Evolving landscape of corporate stress resolution

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Building a better working world

Foreword

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Whilst time is of essence in dealing with India's approximately 16 lakh crore of stressed assets, the actual number of deals done so far is only a fraction. The numerous norms, introduced by the Reserve Bank of India (RBI) from time to time, and the Insolvency and Bankruptcy Code (the Code or IBC), one of the most successful and effective legislations, have all aimed at collective and timely resolution of corporate distress. With the Code's effective implementation, the stage is now set for large scale resolution of *good* assets and timely realisation or winding down of others. There is a need for lenders, regulators and the government to accept that businesses can fail and as long as there is a legitimate reason for business failure, resources should be diverted to more productive resolution of assets which lack the lending and restructuring stimulus.

All regulations that have emerged, be it the Strategic Debt Restructuring (SDR), Scheme for Sustainable Structuring of Stressed Assets (S4A), 12 February 2019 circular or the 7 June 2019 circular, are issued by the RBI in response to the stress in the banking and non-banking finance sectors that it regulates. But a look at some of the large stressed cases reveals that financial creditors may include banks, non-banking finance companies, life insurance companies, mutual funds and pension funds. Debt is not only the prerogative of RBI controlled entities like bank and non-banking finance companies but is also spread in mutual funds through bonds or loans against shares and in life and pension funds through bonds or loans. However, none of the other institutions have any guidelines on stress resolutions. Recently the Securities and Exchange Board of India (SEBI) and the Insurance Regulatory and Development Authority (IRDA) have allowed signing of Inter Creditor Agreements (ICA) to enable resolutions but have not come out with any comprehensive guidelines similar to the recent 7 June 2019 circular. Regulatory issues in mutual funds, pension and insurance sectors need a relook beyond just applicability of the circular.

The problem of stressed assets dawned on us suddenly, as does all distress globally. The insolvency law that came as a result of burgeoning stress and the 'paradigm shift' that it has brought about has had its own issues in terms of capacity of its stakeholders. The much needed change in the minds of the stakeholders is yet to happen. The number of Insolvency professionals grew at an alarming pace but the capacity to take on inter-personal issues, deal with hostile situations, maintain integrity and run organisations in difficult situations has not yet gained the confidence of other stakeholders. Even the creditors empowered with appointing the insolvency professional lacked exposure in dealing with stress and hence are unable to fully contribute to positioning corporate debtors for a change in control. The investors, though sophisticated in distress, are yet to fully understand the Indian dynamic and hence struggle to accumulate, structure and close distressed deals. Our courts too have had many

challenges in decision making or in dealing with the sheer quantum of cases. They are also yet to build the experience that effective implementation of a bankruptcy law requires. The promoters too are yet to fully get to terms with the regulation and end up litigating endlessly to save the status quo. Dealing with stress and related insolvencies require a high-degree of stakeholder capacity building to ensure sustained success. India has come a long way since the introduction of the IBC and we are seeing significant change, but a lot more is required.

It should be noted that consolidation of public sector banks will give us much larger banks which would be able to sustain further shocks that await us. Most banks undergoing Prompt Corrective Action (PCA) have provisions already of around 70%, which, after the consequences of the 7thJune circular of incremental 20% provisioning by March 2020 quarter, would become somewhere near 80%. This leaves banks to be able to accept resolution plans amicably and may even result in an upside to their P&L. We need to take the plunge from provision to realisation of stressed assets through either cash or better credit. This may also be a big opportunity for well-run ARCs, which would now be able to pick up more assets on a 15/85 basis, as banks would have a little consequence and compared to all cash deals would get better realisations. However, only ARCs with good investment teams, cash to fund 15% and a turnaround mindset would be able to capitalise on the opportunity. Banks on their parts will need to set up active special asset management groups to facilitate turnarounds.

The section 227 route for resolution of financial institutions is also welcome. However, the interim need of a resolution mechanism for other financial institutions except banks is also needed. The Financial Resolution and Deposit Insurance (FRDI) bill, while progressive, was shelved due to various reasons. Awareness programs for educating the masses would be necessary to introduce the bill at an appropriate stage.

In conclusion, I would reiterate that whilst substantial progress has been made with the introduction of IBC, and there has been a change in promoter behaviour towards repayments, an alternative mechanism for resolution should be developed and guided well by regulation and capacity build to enable the lender community to settle debts outside of an IBC process. The IBC would then occupy a back-seat in resolving distress and be used only as a deterrent against default. Investors too would find better and timely deals enabling much needed flow of capital to revive distressed assets.

This report spans across three sections – look-back at three years of India's bankruptcy regime, the industry view on way forward and finally, a primer on distress resolution in the financial sector and corporate turnarounds.

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Special feature

In conversation with

Rajnish Kumar

Chairman, State Bank of India

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In retrospect – The Code

IBC – inception to evolution

While the journey has been full of ups and downs, the Code has largely lived up to the expectations of the stakeholders

Shailendra Ajmera
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On the eve of implementation of the Insolvency and Bankruptcy Code (the Code or IBC), in 2016, it would have been hard to anticipate where the Code and insolvency eco-system would be in next three years. Prior to the Code, the set of actions available to a banker were time-consuming and getting lost among the various laws that were applicable to resolve a distressed situation. The RBI also accorded several mechanisms for resolving distress through various frameworks, however, there were only a few cases which benefitted, as envisaged, by these schemes.

Unsurprisingly, the Code, since its implementation, has seen large number of corporate debtors enter the Corporate Insolvency Resolution Process (CIRP) as per the provisions of the Code. Notwithstanding the numbers, the market has oscillated from exhorting its success to decrying the several problems that have emerged during the implementation of the Code.

The assessment thus far

While the journey has been full of ups and downs, the Code has largely lived up to the expectations of the stakeholders. So much so that India's ranking in the World Bank's Ease of Doing Business (EoDB) report has risen from 100th place in 2018 to 77th place in 2019 to 63rd place in 2020. A major driver for this has been the improvement in the 'Resolving Insolvency' parameter in EoDB rankings (from 108th place in 2019 to 52nd place in 2020).

Until 30 September 2019, more than 2,500 cases were filed, with almost ~1,000 being concluded via resolution (a restructuring plan being approved), settlement or passing in to liquidation and remaining ~1,500 cases are currently undergoing the process. Approximately US$50 billion of financial debt was resolved in 156 cases, with an average recovery of 42% for the financial creditors. The recovery percentage, while may be considered healthy, but is limited to few cases, as, so far only a sixth (156 cases) of the ~1,000 closures have resulted in a resolution. Moreover, the average time taken for the resolutions is 374 days i.e. well over the 270/330-day timeline. Refer **section 1.2 - The Code on the ground,** of the report for more details and analysis on some of the key statistics pertaining to first three years journey of IBC.

Continuous evolution

The large volume of cases meant that all the stakeholders – government, regulators, banks, investors and professionals – have kept busy. Given the dynamic nature of insolvencies and the magnitude of monies involved, the government and regulator have been pro-active and brought about several changes in the law and corresponding regulations, such as giving powers to the Reserve Bank of India (RBI) to refer non-banking finance companies into bankruptcy, blocking promoters who had defaulted from bidding and allowing exit from the Code post admission (provided the committee of creditors (CoC) vote for the exit). The government and the regulator have also taken regular market feedback, while introducing updates or amendments to the Insolvency and Liquidation process.

Most recently, as a stop gap arrangement, rules were notified by the Ministry of Corporate Affairs (MCA) providing a framework for insolvency resolution of systemically important

Financial Service Providers (FSPs), excluding banks. These rules are under the powers given to Government in Section 227 of IBC and are only applicable for NBFCs (including Housing Finance Companies) with asset size of INR 500 crore or more as per last audited balance sheet. The rule, and the notification thereunder, is another important juncture for the Code.

Such timely and substantial interventions at frequent intervals are unprecedented in the Indian context, which is again testament to the promise and potential that the Code holds. The continuous evolution of the Code and emerging jurisprudence has acted as a catalyst for the law to keep progressing forward.

Refer **section 1.1 - Status check – learn, unlearn and relearn,** of the report, wherein we have presented a point-by-point review of the contribution by various stakeholders to support the implementation journey of the Code, along the similar lines as in our previous reports in 2017 (IBC: Experiencing the Code) and 2018 (IBC: The journey so far and way ahead).

Like government and regulator, judiciary has also played its part. It can take several years for a new law of this magnitude to settle down, and provide complete clarity, certainty and predictability for the stakeholders. The Supreme court, along with NCLAT and NCLT, has settled several contentious and principle-based issues and delivered landmark judgments. The Supreme Court has been in the forefront in setting the jurisprudence and supporting the implementation of the Code including upholding the constitutional validity of the Code in Swiss Ribbons verdict. In addition, courts have also opined on role of CoC, Insolvency professional, claims moratorium etc. Some judgements, including Jet Airways and Videocon, have taken the Code to entirely new frontiers – areas like cross border and group insolvency, which are not currently covered in the legislative framework. In **section 1.3 - Select Judgements – setting the precedents,** of the report, we have given a bird's eye view of the few of the select judgements which have helped in setting the jurisprudence for the Code.

We also conducted polls on some of the key aspects of corporate stress resolution to shed light on financial creditors' perspective. Refer **section 1.4 - Market perspectives - a dipstick study**.

Steady progress, but more ground to cover

It should be noted that the Code's implementation coincided with the worst NPA cycle of the independent India's last 70 years without the corresponding increase in judicial or institutional capacity. Combined with lack of required out-of-court restructuring options, the Code has been converted into a primary restructuring and reorganization mechanism for the corporate distress which may lead to sub-optimal outcomes. There is a need to build capacity across the spectrum to better the yield and enable the code to effectively realise its goals.

While the Code and the incumbent stakeholders will continue to evolve, there is a need to protect the insolvency framework from pernicious trends to ensure the strength, integrity and effectiveness of the bankruptcy system.

In the immediate future, a stringent focus on timelines and post approval implementation support would enable the insolvency ecosystem in India to enter the next phase.

Status check – learn, unlearn and relearn

The Code, envisaged as a panacea for resolution of distressed corporates in India, replaced an elaborate and multilayered insolvency and bankruptcy process. The challenges with the incumbent system(s) included lack of clarity on jurisdiction, lack of consistency and efficiency, fragmented systems for debtors and creditors, delays, lack of business / financial expertise with judiciary etc.

The Code, therefore, was put forward as a salutary solution for resolving distress replacing the incumbent distress resolution mechanism(s). Three years on, the Code has evolved preciously – due to a strong legislative support, counter-sandbox methodology of resolving the largest and most complicated cases first and consequent jurisprudence set at courts.

The following section presents a point-by-point review of the implementation journey of the Code.

Key pillars of IBC's ecosystem

Judicial interpretation provides clarity on practical implementation of the Code and bringing consistency in the process

The **role of the regulator** continues to evolve to meet market and industry needs

Committee of Creditors continues to learn and evolve

Behavioural change is taking place with management starting to engage proactively with the stakeholders at the first signs of stress

Insolvency professionals require further training and support to ensure high levels of integrity, competence and professionalism are maintained

Implementation of **Resolution Plan** needs more focus and support from the various agencies

Creditor ranking while has been largely clarified with the recent SC judgements (Essar Steel). However, on ground implementation needs to be tested

International investment needs consistency embedded in the insolvency ecosystem and also needs better quality information on assets for more active participation

Delayed **timelines** has been the biggest challenge and a roadblock for converting promise into delivery for the Code

On track | In process | Requires attention

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On track | In process | Requires attention

Concern	Remarks
Judicial interpretation	- The judicial interpretation of the Code by the National Company Law Tribunal (NCLT), National Company Law Appellate Tribunal (NCLAT) and the Supreme Court (SC) on procedural and substantive matters has brought clarity on several conceptual issues. SC has been active and swift in delivering judgments on IBC-related matter, helping set the precedent for the evolving law. - SC's Swiss Ribbons judgement upholding the constitutionality of the provisions of the Code and SC's Essar Steel judgement clarifying creditor ranking have been landmark developments for the Code. Refer to the section of Select Judgements for more details - However, it should be noted that contradictory judgements across NCLTs (for instance judgements on treatment of claims, timelines, contingent liabilities etc.) and inordinate time delays in resolving matters at the judiciary have led to some negative market sentiments towards the effectiveness of the Code. *Efforts should be fast tracked for embedding technology in the judiciary to enable cross-references of decisions on various matters that can be used by judges not only in NCLT but also in NCLAT. This would not only enable quick disposal of matters but also improve consistency among various courts.*
Role of the regulator *(Insolvency and Bankruptcy Board of India)*	- The Insolvency and Bankruptcy Board of India (IBBI) was envisioned for meeting multiple objectives, namely, bringing procedural clarity and consistency, regulating Insolvency Professionals (IPs) and Information Utilities (IUs) and collecting statistical data on various aspects of insolvencies for further improvement. To this effect, IBBI has continued to be pro-active and responsive to the industry and its developments. As the market and regulator continue to mature, it is important that the objectives of the IBBI continue to be at the forefront of its decision making at the time of allocating its investments in terms of time, energy and resources. - It should be noted that IBBI has received 1,583 complaints/grievances of which 1,137 have been addressed (as on 30 September 2019). - The IBBI also engages in continuous training and development of IPs and its staff and has put in place measures to record and monitor data. There is a wealth of data now available to the IBBI which should be further used for empirical research and to benefit both professionals and the industry. *Role of IBBI is expected to only get more complex and far-reaching. New regulations like personal insolvency, cross-border insolvency and pre-packed bankruptcies and changes to existing regulations would need more strategic and execution bandwidth. Also, with already 2,800 IPs, over 2,500 CIRPs, 600+ liquidation cases and 350+ voluntary liquidation across the length and breadth of the country, close monitoring of cases and individuals would be essential to maintain high quality and ethics standards.*

Concern	Remarks
Committee of Creditors	

Concern

Remarks

Committee of Creditors

- The COC is vested with the power and authority to govern and maximize value of a corporate debtor (CD). A clarification issued in the recent SC judgment on the position of COC as a commercial body and its task to take financial restructuring decisions based on its feasibility and viability may dissipate discourse on the duties and obligations of the COC with regard to approval of the resolution plan.
- Furthermore, certain developments such as change in voting thresholds to 51% for routine matters and 66% for few key matters, appointment of Authorised Representatives (AR) for class of creditors and consolidation of public sector banks have eased the flow of decision-making. Most of the banks now have specialized departments and professionals for dealing with stressed asset management, which has led to development of standardized operating procedures and hence improved the speed and brought consistency in the decision making.
- Financial creditors tend to prefer an all-cash settlement instead of continuing a sustainable level of exposure to the resolved corporate debtor. This seems incongruous with expectations of high recovery. Refer **section 1.4 - Market perspectives** for more details.

As the Code enters its fourth year, it can no longer be called a new legislation, especially when financial creditors have referred over 1,000 corporate debtors to IBC. Financial creditors, now, should take a step back and reflect on the three-year journey and incorporate the learnings into the decision-making process for upcoming cases. For e.g., evaluating restructured resolution plan vs all cash deal (OTS) on a case to case basis.

Behavioral Change

- The Code has made an impact in the way repayment of debts is viewed and treated by the promoters and the management. There is now a conscious move by promoters/directors, to engage earlier into discussion with lenders, at the first signs of distress.
- However, for cases already undergoing CIRP, promoters are still largely perceived as recalcitrant. However, in cases wherein personal guarantee is provided, the promoters may be more supportive. Refer section 1.4 - Market perspectives for more details.
- The Essar judgement reiterated lender's right to enforce personal guarantee, irrespective of a parallel CIRP on corporate debtor. From 1 December 2019, personal guarantors have also been brought into the ambit of IBC, a move which will only strengthen the trend of early detection and action by the Corporate Debtors.

Time lag between filing of petition for commencement of CIRP and actual admission (current range of six to nine months for most cases) may dilute the Code's ability to be an effective deterrent to delinquency and default. Also, provisions regarding directors' responsibility to keep running an insolvent company during the pre-CIRP period and not reporting it, needs more focused and a stronger implementation.

On track

In process

Requires attention

Concern	Remarks
Insolvency professionals	

Concern

Remarks

Insolvency professionals

- The insolvency profession has evolved in a short span since 2016, with over 2,800 IPs already registered. However, while they are abundant in quantity, IPs with qualities such as high professional ethics, turnaround and crises management expertise and relevant industry / sectoral knowledge would be equally important.
- An IP is vested with significant powers and duties. They are vested with the powers of the (suspended) board of directors and have wide ranging authority, which is necessary to effectively execute their function in a distressed scenario and run corporate debtor as a going concern. However, any misuse of such powers would threaten to damage the integrity of the profession and the ecosystem. IBBI has also issued disciplinary orders against the offenders including levying monetary penalties, barring participating in cases, forfeiting the registration etc.

Continued professional education of IPs and maintaining a positive dialogue between professionals, regulator and market participants is the key. Maintaining the highest standards of ethics and integrity would be paramount for the profession to succeed.

Implementation of Resolution plan

- NCLT approval on a resolution plan is a job half done. The objective of the Code would only be achieved once the approved plan is also successfully implemented. It should be noted that the Resolution Applicants (RA) have expressed difficulties in the implementation of resolution plans due to lack of clarity on issues related to past contingent liabilities and action against corporate debtor by investigative agencies. Adequate support and protection to the resolution applicant from past liabilities, a well-established international practice, is a fair ask.
- Cases in which the resolution applicant delays or withdraws from implementation of approved resolution plans may set an inappropriate precedent. An RA should not be allowed to take the CoC and the resolution process to the point of no return and then not complete the process in a timely manner. Punitive actions against such rogue or obstinate RAs may be embedded in the Code to ensure that the overall resolution process is not compromised. However, issues regarding information availability and past contingent liabilities that underpin the rationale of a rogue bidder must be addressed as well.

An objective test for successful resolution can only be known in the future, following the resolution applicant having fully taken over operations and delivering positive returns. Unsuccessful implementation of resolution plans, resulting in liquidation or re-entering the CIRP, could lead to serially insolvent corporate debtors. It is important to support the resolution applicants acting in good faith with appropriate protection for assets acquired under the provisions of the Code.

Concern	Remarks	
Creditor rankings	- The ranking of creditor claims (and the consequent priority of distribution) is provided in Section 53 of the Code. However, there is a difference of opinion on applicability of the section to the CIRP also and not only to liquidation. There is a need to have a well-defined system of priorities, which would be applicable even to distributions made under a resolution plan, as is the case in other jurisdictions. This would ensure that the entitlements of various categories of creditors are clearly defined. - In the recent SC's judgement in the Essar Steel case, it is held that the Committee of Creditors (COC) has the discretion to decide on the distribution of proceeds. This has brought clarity to one of the most disputed points which was resulting in delays due to litigation among creditors.	*Due to the recent development, clarity has emerged between creditors ranking for secured financial creditors, unsecured financial creditors and operational creditors. Going forward, better clarity would be required on the rights of secured creditors with regards to nature of security i.e. distinction between first and second charge or between a working capital or term loan lender. For instance, the rights of payment of secured creditors under the distribution waterfall in Section 53 of the Code may be restricted to the extent of their security, or property right.*
International investment	- In the first three years of IBC's journey, majority of successful resolution applicants were strategic investors, who are aware of the situation on ground and are willing as well as able to transact in India. While international players are investing more resources in India, including large commitments, as they look to build both capability and knowledge, major challenges remain in a distressed buyout which is reflected in the actual amount deployed in IBC deals. - Challenges pertaining to availability of high-quality information coupled with stringent timelines, lack of clarity on contingent liabilities and statutory dues, high cost of capital, lack of talent to run operations, inordinate delays in approval of resolution plan and contradictory judgements leading to unpredictability are some of major concerns expressed by international investors.	*Uncertainty of outcomes are expected to settle with time as interpretations become clearer and the process embeds, recognising the key attribute of consistency. However, concern remains on the ability to generate meaningful information about the corporate debtor and active market corporate debtors during the CIRP. These concerns must be addressed to attract international investments and funds and solutions like vendor due diligence much be thought through by the RP and COC.*

On track

In process

Requires attention

Concern	Remarks
Timelines	See below

Concern

Timelines

Remarks

- One of the key objectives of the Code was to achieve time-bound resolution of distress since delays severely affect deal value, particularly as capital does not wait to be deployed. Furthermore, one of the basic tenets of credit is repayment of deployed capital with the interest rate serving as the return for the risk undertaken. The Debt Recovery Tribunal (DRT) and related systems prevalent prior to IBC were replaced with the view to improve a system which was marred with delays and consequent value destruction. The Code was therefore intended to provide lenders with an effective mechanism to recover public money. Lack of an robust and effective mechanism for appropriate resolution of distress could have several long-term debilitating repercussion on the economy including deposit flight from banking system, increase in cost of capital and trade deficit, truncation of new investments and consequent increase in supply-side constraints, currency depreciation and fiscal debt trap.
- To this effect, it is worth noting that since the implementation of the Code, while average rate of new admissions is increasing (*from 280 per quarter for January - September 2018 period to 350 per quarter for January - September 2019 period*), the rate of closures is still insufficient (*148 per quarter for January - September 2019 period*). Of the 1,497 ongoing cases as on 30 September 2019, 859 (57%) were ongoing for more than 180 days and 535 (35%) had crossed the 270-day timeline. In other words, based on the current run rate, NCLT would take almost two and a half years to clear just the current number of cases.
- A recent survey revealed the concern regarding delays in CIRP admission and approval of resolution plans are common amongst financial creditors. Refer **section 1.4 - Market perspectives** for more details.

Recent appointment of thirty new judges to various benches of the NCLT across the country is a welcome move and should lead to speedier resolution of cases. However, much more collaborative thinking and ownership is required to overcome the situation, before delayed timelines gets completely implanted into the ecosystem and becomes a norm rather than an exception.

Conclusion

Considering India's history of distressed asset resolution, judicial capacity and recalcitrant promoters, forecasting an exuberant or a drastic change in 2016 due to the implementation of the Code might have been difficult.

However, the journey of the Code from December 2015, when it was first placed before Parliament, has been largely unprecedented in the history of India in terms of its speed of implementation, development of the ecosystem and sustainable change the Code has ushered. While not without challenges, the Code has clearly achieved more than what anyone expected in 2016 and has consequently set a very high bar for itself.

The Regulator has been active to the needs of the market, judicial conclusion of cases at the Supreme Court has brought clarity on various aspects of the Code and creditor-borrower relationship has changed for the better.

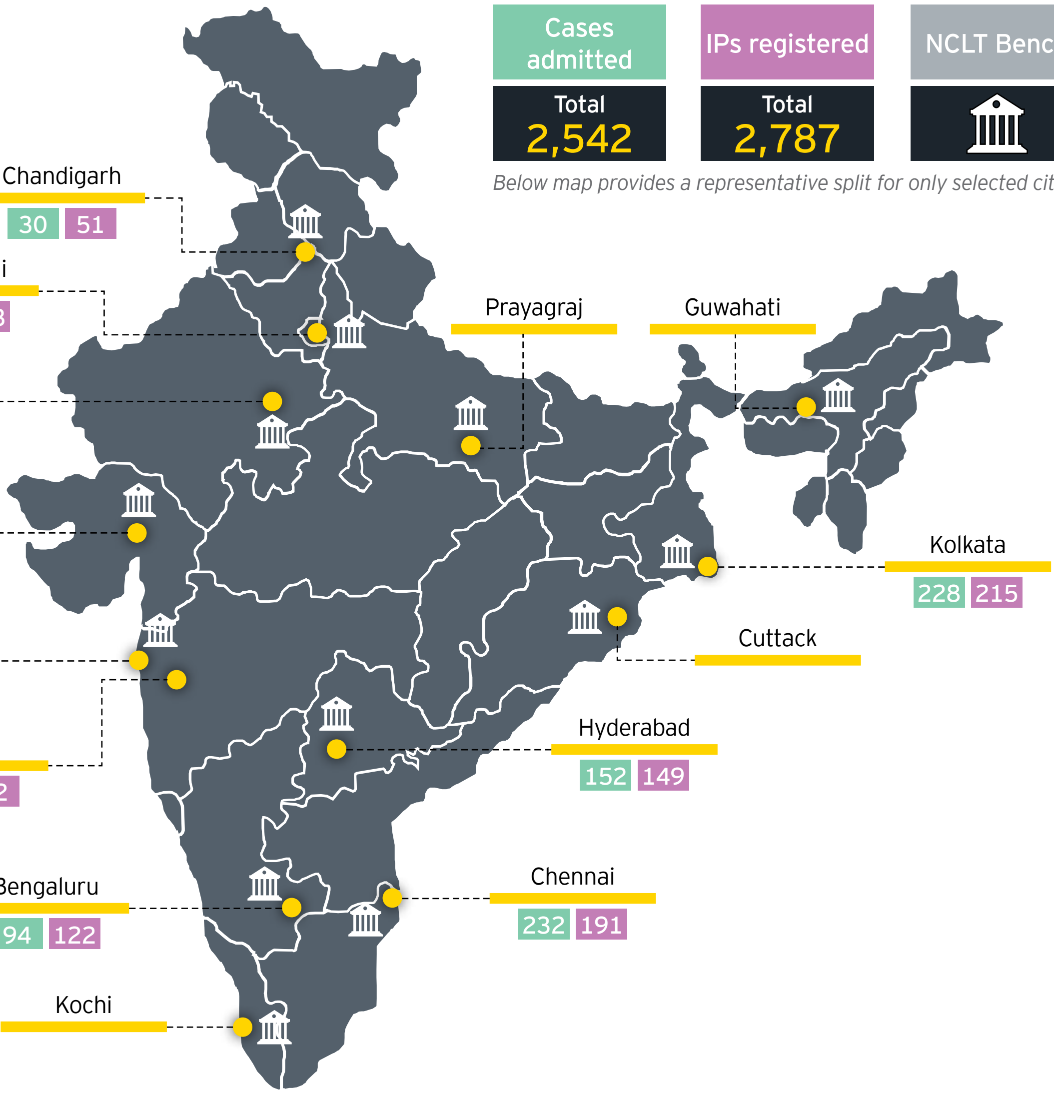
However, it must be noted that delays, multiple litigations and inconsistent plus unpredictable outcomes in the courts may create a fog of uncertainty in practice. The effectiveness of the Code is derived largely from a paradigm shift to creditor-in-control regime and trends that attack this basic tenet need active supervision and corrective action.

The Code on the ground

India's rank for resolving insolvency in World Bank's Ease of Doing Business reports has improved from 136 in 2016 to 52 in 2020. The rise is primarily attributable to implementation of the Code and the progress made thereafter. This section provides an overview of the IBC's three year journey.

Cases admitted	IPs registered	NCLT Bench
Total 2,542	Total 2,787	

Below map provides a representative split for only selected cities



3 IPAs | 61 IPEs | 2,374 Registered Valuers | 588 IPs empanelled under SEBI Regulations

1 Information Utility (IU) with data on INR 56+ Lac Cr. of debt

21,645 attempts for insolvency examination with success rate of 18%

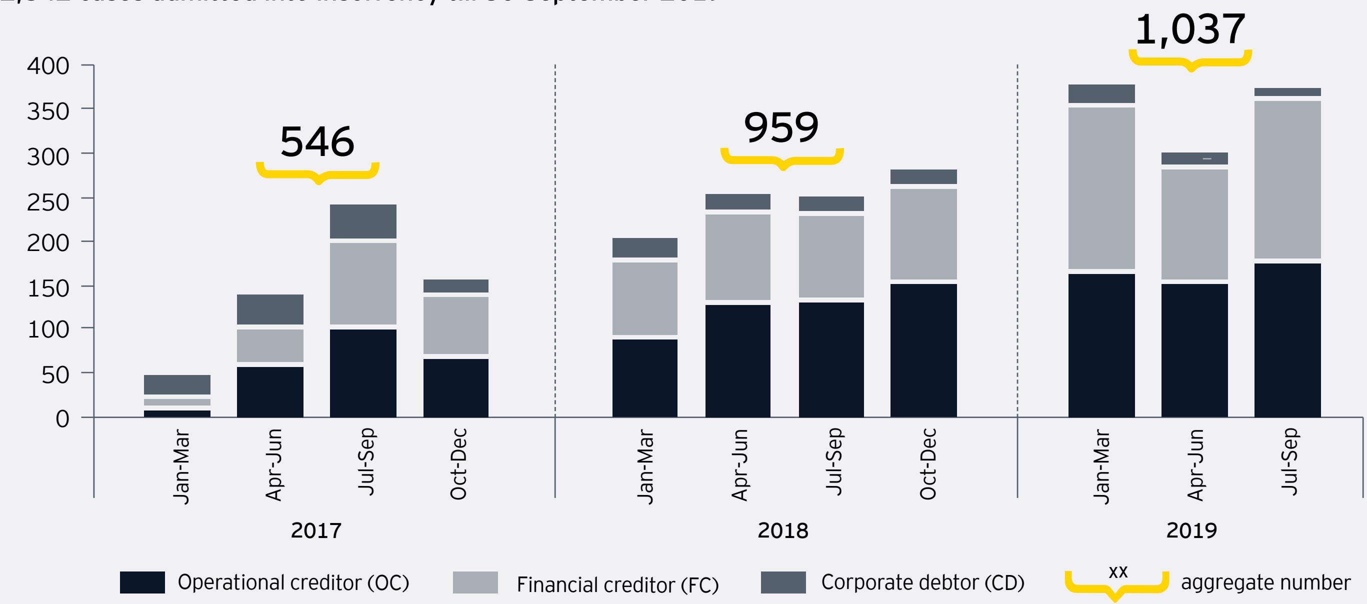
20,172 attempts for Valuation examination with success rate of 16%

Only 9% of IPs are female and 700 IPs are over 60 years old

In 30% cases IRP was replaced by another RP

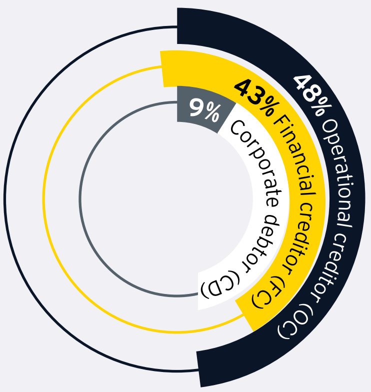
1,583 complaints and grievances received by IBBI

2,542 cases admitted into insolvency till 30 September 2019

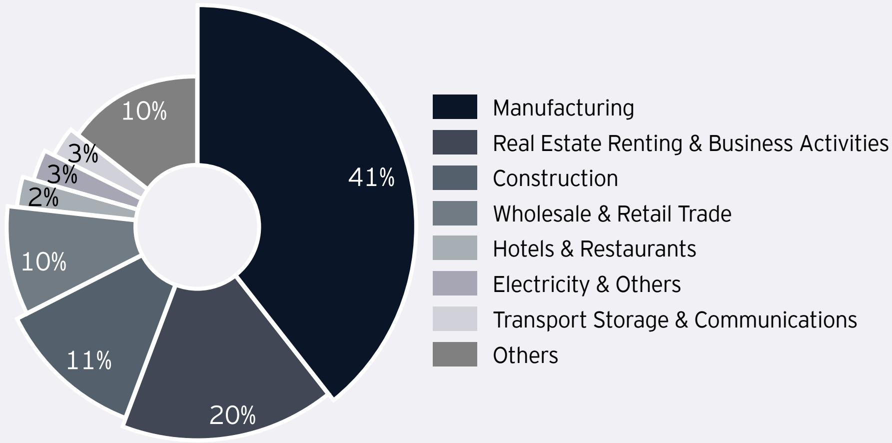


Average 350 cases per quarter admitted for the last 3 quarters in 2019

OCs account for almost half of all CIRPs admitted (2,542 cases)



Over 70% of cases admitted are from manufacturing, real estate and construction sectors



Year-on-year, filings by FCs are increasing 205 in 2017, 384 in 2018 and 497 in YTD 2019

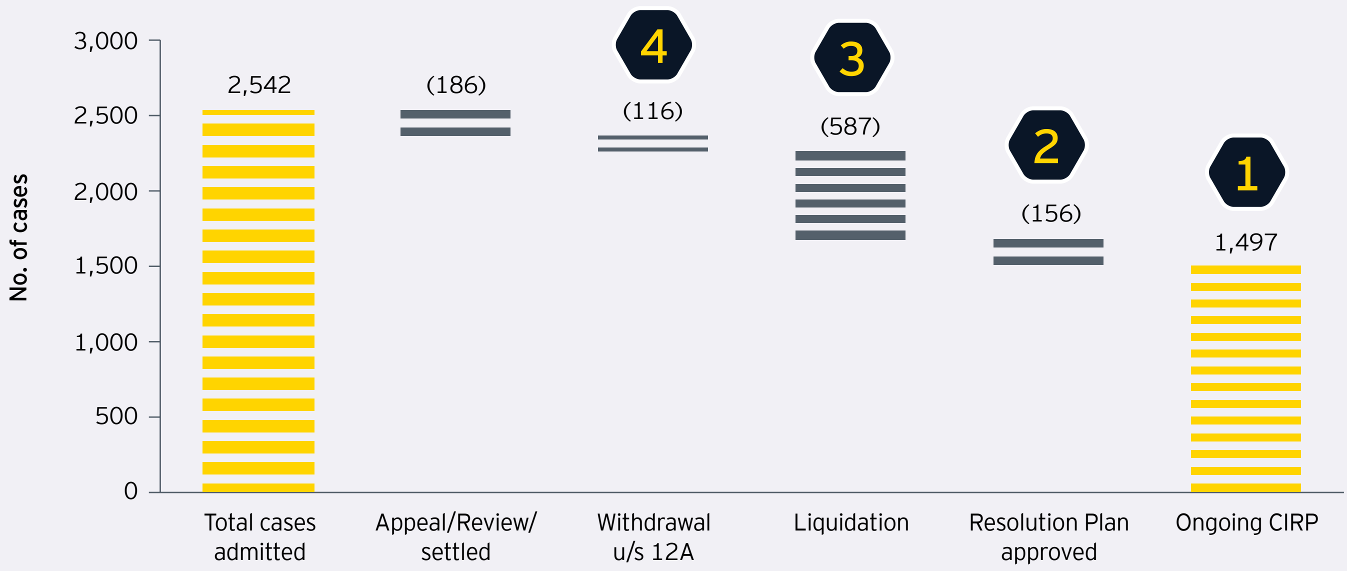
Real estate, construction, electricity and financial services sectors are seen as undergoing significant stress and may lead to fresh NPAs in 2020.

*Refer **section 1.4 - Market perspectives** for more details.*

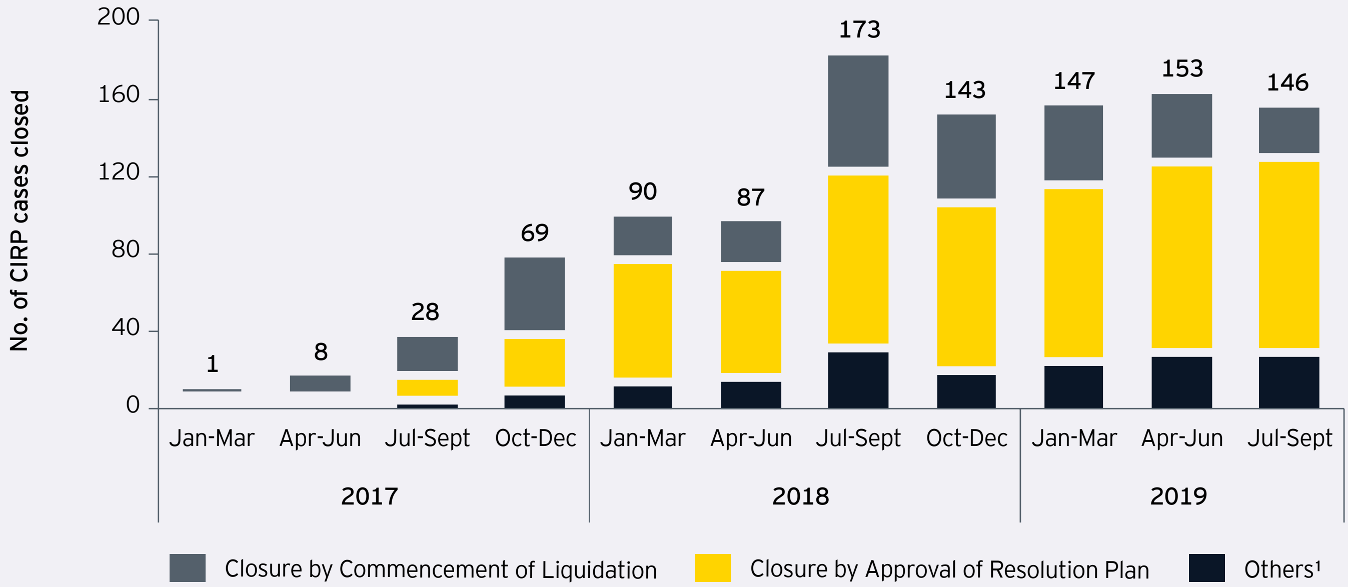
Source: IBBI.Gov; EY Analysis

The Code on the ground

Breakdown of 2,542 cases admitted to insolvency – 1,497 ongoing and balance 1,045 closed



Trend on closure via liquidation, plan approval or withdrawal

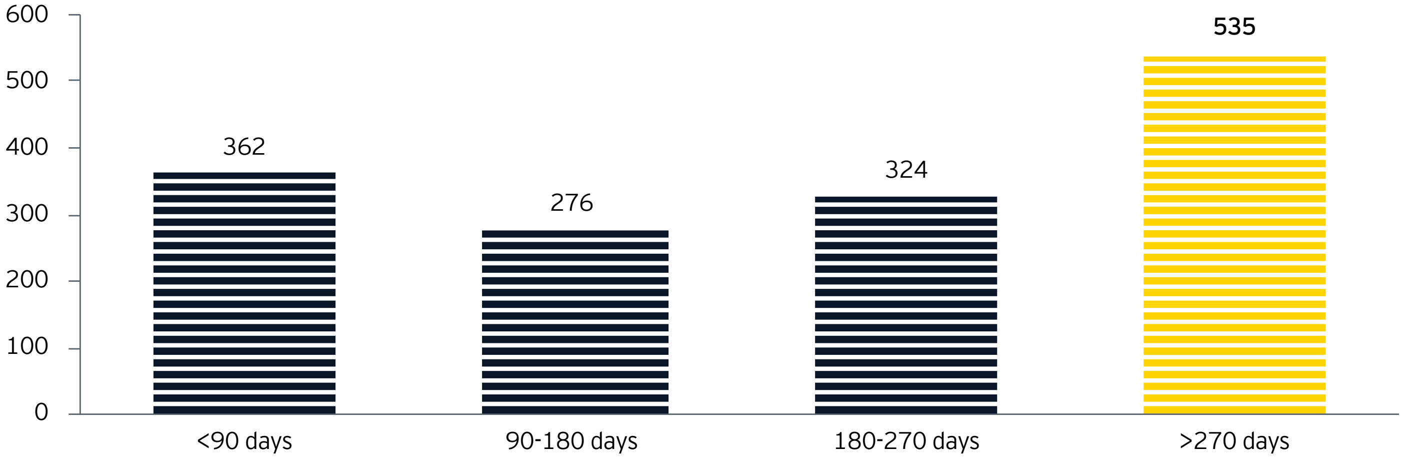


[1]Others include appeal/review/settlement and withdrawal u/s 12A
Source: IBBI.Gov; EY Analysis

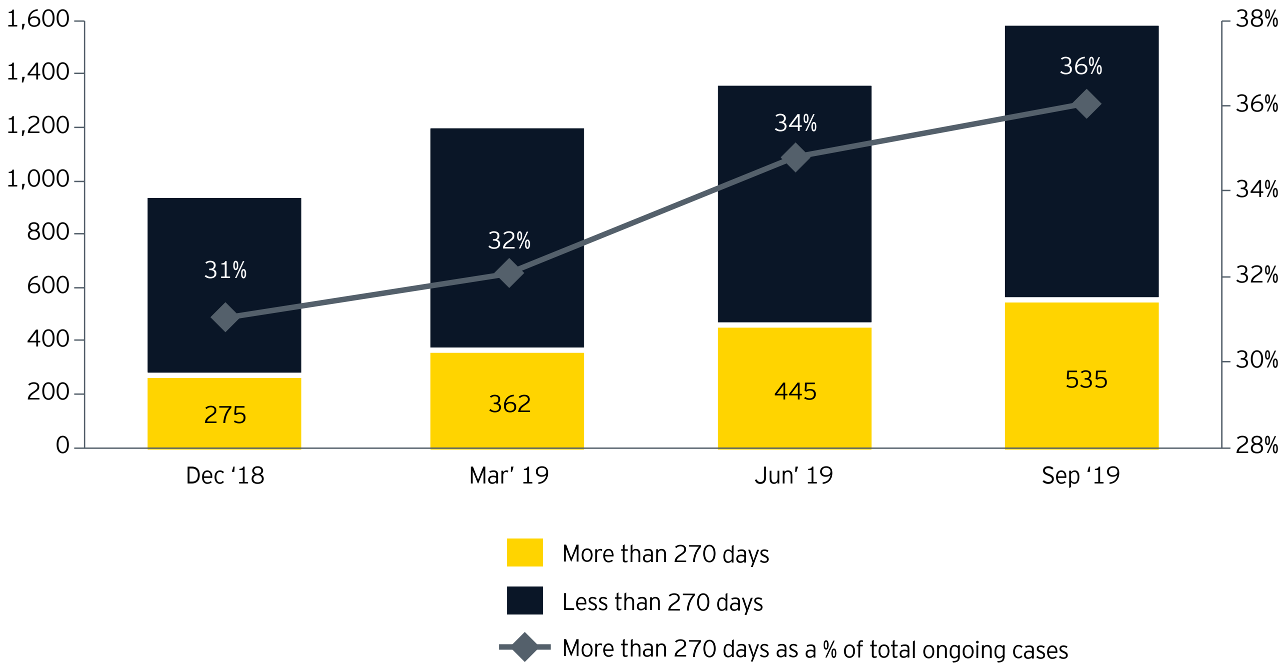
1

1,497 cases are currently ongoing of which 535 (35%) have crossed the 270 day timeline

535 cases have exceeded the 270 day timeline...



...and cases above 270 days continue to increase



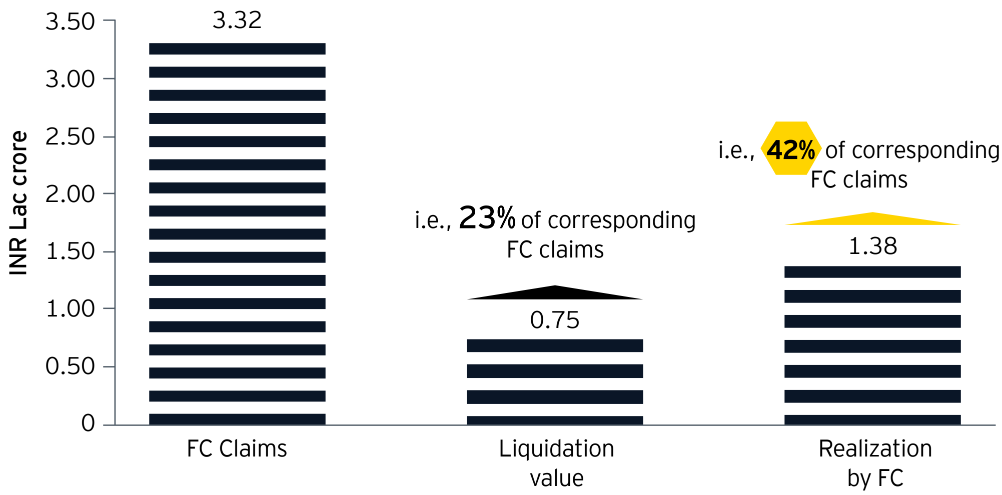
Note 1: Number of days is from the date of admission by NCLT

Note 2: The number of days includes time, if any, excluded by the Tribunals

Source: IBBI.Gov; EY Analysis

The Code on the ground

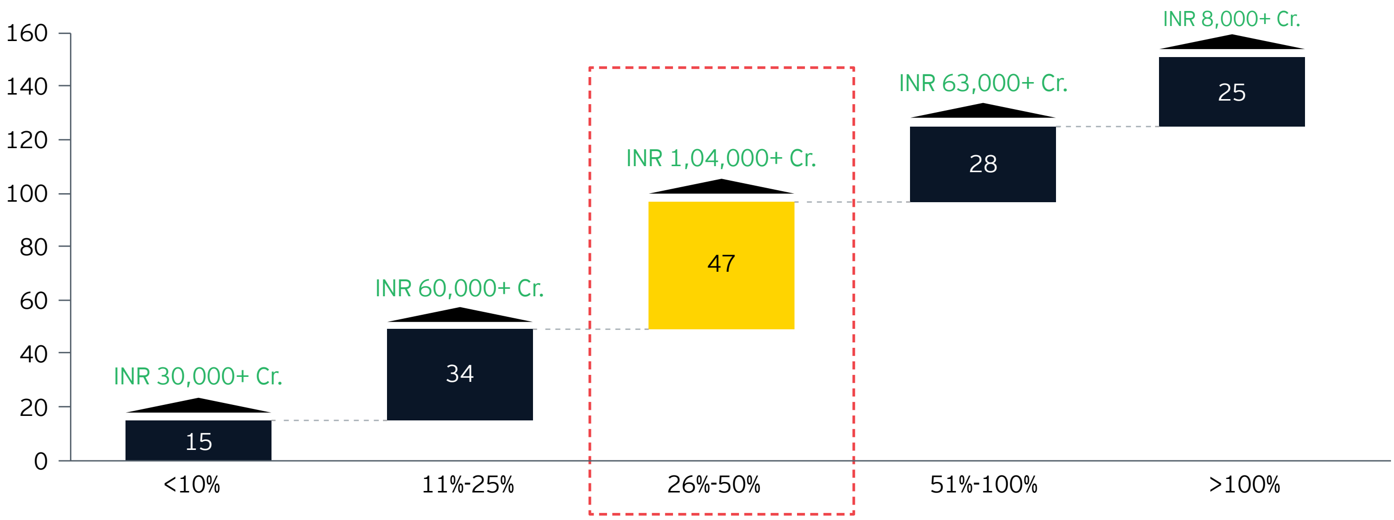
2 For the 156 resolved cases, average recovery is 42%...



374 days average time in cases resolved

Recovery expectation of financial creditors is in the range of 50-75%. Refer **section 1.4 - Market perspectives** for more details.

...and most resolutions are in 26-50% range



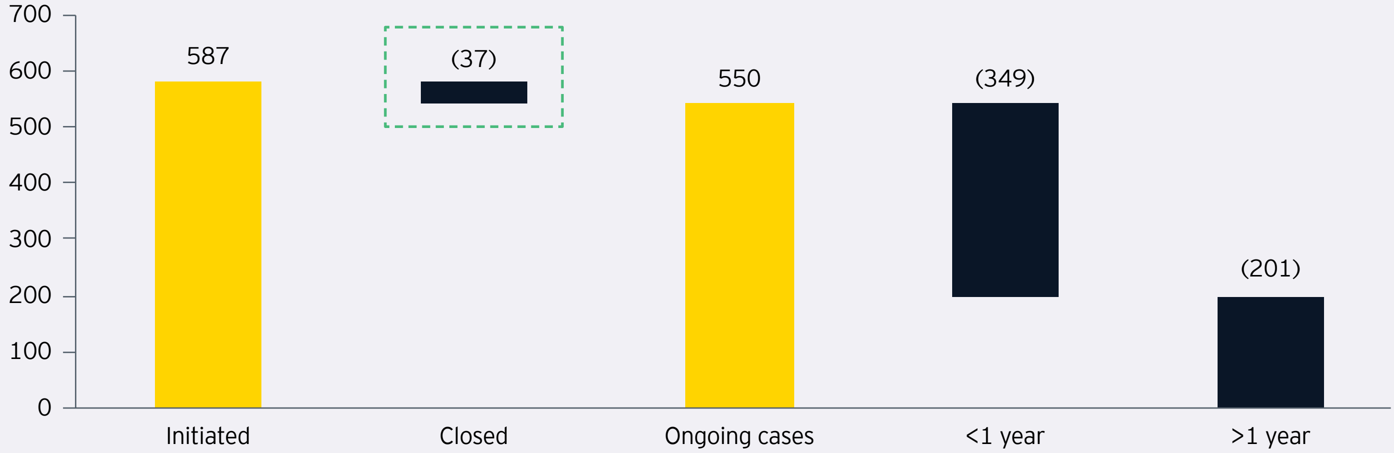
**Amounts in green signify corresponding FC amounts*

**Includes only cases for which complete data is available

Top 5 resolutions contribute ~65% of value

Source: IBBI.Gov; EY Analysis

3 Of the 587 cases under liquidation, only 37 have closed; 200+ cases are ongoing for more than a year...



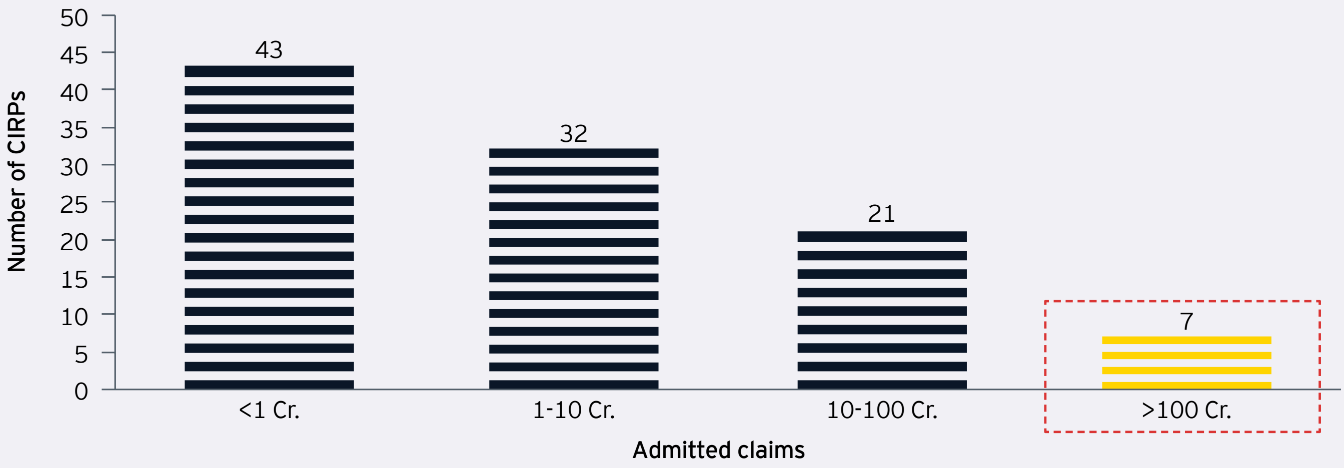
Less than 1% amount realised on 37 liquidation completed

INR 3.46 lac Crore of claims received for 354 ongoing liquidations

70% of liquidation cases did not receive any resolution plan during CIRP

Note: ~75% of the liquidation cases are erstwhile BIFR cases

4 Of the 116 cases withdrawn, u/s 12A, 7 cases had claims over INR 100 Crores



498 voluntary liquidation filed of which 144 are closed.

Asset size of INR 4,000 Cr+ for Vol liquidation cases

Source: IBBI.Gov; EY Analysis

Select judgements - setting the precedents

The Doctrine of Precedent is one of the fundamental principles that underpin common law. When a law is evolving, precedents set the tone for the pronouncements relating to interpretational issues. Such precedents are critical, especially for any emerging legislation, as the law settles on the basis of legal interpretations. In this section, we look at a wide ambit of orders interpreting IBC and examine how such orders are shaping the interpretation of the various provisions of the Code and its regulations.

Admission

- Ferro Alloys Corporation vs. Rural Electrification Corporation (NCLAT - 8 January 2019)
- B.K. Educational Services vs. Parag Gupta and Associates (Supreme Court - 11 October 2018)

Moratorium

- NUI Pulp and Paper Industries vs. Roxcel Trading GMBH (NCLAT - 17 July 2019)
- ICICI bank Ltd. vs. Ruchi Soya Industries (NCLAT - 24 July 2018)
- State Bank of India Vs. V. Ramakrishnan & Anr (Supreme Court - 14 April 2018)

Timeline

- CoC of Essar Steel vs. Satish Kumar Gupta & Ors. (Supreme Court - 15 November 2019)

29A

- Jindal Steel and Power vs. Arun Kumar Jagatramka & Anr. (NCLAT - 24 October 2019)
- Swiss Ribbons & Anr. vs. Union of India (Supreme Court - 25 January 2019)

Liquidation

- S.C. Sekaran vs. Amit Gupta & Ors. (NCLAT - 29 January 2019)
- State Bank of India vs. Moser Baer Karamchari Union & Anr. (NCLAT - 19 August 2019)
- Rajnish Gupta vs. Small Industries Development, Bank of India & Anr (NCLAT) - 5 September 2019

Resolution Plan

- CoC of Essar Steel vs. Satish Kumar Gupta & Ors. (Supreme Court - 15 November 2019)
- ArcelorMittal India vs. Satish Kumar Gupta & Ars (Supreme Court - 4 October 2018)

Committee of Creditors (CoC)

- CoC of Essar Steel vs. Satish Kumar Gupta & Ors. (Supreme Court - 15 November 2019)
- Sanjay Chemicals vs. Sharon Bio-Medicine (NCLAT - 11 November 2019)
- Vijay Kumar Jain vs. SCB & Ors. (Supreme Court - 31 January 2019)
- Swiss Ribbons & Anr. vs. Union of India (Supreme Court - 25 January 2019)

Financial and Operational creditors

- Pioneer Urban Land and Infrastructure & Anr. vs. Union of India (Supreme Court - 9 August 2019)
- Swiss Ribbons & Anr. vs. Union of India (Supreme Court - 25 January 2019)

Resolution professional

- Swiss Ribbons & Anr. vs. Union of India (Supreme Court - 25 January 2019)
- ArcelorMittal India vs. Satish Kumar Gupta & Ars (Supreme Court - 24 October 2018)

Cross border and group insolvency

- Jet Airways (NCLAT - 26 September 2019)
- Videocon Industries (NCLT, Mumbai 8 August 2019)

NCLT/NCLAT jurisdiction

- K. Sashidhar vs. Indian Overseas Bank & Ors. (Supreme Court - 5 February 2019)

Non-obstante clause

- Pioneer Urban Land and Infrastructure & Anr. vs. Union of India (Supreme Court - 9 August 2019)
- Commissioner of Income Tax vs. Monnet Ispat and Energy (Supreme Court - 10 August 2018)
- Anand Rao Korada vs. Varsha Fabrics & Ors. (Supreme Court - 18 November 2019)

CoC of Essar Steel vs. Satish Kumar Gupta & Ors. (Supreme Court - 15 November 2019)

- Feasibility and viability of a Resolution Plan is a decision left to the CoC. It considers all aspects of the plan, including the manner of distribution of funds among the various classes of creditors.
- The CoC does not act in any fiduciary capacity to any group of creditors. It takes business decisions by majority, which binds all stakeholders, including dissenting creditors.
- The CIRP regulations do not lead to the conclusion that FCs and OCs, or secured and unsecured creditors, must be paid the same amounts, percentage-wise, under the resolution plan. It is the commercial wisdom of the CoC, with requisite majority, to negotiate and accept a resolution plan, which may involve differential payment to different classes of creditors. It is for the CoC to negotiate with a prospective resolution applicant for better or different terms which may also involve differences in distribution of amounts between different classes of creditors.
- Ordinarily the insolvency resolution of the Corporate Debtor (CD) must be completed within the outer limit of 330 days from the insolvency commencement date, including extensions and the time taken while the legal proceedings were ongoing. However, if a short period is left for completion of CIRP, the NCLT/ NCLAT can extend the time beyond 330 days.

Pioneer Urban Land and Infrastructure & Anr. vs. Union of India (Supreme Court - 9 August 2019)

- Home buyers are to be treated as financial creditors who can initiate insolvency proceedings against the CD and also form a part of the CoC.
- The Real Estate (Regulation and Development) Act, 2006 (RERA) and the Code must be held to co-exist, and, in the event of a clash, RERA must give way to the Code. RERA, therefore, cannot be held to be a special statute

K. Sashidhar vs. Indian Overseas Bank & Ors. (Supreme Court - 5 February 2019)

- The legislature has not provided the Adjudicating Authority (AA) with the jurisdiction or authority to analyse or evaluate the commercial decision of the CoC or to enquire into the justness of the rejection of the resolution plan by the dissenting financial creditors.
- The jurisdiction bestowed upon the NCLAT is limited. It can examine the challenge only in relation to the grounds specified in section 61(3) of the Code i.e. if the plan is contrary to existing laws, there is material irregularity in the conduct of the CIRP by the RP, CIRP cost has not been accorded priority etc. The NCLAT cannot enquire into the autonomy or commercial wisdom of the dissenting FCs.

Vijay Kumar Jain vs. SCB & Ors. (Supreme Court - 31 January 2019)

- The erstwhile Board of Directors are not members of the CoC, yet, they have a right to participate in each and every meeting and also have a right to discuss, along with members of the CoC, all resolution plans that are presented at such meetings.
- Members of the suspended Board of Directors, being participants in the CoC are entitled to the notice of the meetings, agendas, and all such documents relevant for the matters to be discussed and issues to be voted upon in the CoC. The aforementioned term "documents" also includes Resolution Plans

NUI Pulp and Paper Industries vs. Roxcel Trading GMBH (NCLAT - 17 July 2019)

- The NCLT held that once an application for initiation of Insolvency is filed before the NCLT, it is not necessary for the NCLT to await hearing of the parties for passing order of Moratorium. Hence, it is always open to the NCLT to pass an ad-interim order before admitting any application for initiation of insolvency.

Select judgements - setting the precedents

Swiss Ribbons & Anr. vs. Union of India (Supreme Court - 25 January 2019)

- There is no vested right in an erstwhile promoter of a CD to bid for the immovable and movable property of the CD in liquidation. Section 29A of the Code not only applies to resolution applicants but also to liquidation.
- The RP is a facilitator of the resolution process, whose administrative functions are overseen by the CoC and by the AA.
- The CoC has the primary responsibility of financial restructuring. It assesses the viability of a CD by taking into account all the available information and also evaluates the resolution plan on the basis of feasibility and viability of said plan.
- There is an intelligible differentia between the FCs and OCs which has a direct relation to the objects sought to be achieved by the Code. The classification between FCs and OCs is neither discriminatory, nor violative of Article 14.

Commissioner of Income Tax vs. Monnet Ispat and Energy (Supreme Court - 10 August 2018)

- In view of Section 238 of the Code, the provisions in the Code will override anything inconsistent contained in any other enactment, including Income-Tax Act.

State Bank of India vs. V. Ramakrishnan & Anr (Supreme Court - 14 April 2018)

- Moratorium referred to in Section 14 can have no application to personal guarantors of a corporate debtor.
- The objective of the Code is not to allow such guarantors to escape from an independent and co-extensive liability to pay off the entire outstanding debt, which is why Moratorium is not applicable to personal guarantors of a CD.

ArcelorMittal India vs. Satish Kumar Gupta & Ars (Supreme Court - 4 October 2018)

- An RP is only required to give a prima-facie opinion to the CoC on whether a resolution plan contravenes any provision of law including Section 29A. Section 30(2)(e) of the Code does not empower an RP to decide whether the resolution plan contravenes the provisions of law.
- A resolution applicant has no vested right that his resolution plan be considered. It is clear that no challenge can be preferred to the NCLT at the stage when a resolution plan is received by the Resolution Professional.
- When an RP presents a Resolution Plan to the CoC and the CoC does not approve such plan by the requisite majority, no application before the AA can be entertained as there is no vested right in the resolution applicant to have its resolution plan approved.
- A Resolution Plan once approved by the CoC and the AA can be challenged before the NCLAT and later before the Supreme Court

Shree Bhawani Paper Mills vs. Bombay Stock Exchange (NCLAT - 23 April 2019)

- Moratorium under IBC entails the prohibition of institution of suits/continuation of pending suits against the CD, including execution of any judgment, decree or order. The NCLAT observed that the moratorium provision will prevail over Section 28A of the Securities and Exchange Board of India Act, 1992 (SEBI Act) and SEBI cannot recover any amount including the penalty from the CD. The Bombay Stock Exchange (BSE) for the very same reason cannot take any coercive steps against the CD nor can it threaten the CD for suspension of trading of shares.

Jet Airways (NCLAT - 26 September 2019)

- The NCLAT has led the charge in giving effect to cross border insolvency in India, even in the absence of a legal framework. The NCLAT advised the exploration of an arrangement between the Resolution Professional in India and the Administrator in Holland. Accordingly, a Cross Border Insolvency Protocol, as agreed between the RP in India and the Administrator in Holland, was filed before the NCLAT. The said protocol is to be treated as a direction of the NCLAT. The protocol recognises that the Indian roceedings are the main insolvency proceedings and the Dutch proceedings are the non-main insolvency proceedings.
- The protocol places reliance on the UNCITRAL Cross Border Insolvency Model Law, with an aim to ensure Coordination, Communication, Information and Data Sharing and Preservation of the Assets of the CD and at the same time explicitly recognised the independent jurisdiction, sovereignty, and authority of the NCLT, NCLAT and the Dutch Bankruptcy Court.

Videocon Industries (NCLT, Mumbai 8 August 2019)

- In the absence of a regulatory framework to deal with the Group Insolvency, the NCLT in its detailed Judgment has extensively placed reliance on principles laid down by judicial authorities in UK and USA.
- The NCLT, based on the judicial principles, has ordered for a substantive consolidation of the assets and liabilities of Videocon Industries 13 group entities. The NCLT while considering the commonality of control, directors, assets, liabilities, degree of Inter-dependence, inter-lacing of finance and the presence of common financial creditors, amongst other factors directed that 13 of the 15 group companies to be consolidated and accordingly appointed a common Insolvency Professional to conduct the insolvency resolution process

State Bank of India vs. Moser Baer Karamchari Union & Anr. (NCLAT - 19 August 2019)

- The liquidation estate/ assets of the Corporate Debtor do not include sum due to any workman and employees from the provident fund, the pension fund and the gratuity fund, for the purpose of distribution of assets under the prescribed waterfall mechanism under Section 53. Hence, Provident Fund, Gratuity Fund and Pension Fund do not come within the meaning of 'liquidation estate' for the purpose of distribution of assets under Section 53

Jindal Steel and Power vs. Arun Kumar Jagatramka & Anr. (NCLAT - 24 October 2019)

- Promoters, who are ineligible under Section 29A, are not entitled to file application for Compromise and Arrangement in their favour under Section 230 to 232 of the Companies Act

Rajnish Gupta vs. Small Industries Development, Bank of India & Anr (NCLAT - 5 September 2019)

- The NCLAT held that even during liquidation, the corporate debtor or its creditors may seek for compromise or arrangement by making proposal of payment to all the creditor(s) pursuant to which the liquidator on behalf of the company will move an application for restructuring under the Companies Act, 2013 before the NCLT. The NCLAT further held that the liquidator has the power to sell the business of the corporate debtor as a going concern.

Sanjay Chemicals vs. Sharon Bio-Medicine Ltd. (NCLAT - 11 November 2019)

- Any claim prior to CIRP period can only be dealt with under terms of approved Resolution Plan by the Adjudicating Authority and was not maintainable after completion of the CIRP against a Corporate Debtor.

Select judgements - setting the precedents

ICICI bank vs. Ruchi Soya Industries (NCLAT - 24 July 2018)

- The NCLT observed that the creditor appropriated monies lying in the account of the Corporate Debtor against the loan account soon after moratorium was declared. The NCLT accordingly held that the appropriation of monies against the loan account of the corporate debtor by the creditor was bad in law and in violation of the moratorium. The NCLT accordingly clarified that it was not open for the lenders to debit any amount from the account of Corporate Debtor subsequent to the order of moratorium, irrespective of the date of receipt of order copy.

B.K. Educational Services vs. Parag Gupta and Associates (Supreme Court - 11 October 2018)

- The Supreme Court observed that the provisions of the Limitation Act shall be applicable on applications filed by the FC, OC and the CD for initiation of insolvency under IBC from the inception of the Code. Hence, if the default has occurred over three years prior to the date of filing of the application, the application would be barred under Article 137 of the Limitation Act, and except in those cases where, in the facts of the case, a delay has been condoned.

Anand Rao Korada vs. Varsha Fabrics & Ors. (Supreme Court - 18 November 2019)

- Section 238 of the Code gives an overriding effect to the IBC over all other laws. The provisions of the IBC vest exclusive jurisdiction on the NCLT and the NCLAT to deal with all issues pertaining to the insolvency process of a corporate debtor, and the mode and manner of disposal of its assets.
- The Supreme Court accordingly held that the High Court was not justified in passing the Order for carrying out the auction of the assets of the CD, which was undergoing CIRP and the alienation of such assets would jeopardise the interest of all stakeholders.

Ferro Alloys Corporation vs. Rural Electrification Corporation (NCLAT - 8 January 2019)

- The NCLAT while relying on various decisions of the Supreme Court held that it is not necessary to initiate CIRP against the Principal Borrower before initiating CIRP against the Corporate Guarantors. NCLAT further held that it is always open to the Financial Creditor to initiate CIRP against the Corporate Guarantors, as the creditor is also the Financial Creditor with regards Corporate Guarantor.

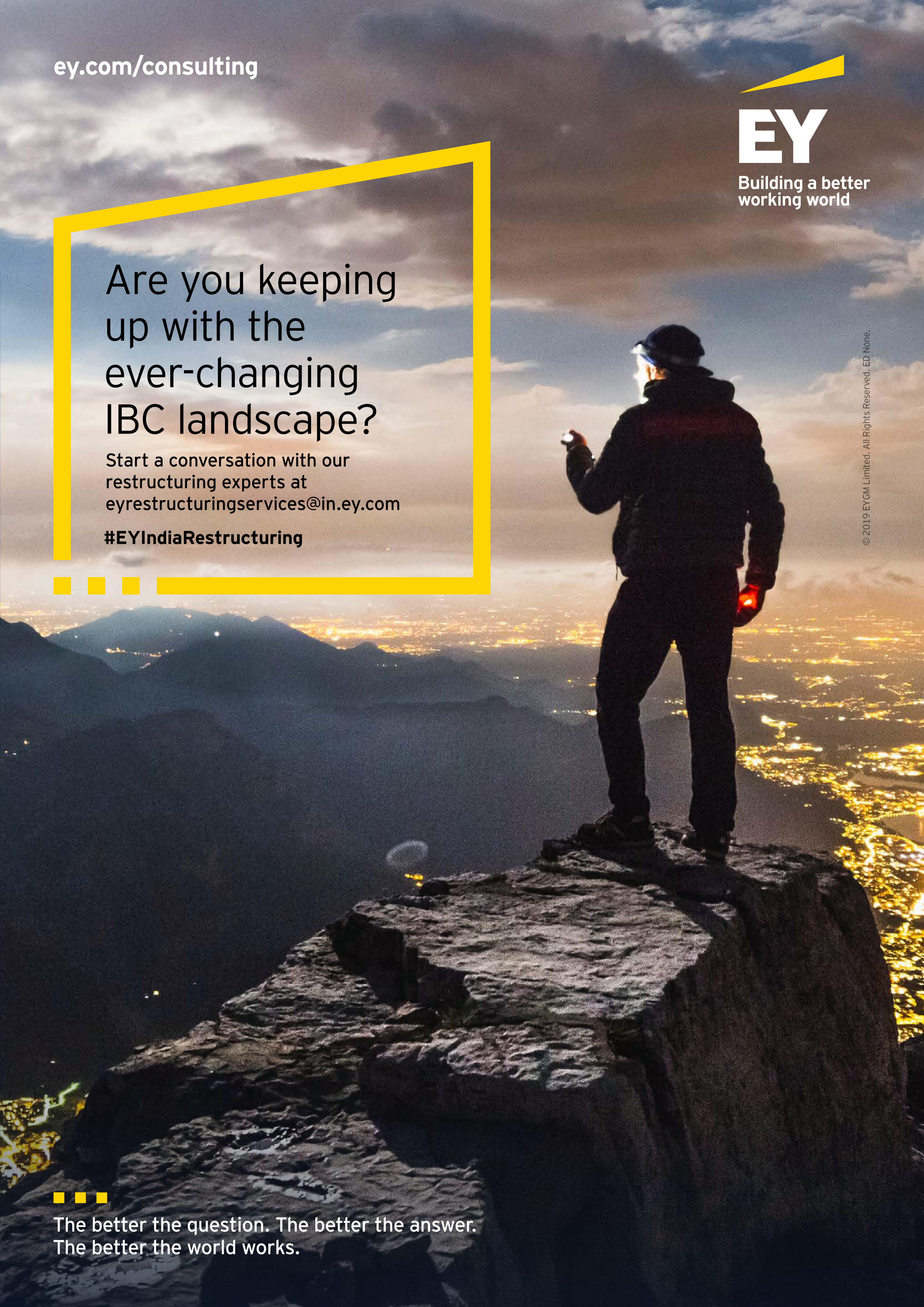
S.C. Sekaran vs. Amit Gupta & Ors. (NCLAT - 9 January 2019)

- Liquidator is required to keep the CD as a going concern even during the period of liquidation and can take steps to undertake a restructuring scheme under Section 230 of the Companies Act, 2013

Chitra Sharma vs. Union of India (Supreme Court - 9 August 2018)

- The Supreme Court in exercise of its inherent powers under Article 142 of the Constitution of India recommenced the resolution process afresh from the stage of appointment of IRP by Order dated 9 August 2017. Resultantly, the prescribed period for the completion of the resolution process was renewed. This was in view of the fact that the period of 270 days expired before the Ordinance conferring a statutory status on home buyers as financial creditors came into existence.
- The Supreme Court accordingly directed for a fresh constitution of the CoC (to now include homebuyers) and also allowed the IRP to invite fresh EOIs for submission of a Resolution Plan.

The information contained in this section is a summary and is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EY Restructuring LLP nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication.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Building a better working world
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Start a conversation with our restructuring experts at eyrestructuringservices@in.ey.com
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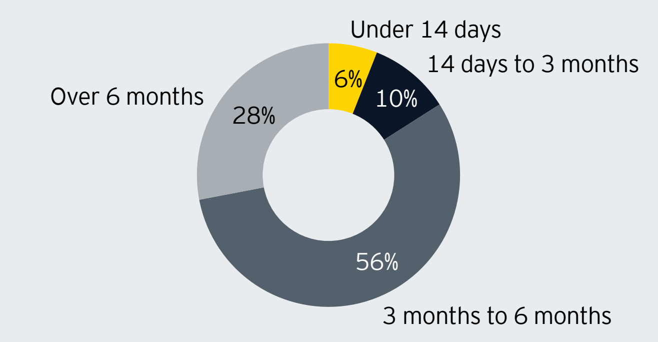
The better the question. The better the answer. The better the world works.

Market perspectives - a dipstick study

This section brings you an on-the-ground perspective from a recent conference on distressed asset resolution. We conducted polls on some of the key aspects of corporate stress resolution to shed light on financial creditors' perspective.

Practically speaking, how long does it take for a **CIRP initiation** application to get admitted, i.e from date of filing to date of approval?

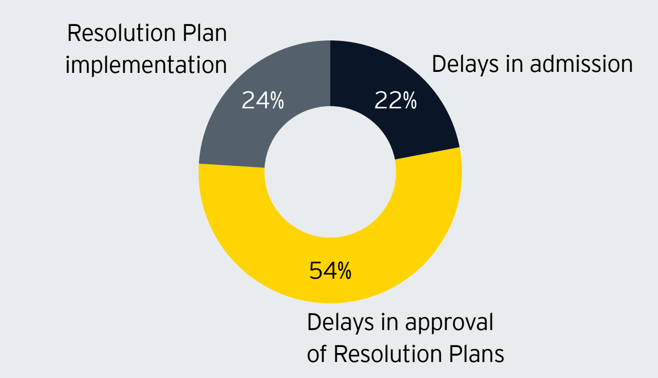


Delays at the admission stage has been an area of concern for the FCs and 84% of respondents (mostly financial creditors) feel that the application takes more than 3 months.

While the Code specifies 14 days for admission of an initiation application, however the Supreme Court has held the timelines prescribed are directory and not mandatory. Furthermore, some estimates peg the current outstanding number of admission petitions at over 700. Moreover, around 20,000 cases were pending at NCLT benches as on 30 September 2019 of which almost 10,000 cases are under IBC.

> Multiple options are being deliberated to resolve the clogging, including raising threshold of INR 1 lakh to invoke insolvency and 'deemed admission' for financial creditor applications. With profusion of technology in the banking and insolvency ecosystem, verified records of default could be readily made available to the courts for swifter admission of cases. Presently, there is over INR 56 Lakh crore of data with the information utility and is only expected to increase in future.

Which **concerns** are currently most critical in terms of ensuring the strength of IBC?



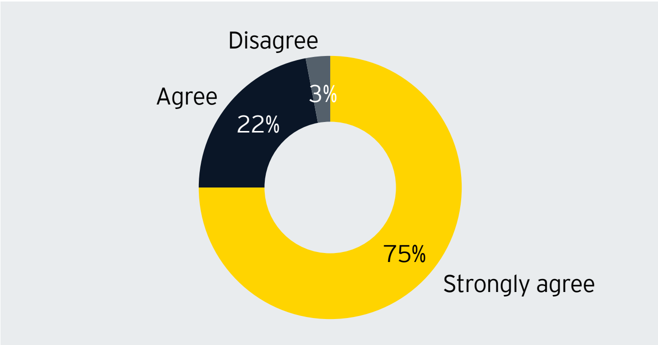
Concerns regarding the delays in admission of CIRP, and even implementation of resolution plan, are eclipsed by delays in approval of resolution plans.

Approval of the resolution plan marks a significant milestone in the CIRP and delays in this aspect has several negative consequences. Once a successful application is shortlisted and voted by the CoC, any delays beyond reasonable time limit exposes the CoC for the risk of default in implementation.

While strategic and financial investors displayed significant interest in the first round of cases that were admitted, going forward, the delay and uncertainty regarding resolution plan approval may be taken into account while bidding and consequently, it may result in lower recovery for financial creditors.

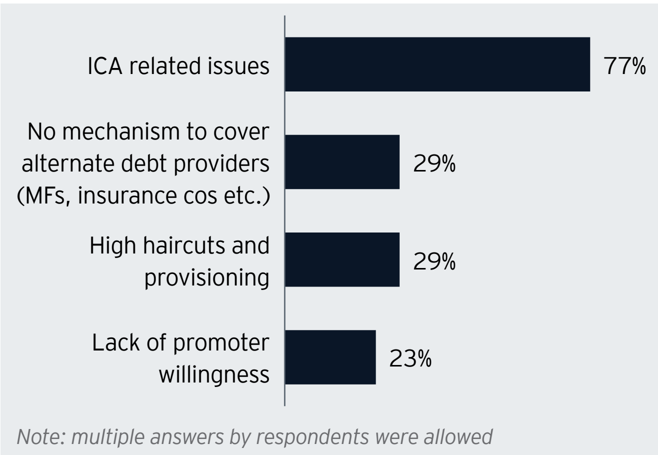
> With further clarity on whitewash provisions and with due precedents set, the delays would be expected to reduce.

Do you feel there is an immediate need for bringing a comprehensive bill for resolution of stress in financial institutions (banks, NBFCs, insurance cos etc.)?



India currently lacks a comprehensive bill for resolution of financial firms. Refer section 3.1 – Resolution of financial service providers for more details.

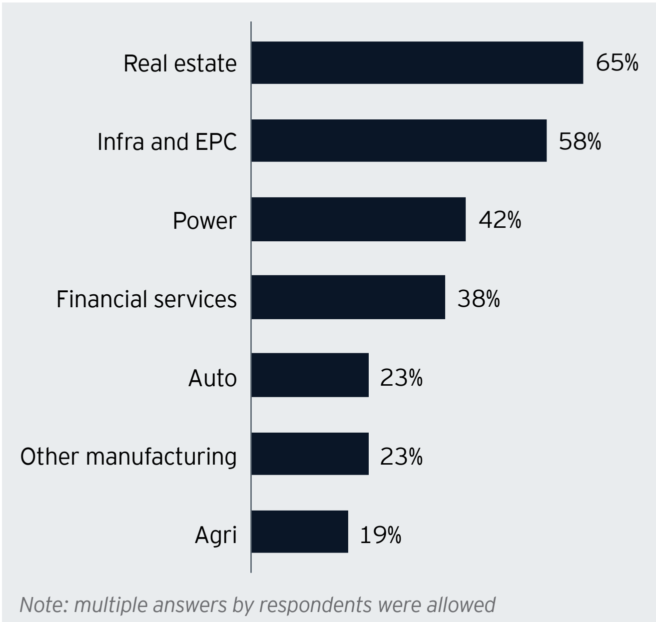
What is the primary reason for the low number of cases resolved under 12 February 2018 or 7 June 2019 circulars? (multiple answers)



The 7 June 2019 circular has several issues including lack of mandatory provisions regarding signing and lack of a mechanism to cover alternate debt providers. With January 2020 around the corner, the 180-day period from the Reference Date (i.e. 7 June 2019) for cases with debt above INR 2000 crores is ending. It would be important to note the number of cases resolved, feasibility of approved resolution plans in terms of slippages down the road and the upsurge in cases referred to NCLTs.

> For the corporate stress resolution market, a successful out-of-court framework is very critical. Resolution in court should be used as the last resort and not the first.

Which sectors do you feel are undergoing significant stress and would lead to fresh NPAs in 2020?

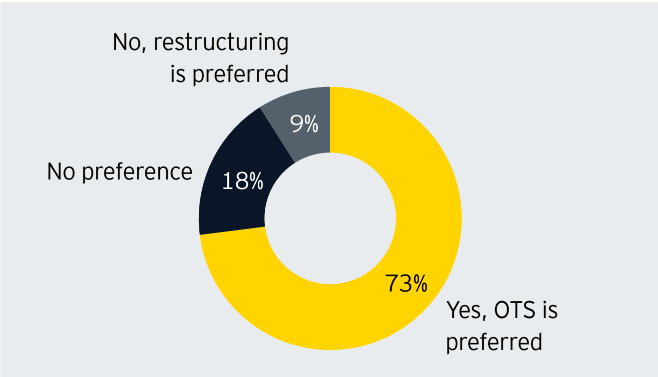


Respondents feel that the cases in the real estate, infrastructure and EPC, power and financial services sectors would lead to fresh slippages in 2020. The former two industries are interconnected with NBFCs with wholesale books. The Finance Ministry announced commitment of INR 10 thousand crore to a fund for last mile financing of stuck real estate projects (almost1,600 projects already identified). Private participation, to the tune of 15 thousand crore, is also expected in the fund. However, there is a lacuna in the Code presently regarding differential treatment of different classes of financial creditors in a CIRP resolution. This would have to be addressed to bring down the cost of capital for the identified 1,600 identified real estate project.

The deal size in these sectors is expected to be on the larger side, and hence, CoCs would be required to look beyond 'all cash deals' and explore other forms of restructuring to improve recovery rates.

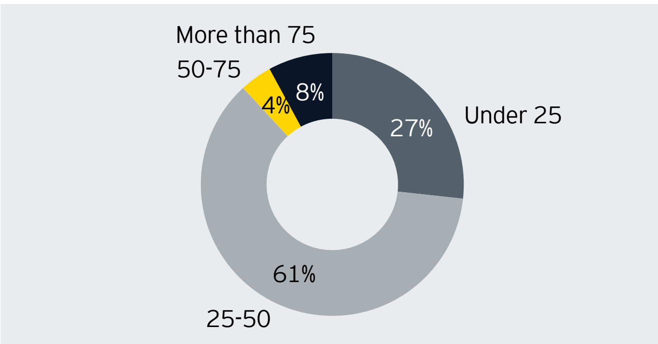
Market perspectives - a dipstick study

Is there a preference towards one-time-settlement (OTS) rather than restructuring?



For a developing economy with 16 lakh crores of stressed assets, there is a dire need to exit bad assets and re-channel the capital to productive sources. An asset which was non-performing, could be standard asset with a restructured and reduced schedule of repayment. The decision to continue exposure should be governed by a cogent set of criteria to enable maximum recovery.

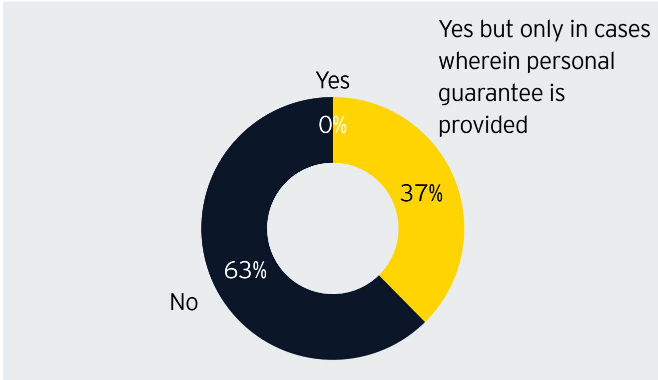
In your experience in large cases, what is the haircut expectations of CoC members (in %)?



Haircut expectations of 25-50% translates to recovery expectations of 50-75% i.e. above the average recovery for 156 resolved cases at 42%.

> The expectation of recovery should be in-line with the extent of value deterioration of cases which are referred to NCLTs.

Do you feel promoters are cooperative / supportive in providing assistance to IPs / RP advisors?



Over a third of total respondents believe that promoters are not cooperative with the insolvency professional and his advisors for the resolution process. With the personal guarantee notification now in force (since1 December 2019), promoter cooperation could see an uptick.


1217.72
1211.96
1193.89
EMA5
EMA10
EMA50
1208.71

Chapter 02

The road ahead

IBC: fighting a lone battle?

Approaching asset resolution with a multi-pronged strategy

Dinkar Venkatasubramanian

Partner and National Leader,
Restructuring and Turnaround Services, EY

The Code received presidential assent in May 2016 and was made effective on 1 December 2016. The speed and commitment at which the Code has progressed in the past 36 months has been surprising.

While the full impact of the new insolvency regime is not expected to be visible in the short term, significant success has been recorded already. Under the RBI's baseline scenario, the GNPA ratio of the scheduled commercial banks have reduced from a peak of 11.7% to 9.3% (approaximatelyUS$135 billion) as in March 2019.

The Code is, today, well and truly entrenched in the system and has, importantly, driven a behavioural change among the market participants especially the business owners.

New stress

The large cases (12 in first list of cases referred by RBI and 27 in the second list) are being resolved but the remaining comprise of a large magnitude and a wide variety of cases of differing sizes and complexity which may present a unique set of challenges in the resolution.

Critically, though, India Inc. is facing a recent and a strong onslaught of financial stress owing to slowing economic conditions and the NBFC liquidity situation. This has exacerbated the problem in the banking system that has already been beset by a "twin balance sheet" crisis. Can we, effectively, resolve the mounting NPA crisis and the resultant logjam in the availability of credit – with IBC being the only "resolution play" in town?

Fighting a lone battle

India lacks an effective pre-insolvency bilateral work-out mechanism by creditors (even though the ICA Framework under the 7 June 2019 circular issued by the Reserve Bank of India is being tested). This has resulted in an "all roads lead to IBC" phenomenon, putting immense pressure on already struggling bandwidth and infrastructure at NCLTs.

The IBC ecosystem is being threatened by some fundamental challenges that impact its efficiency:

- Constant erosion of value of businesses lined up for / in insolvency owing to lack of adherence to timelines and lack of liquidity. *For example, of the 1,497 ongoing cases in CIRP as at 30 September 2019, over 36% of them are running beyond 270 days without a resolution. Raising interim finance is also not looked at favourably by the lenders;*
- Erosion of value due to lack of quality IPs who are experienced in managing businesses in stress; and

- Limited interest from alternative capital providers – owing to lack of clarity on the timelines, contingent liabilities, risk of post-deal investigative actions and lack of quality information/ time for diligence.

An effective resolution framework designed to tackle burgeoning stress should:

- Fast-track alternatives to IBC such that IBC is more effectively used as a "nuclear option"
- Decongest the NCLTs
- Enable the flow of alternative private capital to stressed situations

Alternatives to IBC

Couple of innovations that can help augment the stressed asset resolution framework include:

- Pre-packaged insolvency proceedings ('pre-packs')
- Pre-insolvency workout mechanism (June 7 circular)

Pre-packaged insolvency proceedings

Internationally, pre-packaged insolvency proceedings ('pre-packs') have been around for some time now, but in the last decade or so, the number of pre-packs has increased dramatically across the United Kingdom and the European Union.

The term "pre-pack sale" has been defined by the Association of Business Recovery Professionals in the UK as, "*an arrangement under which the sale of all or part of a company's business or assets is negotiated with a purchaser prior to the appointment of an administrator, and the administrator effects the sale immediately on, or shortly after, his appointment*". In the UK, pre-packs developed as a market tool to promote corporate rescue, but no legislation is directly applicable to them.

The advantages of a pre-pack process:

- The *speed* at which pre-packs can be accomplished;
- The *business continues without interruption* and may lead to minimal disruption owing to erosion of customer confidence, damage to relationships with key employees, suppliers, and other stakeholders in the business;
- A pre-pack sale *avoids the cost of trading* the company in administration, which leads to value maximisation; and
- The pre-pack sale is a *valuable tool where a business has a strong brand or intellectual property*, the value of which may decrease dramatically by even a hint of a formal insolvency.

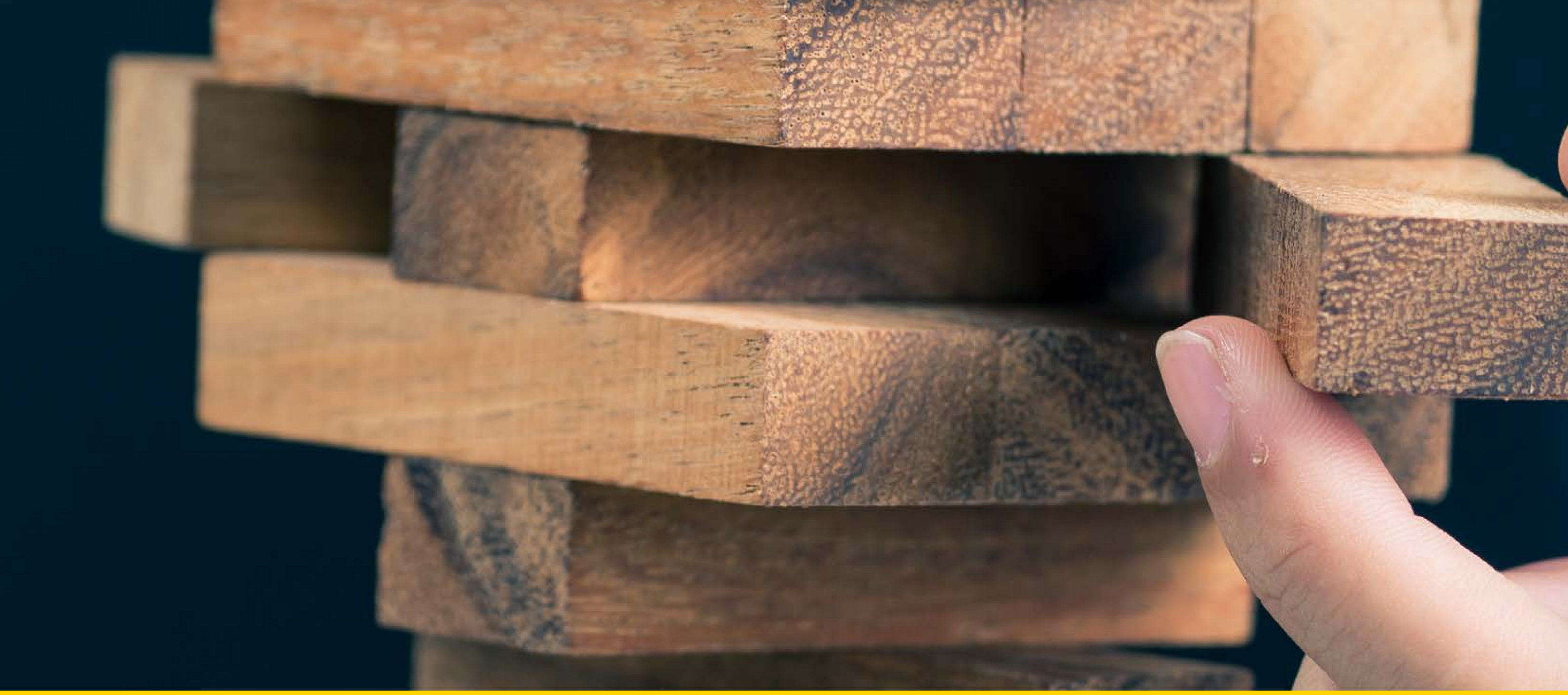
An effective pre-pack mechanism can prevent value erosion caused by disruption in insolvency, is significantly cheaper than IBC processes, de-clog the NCLTs, provide access and certainty to potential buyers, and, importantly, provide the sanctity and security of approval by the Adjudicating Authority.

The biggest disadvantage of pre-packs has been the lack of transparency and the potential bias towards secured financial creditors.

While there are variations to pre-packs being used, in the UK and the US, primarily around lender and court approvals, we need to develop an appropriate mechanism that can work in India. Please refer Annexure A for a suggested pre-pack framework for India.

Pre-insolvency workout mechanism

There is a dire need for an effective pre-insolvency bilateral work-out mechanism. While resolutions through such mechanisms were very common pre-2014 (via CDR), they were rarely found to be effective. Post 2014, though, banks have been reluctant to effectively implement the mechanisms proposed by the RBI – SDR/ S4A (until they were taken away in February 2018).



The RBI (post the Supreme Court scrapping the Feb 12 Circular), introduced a Circular on June 7, 2019 which enables lenders to come together and implement a collective restructuring solution within 210 days of default of loans. If lenders cannot agree on such a solution, the IBC action is inevitable.

Stressed loans worth over US$35 billion have been signed up until date by lenders to be resolved under the 7 June 2019 circular mechanism, and many more are in the process of being identified for the purpose. The effectiveness of this mechanism and the intent of the lenders to implement the same would only be clear by 7 January 2020, which is the 210-day deadline for the initial set of such cases.

This requires business owners/professional managers and potential capital providers for stressed assets to, proactively, focus on developing a bonafide and credible rescue plan and engaging with their creditors in time. Such a mechanism also enables lenders to acknowledge the stress and act decisively in support of deserving businesses in their revival efforts. This mechanism should become the norm to resolve stress/ distress while IBC may be best served as a nuclear option.

Key success factors

The success of these alternatives may also hinge on how some of the following factors play out:

- Alignment of creditor interest: If lenders are not aligned and create legal hurdles, then the mechanisms may fail.
- Strict and timely implementation: No litigations should be entertained (except for claims and modification, therein) as long as the NCLT is satisfied with the process that was followed.
- Complete clarity: Clear determination of applicability of Section 29A of the IBC to such processes.
- Cooperation from incumbent management: Adequate support being provided by the business owner in providing information and access for the process. A carrot and stick approach may be followed – as the alternative is a formal insolvency process.
- Monitoring: Given the perception of lack of transparency in pre-packs, effective monitoring of IP behaviour and conduct by IBBI and IPAs
- Stakeholder interests': Adequate consideration of the interest of other stakeholders (unsecured creditors, trade creditors, public shareholders, etc.) when negotiating and finalising the plan.

Conclusion

The IBC has cut through many hurdles to create an effective distressed resolution ecosystem in India. However, IBC may not achieve its desired impact if left to fight alone in its battle against stress assets.

An effective use of pre-packs and the June 7 circular can help maximise value for various stakeholders by containing the erosion of value caused by disruption, delay and insolvency. In the Indian context, this would also allow the focus to be on the resolution, allowing adequate time and access for diligence and enabling alternative capital providers to participate in the process.

Proposed contours of pre-packaged mechanism for India

Stage I

Pre-insolvency planning and execution

These could be enshrined in an RBI Circular

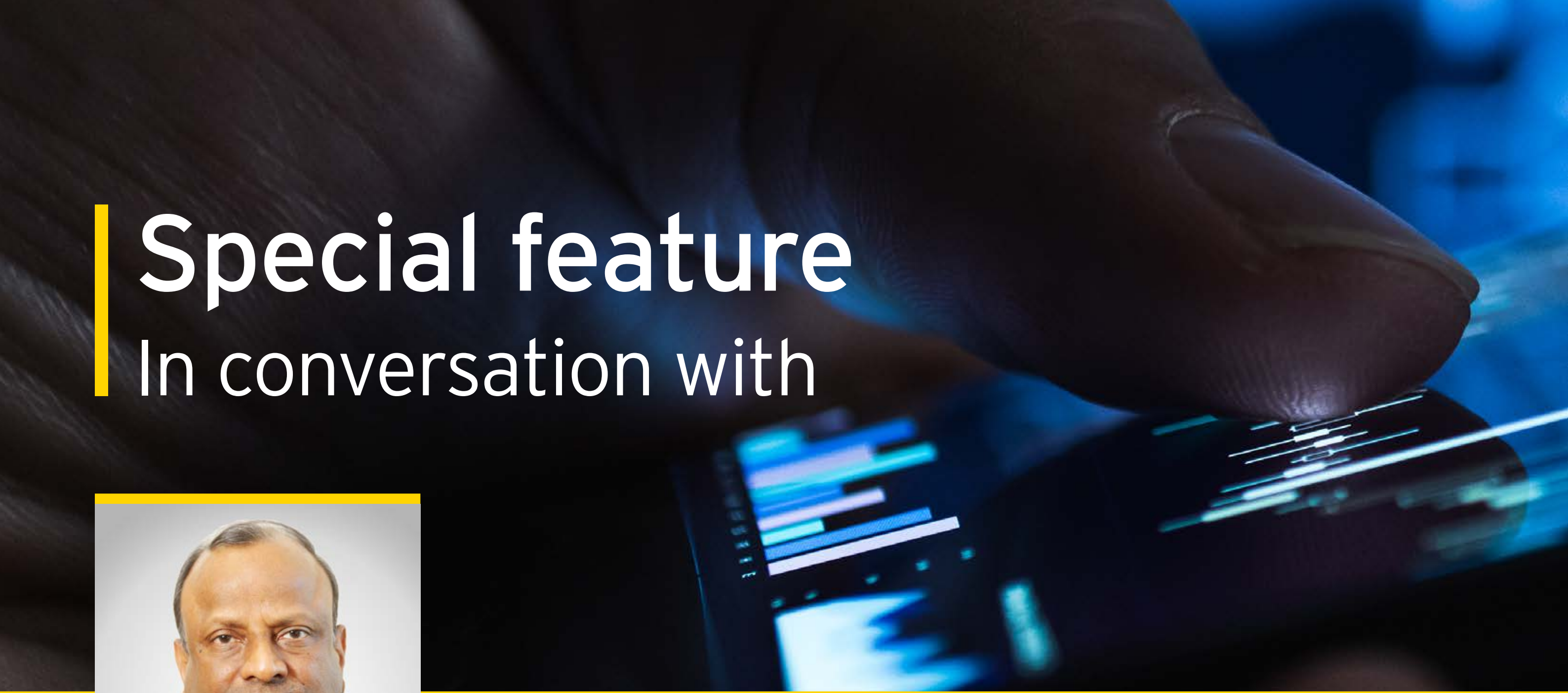
1. Group of lenders (consortium of lending banks), along with the Board of Directors of the Corporate Debtor decide to appoint an Insolvency Professional (IP) to oversee the pre-packaged resolution.
2. The IP will review the financial position and performance of the business and collate claims - as available from the books of account - for FCs and OCs [this will get more solidity after the development of IUs].
3. The IP will lead a transparent process for attracting, evaluating and negotiating a resolution plan for the Corporate Debtor, involving the Board of Directors, the lenders and other stakeholders.
4. The Board of Directors would be responsible for providing all data and information needed by potential resolution applicants for conducting a proper diligence.
5. The IP should facilitate the selection of the most appropriate resolution plan (given the interests of all stakeholders) and ensure the compliance of the same with law (compliance of law requirement could be similar to what exists in Section 30(2)(e) of IBC and CIRP Regulations). The IP could also be required to submit a report similar to the one required under SIP 16 in UK.
6. Valuations and feasibility of the plan should also be independently determined.
7. The IP, supported by the Board of Directors and the lenders, could have the plan and process reviewed by the Oversight Committee (similar to the Expert Pre-Pack Pool in UK). The Oversight Committee is already involved in approval of plans under the Sashakht process.

Stage II

Filing with NCLT and approval thereof

This would need an amendment to the law

1. The IP should file the plan in the NCLT along with statutory disclosures required under the law (like in a normal resolution under CIRP). The IP should submit the claims collated (along with the details of the claims collection process) and all other details of the process conducted until filing date.
2. NCLT, if satisfied with the process followed, should admit the corporate debtor into CIRP within 14 days of such filing - appointing the IP as RP.
3. The RP should invite claims and form the Committee of Creditors, as prescribed currently under IBC.
4. The pre-pack resolution plan should be put to vote in the first meeting of the Committee of Creditors. If such approval is not received from the CoC, normal CIRP should continue.
5. Upon the approval of such a plan in the first meeting of the CoC, such an approval should be filed with the NCLT forthwith.
6. NCLT, if satisfied with the process followed, should approve the plan within 14 days of filing by the RP.



Special feature
In conversation with

Rajnish Kumar
Chairman, State Bank of India

The following section recapitulates excerpts from our discussion with Mr. Rajnish Kumar, chairman of State Bank of India, the largest commercial bank in India.

RBI Financial Stability report in June 2019 mentioned NPAs have peaked and Indian banks should continue to see an improvement in asset quality with bad loans expected to fall to 9% by FY20. How do you analyse the NPA situation for India Banking system beyond FY20?

Slowdown in many major sectors of economy is one of the reasons for further slippages. NBFC sector is particularly vulnerable post IL&FS insolvency. Automobile, infrastructure, power and real estate sectors are still not out of woods. Hence, there may always be some surprises and slippages. Even then our view is that **worst is over** and asset quality of banks can only **improve** from this level.

With the government's initiative in the formation of IBC, we are moving closer to the end of deteriorating asset quality issues. Gross NPA (GNPA) has started to decline and is at 9.3% as on Mar'19 from 11.5% as on Mar'18. It is likely to dip below 9% by March 2020. As far as SBI is concerned, GNPAs declined in FY19 to INR 1.75 lakh crore from about INR 2.2 lakh crore, a decline of 23%. We have **intensified our recovery efforts** in NPA accounts and **enhanced our monitoring system** to identify any nascent sickness and treat it at the outset. Our efforts are bearing fruits as rate of slippages has been arrested and bank is confident of much better recovery numbers this financial year. I think many other banks are also adopting similar strategies to reduce slippages.

Going forward, we expect GNPA ratios of banks to decline further considering we have recoveries in many big ticket NCLT cases lined up in the next couple of quarters.

"Worst is over and asset quality would only improve hereafter.

Currently, IBC is the only an effective resolution mechanism available to banks. Do you feel that the present infrastructure is unable to handle the demand?

While IBC has proved to be an effective resolution mechanism, there are **other recovery mechanisms** available to banks. Significant portion of our recovery is coming through other mechanisms such as **sale to ARCs, SARFAESI** action and even **compromise settlements.** The inter-creditor agreement **(ICA)** is another mechanism now formalised by RBI and can be an effective resolution mechanism before putting any enterprise into bankruptcy.

As far as infrastructure is concerned, there is **always room for strengthening** the system and I am quite sanguine that necessary steps in this direction will be taken by the Government of India, Insolvency and

Bankruptcy Board of India and National Company Law Tribunals.

There is always a room for strengthening the infrastructure and I am quite sanguine that necessary steps will be taken in this direction.

How would you rate first 3 years journey of IBC and has it managed to make a permanent positive change?

Three years of IBC have been quite a roller coaster ride with its **ups and down**. Being a new law, some sort of teething troubles were expected. However, we are happy that IBC is **settling down** and has been able to make **positive changes in credit markets** such as focus on resolution and commercial wisdom of financial creditors, regulation of professionals, dedicated tribunals and time bound resolutions. These changes will make our businesses more competitive and facilitate banks in better assessment of risk and better credit management.

As per the RBI report, the average recovery by banks based on the amount filed through the Insolvency and Bankruptcy Code (IBC) was 41.3% in FY18 against 12.4% through other mechanisms such as SARFAESI Act, Debt Recovery Tribunals and Lok Adalats etc. This has further improved to 46.1% in H1FY19. This shows that the alternate new methods are proving to be quite effective in ensuring recovery for the Banks.

Up to Sept'2019, 156 cases were resolved under IBC with a recovery INR 1.38 lakh crore from the total admitted of INR 3.32 lakh crore by Financial Creditors.

The alternate new methods are proving to be quite effective in ensuring recovery of the banks.

What, in your opinion, are the two major areas of concern that are currently not addressed in the IBC process?

Most of our concerns are already addressed through three amendments to IBC. However, IBC is such a fundamental and dynamic law, challenges will keep appearing. As of now two or three major issues faced by us are attachment or action by **PMLA/ED** authorities in IBC matters derailing the CIRP process, **group** insolvency and **cross-border** insolvency. I think the government is already cognizant of these issues and we expect amendments to Code and regulations/guidelines shortly.

Hopeful that concerns over PMLA/ED action, group insolvency and cross-border insolvency will be addresses shortly.

What more must be done to attract foreign capital into the Indian distressed market?

The driving factors for foreign capital's interest in Indian stressed asset market are **supply** of stressed assets, **regulatory transparency** and robustness, and potential for greater **returns** on investment compared to other such assets globally.

As regards supply, the stressed asset market in India is approximately **USD 150+ bn**, indicating significant potential for investments. It presents a **huge opportunity** for foreign capital to participate either through IBC or through out-of-court alternatives such as in collaboration with ARCs or through participating in Inter Creditor Agreements (ICA) transactions.

With a proper regulatory framework for stressed assets under IBC, such as NCLT, IBBI, IPs etc., India now matches the **best in any global market** in terms of insolvency resolution mechanism. However, there are some **challenges** like time taken in concluding CIRP, frequent litigations and post resolution issues with PMLA, ED etc., which I think the government is already working overtime to sort out.

As regards potential for ROI (return on investment), my sense is that India being a **huge market** of 1.3 billion consumers with a middle class of approx. 30% itself provides a good potential for ROI. Further, as **US-China trade dispute** also provides a good opportunity to global investors to set up base in India for tapping export market.

India now matches the best in any global market in terms of insolvency resolution mechanism.

How important do you believe are developing a deep and robust bond market and a secondary loan trading platform in India?

A deep and robust bond market and a secondary loan trading platform are critical for not only providing **depth to the credit markets** but also important for **better credit management** of banks. Due to not so developed bond market, banks have to bear the maximum burden for providing credit. In a bond market, there can be specialised intermediaries for underwriting different types of credit risk related to different industries. Secondly, bond market ensures second level of borrower scrutiny which brings lot of **financial discipline** in the borrowers. A robust and well-functioning secondary market or platform for loans will facilitate better **risk management**, better **pricing** of loans and more robust **balance sheets** of banks with not too many hold-till-maturity kind of assets.

Robust bond market and secondary loan trading platform provide depth to the credit markets and helps better credit management.

What is your opinion on bank consolidation from efficiency and effectiveness perspective and its impact on NPAs going forward?

Bank consolidation is **certainly effective** for efficient use of capital and resources. However, effectiveness as a consolidated entity will also depend on **organisational structure**. A small bank may be more effective in certain businesses like retail but not in financing of infrastructure, large corporates etc. Hence to say that bank consolidation itself will lead to both efficiency and effectiveness will depend on factors like **assimilation and motivation** of employees in new organisation, quality of **top management**, robustness of **policies, capital structure, technological prowess** and ability to adapt to the market **expectations**.

Bank consolidation will lead to efficient resource allocation. However, implementation of merger will determine true efficiency and effectiveness.

Expert speak – priorities for 2020

In this section, we have sought to consider the way forward for IBC and the distress market in 2020. We interacted with various veterans of the industry from banks, investors, corporates and lawyers, and complied their views on what they think would be the focus areas on IBC and stressed market in the near future.

These are the key themes from across our discussions:

Whitewash provisions extinguish past liabilities and ensure that a clean asset is picked up by a resolution applicant. Implementing / strengthening this could increase investor interest and potentially lead to higher recovery. The view is shared amongst resolution applicants, banks, ARCs and lawyers.

The liquidation process has more autonomy for the liquidator and differs principally from a CIRP. With the addition of ability for going concern sale, **liquidation process** is another key area for improvement in terms of clarity on conceptual issues and transparency of the process.

Notifying a mechanism for **pre-packaged bankruptcy** is another area which is suggested by funds, banks and lawyers. Benefits envisaged include reduction in time, lower value destruction and consequent higher recovery to creditors.

A comprehensive framework for resolution of **financial service providers** is a major lacuna in resolving few of the larger stress cases. Lawyers and bankers have expressed a need for devising a framework that adequately addresses bankruptcy in this scenario considering the contagion effect and systemic importance of financial entities and interest of public deposit holders.

Strengthening **out-of-court** restructuring processes is important to de-bottleneck the IBC thereby solidifying the Code's position as last resort deterrent.

Challa Sreenivasulu Setty,
Deputy Managing Director,
State Bank of India

- **Circuit benches** of NCLAT should be set up at the earliest and technology to cross-reference precedents should be used to enable swift disposal of routine / similar cases.
- **Secondary loan trading** platform should be created to enable exit to the traditional banking system from high yield/risk assets.
- **Operational turnaround** and interim management expertise for value preservation in a corporate debtor undergoing distress situation.
- Creation of a centralised database for asset sales under **liquidation** to enable swift price discovery.
- The Code should simplify creation and transfer of charges during **implementation** of a Resolution Plan.

Vinod Joshi,
General Manager,
Recovery Division,
Punjab National Bank

- **Pre-packs** can be an important framework of resolving distress, considering time and cost involved in CIRP.
- **Secondary loan trading** platform necessary to cater to specialized market of high yield trading.
- There is a need for a more stringent institutional mechanism to appoint, advise and have **oversight on the liquidator** appointed by NCLT to protect the interest of the creditors.
- Suitable additions in **CIRP regulation** may be made to identify the roles and responsibilities of CoC, RP and the Resolution Applicant after approval of Resolution Plan by NCLT. Period post NCLT approval and before transfer of Control to the Resolution Applicant is a grey area currently.
- The Resolution Professional and their team need to initiate work on resolution early in the CIRP. They also need to work in tandem with management and promoters (if appropriate and consented by CoC) to collate relevant information for resolution applicant.

Sunil Chug,
General Manager,
Stressed Asset Management Vertical,
Oriental Bank of Commerce

- **Renegotiations,** solely on the grounds of financial restructuring of the corporate debtor, on pre-existing contracts that are critical to the survival of the corporate debtor (for example Power Purchase Agreements, Fuel Supply Agreements) should be avoided to the extent possible to alleviate uncertainty.
- The Adjudicating Authorities seem to be overwhelmed with the number of applications for **admission**. A fast track framework may be considered for admission of cases with total debt size above a particular threshold, say INR 500 Cr., could enable swifter admission.
- Prevention of Money Laundering Act **(PMLA) and other investigative issues** create hurdles in the resolution process and for creditors. Deferring / delaying implementation of approved resolution plan for such issues has significant adverse impact on valuations. Clarity on this front is needed.
- Clarity is required on coverage of the **inter-creditor agreement**, promulgated pursuant to June 7 circular of RBI, for several stakeholders including but not limited to foreign banks, NBFCs, mutual funds, asset managers, funds etc.
- Insolvency ecosystem with respect to **financial service providers** and related entities needs to be developed further.

Eshwar Karra,
CEO,
Kotak Special Situations Fund

- **ICA** signing should be made mandatory for the creditors. Unless an investor gets assurance that all the creditors are together in the process, it becomes very difficult to complete the transaction. This is also important to reduce the burden on IBC and resolve cases outside the Code.
- IBC process, once the bidding is done, should be closed quickly. It is unfair to tie an investor to a price, without transferring the control. Not only is the capital committed, but also the value deterioration in the asset, especially if in service/asset light business, would be out of investor's control.
- **Financial entity / NBFC stress** resolution would be another focus area for 2020. Sec 227 of the IBC and FRDI are steps in the right direction. However, implementation should be done very carefully otherwise value could go down quickly for these financial firms.
- 2020 would also see resolution of large size Infrastructure and real estate projects. However, CoCs should look at **restructuring deals** rather than only all-cash deals to enable higher recovery.
- Process vs price – going into fourth year of IBC, process should be streamlined and price should be key criteria for decision making. **Provisioning** for CoC is still the key decision-making criteria for banks and sometime makes it difficult to complete a transaction.

Shantanu Nalavadi,
Managing Director,
India Resurgence Asset Management Business

- Clear objective criteria for **admission** of section 7 application could reduce the time taken for admission. If there is default on financial debt, then application should be expeditiously admitted.
- Regulations for **pre-pack** should be introduced to allow investors to clearly identify and take over the business / assets after capping / settling all liabilities of the business.
- Greater transparency and clarity on sale of assets in **liquidation** is needed.
- **ARCs** should be permitted to purchase the loans by foreign branches of Indian banks or ECBs to execute "loan to own" strategy.
- Clarity on **attachment** by ED, CBI and Income Tax is needed. Their claims should be limited to erstwhile promoters or former functionaries of the corporate debtor.
- Removing **pricing restrictions** on re-capitalisation of listed companies (pre-IBC). Majority shareholders of the Company should be allowed to decide the recapitalisation price rather than based on a formula that may have lost relevance given the stress.

Indranil Ghosh,
Managing Director,
Cerberus Capital

- **Prepacks** could be helpful in resolving cases especially for financial service providers wherein time is of essence.
- **Homebuyers** are important stakeholders to the real estate bankruptcy but as a part of CoC they have substantial powers with limited information. Voting thresholds may have to be reassessed to ensure misinformed or rogue set of buyers do not derail the resolution process.
- **Non-performing loan (NPL) trading** should be opened-up to players other than ARCs.
- Unequivocal clarity on debt funding of (at least senior trances of) distressed asset acquisition by funds.
- **Rolling-over of debt** on a corporate debtors balance sheet in resolution by a financial investor would lead to lower cost of capital for RA and higher recovery for the CoC. This should receive greater consideration from the CoC.

Manish Jain,
Managing Director – Head of India,
SSG Advisors LLP

- Civil or criminal **past liabilities and non-compliances** should be waived for the resolved corporate debtor while allowing action for the incumbent directors/promoters.
- **Prepacks** could be helpful for resolving cases and reducing the time and cost involved in bankruptcies.
- Clarity on sale as going concern in **liquidation** regarding applicability of waterfall mechanism.
- Penal provisions and criminal liability for **rogue bidders** should be implemented. Once a binding plan is submitted, no changes should be permitted without mutual consent and the penalties should be severe enough to dissuade bidders from walking away.
- Recognition of contracted **priority amongst lenders** and any inter creditor arrangements. Currently IBC doesn't make distinction between differently ranked charges.
- Clarity is required on payment of **liquidation value to dissenting creditors** in situations wherein a small upfront payment and large deferred payment is envisaged. Moreover, there is ambiguity and subjectivity in determining the LV payable to lenders with different priority charge (e.g., TL vs WC loans).

R.K. Bansal,
Managing Director,
Edelweiss ARC

- Wider **data** collection and dissemination on assets bid out by lenders and success thereof.
- Review of **provisioning norms** on assets sold by banks with SR holding at more than 10%.
- Review of 15% minimum investment by ARCs: Instead of 15% of the total SRs issued, to be limited as 15% of SRs held by the selling Bank/FI/NBFC.
- Process enabler: Simplification of charge modification from lender to acquiring ARC based on simplified, automatic process without involving the borrower.
- Clarity on unresolved portion of the assets assigned to ARCs after completion of eight years.

Gaurav Gupta,
CEO,
Adani Capital

- **Out-of-court restructuring** processes should be harmonized with respect to different banks. The lead bank or a core committee should be entrusted with authority to negotiate and cram-down a restructuring package.
- **Homebuyers** are critical to any real estate bankruptcy and revival, and hence should get a voice in the CoC. However, they are asset owners that have purchased homes and should not be treated on par with financial creditors.
- Position of **past liabilities** irrespective of whether claimed or not and non-compliances and penalties thereof should be unequivocally clarified for a resolved corporate debtor.
- After the Essar Steel judgement, CoC behavior in 2020 would be critical. As the underlying principle of IBC is maximizing going concern value, **OCs** should be treated in cognizance of this principle by the CoC. A defined distribution methodology would take away subjectivity and risk of litigation.
- **Evaluation matrix** that are drafted with the algorithmic characteristics should be reconsidered. One-size-fits-all methodology may lead to selection of sub-optimal resolution plan.

Kaustubh Kulkarni,
Group Head – M&A and Strategic Finance,
JSW Steel

- Basic standards of **information availability** to be put in place for a prospective buyer to conduct a meaningful and transparent due diligence of assets.
- Clarity on **attachment of assets** by Enforcement Directorate (ED)/ Serious Fraud Investigation Office (SFIO) etc. and waiver of past non-compliances under various legislations.
- While multiple judgements have approved extinguishment of **contingent tax liabilities** yet tax authorities continue to issue notices and claims for outstanding dues pertaining to the pre-CIRP period. A notification should be issued to clarify that post implementation of a resolution plan that extinguishes past tax liabilities, no dues can be claimed by tax authorities for the prior period.
- Upon approval of a resolution plan that requires **squashing of litigations** initiated in the pre-CIRP period such proceedings at whichever forum, court, tribunal should stand terminated.
- Involuntary change of control effected by way of **implementation** of an approved Resolution Plan should not trigger any charges or fees under any pre-existing licenses, approvals, land lease / mining rights etc.

Bahram N. Vakil,
Founder and Managing Partner,
AZB & Partners

- **Financial Regulation and Deposit Insurance** Bill (or its equivalent) needs to be re-considered with appropriate modifications for the insolvency of banks and financial institutions.
- Appropriate regulations for binding ARCs, pension funds, mutual funds and insurance companies similar to **ICA** under 7 June 2019.
- There is a need to organize regular **colloquia of judges** to ensure more interaction and discussion on legal aspects between judges on different benches of the NCLT and the NCLAT.
- **Indian debt regulations** need to be reconsidered and streamlined, including permitting investment in domestic Rupee debt by foreign investors through securitization trusts, easing stamp duty and registration related regulations etc.
- There is a need to ease **secondary trading of debt** through a centralized registry for secondary trading of standard and distressed debt (which acts as a one-stop portal for all debt investments proposed to be sold by banks/ financial institutions).

Cyril Shroff,
Managing Partner,
Cyril Amarchand Mangaldas & Co

- **Technology**-based case management system for IBC cases could alleviate the increased burden on the judicial system and would also improve consistency in the decision making.
- **Companies Act compliances** must be relaxed for a company undergoing CIRP. This would help in keeping the focus on running the corporate debtor as going concern and effective resolution.
- Capacity building of NCLTs including continuing knowledge development of judges, increase in administrative functions to effectively coordinate with foreign proceedings etc. will be necessary to supplement **cross-border** insolvency cases.
- To consider a fast track scheme under the Companies law for an **out-of-court restructuring.** This would help in managing burden on IBC ecosystem, distribute workload and improve timelines for resolution.
- Capacity building of Debt Recovery Tribunals to handle **personal insolvency** cases would be necessary to ensure adherence to timelines.

Shardul Shroff,
Executive Chairman,
Shardul Amarchand Mangaldas & Co

- Notifying **financial service providers** within the scope of IBC, in consultation with relevant regulators, is, at best, a temporary solution. Detailed legal framework needs to be developed to deal with the insolvency and stress in FSP segment.
- **Cross border insolvency** had been left out from initial design of the Code. With upcoming amendments to the Code, cross border insolvency is bound to become priority area.
- There are several intricate and complex legal issues around **group insolvency** which need to be tackled.
- **Liquidation process** including rules with respect to distribution of liquidation estate, sale as a going concern, contours of stakeholder participation need deeper dive down.
- With clarity on aspects of distribution under a resolution plan after the Essar Steel judgement, **valuation** and methodology adopted for arriving at fair and liquidation value will assume importance.

Sumant Batra,
Manager Partner,
Kesar Dass B. & Associates

- High level and in-depth introspection on **intrusive policy making** and excessive regulations that show a lack of trust on market mechanism.
- **Promoter cooperation** / association may be necessary for successful resolution and cases of malfeasance shouldn't accord suspicion on promoters as a class. Section 29A may need further dilution.
- **Whitewash provisions** protecting investors in stressed assets necessary due to challenge of effective due diligence.
- The government should set up an institute to develop and possess **requisite skill sets** in managing turnaround stories in distress asset space.
- A hybrid of formal and informal resolution process in the form similar to **pre-packs** is needed. Combining ease of out of court resolution with court sanction will provide speed and certainty.

Nitin Jain,
Partner,
Restructuring and Turnaround Services, EY

- Rescue finance should be recognized and given priority in IBC, similar to real estate AIF that is currently being assessed by the government. Higher priority would lead to active consideration of such deals by domestic and foreign capital providers.
- Restructuring of debt, when it becomes NPA, should be first option rather than ruminating on way forward while anchoring on to IBC as preferred solution. While the June 7 circular directs the banks to take early action, the decision making is still slow and is governed on provisioning policy which leads to cases being referred to IBC.
- Mechanism to rationalize ratings based on objective criteria is required from RBI. Rating agencies may be excessively conservative in their RP4 assessment.
- ICA mechanisms needs rework. Presently dissenting banks delay the signing which defeats the purpose of creating a time-bound resolution mechanism.
- Culture of considering only all-cash deals needs rethink. Sustainable continuing debt should be assessed objectively to allow better NPV recovery. Recovery and credit departments cannot work in silos.

Ramkumar SV,
Partner,
Restructuring and Turnaround Services, EY

- A focus on operational turnaround is critical for expanding the horizon from value preservation to value maximization.
- Litigations have undoubtedly led to delays in closure of CIRPs. Cogent criteria for appealing against a resolution plan should be set to streamline the resolution process.
- Framework for implementing pre-packaged bankruptcies could provide an opportunity for revival of businesses which are technocrat centric.
- Infrastructure sector is critical to India's economy and provides significant employment opportunity. So far EPC has contributed 12% to the 2500+ admitted cases and resolutions are only a fraction. Timely release of arbitration claims and clarity on bank guarantee treatment required.
- Liquidation valuation is critical for resolution of a Corporate Debtor. The governing regulations need more clarity with respect to joint ventures, value deterioration due to delays, write offs etc.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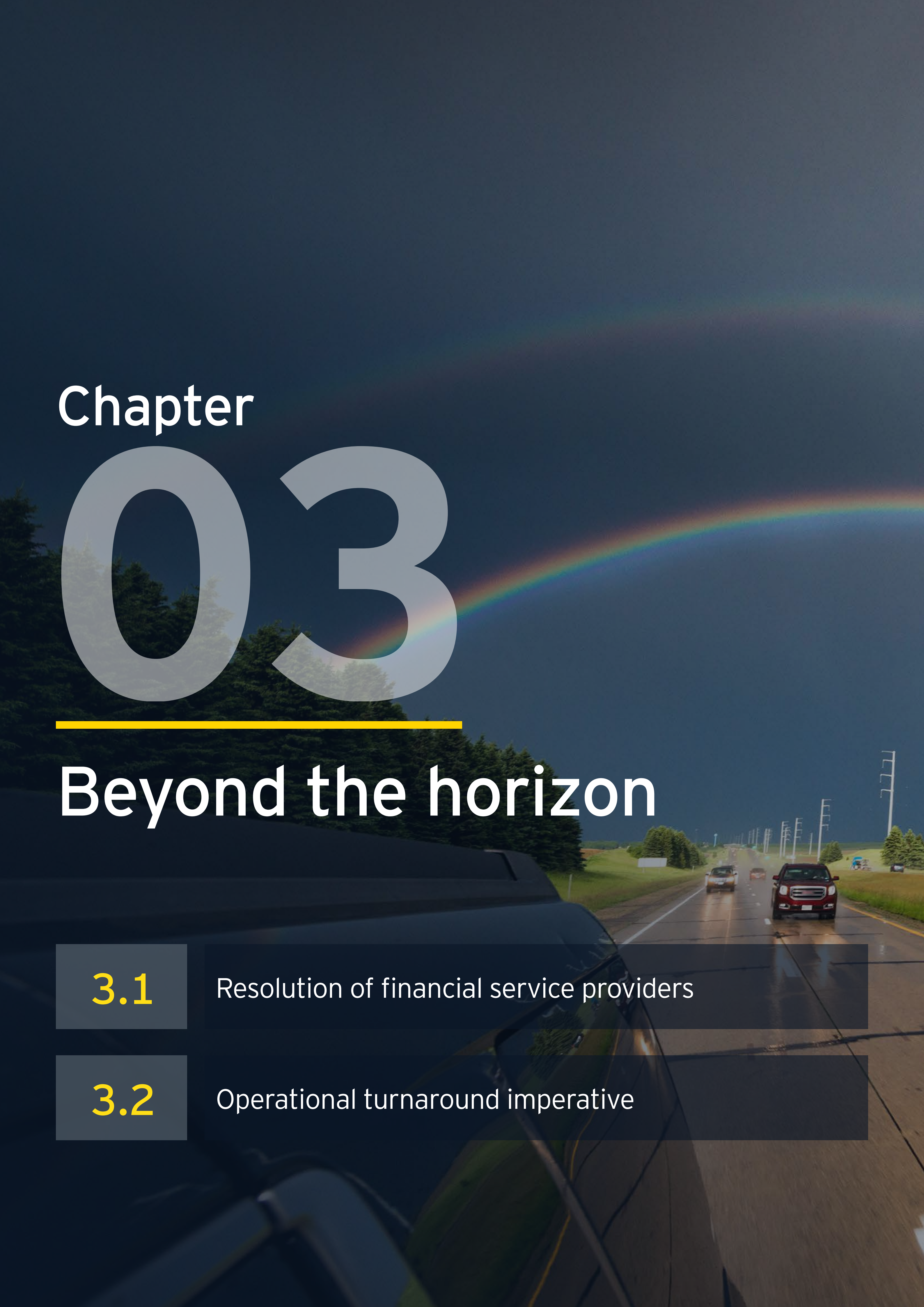


Chapter 03

Beyond the horizon

Resolution of financial service providers

Resolution of Financial Service Providers

India currently lacks a comprehensive framework for dealing with and resolving distress in Financial Service Providers (FSPs). With the recent rise in stress in the non-banking financial sector, this section outlays the need for a comprehensive framework and provides an overview of key aspects of the Financial Resolution and Deposit Insurance (FRDI) bill.

In his budget speech 2016-17, the Finance Minister, Mr. Arun Jaitley, had announced:

> *"A systemic vacuum exists with regard to the bankruptcy situations in the financial firms. A comprehensive Code on Resolution of Financial Firms will be introduced as a Bill in the Parliament during 2016-17. This Code will provide a specialised resolution mechanism to deal with bankruptcy situations in banks, insurance companies and financial sector entities. This Code, together with the Insolvency and Bankruptcy Code 2015, when enacted, will provide a comprehensive resolution mechanism for our economy."*

Following an announcement of government's intent to introduce a comprehensive code on resolution of financial firms, during the 2016-17 budget speech, the Ministry of Finance issued an Office Order, on 15 March 2016, to constitute a committee to draft and submit a bill on resolution of financial firms. The committee submitted a draft in September 2016 and the Financial Resolution and Deposit Insurance (FRDI) Bill, 2017 ('the Bill') was introduced in the Lok Sabha in August 2017. However, the Bill was withdrawn a year later.

> *Ministry of Finance, Press Release dated 2 January 2018: Bail in has been proposed as one of the resolution tools in the event a financial firm is sought to be sustained by resolution. Certain misgivings have been expressed in the media, especially social media, regarding the depositor protection in the context of "bail-in" provisions of the FRDI Bill. These misgivings are entirely misplaced:*

Type of deposits	Existing framework	Proposed FRDI bail-in
Insured deposits#	Insured upto INR 1 lac	Insured upto INR 1 lac
Uninsured deposits	Treated on par with unsecured creditors*	Ranked higher than unsecured creditors and government dues

**Rank after preferential dues (incl. government dues)*

#per depositor

As mentioned in the press release above, the bail-in clause received public backlash after the bill was introduced in Lok Sabha. Section 52 of the bill talks about the Bail-in clause and effectively means in case of a restructuring, the depositor money could be appropriated over and above the insured amount, which is INR 1 lacs currently.

As explained in detail below, bail-in is proposed as one of the resolution methods in case a financial firm is classified in the highest risk bracket envisaged in the Bill. Further, in case of critical risk (highest risk category), bail-in is one of the five resolution method available to resolve the problem. Hence, it is only one of the many resolution tools proposed to resolve a FSP in the highest risk category.

However, in 2018, the need for an insolvency regime for financial services firm was highlighted again, when in 2018, Infrastructure Leasing and Financial Services (IL&FS) Group, one of India's biggest non-banking finance companies (NBFC) with the debt of almost INR 1 lakh crore, defaulted on its debt obligation and the Government stepped-in and took control of the Group by reconstituting its board on 1 October 2018 and vide NCLAT order dated 15 October 2018 was granted a comprehensive moratorium. Almost two thirds of the aforementioned debt was due to public sector banks and majority of capital invested in IL&FS was by public financial institutions such as LIC, UTI, AMC etc. An immediate aftermath of the defaults was a severe contraction in the commercial paper (CP) market (-22% Q-on-Q for quarter ended 31 December 2018), increase in CP spread to 200+ bps (in November 2018) from almost90 bps (in August 2018) which precipitated in the asset-liability mismatch (ALM) for many in the sector. The year-on-year growth for CP reduced from 13% in FY 18 to 4% in FY19, for debentures it reduced from 13% in FY18 to 5% in FY19 and for bank borrowings it increased from 34% in FY 18 to 48% in FY 19. Major sources of capital for NBFCs include debentures, bank borrowings and commercial paper held across investor types.

Large FSPs (DHFL with around INR 90,000 crore of debt and Altico with INR 5,000 crore of debt) also missed debt payments in 2019. Public discourse was further exacerbated when news of financial misconduct by a cooperative bank, Punjab and Maharashtra Cooperative Bank, raised questions of treatment of deposit holders.

Recently, as a stop gap arrangement, rules were notified by the Ministry of Corporate Affairs (MCA) providing a framework for insolvency resolution of systemically important FSPs, excluding banks. These rules are under the power given to Government in Section 227 of IBC and are only applicable for NBFCs (including Housing Finance Companies) with asset size of INR 500 crores or more as per last audited balance sheet. RBI will be the FSP regulator allowed to file an application.

Overview of the notified rules under Sec. 227 of IBC, 2016		
Particulars	**Sec. 7, 8, 9**	**Sec. 227**
Who will it apply to?	Companies other than FSPs	Notified FSPs with asset size over INR 500 Cr.
Who can apply?	Any creditor with default above amount specified	Only notified regulators can apply. The RBI has been notified for aforementioned FSPs
When does the moratorium start?	Starts from the date of the admission order	Interim-moratorium from the date of filing application
Who runs the process?	An Insolvency Professional registered under the IBBI regulations	An 'Administrator' proposed by the appropriate Regulator and appointed by NCLT
Approval on resolution plan	CoC + NCLT	CoC + NCLT + No objection from the appropriate regulator

Implicit in the issuance of aforementioned rules is the recognition that financial firms are dfferent from the traditional industry corporates, and their failure may have to be handled dierently. Financial firms, in addition to managing their own resources, handle large amounts of public money. Banks, insurance companies, NBFCs etc. channel a large part of the savings of households and firms. Some of the financial firms are also systemically important, as their failure may disrupt the financial system and hurt the real economy.

Hence, unlike traditional corporate insolvency, financial firms insolvency tends to attract a regulator-driven process instead of a completely-independent market driven process. Internationally also, standard insolvency and bankruptcy processes are usually not considered suitable for financial firms, especially those handling consumer funds, and those considered to be of systemic significance. Such processes, even if they are efficient, tend to drag on for longer periods of time than are acceptable for instances of financial firm failure, aggravating the threats to consumer funds and systemic stability. Also, the fear of a financial firm going into a long-winded process may trigger knee jerk reactions from the depositors of these firms even when they have not really failed.

> *As per the Report of Committee to Draft Code on Resolution of Financial Firms - Zero failure of financial firms is not always possible. Regulation will sometimes fail, and a prudentially regulated financial firm will become insolvent. Moreover, some instances of firm failure are good for creative destruction of ineffcient firms. However, it is important to ensure that the failure of a financial firm is orderly, so that consumers are protected, and systemic stability and resilience are preserved, without relying on taxpayer-funded bail-out. Therefore, unlike most non-financial firms, financial firms tend to attract intrusive interventions from statutory regulators, including frequent on-site inspections, close off-site monitoring of business and detailed restrictions on business*

Hence, as the financial market in India matures and we move towards the US$5 trillion GDP and beyond, having a credible resolution regime for the financial firms is inevitable.

Recent reports suggest the Central government is likely to make changes in the original draft of the Financial Resolution and Deposit Insurance Bill and present it in the current winter session (Nov-Dec 2019) of the parliament.

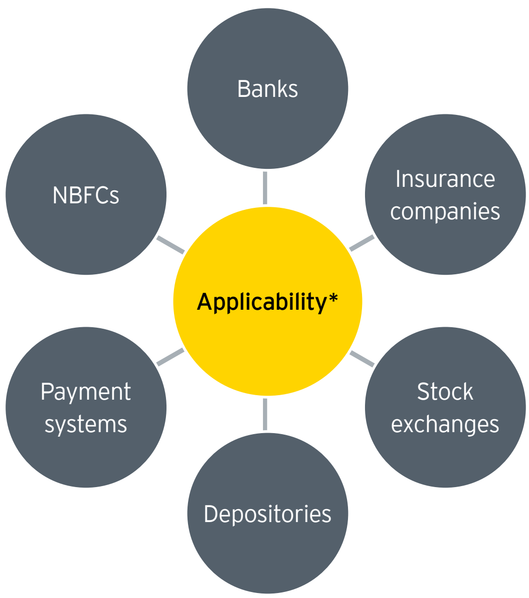
> *The FRDI Bill does not propose in any way to limit the scope of powers for the Government to extend financing and resolution support to banks, including public sector banks. Government's implicit guarantee for solvency of public sector banks remains unaffected as the Government remains committed to adequately capitalise the public sector banks and improve their financial health. The Government is committed to protecting the existing protection to depositors and providing additional protection to them.*
>
> *- Ministry of Finance, Press Release dated 2 January 2018*

A recent survey also revealed that financial creditors strongly feel the need for a comprehensive bill for resolution of stress in financial institutions. 97% of respondents agreed with the above. Refer **section 1.4 - Market perspectives** for more details.

In this section we break down how the Bill is envisaged to operate and what it proposes to change -

The Bill envisages consolidating the fragmented provisions related to resolution of financial firms by either amending or repealing almost 15 different laws. Some laws impacted by FRDI Bill would include:

- The Banking Regulation Act, 1949
- The Insurance Act, 1938
- The State Bank of India, Act, 1955
- The Companies Act, 2013
- The Reserve Bank of India Act, 1934
- The Life Insurance Corporation Act, 1956
- The General Insurance Business (Nationalisation) Act, 1972
- The Multi-State Cooperative Societies Act, 2002
- The State Bank of India (Subsidiary Banks) Act, 1959

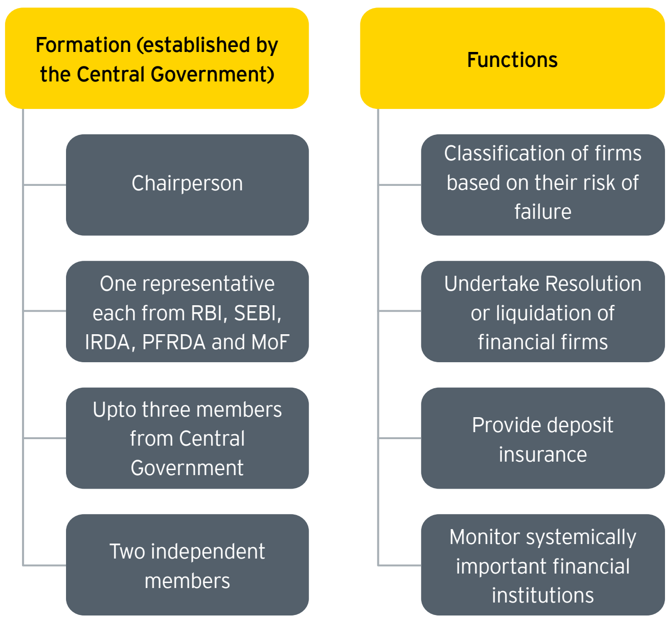


Including their parent Companies

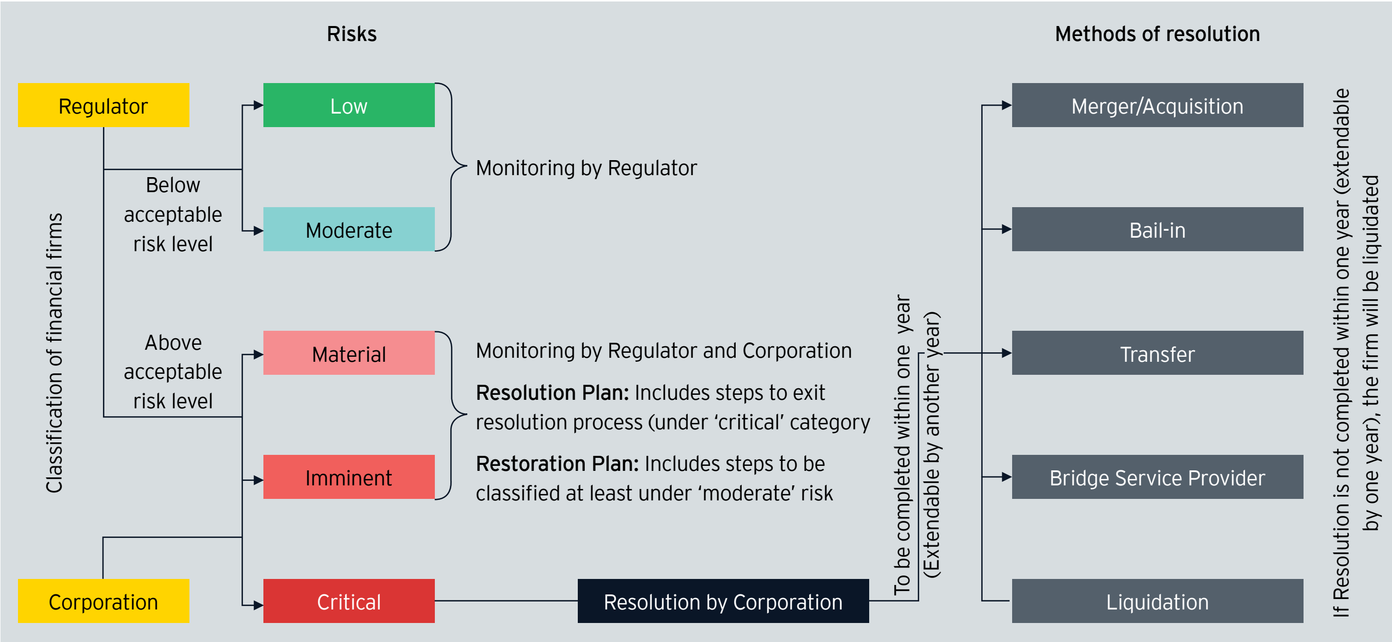
Resolution Corporation

It is also proposed to repeal the Deposit Insurance and Credit Guarantee Corporation (DICGC) Act, 1961, which currently provides insurance of deposits, to transfer the deposit insurance powers and responsibilities to an independent Financial Resolution and Deposit Insurance Corporation ('Resolution Corporation' or 'Corporation' or 'the RC').

The RC would perform resolution functions for a wide range of financial firms and provide deposit insurance to banks. The RC's board would have representation from financial regulators and the Central Government, and it would also have whole-time and independent members. The RC would be financed by levying premia and fees on the financial firms covered by it. The RC would also create clearly separated funds for deposit insurance, resolution, and general administration.



FRDI Process – Monitoring and Resolution of Financial Firms



Key Highlights of the Process

Risk Classifications – The Resolution Corporation, in consultation with the sector regulator, to specify objective criteria for classification of service provider into any one of the following categories of risk to viability:

- **Low –** substantially below acceptable levels
- **Moderate –** marginally below acceptable levels
- **Material –** above acceptable levels
- **Imminent –** substantially above acceptable levels
- **Critical –** service provider on the verge of failure

Risks will be evaluated on the metrics of capital adequacy, assets and liability, asset quality, caability of management, earnings sufficiency, leverage ratio, liquidity of firm, compliance etc.

A process would be put in place to monitor a firm that is classified as "material" or "imminent" risk to failure, giving time to the firm (and its system) to either recover from illness or to prepare for failure if it is edging towards the critical stage.

If a covered service provider is classified as material or imminent risk to viability, as the case maybe, such covered service provider shall submit a Restoration Plan to the Appropriate Regulator and a Resolution Plan to the Corporation within ninety days of such classification.

Restoration Plan: FSPs under the **'material' or 'imminent' category** will submit a restoration plan **to the regulator** within 90 days of such classification. These plans will include:

- Details of assets and liabilities of the service provider
- Any contingent liabilities of the service provider
- Steps, along with the application, to improve the risk-based categorisation to at least 'moderate'
- Implementation timeline of the Restoration Plan

The Restoration Plan would need to be updated annually and be communicated to the regulator and the Resolution Corporation within 7 days post revision.

Resolution Plan: FSPs under the **'material' or 'imminent' category** will submit a resolution plan **to the Resolution Corporation** within ninety days of such classification. These plans will include:

- Details of assets and liabilities of the covered service provider
- Any contingent liabilities of the covered service provider
- Details regarding critical functions of the service provider
- Direct or indirect access to Financial Market Infrastructure Services
- Strategy plans to exit the resolution process

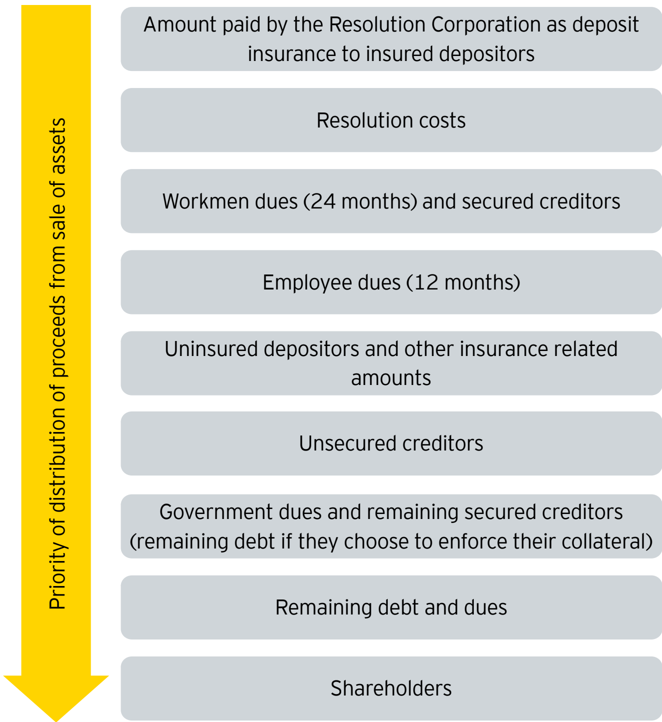
A copy of every Resolution Plan submitted to the Corporation would be sent to the Appropriate Regulator, and a copy of every Restoration Plan submitted to the Appropriate Regulator would be sent to the Corporation within fifteen days of its receipt.

The RC will take over the administration of a financial firm from the date of its classification under the **'critical' category.**

- The Corporation will resolve the firm using various methods specified in the Bill within one year. This time limit may be extended by another year (i.e., maximum limit of two years). During this period, the firm will be immune against all legal actions.
- **Methods of resolution:** The Resolution Corporation may resolve a financial firm using any of the following methods: (i) transferring the assets and liabilities of the firm, (ii) merger, acquisition or amalgamation of the firm, (iii) creating a bridge financial firm (where a new company is created to take over the assets, liabilities and management of the firm), (iv) bail-in (internally transferring or converting the debt of the firm), or (v) liquidation (subject to approval by the National Company Law Tribunal).
- **Bail in:** The Resolution Corporation will provide deposit insurance to banks up to a certain limit. This implies, that the Corporation will guarantee the repayment of a certain amount to each depositor in case the bank fails and for the balance amount, depositors may have to take a haircut. Currently, the Deposit Insurance and Credit Guarantee Corporation (DICGC) provides deposit insurance for bank deposits up to INR 1 lakh per depositor. The Bill proposes to subsume the functions of the DICGC under the Resolution Corporation.

Supersession of the Board of Directors: On classification as 'imminent' or 'critical' risk to viability, the Corporation can supersede the board of directors of the financial service provider for a period not exceeding two years.

Liquidation and distribution of assets: The Corporation will require an approval of the National Company Law Tribunal ("NCLT") to liquidate the assets of a service provider. Proceeds from the sale of assets will be distributed in the following priority:



Material risk to viability: On classification of a covered service provider under the 'material' risk category, the regulator may prevent it from carrying out of any / all of the following actions:

- accepting funds which increase liabilities to consumers
- declaration or payment of dividends to any shareholder
- payment of any bonuses to any director, employee or manager
- acquiring any interest in any other business
- establishing new locations of carrying out business or acquiring new clients
- carrying out transactions with any member of any group to which the covered service provider belongs
- repayment of any debt which is not due

Imminent risk to viability: On classification of a covered service provider under the 'imminent' risk category, the corporation may prevent covered FSP from carrying out of any / all of the following actions:

- All preventions mentioned under the material risk category
- payment of any fees to any agent or service provider
- payment of remuneration to any employee, director or manager in excess of any limit set
- providing any financial service as specified in the order
- making advances
- In case of branch office - repatriation of capital or deployment of funds without approval
- repayment of any debt which is not due

The regulator may also require the service provider to carry out any/ all of the activities specified under the material risk category. Furthermore, as mentioned earlier, Corporation may supersede the board of directors of the FSP.

Critical risk to viability: The Corporation will take over the management of the financial service provider from the date when covered FSP is classified as 'critical'.

- Moratorium on any legal action against the service provider
- No payment, repayment or acceptance of deposits shall be made or liabilities incurred
- In case of insurance companies, no exercise of any contractual rights to surrender or terminate an insurance cover
- The Corporation to make payments of Deposit Insurance

Upon classification under 'critical' risk to viability, notwithstanding anything in any law for the time being in force:

- Regulator may withdraw/ modify any authorisation or licence to carry out any financial service
- Deposit insurance on further deposits accepted would not be provided

Systemically Important Financial Institutions (SIFI): The Central Government, along with the regulator, may designate a financial service provider as a SIFI. Every SIFI is required to submit a restoration plan to the regulator and a resolution plan to the Corporation, within a period of ninety days from being designated as a SIFI, in line with the requirements specified above. Moreover, the RC would monitor safety, soundness and resilience of SIFIs through periodic collection of information. The RC would also be empowered to conduct inspections, in consort with appropriate regulator.

Other provisions:

Funds: The RC will constitute three Funds: (i) Corporation Insurance Fund for deposit insurance, (ii) Corporation Resolution Fund for resolution expenses, and (iii) Corporation General Fund for all other functions.

Bar on jurisdiction: The Bill prohibits any court or tribunal from entertaining matters related to the decisions of the Resolution Corporation or regulators, unless specified in the Bill.

Conclusion and way forward:

Keeping in view the vulnerability and high dependences of the economy towards its financial institutions and the current lacuna in terms of a consolidated and complete law to support adversity which may befall such institutions, there is a discerning need for introduction of a legislation that addresses, comprehensively, resolution or liquidation of financial service providers.

It was slightly unfortunately, for one clause of a detailed bill to get a disproportionate attention in 2017-18 when the bill was first put up for discussion and limited deliberation happened on the remainder of the bill. It would be prudent for all stakeholders and impacted parties, to have a balanced discussion on all the aspects of the bill including on infrastructure requirement and readiness. The introduction of the bill, therefore, should be preceded by continuous engagement, knowledge sharing, planned dissemination of credible information and public education.

Operational turnaround imperative

Turnaround in 2020 and beyond

The IBC is here to stay and that has been well established since the first 12 cases were admitted in 2017. Over the last three years, some of the biggest cases have been pushed into insolvency and the companies have effectively changed hands from the incumbent management and board to a team of professionals under the aegis of financial creditors. With the constitutional validity of the Code established and rules of the game in terms of section 12A and 29A now clear and tested, the fear of losing one's business is real and imminent. This has reshaped the contours of the lender-borrower relationship in India.

However, for sustaining the change in behavior, it is imperative that the Code's vitality is preserved not only by consistent regulatory and legislative push, but also supported on the ground with adequate and quality management skills. Value preservation of the organization in the interim CIRP period is crucial to supplement the effectiveness of the Code.

Managing a Corporate Debtor

The Code confers significant powers to the Insolvency Professional while stripping powers from the incumbent board of directors. The IP pierces the organizational strata directly above the top management to manage the operations of the business, thereby lifting the curtain on creditor-in-control regime. The promoters and / or the management may or may not be hostile to the change in control which brings its own arduous challenges. However, with the personal guarantee provisions coming into force from 1 December 2019, the borrower may be incentivized to provide cooperation and assistance in resolving distress even after commencement of bankruptcy.

A restructuring, of whichever nature, can never be completed without securing buy-in of all stakeholders. Going concern requires all involved to take concessions, shake hands and continue the business. The first step is acknowledging the decrepit nature of stakeholder management. While different bankruptcies will have varying degrees of problems, the spectrum of the issues would be similar. The IP, at commencement, stands at the precipice of a combination of problems which may vary depending on when a financial creditor pulls the trigger:

Typical indicators of stress across the business cycle of an organisation

Underperforming Business	Stressed Business	Distressed Business
▸ Stagnating / declining revenue, increasing costs, stressed margins ▸ Growing asset liability mismatch ▸ Sub-optimal operations ▸ Delays in CAPEX and project execution ▸ Uptick in customer complaints	▸ Growing lender discomfort about business performance ▸ Longer working capital cycle and weaker operating cash generation ▸ Rating downgrades ▸ Increase in cost of capital and erosion of equity value ▸ Covenant breaches ▸ High attrition, salary delays	▸ Failure to meet interest / debt obligations ▸ Declaration of default / NPA ▸ Non-payment of dues; supply chain disruption ▸ Scaled down operations / closure of production facilities ▸ Irrevocable loss of business/ customers ▸ Change of management control or transfer of control to lenders

Business Growth →

Common issues with employees and workforce:

- unpaid salaries and lost variable components
- poor employee management
- high attrition and consequent lacuna in the organization structure
- low morale
- lack of direction and clarity

Common issues for business partners may include:

- low quality goods / service
- fear of imminent closure and disruption of their supply chain
- lack of trust and misinformation
- inadequate communication

Common regulatory and compliance issues:

- several gaps in compliance
- inadequate communication
- levy of penalties and issuance of ex-parte orders

Common issues for public shareholders:

- erosion of shareholder wealth
- suspension of trading
- window-dressed books of accounts
- communication gap or misinformation

The compounding effect of issues, arising from the interconnected nature of businesses, often lead to complete halt of the organizational machinery. Imminent loss of market share, erosion of market trust and burgeoning losses may be some common themes which needs immediate attention of an IP. However, the inertia that an IP may encounter to restart the business and reach breakeven momentum may be arduous. The execution of a turnaround plan in this scenario may include two stages:

- Crisis management and stabilization through constant bilateral communication, stakeholder education (of the Code), and implementing processes and procedures to re-organise the company
- Performance improvement, to utilize the value creation levers implemented throughout the first phase

Shifting the focus from bankruptcy to turnaround

Due to the protections conferred under the Code to the Corporate Debtor, the IP is accorded significant buffer to deal with the distress. However, value erosion in terms of loss of business and increase in costs may prove too debilitating and irreversible. Therefore, the need to address the stress, before the point of no return is paramount. Broad flow of events in a typical case under IBC is as follows:

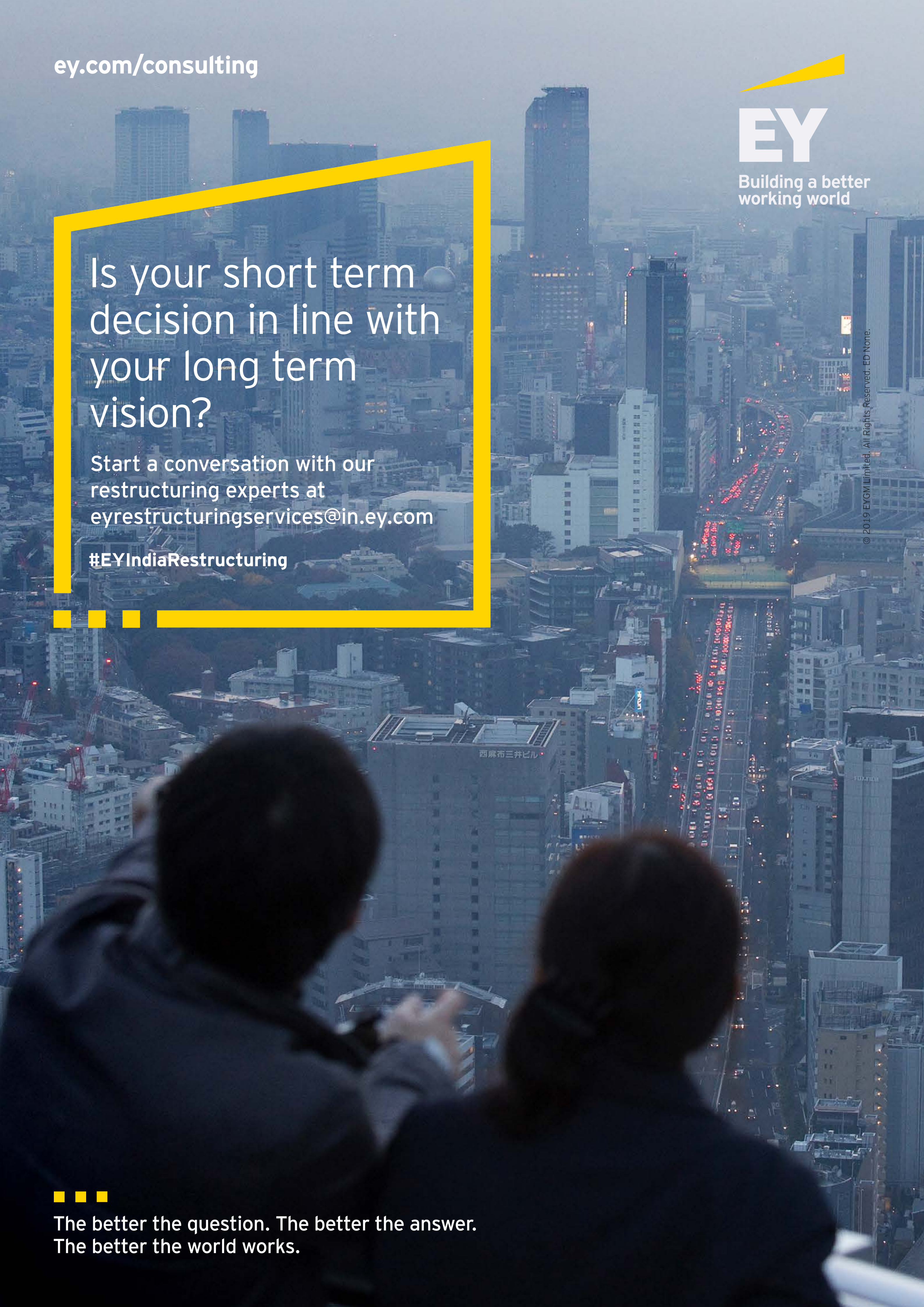
However, it is imperative to note that value deterioration in a business may have begun well before the case is admitted into IBC and much prior to the actual default / delay in debt servicing. The need of the hour is, therefore, for consorted strategy and action much prior to the event of default.

Value add to stakeholders across Turnaround engagements

Value to / Stages	Underperforming business (Promoter driven)	Stressed business (Lender driven)	Business under IBC	Post resolution / acquisition
Lenders	▸ Pre-emptive action to avoid distress and default	▸ Cash flow control ▸ Stability and proof of value in business to positively influence valuation	▸ Full control of the business as the CoC ▸ Value preservation for resolution	▸ Lending opportunity to a clean business
External Stakeholders (customers, vendors)	▸ Organic growth alongside the business	▸ Transparency in business dealings ▸ Professional approach to business	▸ Business continuity ▸ Assured supply / payment milestones	▸ Long term business relationship
Internal Stakeholders (employees)	▸ Continued visibility on long term value creation and stability	▸ Greater chance of being heard and adding value	▸ Transparent communication channel ▸ Loyalty and commitment likely to get recognised with resolution	▸ Job security and long-term growth potential
Promoter/ Acquirer	▸ Improved decision making ▸ Towards creating sustainable value	▸ Regain stakeholder trust ▸ Last opportunity to retain ownership	▸ Safeguard personal guarantees to the extent of realization	▸ Post acquisition integration and onboarding ▸ Long term value-creation and ROI

Conclusion

Restructuring decisions that only address the cash flow mismatch and prescribe a restructured schedule of repayments may just act as a short term palliative. It is imperative to shift the focus to early recognition of stress and accordingly devise a restructuring plan that takes into account such challenges.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