, thus re-confirming the significance of this variable. The low demand of a corporate debtor is significant but with a negative

co-efficient. However, the confidence interval of its $\text{Exp}(B)$ includes 1 which makes its result unreliable (Field, 2013). Rest of the variables are insignificant.

Hypothesis testing

Based on tables 1 and 2, $H2$ stands rejected and $H1$, $H3$, $H4$, and $H5$ are accepted.

Qualitative Analysis

Open-ended questions based on the theoretical footing of the study were asked from each interviewee. Based on the phenomenological analysis, the following six themes have been developed after analyzing the interviews of insolvency professional (Creswell, 2007):

- IBC requires to be amended based on judicial pronouncements and comments of key stakeholders.
- The plight of insolvency professionals should be addressed on a priority basis as they pursue risky jobs without adequate fees, powers, and police support.
- NCLT lacks benches, judges, and infrastructure to implement IBC effectively.
- NCLT judges should be asked to meet the deadlines stipulated under IBC especially for admission of petition.
- Good assets are going for liquidation as it is an easier route for committee of creditors.
- Tendency to defer filing of petition leads to deteriorated quality of assets and scarcity of resolution plans.

CONCLUSION AND IMPLICATIONS

This study has derived meaningful ideas for distressed companies and regulators. Independent sample t-tests show that the outcome of resolution vs. liquidation does not depend on the quality of assets and strength of assets' demand. In line with the findings of Blazy, Chopard, and Fimayer (2008), bankrupt companies in India also are not being resolved and liquidated based on their economic efficiency. As per the results of this study, so far resolutions have been possible due to timeliness in the bankruptcy filing and not due to economic efficiency. It implies that we need to minimize type I and type II errors. Moreover, companies facing signals of danger and distress should file for

bankruptcy well before the time when assets have not lost their value and viability. Institutional investors should encourage early filing for bankruptcy to maximize recovery. Both quantitative and qualitative analyses have confirmed the importance of timeliness in filing bankruptcy. Respondents quoted it as the major reason behind the scarcity of good resolution plans.

Denying the findings of Basu (2018), the activism of operational creditors is not being able to impact the outcome of insolvency resolution processes due to the prevalence of absolute priority rule. Interviews revealed that there are several severe concerns of insolvency professionals that need to be addressed promptly. Insolvency professionals requested for clear provisions for their fee structure, powers, and support from police and regulators. Given that IBC allows 14 days to NCLT to accept or reject a petition, respondents expressed that NCLT takes longer than 6 months for the same. CIRPs are getting delayed over the stipulated 270 days due to litigations, lack of NCLT benches, judges, and poor infrastructure. Some regulations are needed for CoC as well. Similar to the findings of Pochet (2002), COC of economically efficient companies was also reported to favour liquidation with total disregard for interests of shareholders, workers, and the whole economy. As resolutions prevent unemployment and boost the confidence of investors, we urge the IBBI to consider these implications while introducing future amendments to IBC.

LIMITATIONS AND SCOPE FOR FUTURE RESEARCH

Firstly, this study has a small sample size that restricts its generalizability. Researchers can develop more reliable models with a larger sample size. Secondly, this study uses a limited number of predictors. A wider range of predictors can be taken by future studies. Thirdly, the result of bankruptcy proceedings is studied based on primary data analysis in this study. Resolution vs. liquidation can also be analysed based on secondary data. Lastly, themes derived under qualitative analysis have not been tested. Scholars can test them quantitatively.

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