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Insolvency and Bankruptcy Code, 2016 - An Analysis of the Detrimental Economic Impacts

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Abstract: ***The brief paper analysis the economic impact of the Insolvency and Bankruptcy Code, 2016 of India with special emphasis on the current Recession in the economy. The paper analysis the loopholes in the Code including poor implementation, biased approach, and flawed focus on liquidation. These loopholes have been analyzed on the detrimental economic impacts they carry. Recommendations to improve have also been stated.***

Keywords: Insolvency, Bankruptcy, Economy

1. Introduction

Insolvency is a situation of afinancial crisis when the business is unable to pay the creditors. This leads to insolvency proceedings, wherein, legal actions are taken against the insolvent business and a meaningful resolution plan is made between the business and the creditors. This includes, but is not limited to, settlement of creditors, the viability of a business, change in management etcetera. Insolvency is not the result of any one particular factor; it can be a result of multiple factors. One of the major reasons is an increase in the input costs because of the increased cost of raw materials, high cost of capital, fluctuating business environment, changes in economic policies, change in industrial policies etcetera. This results in increased prices for the final goods. If this is an industrial phenomenon, the consumer might shift to the substitute goods that ultimately destroy the industry if no measure is taken. A change in management or lousy business practices can also result in insolvency. Insolvency and Bankruptcy are very different and do not mean the same. Insolvency is a situation wherein the liabilities of the entity are more than the assets and hence the entity is unable to meet its debts. Bankruptcy, on the other hand, is a legal process where a court has declared the entity insolvent on the application made by the entity to declare itself. This means that Bankruptcy is a legal process and insolvency might or might not lead to bankruptcy.

The Insolvency and Bankruptcy Code, 2016 is the bankruptcy law in India, which was introduced in December 2015 and was passed by the Lok Sabha in May 2016.The long title of the Insolvency and Bankruptcy Code, 2016 states as follows – "*An Act to consolidate and amend the laws relating to reorganization and insolvency resolution of corporate persons, partnership firms and individuals in a time-bound manner for maximization of value of assets of such persons, to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders including alteration in the order of priority of payment of Government dues and to establish an Insolvency and Bankruptcy Board of India, and for matters connected therewith or incidental thereto*."

It is not that this code is the first to govern Insolvency and Bankruptcy in India. Before this code,there was no single legislation that governed the Insolvency and Bankruptcy proceedings in India.There were a slew of organizations governing the legal framework, namely: The Companies Act, 2013; The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (Amendment Bill of 2016 has already been passed by the Lok Sabha on 01.08.2016 and by the Rajya Sabha on 09.08.2016); The Sick Industrial Companies (Special Provisions) Act, 1985; The Recovery of Debts Due to Banks and Financial Institutions Act, 1993; The Presidency Towns Insolvency Act, 1909; and The Provincial Insolvency Act, 1920.

Despite the above-mentioned provisions, the need for a standardized law was due to the following reasons: (a) To consolidate and amend all existing insolvency laws in India; (b) To simplify and expedite the Insolvency and Bankruptcy Proceedings in India; (c) To protect the interest of creditors including stakeholders in a company; (d) To revive the company in a time-bound manner; (e) To get the necessary relief to the creditors and consequently increase the credit supply in the economy; (f) To work out a new and timely recovery procedure to be adopted by the banks, financial institutions or individuals; (g) To maximize of the value of assets of corporate persons. This code repeals three legislative acts namely, Presidency Towns Insolvency Act, 1989, Provincial Insolvency Act, 1920, and Sick Industrial Companies (Special Provisions) Act, 1985.

This code applies to four entities: Individuals, Partnership firms, Limited Liability Partnerships, and companies. It does not apply to entities like societies, trust boards, etc. Insolvency and Bankruptcy Code promotes entrepreneurship as stated in the Long title. This is achieved by providing security against private properties by establishing limited liability partnerships. At the time of winding up of a company, when creditors demand their money back, it allows other companies to acquire by providing resolution plans that satisfy the creditors.

Recession

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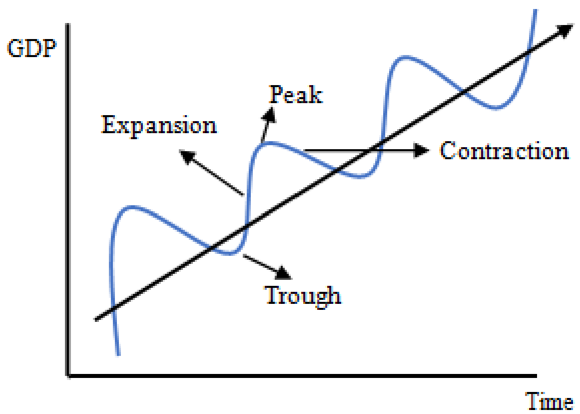
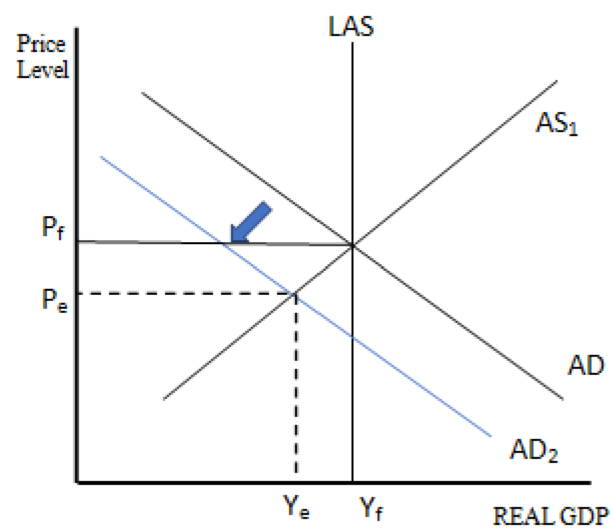
A period of temporary economic decline during which trade and industrial activity are reduced, generally identified by a fall in GDP in two successive quarters is called arecession in the economy. This is the traditional “definition” of Recession; however, a recession is a bit more dynamic than the definition stated in books. The National Bureau of Economic Research (NBEC) defines it as a significant reduction in the economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales.We can understand this with the Economic Cycle.



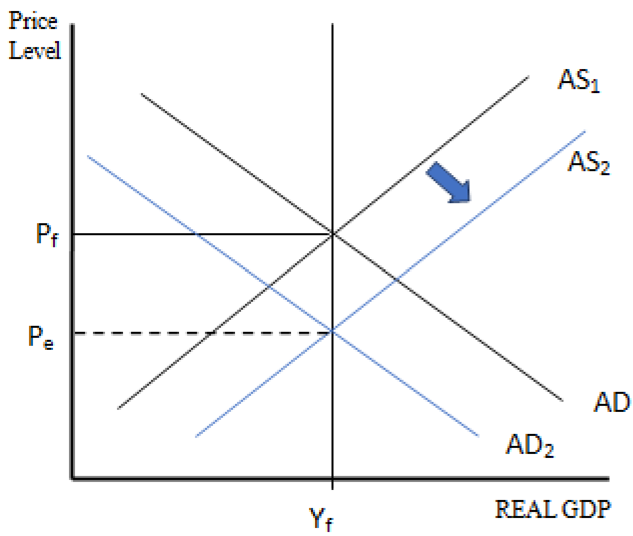
Economies are cyclical. This means that an economy will go through ups and downs but in the long term, they will be in an uptrend. Most countries, including India, have followed this over the years. But the economy does not just stay in an uptrend, always. There are periods of short-term fluctuations when macroeconomic indicators show a slowdown. These short-term fluctuations are called recession. The time frame, however, varies. A recession can be there for 6 months or several years, leading to a situation of depression. Recession does have a negative impact but the extent of it is determined by the fall in the GDP and the time for which the recession continues.

Many factors can contribute to periods of Recession. Major recessions in past have been caused by suddeneconomic shocks. Considering that we look at the Long-Run Aggregate Supply curve (Vertical line), an economy is in perfect equilibrium when aggregate demand is equal to aggregate supply at the full employment level. However, a fall in the aggregate demand, if the aggregate supply is constant, would reduce the prices. The economy would produce lower than its optimal capacity. This is the recessionary gap. This sub-par performance of the economy results in job loss and other detrimental effects on the economy. COVID-19 has played a major role in deteriorating the already affected Aggregate Demand in the Indian economy. The focus of the government at the same time over the past 3 years was on Supply-side economics. Their approach towards increasing the supply in the economy in the hope that the Aggregate demand would follow the increase in the Aggregate Supply had resulted in overproduction in various sectors. Because of this, the inventories of the businesses increased and so did the costs, however, the demand in the economy was falling. The businesses were not able to sell what they produced, and this resulted in them becoming insolvent. All the key economic indicators had been signaling a downtrend in the Indian economy since the end of the year 2019. The current post-COVID recession quite contradicts the belief of the Finance Minister Nirmala Sitharaman, as stated at the Rajya Sabha on November 27, “If you are looking at the economy with a discerning view, you see that growth may have come down but it is not recession it will not be a recession *ever*”. Several factors like a sudden change in the legal and economic policies by the incumbent government had previously led to the pre-existing weakness in the economy.

This can be understood with an AD-AS diagram explanation. Over here, Long-Term Aggregate Supply Curve (LAS), Aggregate Supply curve (AS), Aggregate Demand Curve (AD), Full-employment level (Y_f), Equilibrium Price Level at Full Employment (P_f), Reduced Production Level (Y_e), and Price at Y_e (P_e) are mentioned.



This graph shows the Economic Condition of Indiaoverthe past 7 years. India has been facing reduced Domestic Aggregate Demand. This has resulted in a leftward shift in the Short-Term Aggregate Demand (AD) curve. The obvious measure here, by the government, should be to increase the Aggregate Demand by Expansionary Fiscal Policy and this should be supported by the RBI with Expansionary Monetary Policy. However, the government did not completely focus on aggregate demand. It followed policies to increase the Aggregate Supply as mentioned before. However, these policies were brought in toincrease Aggregate Supply in the short term. The failure to affect the Aggregate Demand would naturally bring the Aggregate Supply down. The obvious part to analyze here is that if the Aggregate demand was reduced, why did the economy not face recession on paper? No report showed any signs of recessionbefore the latest Post-COVID report. Apart from the biased statistical reports and calculation methods, the changes in the economy, temporarily, did not cause a recession on paper. However, it could be felt. The simple reason why this happened was that an increase in the short-term aggregate supply curvefurther reduced the prices such that either the recessionary gap was really small, or it did not exist. Now, it would have been a great policy as it reduces the recession. But one thing to understand here is that as the producers were asked to increase the supply, they did not realize the macroeconomic effect of the reduced demand. So, they kept on increasing the production until it was too late that they realized that the reduced demandaffected their sales and they were not able to sell what they produced and it all just filled up their inventories. Further, on the graph the prices must go down because the economy adjusts the prices as the Supply increases, however, this was also not realized. The inability of the producers to interpret the economic situation that increasing production and the ability to sell that production would reduce the price at which they are selling it. As the businesses started to realize this situation, they acted immediately reducing the supply massively. This happens because of uncertainty. The negative effect of the inability to sell and increasing inventories resulted in a much-decreased Aggregate Supply than the initial one. So, the policy to increase the supply did help with the recession in starting, but it was a temporary phenomenon that was bound to come down. This, coupled with economic shocks and COVID-19, reduced the aggregate supply to levels where the unemployment in the economy increased and Inflation also rose. This gave rise to the situation of Stagflation.



Money Supply, the total amount of money in circulation or existence in an economy, is one of the major reasons why people can buy. The money supply is influenced by the Reserve Bank of India and the amount of money in the Indian economy is controlled by the Reserve Bank of India through expansionary and contractionary monetary policy depending on the economic need. If the money demand in an economy is constant, a decrease in the money supply would increase the interest rates. Reduced money supply makes it pricier for consumers to take out a loan. In an open economy, where the prices are influenced by market forces of supply and demand, the price of money is also influenced by supply and demand. If a consumer demands more, but the supply of money is less, the consumer would enter the credit market and borrow. Interest rates here would determine the cost of the borrowed present money. If the supply of money is less, it will be difficult to seek credit. As demand increases or remains constant but the supply decreases, price rises. The interest rate is the price of money and so it increases when money supply decreases without a similar directional change in the money demand.

$$Money\ Supply \propto 1 \div Interest\ Rates \quad \text{(Constant Money Demand)}$$

Considering that the interest rates increased because of decreasing the Money supply, this would affect the investments in the economy.

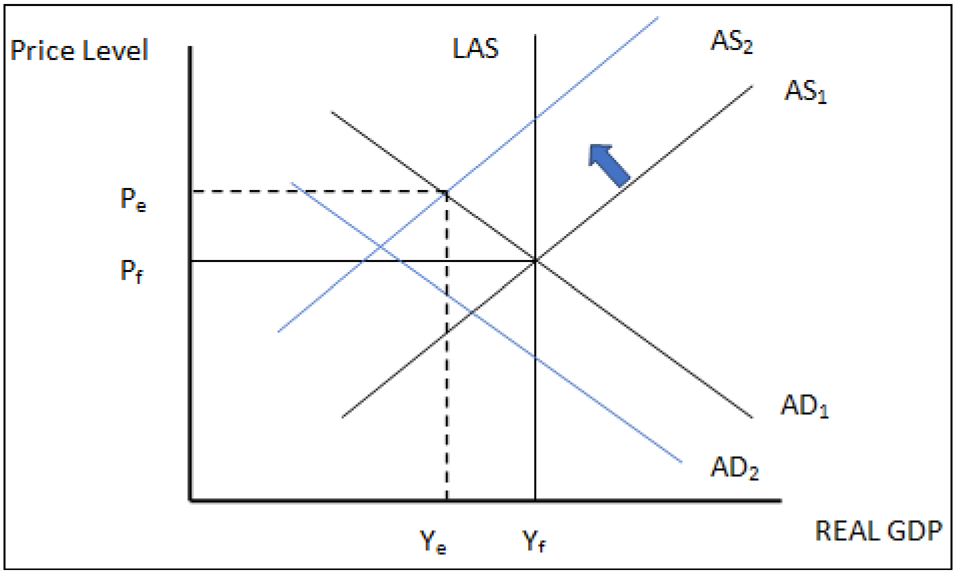
$$Interest\ Rates \propto 1 \div Investments$$

This means that as the interest rates (cost of borrowing) increase, investment in the economy decreases. It is costly for the entities to borrow money and so they wait until the cost of borrowing is less than the return they expect, and then they invest.

$$Investments \propto GDP$$

This means that the investment in an economy directly affects the Gross Domestic Product, the value of all the final goods and services produced by all the producers in the economy.

A decreased Money Supply because of Supply shocks in the economy further reduced the Aggregate Supply because there was a lack of money to invest. It can be understood by the below diagram. This caused the Aggregate supply to go down, even below the previous or original levels.



Effect of Insolvency and Bankruptcy Code

Apart from the obvious benefits stated in the Code and seen otherwise, the Insolvency and Bankruptcy Code is one of the hidden factors leading India to a recession. Several loopholes in the Code have affected the Money Supply in the economy by increasing disparity and, hence reducing the aggregate demand. At the time when the domestic economy was suffering from the cyclical change deepened by an acute reduction in the Money supply due to Demonetization, the introduction of the much controversial Goods and Service did plat its part. But the other law party to this recession, which was overlooked by most was the Insolvency and Bankruptcy Code. There are several problems in the law as a whole that make it an ill drafted law and a curse for the economy.

Insolvency and Bankruptcy Code has divided the creditors into two broad categories: Operational and Financial creditors. The financial creditors are further categorized as Secured and Unsecured Financial Creditors. At the time of liquidation of the company, the event when the assets of the company are sold to settle the dues to the creditors, this Code follows a preferential order that states the order in which the dues of the creditors will be settled. The first in line are the dues to the Secured Financial Creditors and the Workman dues. This includes the principal and the interest that has to be paid. Off the money left, the employees are paid their salary. Then come the Unsecured Financial Creditors and after all, these are settled, if money is left, the dues to the Operational Creditors and the Government dues are paid. The direct microeconomic problem here can be understood with a simple example.

Consider a Company 'A' entering the Insolvency and Bankruptcy for a resolution plan. But they have to liquidate their assets and payment of the debts. One thing to note here is that the Liabilities are more than the assets. This means that not all creditors will get full payment.

$$
\begin{aligned}
&\mathit{Assets\ of\ 'A'}\\
&< \mathit{Dues\ payable\ to\ (\ Secured\ Financial\ Creditors}\\
&+\ \mathit{Workman\ dues}\ +\ \mathit{Employee\ Salary}\\
&+\ \mathit{Unsecured\ Financial\ Creditors}\\
&+ \mathit{Operational\ Creditors} + \mathit{Governemnt\ Dues})
\end{aligned}
$$

Say, the value of all the assets of 'A' is ₹100,00,00,000. The division of the dues payable is the following:

Category	₹
Secured Financials Creditors	57,00,00,000
Workman Dues	3,50,00,000
Employee Salary	8,50,00,000
Unsecured Financial Creditors	25,00,00,000
Operational Creditors	20,00,00,000
Government Dues	15,00,00,000

In this hypothetical situation, if the value of the dues that have to be paid before Operational Creditors or the governmentgets anything, is ₹94,00,00,000. So, a settlement of ₹6,00,00,000 has to be made at a debt of ₹35,00,00,000. This harshly impacts both the government and the Operational Creditors. In many cases, Operational creditorsand the government end up getting nothing. The problem here is that the provision is to safeguard a few entities completely and leaving the rest to absolute loss rather than having a system of uniform loss such that all are equally affected, and the disparity is reduced.

Statistics show that the Operational Creditors are not able to get their dues back in most cases. This is the major loophole in this part of the law, responsible for the current deteriorating economic condition and the debt bubble to come. The Operational Creditors are the fundamentals on which the major economy is built. Financial Institutions do play a major role in money circulation and the money side of economics, but here we are not just talking about a few companies or firms not getting their dues. We are talking about thousands of Operational Creditors going bankrupt because they are not able to get their dues back. As a result, they are incurring losses or do not simply have the potential to pay for the expenses incurred. This results in them taking more credit. The increase in credit increases their liability. Due to already incurred losses and ongoing expenses, the businesses are not able to pay the interest on the loan taken, let alone the principal. As a result, they become insolvent and, in most cases, bankrupt. We see that to solve the Insolvency situation of one business, this law affects many other businesses at the same time. This effect does not stop at one level. It creates a multiplier effect. We make certain assumptions here:

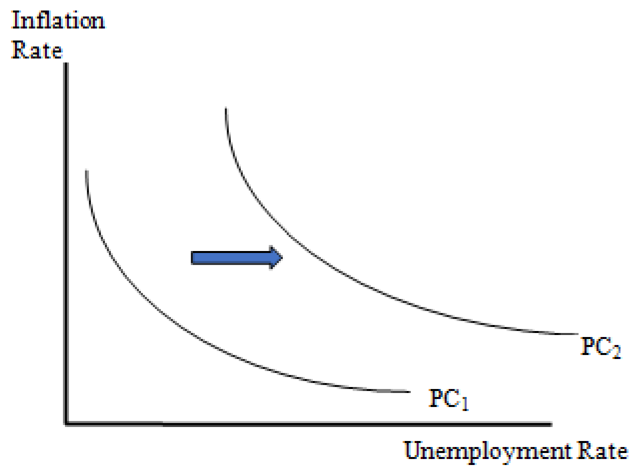
1) In the market, there are 100 entities of different market capitalizations.
2) The business of 1 entity (E_1) affects the business of exactly 2 entities (E_{12}) and (E_{13}) and is affected by the business of 2 entities (E_{01}) and (E_{02}).
3) The market capitalization of entities (E_{12}) and (E_{13}) is less than (E_1) and the market capitalization of (E_1) is less than (E_{01}) and (E_{02}).

This way we can imitate the structure of an economy, wherein, a big company is supported by smaller companies that either outsource or provide raw materials or any other service/product to the bigger company. These smaller companies are further supported by companies that provide the initial raw materials. This process goes on and on until we reach the primary producers.

Assuming that (E_1) owed ₹30,00,00,000 to (E_{12}) and (E_{13}), out of which only ₹6,00,00,000 were paid under the Insolvency and Bankruptcy Code.

$$\begin{aligned} \textit{Bad debts} &= ₹30,00,00,000 - ₹6,00,00,000 \\ &= ₹24,00,00,000 \end{aligned}$$

Because the business of (E_{12}) and (E_{13}) is just affected by two entities, the impact of huge bad debts (80%) of the debtors would be harsh. Considering that just 1 entity out of two goes bankrupt because of the large losses and inability to pay to the creditors, two more entities, say, (E_{121}) and (E_{131}) are affected. This would create a multiplying effect where the liquidation of 1 entity has made numerous entities insolvent. But this does not end here. Most of the Operational Creditors would supply a lot of big entities. If these basic suppliers get affected, the number of suppliers in the economy would drastically reduce. Apart from the reduction in the number of goods and services supplied in the economy at the basic level, the price would also increase. Because here the number of big companies demanding the raw materials are much more than the number of suppliers willing to supply the required quantity. This hike in prices would increase the prices for the end consumer. This gives birth to a rather complex economic problem: Stagflation. A condition in the economy where the prices increase but the aggregate supply falls. This can be explained on Phillip's Curve.



In this situation, the economy does not operate on PC$_1$ anymore. So, the economic law that as inflation increases, unemployment decreases, does not fully apply here. Because the curve itself shifts forward, the price levels i.e. the inflation rate increase and is coupled by an increase in the Unemployment rate as well, something explained before.

Further, the main purpose of the Insolvency and Bankruptcy Code, as mentioned in "The Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design" on Page 27, is "Striking a Balance between liquidation and reorganization". The other big problem with the implementation of this code is liquidation. The code was brought in to increase entrepreneurship by keeping the businesses running so that the economy keeps running and growing. However, right now the liquidation rate is close to 70%, which means of the businesses that enter Insolvency, 70% are liquidated: assets are sold to fill in for the liabilities. The major problem here is the reduction in the number of businesses. This reduction causes a decline in the total production of all the final goods and services in the country and thus reduces the Gross Domestic Product of the country as a whole, and GDP per Capita in particular. The other major problem attached to this is of reduction in the domestic supply. This is the reason why GDP reduces. The domestic production has reduced and so the country has to depend highly on imports. Being a country with a trade deficit, further reduction in Exports due to a reduction in the production and increased imports to fulfill the domestic demand, the GDP would further reduce. This causes a drop-in capital investment and a partial drop in the rankings of making business in a country. But the question we face is why India's ranking in ease of doing business increase then did? The increase in the ranking was a direct impact of the Insolvency and Bankruptcy Code and several other factors like improvement in starting a business, dealing with construction permits, and trading across borders. Insolvency and Bankruptcy have had certain amazing immediate results but the problem here is that a law guarding Bankruptcy is not wrong; it is probably the best thing the financial sector needs today,the problem is the focus on Secured Financial Creditors, those who will improve the ranking. The lack of focus on Operational Creditors will burn a hole in years to come when people realize the actual weakness in the foundation of the economy. Apart from these, a direct effect on a decrease in volumes of production in the economy would be on the Fiscal Income of the government in the form of various taxes. As it is, the government has crores of debt coupled with the inability to secure it from the debtor in most cases, owing to the Insolvency and Bankruptcy Code provision, a further Fiscal Deficit directly impacts the ability of the government to run the economy.

Implementation issues are another aspect where the Insolvency and Bankruptcy Code in general and the National Company Law Tribunal, in particular, are responsible.Delayed and prolonged decisions on Insolvency cases have a negative multiplier effect. If a business is stuck in Bankruptcy proceedings for months without any decision, the assets of the company are severely affected. Two situations broadly happen after the proceedings are over. Either the company or partnership is liquidated or with several restructuring, the operations start again, in hope that the business will prosper paying off the debts. But delayed proceedings tend to impact both of these situations. If, after months or sometimes years of bankruptcy, the business is liquidated, the value of the assets of the business goes downeven if they are not put to any use because of depreciation and amortization. So, the amount that the liquidation would bring up just keeps on decreasing and so does the money that the creditors will get. And if the business is restructured, the prolonged proceedings impact the ability of the business to catch up with the market upbringings and stopped operations that cause other indirect losses to the business. This directly contributes to the above-mentioned problem that either the businesses are reducing or are not functional.

2. Recommendations and Scope of Further Improvement

It can be safely concluded that there are a lot of unidentified loopholes in the framing and the implementation of the Insolvency and Bankruptcy Code. At a point in the economy when the Householddebt to GDPisthe highest at 12.6% and the Government debt to GDP is above the safe 60% (69.2%), another economic shock can weaken the state of the economy and make it vulnerable to a potential financial crisis. In such situations, businesses must continue, and the roots of the whole system are intact. Certain changes in the Insolvency and Bankruptcy Code can give the law the direction that it needs. Recommendations are:

1) While the Operational Creditors can file cases under this code, there is no representation of the operational creditors in the Committee of Creditors. As a result, all decisions in the committee of creditors are influenced by financial creditors. The representation has to be increased that would allow a fair distribution of the liquidated assets.
2) Assuming that the financial creditors have recovered some amount from the Bankrupt Company/Partnership in the form of interest, the amount distributed must be set off at a nominal interest rate or a reduced interest rate, in case, the assets are not able to meet up for the liabilities towards operational creditors and there isa disparity between the percent of the debt that is met of financial creditors and operational creditors. For example, if a company ‘A’ is worth ₹80 cr. and owes ₹60 cr to the Secured financial creditors and ₹30 cr. to the operational creditors. If before interest, the amount owed to the Financial creditors was ₹53 cr., it is advisable that the interest charged on the Principal be reduced so that the Operational Creditors can get a part of their principal.
3) The main purpose of this Code was to promote entrepreneurship, so, the resolution plan should focus on restructuring the business through changing the management or providing direct tax incentives so that the business can function and is not liquidated. If a company goes out of business, apart from entrepreneurs, the daily workers are also affected which further reduces the ability of the national to embed entrepreneurial skills. A focused approach toward keeping the business alive is extremely important.
4) The delay in the decision has to be looked into. A provision made in the law must be followed by the National Company Law Tribunal. The compliance has to be made stricter and the number of judges has to be increased. Timely decision-making would help shape the businesses and give them a direction without losing motivation. An increase in the number of NCLATs in the metro cities is also required.

The strong correlations between increasing insolvency cases and deteriorating economic conditions have given grounds for further research.

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