

CoC Dharma: Maximisation with Fairness

Failure of a firm to service debt, which is otherwise known as insolvency, is an outcome of the market. The Insolvency and Bankruptcy Code, 2016 (Code), therefore, envisages market-led solutions to address insolvency. It offers resolution, wherever possible, and liquidation, wherever required, of the firm.

CoC

The Code believes that a limited liability firm is a contract between equity and debt. As long as debt is serviced; equity, represented by a Board of Directors, has complete control of the firm. When the firm fails to service the debt, control of the firm shifts to creditors, represented by a committee of creditors (CoC), for resolving insolvency.

Resolution invariably entails restructuring of business as well as liabilities of the firm as a going concern. The operational creditors (OCs) typically do not have the ability and willingness to restructure liabilities. The CoC may opt for liquidation to realise whatever is available, if it comprises OCs. The financial creditors (FCs), on the other hand, generally have the ability to restructure liabilities and to take business decisions, as may be required for resolution. The CoC, therefore, comprises FCs in the interest of resolution.

The Bankruptcy Law Reforms Committee, which conceptualised the Code, used, inter alia, two design principles, namely, (a) the liabilities of all creditors, who are not part of the process, must also be met; and (b) the rights of all creditors shall be respected equally. The Code accordingly envisages resolution for maximising the value of the assets of the firm to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders. Therefore, the CoC must maximise the value of the assets of the firm and balance the interests of all stakeholders, irrespective of its composition.

Maximisation of Value

If a firm has failed to service debt, most probably it is not performing well. If it has potential to perform well, the Code envisages and facilitates resolution to put the firm on a viable track, that improves its performance and maximises the value of its assets. The turnaround of the firm thus is the heart of resolution, that preserves the going concern surplus.

The Code does not contemplate recovery as it destroys the value of the firm. When creditors recover their dues - one after the other or simultaneously - from the available assets of the firm, nothing may be left in due course, bleeding the firm to death. Further, recovery serves the interests of the creditors on first come first serve basis - the creditor, who initiates recovery first, realises the highest, and who initiates the last, realises the least. The Code, therefore, prohibits recovery during resolution.

The Code does not contemplate liquidation either. Liquidation destroys the going concern surplus, and renders its resources idle till reallocation, reducing the value of the assets of the firm. Further, it considers the claims of a set of stakeholders only if there is any surplus after satisfying the claims of a prior set of stakeholders fully. The Code, therefore, does not allow liquidation until the option of resolution is exhausted.

Resolution preserves the going concern surplus (excess of fair value over the liquidation value), while liquidation destroys it. Therefore, the CoC must prefer resolution wherever fair value exceeds liquidation value. It must not confuse fair value with resolution value, which a resolution applicant offers for resolution of the firm. It must engender competitive resolution plans through appropriate enhancement to push up the resolution value. Then it must extrapolate the resolution value to arrive at the fair value. If such fair value exceeds the net liquidation value (liquidation value minus the cost of liquidation), it must avoid liquidation.

The Code does not contemplate a haircut simpliciter that diminishes value for a creditor. It also does not contemplate sale of the firm where stakeholders merely trade places. One does not need the Code (IP, interim finance, calm period, essential services, CoC, resolution applicant, resolution plan, voting, etc.) for selling a firm or any rights in the firm. The Code envisages resolution plans which uniquely package limitless combinations of business, financial and operational restructuring entailing change of technology, product mix or management; acquisition or disposal of assets or businesses; infusion or withdrawal of resources in cash or kind; modification of capital structure or

leverage; capability and credibility of resolution applicant; etc.; immediately or over a period of time, as may be required to resolve insolvency of the firm as a going concern. Consequently each resolution plan has a unique likelihood of resolving insolvency and its sustainability. The Code, therefore, envisages application of mind by market savvy FCs, through deliberation and voting for approval of the best resolution plan.

Fairness

The CoC or its members do not own the assets of firm. They hold the assets as trustees for the benefit of all stakeholders. The gain or pain emanating from the resolution, therefore, need to be shared by the stakeholders within a framework of fairness and equity. The CoC must not allocate a higher share of gain or a lesser share of pain to FCs. It must not allow FCs to be paid before the OCs are paid. That is why the Code mandates that the OCs be paid first and be paid at least the liquidation value.

A firm gets credit from FCs and OCs. Neither credit is enough for a firm nor does the State have any reason to promote either. If OCs, for example, are not provided a level playing field, they would not provide goods and services on credit. If their interests are not protected, they will perish. This defeats the objective of promoting the availability of credit. Similar argument applies to creditors of OCs. The CoC, therefore, must not discriminate amongst the creditors.

The Code allows initiation of resolution process on default of a threshold amount. If it is initiated early, the firm can probably meet the dues of all the creditors, and yet remain viable. In such cases, the CoC must not approve a resolution plan that curtails the rights of shareholders. Wherever such curtailment is absolutely required, it must be reasonable and not more than required, subject to the shareholders getting at least the liquidation value.

Statutory Role

The CoC has a statutory role. It discharges a public function. It can even write off dues of stakeholders. It must, therefore, apply the highest standards of duty of care. It must not only follow the due process, but also be fair towards all stakeholders and transparent in discharge of its responsibilities.

The CoC influences the resolution plan through an evaluation matrix. If the evaluation matrix assigns zero weight to claims of OCs, the resolution applicant may not offer any value for them. If it assigns a higher weight to claims of a class of OCs, the resolution applicant may offer higher value for that class of OCs. Similarly, if it assigns zero weight to improved productivity, resolution applicant may not offer better technology. The CoC must design the evaluation matrix to engender resolution plans that consider the interests of all stakeholders of the firm with fairness and equity, while maximising the value of the assets of the firm.

The Code has demarcated responsibilities of CoC and IP, while assigning certain responsibilities to them jointly. For example, the CoC needs to approve a resolution plan after considering its feasibility and viability, while the IP needs to file an application before the Adjudicating Authority in respect of fraudulent transactions seeking appropriate relief. The CoC must not encroach upon the role of IP and must not allow the IP to encroach upon its role.

The CoC must have competent and empowered representatives of FCs. The representatives must attend the meetings, deliberate the matters and take decisions in accordance with the provisions of the Code. It should also benefit from the presence of members of the suspended board of directors of the CD and OCs in its meetings. This will prevent delay in concluding of the process and consequential depletion of value.

Conclusion

A firm embodies interests of many stakeholders. The CoC holds the key to the fate of the firm and its stakeholders. It is the custodian of public faith during resolution process. It must pursue resolution and avoid recovery, liquidation, or sale of the firm. While pursuing resolution, it must maximise the value of the firm for the benefit of all stakeholders. It must rise to the occasion to preserve its stature and authority granted under the Code.

Dr. M. S. Sahoo