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Key Developments under the Indian Insolvency Regime - Insolvency and Bankruptcy Code

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Overview:

Historically, insolvency resolution in India has been an arduous, complex and long drawn process. India is currently ranked 103rd globally in insolvency resolution with a typical insolvency case taking up to four years. While several schemes / mechanisms have been in existence to assist recovery and / or restructuring of distressed assets, for a variety of reasons, they have met with limited success. Overhauling the insolvency regime had, therefore, become the need of the hour.

The Insolvency and Bankruptcy Code, 2016 (the ***Code***), which was approved by both houses of Parliament in May 2016, replaced and consolidated a number of scattered and archaic insolvency provisions. It has sought to create a comprehensive framework dealing with the insolvency of companies, firms and individuals and has been implemented in a staggered manner over the last 18 months.

This note seeks to briefly summarize the key developments under the Indian insolvency regime so far.

Significant Changes Brought Under the Code:

By way of recap, the Code has brought about the following salient changes in the Indian insolvency regime:

- Fixed timelines have been set out under the Code to complete the insolvency resolution process;
- Exclusive jurisdiction has been vested with the National Company Law Tribunal (***NCLT***) for matters relating to corporate insolvency;
- Creditors have been put in control of the insolvency resolution process; and
- The payment of dues owed to secured creditors has been prioritized over the payment of dues owed to the Government (which is a significant departure from the distribution waterfall that existed under the previous insolvency regime).

Evolution of the Insolvency Regime under the Code:

The biggest flaws with the erstwhile corporate insolvency process were the inordinate delays associated with liquidating a company and the absence of a specialized adjudicating authority. A fixed time frame for every stage of the insolvency process has been specified. The Code requires the NCLT to admit or reject an application for initiating a resolution process within 14 days. In addition, it also imposes an outer limit of 270 days (which consists of an initial period of 180 days with a one-time extension of 90 days) to complete the resolution process. A resolution plan can be undertaken by way of a share sale, asset sale or a merger of the stressed entity with the acquirer – though it remains to be seen which alternative emerges to be the most preferred option. If the resolution plan is not agreed to by at least 75% of the financial creditors in value, the plan is required to be rejected by the NCLT[1] or if the plan, once approved, is not implemented in accordance with its terms, the NCLT can require the commencement of liquidation proceedings. The Code imposes an obligation on the liquidator to complete the liquidation process within a period of 2 years, but leaves scope for the liquidator to seek an extension.

Following the implementation of the Code, the Reserve Bank of India (the ***RBI***), India's central bank, had recommended certain banks to initiate corporate insolvency process against 12 companies whose loans aggregated to around 25% of the gross non-performing assets of the Indian banking system. Insolvency professionals have been appointed in 11 of these cases and proceedings are still ongoing. The RBI has recently sent a list of another 26 companies to banks for the purposes of initiation of corporate insolvency process.

Recent reports seem to suggest that around 400 cases in total have been referred to the NCLT in 2017 under the Code. A majority of these have been filed by operational creditors with 150 cases having been filed by financial creditors. 2 companies have already been taken up for resolution and 7 have been directed to undergo liquidation. As a departure from the usual practice adopted by Indian judicial authorities, the NCLT has permitted extensions or interim relief only sparingly. The fact that the jurisdiction of civil courts has expressly been barred has been an enabling factor in respect of adherence to timelines.

In an attempt to tighten the framework of the resolution process, the Government had passed an ordinance amending the Code. The ordinance barred certain persons who had guaranteed the debt of any firm undergoing insolvency proceedings, or who were in control of such a firm, from submitting resolution plans.

A plain reading of the ordinance suggested that all promoters (and certain persons connected to such promoters) whose companies were undergoing insolvency proceedings in any part of the world would be ineligible to bid under a corporate insolvency process being conducted pursuant to the Code. This ordinance is, however, proposed to be replaced by a bill that seeks to amend the Code in a more thoughtful manner. At the time of writing, the bill has been approved by both houses of the Parliament and is awaiting Presidential assent. Narrowing the scope of the circumstances of ineligibility, the amendment bill has attempted to strike a balance between punishing defaulters and maintaining the credibility of the insolvency resolution process under the Code – defaulting owners will be given an opportunity to participate in the bidding process if they manage to make payments of overdue amounts within a period of up to 30 days of being requested to do so by the committee of creditors.

[1] This threshold under the Code needs to be clarified as two benches of the NCLT have adopted opposing views. One bench has taken the view that it is empowered under the Code to approve a resolution plan that has been agreed to by less than 75% of the financial creditors in value. This is based on the interpretation that the threshold set out under the Code is recommendatory rather than mandatory and accordingly, the NCLT can exercise its discretion when it comes to approving resolution plans that do not have the support of 75% of the financial creditors in value. Another bench has taken the view that the majority requirement under the Code is sacrosanct as it is beyond the NCLT's jurisdiction to approve a resolution plan that has been agreed to by less than the prescribed percentage of the financial creditors in value.

Other Regulatory Changes Supplementing the Code:

Recently, the Government has made the following efforts to supplement the Code as part of the broader overhaul of resolution of distressed debt:

- Asset reconstruction companies (***ARCs***) are intended to perform a significant role in developing the market for distressed assets and securitization in India. To that end, restrictions on foreign investment in ARCs were removed in May 2016 with 100% foreign investment now permissible[2]. Foreign investors have now also been permitted to hold up to 85% of each tranche of security receipts issued by an ARC and the prohibition on the "sponsor" of an ARC from holding more than 50% in an ARC has been done away with. Plans to introduce listing and trading of security receipts on stock exchanges are being considered, but the fine print on this is yet to be issued. If implemented, this move could improve the depth of, and liquidity in, the securitization industry.

- As an example of the RBI requiring public sector banks to "clean up" their books, the RBI has restricted the simple swapping of their distressed assets into security receipts issued by ARCs. Previously, an Indian bank which had an investment of more than 50% in security receipts issued by an ARC in respect of its own debt had to make a provision against these investments in its books. From 1 April 2018, however, this threshold of 50% is proposed to be reduced to 10%. This development is likely to generate a lucrative secondary market for these security receipts. Eligible foreign investors can use this opportunity to enter the Indian market for distressed assets by acquiring security receipts that are likely to be offloaded by banks.

- Further streamlining is afloat in connection with obligations under the Takeover Code (in the case of listed companies) and the availability of exemptions under tax and antitrust law which could significantly assist the M&A activity that will be a likely result of the roll out of the Code.

What Needs to Be Done?

While various steps have been taken to incentivize foreign investment in ARCs, more effort needs to be made to attract foreign investment.

- Under the existing regime, the shareholding threshold for an investor to be deemed a sponsor of an ARC continues to remain 10% of the share capital of an ARC. Given that certain responsibilities and liabilities for the operations of ARCs are imposed on sponsors, efforts are being made by certain industry participants to have the Government increase this threshold to 26% to facilitate fund raising by ARCs.

- Current regulations only permit ARCs to conduct the business of asset reconstruction and securitization (both of which exclude lending to, or investment in, distressed firms). Hence, it seems that ARCs are also keen that the regulatory regime be amended to allow them to lend to, and invest in shares of, distressed firms. The ability of an ARC to lend could also galvanize the provision of interim financing during the insolvency resolution process.

- A potential grey area for financial investors could arise in connection with the treatment of convertible instruments in companies that are now distressed. Will these instruments allow the financial investor to claim as a financial creditor or will these be treated as equity?

[2] KKR & Co has recently received RBI's nod to commence operations as India's first wholly foreign owned ARC.

Timely resolution of defaults and effective debt recovery are important in generating investor confidence. The statutory and regulatory steps taken in the last year or so demonstrate the seriousness of the Government to tackle these long standing issues head on. It remains to be seen whether the regime is resilient enough to withstand the numerous pitfalls that the system is likely to throw up.

We are closely monitoring developments regarding this and if you would like any further information, we would be happy to assist.

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