Why both Protection and Dissemination of Information under IBC are Critical for a Successful Insolvency Resolution?

Access to the right information at the right time is very crucial for various IBC processes starting from filing of CIRP application to withdrawal, resolution, or liquidation of the CD.

Creditors, lawyers, IRP/RP, CoC, investors, Successful Resolution Applicant, and ARCs etc., need reliable pieces of information to participate in CIRP and make relevant decisions. Besides, CIRP itself is a big source of information which is generated in CoC meetings, and during its interaction with various stakeholders. In this article, the author analyses the importance of reliable information at various stages of IBC processes, highlights loopholes and makes recommendations for preparing a robust information sharing mechanism.

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1. Introduction

A major feature of a market economy is its dynamic selection mechanism whereby the strong and efficient enterprises replace weaker and less efficient ones, and new processes and products replace older ones. Some entrepreneurs and firms are unable to withstand the competitive pressure and exit the market, enabling their resources to move to more efficient employment. The Schumpeterian concept[1] of creative destruction encapsulates this dynamism. The establishment of new market-oriented economic systems in growing economies like India[2] accentuate the selection process and give it more prominence than in mature market economies.

The high rate of entry and exit of new firms in an economy also highlights the operation of the selection mechanism on the ground. One of the objectives of the Insolvency and bankruptcy Code, 2016 (IBC) is to regulate this selection mechanism. It establishes the procedures for the orderly exit of failed enterprises and the re-allocation of their assets and other resources into new firms and new activities. Moreover, the prescribed insolvency procedures

[1] https://businessjargons.com/schumpeters-theory-of-innovation.html
[2] Suphan Sarkorn, Rattaphong Sonsuphap, Pirom Chantaworn. (2022) The political economy transition in a developing country. Corporate and Business Strategy Review 3:2, special issue, pages 339-348.

in the IBC provide a legal assurance to the potential investors and creditors of a Corporate Debtor (CD) that even in the case of financial distress and business failure, there will be clearly defined legal processes at work to prevent a rush on the assets of the distressed firm and to regulate the distribution of the resolution proceeds of the firm under a Successful Resolution Plan (SRA) or distribution of liquidation dividend from the estate of the firm under liquidation amongst its creditors. This very purpose is served by the provision of moratorium to prevent any individual creditor from enforcing a claim against the company so that only the Insolvency Professional (IP), under the supervision of the insolvency court (NCLT), can make distributions to creditors in as per provisions of the IBC.

2. Genesis of Information Asymmetry

The triggering of the insolvency process is one of the important points at which the information asymmetry between the CD and others may generate serious perverse incentives and inefficient outcomes. It is essential that all stakeholders of a firm are made aware of its possible default or insolvency as soon as possible. Even in mature market economies with developed financial markets and institutions, it is recognised that a firm's financial distress may not always be picked up sufficiently early by the creditors, financial analysts, and markets. The management of a failing corporate debtor are in a unique position of knowing the affairs of the company and its potential imminent distress well in advance than other stakeholders.

Managers also have a tremendous incentive to distort information as they attempt to gain even more credit even when they are aware of their inability to pay. Since it is difficult to have an effective corporate control that can keep the management in check, there is a case for framing mandatory disclosure rules, and even stronger case in the context of insolvent corporate debtors[3]. The management of corporate debtors whose default is imminent, may embark on opportunistic behaviour aimed at benefiting themselves, by engaging in highly risky undertakings to prolong their control over the firm[4]. Thus, although as per law the insolvency procedure may be triggered by either the debtor itself or by a bona-fide creditor, it has often been argued that the management should be required by law to declare their insolvency within a short period of realising that their company may default on its debt. In the interest of addressing information asymmetry and considering the reluctance of large creditors like banks to initiate insolvency process even after an event of default, Bankruptcy regulator may consider making managers of defaulting company responsible to file a petition in bankruptcy court within a specific time of default.

3. Marketisation of Insolvency process

IBC has been designed as a market-oriented law and has enabled development of a new marketplace where sales of stressed corporate debtors take place and accordingly, the IBC has morphed into a branch of the laws governing mergers and acquisitions. The marketization of bankruptcy process has also been driven largely by two phenomena: (1) the growth of secondary markets for claims against distressed firms and (2) the growth of large pools of capital that purchase these claims, or other interests in, or assets of, failed companies[5]. The players in this arena can be either Asset Reconstruction Companies (ARCs) or AIFs or even large corporates with deep pockets. Today, all these entities play an increasingly important role in bankruptcy reorganization because of their access to capital, nimbleness of decision making and expertise in resolution.

4. Why Does Information Matter?

To function efficiently, markets need at least two things: capital and information[6]. While capital can be raised from markets, it is the availability of robust information about CD in an insolvency case, which is critical to development of efficient market for stressed assets.

Information plays an unusually important role in bankruptcy for both "private" and "public" reasons. The

[3] See David A. Skeel, Jr., Rethinking the Line Between Corporate Law and Corporate Bankruptcy, 72 TEX. L. REV. 471, 542 (1994).

[4] Failure's future: Controlling the market for information in Corporate Reorganisation by Jonathan C. Lipson

[5] For discussions of the development of this market see Robert D. Drain & Elizabeth J. Schwartz, Are Bankruptcy Claims Subject to the Federal Securities Laws?, 10 AM. BANKR. INST. L. REV. 569, 576 (2002) (describing the market for distressed debt, particularly trade debt, but noting the liquidity of debentures and bonds); Chaim J. Fortgang & Thomas M. Mayer, Trading Claims and Taking Control of Corporations in Chapter 11, 12 CARDOZO L. REV. 1 (1990); Paul M. Goldschmid, Note, More Phoenix Than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process, 2005 COLUM. BUS. L. REV. 191, 193 n.6 (noting that the term "distressed-debt investors... refers to a class of investors who purchase the assets or claims of firms once their debt or operations become 'distressed'");

[6] See Ronald J. Gilson and Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev.549, 555 (1984) (discussing "focus on the distribution of information as a determinant of capital market efficiency."). "Despite certain anomalies, numerous studies demonstrate that the capital market responds efficiently to an extraordinary variety of information." Id. at 551

private rationale has been that forcing information disclosure has a deterrent effect that prevents pre-default misconduct by corporate debtors (e.g., the creation of secret liens/avoidance transactions/diversion of funds) and that it promotes reinvestment by enabling existing (or potential) stakeholders such as banks or even equity/debt investors to make informed decisions about further investment/credit to the corporate debtor, especially as regard to matters of valuation and governance.

Once a CD defaults and is insolvent, the creditors will need this information to decide whether to initiate CIRP or to sell their claims to ARCs, or to take alternate action to recover their dues. For a CD undergoing insolvency, creditors who are members of CoC will need this information to vote for or against a resolution plan. Hence, the availability of robust and reliable information about a corporate debtor will maximize its value, and thus creditors' recoveries.

5. Problem of Information Evasion/Alienation in Insolvent Companies

Most of the insolvency matters face the challenges of information asymmetry. Forcing timely disclosure of information about the insolvent CD from promoters/ managers to Resolution Professional (RP) as well as creditors has been a major challenge in the past and an important aspiration of IBC. In most CIRP (Corporate Insolvency Resolution Process) cases, the audited accounts of CD are not finalized for the several years prior to default. Even when the RP approaches NCLT and is able to get a suitable direction, promoters remain non-cooperative and non-compliant. However, neither our Company's Act nor IBC has been able to tackle this rampant evasion of information in the absence of effective disincentives and penalties. Without such critical information about past dealings of CD, the CIRP is frustrated at the outset, and it becomes very difficult to market the asset of CD to potential resolution applicants (PRAs) without robust and reliable data.

In addition to the above, most of the corporate debtors apparently enter bankruptcy with fewer unencumbered assets. This means they have little cash-flow available to devote to investigation into how and why the company ran into trouble in the first place. Such information about the CD is critical for its revival and to detect the avoidance

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transactions, but the reality is that most CoC members are reluctant to go for it in all out manner as costs of such detailed audit/ investigation are high and add to CIRP costs and reduce their recoveries from sale of assets. The CoC's haggling on the fees quoted by good forensic auditor is not conducive for such investigation. Lastly, even where significant avoidance transactions have been discovered through investigation, there are hardly any matters where creditors are able to recover funds by pursuing avoidance action in insolvency courts. Hence the IBC and underlying regulations needs more clarity on the enforcement of its avoidance provisions so that creditors are encouraged to dive in deeply into the past conduct of CD and are able to recover significant of haircuts through such recoveries from promoters.

6. How to Approach the Information Asymmetry

Legally speaking, the problem of information asymmetry can be approached from one of three perspectives. First, a "transactional" model views information sharing and verification as rational market behavior in commercial transactions. Thus, in a negotiated transaction, reasonable parties must recognize that information sharing is in their common interest, as this will facilitate the discovery of a "right" price for the deal in question.

A second model is adversarial, such as in litigation, where parties may have no common interest in sharing information. Thus, Court procedures involve rules and processes for discovery and production of evidence which force parties to share information, even if it is against their perceived self- interest. Accordingly, the civil litigation system allows extensive intrusion into the affairs of both litigants and even third parties.

A third model comes from the securities laws, which force market participants to disclose information, with the objective of removing any information asymmetries through a mandatory disclosure system that compels companies and other securities issuers to publish detailed information by way of Prospectus/Information Memorandum while selling new securities to the public

and require issuers to file and publish annual and quarterly reports containing similar information.

However, the reorganization under the IBC does not fit perfectly into any of these models because it is not exactly a "business deal," a "litigation" or a "securities transaction".

Keeping the above in view, let us now investigate the aspects of information required for successful conduct of insolvency process and information generated in an insolvency process.

7. IBC's Intervention in addressing Information Asymmetry

IBC has certain specific provisions to address information asymmetry by empowering the IRP/RP to seek information from the management, officers, employees of CD as well as from Information Utility (IU), statutory authorities, creditors, and other sources.

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IBC has introduced the innovative concept of IU, which is a public depository of all information related to debt transactions entered by the corporate debtors. The record of such transactions comes in handy for any financial or operational creditor in the event of a default. However, the real experience of the majority of RPs in accessing the old records, books of account, electronic databases, list of assets and liabilities from promoters and manager, despite enabling provisions of IBC has been far from satisfactory. The unscrupulous promoters of defaulting corporate debtors often alienate the records/books of account from access of RP by practices such as removing them from the office, taking away hard disks of computer systems, burning books of accounts, and sometime then filing reports of theft of books or loss in a fire.

8. Maintaining Confidentiality of Information Generated during CIRP

Apart from the information about corporate debtor's past dealing, assets, liabilities, technology, IPRs and patents, a considerable amount of information is generated during CIRP. These relate to valuation of CD, claims by creditors, confidential discussions in CoC regarding strategy of resolution and the contents of resolution plans, which must be kept confidential to maintain the sanctity of CIRP. Information confidentiality during CIRP is being subjected to increasing pressure, both internal and external to the system, which is likely to grow. The Resolution Applicants (RAs) bidding for stressed corporate debtors such as ARCs, AIFs etc. look for such insider information to unravel the complexity as it gives them an advantage in arriving at the realistic valuation of CD. They are even ready to go behind the back of RP to get such information directly from promoters or their employees.

To curtail such practices, IBBI Regulations prescribe confidentiality of such information and puts onus on the RP as leakage of information can compromise the integrity of the bidding process. However, despite the RP taking non-disclosure agreements from members of CoC before sharing such sensitive information, it has been the experience that confidential information is many times leaked to the other participants/applicants. This phenomenon has been counterproductive for maximization of value of CD as can been seen in some CIRPs where multiple resolution plans have bid value very close to each other or to the liquidation value. The members of CoCs and RPs must understand the impact of such leaked information on the values of resolution plans and must try to plug all the possible sources of leakage through adopting foolproof systems and procedures.

9. Public rationale of Information function of IBC

Although IBC has multiple policy goals as enshrined in its preamble, in essence the IBC balances two competing policy goals: maximizing creditor recoveries through maximization of value, on the one hand, versus rehabilitating the corporate debtor, on the other. Yet, insolvency reorganization under IBC also has a third, related goal: that is to create a transparent medium to force information about defaulting corporate debtors into the open, to enable the debtor's stakeholders—and the "Public at large"—to better understand the reasons for failure of the CD, and its possible repercussions. Moreover, as larger institutions fail, Regulators may be tempted—as they were with IL&FS—to "protect" the markets from systemic risk by keeping companies out of corporate insolvency, even at the expense of withholding information about how and why the company failed.

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lending community to learn why a company failed. The hope seems to be that knowledge reduces the likelihood of similar future failures or at least makes it difficult for such unscrupulous corporate debtors to raise funds from the public adopting similar tactics. Altering the flow of information thus affects not only the parties involved in any given resolution, but also those who construct financial transactions.

Although insolvency resolution is not the only way to produce information about financial failure, it is becoming an important one. Our knowledge about insolvency of Essar Steel, VOVL, DHFL or Jet airways, for example, would have been far more limited had the company not gone through CIRP. Today, the insolvency reorganization of companies has helped both investors as well as credit analysts to understand complex transactions that led to substantial loss of value leading to substantial haircuts suffered by lenders. They also enable new learnings for lenders in formulating new approaches to lending and risk mitigation tactics they can adopt in their loan appraisal systems and processes to avoid similar pitfalls in future lending.

The actual market values of insolvent entities discovered through CIRP also provide the lenders/ stakeholders with important industry specific benchmarks for valuing their security coverage in existing loans or potential loans. If, instead, such information about realizations or haircuts remains concealed, it will reduce their chances of learning from their past mistakes.

10. Conclusion

Thus, the future of CIRP and its interplay with credit markets will depend on how we set the rules on the production and sharing of information. Despite a vast literature on insolvency resolution, scholars and practitioners have paid inadequate attention to its information functions. Rather, they assume that the information needed to make intelligent market and social decisions in the insolvency process will miraculously and automatically work its way into the right hands. But they are wrong

because, if information is a commodity, it will be hoarded as surely as oil or gold and its non-availability to stakeholders will not augur well for the future of IBC.

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11. Recommendations

(a) The Government and IBBI need to give serious thought to information evasive practices of corporate debtors and suitably amend policy guidelines/ company laws to ensure timebound information out of corporate debtors and their management to address problem of information asymmetry.

(b) Financial Creditors, who are the biggest sufferers of information asymmetry and information evasion by promoters, should improve their systems to raise red flags early on when such critical information is not provided by the corporate borrower within strict timelines.

(c) Approved Resolution Plans, once fully implemented, should be placed in public domain to enable credit analysts and other market participants to learn from their finer points.

(d) Presentation of successful resolutions through case studies should be encouraged so that IPs, insolvency lawyers and other stakeholders are able to learn better techniques for successful resolutions.