IBC: A Code for Corporate Governance

By laying down norms that seek to prevent failure of companies and rescue failing companies, the Insolvency and Bankruptcy Code, 2016 has taken corporate governance to new heights in the country.

A company is an amalgam of many stakeholders. Each stakeholder, however, has a unique objective function, with a distinct set of rights, interests, and level of engagement with the company. Consequently, the interests of one stakeholder may conflict with those of another and / or of the company. The stakeholders may work at cross purposes, and even against the interest of the company. In their drive to maximise the upside for them while enjoying limited liability, the shareholders may expose the company and other stakeholders to unlimited liabilities. Such conduct has potential to benefit a set of stakeholders, often at the cost of another, the company and the society. Persistent uneven sharing of losses and gains may endanger the life of the company.

A variety of norms such as independent directors, key managerial personnel, regulation of related party transactions, protection of minority interest, financial and secretarial audit, timely and accurate disclosures about material matters, taxes and subsidies, corporate social responsibility, etc. - collectively referred to as called corporate governance - endeavour to synchronise and balance the interests of the stakeholders, subordinate the interests of immediate stakeholders to those of the company and establish precedence of interests of the society over those of the company. Some jurisdictions have codified these norms through codes for corporate governance. India too has well-codified corporate governance norms and has been continuously raising the bar for them. The Companies Act, 2013 and SEBI regulations serve as important milestones in this direction. These norms typically apply to a company in normal times when it is managed by shareholders, represented by a Board of Directors, with assistance of a governance professional.

A company has indefinite life by law. There is, however, a continuous threat to its life from the 'market'. It loses business to others when it fails to compete with its peers. Every other company is its predator - a company swallows another company for its own growth, through a variety of hostile or friendly restructures. *Creative destruction* often destroys more companies than it creates! Consequently, the average life of S&P 500 companies has reportedly reduced from 90 years to 18 years over the last century. The average life span of publicly traded companies, taking into account acquisitions, mergers and bankruptcy, is about 10 years,[1] though longest life, a company ever lived, is 1429 years.[2] Thus, a company having perpetual succession now lives shorter than a human![3] The strategies of resilience and adaptation, research and development, risk management, sustainable business model, visionary leadership, preparedness for unknown unknowns, etc., minimise threat to the life of a company. There is, however, no governance norm to have such strategies, though many have these on their own volition.

The companies are modern engines of growth. They have huge resources and are very powerful. They often have organisational capital, which represents the excess of the fair value of the company over liquidation value of its assets. Closure of a company destroys its organisational capital. It takes years of efforts to bring up a company, which can replace an existing one. Therefore, it is necessary to rescue a company, with a viable business, from premature death, and nurse it back to normal life, while also aiming for higher growth by stimulating competition and innovation and eliminating anti-competitive conduct at marketplace.

The raison d'être of a company is that it must live, and it must generate value and share the same equitably among stakeholders. The framework which enables a company to do so is, in essence, corporate governance. 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 assets of the company and the third order objective is promoting entrepreneurship, availability of credit and balancing the interests of all stakeholders. This order of objectives is sacrosanct.[4] By laying down governance norms for companies in distress, the IBC has taken corporate governance to new heights in the country. Some scholars, however, consider corporate governance and insolvency arrangements as different parts of a continuum in the life of a company.[5] The OECD advocates an effective and efficient insolvency framework to complement corporate governance framework.[6]

Saving Life

The IBC endeavours to save the life of a company in distress. It is a beneficial legislation which puts the company back on its feet, not being a mere recovery legislation for creditors.[7] It bifurcates[8] the interests of the company from that of its promoters / management with a primary focus to ensure revival and continuation of the company by protecting it from its own management and from death by liquidation.[9] If there is a resolution applicant, who can continue to run the company as a going concern, every effort must be made to try and see that this is made possible.[10]

The IBC empowers creditors, represented by a committee of creditors (CoC), with the assistance of an insolvency practitioner, 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 which allowed creditors to find a resolution only from the existing promoters. Further, the resolution plan can provide for any measure that rescues the company. It may entail a 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 turn-around, buy-out, merger, amalgamation, acquisition, or takeover; and so on.

The IBC provides a competitive, transparent market process, which identifies the person, who is best placed to rescue the company and selects the resolution plan, which is the most sustainable under the circumstances. It mandates consideration of only feasible and viable resolution plans, that too, from capable and credible persons, to ensure sustained life of the company.

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1. Daepp MIG, Hamilton MJ, West GB, Bettencourt LMA (2015), "The Mortality of Companies", Journal of the Royal Society Interface 12(106).
2. Kongō Gumi Co., Ltd., a Japanese construction company, which survived the Meiji Restoration and two atomic bombs, but could not survive debt and went into liquidation in 2006.
3. The country where people live the longest is also home to some of the oldest companies in the world.
4. Binani Industries Limited Vs. Bank of Baroda & Anr., [CA (AT) No. 82,123,188,216 & 234 -2018].
5. Mr. Stilpon Nestor at the third meeting of the Latin American Corporate Governance Roundtable, April, 2002.
6. OECD (2015), 'G20/OECD Principles of Corporate Governance', OECD Publishing, Paris.
7. Swiss Ribbons Pvt. Ltd. & Anr. Vs. Union of India & Ors., (2019) 4 SCC 17.
8. The Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 propose to separate promoters (Chairman) from management (Managing Director) of the company with effect from April 1, 2022. Swiss Ribbons Pvt. Ltd. & Anr. Vs. Union of India & Ors., (2019) 4 SCC 17.
9. Swiss Ribbons Pvt. Ltd. & Anr. Vs. Union of India & Ors., (2019) 4 SCC 17.
10. Arcelor Mittal India Private Limited Vs. Satish Kumar Gupta and Ors., (2019) 2 SCC 1.

This releases the company from the clutches of current management and puts it in the hands of a credible and capable management to avoid liquidation. The processes under the IBC have, up till now, rescued about 190 companies, some of which were in deep distress.

Maximising Value

The IBC safeguards and maximises the value of the company and consequently, value for all its stakeholders. First and foremost, it enables initiation of resolution process at the earliest to preserve the value, when the stakeholders have the motivation to rescue the company rather than liquidate it. It mandates resolution in a time-bound manner to prevent decline in the value with time during resolution process, reducing motivation of the stakeholders to opt for liquidation. Further, it does not envisage recovery, which maximises the value of the creditors on first-cum-first-serve basis, while bleeding the company to its death. It does not allow direct liquidation, which maximises the value for stakeholders who rank higher in the waterfall, while destroying organisational capital. Liquidation process commences only on failure of resolution process to revive the company.

The IBC facilitates resolution as a going concern to capture going concern 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 licensces, permits and grants; stays execution of individual claims, enables raising interim finances for running the company, insulates the resolution applicants from the 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 about 200% of the liquidation value. It also maximises value through sale of the company or its business as a going concern, even after the liquidation process has commenced. These provisions endeavor to maximise the value of the company.

Where value has been lost on account of undesirable transactions (preferential transactions, undervalued transactions, extortionate credit transactions and fraudulent transactions) with related parties in the preceding two years or with others in the preceding one year, the IBC enables claw back of such value. It even mandates retrieval of value lost due to the failure to exercise due diligence. There is a twilight zone which begins from the time when a director knew or ought to have known that there was no reasonable prospect of avoiding the commencement of resolution process of the company 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 the creditors of the company and he is liable to make good such loss.There are thus, strong deterrence measures to prevent directors and promoters from causing loss of value to the company in the run up to insolvency.

Balancing Interests

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 for resolving insolvency. The IBC moved from *debtor-in-possession* model to *creditor-in-control* model, balancing the rights and powers of shareholders and creditors vis-a-vis a company.

While the control shifts to creditors, the CoC has authority to take decisions about the fate of the company. There are, however, several check and balances to ensure that the resolution process yields fair and equitable outcomes for the various stakeholders – financial creditors (FCs) and operational creditors (OCs) and secured and unsecured creditors. The IBC prescribes several balances in a resolution process such as payment of a certain minimum amount to OCs, payment to OCs in priority over FCs, payment of a certain minimum amount to dissenting FCs, requirement of a statement as to how a resolution plan has dealt with the interests of all the stakeholders, including FCs and OCs, etc. The ultimate discretion of what to pay and how much to pay to each class or subclass of creditors is with the CoC, but its decision must reflect the fact that it has taken into account maximising the value of assets of the company and the fact that it has balanced the interests of all the stakeholders.[11]

Proactive Governance

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 under the IBC, in all probability, it would move away from the hands of current promoters / management for ever. 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, or the creditors may choose liquidation. This prevents use of resources below their potential before resolution. The scheme of incentives and disincentives under the IBC has brought in behavioural changes on the part of every stakeholder of a company, minimising the incidence of failure, default and under-performance. In the long run, the best use of the IBC would be not using it at all. That would be the ultimate corporate governance.

Going Forward

A well governed company commands respect of the society and a premium from stakeholders. A company should be so governed that it is unlikely to have distress, and, in rare eventuality of distress, it should facilitate its resolution without loss of much time and value. This is important because 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 against non-resolvable companies through reduced cost of debt. The value of a company often lies in informal, off-the record arrangements or personal relationships among promoters or their family members. In such cases, 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 prospective 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.

(Dr. M. S. Sahoo)

11. Committee of Creditors of Essar Steel India Limited Vs. Satish Kumar Gupta & Ors., Civil Appeal Nos. 8766-67/2019 and other petitions.