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India's Sustained Economic Recovery Will Require Changes to Its Bankruptcy Law

Anirudh Burman

CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE

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Anirudh Burman

Carnegie Endowment for International Peace
Publications Department
1779 Massachusetts Avenue NW
Washington, DC 20036
P: + 1 202 483 7600
F: + 1 202 483 1840
CarnegieEndowment.org

Carnegie India
Unit C-5 & C-6, Edenpark,
Shaheed Jeet Singh Marg
New Delhi—110016, India
P: + 011 4008687
CarnegieIndia.org

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Summary

One of the key drivers of economic recovery in India will be the efficient movement of capital from inefficient firms to efficient ones. The economic downturn caused by the coronavirus pandemic has been severe, and India's economy was one of the worst affected in 2020–2021. Though the economy is recovering faster than initial estimates, sustained economic recovery will not take place if stressed businesses cannot restructure their debts properly or if failing firms cannot be resolved efficiently. India's bankruptcy law is key to solving these challenges.

In 2016 India enacted the Insolvency and Bankruptcy Code, 2016 (IBC), which was a landmark reform to the nation's financial system and the first comprehensive law to regulate insolvency.[1] But the IBC has been suspended for a period of one year since the COVID-19-related lockdown was imposed in March 2020. In its place, India's banking regulator, the Reserve Bank of India (RBI), has introduced a limited restructuring scheme for COVID-19-related stress in the meantime. Older mechanisms for insolvency that are still in operation have historically not worked according to expectations. As the one-year period of suspension comes to a close, this paper argues that bringing back the IBC—with adequate modifications—is an important prerequisite for sustained economic growth.

India historically suffered from a patchwork framework of insolvency laws that either did not give lenders adequate powers to recover their debts upon default or only catered to the interests of certain kinds of lenders—to the exclusion of others.[2] The IBC is a modern and comprehensive bankruptcy law that since its enactment has had a significant role in reducing the problem of nonperforming assets (NPAs), or "bad loans," in India's financial system.

In the wake of the economic disruption caused by COVID-19, the Indian government suspended the operation of critical parts of the IBC. These changes meant that lenders could not trigger insolvency proceedings against defaulting businesses if the default occurred after March 20, 2020. While this suspension possibly prevented unnecessary business failures and provided a "calm period" for the economy, these measures have outlived their utility.

This paper argues that while this drastic measure of complete suspension was perhaps necessitated by the financial disruption caused by the pandemic, it is imperative that the IBC be brought back with suitable modifications for enabling sustained economic growth for India. India's economy was slowing down even prior to the lockdown, and therefore it has a higher imperative for growth than do the economies of most other countries. Insolvency and bankruptcy laws like the IBC play a critical role in the financial system by allowing inefficient firms to "die" with minimal disruption

and reallocating capital to the most productive and dynamic firms. As this paper highlights, the suspension of the IBC, and the problems that ail its existing design, are likely to inhibit the allocative process in the Indian economy.

The functioning of the IBC had led to dissatisfaction in many quarters, mainly because of its inflexibility toward borrowers. This made its functioning more contentious than required. This paper recommends rebalancing the design of the IBC to provide greater flexibility and control to debtor firms. This is more critical in view of the much-needed economic recovery, where the financial system should support and incentivize those firms that face financial difficulties because of the pandemic but are otherwise healthy and productive. Such firms must be prevented from being dragged into liquidation and allowed to reorganize and restructure their businesses.

While existing policy measures have provided this cushion to businesses for a temporary period, many businesses in different parts of the economy will continue to suffer from the pandemic-induced economic difficulties for some time to come. A fully functioning IBC framework that is also suitably tailored to the requirements of debtor firms is a sustainable, market-based solution to cater to these firms and their lenders.

This paper argues that policymakers must seriously consider several options to improve the functioning of the IBC, including introducing more debtor-friendly provisions in the IBC and reducing incentives for borrowers and creditors to litigate. Some of these proposals will require the government to overcome the dominant discourse on cronyism and corruption. However, enacting these measures will be essential for ensuring a sustained economic recovery for India.

India's Economic Slowdown and Why the IBC Matters

India's gross domestic product (GDP) recorded a contraction of 23.9 percent in the first quarter of 2021 due to the economic shock of the COVID-19-induced lockdown. The total contraction in GDP for 2020–2021 is estimated to be 7.7 percent.[3] While growth is expected to pick up sharply in 2021, some underlying weaknesses in the economy have to be addressed to ensure a sustained high-growth trajectory.

One of these is the problem of resolving failed firms and the consequent rise in NPAs in the financial sector. While this is a decade-old problem, the economic lockdown has exacerbated it. India's banking regulator, the RBI, estimates that gross NPAs of banks might increase to 13.5 percent by September 2021.[4] Solving the NPA problem is key to unlocking credit growth in the economy.

The Indian economy was already slowing prior to the lockdown, and the lockdown has further stretched the resilience of many Indian firms and the financial system.[5] GDP growth slowed from 8.2 percent in 2016–2017 to 5 percent in 2019–2020.[6] NPAs still made up 9.5 percent of bank assets in 2019, despite capital injections from the government.[7] Between 2011–2012 and 2017–2018, per capita personal consumption expenditure declined by 3.7 percent.[8]

While both structural and cyclical causes for this slowdown have been proposed, economists Arvind Subramaniam and Josh Felman argue that the slowdown is a consequence of long-standing macro-economic issues unresolved after the financial crisis in 2008, and therefore, both cyclical and structural: "For the past decade, there has been a race between stimulus and stress. Repeated doses of stimulus have kept the economy afloat, buying time for the Twin Balance Sheet (TBS) crisis to be addressed. But the bulk of the legacy TBS problem has not been addressed, a second wave of problems has arrived—and now the stimulus has run out."[9]

According to Subramaniam and Felman, India's long-standing NPA problem has exacerbated over the past two years.[10] The main reason for this is the regulatory forbearance by the RBI. The "extend and pretend" regime has allowed banks to hide NPAs for close to a decade. This finally ended in 2015 when an asset quality review conducted by the RBI highlighted a significant proportion of bank assets to be NPAs.[11]

While other reasons for India's stalling economy continue to exist (including overzealous tax enforcement), reducing NPAs is key to improving credit growth and investment in the Indian economy.[12] This is because banks, and particularly government owned banks, play an outsize role in India's financial system.[13] In spite of the growth of India's equity market, banks remain an important—if not the primary—source of financing in India's financial system.[14] In turn, government-owned banks make up the large majority of the banking system, and the RBI's asset quality review found that such banks had a much larger share of NPAs than did private banks.[15] By 2018–2019, the percentage of NPAs on government bank balance sheets was much higher than that of private banks.[16]

Existing mechanisms for resolving NPAs were suboptimal. These mechanisms were created mostly by the RBI and thus excluded other creditors who were not banks.[17] RBI mechanisms that tried to co-opt other creditors did not work, and other mechanisms allowed certain creditors to walk away with secured assets but provided nothing for unsecured creditors.[18] There was no mechanism that brought together different kinds of creditors into the same forum and gave them equal places at the bargaining table. In addition, existing mechanisms left debtors' owners and management in charge of the firms. This made it harder for creditors to get adequate information to resolve NPAs efficiently.

The IBC was introduced as a critical element of the solution to India's long-standing NPA problem. Following its enactment, and amendments to banking regulation legislation,[19] the RBI issued a circular directing banks to mandatorily take all nonperforming loans through the bankruptcy framework within stipulated time frames.[20] While this move was successful in reducing bank NPAs, the IBC's extreme debtor-unfriendliness generated severe opposition. This was exacerbated by changes to the IBC that prevented certain business owners, and "related parties," from bidding to take back control of their firms during the insolvency process.[21]

As of today, the IBC remains the best mechanism for the resolution of bad debts in India's financial system, as debt recovery rates under the IBC have been vastly superior to those under other resolution mechanisms in India.[22] As the RBI's 2019 report *Report on Trend and Progress of Banking in India* states, "Recovery of stressed assets improved during 2018–19 propelled by resolutions under the IBC, which contributed more than half of the total amount recovered."[23]

The IBC also allows any creditor to trigger an insolvency proceeding if a default occurs.[24] In addition, in contrast to the frameworks under the RBI, a wide variety of creditors are part of a creditors' committee after an insolvency proceeding has started.[25] The disposal of cases has also been much faster under IBC than under other resolution frameworks. Proceedings under the IBC take an average of 394 days to completion, compared to 4.3 years in non-IBC frameworks.[26]

Yet the IBC was suspended as a result of the COVID-19-induced lockdown in March 2020. The following sections explain the reason for this suspension and the need for an improved IBC in India's financial system.

Policy Measures After the Lockdown

In March 2020 the Indian government suspended certain provisions of the IBC in order to prevent firms from being forced into bankruptcies due to the economic shock of the lockdown.[27] Specifically, the government suspended sections 7 and 9 (insolvency initiation by financial and operational creditors, respectively) and section 10 (debtor's initiation of insolvency proceedings). In addition, the government declared that all debt liabilities that arose during the period of the lockdown could never be treated as a default under the IBC. This meant that no IBC proceeding could be brought against a business for any default during this period. Initially enacted through an ordinance, these changes were given parliamentary approval in the 2020 monsoon session of Parliament.[28] In September 2020 the suspension was extended for another three months, bringing the total period of suspension to nine months.[29]

This left creditors of firms without recourse under the IBC to proceed against firms that defaulted during the lockdown. Critically, the suspension also prevented firms from filing for bankruptcy by themselves in order to restructure their debts. India's bankruptcy-related response was broad ranging compared to that of many other countries that provided partial or sectoral relief from bankruptcy proceedings.[30]

Additionally, the Insolvency and Bankruptcy Board of India amended its regulations for the corporate insolvency resolution process to state that the period of the lockdown shall not be counted toward the time frame for any activity to be completed under an existing resolution process.[31] This gave relief to firms that were already in the middle of a resolution process, some of whom may have gone into liquidation if not for this relaxation.

At the same time, the RBI imposed a moratorium on debt collection. Specifically, it permitted all lending institutions regulated by it to offer a three-month moratorium for all debt payments due between March 1 and May 31, 2020. (This was subsequently extended by another three months, ending on August 31, 2020.)[32] In addition, the RBI infused liquidity into the market to the tune of Rs. 3.7 lakh crore.[33] It also declared that a moratorium of debt payments under this announcement would not result in an asset classification downgrade for firms covered under its earlier scheme of stressed asset resolution.[34]

Finally, on August 6, 2020, the RBI announced an out-of-court resolution scheme that its regulated lenders could avail themselves to restructure and resolve corporate debts without effecting a change in control.[35] This benefit was extended only to borrowers affected due to COVID-19. This was followed in September by the report of an expert committee that made recommendations on the "required financial parameters to be factored in the resolution plans."[36]

These measures led to the introduction of a "calm period" during which businesses that suffered due to the economic effects of the lockdown did not become bankrupt due to the financial disruption. The suspension of the IBC and the RBI moratorium also prevented a flood of pro-debtor judgements that would have acted as judicial precedents and hurt debt recovery incentives and institutional mechanisms in the long term.[37]

On the other hand, creditors have been left without a recourse for debts that became liable during the IBC suspension. This means that firms that were unhealthy prior to the lockdown and about to default also received the benefits of the IBC suspension, as did healthy firms. Some of these firms can now apply for restructuring under the August 6 framework introduced by RBI.

This will, in turn, impact the recovery for lenders due not only to the moratorium and the IBC suspension but also the continued existence of unhealthy firms in the economy that cannot be restructured or resolved in an orderly manner.[38] After the first few months, the continued existence of unhealthy firms that can get their debts restructured will possibly crowd out investments into healthy firms. Similar patterns were noticed in Japan in the mid-1990s and in the European Union after 2012.[39]

While the government's and the RBI's measures enabled many businesses to withstand the pain of the lockdown, a different set of policy measures is required to enable sustained economic recovery. Such recovery necessitates two things: the growth of firms that are competitive, and the reallocation of capital from firms that are failing to healthy and competitive firms. The IBC is critical to this process, as it can enable the orderly resolution of failing firms and enable lenders to either restructure debt or reallocate it to competitive firms.[40]

However, the only resolution mechanism available for lenders during the IBC's suspension has been the RBI resolution framework mentioned herein. This framework is suboptimal. One reason for this is that the RBI framework is designed only for RBI-regulated lenders like banks; it does not provide a viable resolution framework for other lenders like bond holders. In addition, banks and other RBI regulated lenders are allowed to classify restructured loans as standard assets even if they are impaired before the restructuring is implemented. This is likely to reduce the transparency of the asset quality of banks. Finally, the RBI resolution mechanism is predicated on the signing of intercreditor agreements between banks and nonbank lenders. This is required to reduce coordination problems between different categories of lenders. Historically, however, lenders have been hesitant to enter into such agreements.[41]

This mechanism also promotes the same kind of regulatory forbearance that created issues of high NPAs and "zombie lending" before 2015. After the pandemic, the most creditworthy firms may not be the most competitive or productive ones. This is especially true because economies do not always revert back to the "old normal" after an economic shock. Instead there are disruptions in economic arrangements, and many old ways of doing business cease to exist permanently and give way to new ones.[42] Forbearance would, however, reward creditworthy firms over competitive ones.

Why Was the IBC Suspended?

If the IBC is indeed the best option for smoothening the process of creative destruction necessary for India's sustained economic recovery, why was it suspended? This is an important question in India due to the scope of the suspension; other jurisdictions provided limited relief from bankruptcy laws during the pandemic. On the other hand, firms have been basically exempt from the IBC during the period of its suspension.

Other than the obvious intention of preventing unnecessary firm failures during the pandemic, the answer to this lies partly in the structural issues within the IBC framework and partly in the political economy of the past decade. Prior to the IBC, lenders found it extremely difficult to recover debts from firms. The IBC corrected this situation by allowing any creditor to trigger insolvency on a default and by taking the firm out of the debtor's possession and into the creditors' possession on the initiation of insolvency.[43]

Once a firm enters the IBC process, the debtor loses possession of the firm and the creditors take control. This is in contrast to resolution frameworks in other major jurisdictions, where debtors have some mechanism to reorganize their firms and come out of bankruptcy while retaining possession.[44] This extreme rebalancing is intended to incentivise firms to negotiate with their creditors prior to a default and avoid the pain of being out of possession. To a large extent this has worked. The extreme consequences for debtors under the IBC have altered the relationship between debtors and their creditors.[45]

But this structural shift has led to a situation where, once a firm goes under an IBC process, it is more likely to be liquidated than not. The Insolvency and Bankruptcy Board of India mentions in its quarterly newsletter for April–June 2020 that 955 out of a total of 1,803 closed cases went into liquidation.[46]

Additionally, debtors have limited mechanisms for retaining control of their firm even when cases do not go into liquidation. In cases where a firm's debt is restructured instead, the IBC requires all those interested in the firm to submit a resolution application to the creditors in charge of the insolvent firm.[47] There are three issues with this process.

The first issue is that the resolution process currently functions as an auction of the firm rather than a reorganization of the firm's business. This reduces the ability of debtors to retain control of the insolvent firm.

Under the IBC, the creditors' committee is required to invite plans for the insolvent firm's resolution and select the best plan. This plan is supposed to provide for the debts of creditors as well as the management of the affairs of the firm.[48] Yet while the price quoted for the firm is an important consideration, so is the proposed plan for the firm's reorganization.

In 2018, however, Indian bankers resolved that they would negotiate only with the highest bidder in an insolvency process, stating that this approach is consistent with the guidelines of the Central Vigilance Commission (CVC), a government body tasked with ensuring probity in the conduct of government bodies and government-owned entities.[49] This has transformed the process of considering a resolution plan into a pure bidding process and, as a result, the creditors' committee is concerned with the highest bid rather than the viability of the firm.[50]

If the process adhered more closely to legislative intent, the debtor shareholders would arguably have a better chance of retaining control over the firm. But India's current political economy, leaning toward anticorruption concerns and government bank ownership, has meant that a creditors' committee is more inclined to run an auction mechanism that enables it to recover its loans rather than to reorganize the firm.[51]

Even if a secured creditor agrees to relinquish his or her security interest, the claim during the resolution is to be limited to the value of the relinquished interest.[52] If, however, a secured creditor chooses to keep the firm alive as a going concern and not enforce his or her claim, there is a chance that the creditor's ability to recover on the debt may reduce in the future. The risk aversion of the government-dominated banking sector means, however, that this business decision of keeping the firm alive is hard to take.[53]

The second issue is that a certain category of debtors have been legally prohibited from even attempting to take back control of their firms if the firms go into the IBC. Debtors who fall under the definition of section 29A are ineligible to submit a resolution application; this includes those who are currently insolvent, those classified as "wilful defaulters" by the RBI, those who have an outstanding loan that is classified as an NPA, and those who have been convicted of certain categories of offenses, among others. The list also precludes persons who are related or connected to those currently in charge of the insolvent firms. These exclusions significantly narrow down the ability of debtors to retake control of their firms.

The third issue is that there are delays within the judicial process. All IBC cases go to the National Company Law Tribunal (NCLT), the specialized tribunal for company law cases. The IBC stipulates that the resolution process be finished within a period of 330 days under the supervision of the NCLT. By 2019, the average time taken for resolution was 394 days.[54] This is due to three reasons:

1. **A shortfall in judicial capacity within the NCLT.** In order to meet this shortfall, the number of NCLT members are being increased, and dedicated benches for insolvency cases

are being considered.[55] Yet there are also other structural reasons for the delays within the NCLT. The first is that a significant proportion of cases go into liquidation, which requires more judicial time compared to a process that ends in resolution.

2. **A low threshold for triggering IBC proceedings.** The threshold for triggering insolvency was Rs. 1 lakh prior to the pandemic, and a single creditor can trigger insolvency. While this acts as a significant deterrent for firms, the low threshold also increases the number of cases before the NCLT and results in judicial delays.[56] This issue has now been resolved by increasing the threshold tenfold, to Rs. 1 crore.
3. **Parallel or related litigation in other courts, leading to delays in the IBC process.**[57] The IBC was amended to state that all corporate insolvency resolution processes must be completed within 330 days in order to account for such delays, yet the Indian Supreme Court has stated that there are exceptions to this requirement.[58] One significant source of such litigation has been section 29A of the IBC.[59]

While capacity augmentation might ameliorate some delays, unless these structural issues are fixed, we might witness greater stress on the NCLT infrastructure. This is because even though the incentives to litigate are not being reduced, the infrastructure for handling litigation is being steadily improved.

In summary, there are three points to take into consideration.

The first point is that the suspension of the IBC was deemed required in order to provide businesses a "calm period" and prevent unnecessary value destruction. While many countries provided relaxations from their insolvency laws, in India the scope for value destruction is much higher due to both the structural features of the IBC and the way it has been used by lenders. The IBC is necessary, however, to enable sustained economic growth and increases in productivity and employment.

The second point is that the lack of sufficient mechanisms in the IBC that allow debtors to retain or regain control, and the incentives to liquidate rather than reorganize, are likely to negatively affect economic recovery. The IBC has to be modified to increase incentives for reorganization, and to allow debtors better opportunities to restructure debts within the IBC while still retaining control of their firms.

The third point is that there are delays in the insolvency process because of a shortfall in judicial capacity within the NCLT. This is due to a shortage in personnel and the nature of the IBC process itself. Since many cases go into liquidation, these are more resource intensive and take up more judicial time. In addition, parallel litigation related to insolvency processes also adds to delays. The government's efforts to augment NCLT capacity have to be supplemented by changes to the legal framework that reduce incentives to litigate.

As a result, a reassessment of the design of the IBC is in order to make it better suited to the immediate context of India's economic recovery.

Conclusion: Reassessing the IBC in the Context of India's Economic Recovery

This paper highlights key structural problems in the IBC framework. Debtor-unfriendliness is perhaps the biggest issue with the existing design of the IBC, and it has been exacerbated by the political discourse on "crony capitalism" and the political economy of government-owned banks. In addition, the judicial infrastructure for handling IBC cases needs improvement. I accordingly propose certain improvements to the IBC framework.

Creating a More Debtor-Friendly IBC

The IBC has been more successful in ensuring that creditors can recover their debts than any previous regime. Therefore, the basic creditor-friendliness of the IBC has to be maintained, while allowing debtors increased opportunities to maintain control over their firms. There are multiple steps that government can take to improve the functioning of the IBC in a more balanced manner:

A new debtor-in-control bankruptcy process. An entirely new chapter, with a debtor-in-control insolvency framework, must be inserted into the IBC. This chapter should be similar to chapter 11 of the U.S. Code, which gives a debtor a chance to file for bankruptcy while retaining possession of his or her firm.[60] Once a petition under this chapter is admitted by the court, an automatic stay operates to allow the debtor the time to negotiate with his or her creditors.

The specifics of the Indian situation may necessitate that an additional oversight mechanism be added to such a framework. For example, under the recent amendments to UK bankruptcy law, the debtor firm operates under the supervision of an insolvency practitioner during a period of moratorium. A similar design could be used in India. A new chapter such as this should also operate independent of section 29A, since this framework would be fundamentally different from the existing creditor-in-control framework within the IBC. This framework could also serve as the default framework for micro-, small-, and medium-size enterprises.[61]

An important benefit of such a framework is that it would retain the existing provisions on creditor-in-control insolvency but incentivize debtors to file a chapter 11–style petition before the actual event of insolvency. This would not only allow creditors to trigger insolvency under existing provisions if the reorganization plans did not meet their requirements but would also allow them an opportunity to reorganize while keeping their business within their control.

Reducing the threat of anticorruption bodies like the Central Vigilance Commission. Given the outsize role of government banks in the Indian credit market, accountability measures have to give precedence to business judgment. This is especially vital given the need for a sustained economic recovery. It is possible to reduce the likelihood of government creditors considering the resolution process as merely an auction process. One way to do so would be to have specific CVC guidelines with regard to the IBC that allow for greater flexibility in decision making rather than allowing government-owned banks to follow the general CVC dictum that the highest bidder alone be negotiated with. While the government has taken other steps like amending the Prevention of Corruption Act, the incentives to auction the firm during a resolution process still hold true.[62]

The introduction of prepacks. The government has signaled its willingness to consider introducing prepackaged insolvency resolution processes, or prepacks, within the IBC framework, and the Insolvency Law Committee has published a report proposing such a process.[63] There are two factors that may, however, dilute the efficacy of prepacks: the applicability of section 29A to a prepack process, and the incentives of secured creditors. The report of the Insolvency Law Committee also proposes retaining the applicability of section 29A to prepacks: all debtors must be allowed to participate in prepacks and be exempt from section 29A in order to enable a prepack framework to serve its larger economic objectives of allowing greater flexibility for debtors. Additionally, secured creditors would only participate in a prepack if they received a higher value for their assets than they would if the firm went into liquidation. A prepack process would therefore have to ensure that secured creditors are sufficiently incentivized to participate in negotiations during the period of insolvency.

Reducing Incentives to Litigate

Improving the efficiency of the NCLT is key to the sustainability of the IBC process. To this end, the government's focus on adding more judges and specialized benches for IBC cases is a welcome one. In addition, there should be commensurate focus on reducing the demand for judicial resources within the IBC framework. This can be aided through two efforts.

Creating alternative mechanisms for firm resolution. Allowing debtors to reorganize their firms can possibly reduce the number of cases that currently go into liquidation, in turn reducing judicial time spent on such cases. If some of the policy suggestions stated herein are accepted, there will exist debtor-in-control insolvency frameworks to which section 29A will not apply. This would ensure that one significant source of insolvency-related litigation would be reduced, freeing up judicial resources.

Increasing the threshold for triggering insolvency. The threshold for triggering insolvency has been increased by the central government to Rs. 1 crore from Rs. 1 lakh. This is likely to reduce the number of claims that can be filed, especially against small firms. This, in turn, can ensure that more judicial time is spent on larger-value cases. Thresholds for triggering insolvency should remain similarly calibrated so that most delinquent firms can be taken to the IBC, while preventing businesses from going through insolvency procedures for the non-payment of very small debts.

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About the Author

Anirudh Burman is an associate fellow at Carnegie India. He works on key issues relating to public institutions, public administration, the administrative and regulatory state, and state capacity.

Notes

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Unit C-5 & C-6 | Edenpark | Shaheed Jeet Singh Marg | New Delhi, India 110016 | P: +011 4008687

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