

Handling Business Failure: A Dharmic Way



Under the IBC, 2016, existing default to payback the debt is considered a sign of business failure. However, if you go under the skin, you will realize that default is not the cause but a symptom of business failure. It is like a doctor in a small town immediately gives you some pills to cure your fever but those sitting in reputed medical institutions consider fever as symptom of any major infection. They administer fever control pills only if the fever is very high and damaging. Describing his personal experiences, the author argues that the lack of cash in hands of businessmen to continue their businesses brings them to a point of standstill, which ultimately leads to closure.

Read on to Know More...



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1. Introduction

Day-in & Day-out, we come across many business successes and umpteen number of failures. In our business streets, some of the new shops, showrooms & small hotels opened in the last 1-2 years back are no longer there. In some cases, those shops continue to exist with a new set of owners, as the earlier owners were not able to run it viably.

Quite often, we hear about some of our acquaintances incurring losses in their business resulting in the loss of even their houses. On its extremity, we come across disturbing news of some family suicides in newspapers, due to business / personal debts. While coming across all such business failure news and incidents, many of us feel pity for their bad luck and often we generalize such failures to their inefficiency, poor planning, greediness and being over ambitious etc., etc.

Business failure is part and parcel of any business process. One may fail in one business for various reasons. But that is not the end of his life. He can explore the next available opportunity for success. After all, a child learns to walk after repeated falling. Learning the art of balancing on her legs happens through repeated trial and error process. All said and done on positive side, is the business failure so simple to handle? For a man of positivity, the answer is

certainly YES.

When this question is put to me, I have answered it as “YES, provided there is no repercussion”.

The next question was what you mean by “Repercussion”. I simply answered it as “One person’s loss should not become another person’s loss”. Let me try to explain my understanding of Dharma in the context of handling a business closure [rather a business failure] by a sensible businessman.

2. Possible Causes of Business Failure

Before dealing with Dharma, let’s analyze some of the business elements causing success and failures, business

Asset	Liability	Profit	Loss
Capital	Sales	Purchase	Taxes
Lenders	Workers	Customer	Suppliers

environments and the interested stakeholders.

I am not going to define each of these terms here. Just listing the key components of a business.

When a business flourishes, they attribute the success to hard work put in by the owner, her determination and managing skills. On the flipside, when it fails, the reasons for failure expand as usual, as the reason for failure is always “You” and not “Me”.

Let’s list some of general reasons of business failure we hear very often:

- Sales didn’t pick-up as expected [Market expectation gap]
- Cost of manufacturing was very high [unable to cover-up fixed costs]
- Lack of adequately trained manpower [high attrition]
- Lack of adequate working capital fund flows

This list can grow much bigger, as we are experts in pinpointing reasons for failure. The question here is,

“Did the businesspeople know all these likely problems upfront?”

[OR]

“Did they conveniently overlook these matters in their pursuit of being optimistic about their business and its management?”

3. Loss V/s Cash Flow Issue

The layman thinks the reason for business closure is continuous losses. However, in reality the businesses get impacted/closed on account of cashflow issues. In 2008, the financial meltdown started because the Lehman Brothers did not have money to pay their dues, although they were always profitable in papers until their last quarter results.

In my experience and knowledge, I have come across at least 1000+ cases of small business failures and/or bankruptcies in the garments sector, just because of bankruptcy of an overseas buyer!!

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This is not a unique phenomenon in the export segment alone. There are many small-scale businessmen, who close their businesses, because their customer(s) fail to make the payments. The lack of cash in their hands to continue the business brings them to a point of standstill, ultimately leading to closure.

4. Hopeless Hope & Consequences

Many entrepreneurs, with the hope of recovery in the near future, borrow funds from friends and relatives and invest in their business. After exhausting those sources, they next resort to high interest borrowing from private money lenders to continue their business. Besides such borrowings, they take more and more supplies on credit and use those funds also in their business. When their continued optimism & unrealistic recovery dream fails, it causes serious financial repercussions in society.

Individually, they lost in their business. But their “Hopeless Hope” leads to multiplier effect:

- The friends and relatives, who have lent them on trust end up loosing their money
- The suppliers who gave on credit lose their money, which in turn may push them towards insolvency.
- The default on the loans taken from banks causes loss to the banks and their depositors.

One failure leads to another failure, due to irrational behavior of the hopeful entrepreneur. It’s true that the

person had tried his best for a business success. He may be an honest man, but his business failure not only eroded his wealth, but the wealth of all those who trusted him. The biggest question here is, does anyone have the moral right to carry on business with other's money and lose it?

5. Leveraging Beyond Limits

There is a famous saying that "An Intelligent will earn Money with Others Money". So long as you are successful, there is no problem in trading with other's money. The trouble starts at the point of incurring loss. When a loss occurs, whose money is he losing?

Losing the money of those who trusted him not only upset the trust and faith of the individual, but the whole financial and economic activity. Such irrational behavior of the optimistic businessmen causes serious repercussions in the financial system and the on-going business / economic activity of the society:

- a. Bankers charge high interest rate margins on lending, when the failure rate is high (e.g., credit cards are charged @ 3% p.m. as repayment failures are high)
- b. Small savings of individuals are not reinvested into the business cycle, because of the fear of failure of businesspeople.
- c. At times, to hide failure, few resort to unhealthy / illegal business activities thereby spoiling the total business credibility [e.g., adulteration, etc.,]
- d. This vicious circle of debt and the promoter's attitude of holding on to the assets, becomes a national waste as many of the productive assets and resources remain unutilized.
- e. Some business failure leads to yet another, wherein this chain of failures results in loss of many gainful employment in the society.

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Additionally, the entrepreneur's family & their lifestyle gets toppled. On good days, the spouse and kids would have enjoyed a comfortable living and good schooling. Business failure leads to the loss of their homes. The

financial stress disrupts the morality of the family altogether. Many family suicides we come across are mainly on account of financial stress and reputation loss in society.

6. Point of Insolvency

Morally, no one has the right to carry on a failing business, when his capital is eroded. Once his entire Net worth is lost, the entrepreneur starts playing with the money of lenders and suppliers. Any further loss in the venture is no longer his loss. It is the loss of his trusted stakeholders [Creditors].

Every entrepreneur presumes the recovery is certain if he somehow manages to stay in the business. In more than 99% of such cases, this tendency of "somehow continuing to stay" further widens the loss and leads to vicious circle of debt [i.e., new borrowing for servicing the old debt].

Increased debt, higher interest cost, higher procurement cost due to lack of capital, higher operating cost, low sales etc., ultimately lead to insolvency. Such chronic financial stress collapses the entire business, which otherwise may be viable at certain borrowing levels.

In an ongoing stressed business, which is the right point for deciding its continuity?

- a. When your asset value equals the liability (without own capital). i.e., when your entire capital investment is eroded on account of cash losses. At this point, you have a fair chance of disposing of all the assets and settling the liabilities. No one will lose, although you have lost.
- b. If you fail to take appropriate action at this point and continue to incur loss beyond this point, you become the source point for chain of losers in the forthcoming period.

This point of "Assets equals (or marginally exceeding) the debt value" is the point of insolvency for the business. Beyond this level, if business continues, the probability of "Vicious circle of debt" is high for any business and the chance of collapse magnifies.

7. Point of Insolvency as per IBC

The Insolvency and Bankruptcy Code 2016 hints the start point of insolvency as "Failure/Inability to honor any debt on its due date" [whether financial or operations].

The law makes the point simple. When an entrepreneur can't pay his bill on a date, it clearly depicts his inability to manage the cashflow and the increased chance of failure. The present law stipulates monetary threshold of ₹ 1 Crore for initiating insolvency process against companies [with some variations for MSME companies, partnership firms & individuals].

The intent of the law is to identify stress at the earliest possible instance and find a viable buyer to continue the business, so that the business and employment of many are continued without any disruption (may the owners change). Will the business owners understand this intention of law in its right perspective?

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Certainly, a "Big No". Given the proprietary mindset of many Indian businessmen, and their way of perceiving the business failure as personal failure, almost all of them continue to hold the rotten apple tightly causing serious financial and economical repercussion in the business world.

8. NPA Classification of Bank

This new version of insolvency law is still evolving. The law & procedures are being tested with the stalwarts. On the other hand, the stress identification in the form of NPA classification and SARFAESI auctions are more than two decades old in our banking circle.

IBC narrows the point of insolvency as failure to repay the debt which is due. Whereas the RBI norms narrow the point of insolvency as 90th day from the date of default. On the 91st day, they brand the loan as Non-Performing Asset (NPA). All the entrepreneurs cry and make a huge noise at this point that

"My business is still doing Good. Due to temporary cashflow mismatch, there is delay in repayment. Just because I have delayed the installment for 3 months, it doesn't mean that I have to lose the business".

"Bank has not supported me at the right time. If they had given the additional loan, I would have solved serviced the orders and repaid all the loans."

As these NPA classification & consequential actions are legal norms, no one is ready to hear their cries. Any number of DRT (Debt Recovery Tribunal) filing & writ petitions in this matter, just enriched the lawyers. *Leave aside these norms, let me ask a question here. Is the entrepreneurs' cry genuine?*

Sitting in the shoes of the entrepreneur, you may feel that they are right. At this point, let me ask you the next question - Is the bankers, real reason for business failure?

Before you conclude your answers, ensure to evaluate the following facts also, for the given business of any entrepreneur:

- a. What shall be the right amount of own capital & borrowings in a given business [Debt: Equity]?
- b. Is it appropriate to use the entire CC / OD limits to its brims, without keeping any reserve for tougher times in the business?
- c. Is it appropriate to use the short-term funds for long term uses [i.e., buying land, plant & machinery with the OD/CC borrowings]?

From the lender's angle, when a party can't service their debt even after giving 90 days additional time, they presume a chronic financial issue in the business and hence they classify it as NPA for further course of initiating recovery actions (after all, they are answerable to the deposit holder's money).

9. Tough Business Decision

In the angle of insolvency law, when you fail to honour any bill or debt on its due date, the point of insolvency kicks in. Whereas bankers grant 90 days waiting time.

The point of insolvency may vary between statutes. The end result is the same. Whether the entrepreneur takes appropriate tough decision on its continuity at the crucial point, that is the key for holding on to the business dharma. Explaining directive principles for head/leader of the State (King), the great philosopher and polymath Archarya Chankya¹ has said, "All urgent calls he shall hear at once, but never put off; for when postponed, they will prove too hard or impossible to accomplish¹." In the context of business leaders, one of the key takeaways from this verse is - tough decisions should be taken on time, when business needs it.

¹ Arthashastra. Part-I, Chapter 19, Shlok. 35.

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In business, there are times wherein owners are put in tricky situation demanding a tough decision. It includes the decision of whether to continue the business or not. A deeper understanding of the business situation and financial prudence should guide the businessmen in arriving an appropriate business decision.

Every business owner wants its business to be successful. Every businessman dream of becoming a billionaire.

When everything goes well, it's happy doing & happy ending. However, in reality many go in the opposite direction and end up incurring losses.

When your business travels northwards, at what point of time you will take the tough decision of closure is crucial for an honest business closure and holding back the trust and faith of the kith & kin. At times, timely closure holds the path of Dharma, as the arrest of loss safeguards the wealth of many.

