

Going Bankrupt in India

Episode 80 | Everything is Everything

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Transcript

January 3, 2025

Shah, Ajay, and Amit Varma. “Going Bankrupt in India.” Episode 80 of Everything is Everything. XKDR Forum, January 3, 2025. Podcast, video, 1:09:33. <https://www.xkdr.org/viewpoints/going-bankrupt-in-india-episode-80-everything-is-everything>

Abstract

Creative destruction requires both Vishnu and Shiva—the creation of firms and their death. While most people celebrate entrepreneurship and firm creation, they become sentimental about firm destruction, missing a fundamental insight: bankruptcy is not a bug in capitalism but an essential feature that keeps the system healthy.

Ajay and Amit examine why zombie firms and zombie banks can cripple entire economies, as Japan learned during its lost decades. They trace India’s journey from having no bankruptcy process to crafting the Insolvency and Bankruptcy Code, exploring the complex negotiations between different types of creditors and the delicate balance between liquidation and keeping firms as going concerns. The conversation reveals how good laws can perform poorly without proper commercial culture and state capability—banks that want to hide bad news, courts that work slowly, and regulators that seek expanded roles. The bankruptcy process becomes a lens for understanding broader challenges in India’s economic development, from the absence of rule of law to the difficulty of building knowledge ecosystems that can sustain reform.

This discussion illuminates not just bankruptcy mechanics, but the invisible infrastructure required for any major policy reform to succeed.

Supplementary Resources

- **Report of the Bankruptcy Law Reforms Committee, Volume I: Rationale and Design** by Bankruptcy Law Reforms Committee (Committee Report) [1]
- **The Insolvency and Bankruptcy Bill, 2015** by Bankruptcy Law Reforms Committee (Draft Legislative Bill) [2]
- **Insolvency and Bankruptcy Reforms in India** edited by Susan Thomas (Book) [4]
- **The Corporate Bankruptcy Decision** by Michelle J. White (Journal Article) [5]

- **Evolution of the Insolvency Framework for Non-financial Firms in India** by Rajeswari Sengupta, Anjali Sharma, and Susan Thomas (Book Chapter) [3]
- **Building the Insolvency and Bankruptcy Board of India** by Working Group on Building IBBI (Working Group Report) [6]

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Introduction: We Love Firms!

[00:00:14] **Amit Varma:** General readers, welcome to Everything is Everything. I'm Amit and this is my good friend Ajay.

[00:00:18] **Amit Varma:** And if there's one thing you know about us, it is that we love firms, right?

[00:00:23] **Amit Varma:** Firms are awesome, firms are amazing, firms are edifying, firms are illuminating and when firms are sexually aroused, firms are firm.

Chapter 1: Creative Destruction

[00:00:40] **Amit Varma:** All right, I think for the first time ever he laughed at one of my jokes. But to be serious, to be serious, we've done a bunch of episodes on firms in the past.

[00:00:51] **Amit Varma:** And I've, you know, collected them in the show notes as a collection of resources that you should really check out.

[00:00:56] **Amit Varma:** Episode 21 was the history of finance, which, at a foundational level, is an episode I absolutely love.

[00:01:03] **Amit Varma:** Then Ajay went on to tell us about family firms, how family firms can and should evolve, and the obvious answers may be wrong.

[00:01:11] **Amit Varma:** After that, we've spoken about the different kinds of firms from imperial to adaptive firms, when you should be central, when you should be more decentralized.

[00:01:19] **Amit Varma:** And we've also spoken about the importance of internationalization or globalization. Ajay, I want you to say the word internationalization.

[00:01:27] **Ajay Shah:** Internationalization.

[00:01:29] **Amit Varma:** But that's not how you say it. How do you say it?

[00:01:31] **Ajay Shah:** I18N.

[00:01:32] **Amit Varma:** There you go. I18N. So what are we talking about today?

[00:01:42] **Ajay Shah:** Today we're going to talk about the death of firms.

[00:01:45] **Ajay Shah:** So, to take interest in firms is to take interest in birth and death.

[00:01:50] **Ajay Shah:** Schumpeterian creative destruction requires both. You need the creation of firms; you need Vishnu, and you need Shiva.

[00:01:58] **Ajay Shah:** Okay, so all three have to be there, otherwise the harmony of the world is incomplete.

[00:02:03] **Amit Varma:** You have weaved it skillfully into mythology. Am I sitting with Ajay Shah or am I sitting with my friend Devdutt Pattanaik?

[00:02:09] **Amit Varma:** Regardless, before we get going with the subject of this episode, tell me, let's talk about the term creative destruction by Schumpeter.

[00:02:19] **Amit Varma:** What does it mean to you? Why is it so important? Because typically a lay person who is not familiar with economics or the way society works would look at the term destruction and say, hey, that's a damn bad thing.

[00:02:28] **Amit Varma:** But actually creative destruction is the very essence of life and the essence of the world.

[00:02:33] **Amit Varma:** And in a sense, it is rebirth and recreation happening all of the time, so it fits well into mythology as well.

[00:02:38] **Ajay Shah:** Yeah. Firms consume labor and capital and they organize them in certain ways.

[00:02:45] **Ajay Shah:** You should think of the ways of a firm as being the DNA of an organism. The DNA of the organism contains instructions about how the atoms and the molecules are put together into a well-functioning creature.

- [00:02:58] **Ajay Shah:** And it is easy to become emotional about a firm. It is easy to become emotional about a creature, but it can happen that that recipe is not a great one or that the world moves on, the world changes.
- [00:03:10] **Ajay Shah:** The great economist Joseph Schumpeter tells us a story where the process of progress, the process of innovation, the process of productivity change is critically connected to the birth and death of firms.
- [00:03:24] **Ajay Shah:** He tells us a story that new ideas come, there are innovators, the innovators take risks and they create a temporary monopoly because they have a new idea.
- [00:03:35] **Ajay Shah:** In time, others will copy the idea, but for a narrow period of time, they will get a rent on their unique idea, which is their monopoly.
- [00:03:45] **Ajay Shah:** And that the prospect of that rent motivates investments in research and business model innovation.
- [00:03:52] **Ajay Shah:** And side by side with that when these new ideas come along, there are old firms that are not able to keep up.
- [00:03:57] **Ajay Shah:** There are old firms that are not able to compete and they go bankrupt and they go out of business.
- [00:04:02] **Ajay Shah:** But when a firm goes out of business, in a way, the labor and the capital are not lost. They come back into the hands of other firms.
- [00:04:10] **Ajay Shah:** So, it's just like, you know, the carbon and the hydrogen atoms inside you will go back into other forms of life.
- [00:04:17] **Ajay Shah:** So, there's a ceaseless concept of firm destruction and firm creation, and that's a normal and healthy part of society.
- [00:04:25] **Amit Varma:** And I think of two axioms that tie it all together for me.
- [00:04:31] **Amit Varma:** One of them is that the world is complex, and the other one is that the world is in flux. Things are changing all the time.

- [00:04:37] **Amit Varma:** Now, if you think about society, how do the needs of individuals within society get fulfilled? It cannot possibly happen through central planning because flux, because complexity.
- [00:04:47] **Amit Varma:** Right? There have to be other processes which bring it about. We had also done a great episode on four papers that changed the world.
- [00:04:53] **Amit Varma:** One of them of course was a paper talking about firms. Another was Hayek's paper on the price system and how it works, a bottom up way through which markets operate.
- [00:05:03] **Amit Varma:** And we fulfill each other's needs. We fulfill each other's needs perhaps at an individual level that you need some plumbing work and I'm a plumber.
- [00:05:10] **Amit Varma:** And perhaps at a broader level that I look around me and I think, oh, people in society want omelets for breakfast and therefore there is a business in eggs and should I make a business.
- [00:05:20] **Amit Varma:** And firms come up and as long as you're fulfilling needs, you are profitable and profit is a fantastic motive because everything is a positive sum game.
- [00:05:27] **Amit Varma:** There's mutual benefit everywhere, but at some point in time, if a firm gets complacent, then competition will come up and the firm will be in trouble.
- [00:05:37] **Amit Varma:** And the firms that keep adapting, adapting, adapting, adapting, they survive, they do well.
- [00:05:41] **Amit Varma:** What is adaptation? Adaptation is learning how to keep serving other people in society. It is such a fantastic incentive.
- [00:05:48] **Amit Varma:** And if you fail to adapt, then you should go out of business because the labor and the resources that you have can be better used for other purposes within society.
- [00:05:58] **Amit Varma:** They should not be tied down. So this is, I'm just sort of, I'm just thinking aloud and kind of paraphrasing.

- [00:06:03] **Ajay Shah:** A great organizing principle is, can you teach an old dog new tricks?
- [00:06:06] **Ajay Shah:** And you undoubtedly can to some extent because for example, Tata Steel of 2024 is unrecognizably different from the original Tata Steel of Jamshedji Tata.
- [00:06:18] **Ajay Shah:** More power to them. It's great. And this kind of organizational transformation will not have taken place in many firms and they should go out of business.

Chapter 2: What is a Firm?

- [00:06:35] **Amit Varma:** So Ajay, even though we've covered some of this territory before, let's start at the very basics. What is a firm, what is equity, what is debt? How does the whole system function? Tell me about that.
- [00:06:45] **Ajay Shah:** So a firm starts with some capital by the shareholders and the firm generally chooses to borrow some money.
- [00:06:53] **Ajay Shah:** Borrowing can come either from financial creditors or it can just be buying goods on credit.
- [00:06:58] **Ajay Shah:** So you've rented the camera equipment for this show, but you've not yet paid for it.
- [00:07:04] **Ajay Shah:** That's an operational credit. So it's tantamount to borrowing. There's no difference. Operational creditors and financial creditors are both creditors.
- [00:07:12] **Ajay Shah:** So there is some money that has been brought in by the shareholders and there is borrowed money.
- [00:07:16] **Ajay Shah:** The way the concept of the company was invented in 15th, 16th century Europe was that the shareholders have control of the firm.

- [00:07:26] **Ajay Shah:** They make all the decisions as long as they are servicing all their debts. As long as they service all their debts, they're in charge.
- [00:07:35] **Ajay Shah:** The creditor has no say in how the firm works. The creditor has paid in 100 rupees and expects to get 110, that is 100 rupees with interest after one year, and so on.
- [00:07:46] **Ajay Shah:** So the creditor has no say on how the firm is run. The creditor has the right to demand, you gave me a contract, you were supposed to pay me so much, did you pay me so much?
- [00:07:54] **Ajay Shah:** And all this is how the firm normally works, but when the firm fails to pay its creditors, at that point, the very concept of company law, the basic fundamental concept of a company is that the creditors are able to go stand in front of a judge and demonstrate that this guy was supposed to pay me 110 and he did not.
- [00:08:18] **Ajay Shah:** Note, the only thing to be demonstrated in front of a judge is that there was indeed a credit relationship and it was indeed a default.
- [00:08:27] **Ajay Shah:** Other than that, the judge has no say.
- [00:08:31] **Ajay Shah:** At this point, the shareholders get thrown out, they lose control of the company and in general, they also get wiped out.
- [00:08:38] **Ajay Shah:** They lose their equity capital and now the creditors come in control of the company.
- [00:08:44] **Ajay Shah:** So it's a very dramatic fact about the concept of a limited liability company that shareholders are in charge of the company as long as they are meeting their dues.
- [00:08:54] **Ajay Shah:** The day the shareholders fail to pay their dues, they're supposed to get thrown out and replaced by the creditors.
- [00:09:01] **Ajay Shah:** This is the very basic concept of a limited liability company. And all too often in India, you're going to see me lament the lack of a commercial culture.

- [00:09:09] **Ajay Shah:** Too many people in India don't understand these basics. These are definitional things in the words limited liability company.
- [00:09:17] **Ajay Shah:** Our subject for discussion today, the bankruptcy process is about the machinery, about how this happens. So far I've been very high level that something is supposed to happen, you're supposed to demonstrate that there was a credit default.
- [00:09:28] **Ajay Shah:** And then the creditors get the control of the company and the shareholders are thrown out. We need to flesh this out.
- [00:09:34] **Ajay Shah:** We need to make it institutions. So this is in the sense of North Williamson that the institutions create conditions for people to enter into these complex contracts.
- [00:09:45] **Ajay Shah:** And let's just pause to think about what happens in the balance sheet of a company.
- [00:09:48] **Ajay Shah:** Imagine there's a company where there's 100 rupees of equity and 100 rupees of debt and the firm defaulted on the 100 rupees of debt.
- [00:09:55] **Ajay Shah:** Then you literally have to think that we're going to reconstruct this company under a brand new balance sheet where the equity guys are gone.
- [00:10:04] **Ajay Shah:** And the creditors sort of are now an equity like play, they control the full company. So the concept of bankruptcy extends to a complete transformation of the balance sheet as defined by the law.
- [00:10:17] **Ajay Shah:** It is that deep. It's not a small superficial thing. So it's impossible to think of the word company without all this machinery.
- [00:10:23] **Ajay Shah:** And I just want to launch my protest against mainstream Indian thinking about business and economics that very often people become emotional and sentimental about a company, about its erstwhile shareholders, about the family that created the company.
- [00:10:38] **Ajay Shah:** And no, right in 15th century, 16th century England, there was no sentimentalism around these things. These are the cold relationships between equity and debt.

Chapter 3: Don't Be Sentimental

- [00:10:56] **Amit Varma:** So Ajay, with your newfound interest in Hinduism perhaps sparked by this author, entirely my fault. You have invoked Vishnu and Shiva in the concept of finance, kindly explain.
- [00:11:07] **Ajay Shah:** There is a very basic human instinct for all of us that we become sentimental, we tend to fall in love with an organization.
- [00:11:14] **Ajay Shah:** We respect and value the contribution of the founders, very often in India, of a founding family.
- [00:11:21] **Ajay Shah:** And we see this in very sentimental ways. And it is important to simultaneously assert the importance of the bankruptcy process as the Shiva.
- [00:11:32] **Ajay Shah:** That there has to be a process of destruction as well. Both are first class creations. So, you know, in Hindu philosophy, you have a creation, you have a preservation and you have a destruction and they are all vital.
- [00:11:44] **Ajay Shah:** If you'd interfere with any one of them, the great balance of the universe would be disrupted. You need all three.
- [00:11:49] **Ajay Shah:** And bankruptcy process is about the operations of the destruction. Now, how will the universe go into an imbalance if we don't have the process of destruction?
- [00:12:01] **Ajay Shah:** I want to come at this in a couple of different ways. One is the concept of a zombie firm. Okay, so imagine I am a weak firm. I'm really not doing well.
- [00:12:11] **Ajay Shah:** Okay, I'm running losses and my creditors are filling the holes. I'm failing to pay the creditors. Basically this thing is going very badly.
- [00:12:18] **Ajay Shah:** Now in a reasonable healthy capitalism, what ought to happen is the firm ought to go out of business. Suppose it doesn't go out of business.

- [00:12:25] **Ajay Shah:** Suppose it is propped up using more and more debt, maybe because of the incentives of badly regulated banks who don't want to recognize that they have a problem on their hands or maybe because the government is prodding the banks that no, I don't want this firm to go bankrupt.
- [00:12:45] **Ajay Shah:** Okay, for whatever reason. If you keep this firm artificially alive, it is standing and it is competing with healthy firms.
- [00:12:52] **Ajay Shah:** It is damaging the profit margin of healthy firms. So this is a very deep insight. These firms that are dead men walking are called zombie firms.
- [00:13:02] **Ajay Shah:** By the way, by symmetry, the banks that are dead men walking are called zombie banks. Okay?
- [00:13:08] **Ajay Shah:** And in a way, the single great insight of Japan in the bad years after 1986 is that Japan went through 30 years of misery because they had zombie banks which were keeping zombie firms aloft.
- [00:13:21] **Ajay Shah:** And the presence of these zombies shatters profitability for everybody else. So you lose economic dynamism all around the country.
- [00:13:29] **Ajay Shah:** The process of investment requires healthy firms that make money. The healthy firms should be profitable.
- [00:13:34] **Ajay Shah:** If healthy firms are not profitable, how will they invest? If zombie firms are present, if an Air India or a Jet Airways is artificially kept alive, it is selling tickets and it is driving down the prices of plane tickets.
- [00:13:52] **Ajay Shah:** And it is harming the health of the high quality airlines like Vistara. Okay, so it is important to get the weak players out of the way, which creates conditions of profitability for the successful firms.
- [00:14:06] **Ajay Shah:** And then those successful firms feel that, wow, this is working so well, we are making money, come, let's go invest more.

- [00:14:11] **Ajay Shah:** So what we saw in Japan was that the bad firms were artificially kept alive. And they were artificially kept alive by bad banks.
- [00:14:18] **Ajay Shah:** And this whole thing was orchestrated by the industrial policy of the Japanese Ministry of Finance and the MITI.
- [00:14:25] **Ajay Shah:** And this whole thing went badly wrong. And in fact, it cost 30 years of economic dynamism in Japan.
- [00:14:32] **Ajay Shah:** So this is one good way to see the cost to society of artificially keeping these bad firms alive.
- [00:14:40] **Ajay Shah:** Another way to think about it is that imagine you're a promoter run company, okay?
- [00:14:44] **Ajay Shah:** And that there is fair power in the hands of a founding family. Now, the family, asymmetric information, the family always knows more than external persons.
- [00:14:54] **Ajay Shah:** The family understands this company is going to get into trouble. What do they start doing? They start extracting cash. They start stealing cash from the company.
- [00:15:02] **Ajay Shah:** It's entirely illegal, but it does happen in India. And there again, when you give more time, when you don't rapidly resolve difficulties, the family gets more time to extract cash.
- [00:15:13] **Ajay Shah:** Whereas if you will move swiftly and resolve a firm when it gets into trouble, put it into the bankruptcy process rapidly, then you will rule out these kinds of scenarios.
- [00:15:24] **Ajay Shah:** Another element of how we should think about this is that once a firm gets into trouble, it's a melting ice cube.
- [00:15:31] **Ajay Shah:** Okay, things start going bad. So watch, the insiders know that things are going badly. Some key employees start leaving.
- [00:15:37] **Ajay Shah:** The firm starts renegeing on some of its suppliers. The suppliers start holding up the goods. Regular maintenance of machines is not done.
- [00:15:45] **Ajay Shah:** Once a firm starts getting into trouble, it's a melting ice cube. It rapidly falls apart. The wheels come off.

- [00:15:51] **Ajay Shah:** Once again, it's a call for speed. So, what you want in every healthy society is a high speed mechanism where there is an objective early warning about the malfunctioning of the firm, which leads to the bankruptcy process being kicked into action.
- [00:16:08] **Ajay Shah:** And rapidly resolving the firm, if maybe it gets sold off, maybe it gets shut down. We'll come to that in a moment.
- [00:16:15] **Ajay Shah:** But we need these institutions. We need to respect the failure of a firm, the death of the firm, the bankruptcy process as a normal, healthy activity.
- [00:16:26] **Ajay Shah:** It should not carry a stigma. So, business failure is normal. All of us should be trying things that fail, right?
- [00:16:32] **Ajay Shah:** The great Amit Varma always encourages creators that throw things at the wall. You never know what's going to work.
- [00:16:37] **Ajay Shah:** Okay? That's the nature of the modern world. We should be taking risks. Firms should be going bankrupt. And when they go bankrupt, there should be a well-defined script about how these things will proceed after the bankruptcy, after the default event.
- [00:16:51] **Amit Varma:** So I told a creative friend of mine when he asked me for advice that bro, you have to throw things at the wall. He was wanting to make a vlog.
- [00:16:56] **Amit Varma:** I said, throw things at the wall. Five minutes later, he calls back and says the camera broke. So this is not always great advice.
- [00:17:03] **Amit Varma:** And speaking of Japan, you know, Japan not only had zombie firms and zombie banks, they also made a lot of great zombie movies.
- [00:17:09] **Amit Varma:** And I am wondering if I should go back and look at them and see if with new eyes, if there is great metaphorical art being created and we are taking it at surface value, dead man walking, ax in hand, hand chopped off, ha ha ha.
- [00:17:21] **Amit Varma:** But actually, perhaps there's something deeper going on there.

[00:17:23] **Ajay Shah:** Yeah. Uh long ago, there was a Percy Mistry committee on Bombay as an international financial center.

[00:17:29] **Ajay Shah:** And there Percy and I were merrily banding the words zombie bank around. And some people in the committee got very offended.

[00:17:35] **Ajay Shah:** They thought that this is a disrespectful word. But it's actually a technical word. I mean, in this field, zombie firm, zombie banks are technical terms that have been introduced in the research on Japan.

[00:17:47] **Amit Varma:** And my memory is pretty close to being a zombie. So I'm not quite sure of this, but I think the very first episode of the Seen and the Unseen we did was on zombie banks.

[00:17:54] **Amit Varma:** And the second one was about finance in general. So gentle readers, you should check them out also.

Chapter 4: Intangible and Tangible Capital

[00:18:08] **Ajay Shah:** So a firm gets into trouble. How would we proceed? One worldview is liquidation, okay?

[00:18:14] **Ajay Shah:** That a firm has a factory, it has an office. The creditors will come, they'll grab the factories, they'll grab the office, they'll sell it off.

[00:18:20] **Ajay Shah:** Now that may be optimal. Most often, if you get there sufficiently early, okay, so remember I talked about a melting ice cube.

[00:18:29] **Ajay Shah:** If you get there soon enough, actually the value of the firm as a going concern is higher than the sum of the parts.

[00:18:37] **Ajay Shah:** It's not just a factory and the offices and the distributors. It is a whole bunch of people and processes and IT systems and the orchestration, the culture, the ability of those people to work together, external contracts, external relationships.

- [00:18:52] **Ajay Shah:** All these add up to intangible capital and in general, the intangible capital is worth quite a lot.
- [00:18:57] **Ajay Shah:** So there can be firms where you came in late. When the bankruptcy process starts late, the intangible capital is destroyed.
- [00:19:05] **Ajay Shah:** Then you want to just shut up and do a liquidation, sell the factory, sell the land for whatever it's worth. There's nothing there.
- [00:19:12] **Ajay Shah:** But in general, we are always hoping that a bankruptcy process will commence sufficiently early.
- [00:19:16] **Ajay Shah:** And when it commences sufficiently early, the firm is a going concern. Now you want to hang on to that going concern.
- [00:19:21] **Ajay Shah:** So this is a very interesting tension in the bankruptcy process that do we think there is value in this firm, that it should be protected as a going concern, or is it hopeless and you just want to take some of the pieces and liquidate them?
- [00:19:38] **Ajay Shah:** And a central question of the bankruptcy process is how the creditors will arrive at this decision.
- [00:19:45] **Ajay Shah:** And I'm going to come to that in a moment, but I just want to flag off this as the great decision of the bankruptcy process, that is there value in this company or not?
- [00:19:54] **Ajay Shah:** Do we protect this company as a going concern? And what would be the pathway that in that case somebody else would come along and become the new shareholder of the company?
- [00:20:03] **Ajay Shah:** He'll pay a chunk of money to the creditors and become the new shareholder, pick up the reins of the company.
- [00:20:08] **Ajay Shah:** And now all the factory and the labor and the IT and all that is orchestrated by a new equity guy and then it keeps going as a going concern or we just think, no, this is gone.

- [00:20:19] **Ajay Shah:** This is too late. Now you want to sell the factory, you want to sell the land, you want to terminate all the workers and remember, now it goes back into the society.
- [00:20:28] **Ajay Shah:** The land that you free up belonging to the failed firm goes into the hands of other companies. It rejuvenates the land market of all the cities where the firm operated and so on.
- [00:20:40] **Ajay Shah:** I want to emphasize that this is not a value judgment. This is not any humanitarian notion that, oh, we should protect the company as a going concern.
- [00:20:48] **Ajay Shah:** This is a business judgment. So the firm goes bankrupt, the equity guys are thrown out, the old management is thrown out.
- [00:20:55] **Ajay Shah:** The creditors come in, they gain control of the firm. Now the creditors have to make a business judgment that if I liquidate the firm, will I get 40?
- [00:21:04] **Ajay Shah:** And if I sell the firm as a going concern, will I get 70? And 70 is more than 40. So I should not do liquidation.
- [00:21:10] **Ajay Shah:** So I don't want to at all be moralistic about it and that is one of the big mistakes that we make in India.
- [00:21:15] **Ajay Shah:** We become very sentimental. We start using words like stakeholder. Okay? The word stakeholder is a sure sign of, you know, feeble reasoning.
- [00:21:25] **Ajay Shah:** What is needed here is cold business reasoning, that look, the firm went bankrupt. Now the creditors stand to make losses.
- [00:21:31] **Ajay Shah:** They should evaluate these two choices. Is there a good buyer who will come along, value this as a going concern, pay me well, pay me 70, pay me 90, okay?
- [00:21:39] **Ajay Shah:** So that I'm actually doing rather well, or no, I can't find that. The firm is so far gone, there's no reasonable person who will come up and offer a good price.
- [00:21:49] **Ajay Shah:** Then yeah, let me just cut it up, sell the real estate, sell the machines, and I'll get 40.

- [00:21:54] **Ajay Shah:** So in general, the liquidation value of a firm is not great, but it may not be possible to find a buyer to come in at a good price to take the firm as a going concern.
- [00:22:05] **Amit Varma:** So here's a question. Let's say that I borrow 100 rupees to run a business. And then at some point I realize I'm not going to be able to pay it back. The business is going to fail.
- [00:22:14] **Amit Varma:** You know, the natural tendency of many promoters in India as you pointed out would be that let's keep quiet about this.
- [00:22:20] **Amit Varma:** Let's just siphon off whatever money that we can and then later on when it goes down, it goes down too bad for the creditors.
- [00:22:27] **Amit Varma:** How does one avoid this kind of situation?
- [00:22:30] **Ajay Shah:** So there is a step in the bankruptcy process that at the point of bankruptcy, if the committee of creditors and the people overseeing the bankruptcy, look inside the books, remember they've got control of the company.
- [00:22:42] **Ajay Shah:** They look inside the books and they start seeing evidence of this kind of siphoning off, it is a criminal offense and you ought to be able to go after promoters.
- [00:22:51] **Ajay Shah:** Now, that hasn't happened a whole lot and it is very difficult to create the institutions to do that correctly. But theoretically, this is one check.
- [00:22:59] **Ajay Shah:** That when the bankruptcy process commences, you've got new people who are in charge of the books and the records of the company.
- [00:23:07] **Ajay Shah:** And they're supposed to look back and assess whether there was malfeasance and initiate action against the promoters.
- [00:23:15] **Ajay Shah:** At a practical level, what also happens in India is promoters have a reputation. So you can do this a couple of times. You can't do this too much.
- [00:23:24] **Ajay Shah:** Then the lenders wise up that these guys can't be trusted. So it is not true that lenders are completely stupid.

[00:23:31] **Ajay Shah:** The credit markets in India are medium foolish. They are not deeply foolish. So in time, the families that misbehave, the businesses that misbehave, the individuals that misbehave do suffer reputational damage and over the long term, it does re-shape their business possibilities.

Chapter 5: The Committee of Creditors

[00:23:57] **Amit Varma:** So, Ajay, this also seems to me to be a little bit of a complex problem because often a firm will have many different creditors.

[00:24:02] **Amit Varma:** Their interests will be different. Some will want as much as they can make immediately.

[00:24:07] **Amit Varma:** Some will say, okay, can we play a longer game and think about it in a different way? Is there a way for that process to work out and not degenerate into squabbling?

[00:24:14] **Ajay Shah:** So what you described is very real. And my God, there is squabbling. Okay? To make matters worse, some creditors have given a loan to the firm where a collateral is one machine.

[00:24:26] **Ajay Shah:** Some creditors have given a loan to the firm where the collateral is a factory. So they can say, see, I'm taking my machine and going away. Hell with you.

[00:24:34] **Ajay Shah:** You are the other creditors, you are saying, no, no, no, we'll do better as a going concern. But the guy's playing a game.

[00:24:39] **Ajay Shah:** The guy's saying, see, you pay me well, then I will not disrupt your going concern. Okay? So the guys with secured credit effectively get bargaining power.

[00:24:48] **Ajay Shah:** And they negotiate with the other creditors. Tum karo. You do a going concern. If you are happy with a going concern, fine, but please understand I have the ability to torpedo your attempt at keeping the firm as a going concern.

[00:25:00] **Ajay Shah:** So you got to pay me well. So I want my 100 and you guys figure out whatever else you want to do.

- [00:25:06] **Ajay Shah:** This kind of jostling happens as it must. This is a world of business. There are many, many creditors.
- [00:25:11] **Ajay Shah:** They have different, different kind of claims and contracts and seniority of the cash and all that. All this comes together in a negotiation.
- [00:25:18] **Ajay Shah:** And the forum of negotiation in India, the legal word adopted is Committee of creditors. Elsewhere in the world, these things evolved informally.
- [00:25:25] **Ajay Shah:** One of these days we will do a glorious conversation around the history of the bankruptcy process in the UK where you learn to respect what makes an advanced economy.
- [00:25:35] **Ajay Shah:** This is a little bit centrally planned. Okay, I'm embarrassed to say that words like committee of creditors are coming from the law.
- [00:25:42] **Amit Varma:** CoC.
- [00:25:42] **Ajay Shah:** Yeah. And so the committee of creditors is supposed to argue about all this.
- [00:25:47] **Ajay Shah:** They're supposed to haggle about terms which are their internal bargains about how we're going to proceed.
- [00:25:53] **Ajay Shah:** And the way the law is structured, it needs a super majority, meaning not just 51%, get 60% of the creditors to say yes, get 70% of the creditors to say yes.
- [00:26:03] **Ajay Shah:** Economists write theoretical papers on what is the appropriate super majority that should be there in a committee of creditors.
- [00:26:09] **Ajay Shah:** Okay, but this haggling happens in the committee of creditors. And these are all the core questions that some people say, no, this is pointless.
- [00:26:16] **Ajay Shah:** Let's just cut it up and sell the pieces. And maybe they have good pieces. Some people say, no, no, no, we should try going concern.

- [00:26:22] **Ajay Shah:** Some people argue, you're welcome to try going concern, but I have primacy because I can take away the core assets.
- [00:26:29] **Ajay Shah:** And then they make a deal that okay, we're going to try for going concern. You will get primacy, you will get your first 100.
- [00:26:34] **Ajay Shah:** After that, what is left over will come to me like that. All these complex deals are made in the committee of creditors.
- [00:26:40] **Ajay Shah:** You can imagine it requires really sophisticated business instincts and bargaining in the committee of creditors, which all too often doesn't happen in India because most financial firms in India are basically, you know, a bureaucracy.
- [00:26:54] **Ajay Shah:** They are regulated to death and they are a bureaucracy. It's very difficult to find business instincts and commercial culture in the employees of the financial firms.
- [00:27:03] **Ajay Shah:** This is one of the choke points. But conceptually this is what we want. What we want is a badass, commercially sophisticated committee of creditors that is able to view these risks and make deals and do negotiations and come up with a value maximizing answer.

Chapter 6: What is the Endgame?

- [00:27:18] **Ajay Shah:** This is something which really is not happening in India, partly because our instincts are very bureaucratic, partly because the entire landscape is a centrally planned bureaucracy.
- [00:27:32] **Ajay Shah:** The banks have very low business capability. The banks are bureaucracies, they're just discharging rules and procedures, they're not thinking.
- [00:27:42] **Ajay Shah:** So, what you really want is this kind of qualitative judgment and risk taking by the committee of creditors.

- [00:27:48] **Ajay Shah:** That's what a good bankruptcy process has, and that's not easy to get under Indian conditions.
- [00:27:53] **Amit Varma:** I want to ask you about what the Indian bankruptcy process was before you guys came into the picture.
- [00:27:58] **Amit Varma:** But even before that, here's a fundamental question. How does the rule of law play into this? Because my impression always has been and many of my friends who are in business who run businesses and factories and so on will often tell me that,
- [00:28:09] **Amit Varma:** yaar, the rule of law is so absent that you have to account for the absence when you make deals.
- [00:28:15] **Amit Varma:** That okay, in an advanced country if a contract is broken you can kind of enforce it, you can do stuff about it.
- [00:28:22] **Amit Varma:** Over here you have to weigh the probabilities of that happening and then do the deals accordingly.
- [00:28:28] **Amit Varma:** And the friction this introduces and the fear this introduces and, you know, what the lack of trust endangers is that there's a huge opportunity cost.
- [00:28:36] **Amit Varma:** A lot of deals that could be happening simply don't happen.
- [00:28:39] **Ajay Shah:** So I've already started complaining to you about the Indian environment where some of these things don't work.
- [00:28:44] **Ajay Shah:** I'll come back more tangibly at choke points at several points about how in the Indian environment some of these things have not worked well.
- [00:28:52] **Ajay Shah:** And this is a part of our larger lament that you do anything in India in one field, you'll try to make progress.
- [00:28:58] **Ajay Shah:** We have to factor in the difficulties of the broader environment, the invisible infrastructure and find some B grade, C grade choice.
- [00:29:05] **Ajay Shah:** It is not possible to get a perfect answer because there are too many malfunctioning pieces all around. [00:29:11] [MUSIC]

- [00:29:19] **Amit Varma:** So Ajay, you've explained quite excellently the different kinds of problems that come up with the creditors, the different kind of deals that can be on the table, the choices you face, the squabbles that might happen, and the competing interests.
- [00:29:34] **Amit Varma:** What does an ideal bankruptcy code look like which takes all of this into account and finds an optimal way to reconcile it?
- [00:29:41] **Ajay Shah:** So I've already put many of the pieces up, but let me just assemble them so that we are all crystal clear on what's going on.
- [00:29:46] **Ajay Shah:** So there's a company, it has equity, it has debt. Debt can be either financial creditors or operational creditors.
- [00:29:52] **Ajay Shah:** There's no disrespect for an operational creditor that if you're a supplier, you sent raw materials to the company, the company did not pay you, it's credit.
- [00:30:00] **Ajay Shah:** There's no difference at all. So we should not disadvantage the operational creditors in any way. Okay.
- [00:30:07] **Ajay Shah:** Now a default takes place. So step one, the aggrieved person goes to the court.
- [00:30:12] **Ajay Shah:** In this case, the court is the NCLT, the National Company Law Tribunal. And the only question at court is, was there a credit and was there a default?
- [00:30:23] **Ajay Shah:** Nothing else. That's how it ought to be. Sometimes it isn't. Okay. But what ought to happen is within one, two, three days, this step should be done.
- [00:30:33] **Ajay Shah:** That there was a credit and you didn't pay me. Okay, at that point, the bankruptcy process commences.
- [00:30:39] **Ajay Shah:** What happens in the bankruptcy process? The power of the managers and the equity guys is thrown out.
- [00:30:47] **Ajay Shah:** The creditors are brought together. So, any one creditor goes to the NCLT, but the NCLT assembles all the creditors into a committee, which is called the Committee of creditors.

- [00:31:00] **Ajay Shah:** And they are given the powers of the equity guys under normal company law. And they are told, now you start the bankruptcy process.
- [00:31:07] **Ajay Shah:** And in that bankruptcy process, what they're supposed to do is they're supposed to assess, what are our choices? Do we liquidate?
- [00:31:14] **Ajay Shah:** Do we bring in some new guy to keep the company going? And they judge these choices in a cold commercial way.
- [00:31:22] **Ajay Shah:** Based on that, they decide. And then either they cut up the company into parts and they liquidate it, they sell off their assets, or they hand over control of the company to a new guy under a brand new balance sheet where the old equity is all gone.
- [00:31:35] **Ajay Shah:** So there is a brand new balance sheet that's reconstructed under the notional value promised by the new guy, and it becomes an all equity company in the hands of the new guy and we get going. [00:31:46] [MUSIC]

Chapter 7: What is an Ideal Bankruptcy Code?

- [00:31:55] **Ajay Shah:** So, this is theory. This is the way things should be. How have they been historically?
- [00:32:01] **Amit Varma:** Especially in India.
- [00:32:02] **Ajay Shah:** Yeah. In the UK, a lot of the elements of the bankruptcy process evolved out of common sense and common law and good behavior by a variety of persons.
- [00:32:17] **Ajay Shah:** The first codification of bankruptcy law in the UK actually came very late in the game. For hundreds of years, it was just going on as market practice.

- [00:32:25] **Ajay Shah:** People did business with each other and the self-organizing system groped and found these institutions. It's really quite remarkable.
- [00:32:34] **Ajay Shah:** In India, in the bad old days, there was no bankruptcy process, which meant that you basically had no recourse, nothing.
- [00:32:39] **Ajay Shah:** That if somebody defaulted on you, you had nothing. You had no ability to ask for anything. The first milestone was the SARFAESI Act, which was enabled, which was enacted in 2002.
- [00:32:51] **Ajay Shah:** What it did was it created rights for a secured creditor. So if I give you a loan, you give me that pretty microphone as a collateral.
- [00:32:59] **Ajay Shah:** So when you default on the loan, I'm able to go to the court and get the policeman and we expropriate you of that microphone because a deal is a deal.
- [00:33:07] **Ajay Shah:** You promised if you fail to pay, you'll give me that microphone. Okay. That was done at SARFAESI 2002.
- [00:33:13] **Ajay Shah:** And you can see the perverse dynamic that it takes you only towards liquidation. It will never keep the company as a going concern.
- [00:33:20] **Ajay Shah:** And there was no negotiation mechanism between the creditors for a collective solution where all the creditors come together.
- [00:33:30] **Ajay Shah:** A weird thing happened in 2013. There was a new Companies Act and I remember Monte Ahluwalia said to me that he spoke with, he was a cabinet member at the time.
- [00:33:40] **Ajay Shah:** He was deputy chairman Planning Commission, and he spoke to the people in the Ministry of Company Affairs saying, there should be chapters in the new Companies Act, which are a full bankruptcy code with the negotiation process with the collective action by creditors.
- [00:33:55] **Ajay Shah:** And they assured him, yes, yes, we are going to do it. And in fact, it was not there. So when I first started these conversations with him, he said, are you sure it's not there in the Companies Act 2013?

[00:34:04] **Ajay Shah:** And I said, I have done my fair share of bedtime reading of the Companies Act. And there is some trivial winding up provisions, but there is no bankruptcy process in the Companies Act.

[00:34:14] **Ajay Shah:** And it took a long time for people to understand some of these basics.

[00:34:20] **Ajay Shah:** The next milestone was FSLRC, Financial Sector Legislative Reforms Commission, led by Justice Srikrishna, which worked from 2011 to 2015.

Chapter 8: The History of Bankruptcy Law

[00:34:28] **Ajay Shah:** Here, they got a full understanding of a certain specialized kind of bankruptcy, the bankruptcy of financial firms that have retail claimants like bank depositors or insurance policies.

[00:34:41] **Ajay Shah:** And they said there has to be a larger bankruptcy code. Somebody's got to do that. We are doing this much.

[00:34:47] **Ajay Shah:** Okay. So they built out that full piece of the legal machinery for banks and insurance companies where a specialized bankruptcy code was required.

[00:34:55] **Ajay Shah:** And that is a little more state led. I'll explain later as to why. And they said, guys, somebody's got to do this.

[00:35:01] **Ajay Shah:** And then I think in your Seen and the Unseen conversation with KP Krishnan, he tells the story that in 2015 in the budget speech, in the part A of the budget speech, there was a para from Ministry of Small and Medium Enterprises which said that we will build a bankruptcy code for small companies.

[00:35:17] **Ajay Shah:** And Krishnan went to Jaitley with that and said, yeah, you could do that, but don't you think we could do bigger?

[00:35:23] **Ajay Shah:** Shall we do a full bankruptcy code? And Jaitley was like, do we have the ability? Do we have the teams?

- [00:35:27] **Ajay Shah:** And Krishnan described the work of FSLRC and he said, we've done big complex laws, large research teams, for the first time in India, world class law drafting capabilities.
- [00:35:39] **Ajay Shah:** And so, yeah, we can do these kinds of things. So inspired by FSLRC, there was a thing set up that is called the BLRC.
- [00:35:47] **Ajay Shah:** The bankruptcy, I don't remember what the LRC is.
- [00:35:52] **Amit Varma:** Bankruptcy Law Reforms Committee.
- [00:35:54] **Ajay Shah:** Okay. BLRC. And this was led by the wise old experienced person from the world of Ministry of Law, TK Viswanathan.
- [00:36:05] **Ajay Shah:** Okay. And Susan and I were both members of the BLRC. And that's how the process began.
- [00:36:09] **Ajay Shah:** And again, at the beginning of the BLRC, there was a very narrow vision that, oh, we'll do some amendments to the winding up provisions of the Companies Act and it was really a while before people got the point that no, a bankruptcy code is something playing at a different level.
- [00:36:25] **Ajay Shah:** It's a negotiation mechanism for the creditors whereby the things that I described to you will happen.
- [00:36:33] **Ajay Shah:** And Rajiv Mehrishi became the secretary of the Department of Economic Affairs and he supported and encouraged this more radical view that don't make do with the dinky trivial refinements to the law, but go for a full bankruptcy code.
- [00:36:48] **Ajay Shah:** And then Susan led the team that did a first draft of the code, which became a law in 2016.
- [00:36:53] **Ajay Shah:** It's now called the Insolvency and Bankruptcy Code. [00:36:56] [MUSIC]
- [00:37:05] **Amit Varma:** So you know I've discussed the bankruptcy code in the Seen and the Unseen episode with Bhargavi Zaveri who was part of Susan's team in drafting it.

- [00:37:11] **Amit Varma:** I've discussed a little bit of it with you in the Seen and Unseen episode we did together.
- [00:37:16] **Amit Varma:** And I know a fair bit of the inside story in terms of how it came together. It's absolutely inspiring, you know, serious analysts and thinkers and wonks coming together to craft this.
- [00:37:26] **Amit Varma:** But how did it work in the real world? What are the problems that it faced?
- [00:37:31] **Ajay Shah:** Yeah. So it is not true that everything is solved and India now has a great bankruptcy process.
- [00:37:37] **Ajay Shah:** India has a C grade bankruptcy process. Okay. Like it's there and yeah, it's better to have it than not to have it, but it has many difficulties.
- [00:37:44] **Ajay Shah:** So let's go through a couple of building blocks of the problems. The first class of problems is what I already alluded to earlier that do you have employees of the Indian financial firms who are able to become a member of the Committee of creditors and be fully badass and commercially oriented and exert their own judgment in choosing between rival resolution plans or liquidation and be able to understand that, oh, this guy has the secured credit on this factory.
- [00:38:22] **Ajay Shah:** So I have to pay him 100 because without him the going concern is impossible. You know, that it is an advanced state of business thinking to be a member of the committee of creditors.
- [00:38:33] **Ajay Shah:** The problem in India is that banking regulation works badly. Okay. So you've heard me talk many times about banking.
- [00:38:40] **Ajay Shah:** Banks and banking in India are one of the weak spots of finance. For banks, there's really only one overriding objective that how to hide the bad news.
- [00:38:49] **Ajay Shah:** They just want to delay. They don't want to recognize that there is a problem. So a core insight in bankruptcy is a business has failed, the loss has already taken place.
- [00:38:59] **Ajay Shah:** Now all we're debating is who is going to bear the loss, how will it play out? We're only discussing the rights that take place at the end.

[00:39:10] **Ajay Shah:** But in the books of the bank, it's being carried at 100. And banks just want to do all they can to not recognize that a loss has taken place.

[00:39:18] **Ajay Shah:** The present crew wants to say, let somebody in the future think about it. So there's a profound flaw in banking regulation.

[00:39:26] **Ajay Shah:** Now what you need is the kind of banking regulation that drives aggressive marking to market rules for banks, but we are not there yet.

Chapter 9: Our Bankruptcy Code in the Real World

[00:39:34] **Amit Varma:** Yeah, there's a term called the evergreening of loans, which is why if a bank wants to delay the bad news that, you know, your loan is bad, the company has failed, you simply lend to the guy again so he can pay off the previous loan and it just goes on and on and it helps nobody.

[00:39:47] **Amit Varma:** And when the incentives of the bank is to hide the bad news and to kick the can down the road, this is, you know, the easiest thing in the world to do.

[00:39:55] **Ajay Shah:** And now banks with those kinds of incentives are given a pivotal role on the committee of creditors.

[00:39:59] **Ajay Shah:** What do you think they're going to do? They're going to say, look, let's have our next meeting next month. They're not going to come into the situation with whim and vigor.

[00:40:07] **Ajay Shah:** You know, the whole thing should be a couple of days. Instead it drags out for months and years.

[00:40:12] **Ajay Shah:** And all the while, a bankrupt firm is a melting ice cube. So that's one thing that went wrong that we just don't have the commercial culture of the creditors who are able to play the role that they're being asked to play.

- [00:40:26] **Amit Varma:** So let's assume that there is a committee of creditors, a CoC as it were, and you have three banks and two NBFCs there, and their representatives are on that committee, right?
- [00:40:35] **Amit Varma:** My question is this, let's say I'm a biscuit factory. I try to manufacture biscuits, but everything goes to hell, and I go into bankruptcy, and these five creditors are meeting, three banks and three NBFCs.
- [00:40:45] **Amit Varma:** They don't know the first thing about the manufacturing industry or about biscuits or about this how do they
- [00:40:51] **Ajay Shah:** Not fair. They gave a loan. They gave you 100 crore rupees.
- [00:40:54] **Ajay Shah:** Correct. At that time, they bloody well going to understand your industry. They're going to understand you. So, not fair to think they don't know.
- [00:41:00] **Amit Varma:** So cool, if they knew enough to give that, then they know enough to now figure out what to do.
- [00:41:04] **Ajay Shah:** What to do. They ought to know all these things. So you see banks, NBFCs, private, public, FIIs, mutual funds.
- [00:41:14] **Ajay Shah:** These are all different kind of characters. And I would generally expect that a private NBFC, a private bank, a mutual fund, an FII would be far more commercial, have the ability to think and just work with commercial common sense.
- [00:41:31] **Ajay Shah:** But in general, banks and particularly PSU banks are less able to engage in commercial thinking.
- [00:41:37] **Ajay Shah:** The PSU bank is also thinking of the CBI. The private bank is also thinking of the CBI, that if losses are made, will there be a future CBI investigation?
- [00:41:45] **Ajay Shah:** I have to look good. So, you know, they are painting the tape to look good in a future investigation.
- [00:41:50] **Ajay Shah:** That's different from a commercial instinct. And look, you need a super majority of the creditors. Banks are generally big enough to have an adverse impact upon the working of any committee of creditors.

- [00:42:02] **Ajay Shah:** What banks like to do is to negotiate in darkness. They'll work with one creditor at a time, do a renegotiation, take a write down, but they don't want to do it in the ages of the committee of creditors where it's actually more complicated where they have to negotiate with all the others.
- [00:42:18] **Amit Varma:** Sunlight is the best disinfectant.
- [00:42:21] **Ajay Shah:** So given these constraints of India, you have to think in unorthodox ways.
- [00:42:28] **Ajay Shah:** And one of my unorthodox ways, which is going to be very hard to persuade people about is that until banking regulation figures out its act.
- [00:42:37] **Ajay Shah:** The voting power of banks in the committee of creditors should be reduced. Because the others are more commercial.
- [00:42:43] **Ajay Shah:** A mutual fund is more commercial, an FII is more commercial, an NBFC is more commercial, an insurance company is more commercial.
- [00:42:50] **Ajay Shah:** It is banks that are the problem. So, you know, one day banks will get their act right, banking regulation will get its act right.
- [00:42:57] **Ajay Shah:** In the meantime, maybe what you should do is give them less voting power in the committee of creditors.
- [00:43:01] **Amit Varma:** And it's a structural question. It's a question of incentives, right? Banks have a particular kind of incentives, which is why they become a problem here.
- [00:43:09] **Amit Varma:** The other guys who are pure commercial players, their incentive is wind it up as fast as possible, don't delay the inevitable.
- [00:43:15] **Ajay Shah:** Similarly operational creditors, your suppliers are great creditors. And there's been some real design mistakes in India that operational creditors are being shut off from the bankruptcy process.
- [00:43:24] **Ajay Shah:** And that's not right. They are first class business people. They understand their interests and they will play for their interests.

Chapter 10: The Role of Promoters

- [00:43:40] **Ajay Shah:** So Ajay, what happens to the promoter in all of this? Do they have a role once the bankruptcy process starts?
- [00:43:46] **Amit Varma:** So the way India is structured, they don't. Okay, when the bankruptcy process starts, they're out of the game.
- [00:43:52] **Ajay Shah:** The creditors will figure out what to do with the company, the promoters are out. There there has been a great attempt at ensuring that the promoters cannot even bid to buy the company.
- [00:44:03] **Ajay Shah:** Now, I think that's a mistake. So, I think it's a healthy thing that it's a competitive process.
- [00:44:08] **Ajay Shah:** Many people can come in with offers to the committee of creditors and the promoter should be permitted to be one of them.
- [00:44:16] **Ajay Shah:** Why? Because actually have a lot of knowledge. They have a deep understanding of every corner of that business.
- [00:44:23] **Ajay Shah:** So they'll probably give you a higher bid. Okay. So it's a very nice thing to have the promoters also competing in the bankruptcy process.
- [00:44:32] **Ajay Shah:** But in India, it has been viewed that how can you have a man that ran the company down into the ground?
- [00:44:40] **Ajay Shah:** How can you have them coming back into the bankruptcy process? And there has been a strong belief that you've got to just block all promoters, which I think is a bit unfair.
- [00:44:51] **Ajay Shah:** There is another argument which I think makes more sense. Suppose promoters knew that they could bid to come back into their company.

- [00:44:58] **Ajay Shah:** They could leave a whole bunch of poison pills inside the company that would deter any other bidders. That's a good argument.
- [00:45:06] **Ajay Shah:** And the approach taken in India has been that promoters are completely blocked from bidding for the company in the face of the Committee of Creditors.
- [00:45:17] **Ajay Shah:** So that's another awkward thing that has happened in India because of the broader difficulties of rule of law and the checks and balances and the fair play.
- [00:45:27] **Amit Varma:** What's a poison pill?
- [00:45:28] **Ajay Shah:** A poison pill is where the promoter leaves messy things inside the company that she knows about, that she understands, that she will be able to diffuse once she's back in charge.
- [00:45:39] **Ajay Shah:** But the new person will stumble on a landmine because they don't know what is going on.
- [00:45:44] **Amit Varma:** Like a rat trap in the corner office under the chair, under the table.
- [00:45:47] **Ajay Shah:** Correct.
- [00:45:48] **Amit Varma:** What correct? I'm joking.
- [00:45:49] **Ajay Shah:** It's literally what can be done. I mean, there can be all kinds of commercial contracts where there's one weird provision that is left in there where suddenly something bad happens.
- [00:45:58] **Ajay Shah:** And only the promoter knows. So if the promoter comes back, she's able to immediately diffuse those traps.
- [00:46:03] **Ajay Shah:** But a new person comes in, they don't know about the traps and three months later something horrible happens. And then the fear of that will keep everybody else out of bidding for the company.
- [00:46:12] **Amit Varma:** Has this ever realistically happened? Because I would imagine that yeah, in theory, you can bring up this scenario that it could happen like this.

- [00:46:18] **Amit Varma:** But in practice, I imagine the way most bankruptcies would happen and the way you know, this almost takes a lot of Machiavellian scheming to
- [00:46:27] **Ajay Shah:** People respond to incentives. So we do need to think like this. I think this is a fair concern that you need to assume the worst.
- [00:46:37] **Ajay Shah:** See again, given Indian rule of law, these things ought to be criminal offenses and you know, people ought to go to jail for that, but they don't.
- [00:46:44] **Ajay Shah:** So now here we are, what you're gonna do?
- [00:46:46] **Amit Varma:** What you're going to do when they come for you?
- [00:46:49] **Ajay Shah:** So what is happening in India is the promoters are quietly sitting with the banks and renegotiating in secrecy.
- [00:46:57] **Ajay Shah:** Okay, which is also not a great arrangement. It's not a market based auction. So we are faced with these two extremes.
- [00:47:03] **Ajay Shah:** That the banks are generally not keen on going into the IBC because it will reveal the bad news that they've been giving out these loans and they've got these bad assets.
- [00:47:13] **Ajay Shah:** So the bank sit quietly with the promoters and keep on restructuring the loans under conditions of full secrecy.
- [00:47:18] **Ajay Shah:** And when a bankruptcy process commences, the promoters are fully kept out. This is not a great arrangement, but that's where we are.

Chapter 11: The Courts

- [00:47:34] **Ajay Shah:** The next group of problems is about the court. The court where these steps happen is called the NCLT, the National Company Law Tribunal.

- [00:47:41] **Ajay Shah:** Now by the law, there is no role for the court. The court is just supposed to do these basics. It is supposed to assess one, was there a credit?
- [00:47:52] **Ajay Shah:** Two, was there a default? Bankruptcy process is initiated. Committee of creditors has come back saying we have a super majority, we have an agreement on the plan.
- [00:48:01] **Ajay Shah:** All that the court has to ascertain that do you actually have a super majority? Are you lying that you actually don't have a super majority? Done.
- [00:48:09] **Ajay Shah:** Okay? That's all. There's supposed to be nothing else. And all this ought to happen in weeks. This has gone wrong at two levels.
- [00:48:15] **Ajay Shah:** The first is that the NCLTs like every other court in India and the Indian legal system works fairly poorly.
- [00:48:21] **Ajay Shah:** Okay. So there's a big field, there's a big journey on how to improve the Indian legal system, on how to improve the working of the judicial branch in India.
- [00:48:30] **Ajay Shah:** But as at present, the NCLT works like any other court in India.

Chapter 12: The Regulator

- [00:48:42] **Ajay Shah:** Then the next piece we come to is a new regulator which is called the IBBI, the Insolvency and Bankruptcy Board of India.
- [00:48:48] **Ajay Shah:** Here's the logic. The logic is that there may be many intricacies in the mechanism of the bankruptcy process.
- [00:48:54] **Ajay Shah:** You don't want to code it all in parliamentary law. Okay. So, at many places the law envisages something more detailed that will be done through regulations.

- [00:49:04] **Ajay Shah:** And there's supposed to be an expert body that's the regulator which will come up with those regulations and be able to rapidly evolve those regulations through time.
- [00:49:15] **Ajay Shah:** Here, in the original draft of the law that was done by the technical expertise, for the first time in India's history, there was a whole machinery of an FSLRC quality treatment of how you build a regulatory organization in India.
- [00:49:32] **Ajay Shah:** There are 140 sections that establish the checks and balances, separation of powers, governance, all the machinery of how you build a regulator was there in the original draft law.
- [00:49:42] **Ajay Shah:** Unfortunately, it all got deleted. And some people just chose to cut and paste some eight sections from the SEBI Act into the IBBI.
- [00:49:51] **Ajay Shah:** So all the bad practices of how SEBI malfunctions were brought into IBBI.
- [00:49:56] **Ajay Shah:** So there was really a lost opportunity to get a regulator right with the correct 140 sections of law.
- [00:50:02] **Ajay Shah:** That opportunity was lost. But then you get the usual Indian state capability constraints. The IBBI again has a very narrow role, but there is a state capability problem.
- [00:50:13] **Ajay Shah:** On day one, they don't have the capabilities to discharge those roles. And it's very easy to engage in self-aggrandizing behavior where the regulator seeks a bigger role for itself because it is the fundamental nature of government agencies that you want more power.
- [00:50:29] **Ajay Shah:** So that's another piece which did not work out so well. And I just want to say in a British common law system, it's not as if those regulations are codified by the government.
- [00:50:39] **Ajay Shah:** They evolve as market practice. And we in India have just lost sight of the concept of a market economy.
- [00:50:45] **Ajay Shah:** We are so coded into expecting everything to be written in laws and regulations. And everybody, the banks will not work unless it's clearly written as a regulation.

[00:50:55] **Ajay Shah:** We've lost business common sense. What should be happening as ground up self-organizing system of creditors negotiating with creditors, coming up with contracts that meet their needs.

[00:51:05] **Ajay Shah:** We've just lost sight of that completely. We wait for the regulator, the regulator will write a regulation, then we will obey that.

[00:51:11] **Ajay Shah:** And then in the process you're down to the quality of the regulator and that one regulation may be a one size fits all and it may not work too well.

Chapter 13: Rule of Law

[00:51:28] **Ajay Shah:** The next group of problems comes under the problems of the Indian non-rule of law, the corrupt environment.

[00:51:35] **Ajay Shah:** Okay, this whole dance involves many people who are supposed to be professional and commercial. The employees of the financial firms that sit on a committee of creditors are supposed to vote based on what is the best realization for their employer.

[00:51:51] **Ajay Shah:** And you sometimes worry that, you know, are there other rival interests that are shaping their behavior?

[00:51:55] **Ajay Shah:** There's a critical person called an insolvency professional, who's a bit of a maître d overseeing the entire working of the bankruptcy process.

[00:52:04] **Ajay Shah:** The insolvency professional can come under corrupt pressures. The promoters may often have incentives for doing certain bad things.

[00:52:12] **Ajay Shah:** And the larger context like the NCLT registry and others, there can be problems.

[00:52:19] **Ajay Shah:** So, it is not a great situation where all this low rule of law is operating in the Indian environment and it's not giving us great outcomes.

[00:52:31] **Ajay Shah:** And there is no real solution to that. Like, we have to go through 100 years of becoming an advanced economy, and these problems will get solved, but in the short term, there's really no answer.

[00:52:40] **Ajay Shah:** So these are all the problems and all the difficulties that I have described about how the bankruptcy code has not worked out great.

[00:52:48] **Ajay Shah:** And that doesn't mean it should not be done and we need to do it better. We need to think more about the reform process, about how these things are done.

[00:52:55] **Ajay Shah:** But it is a B grade or a C grade project so far.

Chapter 14: Inputs, Outputs and Outcomes

[00:53:08] **Amit Varma:** So Ajay, it makes me deeply sad that something that you were involved in, that Susan was involved in, that Bhargavi was involved in, is today being dismissed by some random uncle as third rate.

[00:53:19] **Amit Varma:** You know, I do not like this, but jokes apart, what's the way forward? You know, how could it get better in just in terms of the frames through which we think about it?

[00:53:28] **Amit Varma:** How do we need to think differently?

[00:53:30] **Ajay Shah:** So one very useful classification scheme in the world of public policy is that of inputs and outputs and outcomes.

[00:53:37] **Ajay Shah:** Okay. So for example, classic education setting, we've talked about it. The inputs are the schools, the outputs are the grades that kids get at school or the teaching that is delivered at school.

[00:53:51] **Ajay Shah:** And the outcomes are actually learning that we are doing all this for a reason that we want the kids to learn.

- [00:53:56] **Ajay Shah:** How would we apply that here? The inputs are a bankruptcy law, some NCLT, some creditors coming together in a committee, all that is the inputs.
- [00:54:09] **Ajay Shah:** The outputs is a flow of bankruptcy cases where somebody goes bankrupt, goes to the NCLT, and there is some percentage of the money of the creditors that comes back to them.
- [00:54:20] **Ajay Shah:** But the outcome that we want is a better working credit market where there are borrowers and there are lenders and they play this smooth process because they all know that these are the rules of the game.
- [00:54:34] **Ajay Shah:** So, you know, your likelihood of defaulting changes when you know that this kind of threat is there at the end.
- [00:54:40] **Ajay Shah:** This is where the glory of what we see in advanced economies. In advanced economies, most transactions are privately negotiated between the creditors and the shareholders under the threat of the law.
- [00:54:54] **Ajay Shah:** So the term used is in the shadow of the law. Only a few cases go to court because you're not able to find the correct negotiation.
- [00:55:02] **Ajay Shah:** Most cases, actually the behavior of all counterparties is changed. So what you want as the outcome is a better commercial culture, better credit discipline where borrowers are keen to repay and then lenders are keen to lend.
- [00:55:16] **Ajay Shah:** So, you know, leverage in India should go up when the bankruptcy code comes in.
- [00:55:21] **Ajay Shah:** And most disputes should get resolved in the shadow of the law through private negotiations. So that's a good classifying scheme that we should not be satisfied with putting in inputs.
- [00:55:31] **Ajay Shah:** And we should not judge it exclusively by the outputs. Ultimately, we're about outcomes. We've got to get to the outcomes.

- [00:55:39] **Ajay Shah:** So what is that journey? How will it work out? How could it work out? The basic story is the same as what we told in our theory of change episode.
- [00:55:50] **Ajay Shah:** In all issues in public policy, the theory of change is that there is a pipeline where there is data, there is research, there are multiple rival public policy proposals happening in the public domain.
- [00:56:05] **Ajay Shah:** There is a criticism of the status quo happening in the public domain and out of all that, we start getting to various legislative and executive actions where some things are done better.
- [00:56:18] **Ajay Shah:** And you need that entire pipeline. So you need that flourishing ecosystem of data, of researchers, of a steady flow of research products coming out.
- [00:56:27] **Ajay Shah:** So, you know, it's an embarrassment that there's probably two papers in this field coming out a year.
- [00:56:32] **Ajay Shah:** There ought to be like 20 papers on this field coming out every year, but we really don't have that kind of research community.
- [00:56:40] **Ajay Shah:** And then you create the vibrant public discourse where there are people writing, criticizing, disagreeing, arguing with each other.
- [00:56:47] **Ajay Shah:** And then in out of that ferment, some joint secretary and some future minister will make better decisions.
- [00:56:55] **Ajay Shah:** Also, criticism is key. If you don't have people criticizing the working of the bankruptcy code, you're fine.
- [00:57:00] **Ajay Shah:** Like, why would any minister or any secretary make any changes? Because, you know, we're fine. We've got our bankruptcy code.
- [00:57:07] **Ajay Shah:** Everything is fine. So, I think that at heart, this is about the theory of change, that for some time, it looked like there was a bankruptcy community in India where there were data sets and there were researchers.

- [00:57:19] **Ajay Shah:** and there were blog articles and research papers coming out, and there were newspaper op-eds criticizing this and criticizing that.
- [00:57:28] **Ajay Shah:** And then as with so many other elements of the Indian economic reform, that period ended and that community dissipated and we've just broken down this entire pipeline that we don't have,
- [00:57:39] **Ajay Shah:** we don't make data sets, we don't have researchers, we don't have a steady flow of working papers and blog articles, we don't get op-eds criticizing what is being done.
- [00:57:50] **Ajay Shah:** So, you know, then nothing will ever get fixed.
- [00:57:53] **Amit Varma:** So, you know, for me the key phrase in all of this, which really sums up I think the big learning of this episode is in the shadow of the law.
- [00:57:59] **Amit Varma:** And an important realization for me over a period of time is that when you use a phrase like that in the shadow of the law, what do you mean by the law?
- [00:58:08] **Amit Varma:** Is not just a statute that is written on paper. It involves the entire invisible infrastructure, as you might say, that what is the state capability, what is going to get enforced?
- [00:58:19] **Amit Varma:** What is a reasonable expectation on the creditor and the promoter that hey, the law is going to work as intended.
- [00:58:26] **Amit Varma:** And unless all of that is in place, just writing a great law doesn't make sense.
- [00:58:31] **Amit Varma:** And therefore what happens is that it is in a sense turtles all the way down that because the law is broken in these fundamental ways, which go beyond the way in which the statute is written.
- [00:58:43] **Amit Varma:** What you then have is that the whole culture is affected by that. The bad commercial culture that you're talking about, the lack of trust and all the unseen ways in which they hobble business and innovation and all of that.

- [00:58:54] **Amit Varma:** So my question really then is that how do we change that? A lot of the talking that we've done is around what should a big bankruptcy law look like.
- [00:59:03] **Amit Varma:** But that is, you know, the words on paper. How does this whole system change so that we can turn this vicious cycle around?
- [00:59:13] **Ajay Shah:** So, one is if you narrowly wanted to run a bankruptcy reform, because finally, you know, you have to do one thing at a time, you can't do all the things.
- [00:59:19] **Ajay Shah:** If you had to run a bankruptcy reform, we should be seeing that the site of change includes the NCLT.
- [00:59:25] **Ajay Shah:** Okay, that side by side with building a good bankruptcy law, and you need to actually build a good bankruptcy law as opposed to like some version of a law that came out,
- [00:59:36] **Ajay Shah:** which has many problems in it. So you do need to get to a good bankruptcy law, you do need to make the NCLT work.
- [00:59:43] **Ajay Shah:** You do need to make the IBBI work. You do need to nurture the data sets and the researchers, which will go with you along the journey.
- [00:59:50] **Ajay Shah:** It's not as if the day we passed the law, we inaugurate the IBBI, we're done. In fact, that's only the beginning.
- [00:59:56] **Ajay Shah:** Because now starts a process of iterative refinement, where the data and the research and the researchers will keep the thing honest all along.
- [01:00:04] **Ajay Shah:** And I think most people in India don't understand the importance of the knowledge ecosystem that every area of work has to be ensconced in a successful knowledge ecosystem.
- [01:00:15] **Ajay Shah:** Then and only then you get the diagnosis, you get the debates, you get the criticism, and that the people who are in charge of running the place have a better chance at getting some of these things right.
- [01:00:26] **Ajay Shah:** We tend to think the secretary and the minister and the joint secretary will lead a reform.

- [01:00:31] **Ajay Shah:** But they are not able to because it is not their job to form knowledge. So knowledge ecosystems are something far different from the thought process and the capability.
- [01:00:40] **Ajay Shah:** Or, you know, for example, like there are a couple of policy support orgs in India who do consulting for the joint secretary and consulting for the secretary.
- [01:00:51] **Ajay Shah:** But they are more in the nature of like an HR arrangement. It's a staffing arrangement that you get a young person that speaks perfect English to work for the joint secretary.
- [01:01:02] **Ajay Shah:** And that's not going to give intellectual leadership. The people required to participate in the policy life have to have intellectual leadership, have to know more about these subjects than the joint secretary and the secretary.
- [01:01:15] **Ajay Shah:** Then we're starting to get somewhere because you're actually feeding new knowledge into the policy debates and the policy process.
- [01:01:22] **Ajay Shah:** That's a narrow conception of the bankruptcy reform. And then, let's go back 1991 to 2011. Why did so many things work out right?
- [01:01:29] **Ajay Shah:** Answer, because so many things were being done at once. The project of fixing the capital controls was going on in parallel to fixing the equity market, was going on in parallel to opening up the software industry, was going on in parallel to opening the telecom industry.
- [01:01:45] **Ajay Shah:** And all these things reinforced each other. So when many, many policy projects are moving, it's actually a virtuous cycle, it strengthens everything.
- [01:01:52] **Ajay Shah:** Whereas when we are in a more difficult environment where only a few policy projects are being done, there is less of that positive feedback.
- [01:02:00] **Ajay Shah:** You know, so there should have been a vibrant financial sector reforms journey going on in parallel here, whereby the banking regulation was getting fixed, but that wasn't happening.

- [01:02:10] **Ajay Shah:** So we got banks as poor actors in the bankruptcy reform and that had far reaching consequences.
- [01:02:18] **Amit Varma:** So I have three propositions and tell me what you feel about them. The first of them pretty obvious, you should only judge a policy or a law by its outcome.
- [01:02:25] **Amit Varma:** The second is that there is nothing called a good law or a good policy in a vacuum. You have to see the society it's in, you have to see the supporting infrastructure, state capability.
- [01:02:35] **Amit Varma:** All of those things if you do not take them into account, then it simply doesn't work. It's pointless to say this is good or this is bad. You have to take the real world into account.
- [01:02:45] **Amit Varma:** And my third proposition therefore is that some reforms are more important than others, in the sense that this invisible infrastructure that you talk about, which run across all these different sectors, you know, it is critical to sort that out first.
- [01:02:58] **Amit Varma:** In the 91 to 2011 journey, as you pointed out, there was work happening on a lot of those. So you could do an arcane reform on a subject somewhere on the side.
- [01:03:08] **Amit Varma:** But because you were simultaneously reforming the bureaucracy and reforming the machinery, it could actually take place. So would you broadly agree with these three?
- [01:03:16] **Ajay Shah:** I want to say this slightly differently, that imagine you get a pretty good law done, but the invisible infrastructure is lacking, then it will perform weakly today.
- [01:03:25] **Ajay Shah:** But we hope that as other pieces fall into place, that same law will get us better. That can happen. Or we should be thinking, no, this is not going to work.
- [01:03:34] **Ajay Shah:** That this kind of good law would function poorly given this invisible infrastructure, then we should settle for a compromise which is less good compared to the good law.

- [01:03:43] **Ajay Shah:** So, these are trade-offs to make. And the second is, it is precisely correct that some things are more fundamental than others.
- [01:03:51] **Ajay Shah:** We should not be pushing all areas with equal intensity, meaning some areas are more interesting and more important than others.
- [01:04:00] **Ajay Shah:** And the way Vijay Kelkar and I like to think about it is we like to zero base and say, give me a list of the elements of the state of public policy that are essential for civilization.
- [01:04:13] **Ajay Shah:** That without that, you will be in barbarism. So come to me with ideas that are just absolutely fundamental. Without that, there can be no possibility of civilization and a market economy.
- [01:04:24] **Ajay Shah:** And so we will start, you will need a foreign policy, you will need military, you'll probably need a fiat money.
- [01:04:31] **Ajay Shah:** You'll need a criminal justice system, you'll need police and courts. Okay, like that, think of a few things. And then to pay for these, we'll need a tax system and you know, we'll need some commercial law and some financial regulation.
- [01:04:42] **Ajay Shah:** So we think of these as just the primal foundations, that get these basics right because after that you can think of more complex other fields.
- [01:04:51] **Ajay Shah:** There are many other fields that tend to push their own priority. Often times, there is a humanitarian perspective that, oh, health is so important.
- [01:05:01] **Ajay Shah:** But actually in sequence, these are the fundamental pillars of a country that need to come into place first.
- [01:05:07] **Amit Varma:** Everything falls apart if you don't get these right.
- [01:05:09] **Ajay Shah:** And we can't do everything. So, you know, this idea that state capability, the reformers of the country, the intellectuals of the country, the researchers and the data sets of the country, the philanthropic capital of the country, these are very limited.

- [01:05:22] **Ajay Shah:** There's only a handful of the people and the orgs who are going to do anything. So then, you know, it should really not be squandered on all kinds of random subjects.
- [01:05:30] **Ajay Shah:** Really these few subjects are the core which should get precedence.
- [01:05:42] **Ajay Shah:** So Amit, give us recommendations for today.
- [01:05:45] **Amit Varma:** So, I'll recommend the first book that comes to mind when you're talking about law and the powerful impact it can have and how every word matters.
- [01:05:52] **Amit Varma:** Code 2.0 by Lawrence Lessig, where he famously wrote about how in a sense, a law is like code, that the way the rest of the machinery runs can be shaped by the law itself and everything being under the shadow of the law, as it were.
- [01:06:08] **Amit Varma:** Ajay, what about you?
- [01:06:10] **Ajay Shah:** So, I want to recommend a few things. Susan Thomas has an edited book of papers on the Indian bankruptcy reform.
- [01:06:17] **Ajay Shah:** Gentle reader, there is work that is going on right now for a next edited book, which is a collection of papers.
- [01:06:25] **Ajay Shah:** There is a meet up of the authors on the side of the emerging markets conference in December.
- [01:06:32] **Amit Varma:** Which has already happened by the time you see this, but we are recording this before. So there you go.
- [01:06:36] **Ajay Shah:** So, the attempt at trying to bring researchers together and build papers is afoot in this fashion.
- [01:06:44] **Ajay Shah:** The second thing I will recommend is a movie. Okay, a movie of bank robbers, Butch Cassidy and the Sundance Kid.

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