Introduction to the Special Issue on ‘Financial Distress, Bankruptcy, and Corporate Finance’

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BANKING CONCERNS AND GENESIS OF THE INSOLVENCY BANKRUPTCY CODE

In the aftermath of the 2008 global financial crisis, economic growth concerns, and the need for a faster recovery dominated the public policy discourse in India. The Reserve Bank of India (RBI) allowed forbearing on certain kinds of stressed loan restructuring. Presumably, the RBI envisaged it as a short-term temporary measure, and regulatory forbearance could be quickly withdrawn with the upturn of the business cycles. However, in reality, it played out quite differently. Ever greening of loans continued and inadequate recognition of non-performing credits under earlier bankruptcy regimes made banks’ balance sheet appear healthy. As a consequence, the Indian banking sector started facing increasing challenges of managing surmounting stressed assets, particularly after 2011.

A large portion of stressed but restructured assets was emanating from the infrastructure-related sectors such as construction and power, which were primarily government owned. For the private corporate sector, it faced a typical moral hazard problem. For example, the loan default of Kingfisher Airlines to the tune of over ₹9,000 crore during 2015–2016 made headlines. It was less than 4 per cent of the total outstanding gross non-performing assets (NPAs) of banks. In the absence of any resolution mechanism, the said company made an offer to pay back ₹4,000 crore. Such settlement was avoided as it would have set a precedence which would have far-reaching consequences on the banking sector.

Once the regulatory forbearance of restructuring or over greening of assets was withdrawn, and RBI introduced a systematic asset quality review (AQR) in July 2015, the dimension of the stressed asset problem was relatively clear. The gross NPA ratio of public and private sector banks together went up from 3.4 per cent of gross advances in March 2013 to 4.7 per cent in March 2015, and further to 9.9
per cent by March 2017. As on March 2019, this ratio remained high around 9.3 per cent (or ₹. 949,279 crore in the absolute sense). In dealing with delinquency issues, public sector banks faced major dilemmas.

The public sector banks, in particular, struggled to maintain minimum regulatory standards of capital adequacy. Although non-bank financial intermediaries gained prominence in credit allocation over time, organized banking system remained the fulcrum of the financial intermediation process in India. As a consequence of its sub-per performance, credit growth was severely hampered, and that effectively contributed to the slowing down of economic activity. In terms of strategy, Ms Nirmala Sitharaman, Finance Minister, Government of India, in 2019 emphasized the so-called 4R’s strategy of ‘recognising NPAs transparently, resolving and recovering value from stressed accounts, recapitalising public sector banks (PSBs), and reforms in banks and financial ecosystem to ensure a responsible and clean system’.

Introduction of the Insolvency and Bankruptcy Code (IBC) in 2016 is considered a landmark reform in the Indian financial system. At the same time, performance-linked recapitalization of public sector banks was believed to ‘bring in discipline and disincentivize the recurrence of forbearance and stress’ (RBI, 2017). Note that India was not necessarily lagging in terms of institutionalizing a legal framework of stressed assets or default debt resolution. From the financial intermediary side, there were three related acts, namely the Indian Contract Act, 1872; the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDBDBFI); and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002. From the firm side, there were acts such as the Companies Act, 1956, and the Sick Industrial Companies (Special Provisions) Act, 1985. These acts, however, got limited traction among banks. In this context, if implemented in the true spirit, IBC is a real game changer.

The RBI has been quite active in addressing the problems of stressed assets and their timely resolution. Through a detailed circular dated 7 June 2019, the RBI overhauled and rationalized the stressed assets resolution framework. These developments have far-reaching implications for the financial sector. Immediately after the default of a loan account, banks are asked to identify and report incipient stress in loan account under three-tier special mentioned accounts where the principal or interest is overdue for 1–30 days, 31–60 days, and 61–90 days, respectively. For a given exposure limit of a borrower, these data are to be reported to Central Repository of Information on Large Credits (CRILC) of RBI every month. In addition to monitoring, banks were asked to put a board-approved resolution plan, including timeliness, and if the resolution of the stressed assets would be pursued under IBC. The resolution plan can only be considered as implemented if some set criteria/standards are met. Once decided, banks can file insolvency proceedings and realize the best value of their assets. Further, recent amendments to IBC will strengthen banks’ ability towards better resolution and settlement. These amendments have sector-specific implications as well. In the medium term, cleaning up of balance sheets of banks will further push up non-performing loans (NPLs), and higher provisioning therefore will hit the bottom lines of banks. However, provisions of IBC will safeguard the interest of lenders and create a transparent credit culture. Therefore, IBC will provide a way to clean up banks’ balance sheets, improve performance, and make the Indian banking system more competitive.

Four years after the promulgation of the Insolvency and Bankruptcy Act in 2016, an ordinance—The Insolvency and Bankruptcy Code (Amendment) Ordinance, 2020—was promulgated to suspend the IBC, 2016. Such is the uncertainty of life that lawmakers are presently compelled by the fast-changing circumstances to rise to the occasion and make laws which seem to be needed at that time. The amendment through the ordinance has given a breather to stressed corporates by suspending fresh insolvency proceedings for six months from 25 March 2020—the day when the lockdown was imposed in India as a preventive measure against the COVID-19 pandemic. It is anticipated that the period of six months will be extended up to a year or even more, as the need may arise.

**REFORMS RELATED TO BANKRUPTCY AND INSOLVENCY IN INDIA**

In 2016, when IBC was legislated, and it came into force, there were high hopes for the streamlining of insolvency and bankruptcy proceedings in India—an area of commercial activity which had been neglected for a very long time. Insolvency laws and proceedings in India were out of sync with the best practices followed in the developed economies in the world, and it had been one of the major grievances of foreign and
domestic investors alike. The period of about four years since the law came into force has been of hectic activity on all the fronts—action taken on the part of lenders, insolvency resolution professionals, the Insolvency and Bankruptcy Board of India (IBBI), tribunals, lawyers, businesspersons, and also academics.

While the IBC made shutting down a business easier and smoother by declaring insolvency, the cultural and social issues of being stigmatized have still haunted Indian businesspersons. Efforts have been made to spread awareness and change the mindset of businesspersons so that there can be an honourable exit option for loss-making business propositions.

In India, it has been difficult to truly understand the phrase ‘you win some, you lose some’ as opting for insolvency proceedings has been perceived to be losing the battle. The businessperson doing so is labelled as a ‘loser’. Besides the cultural and social issues, there have been serious legal roadblocks in the process of insolvency. Despite the economic reforms of 1991, which were detailed and had resulted in the overall economic growth of all sectors of the society (Ahluwalia, 2016), prolonged legal proceedings decelerated the process and often resulted in a lot of waste of precious resources (Chemin, 2012). The Companies Act, 1956, proved to be cumbersome and circuitous with the provisions for winding up of a company.

The Sick Industrial Companies Act (SICA), 1985 was enacted to expedite the process. The Board for Industrial Finance and Reconstruction (BIFR) was set up under this law. However, insolvency cases continued to pile up over time, as the existing laws at that time were cutting no ice. Globally, India’s position in the World Bank’s Ease of Doing Business Index was very low, and insolvency laws inter alia were also responsible. Jurisdictions around the world were using different legal mechanism with a varying degree of success and effectiveness (Djankov et al., 2008). The Bankruptcy Law Reform Committee (BLRC) recommended enacting a new law for insolvency and bankruptcy (GOI, 2015). Enactment of the new law, IBC, undoubtedly brought new hope and India’s position in the Ease of Doing Business Index rose sharply, and insolvency laws contributed to the increase along with other economic reforms.

About four years have passed since IBC came into effect, and during this time, several high valuation cases have either been resolved or are in the process of resolution. A few notable cases are Essar Steel, Bhushan Steel, Amtek Auto, Jet Airways, Dewan Housing, Lanco Infra, etc. It is too early for the law to settle. Things have not yet been crystallized. Financial and operating creditors have been trying their best to get the finest deal by lobbying for tweaking the freshly minted law in their favour. In contrast, regulatory bodies, think-tanks and domain experts have been advocating for a balanced approach to take care of the interests of borrowers, and primarily the employees who are usually in a vulnerable position. As this tug of war continued, the time period for resolution was extended from 180 days to 270 days by an amendment in August 2019.

There have been problems regarding the lack of infrastructure at the tribunals, and woefully inadequate number of judicial officers and insolvency resolution professionals. It is unreasonable to expect very high levels of professional expertise in the nascent years of the IBC in India.

The business models of creditors depend on adequate return on investment, even if it takes a much longer time to fructify. One can easily anticipate a lot of conflicting views between borrowers and lenders, resulting in disputes. It would be prudent for both of them to amicably resolve these disputes, particularly in this time of crisis. It is unrealistic to expect the exhibition of prudence from many such parties, and, therefore, in the near future, there may be a large number of applications filed in different judicial and regulatory fora. In a case, recently decided by National Company Law Appellate Tribunal (NCLAT), Mr Srikanth Dwarakanath, Liquidator of Surana Power Limited vs. Bharat Heavy Electricals Ltd, there has been too much confusion about the provisions of IBC vis-à-vis SARFAESI. In NCLAT, the decision was in favour of BHEL, whereas the latter has been in favour of the liquidator. The confusion has been further compounded by the issues related to arbitration and an ex parte award in favour of BHEL. This is not unexpected as the matters are quite ticklish and intricate legal issues are involved. These questions of law—the relationship between IBC and SARFAESI, IBC and arbitration, for instance—can be finally decided either by proper legislative action, or timely judicial interpretation. As any interpretation—whether in favour of creditor or debtor—will set a precedent, it is of utmost importance that the interpretation is not made keeping strict legality in mind but also the social and humane perspective of the insolvency and bankruptcy law.
It has been emphasized by experts on a number of occasions that mechanical treatment to this law resulting in literal interpretation is not desirable, and, hence, subjectivity in disputes between creditors and lenders cannot always be resolved routinely, though objectivity has definitely been a cherished goal of this legislation. Predictability and certainty of insolvency proceedings will remove doubts in the minds of all the stakeholders leading to well-informed decision-making and absence of chaos. Role of insolvency professionals in developing the skills to manage intricate issues involved with lack of resources, high expectations and an urgent need to take action at the earliest brings a lot of tension in the system. It causes serious stress to almost all the parties involved in the proceeding. The sooner a final interpretation is given by the Supreme Court, the better it will be for the business environment.

The difference between financial creditors and operational creditors has been sometimes blurred by conflicting legal provisions, and sometimes treated quite distinctively as interests of these types of creditors are not at par, which needs to have a well-defined priority listing, but the problem arises that the facts of each insolvency case deserve a different type of treatment which may not be possible to be done in a just and fair manner using the predetermined prioritization. Once every insolvency matter is allowed to be handled on a case-by-case basis, the purpose of legislation, rulemaking, and interpretation gets defeated. Everything depends on the discretionary power of the presiding officer. This is a challenging situation, and one of the possible ways to handle is to classify insolvency matters into categories which are by and large homogeneous internally, but the entire set remains heterogeneous. It will be better to get this classification done by the legislature rather than by an interpretation of the Supreme Court.

During this formative period, there has been a harsh blow in the form of the COVID-19 pandemic. Due to the changed circumstances, almost everything has been put on hold. For this purpose, the ordinance of 2020 has been promulgated. The day when the lockdown was imposed—25 March 2020—has been taken as the cut-off date and the law has made the clock to stop ticking. But for how long? A period of six months has been provided for in the ordinance which can be extended to one year. Even if this period is further extended, the borrowers have to payback, and the creditors would surely like to have their pound of flesh in the form of reasonable interest. What would be a reasonable rate of interest or some other form of compensation will be determined in due course of time by the legislature. The developments due to the COVID-19 pandemic will have an impact on the course of lawmakers.

**INSOLVENCY REFORMS AND ECONOMIC CONSEQUENCES: INTERNATIONAL EVIDENCE**

The extant literature suggests that creditor rights during debt defaults and bankruptcies by firms are often related to historical legal origins and can influence the behaviour of managers and creditors. In this section, we review the following: (a) the efforts to create harmonized cross-country indices of creditor rights; (b) the evidence on the influence of creditor rights (particularly during bankruptcy) on the actions of managers in their borrowing decisions and risk-taking activities; and (c) the impact on bank lending and development of credit markets.

In an influential study, La Porta et al. (1998) created a creditor rights index based on the rights of creditors in both reorganization and liquidation of firms that have defaulted on their debt obligations. The authors find that the legal origin matters for creditor rights, with countries following the English common law tradition offering creditors the strongest legal protection against managers and those following the French civil law tradition the weakest protections. DJankov et al. (2007) extended the creditor rights index of La Porta et al. (1998) to a large sample of 129 countries. The World Bank’s Resolving Insolvency index builds on these studies. It provides a harmonized measure of the strength of the insolvency framework based on the time, cost, and outcome of insolvency proceedings that determine the recovery rate in bankruptcy (World Bank, 2019).

Stronger creditor rights have been related to more conservative actions by managers and a reduction in their risk-taking activities. This may be related to the possibility of managers losing control of the firm during bankruptcy under strong creditor protection, and their consequent efforts ex-ante to reduce the chances of financial distress (Claessens & Klapper, 2005). In a cross-country study on the effect of creditor rights on mergers and acquisitions, Acharya et al. (2011) found that stronger creditor rights in bankruptcy are related to a greater propensity for diversifying acquisitions across industries, lower cash flow risk (as measured by the standard deviation...
of return on assets), and a decline in corporate leverage. Favara et al. (2017) found that firms with a higher risk of debt distress take on relatively less risk and invest more after the implementation of bankruptcy reforms.

Cho et al. (2014) reported from a cross-country analysis that stronger creditor rights are associated with lower long-term leverage (long-term debt as a share of book value of total assets) and the extent to which investment is financed by such debt. Using data on firms in 60 advanced and developing countries, Gopalakrishnan and Mohapatra (2020) reported that a stronger insolvency regime reduces firms’ likelihood of defaulting on their debt. They also found that a better insolvency framework moderates the adverse effects of increased policy uncertainty and economic shocks such as debt and currency crises on firms’ default risk. The findings imply that a better insolvency regime, by reducing the ex-ante propensity of managers to undertake risky investment and financing activities, can reduce the risk of debt distress among firms both during normal economic conditions and crisis events.

Prior studies support the role of a stronger bankruptcy framework in facilitating the exit of low-productivity firms and in improved macroeconomic outcomes. For instance, Bergoeing et al. (2002) reported that reforms to enable a faster resolution of insolvency proceedings in Chile contributed to a faster recovery from a debt crisis in the early 1980s compared to Mexico that did not implement similar reforms. Adalet McGowan et al. (2018) argued that the productivity slowdown in OECD countries may be linked to the persistence of low-productivity ‘zombie’ firms in countries with high barriers to exit, which are related to weaknesses in their insolvency regimes. This can distort productivity-enhancing capital reallocation and lower investment and employment growth of more productive firms.

Stronger creditor rights are also linked with improvement in bank financing and credit flows. This is likely to be related to the lower risk-taking by managers in countries with improved insolvency regimes, as discussed above. Djankov et al. (2007) reported that better creditor rights are associated with a higher ratio of private credit to GDP, suggesting that improvement in creditor rights can facilitate the development of credit markets. Bankruptcy reforms in Italy to strengthen creditor rights in liquidation reduced interest rates, improved access to credit, and spurred investment in small and medium-size enterprises (SMEs) in the manufacturing sector (Rodano et al., 2016). Ponticelli and Alencar (2016) found that bankruptcy reforms in Brazil resulted in increased bank loans to manufacturing firms, particularly for those located in judicial districts with less congested courts, and an improvement in their investment and output. Neira (2019) developed a theoretical model of financial intermediation and informational frictions to argue that an improvement in bankruptcy procedures is expected to result in higher lending and lending to more productive firms. The authors show that more efficient bankruptcy procedures in the OECD countries are associated with a higher proportion of new bank loans allocated to large firms.

**OVERVIEW OF THE SPECIAL ISSUE**

The special issue carries a set of insightful and thought-provoking articles on several key issues around the resolution of business insolvency. This special issue featuring perspective articles, research articles, and a colloquium is a sequel to the IIMA–World Bank Financial Distress, Bankruptcy and Corporate Finance Conference held in August 2019.

The perspective articles significantly improve the understanding of the bankruptcy law and the institutional mechanism involved. One of the perspective article, authored by M. S. Sahoo and Anuradha Guru titled ‘Indian Insolvency Law’, presents an overview on the Indian Insolvency Law by interlinking its role with other key enabling elements of an economy. The authors interlink the role of a well-developed credit market to efficiently finance businesses; a structured mechanism to facilitate entry and exit of businesses as well as entrepreneurs; a competitive marketplace to ensure optimum utilization of resources and well-established process to rescue firms from premature death. Further, the article explains the role of the four important institutional elements of the Insolvency Law, namely insolvency professionals, information utilities, the National Company Law Tribunal, and IBBI. Supported by data, the article presents the extent of progress made in insolvency resolutions facilitated by the Law. It dispels several misconceptions about the Insolvency Law which stem primarily from the lack of understanding of the intent of the Law and the processes involved. The authors conclude by arguing that the impact of the Law, such as behavioural changes among the entrepreneurs and lenders, will be visible over a period of time.

The article titled ‘Under Pressure: Integrating Online Dispute Resolution Platforms into Pre-Insolvency
Processes and Early Warning Tools to Save Distressed Small Businesses’ by Antonia Menezes, Nina Mocheva, and Sagar Siva Shankar examines the role that could be played by alternative dispute resolution (ADR) generally referred to as online dispute resolution (ODR). The crucial role that can be played by technology such as ODR is no better highlighted than in the COVID-19 pandemic as social distancing norms have led businesses and courts around the world to seek innovative solutions to continue functioning. They make a compelling case for the ODR system to facilitate the resolution of financial distress of small entrepreneurs before they enter a state of financial distress. In combination with early warning tools (EWT’s), it can incentivize entrepreneurs to seek early assistance, and thereby reduce costs for both creditors and debtors. The article applies the framework to the handling of pre-insolvency procedures of micro, small and medium enterprises (MSMEs) in India and illustrates the issues that governments should deal with in applying combined ODR and EWT platforms. The authors conclude that designing and implementing an ODR-pre-insolvency regime (with or without EWT) would promote the growth of MSMEs, as well as provide increased comfort to banks and financial institutions in extending credit to the sector.

The two research articles included in the Special Issue examine the challenges created by the insolvency of global businesses and business groups and suggests ways to deal with them. The article titled ‘The Need for Implementing a Cross Border Insolvency Regime within the Insolvency and Bankruptcy Code, 2016’ by Ishita Das examines the provisions on cross-border insolvency in the IBC and argues that there is a need to strengthen the current system. Drawing from instances where foreign firms have filed for bankruptcy in another country, in an attempt to avoid dealing with the Indian regulators, the article argues that adopting a UNCITRAL Model Law provides an efficient system of dealing with cross-border insolvency proceedings.

In a related article, titled ‘Cross-border Corporate Insolvency Law in India: Dealing with Insolvency in Multi-national Group Companies: Determining Jurisdiction for Group Insolvencies’ by Priya Mishra, issues presented by the insolvency of one of the group companies are examined, especially when the insolvent group company is located outside India. The article attempts to decipher the approach of common law in dealing with a distressed company which has an existence outside India or where the entire group faces insolvency. The article examines pertinent case law in the UK and other common law jurisdictions while taking into account the international best practices in an attempt to find a solution to such group company insolvencies.

The Special Issue also carries four articles which are part of a Colloquium on ‘Insolvency and Bankruptcy Reforms: The Way Forward’. In the article ‘A Concise History of Bankruptcy, Insolvency, and Debt Restructuring Laws in India’, Saket Hishikar studies the history of bankruptcy and insolvency laws in the post-reform period starting from 1993. The article discusses several key regulations including RDDBFI, 1993, and the SARFAESI Act, 2002. The author argues that until the introduction of the IBC, 2016, there has been no comprehensive framework or strategy to tackle insolvency and bankruptcy proceedings effectively. The article discusses the implementation challenges of IBC. It argues that the repeated use of ordinances to amend the law displays the lack of understanding of ground realities.

Saakshi Bangar in the article, ‘Legal Perspectives on IBC’ provides an overview of the processes under IBC. She explains the recent developments and the challenges faced by the stakeholders. The article describes the key features of the framework under the Corporate Insolvency Resolution Process (CIRP) and the liquidation process for corporate debtors. Under the CIRP, the article explains how to prevent insolvency proceedings against SME amidst crisis such as COVID-19. Under the liquidation process, the article explains the triggers for liquidation and the process followed after liquidation. The article also discusses the recent developments related to IBC such as provisions relating to insolvency and bankruptcy of financial service providers, and the scope of ‘interim finance’. The article presents possible solutions to ease the implementation of IBC.

Taking the discussion on IBC forward, the article titled ‘IBC 2.0 in the Making: A Relook into the Insolvency Regime in India’ authored by Sandeep Parekh and Sudarshana Basu examines the significant amendments to IBC and lays out a framework for future changes. The article discusses the important changes such as the primacy of the committee of creditors; Section 29A: Eligibility for Resolution Applicant; Operational Creditors vis-à-vis Financial Creditors; Home-buyers as ‘Financial Creditors’ Withdrawal of CIRP, and Insolvency of Financial Service Providers (FSPs). The article discusses the roadmap for future, highlighting areas that require attention. For instance,
the article argues that IBC framework is not equipped to deal with the various dimensions of cross-border insolvency. It also highlights the lack of a ‘pre-pack’ insolvency process wherein the sale of all or part of the entity’s business is negotiated with a buyer, before the initiation of the insolvency proceedings. The article also draws attention to the lack of adoption of group insolvency, various sectoral impediments to insolvency, and the large amount of time taken for legal proceedings.

The article titled ‘Impact of the Indian Insolvency Framework on Corporate Governance, Business Practices and Capital Markets’ by U. K. Sinha examines the broader impact of IBC on the behaviour and practices followed by corporates and lenders, on the governance of corporate and on the capital markets. The article explains that IBC has significantly transformed corporate governance by emphasizing the role of creditors as that of a stakeholder. The IBC has put in place strong deterrence measures to prevent directors and promoters from indulging in financial malpractices. The IBC also imposes civil and criminal liability for the erring directors of the company. While discussing the implication of IBC on business practices, the article states that IBC has brought about a sense of responsibility and urgency among the promoters and management of the company. The fear of losing control over their companies is prompting promoters to sell off their assets or ownership to settle or resolve their dues, which presents an opportunity for investors in stressed assets. The author argues that due to increased scrutiny and responsibility, borrowers have started to evaluate loan proposals with stringency and monitor companies during the tenure of the loan, including pre- and post-insolvency proceeding periods. The article identifies several indicators of the positive impact of IBC on the capital markets; increase in recovery from 26 per cent under the previous mechanisms to 72 per cent under IBC and rise in investor confidence in the Indian market accompanied by investments in stressed assets. The article concludes that while the primary outcome of IBC is measured by the number of resolutions made or the amount of lenders’ dues realized, the larger impact on the governance culture of corporations is more fundamental.

NOTES
1. No. 9 of 2020; 5 June 2020.
2. From 130 in 2016 to 63 in 2019.
3. The Insolvency and Bankruptcy Code (Amendment) Act, 2019. https://www.ibbi.gov.in/uploads/legalframework/630a836c9fbed047c42dbfd2aca13.pdf
4. NCLAT, Company Appeal (AT) (Insolvency) No. 1510 of 2019, 18 June 2020.
5. As discussed by La Porta et al. (1998), the origins of legal systems in many countries are related to occupation or colonization by European powers. These legal traditions include English common laws and the French, German, and Scandinavian civil laws.
6. Insolvency reforms carried out in India in recent years, particularly with the introduction of the IBC in 2016, has resulted in a dramatic improvement in India’s rank on the Resolving Insolvency index from 132 in 2016 to 52 in 2020.

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