

# IBC – A Dynamic Economic Legislation Balancing the interest of Stakeholders: A Diagnostic Approach

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**Abstract** - IBC is a dynamic economic legislation emerged after elaborate churning process on economic theories, comprehensive approaches to corporate sickness, Insolvency and Bankruptcy codes of several countries in global scenario Entry and exist freedom are ensured under IBC. IBC became a reform by the stakeholders, of the stakeholders and for the stakeholders (Sahoo M.A, 2019). IBC emerged, after lessons drawn from the failure of Corporate Sickness under Sick Industrial Companies (Special Companies) Act, 1985 (SICA) and emerged. It is creditor driven approach provides one stop solution balancing the interest of stakeholders. It is focused on ease of doing business, creating new credit culture based on market economy and entrepreneurship development. It is based on behavioral and socioeconomic perspective of insolvency and bankruptcy and corporate reorganization.

**keywords** - ibc, sica, corporate sickness, turnaround strategies

## Introduction:

Insolvency Bankruptcy Code, 2016 is a unique a legislation which is panacea for Insolvency and Bankruptcy in respect of corporate, Partnerships and individuals. This dynamic economic legislation emerged after elaborate churning process on economic theories, comprehensive approaches to corporate sickness, Insolvency and Bankruptcy codes of several countries in global scenario Entry and exist freedom are ensured under IBC. IBC became a reform by the stakeholders, of the stakeholders and for the stakeholders (Sahoo M.A, 2019)<sup>1</sup>. IBC primarily addressed ease to exit and maximization of value of Assets while maintaining the balance of interests of stakeholders, which is essential in market driven economy. IBC emerged, after lessons drawn from the failure of Corporate Sickness under Sick Industrial Companies (Special Companies) Act, 1985 (SICA) and emerged

SICA was not based on Market mechanism. No sooner IBC was enacted, quickly gone ahead with appropriate amendments in consonance with market economy. It took all the measures to maintain timeline and thereby maximization of value of Assets. The services of Insolvency Professionals and Institutional development and culture developed under IBC framework is highly appreciated. As observed by Insolvency and Bankruptcy Board of India (IBBI) in its publication the code is hailed as progressive and dynamic economic legislation, is the true embodiment of time bound justice-oriented reforms, providing the much-needed freedom to exit to failing businesses. Further observed that Code is paradigm shift from erstwhile insolvency regime in terms of the design and architecture, professionalization of insolvency services and delicately balancing the interest of all stakeholders<sup>2</sup>.

IBC is pathbreaking reform, with the policy framework, legal framework and institutional frame progressively meeting all challenges with success with its inbuilt strong philosophy , mechanism, Institutional communication, Institutional development and culture with clear political mandate and Institutional framework under four pillars viz IBBI, Independent Adjudicating Authorities – NCLT/DRT Insolvency Professionals, (IP), Information Utilities (IU). IBC could bring about professionalism and culture in the entire process in accomplishing its objectives.

## The objectives of this paper are:

1. To understand the Major Comprehensive Approaches of corporate sickness and turnaround measures
2. To Identify why and how SICA failed and to What extent SICA incorporated the inputs from the theoretical framework;
3. What are the path breaking paradigm shift witnessed under IBC framework in providing one stop solution based on BLRC report & other theories.

These objectives are framed to comprehend why and how SICA failed; and how this behavioral legislation, IBC emerged from the failure of SICA. Further to understand how IBC emerged as an outcome of an elaborate comprehension of theoretical framework, market research and understanding and more so based on BLRC report in arriving at insolvency resolution and maximization of value of assets.

1. **To understand the Major Comprehensive Approaches to corporate sickness and turnaround measures**

The following major comprehensive approaches to prevention and control of corporate sickness are discussed mainly to comprehend the revival process involved in diagnosing the root cause of sickness, turnaround conditions and alternative turnaround solutions available to formulate rehabilitation strategy.

- a) John Argenti's studies on trajectories of corporate failure.
- b) Crescendo model of rejuvenation of matured form.
- c) Kharbanda and Stallworthy's studies on panacea for corporate sickness.
- d) Gupta's comprehensive approach control on of corporate

#### **John Argenti's Approach**

Argenti's (1976)<sup>3</sup> *A Study on Corporate Failures* is by far the best theoretical study in analysis of failure. The approach is dynamic and traces the firm's path from health to failure. Argenti has typified three trajectories of organizations' failure. Argenti distinguished the symptoms of failure from the causes of failure and explained. He says, "if the management of a company is poor the accounting information will be neglected or such information will be deficient and the company will not respond to change, some may be damaged because of a powerful constraint. Poor managers will make at least one of the three errors; they will overtrade; or they will launch a big project; or they will let the gearing rise to level that even a normal business hazard will become a constant threat. When these symptoms appear, financial ratios will deteriorate and managers will resort to creative accounting, which helps companies escape predictive models based on financial ratios. In a few cases luck may run out"

Type I failure commences the business with a wrong relationship between the variables. The proprietor has seriously underestimated his costs especially initial costs. But once the serious estimation errors are revealed there is no room for readjustments. Type II failures are firms that grow at supernormal pace and there is no time for the organization to stabilize itself. Type III failures are typically caused by a change in the environment and launch of a big project. The management, being complacent does not take action to steer the company into an equilibrium. Argenti's study mostly identifies the path of failure for appropriate turnaround strategy.

#### **Charles Baden-Fuller and John Stopford's Crescendo Model of rejuvenation**

Charles Baden-Fuller and John Stopford developed the Crescendo model of rejuvenation<sup>4</sup>. This model helps to solve the problem associated with maturity of a firm. The basic philosophy behind the model is that maturity is a mindset, and with a system and process the problem can be solved. The model is based on the case studies of many MNCs, viz., BOC, Hot point, GEC group, Weir Group, Richardson, Komatsu, Caterpillar, etc. to name a few.

There are many routes mature business might take, however, in the crescendo model the following four stages for rejuvenation are suggested. They are:

- Galvanize: create a top team dedicated to renewal.
- Simplify: cut unnecessary and confusing complexity
- Build: develop new capabilities
- Leverage: maintain momentum and stretch the advantages

This model is an exhaustive study based on the case studies of Multinational Companies. In meeting the challenges of a matured firm. The model brings transformation in turnaround with strategic perspective. It is based on the strategic factor and very relevant in a market economy. It is applicable to only matured firms. This model is suitable for the Type III failures discussed in the Argenti's trajectories of corporate collapse.

#### **Kharbanda and Stallworthy's studies on panacea for corporate sickness:**

Kharbanda and Stallworthy<sup>5</sup> have made an in-depth study on corporate failure. Their study addressed various issues relating to corporate failure and covered prediction and prevention, panacea of corporate failure. The study maintains that the top management, i.e., CEO, is solely accountable for success or failure of an enterprise. The study reveals that reasons for business failure relate to the concept 'why' and symptoms relate to the concept 'how'. They further maintained that there are as many symptoms as there are failures. The study considered reasons for failure as observed in various research findings. The study after review of the literature on crisis management identified that good crises management is seen as a combination of following four factors. They are (a) Close collaboration between the parties (b) The Retention of production resources (knowledge, plant and workforce) (c) Maintenance or increase of efficiency (d) Equitable distribution of the costs of adjusts.

After identifying that the good management is the key factor for corporate successes the study substantiated as to how a poor management could collapse an enterprise. The causes of collapse<sup>6</sup> are (a) Top management (b) Accounting information (c) Change (d) The manipulation of accounts (e) Rapid expansion (f) the economic cycle.

The patterns of companies observed can be used to discern potential failure and help towards turnaround<sup>93</sup>. The management is the vital factor both in the cause of failure and also in formulating turnaround measures. This relates to foundation blocks for good management, viz., (a) Back to basics management (b) Interpersonal relations (c) Effective communication<sup>7</sup>.

Throughout their study they were looking for a panacea – a universal remedy for ailing companies. The study finally maintained that management crisis and various types of failures and problems are bound to occur in the life of a corporate

entity. Good management is the only answer. The study focused mainly on the strategic and operational factors of sickness. This is very relevant especially in the market economy.

### **Corporate Sickness – Comprehensive Approach of Gupta:**

Gupta (1988)<sup>8</sup> makes certain fundamental observations on the concept of sickness relating to causal analysis, process of sickness, and forewarning systems as discussed in the preceding section. He considers that the problem of industrial sickness is gained by making a distinction between two types of cases, viz., (a) Weak management; and (b) Economic maladjustment. The first type requires strengthening or replacement of a firm's management. The second type arises from economic, social and technological changes.

Gupta's comprehensive and integrated approach for conceptualization of corporate sickness involved following steps:

- a) Tracking the root cause of corporate sickness by unraveling the chain of causes;
- b) Identifying the typologies of corporate sickness – viz., operating, strategic, staying power, still born and catastrophic;
- c) Suggesting forewarning ratios for prediction and control of sickness;
- d) Visualizing the required turnaround conditions for successful ameliorative measures, viz., motivating top manager, viability, planning and control, timely cash availability.
- e) Interlinked process and different stages in implementation of turnaround strategy, viz., emergency stage, and stabilization stage return to normal growth stage.

Thus, Gupta's approach has adequately focused on causative factors and appropriate solutions. The approach is analytically presented with interlinked elements in the chain of causes as well as turnaround strategy. His study observed the requirement of turnaround conditions before formulating turnaround strategy. Basically, Gupta focused on two types of decisions namely efficiency moves and diversification moves or both depending upon the typology of sickness.

## **2. To Identify why and how SICA failed and to What extent SICA incorporated the inputs from the theoretical framework**

Primarily there were legal inconsistencies especially in arriving the criteria of corporate sickness viz 100 percent erosion of net worth; cash losses for 2 consecutive years and insisting for the elapse of 7 years for referring to Board for Industrial and Financial Reconstruction (BIFR)<sup>10</sup>. Later with amendments in 1998, 7 years was reduced to 5 years and cash loss criteria was dropped. Even after that these, the criteria only enabled failed units to be referred to BIFR instead of sick units. There was no compatibility between criteria and objectives of the SICA viz., a) Timely detection of sickness; (b) Speedy determination of remedial and ameliorative measures; and (c) Expeditious enforcement of remedial measures. There was no compatibility between policy and legal framework. Ultimately even after 15 years of its operations, BIFR could hardly provide rehabilitation to less than 10 percent units registered with it and many units were referred to concerned High Court for winding up. Hence, the first Chairman of BIFR, referred as Board for Industrial Funeral rites<sup>4</sup>. It was neither a proactive nor reactive legislation. There was obscurity during SICA regime in several reasons mainly because of pre liberalisation era, Licence raj with protectionism. The market economy was not perceived despite recommendations of Goswami Committee<sup>11</sup>

Commenting on the above, Narayanan (1994)<sup>12</sup> states that experience has shown that much of industrial sickness is due to mismanagement, whether deliberate or because of incompetence; but unfortunately, the BIFR does not have the machinery necessary to exercise the powers effectively, and there are other obstacles in the way. Due to the defective definition of sick industrial companies the entire procedure of BIFR has become a futile exercise.

SICA was developed on the basis of Tiwari Committee Report, 1981<sup>13</sup>. However, it omitted certain vital recommendations like potential sick units to be considered for revival. This can be considered as consciously incompetent, which made BIFR under SICA ineffective. It was debtors driven and ignored the creditors interest, cost of funding and resulted in huge Non-performing assets. The BIFR was a quasi-judiciary authority, and SICA did not separate judiciary from administration. It was not a behavioral legislation; it was debtors' paradise and it motivated many managements to further the sickness to get registered with BIFR and could get moratorium for indefinite period

SICA ignored many suggestions of the Tiwari Committee and also suggestions made in various approaches to the concept of sickness. Instead of calling an un-well unit as sick unit, SICA only treats a failed unit as a sick unit. There is no distinction between a sick unit and a failed unit. Sickness is a stage prior to failure and this fact is totally ignored under SICA. In view of the aforesaid inadequacies, SICA did not provide any scope to BIFR to prevent sickness in respect of potentially SICs even after its amendment in 1993. The inadequacies also curtailed the role of BIFR. The recommendations of Goswami Committee for removing the barriers to corporate and industrial restructuring were virtually ignored.

SICA did not borrow crux of these and several other studies available in evaluating the BIFR cases. Rather SICA left it to choice of company management to submit the Rehabilitation Scheme and later discussed and approved at Consortium meetings of Banks and Financial Institutions. Once management and Consortium gave their consent for revival scheme, then BIFR could accept or reject. Virtually BIFR had no discretion in exercising alternative proposals due to inherent constraints under SICA. BIFR in any case could neither compel creditor or debtor could only persuade them. BIFR had no mechanism under SICA to appraise and monitor the cases on the lines suggested by the aforesaid theories nor SICA provided any acceptable mechanism. This resulted in the then existing management to take advantages of the loopholes of the legislation to their advantage. It did not base on any core economic theories despite many research findings available in changing market dynamics. Though the preamble was proactive the provisions were not in consonance with its preamble. The Act could not

visualize the futuristic dynamics of market economy, not adequately borrowed from inhouse studies like Prof. L.C. Gupta, Dr. Omkar Goswami and several others.

Dr. L.C. Gupta<sup>14</sup> suggested for tracking the root cause of sickness and determining the remedial measures based on turnaround conditions. Dr. Omkar Goswami<sup>15</sup> during 1993 suggested the mechanism how BIFR should function in market economy and suggested for setting up National Company Law Tribunals. Based on his recommendations the Government as a proactive step of convergence of law, thereby the provisions of SICA were to be incorporated in Companies Act and in place of BIFR, AAIFR and High Court there shall be NCLT and eventually SICA to be repealed. Accordingly, Companies (Amendment) Act, 2002 was enacted with aforesaid proposition, however, the same did not materialize due to stay order granted against the operation of NCLT from Supreme Court. Thereafter, these provisions under the Companies Act had no sanctity till 2016 when IBC was framed as a consolidation of several legislations. A market economy primarily envisages removal of barriers for corporate and industrial restructuring with a suitable legal framework.

The fundamental assumption in bank lending is one based on symmetric information – the bank and the debtors have the same knowledge about the probability of failure associated with the project. However, in real-life and financial markets in particular, information asymmetries are more than the norm than the exception. (Subhashish Ganagopadhyay 2019)<sup>16</sup> Further as observed by Subhashish Ganagopadhyay apart from interest rate there are other factors in economic literature focused on adverse selection, (Stiglitz and Weiss, 1981)<sup>17</sup>. There are three phases in Bank lending i.e. at the beginning, operational phase and third loan repayment phase. The operational phase is in hands of corporate debtor at his option. The second phase is under discretion of corporate debtor. As further observed by Dr. Subhashish Ganagopadhyay that one part of the literature on credit rationing shows how moral hazard (Holmstrom and Tirole, 1977), (Tirole, 2006) or opportunistic behavior by the debtor in the second phase, is an important determinant of banks' willingness to lend. More is the ability of banks to anticipate and prevent moral hazard, greater will be the bank's willingness to lend. By opportunistic behavior we mean action taken by the debtor, in the second phase of the life-cycle of a project, that trans value away from the lender to the shareholders.

Further it is observed by Dr. Subhashish Ganagopadhyay that Financial market infrastructure performs three fundamental roles in the real economy viz., run the payments system, channel savings to new investment and, reallocate failed investments to new investments with positive returns. The ease with, or the cost at, which the third happens is a function of the bankruptcy institution. Maksimovic and Phillips (1998), Wihlborg, Ganagopadhyay and Hussain (2001) and Bernstein, Colonnelli and Iverson (2018) have studied the efficiency of different bankruptcy systems in the world<sup>18</sup>. As observed by Dr. Ajit Ranade<sup>19</sup> based on the works of Aghion, Hart and Moore (1992) the modern capitalist market-oriented economy works on the foundation of the sanctity of contracts. What happens if a contract is breached? What is the recourse? Economic theory<sup>20</sup> makes a distinction between ex-ante and ex-post behavior and the incentives of players involved in a contract. A contract which is attractive and mutually beneficial ex-ante, may not turn out to be so ex-post. A corporate failure due to lack of innovation or meeting the challenges of competition or other reasons, must be provided exit if opted, if not it gives rise to several issues. That is where the role of the state comes in, even enforcing contracts between them. This in fact created an obscure situation as we witnessed during SICA regime. Socioeconomic factors also envisage maximization of value of assets either by restructuring or insolvency.

It is relevant to state the IBC framework virtually comprehended with theoretical framework and recommendations of the several committees in especially after liberalization via. Dr. Goswami Committee, Justice Erradi Balakrishna and others, which were not adequately addressed under SICA.

### **3. What are the pathbreaking paradigm shift witnessed under IBC framework in providing one stop solution based on BLRC report.**

The Code<sup>21</sup> is a comprehensive legislation 'to consolidate and amend the laws relating reorganization and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner.

GST and IBC are path-breaking legislations have been key in significantly changing India's perception globally as a business-friendly environment<sup>22</sup>. The IBC is benefitted from the cumulative experience of the rich history of bankruptcy law in the west, most notably in the US and UK and other countries<sup>23</sup>. (Ajit Ranade, 2019)<sup>23</sup>.

Firstly, the Bankruptcy Law and Reforms Committee headed by Dr. T.K. Vishwanathan considered adequately the similar Code in US, UK and several other countries, then customized and improvised to suit the Indian Economy and Indian Business Environment. His recommendations were virtually emerged as IBC, 2016<sup>24</sup>.

Secondly it has CIRP mechanism to provide timely insolvency resolutions. The Information Brochure of CIRP<sup>25</sup> published by IBBI state that the IBBI is a key pillar of the ecosystem responsible for implementation of the Code. It is a unique regular; regulates service providers as well as transactions. Further it has regulatory oversight over Insolvency Professionals, Insolvency Professional Agencies, Information Utilities, Registered Valuers and Registered Valuer Organizations. It writes regulations to govern transaction, namely Corporate Insolvency Resolution Process, Corporate Liquidation, Individual Insolvency, and Individual Bankruptcy under the Code and enforces the Code, rules and regulations made thereunder.

Thirdly, Insolvency and Bankruptcy Code, 2016 (IBC) has down lessons from the past failures of SICA. The recommendations of Dr. Omkar Goswami Committee and Justice Erradi Balakrishna have categorically suggested substantially the dynamics of market economy and need for ease of exit. These are considered in BLRC Report.

Fourthly, IBC is a behavioral law. It is Creditors driven while giving option of approaching the Code by both debtors and creditor. The BLRC recommendations is comprehensive and based on several of the international economic theories especially taking cognizance of a) endowment of resources b) Competition c) Innovation and how these factors can decide the fate of an entity. The market forces are given highest importance. The need for honorable exit is considered as a natural

phenomenon while giving importance of ease of entry. Further cost of credit and availability of funds with the financial creditors envisages ease of entry and exit for the long run survival of not only financial creditor but also the growth of industries and economy in general. Therefore, IBC is a behavioral legislation based on creating a culture among stakeholders for consensus for win win situation in pragmatic perspective. The dynamic legislation is an economic legislation with a vision and strategic perspective and path creating platform for strategy focused resolutions and reorganization of corporate entities at micro level and economy at macro level.

Fifthly, The Code is a landmark piece of legislation which provides for institutionalized creditor-in-control mechanism for reorganization and insolvency resolution of corporate persons, partnerships firms and individuals in a timebound manner for maximization of value of assets of such persons, to promote entrepreneurship, availability of credit, while balancing the interests of all the stakeholders.<sup>26</sup>

Finally, as observed by Dr. M.S. Shao<sup>27</sup> Chairman, IBBI, beyond revival of firms, the Code has ushered in significant behavioral changes resulting in substantial recoveries for creditors outside the Code and improving performance of firms. He further says it is important to consider what happens in the processes under the Code and what happens on account of the Code This is where we need to understand the success of IBC as behavioral law from strategic perspective. In the Quarter Newsletter of IBBI, Jan-Mar., 2020<sup>28</sup> it is highlighted that the art of value maximization in CIRP. It requires one needs to read carefully while aiming to maximise the value in a corporate insolvency resolution process as unidirectional approach may yield sub-optimal outcomes. He elaborately focused on Liquidation value, Resolution value, fair value and enterprise value. In the Quarter Newsletter of IBBI, April-June., 2019<sup>29</sup> the chairman, IBBI states he focused on a resolve for resolution – the need for time bound insolvency resolution of corporate debtors for maximization of value of their assets, being the part of IBC (amendment) bill, 2019. In another Insolvency and Bankruptcy News, April- June, 2019, he highlighted how IBC a code for corporate governance – by laying down norms that seek to prevent failure of companies and rescue failing companies, the IBC has taken corporate governance to new heights in the country<sup>30</sup>. He further brought out in July-September, 2019 Insolvency and Bankruptcy news, how IBC is focused on socio economic factors and protecting the interest of stakeholders. He says life of a company is a precious as that of a human. The IBC has added a new lifeline to rescue company when it experiences a serious threat to its life.<sup>31</sup>

IBC is not only a proactive economic legislation but also has institutional mechanism under four pillars to provide solution based on onion process. The institutional development, institutional communication, balancing the interest of stakeholders with timely amendments are the success mantras of IBC. The professional approach and contribution of Insolvency Professionals, Committee of Creditors, Information Utilities, IBBI in maintaining the time line is commendable. The timely contribution of Adjudicating Authorities in upholding the preamble of the Code is speaks about ultimate success.

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