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Insolvency and Bankruptcy Code, not a panacea for Non-Performing Assets

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While the financial markets saw many reforms in the last two decades, the legal framework for resolution of stressed assets did not keep pace with it.

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI), 2002 had a different purpose, providing a legal framework for securitization, establishment and regulation of asset reconstruction companies and enforcement of security held by secured creditors without intervention of the courts. The archaic Board for Industrial and Financial Reconstruction (BIFR) and the Sick Industrial Companies Act (SICA) were inadequate to the address the resolution of stressed assets in the system.

The Insolvency and Bankruptcy Code (IBC) rolled out in 2016 is an important measure to address this issue. The code provides a framework for time bound insolvency resolution of corporates and others, putting the creditor in control in case of a default, through the Resolution/Insolvency Professional and the Committee of Creditors. The adjudicator is the National Company Law Tribunal (NCLT) and the appellate authority is the NCLAT. The Corporate Insolvency Resolution Process (CIRP)'s focus is on resolution as a going concern, with the objective of maximising value of the assets and not recovery through liquidation. The law mandates a timeframe of 270 days for arriving at a resolution of the stressed asset, failing which, it goes into liquidation. The short timeframe is a dream come true, in a country where cases wind through the overburdened judicial system for years, if not decades. As originally envisaged, the law was a game changer from a creditor perspective.

What wrecked the ambitious plans of the code drafters was the adjudicating tribunals/judiciary ignoring the timeframe of 270 days mandated by IBC. But from the judiciary's point of view, there is a learning curve, with IBC being a brand new law, with no precedents/case laws. Some of the cases involved thousands of crores, and it would presumably take time to navigate through the complexities of each case. Case overload and inadequate strength at the Tribunals added to the delays.

While a plan for resolving the stressed asset can theoretically be put in place and approved by the creditors within the timeframe envisaged, there have been many legal challenges to the approved plan and/or the code itself. The case of a steel company illustrates all that went wrong with the 270 day timeframe for completing the CIRP.

The first challenge came in the form of the promoters of the defaulting company, wishing to bid for the asset. This posed a "moral dilemma". If someone in charge has failed to run a company efficiently, perhaps managing to run it into the ground (resulting in default and insolvency proceedings), should the same promoter be given another opportunity to turnaround the company. The bigger issue is that the promoter, responsible for the mess, now gets to walk away with the company, "for a song", depending on the extent of the haircut taken by the creditors/banks.

To address this glaring lacuna, the law was amended to exclude defaulting promoters (with NPA's) from bidding for stressed assets. To overcome this, the promoter's bid was submitted through an apparently unconnected party, though it did not withstand scrutiny. The other bidder, unconnected to the company being resolved, was shown to be a defaulter in yet another company. This bidder then paid up the overdues, so as to be eligible for bidding. Now, the Committee of Creditors accepted its bid, involving a "reasonable" haircut, with the prospect of realizing an amount higher than what banks were hoping to get as part of the Insolvency process.

The matter did not end there. The original promoter submitted yet another proposal, which involved a full pay out for creditors and withdrawal of insolvency proceedings. Banks were astounded. If the promoter did indeed have the resources to pay off creditors, why wait all this while, dragging the company through insolvency, almost losing it to a competing tycoon, and then present a last minute bid to save its "crown jewel". Where was its financial wherewithal to follow through on its bid, were some of the questions that arose. This last-minute bid, ultimately did not see the light of the day, after further litigation.

But then it was too early to rejoice for the banks which were hoping to reverse the provisions made for the non performing assets. The winning resolution plan cut a much larger share of the pie for financial creditors and a smaller share for "operational creditors". The latter cried foul, and went to the Appellate Tribunal (NCLAT). In an apparent act of judicial overreach, the Tribunal dictated an equal share for both types of creditors, completely ignoring the decision of the Committee of Creditors. It did sound fair though, should not everyone get the same payout? But traditionally financial creditors (suppliers of finance) are secured, while operational creditors (suppliers of goods and services) are not. Having agreed to supply on an unsecured basis during a state of a company's solvency, can operational creditors seek an equal standing with secured financial creditors, when the company is taken to the insolvency court?

The government stepped in to address this anomaly, by amending the IBC to give primacy to the Committee of Creditor's decision, which comprises of Financial Creditors. Of course, the operational creditors have not taken this well, and challenged this again in the Courts. One does not know when this latest issue will be resolved, or what next will pop up. With the legal battles continuing ad infinitum, the yet unresolved case has dragged on for more than two years, much beyond the original 270 day timeframe envisaged in the Code, with the judiciary ignoring the time bound aspect of the process.

Track record thus far

A leading light of the Insolvency infrastructure has been its regulator, the Insolvency and Bankruptcy Board of India (IBBI). It plays several crucial roles, including registration and regulation of Insolvency Professionals, and rolling out rules and regulations elaborating on the code itself.

IBBI provides some useful data on the progress of the insolvency cases. Of the 12 large accounts originally directed by RBI for resolution under IBC, six have been approved, though one is still under litigation. The realization for financial creditors has ranged between 17% and 63%. Of the 2162 cases admitted till June 2019, 445 have exceeded 270 days. Resolution plan has been approved only in 120 cases, with another 475 under liquidation. Notwithstanding this, the IBBI needs to be commended for its stellar role in evangelizing the resolution process, providing much needed data on the progress of resolutions and bringing professionalism to the whole process.

The progress of the remaining six cases from the original dozen referred by RBI and other high profile bankruptcy cases from telecom and airlines, will be keenly watched, to gauge the efficacy of IBC. But ultimately the judiciary will have a much bigger impact, on the success or otherwise of IBC and its envisaged attractive timelines.

The larger issue: why NPA's in the first place?

No bank in the world is immune from NPA's whether it is the renowned JP Morgan Chase Bank or the struggling IDBI Bank in India with gross NPA's of 29%. When banks lend, they are aware that a part of the money will not come back, on account of genuine distress, whether it's a job loss/medical bankruptcy of an individual borrower or business failure of a commercial borrower. Therefore, they make loan loss provisions on standard performing assets, currently 0.4% in India, however modest it maybe.

Sadly, a significant factor for NPA's in India is the malfeasance of promoters/owners diverting bank finance into their personal coffers through over invoicing and related party transactions, making the project/company unviable. Not a week passes, without media headlines of a major egregious case of errant promoters treating company funds as their personal entitlement.

When the promoter has no stake left in the company, ruining it in the process, banks running to the Insolvency courts will get back only a paltry amount of their original loan. The bankrupt company becomes an asset light shell of its former self, after having been stripped of its liquid and income earning assets. There is no point in blaming the law (IBC) or the insolvency process for poor recovery, when errant promoters who caused the NPA's in the first place, have got away with the bank's money, and in many cases, fled to safe havens abroad. The CBI, SFIO and Enforcement Directorate step in after the crime has been committed and can only do a post mortem and try and recover whatever is left. Nor can we expect banks to micro manage whether the person in charge, the promoter, is using the bank's funds for personal enrichment or actually running the business.

While the current cycle of malfeasance may abate with all the investigations and with banks turning cautious, once the cycle gets back to normalcy, we may yet see a new breed of promoters finding ever devious ways to ruin banks and minority shareholders. All the stakeholders, the independent board members, credit rating agencies, auditors, bank risk managers, activist shareholders, proxy advisory firms and the media have to be ever vigilant to break the endless cycle of malfeasance, and bring normalcy back to bank balance sheets, as well as to protect the interests of the minority shareholders.

Prognosis

The recent amendment to the IBC extends the Corporate Insolvency Resolution Process timeframe to 330 days, including the time taken for legal proceedings. It remains to be seen if the adjudicating authorities and the higher courts take cognizance of this timeframe or ignore it as before. Be that as it may, the Insolvency and Bankruptcy Code is a step in the right direction for resolving stressed assets on account of genuine business failures, but possibly not meant to address wilful defaults/corporate malfeasance, and certainly not a panacea for Indian banking's burgeoning NPA's.