

# A code for corporate governance

By laying down norms that seek to prevent failure of companies and rescue them, the IBC 2016 has taken corporate governance to new heights

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**THE RAISON D'ÊTRE** OF a company is that it must live, generate value, and share the value equitably among stakeholders. Corporate governance is the framework which enables a company to do so. In this sense, the Insolvency and Bankruptcy Code, 2016 (IBC) serves as a *Code* for corporate governance. Its first-order objective is rescuing a company in distress. The second-order objective is maximising value of the company's assets, and the third-order objective is balancing the interests of stakeholders. This order of objectives is sacrosanct.

The IBC endeavours to save the life of a company in distress. It empowers creditors, represented by a committee of creditors (CoC), to rescue a company when it experiences a serious threat to its life. For this purpose, the CoC can take or cause a haircut of any amount to any or all stakeholders. It seeks the best resolution from the market, unlike the earlier mechanisms that allowed creditors to find a resolution only from the existing promoters. Further, the resolution plan can provide for any measure that rescues the company—change of management, technology, or product portfolio; acquisition or disposal of assets, businesses or undertakings; restructuring of organisation, business model, ownership, or balance sheet; strategies of turnaround, buy-out, merger, amalgamation, acquisition, or takeover; etc.

IBC provides a competitive, transparent market process, which identifies the person best placed to rescue the company, and selects the resolution plan. It mandates consideration of only feasible and viable resolution plans, that too, from capable and credible persons, to ensure sustained life of the company. This releases the company from the clutches of promoters and management, putting it in the hands of a credible, capable management to avoid liquidation. The IBC has rescued about 200 companies, some of which were in deep distress.

The IBC safeguards and maximises the value of the company, and, consequently, value for all its stakeholders. It enables initiation of resolution process at the earliest to preserve the value. It mandates resolution in a time-bound manner to prevent decline in the value. It doesn't envisage recovery, which maximises the value of creditors on a first-come-first-served basis. It doesn't

allow liquidation, which maximises the value for stakeholders who rank higher in the waterfall while destroying going concern value. Liquidation process commences only on failure of resolution process to revive the company.

The IBC facilitates resolution as a going concern to capture surplus. It makes an insolvency practitioner run the company as a going concern, prohibits suspension or termination of supply of essential services, mandates continuation of licences, permits and grants; stays execution of individual claims, enables raising interim finances for running the company, insulates resolution applicants from misdeeds of the company under the erstwhile management, etc. It provides for a market mechanism where the world at large competes to give the best value for the company through a resolution plan. The resolution plans have yielded 208% of the liquidation value.

Where value has been lost on account of irregular transactions, IBC enables clawback of such value. It even mandates retrieval of value lost due to failure to exercise due diligence. There is a twilight zone beginning from the time a director knew or ought to have known there was no reasonable prospect of avoiding the commencement of resolution process till the company enters resolution process. During this period, a director has an additional responsibility to exercise due diligence to minimise the potential loss to creditors, and he is liable to make good such loss. There is, thus, strong deterrence to prevent directors and promoters from causing loss of value to the company in the run-up to insolvency.

A company has two main sets of immediate stakeholders: shareholders and creditors. If debt is serviced, shareholders have complete control of the company. When the company fails to service the debt, the IBC shifts control of the company to the creditors. By moving from *debtor-in-possession* to *creditor-in-control*, the IBC balances the rights and powers of shareholders and creditors *vis-a-vis* a company.

The CoC decides the fate of the company. There are, however, check and balances to ensure that the resolution process yields fair and equitable outcomes for the various stakeholders. The IBC prescribes payment of a certain min-

imum amount to operational creditors and to dissenting financial creditors, payment to operational creditors in priority over financial creditors, a statement as to how a resolution plan has dealt with the interests of the stakeholders, etc. Though the ultimate discretion of what to pay and how much to pay to each class or subclass of creditors is with the CoC, its decision must reflect that it has taken into account maximising the value of assets of the company and it has balanced the interests of the stakeholders.

The IBC contributes to governance of a company even before it gets into distress. There is a credible threat that if a company defaults, and consequently it gets into resolution process, in all probability, it would move away from the hands of current promoters/management forever. Firstly, because the promoters may not be eligible to submit a resolution plan. Second, even if eligible, they may not submit the most competitive plan. This prevents use of resources below their potential before resolution, minimising the incidence of failure and default. In the long run, the best use of the IBC would be not using it at all. That would be the ultimate corporate governance.

The IBC shifted the focus of creditors from the possibility of recovery to the possibility of resolution, in case of default. A company prefers to keep itself resolvable all the time, should a need arise, and the market prefers to deal with a company which is resolvable. A resolvable company obtains a competitive advantage *vis-a-vis* non-resolvable companies through reduced cost of debt. If value of a company lies in informal, off-the-record arrangements or personal relationships among promoters or their family members, prospective resolution applicants may find it hard to trace and harness the value, making resolution of the company remote. A company prefers to have value, which is visible and readily transferable to resolution applicants. Similarly, a company keeps an updated information memorandum ready to enable expeditious conclusion of resolution process, if initiated. By incentivising a company to remain resolvable all the time, the IBC facilitates preparation of a sort of 'living will' for the benefit of the company as well as the society at large.

