

# RATIONALISING GROUP STRUCTURE THROUGH INSOLVENCY LAW

Pratik Datta<sup>1</sup>

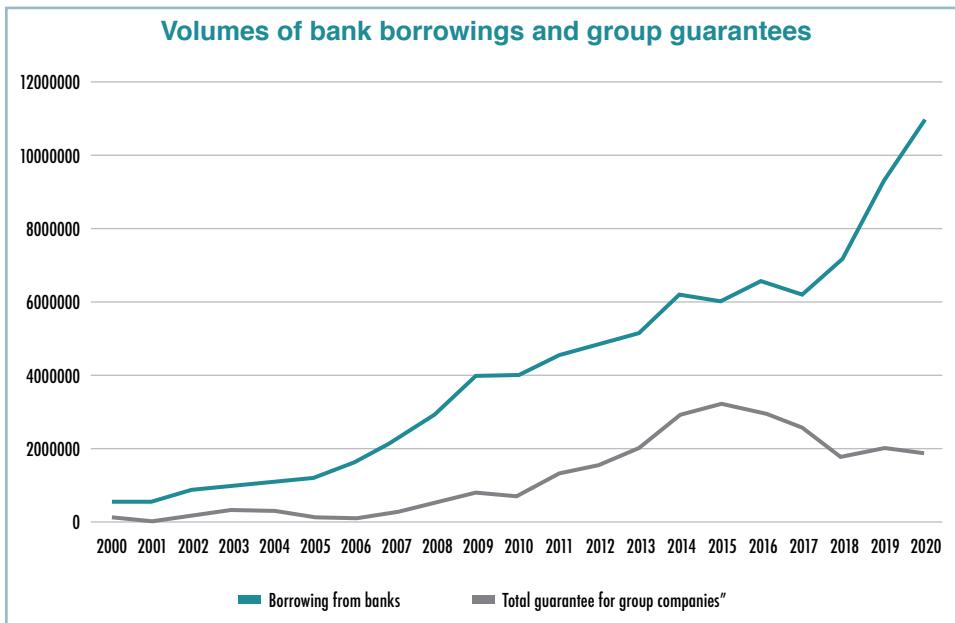
## INTRODUCTION

Complicated group structures make insolvency resolution of group companies challenging. The Insolvency and Bankruptcy Code, 2016 (Code/IBC) does not squarely address such challenges. This is the reason why Indian judges and policymakers have been grappling with group insolvency cases like Videocon, Era Infrastructure, Lanco, Educomp, Amtek, Jaypee, Aircel, RCom and IL&FS. Reacting to these challenges, the Insolvency and Bankruptcy Board of India (IBBI) constituted a Working Group on Group Insolvency in 2019 to recommend a complete regulatory framework to facilitate insolvency resolution and liquidation of corporate debtors (CDs) in a corporate group. The Working Group highlighted that key elements of a group insolvency framework must include procedural coordination mechanisms, substantive consolidation mechanisms and rules against perverse behaviour. However, it recommended phased implementation of these mechanisms, with only procedural coordination of companies in domestic groups being implemented in the first phase.<sup>2</sup> In the meantime, the National Company Law Tribunal (NCLT) in *State Bank of India v. Videocon Industries Limited* used substantive consolidation to simplify the resolution of intricately interlinked group companies.<sup>3</sup>

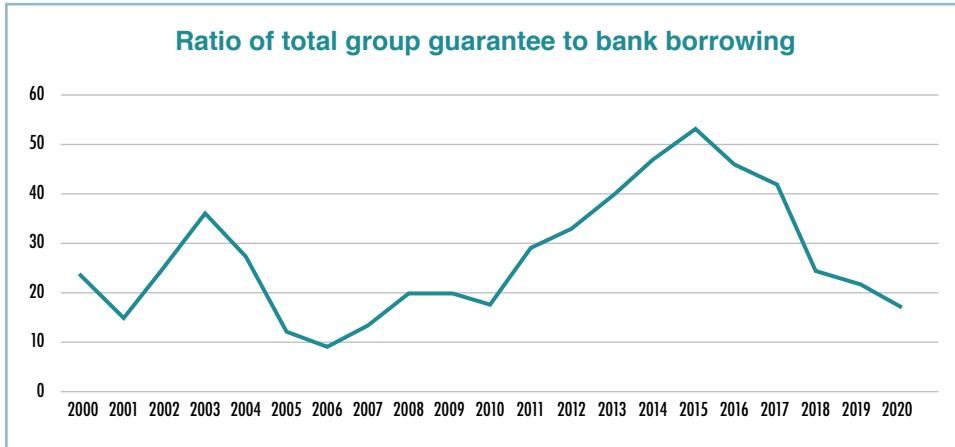
A common source of complexity in group structures is the frequent use of inter-corporate guarantees within group companies for external credit, that is, *intra-group guarantees*. Figure 1 shows that the volumes of total group guarantees and bank borrowings by BSE 500 listed companies have grown steadily over the last two decades.<sup>4</sup> The compounded annual growth rate (CAGR) of total

group guarantees by value over the last 20 years has been 13.68 %. Figure 2 plots total group guarantees as a percentage of bank borrowings by value of BSE 500 listed companies over the last 20 years. Since 2006, the value of total group guarantees as a proportion of bank borrowings steadily increased to reach 53.21% in 2015. Since then, the ratio has steadily decreased to reach 17.2 % in 2020.<sup>5</sup> To better understand this trend reversal, Figure 3 plots the year-on-year growth in total group guarantees against year-on-year growth in bank borrowings by the BSE 500 companies. This reveals that between 2010 and 2015, the growth in total group guarantees was higher than the growth in bank borrowing. After 2015, this trend reversed. However, on average, the value of total group guarantees has been 27.4 % of bank borrowings over the last 20 years. Therefore, it may be concluded that intra-group guarantees have been used quite extensively by listed Indian companies, although their growth in volume terms has been decreasing since 2015-16. Such extensive use of intra-group guarantees creates intricate inter-linkages across group companies complicating the overall group structure.

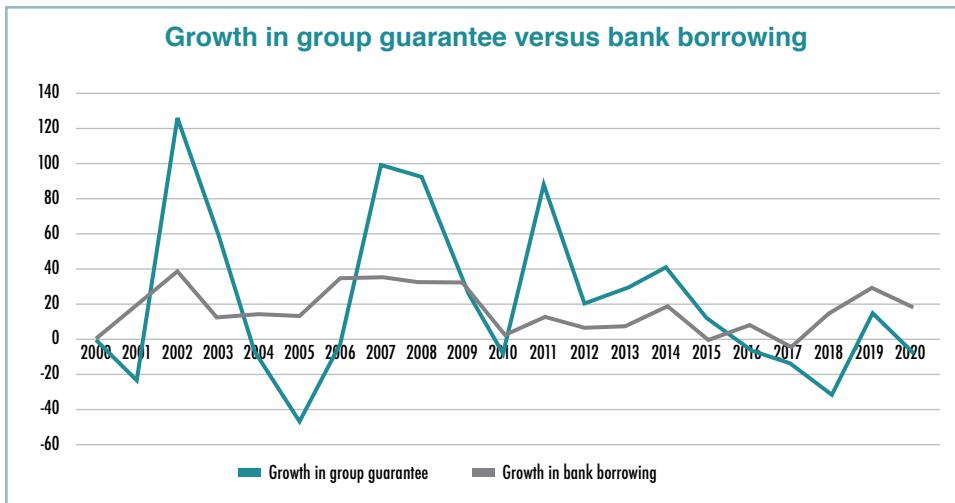
**Figure 1: Volumes of group guarantee and bank borrowings by BSE 500 listed companies**



Source: CMIE

**Figure 2: Group guarantees as a percentage of bank borrowings by BSE 500 listed companies**

Source: CMIE

**Figure 3: Year-on-year growth in group guarantees and bank borrowings by BSE 500 listed companies**

Source: CMIE

These complications impose huge costs during group insolvency resolution in court as well as in out-of-court restructuring. In a bid to reduce such costs, the NCLT has held that the presence of intra-group guarantees could lead to a decisive conclusion for triggering substantive consolidation of insolvent group companies.<sup>6</sup> Yet, a conceptual understanding of why Indian business groups frequently employ intra-group guarantees, that complicate their group structures, is still elusive. In this backdrop, this paper uses concepts from contemporary law and economics literature to examine

whether insolvency law could design *ex-ante* incentives to nudge rationalisation of intra-group guarantees to simplify inter-connectedness within group structures.

The paper is structured into five parts. First, the paper reviews the relevant law and economics literature. Second, based on this review, it develops the research question that this paper will focus on. Third, the paper uses two leading law and economic theories to develop a conceptual theoretical framework to understand the economic function of cross-liability provisions like intra-group guarantees in corporate groups. Fourth, the paper uses this conceptual framework to identify the potential perverse incentive for shareholders to overuse intra-group guarantees, complicating group structures. Fifth, the paper argues that this incentive problem could be resolved by tweaking the statutory waterfall under insolvency law to reduce the incentive of an external creditor to extend credit to a group company based on intra-group guarantees when the assets of the corporate debtor and the corporate guarantor are highly correlated. The paper concludes that such a shift in the *ex-ante* incentive of an external creditor would help address shareholders' perverse incentive to overuse intra-group guarantees and simplify inter-connectedness within group structures.

## LITERATURE REVIEW

Business groups often structure themselves into multiple limited liability companies. A persuasive theory suggests that such group structure helps create internal partitioning of the business assets into separate companies, enabling each creditor to lend against a particular asset pool within the broader group.<sup>7</sup> This reduces the information and monitoring costs for creditors, enabling them to extend credit at lower interest to the business group. Although compelling, the internal partitioning theory fails to explain the extensive use of intra-group guarantees within business groups. Such guarantees dilute the internal partitioning of business assets across group companies and therefore, should increase the cost of capital for the group. This shortcoming in the internal partitioning theory has been addressed by a relatively newer theory - the correlation seeking theory.<sup>8</sup>

The correlation seeking theory argues that a positive correlation between the risk that a firm will fall insolvent and the risk that its contingent liabilities (such as guarantees issued by it) will be triggered enriches the firm's shareholders at the expense of its unsecured creditors.<sup>9</sup> Applied to corporate groups, if there is a high degree of correlation in the insolvency risks of companies within the group, intra-group guarantees would enhance shareholder value at the expense of the unsecured (non-guaranteed) creditors of the group companies. As long as the group is solvent, the guarantees would help reduce their cost of debt capital. Consequently, lesser amounts would be spent to service the debt, enhancing shareholder value. On the other hand, if the group companies go insolvent simultaneously due to their highly correlated insolvency risks, invocation of the guarantees would not affect the shareholder value since the equity value of the group companies would have already been wiped away due to insolvency. The guaranteed creditors would recover their dues from the assets of the insolvent group companies at the expense of the unsecured (non-guaranteed) creditors. Effectively, the group could use contingent liabilities (such as intra-group guarantee) to sell to the guaranteed creditors a part of a group company's future insolvency estate that would otherwise have

gone to the unsecured (non-guaranteed) creditors. Therefore, this theory posits that shareholders have a perverse incentive to form too many subsidiaries and then create intra-group guarantees to enhance shareholder value through correlation seeking opportunities at no cost to themselves, complicating the overall group structure.<sup>10</sup>

An even newer theory however suggests that there are genuine commercial benefits for which groups develop sophisticated legal mechanisms to partition assets across some dimensions but not others - tailored partitions. At the time of lending, neither the creditor nor the group knows which state of the world will materialise in the future. In certain states of the world, there may be group-wide failure and the creditor may need to exit from the entire group. In some other states of the world, there may be a project-specific failure and the creditor may need to exit from that particular project but not from the entire group. The challenge is to design an *ex-ante* legal mechanism such that the creditor has the *ex-post* option to address group-wide risks as well as project-specific risks and failures, depending on the signal that the creditor receives in the future. Tailored partitioning helps create such *ex-post* option for the creditor, reducing cost of monitoring and enforcing loan agreements. This in turn helps reduce the whole group's cost of debt capital. Therefore, the 'tailored partitioning' theory suggests that there are genuine commercial motivations for a group to structure itself into a complex web of affiliates interconnected through cross-liability provisions like intra-group guarantees.<sup>11</sup>

It is important to note here that business groups have also been extensively studied by non-legal academics across a vast range of disciplines including economics, finance, business history, and sociology. This literature throws light on the potential factors behind formation of business groups. For instance, it has been suggested that business groups may make up for the lack of mature economic institutions and rule of law which are necessary for entrepreneurship. In countries with poorly developed capital markets, business groups provide an alternative mechanism to raise capital through their own internal capital markets. For example, a group may include a main bank or a cash-rich group company and provide funding to affiliated companies which are too small or opaque to have easy access to funds from external capital markets. Similarly, in countries with poorly developed labour markets, groups provide an alternative through their own internal market for talent. For instance, the Birla group in India has founded and financed new firms, which were later spun-off using entrepreneurial talent of its employees. The process of 'spawning' new companies by established business groups may be potentially beneficial to an emerging economy where starting new businesses *de novo* may be otherwise difficult.<sup>12</sup>

## RESEARCH QUESTION: SCOPE AND LIMITATION

Against the backdrop of this vast literature on business groups, the research question that this paper aims to address is relatively narrow and specific - whether insolvency law could design *ex-ante* incentives to nudge a business group to simplify inter-connectedness with its structure by rationalising the use of intra-group guarantees?

The paper addresses this research question in three parts. First, the paper uses the correlation seeking theory and the tailored partitioning theory to develop a conceptual framework to understand the economic function of cross-liability provisions like intra-group guarantees in corporate groups. Second, the paper builds on this conceptual framework to explain why in certain circumstances shareholders may have a perverse incentive to overuse intra-group guarantees to complicate group structures. Third, the paper identifies the specific feature in the Indian insolvency law that may be tweaked to provide incentives to a business group to use intra-group guarantees optimally such that they minimise the overall cost of debt capital without enhancing risks of wealth transfer from unsecured (nonguaranteed) creditors of the guarantor group company to the shareholders of the insolvent principal borrower group company.

A critical limitation of this paper is that it does not address various other potential causes of complicated group structures like related party transactions, taxation, regulatory arbitrage and similar factors. Further, it does not deal with various potential commercial reasons behind use of intra-group guarantees (for example, bidding requirements etc.) other than external credit transactions. Moreover, this paper does not specifically address the merits and demerits of substantive consolidation. This paper is intended to provide only initial steps to understand how insolvency law could possibly be used to nudge rationalisation of group structures.

## A CONCEPTUAL FRAMEWORK

The performance of two or more assets of a business could be perfectly correlated, perfectly uncorrelated or partially correlated. For instance, if a business owns two similar hotels next to each other in the same location in a city, the performance (or risk) of these two assets is likely to be (nearly) perfectly correlated. In other words, there will be no failure of one asset without failure of the other. On the other hand, consider a business that owns a hotel in a city and an oil refinery in another country. The performance (or risk) of these two assets are likely to be (nearly) perfectly uncorrelated. In other words, the failure of the hotel would have no implication on the health of the oil refinery and *vice versa*. A third possibility could be that the assets of the business are somewhat correlated and somewhat uncorrelated. For instance, if a business owns a luxury hotel in the city and a budget hotel in the suburbs of that city, these two assets are likely to be somewhat correlated but not fully correlated. For example, the price of their real estates would be affected by the general economy of the city. But a decline in local tourism may affect the luxury hotel more than the budget hotel. Such assets would therefore be partially correlated.

When a creditor extends credit to a group, such correlation between the group's assets is likely to have structural implications. If the assets are highly correlated, the creditor need not monitor each asset separately. The information from any one asset would be a signal of the health of the entire business. Therefore, there is no benefit in partitioning the assets into separate corporate entities. Instead, if any one asset experiences financial distress, the creditor would prefer to take action (like requiring the management to do something, foreclosure etc.) against all the assets simultaneously.

Therefore, it makes sense to keep such correlated assets within the one company - integration.

In contrast, if the two assets are highly uncorrelated, a creditor has to monitor each asset separately. Moreover, a creditor which has expertise in the hotel industry may want to extend credit only to the hotel business and not to the oil refinery business. Such a creditor would therefore not want to be exposed to risks emanating from the oil refinery business. In such an event, the business would be better off putting these two assets in two different corporate entities. It could then raise debt against each of those assets separately from creditors who specialise in those specific types of assets. Such a structure would benefit the creditors too. Each of them would be exposed only to the asset which they can monitor effectively. As a result, they will be taking up lesser risk and would be able to extend credit to the business at a lower interest rate than if the assets were integrated. Overall, the business would be able to raise debt capital at the least cost by putting the assets into separate companies - partitioning.

In reality, however, business assets are unlikely to be either perfectly correlated or perfectly uncorrelated. Instead, they are likely to be partially correlated. In such cases, the risks facing the assets are correlated across some dimensions but not across others. If there is financial distress in any one asset across the correlated dimensions, the creditor should take action against both the assets simultaneously. However, if there is financial distress in one asset across an uncorrelated dimension, the creditor should act against only that asset but not the other. Therefore, in such cases, the creditor would benefit from both integration as well as partitioning - something which is seemingly impossible. It is this conundrum that tailored partitioning resolves.

Structure			
		<i>Integrated</i>	<i>Partitioned</i>
Assets	<i>Perfectly correlated</i>	Yes	No
	<i>Perfectly uncorrelated</i>	No	Yes
	<i>Partially correlated</i>	Yes	Yes

To understand the function of tailored partitioning, it would be useful to consider a simple hypothetical example. Imagine an entrepreneur E who owns two business assets - Asset 1 and Asset 2 - which are partially correlated. Bank B has expertise in monitoring both projects and is willing to extend credit to both. To keep the model simple, assume that monitoring by B could lead to any of the three signals from each project separately:<sup>13</sup>

Signal (1): This means there is no new information. The asset is performing fine and will generate 10% return.

Signal (2): This means that E is incompetent at managing that particular asset. Consequently, this asset will generate 5% return only. This signal by itself does not give any new information about the other asset. Therefore, B will want to exit only from this particular asset and re-invest the capital elsewhere at 8% return ('outside option').

Signal (3): This means that E is incompetent at managing both assets. The incompetence will spread from this asset to the other. Consequently, both assets will generate 5% return only. Therefore, B will exit from both the assets and re-invest the capital elsewhere at 8% return.

**Table 1: Matrix – Tailored portioning**

	Asset 2			
		Sg. 1 (10%)	Sg. 2 (5%)	Sg. 3 (5%)
Asset 1	Sg. 1 (10%)	(c,c)	(c,l)	(l,l)
	Sg. 2 (5%)	(l,c)	(l,l)	(l,l)
	Sg. 3 (5%)	(l,l)	(l,l)	(l,l)

The matrix in Table 1 captures the various potential future outcomes given the possible signals from each project. ‘c’ refers to the asset being continued, while ‘l’ refers to the asset being liquidated. Evidently, there are 9 potential future outcomes. In 6 of them, B will choose to liquidate both the assets and reinvest in the outside option. These include (Sg. 3, Sg.1) and (Sg.1, Sg.3). This is because although, at the moment, E has poorly managed that particular asset leading to 5% returns, it will affect the other asset too causing its returns to fall from 10% to 5%. In contrast, in the future outcome (Sg.1, Sg.1), B will choose to continue both the assets. Evidently, for 7 of these outcomes, the two assets will face the same action - (l, l) or (c, c) - simultaneously. Therefore, for these 7 outcomes, the two assets should be integrated into one corporate entity. However, for the 2 remaining outcomes (c, l) and (l, c) - B will have to liquidate one asset but continue the other. Therefore, for these two outcomes, the two assets have to be partitioned into two different corporate entities.

While entering into the credit contract, B and E have no way of knowing which of these outcomes will materialise in the future state of the world. Therefore, they will have to contractually agree *ex-ante* on a legal mechanism that would enable B the *ex-post* choice to invoke asset partitioning or to ignore it depending on the signals received in the future. One commonly used legal mechanism to achieve this result is tailored partitioning. The two assets are first partitioned and put into different corporate entities. Then cross-liability provisions are inserted in the credit agreement between each company and B.<sup>14</sup> These clauses give B the option to rely on asset partitioning or to ignore it, depending on the signal received in the future. Overall, an *ex-ante* combination of asset partitioning and cross-liability provisions allows for precise *ex-post* balancing between integration and partitioning.

### Shareholders’ perverse incentive

Tailored partitioning through intra-group guarantees serves a useful economic function when used across group companies with partially correlated assets. However, if the same arrangement is used

across group companies with highly correlated assets, it could be the result of perverse incentives of shareholders to engage in correlation seeking.

To put it in the context of our hypothetical example, partitioning is relevant only for the 2 outcomes (c, l) and (l, c) in Table 1. However, if the assets are highly correlated, these 2 outcomes would be highly unlikely. Consequently, there will be practically no need to partition the assets by putting them in different corporate structures. However, from the perspective of E, there may be a perverse incentive to use such tailored partitions even if the two assets are highly correlated. This is because, from E's perspective, the cost of debt capital reduces if the loan taken by each group company is backed by guarantee from the other group company. When the borrower and guarantor companies are solvent, an inter-company guarantee by the guarantor company helps reduce the borrower company's cost of debt capital. This in turn enhances the borrower company's shareholder value, benefitting E. In contrast, when the borrower company becomes insolvent, the guarantor group company is already insolvent or is highly likely to go insolvent given the high degree of correlation between the assets of the two companies. Consequently, the value of E's equity shares in both the companies would anyway be wiped out. Therefore, invocation of the inter-company guarantee by B in insolvency resolution would not have much material effect on the shareholder value of either company. Instead, when B invokes the guarantee to recover its dues from the assets of the insolvent guarantor company, it would essentially be reducing the available pool of assets for the unsecured (non-guaranteed) creditors of the guarantor company. Effectively, tailored partitioning in this case would ensure that E enjoys the upside when the group companies are solvent but the downside risks in insolvency are borne by the unsecured (non-guaranteed) creditors of the guarantor group company including suppliers and other vulnerable operational creditors.

Overall, shareholders have a perverse incentive to engage in correlation seeking when the underlying assets are highly correlated. They may be tempted to overuse tailored partitioning even when the assets are highly correlated. Instead of serving any useful economic purpose, in these cases tailored partitioning ends up complicating the group structure. Insolvency law should therefore be designed to minimise shareholders' incentive to seek correlation seeking opportunities for highly correlated underlying assets through tailored partitioning and thereby help rationalise group structures.

## POTENTIAL SOLUTION UNDER INSOLVENCY LAW

Under Indian law, a 'corporate guarantor' means a corporate person who is the surety in a contract of guarantee to a CD (that is, principal borrower).<sup>15</sup> The liability of a corporate guarantor is co-extensive with that of the principal borrower.<sup>16</sup> Upon default by the principal borrower, the principal borrower and the corporate guarantor are jointly and severally liable to the creditor.<sup>17</sup> The creditor has the right to recover its dues from either of them or from both of them simultaneously.<sup>18</sup> Therefore, the moment the principal borrower commits default in payment of debt which had become due and payable, the guarantee becomes a debt and the corporate guarantor itself becomes a CD.<sup>19</sup>

If the corporate guarantor defaults on this debt, the creditor can initiate corporate insolvency resolution process (CIRP) against the corporate guarantor under the IBC.<sup>20</sup> If the creditor is a financial creditor (FC) to the principal borrower, it can proceed against the corporate guarantor as a FC.<sup>21</sup> Therefore, on default by the principal borrower, the debt due to the creditor from the corporate guarantor is a financial debt.<sup>22</sup> However, since there is no security interest created in favour of the creditor against the corporate guarantor, the creditor would be an unsecured FC to the corporate guarantor.<sup>23</sup> Consequently, during the insolvency resolution of the corporate guarantor, the creditor would stand at par with other unsecured FCs of the corporate guarantor in the statutory waterfall.<sup>24</sup> Applying the conceptual framework discussed earlier, the shareholders of a group (comprising the principal borrower and the corporate guarantor) could engage in correlation seeking through intra-group guarantee to extract wealth away from the unsecured (non-guaranteed) FCs and other junior claimants of the corporate guarantor including the government and other operational creditors.

Insolvency law could potentially ameliorate this perverse incentive of shareholders through *ex-ante* priority rules.<sup>25</sup> During the insolvency proceeding of a corporate guarantor, the claim of a creditor arising out of a corporate guarantee issued by the corporate guarantor in favour of a group company, which is now insolvent, should rank below the claims of unsecured creditors of the corporate guarantor under section 53(1)(f). In other words, the statutory waterfall under section 53 of the IBC needs to be amended such that any debt arising out of a corporate guarantee issued in favour of a group company, which is now insolvent, is subordinated and ranks below all other unsecured debt of the corporate guarantor.

Such an explicit rule would change the *ex-ante* incentive of an external creditor, ameliorating the potential effect of the perverse incentive of the shareholders. While extending credit to a group company based on an intra-group guarantee, the creditor would take into account the correlation between the assets of the two companies - the CD and the corporate guarantor. If they have a low correlation, only then will such an intra-group guarantee be valuable for the creditor. During insolvency of the CD, the corporate guarantor is highly likely to be solvent. Consequently, the creditor can invoke the corporate guarantee and expect to get paid by the guarantor company. However, if their assets are highly correlated and the companies go insolvent at close proximity, such corporate guarantee would be of little value to the creditor. On insolvency of the CD, it is highly likely that the guarantor company would also be insolvent or on the verge of insolvency. Therefore, the creditor has to participate in the insolvency proceeding of the corporate guarantor. In that case, the guaranteed creditor's claim would be subordinated to other unsecured creditors of the insolvent corporate guarantor. Such guarantee is unlikely to be of much value to the creditor. Foreseeing these possibilities, there would not be much incentive to extend credit to a group company based on intra-group guarantees when the assets of the CD and the corporate guarantor are highly correlated. Overall, the proposed rule will help reduce overuse of intra-group guarantees and simplify inter-connectedness within group structures.

## CONCLUSION

Complicated group structures make insolvency resolution of group companies challenging. A common source of such complexity in group structures is the frequent use of intra-group guarantees. These intra-group guarantees are quite commonly used by listed Indian companies, although their growth in volume terms has been falling since 2015-16. Yet, a conceptual understanding of why Indian business groups frequently employ intra-group guarantees has been largely elusive. In this context, this paper explored whether insolvency law could help simplify inter-connectedness within group structures by rationalising intra-group guarantees.

First, the paper reviewed the relevant law and economics literature on the potential reasons why a business group may structure itself into multiple limited liability companies with intra-group guarantees, complicating the overall group structure. Accordingly, it developed a specific research question: whether insolvency law could nudge a business group to simplify inter-connectedness within its structure by rationalising the use of intra-group guarantees? Second, the paper used the correlation seeking and tailored partitioning theories to develop a conceptual theoretical framework to understand the economic function of cross-liability provisions like intra-group guarantees in corporate groups. Third, the paper used this conceptual framework to identify the potential perverse incentive for shareholders to overuse intra-group guarantees, complicating group structures. Fourth, the paper argued that this incentive problem could be resolved by tweaking the statutory waterfall under insolvency law to reduce the incentive of an external creditor to extend credit to a group company based on intra-group guarantees when the assets of the CD and the corporate guarantor are highly correlated. This could be achieved by amending section 53 of the IBC to ensure that the claim of a creditor arising out of a corporate guarantee issued by the corporate guarantor in favour of its group company, which is now insolvent, should rank below the claims of unsecured creditors of the corporate guarantor under section 53(1)(f). The paper argued that such an explicit priority rule would reduce the *ex-ante* incentive of an external creditor to extend credit to a group company based on intra-group guarantees when the assets of the CD and the corporate guarantor are highly correlated. This would mitigate shareholders' perverse incentive to overuse intra-group guarantees, and help simplify inter-connectedness within group structures.

---

## NOTES

<sup>1</sup> This research was supported by the Suresh Shroff Memorial Trust. The author is extremely grateful to Mr. Shardul S. Shroff for his generous support and encouragement that made this research possible. He also wishes to thank Mr. Sudarshan Sen, Mr. G.S. Hegde and Ms. Veena Sivaramakrishnan for their valuable comments. The publication of this article shall not constitute or be deemed to constitute any representation by Shardul

Amarchand Mangaldas & Co. or any of its Partners or Associates.

<sup>2</sup> Report of the Working Group on Group Insolvency, IBBI, September 23, 2019.

<sup>3</sup> MA 1306/2018 & Ors., CP 543/2018 & Ors., August 08, 2019.

<sup>4</sup> Total group guarantee by a company means the sum of guarantees for group companies and counter-guarantees for group companies given by such a company, as available from CMIE database.

<sup>5</sup> The potential cause(s) of this trend reversal is beyond the scope of this paper.

<sup>6</sup> The NCLT identified 14 different factors. These include ‘common liabilities’ and ‘common group of corporate debtors’. Both these factors are essentially based on intra-group guarantees, Refer n. 3, paras 78, 80.

<sup>7</sup> The inception of this literature could be traced back to the famous Landers-Posner debate on the pages of the University of Chicago Law Review during the 1970s. Professor Jonathan Landers had argued that a group of affiliated corporations is in reality a single economic enterprise and should be treated as such. Landers concluded that creditors would be better off if bankruptcy courts relied more heavily on single enterprise doctrines like substantive consolidation. Professor Richard Posner countered by arguing that creditors adjust the interest rate on a proposed loan based on the debtor’s risk of default. After giving the loan, creditors might also monitor the debtor’s compliance to ensure that it is in compliance with the loan covenants that forbid any activity which increases the debtor’s default risk. Posner argued that if large firms were not sub-divided into subsidiaries, a creditor would have to appraise and monitor the entire enterprise, which would make it an expensive undertaking. The group structure enables a creditor to extend credit to any specific part of the group’s business that it understands the best. Thus, legally separate subsidiaries help reduce the creditor’s information and monitoring costs. This in turn enables the group to raise debt finance at a relatively lower interest rate. These commercial advantages of single entity approach would not be available under the single enterprise approach. Landers, J.(1975), “A unified approach to parent, subsidiary, and affiliate questions in bankruptcy”, The University of Chicago Law Review 42.4, pp. 589–652; Posner R. (1975), “The rights of creditors of affiliated corporations”, The University of Chicago Law Review 43, pp. 499–526.

<sup>8</sup> Professor Richard Squire mounted a credible challenge to Posner’s theory. Squire highlighted that while big businesses do engage in asset partitioning by dividing their different businesses across subsidiaries, they also allow select creditors to ignore the separate legal identity of the subsidiaries through heavy use of intra-group guarantees. Posner’s theory fails to explain this apparent contradiction. To resolve this paradox, Squire proposed a new theory - correlation seeking. Squire R. (2011), “Strategic liability in corporate groups”, The University of Chicago Law Review 78, pp. 605–670; Squire R. (2010), “Shareholder opportunism in a world of risky debt”, Harvard Law Review 123, pp. 1151–1213.

<sup>9</sup> Squire R. (2010), “Shareholder opportunism in a world of risky debt”, Harvard Law Review 123, pp. 1151–1213.

<sup>10</sup> Squire R. (2011), “Strategic liability in corporate groups”, The University of Chicago Law Review 78, pp. 605–670.

<sup>11</sup> Casey A. (2015), “The new corporate web: Tailored entity partitions and creditors’ selective enforcement”, The Yale Law Journal 124, pp. 2680–2744.

<sup>12</sup> Khanna T. and Yafeh Y. (2007), “Business Groups in Emerging Markets: Paragons or Parasites?”, Journal of Economic Literature 45; Khosa A., Ahmed K. and Henry D. (2019), “Ownership structure, related-party transactions, and firm valuation”, Cambridge University Press.

<sup>13</sup> In a realistic situation, these signals may be more complicated given potential external events beyond the control of E. However, for sake of simplicity, we are assuming a very simple model to understand the basic economic function of tailored partitioning.

<sup>14</sup> Cross-liability provisions could include cross-guarantees, cross-defaults and holding-company guarantees. A cross guarantee is an agreement by one entity to be jointly liable for the debts of another. A cross-default provision is an agreement by which the default of one borrower on a loan or agreement will trigger the default of another borrower on a loan or agreement. A holding company guarantee is an agreement that provides for equity held by a holding company to serve as collateral for a loan that finances the operations of a subsidiary of the holding company. Overall, these cross-liability provisions help undo the economic impact of legal partitioning. Casey, see n. 11.

<sup>15</sup> Section 5(5A), IBC.

<sup>16</sup> Section 128, Indian Contract Act, 1872.

<sup>17</sup> *Laxmi Pat Surana v. Union of India*, Civil Appeal No. 2734 of 2020.

<sup>18</sup> Report of the Insolvency Law Committee, February 20, 2020; Supra Note 17.

<sup>19</sup> *Ferro Alloys Corporation Ltd. v. Rural Electrification Corporation Ltd.*, CA (AT) (Insolvency) No. 92,93 & 148-2017, January 08, 2019, para 27. See also Supra Note 17, para 27.

<sup>20</sup> Supra Note 17, para 27

<sup>21</sup> *Dr. Vishnu Kumar Agarwal v. M/s. Piramal Enterprises Ltd.*, CA(AT)346-2018, January 08, 2019, holding that ‘without initiating any corporate insolvency resolution process against the principal borrower, it is always open to the financial creditor to initiate corporate insolvency resolution process under section 7 against the corporate guarantors, as the creditor is also the financial creditor qua corporate guarantor.’, Para 25.

<sup>22</sup> *Export Import Bank of India v. Resolution Professional JEKPL Pvt. Ltd.* 2018, EXIM Bank held to be an FC to JEKPL (the guarantor), after underlying loan to Jubilant Energy (the principal borrower) had become non-performing and the guarantee was invoked.

<sup>23</sup> Section 3(30), IBC defines ‘secured creditor’ as ‘a creditor in favour of whom security interest is created’. Section 3(31) defines ‘security interest’ to mean ‘right, title or interest or a claim to property, created in favour of, or provided for a secured creditor by a transaction which secures payment or performance of an obligation and includes mortgage, charge, hypothecation, assignment and encumbrance or any other agreement or arrangement securing payment or performance of any obligation of any person. Provided that security interest shall not include a performance guarantee’, refer n. 15.

<sup>24</sup> Section 53(1)(d), IBC, refer n. 15.

<sup>25</sup> Some scholars have argued that fraudulent transfer laws should be reformed to permit courts to subordinate a contingent debt if a high correlation between the contingent risk and the debtor’s insolvency risk was apparent at the time of contracting. However, such reforms provide only ex post remedies, whereas this paper is focussed on ex ante legislative tools to mitigate shareholders’ perverse incentive to engage in correlation seeking through intra-group guarantees. Squire R. (2010), “Shareholder opportunism in a world of risky debt”, refer n. 8.