

Nudge Theory And Its Behavioural Impact On Stakeholders: A Perspective Under The Insolvency And Bankruptcy Code, 2016

¹Name of 1st Author: CA. Pradeep Kabra

²Name of 2nd Author: Dr. Mukesh Kumar Sharma

¹Designation of 1st Author: Research Scholar

²Designation of 2nd Author: Dean

¹Name of Department of 1st Author: Management

¹Name of organization of 1st Author, City, Country: School of Management, Sangam University, Bhilwara, Rajasthan, India

Abstract: In modern regulatory systems, the integration of behavioral economics into legal frameworks has gained prominence, especially in areas where financial decisions are influenced by human psychology. Traditional economic models assume that individuals act rationally in their self-interest; however, real-world behavior often deviates due to cognitive biases, heuristics, and framing effects. Nudge Theory, developed by Thaler and Sunstein, offers a way to influence such behavior subtly by structuring choices in a way that encourages better decision-making without restricting freedom. Legal mechanisms, particularly those dealing with financial distress and recovery, increasingly rely on these behavioral tools to align stakeholder actions with broader economic goals.

This article examines the Insolvency and Bankruptcy Code, 2016 (IBC) through the perspective of Nudge Theory, highlighting how the Code reshapes the decision-making environment for stakeholders such as promoters, creditors, investors, and insolvency professionals. By embedding nudges like making resolution the default outcome, enforcing disclosure norms, simplifying legal procedures, and leveraging loss aversion, the IBC promotes timely resolution and responsible financial behavior. The article evaluates the behavioral impact of these provisions, outlines their successes in improving recovery rates and reducing NPAs, and discusses ongoing challenges that hinder optimal outcomes. Ultimately, the IBC serves as a compelling example of how behavioral economics can enhance the effectiveness of legal-economic reforms

I. INTRODUCTION

Law and economics often intersect in the regulation of financial systems.

While classical law and economics rely heavily on rational-choice theory — assuming individuals make decisions in their best economic interest — modern insights from behavioral economics challenge this assumption. Individuals and institutions are not always rational; they are influenced by personal biases, mental shortcuts, and the structure of choices presented to them.

In this regard, Nudge Theory, developed by Richard Thaler and Cass Sunstein, offers a useful way to understand behavior.

A "nudge" is a subtle change in the way choices are presented, which influences people's behavior in a predictable way without removing any options or significantly changing incentives. The Insolvency and Bankruptcy Code, 2016 (IBC), although primarily a legal-economic reform, can also be seen as a system of nudges. It changes the environment in which decisions are made, influencing the behavior of promoters, creditors, investors, and other stakeholders to encourage resolution, discipline, and economic efficiency.

This article explores the use of nudge theory in the design and operation of the IBC, evaluates its impact on key stakeholders, and reflects upon its successes and limitations from a behavioral perspective.

II. NUDGE THEORY: A BRIEF OVERVIEW

Nudge theory suggests that policymakers can influence behavior not only through strict rules and controls, but also by subtly shaping the environment in which decisions are made — called "choice architecture."

Common examples of nudges include setting default options, using framing effects, simplifying choices, increasing transparency, and providing feedback.

For instance, automatically enrolling people in pension schemes (with the option to opt out) greatly increases participation. Similarly, displaying energy usage data compared to neighbors encourages households to use less energy. The goal is to guide choices without forcing people to act in a certain way, keeping freedom while making the preferred option more attractive or easier to choose.

The IBC incorporates these principles in its legal design.

Instead of only punishing default, it restructures the decision environment for promoters, creditors, and insolvency professionals — nudging them toward timely resolution and economic recovery.

III. BEHAVIORAL FOUNDATIONS OF THE IBC

(a) Resolution as the Default

The IBC sets resolution as the default outcome when insolvency begins. Liquidation is only available if resolution fails. This is a classic default nudge: since most people stick with defaults, the system is designed to favor company rehabilitation over closure.

(b) Simplification of Choice

Before the IBC, insolvency laws were complex and scattered, involving multiple courts and overlapping laws. The IBC simplifies this by creating a time-bound, collective process under the National Company Law Tribunal (NCLT). This simplification itself is a nudge — reducing mental stress for creditors and making them more willing to get involved.

(c) Credible Commitment and Loss Aversion

Once insolvency is admitted, promoters lose control of the company. The fear of losing control triggers a strong behavioral bias — loss aversion — which pushes promoters to stay disciplined and avoid default. It also discourages unnecessary borrowing and misuse of funds by creditors.

(d) Transparency and Disclosure

The Code requires mandatory disclosure of claims, public announcements, and more recently, the proposal to disclose beneficial ownership of bidders. These are nudges based on the idea of information symmetry. By making essential information visible, the law reduces unfair behavior and encourages fair decisions.

(e) Social Norm Creation

Over time, the IBC has changed how businesses operate. Insolvency is no longer viewed solely as a legal problem but as a legitimate way to restructure. This shift has created new norms around responsible exit and resolution, shaping how companies behave.

IV. STAKEHOLDER IMPACT: NUDGES IN ACTION

(i) Promoters and Corporate Debtors

For promoters, the IBC serves as a clear nudge: either resolve the default or risk losing control forever. The exclusion of willful defaulters and related parties from bidding is another targeted nudge, discouraging strategic defaults. Promoters are now more likely to negotiate with creditors before insolvency arises — showing how nudges can work outside the formal process.

(ii) Financial Creditors

Banks and financial institutions are empowered through the Committee of Creditors (CoC), which manages the resolution process. The nudge here has two parts:

1. Collective decision-making reduces coordination issues and speeds up decisions.
2. Priority for secured creditors over operational creditors encourages lenders to support resolution instead of prolonged legal battles.

Behaviourally, creditors have become more engaged in monitoring borrowers and are quicker to start proceedings — recognizing that delays harm their interests.

(iii) Operational Creditors and Employees

Although they have limited voting rights in the CoC, operational creditors are protected through mandatory minimum payments in resolution plans and priority in liquidation for workmen dues. These provisions serve as fairness nudges, ensuring that smaller stakeholders remain engaged in the process.

(iv) Insolvency Professionals and Adjudicating Authorities

The IBC has created a new group of insolvency professionals (IPs) to manage the process. Their role is designed as an institutional nudge — placing professionals, not promoters, in charge during Corporate Insolvency Resolution Processes (CIRP) reduces bias and conflicts of interest. Similarly, the NCLT and NCLAT are nudged into faster decision-making through set time limits.

(v) Investors and Market Participants

For investors, the existence of a reliable exit mechanism under the IBC serves as a nudge that encourages risk-taking and entrepreneurship. Knowing that capital can be reused through resolution or liquidation builds confidence in India's credit markets.

V. ACHIEVEMENTS OF IBC AS BEHAVIORAL REFORM

1. Reduction in NPAs

Banks are nudged to act faster and more decisively, reducing the accumulation of bad loans.

2. Higher Recovery Rates

Recoveries under the IBC have been much higher than in previous systems like DRT and SARFAESI.

3. Cultural Shift

Entrepreneurs now view insolvency not as a stigma but as a structured process.

4. Institutional Development

The creation of the Insolvency and Bankruptcy Board of India (IBBI), insolvency professionals, and specialized benches of the NCLT has fostered new professional ecosystems.

VI. CHALLENGES AND RISKS

Even though there have been some successes, there are still some behavioral and structural problems that continue to exist:

1. Delays and Legal Battles:

Although the Code sets a time frame of 180 to 330 days, the average time taken to resolve cases has gone beyond 600 days. This long waiting period reduces the effectiveness of time-based discipline as a motivational tool.

2. Excessive Use of Legal Challenges:

Promoters often frequently challenge cases, which weakens the intended effect of making people avoid losses.

3. Lack of Capacity:

There are not enough judges in the National Company Law Tribunal (NCLT) and a shortage of insolvency professionals, which puts stress on the system and reduces the impact of the nudges.

4. Equity Issues:

Operational creditors often feel left out, which makes people question whether the process is fair.

5. Behavioral Fatigue:

As stakeholders get used to the Insolvency and Bankruptcy Code (IBC), its initial impact as a deterrent might lessen unless new reforms are introduced to keep it effective.

VII. THE ROAD AHEAD: STRENGTHENING THE NUDGES

To keep and improve the behavioral impact of the IBC, the following steps might be taken:

1. Improve Institutional Capacity:

Add more NCLT benches, train more insolvency professionals, and use technology to manage cases more efficiently.

2. Clearer Laws:

Make the laws more precise to reduce delays caused by legal disputes.

3. Inclusive Design:

Give more voice to operational creditors and employees to make the process fairer.

4. Transparent Nudges:

Require real-time sharing of resolution results and beneficial ownership details to build trust.

5. Pre-Pack Mechanisms:

Expand pre-packaged insolvency as a faster, consent-based option that encourages early settlements.

VIII. GLOBAL COMPARISON: NUDGES IN OTHER INSOLVENCY REGIMES

The Indian Insolvency and Bankruptcy Code (IBC) can be better understood when compared with insolvency frameworks across the globe. While insolvency laws vary in design, many international systems embed subtle behavioral nudges, either explicitly or implicitly, to guide stakeholders toward efficient outcomes. By examining these systems, we gain insights into the strengths and limitations of the IBC and identify directions for reform.

(a) United States: The Debtor-in-Possession Model

The U.S. Chapter 11 bankruptcy regime offers a striking contrast to the IBC. Its most distinctive feature is the **Debtor-in-Possession (DIP)** principle, under which existing management continues to run the company during restructuring. This functions as a **positive incentive nudge**, encouraging promoters to initiate proceedings early since they do not automatically lose control.

- **Behavioral Impact:** The DIP model reduces fear of insolvency stigma and incentivizes early restructuring. It also leverages the promoters' firm-specific knowledge, which creditors may lack.

- **Case Study:** General Motors (2009) successfully restructured under Chapter 11, with DIP financing enabling continued operations. The system nudged creditors and the state toward supporting restructuring rather than liquidation.
- **Comparison with IBC:** India takes a stricter approach by immediately displacing promoters upon admission. While this reduces misuse, it may discourage early filings. The U.S. model, though flexible, sometimes leads to prolonged processes.

(b) United Kingdom: Administration and Pre-Packs

The UK insolvency regime emphasizes **rescue through administration**, where an external administrator takes charge but aims primarily at rescuing the business.

- **Nudge through Pre-Packs:** Pre-packaged administrations allow negotiations with buyers before formal insolvency. This nudges stakeholders toward quick, consent-based resolutions.
- **Case Study:** The restructuring of the retail chain **Debenhams (2020)** used administration to preserve jobs and reorganize assets, showing how the UK system encourages continuity.
- **Lessons for India:** The IBC's **pre-pack insolvency** framework (introduced in 2021 for MSMEs) echoes this nudge but remains underutilized. Expanding it across all corporate debtors could replicate the UK's efficiency gains.

(c) Australia: Voluntary Administration

Australia's **voluntary administration system** nudges companies to seek professional help early. A voluntary administrator is appointed, creditors vote on future plans, and liquidation is not the default.

- **Behavioral Nudge:** The option of voluntary entry reduces stigma and creates a culture of early action, balancing promoter involvement with professional oversight.
- **Case Study:** **Virgin Australia (2020)** entered voluntary administration during COVID-19, leading to successful acquisition and business revival.
- **Comparison with IBC:** The Indian model lacks a voluntary, promoter-initiated, stigma-free pathway. Instead, creditors often push companies into insolvency, leading to late-stage interventions.

(d) Singapore: Hybrid Model with Judicial Management

Singapore's 2017 insolvency reforms drew on both U.S. and UK practices. They introduced **judicial management** (similar to administration) and **debtor-in-possession provisions**, along with simplified schemes of arrangement.

- **Nudge through Legal Flexibility:** By offering multiple tailored pathways, Singapore nudges firms toward the most suitable restructuring option.
- **Case Study:** The restructuring of **Hanjin Shipping's Singapore subsidiary** showed how the system facilitates cross-border cooperation and preserves enterprise value.
- **Lesson for India:** Greater procedural flexibility in the IBC could encourage early, efficient resolutions and attract foreign investment confidence.

(e) European Union: Preventive Restructuring

The EU Restructuring Directive (2019) emphasizes **preventive restructuring frameworks**, nudging firms to restructure before insolvency is inevitable.

- **Nudge Design:** Early warning tools, stays on enforcement actions, and debtor-friendly procedures guide companies toward negotiated settlements.
- **Case Study:** Several EU member states have adapted the directive to encourage timely negotiations, with Spain and Germany being early adopters.
- **Comparison with India:** The IBC's reliance on insolvency-triggered processes often delays restructuring until default, whereas EU systems incentivize earlier action.

IX. CASE STUDIES: BEHAVIORAL INSIGHTS IN PRACTICE

Case Study 1: Jet Airways (India) vs. Virgin Australia (Australia)

- **Jet Airways (2019):** Under IBC, the company went into CIRP after prolonged defaults. The promoters lost control, but resolution dragged for years, eroding value.
- **Virgin Australia (2020):** Under voluntary administration, creditors swiftly approved a restructuring plan, enabling continued operations.

- **Behavioral Lesson:** Virgin’s process benefited from **time-bound nudges and promoter cooperation**, while Jet suffered from **delays and adversarial proceedings**.

Case Study 2: Essar Steel (India) vs. General Motors (USA)

- **Essar Steel (2019):** Despite multiple appeals, the IBC nudged creditors to achieve a ₹42,000 crore resolution.
- **General Motors (2009):** The U.S. system allowed DIP financing and swift restructuring with government support.
- **Behavioral Lesson:** Both cases highlight the importance of **loss aversion nudges**—promoters risked losing assets, while creditors risked delayed recoveries. Yet, GM’s restructuring was faster, reflecting institutional capacity differences.

X. FUTURE REFORMS: STRENGTHENING NUDGES IN INDIA

1. Earlier Intervention Mechanisms

- Introduce **preventive restructuring frameworks** akin to the EU model.
- Encourage voluntary, pre-default filings to avoid value destruction.

2. Balancing Promoter Involvement

- Explore a modified **DIP model** for certain cases where promoters’ expertise benefits resolution.
- Build checks to prevent misuse, such as oversight committees.

3. Incentivizing Speed

- Monetary incentives for timely resolution by insolvency professionals.
- Penalties for frivolous litigation by promoters.

4. Strengthening Operational Creditor Voice

- Weighted voting rights or class-based representation in the CoC.
- Use of fairness metrics in resolution plan approval.

5. Cross-Border Insolvency

- Adopt the **UNCITRAL Model Law on Cross-Border Insolvency** to handle global companies and reassure foreign investors.

XI. ROLE OF TECHNOLOGY IN BEHAVIORAL NUDGES

Technology can amplify the behavioral effectiveness of insolvency frameworks:

- **Digital Case Management Systems:**

Real-time dashboards for creditors, IPs, and courts reduce uncertainty and delays.

- **AI-Powered Predictive Tools:**

Early-warning systems using financial data to flag stress before default, nudging promoters to restructure early.

- **Blockchain for Transparency:**

Immutable records of claims and resolutions can enhance trust and discourage manipulation.

- **Virtual Hearings & E-Filing:**

Reduces bottlenecks at NCLT and nudges toward faster decisions.

- **Smart Nudges through Data Visualization:**

Presenting creditors with recovery rate comparisons can influence more cooperative decisions.

XII. FUTURE RESEARCH DIRECTIONS

1. Behavioral Experiments:

Controlled studies on how creditors respond to different voting rules or disclosure formats.

2. Comparative Law Studies:

More empirical analysis of outcomes under IBC vs. Chapter 11, UK pre-packs, etc.

3. Cultural Dimensions:

Research into how insolvency stigma in India affects filing behavior compared to Western economies.

4. Technology Adoption:

Examining the role of AI, blockchain, and big data in strengthening insolvency ecosystems.

5. Equity and Inclusion:

Assessing how operational creditors and employees experience behavioral nudges differently from large financial creditors.

XIII. CONCLUSION

The Insolvency and Bankruptcy Code, 2016, is not only a major structural reform of India's insolvency system but also a behavioral experiment in economic governance.

By incorporating principles from nudge theory—such as defaults, simplicity, transparency, loss aversion, and norm-setting—the Code has changed how promoters, creditors, investors, and regulators behave.

Its success lies in changing attitudes as much as in recovering financial assets. However, challenges like delays, capacity issues, and lack of inclusiveness still exist. Going forward, the effectiveness of the IBC will depend on continuously improving its nudges to ensure they remain credible, fair, and efficient.

The combination of behavioral economics and insolvency law shows that good policy isn't just about writing rules, but also about shaping the environment in which decisions are made. When viewed through the lens of nudge theory, the IBC stands as a strong example of how legal systems can influence economic behavior for the benefit of society as a whole.

Globally, insolvency laws reflect a delicate balance between legal mandates and behavioral nudges. The U.S. encourages early filing through the debtor-in-possession model, the UK relies on pre-packs to speed up processes, Australia incentivizes voluntary entry, Singapore offers hybrid flexibility, and the EU pushes for preventive restructuring. Each design subtly guides stakeholders while preserving choice.

India's IBC, by comparison, has successfully nudged promoters, creditors, and investors toward greater discipline, but faces challenges of **delay, inclusiveness, and institutional capacity**. Drawing lessons from global case studies and integrating technology-driven nudges can help the IBC evolve into a more efficient and equitable system.

Ultimately, the future of insolvency law lies not only in drafting statutes but in **designing choice architectures** that account for real human behavior. Future reforms must keep the behavioral dimension at the forefront—ensuring that the IBC remains credible, adaptive, and aligned with global best practices.

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