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Emerging Jurisprudence on Corporate Insolvency

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Abstract

There have been multiple statutory instruments for insolvency resolution process in India. These include the Sick Industrial Companies Act, 1985, the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, the Recovery of Debt Due to Banks and Financial Institutions Act, 1993, and the Companies Act, 2013.Due to this multiplicity of forums there was immense confusion as to the applicability of Law. All of these multiple legal avenues, and a hamstrung court system led to India witnessing a huge piling up of non-performing assets, and creditors waiting for years at end to recover their money. The Bankruptcy Code is an effort at a comprehensive reform of the fragmented regime of corporate insolvency framework, in order to allow credit to flow more freely in India and instilling faith in investors for speedy disposal of their claims. The Code consolidates existing laws relating to insolvency of corporate entities and individuals into a single legislation.

Keywords: *Non-Performing Assets, Debt recovery, Insolvency, Bankruptcy, Liquidation.*

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INTRODUCTION

"*Capitalism without Bankruptcy is like Catholicism without Hell*"

– Frank Borman

According to RBI, term loans on which interest or installment of principal remains overdue for a period of more than 90 days from the end of a particular quarter is called a non-performing asset (NPA). Literally, they are nothing but bad loans. NPAs have grown unprecedented over 135% over the last two years amounting to around 12% of gross advances of public sector banks (PSBs). India's NPA ratio is higher than any major emerging market (with the exception of Russia), higher even than the peak levels seen in Korea during the East-Asian crisis. India is ranked 136 out of 189 countries in resolving insolvency in Doing Business Report 2016 [1].

At 9.9 percent ratio, India has been ranked fifth on the list of countries with highest NPAs, and is on top spot among the BRICS nations, a recent report by CARE ratings revealed. The country is reeling under a huge NPA burden of over Rs. 7.33 lakh crore as of June 2017. To address the crisis, the government has announced the recapitalization of these public sector banks by infusing around Rs. 2.11 lakh crore, besides pumping in Rs. 1.35 lakh crore through recapitalization bonds [2]. The major reasons for such a condition are relaxed lending norms, inadequate contingency planning, lack of transparency and absence of bankruptcy code for systematic adjudication. The IB Code introduced in 2016 in parallel lines with USA and UK tries to resolve the pertinent problem of overlapping of jurisdiction due to the existence of multiple laws which subsequently resulted in a delay of resolution. This code tries to remove this issue and has recommended the institution of two tribunals: the National Company Law Tribunal (NCLT) for companies and limited liability partnership for firms, and the Debt Recovery Tribunal for individuals and partnerships. This paper tries to assess the NPA problem in India on the twin parameters of banking systematization and government's vigilance.

INSOLVENCY AND BANKRUPTCY CODE, 2016

India stands low on ease of doing business and insolvency because of the slow and delayed recovery time. Corporate bad debts contribute as much as 56% of total bad debts of nationalized banks. Due to lack of resolution machinery and legal institutions to deal as per global standards, it takes up 4 years on an average to wind up a company in India. All the laws like SARFAESI, etc., had not yielded desired outcomes in terms of resolving and reconstructing bad debts existing along with century-old laws on insolvency.

Considering all these aforementioned reasons, a major consolidation of all laws to bring a uniform standard legal structure to resolve the problem of NPA came in the form of insolvency and bankruptcy code coming into effect from 28 May 2016. The code has repealed the Presidency Towns Insolvency Act 1909, and Provincial Insolvency Act, 1920. It has also amended 11 legislations including SARFAESI 2002, LLP Act 2008, Companies Act 2013, etc.[3]. To further clarify all the complexities, the code will be deemed to have an overriding effect over all other laws; also no civil court or authority shall have any jurisdiction or injunction granting power.

More than a year has passed since the code came into effect and the impact has been widely felt across, albeit initial proceedings were slow as only 38 companies [4] were undergoing corporate insolvency resolution process (CIRP) but soon the RBI directed the banks to initiate proceedings under the code against 12 large companies [5] (Dirty Dozen). RBI also issued a general circular [5] to banks to provide for a resolution plan as soon as there is a default on any account that is to be implemented latest within 6 months failing which the borrower shall be referred to the court within 15 days. It has been reported that around 461 companies have been subjected to CIRP under the code as of December 2017 [6].

DEBT RECOVERY MECHANISM UNDER IB CODE

Corporate Debtors

For corporate debtors, it is a two-stage process. For initiation, the default should be of at least Rs. 100,000 to Rs. 10,000,000.

The Insolvency Resolution Process (IRP)

Any financial/operational creditor can initiate IPR at NCLT (National Company Law Tribunal). Voluntary initiation can also be undertaken for insolvency proceedings. After this, moratorium shall be ordered on debtor's operations, this is known as the 'calm period'. Basically here the viability of the business shall be assessed to look for options of rescue and revival.

Then an insolvency professional shall be appointed by NCLT who will take over the management and operate the business as a going concern. Therefore, the thrust of the code is to allow a shift of control from the defaulting debtor's management to its creditors, where the creditors drive the business of the debtor with the resolution professional acting as their agent [6]. After this, a creditors' committee shall be appointed that can propose a revival plan or liquidation within a period of 180 days.

The Liquidation Process (LP)

Under the code, a corporate debtor may be put into liquidation in the following scenarios:

i. if 75% majority of the creditors' committee so formed wants to go for liquidation.
ii. if the committee fails to approve of the resolution plan within 180 days.
iii. if the NCLT rejects the submitted resolution plan on technical inefficiencies. Then NCLT shall pass an order.

Insolvency Resolution Process for Individuals/Unlimited Partnerships

The minimum amount for default is Rs. 1000. Two possible ways are:

Automatic Fresh Start: Here eligible debtors can apply to DRT Debt Recovery Tribunal) for discharging certain debts up to a certain limit.

Insolvency Resolution: Here there is a preparation of repayment plan by debtors; if approved, DRT will pass an order and if rejected, they may apply for a bankruptcy order [7]

ANALYSIS OF EXISTING DEBT RECOVERY MECHANISMS

There existed many recovery channels even before IB code was introduced. These mainly include the DRT, Lok Adalat, and SARFAESI Act. Here is the statistical analysis of how successful these recovery courses have been in a span of 6 years.

Debt Recovery Tribunals (DRTs) – 1993

The number of cases reported to DRT has increased from 3728 in 2008 to 28,258 in 2014.

The amount involved has also shown a steep rise from Rs. 5819 crore in 2008 to Rs. 55,300 crore in 2014, but unlike Lok Adalat they have shown their efficiency especially when they were able to recover 81.1% amount of the total claimed amount in 2008-9 and this basically forms the core reason why the commercial banks like to approach DRT instead of Lok Adalats, which are struggling to even cross the 10% mark of claim recovery. Though there is a slight decrease in the amount recovered in the recent years by the DRT, still it manages to maintain its significance [8].

Lok Adalats – 2001

They are helpful in tackling and recovery of small loans; however, they are limited up to 5 lakh rupees loans only by the RBI guidelines issued in 2001. They are positive in the sense that they avoid more cases into the legal system.

During a study, it was found that Lok Adalats were able to recover Rs. 1400 crore out of Rs. 23,200 crore which amounts to only 6.2% of the total amount of the NPAs present in the banking system. There was also a tremendous increase in cases reported, which were 186,535 in 2008 and 1,636,957 in 2014. Due to this inefficiency, corporations start looking for other options for recovery [9].

SARFAESI Act 2002

This has proved to be the most efficient debt recovery channel. In the time period of 6 years, Lok Adalats managed to recover 2535 crore, whereas DRT helped in recovering Rs. 27,231 crore and under SARFAESI Act Rs. 77,241 crore were recovered. As in 2015-16, the recovery percentage of Lok Adalats, DRT and SARFAESI act stands at 4.40, 9.20, and 16.50 respectively [10].

HOW IS IB CODE A REVOLUTION IN DEBT RECOVERY MECHANISMS?

- It provides for insolvency professionals and agencies to take over the control of assets during the process.
- It also provides for Insolvency Regulatory Board: This shall be created apart from NCLT and DRT to overlook the work of the IP and their agencies and information utilities. It shall have 10 members from the central government and RBI.
- There shall also be an insolvency and bankruptcy fund for the protection of immediate liquidation and pending immediate payments. The contribution is voluntary from any person.
- It also provides for two separate adjudicatory authorities, i.e., NCLT and DRT.
- The code also specifies offenses and their punishments for default under corporate and individual insolvency.

The previous Acts operating in this field had suffocated the whole system because of the overlapping of powers. This had led to confusing situations and weird procedures where there was lack of availability of a remedy. The mere fact that decisions by DRT could be reversed by a High Court on appeal made it very tedious and hopeless procedure for creditors to recover their dues [11]. Examining in this light, the new Insolvency and Bankruptcy Code 2016 has come to the rescue of such credit funders. It provides for speedy recovery and separation of powers, authority, and jurisdiction in different categories of debts. It also facilitates the workers by giving them preferential payment of dues. However, the code is silent on employment security [12]. The biggest challenge herein that arises is that how suitable this code shall prove for the Indian economy and to what an extent this code shall be able to answer the questions on increase in the NPAs in the banking system.

NPA: REASONS IMPACT AND SOLUTION

On the recommendations of the Narasimham Committee in 1992-93, RBI introduced prudential norms from where arose the concept of NPA where an asset was considered as non-performing if interest on principal amount remains unpaid for more than 180 days. This was subsequently changed on March 31, 2004, where 90 days were adopted in place of 180 days.

NPA Definition by Reserve Bank of India (RBI)

An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank.

NPA is a loan or an advance where:

- Interest and/or installment of principal remain overdue for a period of more than 90 days in respect of a term loan.
- The account remains 'out of order' in respect of an overdraft/cash credit (OD/CC).
- The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.
- The installment of principal or interest thereon remains overdue for two crop seasons for short duration crops.
- The installment of principal or interest thereon remains overdue for one crop season for long duration crops.
- The amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitization transaction undertaken in terms of guidelines on securitization dated February 1, 2006.
- In respect of derivative transactions, the overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.
- Banks should classify an account as NPA only if the interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter [13].

Assets Classification

1. Standard advances/assets, i.e., an asset which does not disclose any problem and does not carry more than normal risk attached to the business.
2. Substandard assets, i.e., an asset that has remained NPA for less than or equal to 1 year.
3. Doubtful assets, i.e., an asset that has remained as a substandard asset for 1 year
4. Loss assets, i.e., assets that have become uncollectable although there can be some recovery value.

REASONS FOR NPA IN INDIA

NPAs have to be managed to survive and grow in the Indian market because of many reasons that majorly include:

- Proper caution and diligence is not exercised before giving loans and post-disbursement inefficient monitoring are there due to which funds are used by companies other than for the purpose of taking them.
- Relaxed lending norms to big corporate houses whose financial status and credit rating remain unanalyzed. Managerial deficiencies should also be addressed and the top level of the bank management should also be held accountable and responsible to a certain extent.
- Inadequate contingency planning by banks to mitigate project risk and uncontrolled selling of unsecured loans to face competition in the banking sector.
- Public sector banks provide 80% of the credit to industries which forms the largest part of NPA contribution. Priority sector lending such as to education sector (20%), agriculture sector (10%) stands much lower than these industrial lend outs.
- Textile, aviation, infrastructure, and industries are the big players in NPA pile up and they are funded by public sector banks majorly.
- Economic slowdown of 2008 has led to the increase of bad loans as during this period public sector banks lent extensively to corporates to bring a boom in the economy but subsequently, these loans started turning into bad debts due to global slowdown and internal inefficiencies of the system.
- Crony capitalism can also be a culprit here. Under political pressure, banks are forced to lend out money to stressed sectors. Delay in several policy-making decisions due to unstable government also affected corporate performance drastically.
- Willful defaulters who are capable of repaying loans but do not do so should be recognized and loan recovery should be done as soon as possible.
- Lack of a proper bankruptcy code to deal with recovery mechanism also led to the piling up of NPA with no apparent solution.
- Accidents and natural calamities.

IMPACT OF NPAs

- Mismanagement of loan distribution by public sector bank has been the leading reason in such a piling up, which has actually weakened the bank revenue system
- As the NPA rises there will be a scarcity of funds in the market which will lead to crisis situation as the price of loans and interest rates will shoot up and this will, in turn, affect the investors who want to undertake developmental projects**.**
- Such kind of situation will affect the demand in the market which will ultimately result in lower growth rate due to the higher cost of capital [14].

RESOLUTION

General

- Regular review should be done, viable accounts should be given more finance for turnaround, and unviable accounts should be given to ARCs.
- The government should establish ARCs with a stake from government and RBI; this should work effectively in sucking out the NPAs from the banking sector allowing the banks to focus on their core area of lending.
- Credit risk management should be improved including credit appraisal, credit monitoring after analyzing trends. Sources and structure of equity capital should be analyzed giving precedence more to equity funded capital over debt capital.
- Required sensitivity analysis and contingency planning should be conducted at regular intervals to build safeguards against external factors.
- Strong credit monitoring should be developed, which has an early warning mechanism and a comprehensive MIS (management information system).
- Effective implementation of IB code 2016 to deal with such situations giving timely solutions.

Specific

There are a few steps taken by RBI:
To ease up restructuring, provisioning has been increased to 5% in the restructured standard accounts.

- Directions have been issued to give loans on the basis of CIBIL score.
- RBI has directed banks to report to Central Repository of Information on Large Credit (CRILC) when principle/interest payment is not paid between 61 and 90 days.
- Banks have also been asked to conduct sector-wise analysis.
- To make public sector banks more transparent and professional, government has also launched 'Mission Indradhanush'.
- RBI has asked banks to conduct a sector-wise/activity-wise analysis of NPA,
- SEBI has eased norms for banks to convert debt of distressed borrowers into equity.
- The government has launched 'Mission Indradhanush' to make the working of public sector banks more transparent and professional in order to curb the menace of NPA in the future.
- RBI has introduced a number of measures in last few years which include tightening the corporate debt restructuring (CDR) mechanism, setting up a Joint Lenders' Forum, prodding banks to disclose the real picture of bad loans, asking them to increase provisioning for stressed assets, introducing a 5:25 scheme where loans are to be amortized over 25 years with a refinancing option after every 5 years, and empowering them to take majority control in defaulting companies under the Strategic Debt Restructuring (SDR) scheme [15].

There are a few steps taken by the government:

- Banking regulation ordinance: It empowers RBI to initiate insolvency proceedings and also has advisory functions to tackle with the stressed assets.
- SARFAESI Act 2002: It empowers banks to auction residential or commercial properties for loan recovery with exception of agricultural land.
- Debt Recovery Acts: They have helped in establishing DRT (Debt Recovery Tribunals) for fast debt recovery.
- Strategic debt restructuring (SDR): Creditors could take over the assets of the firms and sell them to new owners.
- Public asset reconstruction agency: Proposed in the economic survey of 2016-17, also known as a bad bank, they usually assume bad loans of banks and further sell them off based on their professional know-how.

STATISTICAL ANALYSIS OF RISE IN NPAs

An ASSOCHAM-Crisil joint study shows that gross NPA in Indian banks are expected to rise to Rs. 9.5 lakh crore in March 2018 from Rs. 8 lakh crore in March 2017 whereas stressed assets are expected to be at Rs. 11.5 lakh crore. According to an analysis of 50 stressed assets (forming nearly 40% of stressed assets in the system), sectors like metal, construction, and power form nearly 30%, 25%, and 15% respectively, while other sectors together form the remaining 30% [16]. Thus the percentage increase has been from 7.6% in March 2016 to 8.5% in March 2017 to 9.3% in March 2018. In the recent quarters as per the RBI report, the profitability of PSBs has eroded, viewing which it has laid down guidelines to review the loans as a part of AQR (asset quality review). There was an almost 80% hike in bad loans during 2015-16. The QAR conducted by regulators found out a huge chunk of restructured advances to be again classified as non-performing and as a large proportion fell into NPA category the overall stressed assets ratio increased from 11.3% to 11.5% in September, and subsequent to this gross NPAs rose by 79.7% year to year in March 2016. The net NPA had also seen a rise from 2.8% in September 2015 to 4.6% in March 2016, it was 6.1% in PSBs whereas 4.6% in private sector banks [17]. In 2015-16 NPAs were 3% of the gross advances in 2013 which grew over to 9.3% in 2016 with a wide disparity in public and private sector banks where there was a rise from 2.9% to 13.8% and from 2% to 3.1% respectively for a period of 3 years ending 2016. Talking about the gravity of the situation, nearly 10% of all loans are classified as NPA which amounts to Rs. 7 lakh crore. It increases to 15–20% when restructured and unrecognized assets are added. Gross NPA rose from 9.2% in September 2016 to 9.6% in March 2017. The net non-performing advances ratio also increased from 5.5% to 5.4% in a quarter in 2016. The total amount of GNPAs as of March 2017 was estimated to be Rs. 11 lakh crore. The IAC (The internal advisory committee) of RBI identified 12 accounts with over Rs. 5 crore of loan outstanding accounting for nearly 25% of the NPAs, these accounts qualify for immediate reference under IB Code.

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