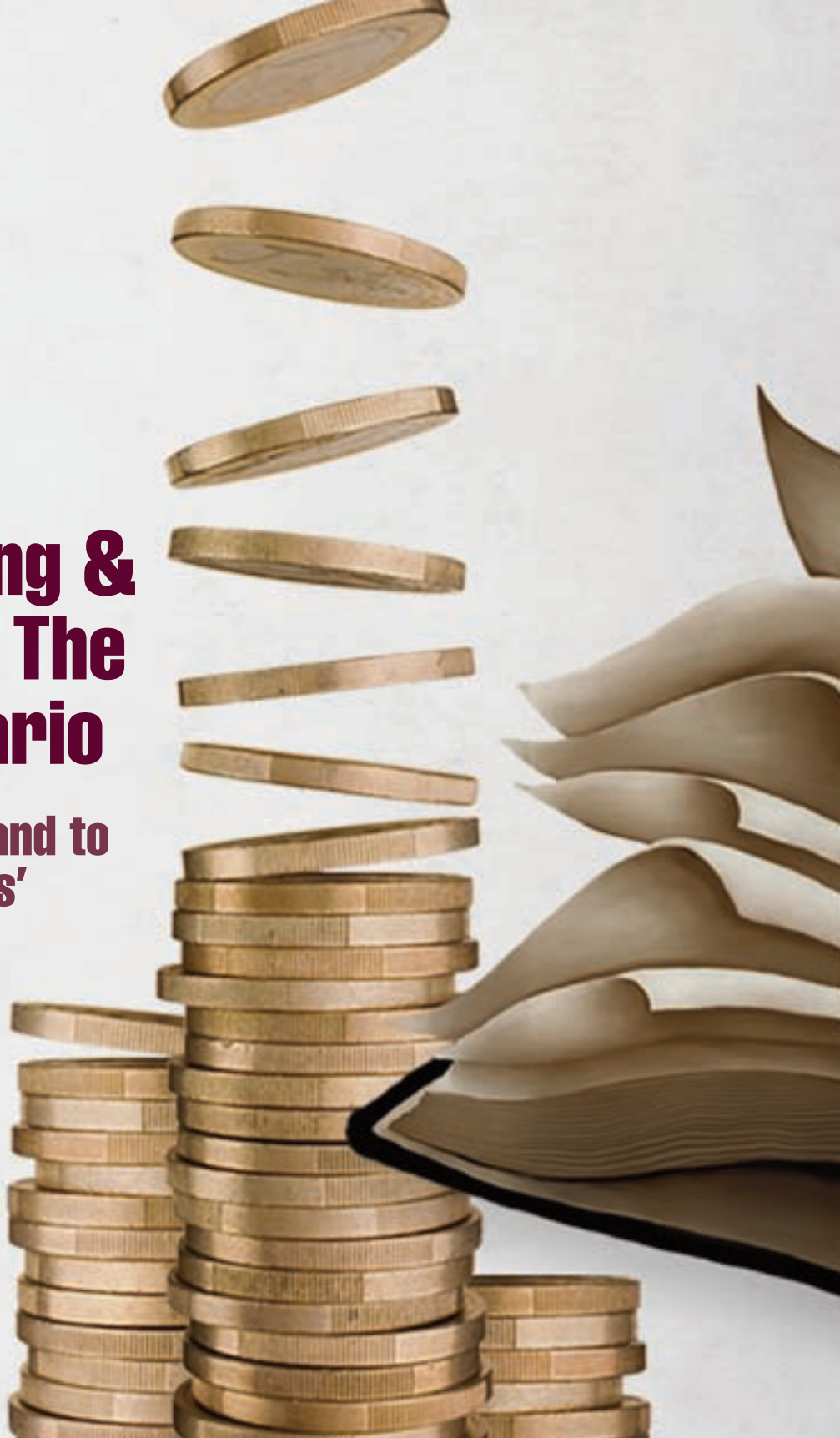


# Restructuring & Insolvency - The Indian Scenario

'Extend A Helping Hand to An Entity in Distress'



Insolvency  
Professionals  
INTEGRITY | RESOLUTION | RECOVERY

**T**he global economic slowdown has already cast its shadow on the Indian industries also, which are also falling under the grip of economic weakness leading to reduced economic activity, high unemployment and increased difficulties in making repayment of loans and honoring their debt obligations. The same has led to an increase in the deterioration in the quality of the loans of the banks and an increasing number of such loans racing towards becoming Non-Performing Assets.

As it is the number of NPAs is increasing each day, but the larger threat lies with the increasing number of prospective NPAs, which are likely to get crystallized in the wake of continuing downturn of the economy.

The same has a dual impact. It adversely affects the borrower as well as the lender. The borrower at its end faces the stress of deteriorating business and increasing pressures of repayment by the lenders while on the other hand, the lender has the humungous task of dealing with deteriorated asset portfolio, making substantial provisioning on such accounts which has an overall impact of weakening the Banks' Balance sheet.

To arrest this menace of spiraling distress/Non-Performing Accounts of the banks, only two options exist viz. either wind up the business and monetize the underlying securities else nurse the accounts and give them a breather to get back to track through the process of restructuring.

At the first instance, monetizing the assets may appear to be an easier option from the Lenders' viewpoint, but a blanket approach towards monetizing, without assessing the real extent and nature of the problem being faced by the borrower, would be detrimental to the interest of the economy at large. The financial difficulties being faced by the industry during the times of distress need to be attended differently. Rather than striking a hammer on the head of an industry which is already neck deep in distress, the need of the hour is to extend a helping hand towards them and to pull them out of the crisis situations with various means and measures.

However, the 'helping hand' principle is not to be applied uniformly across the board for all categories of distressed accounts. The intent behind the 'helping hand' should be an attempt to contribute towards the revival of the industry with a larger objective to 'reboot the economy' and draw it out of the clutches of recession/downturn. It means that only viable entities which have good future prospects and

are likely to come out of the present temporary crisis being faced by them should be nursed in order to save and subsequently enhance the underlying economic value of the assets. In case of entities which are not viable and have no chances of any recovery, in the long run, must be wound up in order to arrest any further depletion in the asset value.

Re-structuring- appears to be the need of the hour. In the most simplistic sense, re-structuring may be inferred to mean re-sizing/re-phasing/re-scheduling etc. by whatever name it may be called. Restructuring" may be understood as an act of reorganizing the debt, capital, operations or management structure of an entity with the objective of improving its profitability and to deal with a distress situation like the inability to honour its debt obligations.

The restructuring may take the shape of either re-structuring the corporate, management or operational structure of an entity or restructuring the capital and debt of the Company or a permutation and combination of all.

The term "debt restructuring" refers to resizing the debt of a business entity to a sustainable level and synchronization of the repayment obligations towards the resized debt with the cash accruals of the said entity.

Due to the continued domestic economic weakness and the liquidity crunch, there has been a surge in matters being referred for restructuring both through the formal and informal modes applicable in India. The increase in cases of distressed advances is also attributable to the global slowdown, reckless lending by some banks in the past, improper monitoring of borrowers' accounts, higher interest rates, power crisis in most parts of the country, etc. The increased numbers have stressed the Indian banking system and, in the event, the economic situation does not improve, the health of the Indian banking sector may further get adversely affected.

Increasing deterioration in asset quality is a cause for concern for the banking sector and the economy as a whole and that the effective restructuring processes act as stabilizers for the economy and reduce the damage that can be afflicted during a recessionary phase.

### **Informal Mechanisms**

Based on the above approach and with an intent to 'help and nurse' the ailing large corporate borrower accounts, the regulator Reserve Bank of India (RBI) introduced the Corporate Debt Restructuring (CDR) mechanism, a non-statutory mechanism, in 2001 to address the distress

situation of large borrowers who are facing a temporary crisis due to several economic factors and for reasons beyond their control. However, the CDR mechanism has also failed to achieve its objective and the outcome was relegated to merely 'evergreening' of accounts rather than actual revival which fact is evident from a large number of CDR failed restructuring.

As a further development, with intent to address the problems at the nascent stage and 'nip it in the bud', the RBI, in February 2014, issued guidelines for 'the formation of Joint Lenders'

Forum (JLF) in stressed advances before the accounts becoming NPAs. RBI also issued guidelines for reporting and classification of stressed accounts, in the same circular, much before the accounts become NPA. As per the said circular, accounts (typically more than Rs. 1 billion) in which delay/irregularity is seen are to be reported and classified as SMA0, SMA1 & SMA2 in different categories of delay. The JLF so formed needs to formulate a Corrective Action Plan to facilitate the distressed entities in meeting their obligations towards the lenders in synergy with its cash flows.

To give further impetus to the banks for resolving stress in the advance accounts, which are capable of revival, the RBI, in June 2015, issued prudential norms for Strategic Debt Restructuring (SDR) whereby lenders are provided with enhanced capacities to initiate a change of ownership in accounts by conversion of their debt into equity of the borrowers subject to fulfilment of the conditions laid down in the circular. The decision to invoke SDR norms should be taken within 30 days of the review of account and it should be supported by 75% of the lenders by value and 60% of lenders in number.

Post conversion of debt into equity, lenders must own 51% or more of the equity of the borrower. Once the conversion procedure is complete, lenders will have 18 months to stabilize operations and find a suitable buyer to sell the controlling stake in his favour. The conversion of debt into equity by the lenders, under the SDR norms is also exempted from certain clauses of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 with regards to the conversion price and from SEBI (Substantial Acquisition of Shares and Takeovers) Regulation 2011.

To further strengthen the lenders in their efforts for an effective management of the distressed accounts to enhance the bank's ability to bring a change in ownership of such borrowing entities which are under stress due to operational/managerial inefficiencies, in September 2015, the RBI introduced guidelines whereby the banks could affect a change in ownership of defaulting borrowers companies, outside of the SDR scheme. Under the said norms the change in ownership may be by way of sale of shares to a new promoter, which shares have been acquired by the banks either by invocation of pledge of shares or by conversion of debt into equity (outside SDR) or issuance of fresh equity shares by the borrowing company, in favour of the new promoter or acquisition of the company by a new promoter. Post change of ownership the banks may re-finance the existing debt of the borrowing entities considering the changed risk profile pursuant to a change in management.

Sale of NPAs to Asset Reconstruction Companies in accordance with the provisions of section 5(1) of the SARFAESI Act 2002 is another

important step in the direction of an effective resolution of distressed assets.

The ARCs with ability to aggregate debt of different classes are in a better position to implement timely resolution strategy thereby enhancing the value of stakeholders.

In January 2014, the RBI permitted Securitization Companies (SCs) and Asset Reconstruction Companies (ARCs) to convert a portion of their debt into shares of a borrower company subject to a maximum of 26 per cent. For the purposes of the enforcement of security interest, the SC or RC is required to have consent of 60 per cent of secured creditors. SCs or RCs are also permitted to acquire debt from other SCs or RCs, subject to certain conditions. In May 2015, RBI allowed ARCs for an extended resolution period of beyond 8 years. For the purpose of restructuring of assets related to BIFR/ CDR/ JLF, ARCs are permitted to accept a resolution period beyond 8 years tenure which is in line with the proposal approved by other lenders in BIFR/ CDR/ JLF.

### **Formal Mechanism**

There is no single comprehensive and integrated corporate insolvency and restructuring law in India that would address the needs of an entity in distress. The insolvency and restructuring framework in India is guided majorly by the following legislative Acts:

a Companies Act 1956;/ 20131

b Sick Industrial Companies (Special Provisions) Act 1985 (SICA);

Companies Act 1956

Chapter V of the Companies Act 1956

lays down the law relating to 'arbitration, compromises, arrangements and reconstructions' of companies in India and contains the provisions for the compromises, arrangements and reconstructions between the company and its creditors and shareholders.

Where a compromise or arrangement is proposed between a company and its creditors, or between a company and its members and if a majority in number representing three-quarters in value of the creditors or members agree to such a compromise or arrangement, it will be binding if sanctioned by the court without or with such modifications as deemed fit by the court. The court shall also monitor the implementation of such a sanctioned scheme and if the court is of the opinion that a compromise or an arrangement sanctioned earlier cannot be worked satisfactorily with or without modifications, it may pass an order for winding up a company.

In the absence of set time lines, the entire procedure turns out to be very lengthy and time consuming.

The new provisions under the Companies Act 2013 (yet to be notified) are broadly similar to that already existing, some new provisions have been incorporated under the Companies Act 2013, which lay down the procedure for the merger of two or more small companies, between a holding company and its wholly-owned subsidiary, or a prescribed class of companies by giving notice of the proposed arrangement to the Registrar of Companies, the official liquidator or the persons affected by the scheme, and inviting objections thereupon. The scheme must be approved by members of both the transferor and transferee companies (holding 90 per cent of the total number of shares) at a general meeting, and also by 90 per cent in value of the creditors of the respective companies. A copy of the approved scheme has to be filed with the central government. On registration, the transferor company is deemed dissolved.

The Act also contains provisions relating to mergers of domestic companies registered under this Act with foreign companies and vice versa. It further states that, subject to the approval of the RBI, the terms and conditions of the merger scheme may provide for payment of consideration to the shareholders of the merging company in cash, partly in cash or partly in Indian depository receipts.

As regards the Sick Industrial Companies (Special Provisions) Act 1985 The focus of insolvency legislation in India is currently on reorganization of the financial and business structure of potentially viable entities facing financial distress so as to allow them to revive and continue their businesses, and on the liquidation of unviable insolvent entities.

The eligibility criterion for filing a reference under SICA is complete erosion of net worth by the Accumulated Losses of a company owning one or more industrial undertakings, with specific exclusion of small scale industrial undertakings. The revival scheme to be sanctioned under the provisions of SICA may provide for several preventive, remedial and ameliorative measures for the revival of sick companies. The scheme so formulated must be consented by central government, state government, any scheduled or other bank, any public financial institution, state-level institution or any other institution or authority if any financial assistance or relief has been sought from them.

Throughout proceedings under this Act, all coercive recovery proceedings (including winding-up proceedings) (except action initiated by the secured lenders under SARFAESI Act 2002) against the company or its guarantors remain stayed except that the same may continue with the prior approval of BIFR.

Despite the legislation being in vogue for nearly three decades, it has failed to achieve its objectives. In view of the moratorium available against all recovery proceedings, it has become a haven for defaulting companies who could manage to get their reference registered with the BIFR by manipulating their accounts to claim sickness. Further, the eligibility criterion of 'complete net worth erosion' lacks pragmatism as the same tantamount to trying to revive a sick company which is on 'ventilator' rather than initiating remedial measures at an incipient stage. Time is an essence for an early revival which necessitates quick and expert decisions in the overall interest of all the stake holders of the distressed entity. However, the entire process under BIFR is fraught with delays (both at the end of the creditors and also the BIFR) and decision making by people not having the required skill sets which catalyze the woes of the genuine companies which can be revived, as by the time the revival schemes are actually sanctioned the originally envisaged plans tend to lose their viability. Under the

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1. Superseded by the provisions of Companies Act 2013 which have NOT been notified, till date. The provisions of the 2013 Act related to arrangement and compromise and winding up are yet to be notified. The same shall become effective from the date the same are notified in the Official Gazette of the Government of India.

present legal scenario there is complete lack of clarity regarding the priority of various debts due to contradiction of Central and State enactments and due to conflicting interpretation of the said law by different Courts. With the growth of economy and the increased business uncertainties, the number of insolvency cases is likely to increase and therefore the insolvency mechanism needs to be made efficient, effective and fast to handle the increasing numbers.

There is a paradigm shift in the legislation dealing with the Revival and Rehabilitation of Sick Companies with the enactment of Companies Act 2013 (relevant provisions dealing with Revival and Rehabilitation of Sick Companies are yet to be notified) wherein the criterion for the determination of sickness will no longer be 'net worth-based' but becomes 'liquidity-based'. Further the concept of 'industrial company' has been done away with and all companies which default in making payments to its secured creditors can file an application before the tribunal. Contrary to the provisions of SICA which did not provide for any consent of unsecured creditors to the scheme of revival, the new provisions require that the revival plan must be consented by at least 1/4th, in value, of the unsecured creditors in addition to the consent from 3/4th, in value, of the secured creditors of the sick company.

Further, the new legislation does away with the concept of the automatic stay on legal proceedings against a sick company, which is presently available in terms of Section 22(1) of SICA. Under the provisions of the 2013 Act, an application will have to be made for such a stay against legal proceedings, which will be granted at the discretion of the tribunal. Further, such a stay, if granted, would be operative only for 120 days and a fresh application will need to be made thereafter. The Act of 2013 lays down specific time limits in the revival and rehabilitation process, which is a welcome endeavour and may go some way to curtailing endless litigation.

Despite the enactment of the new law (pending notification), the Government has proposed 'new rules of the game' with the introduction of the Insolvency and Bankruptcy Bill 2015 (IBB). The provisions of the IBB are a paradigm shift from the

existing provisions of SICA and Companies Act 2013 in as much as 'debtor in possession' concept has been completely transformed into a 'creditor in possession' concept. The Financial Creditors of a defaulting borrower entity will call the shots in the entire proceedings. If the financial creditors are of the view that the entity can be revived then they may collectively (super majority) decide to restructure the dues and file a revival package before the adjudicating authority and if they decide otherwise, the entity will be liquidated. As such under the new rules of the game, it is the collective wisdom of the lenders which will prevail over the entire proceedings. The IBB also stipulates that any revival package, if envisaged, should be approved within a maximum of 180 days, extendable by another 90 days failing which liquidation would be the only fate of the entity.

### **Conclusion:**

Although there exist both informal and informal procedures for dealing with the restructuring of debts of distressed entities and both the Government and the Regulator are continuously taking several initiatives for paving the way for an efficient Restructuring and Insolvency regime, but the success story is not very encouraging.

Even the proposed IBB is borrowed heavily from the UK Insolvency Law without proper application of thought process to make it adaptive to the peculiar market and economic needs of India. Further the stringent time lines proposed under IBB are highly unlikely to be achieved, given the management structure and decision making structure of our banking sector and also the judicial approach and mindsets of Indian Courts wherein there is too much of judicial interference. Does it mean that liquidation is the only fate of such distressed entities being unable to reach a settlement with the lenders within a period of 180 days?

The need is to bring about a robust regime in place which not only addresses the growing menace of financial distress amongst the Indian Inc. but at the same time ensures continuity of operations of Indian industries and rescues entities in line with our constitutional mandate and object of the Draft Bill i.e. to promote entrepreneurship in India.