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Key Developments under the Indian Insolvency Regime

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The Supreme Court of India recently passed an order striking down a circular that was issued by the Reserve Bank of India (the ***RBI***) in February last year (the ***Circular***). The Circular was aimed at getting lending banks and financial institutions to proactively identify and manage stressed assets in a time bound manner, failing which the asset was required to be referred for insolvency resolution. The Supreme Court held the Circular to be unconstitutional, simply because it went outside the remit of what the law permitted the RBI to do. A case in point of an Indian regulator taking an initiative that could not withstand the test of judicial scrutiny!

The RBI Circular

Historically, insolvency resolution in India was an arduous, complex and long drawn process. Whilst several schemes / mechanisms were in existence to assist recovery and / or restructuring of stressed assets, for a variety of reasons, they had met with limited success. With a view to overhauling the insolvency regime, in 2016, a new law, i.e. the Insolvency and Bankruptcy Code, 2016 (the ***IBC***) was brought into effect.

In keeping with the spirit of the IBC and with an eye to bolster the resolution process for stressed assets further, the RBI, on 12 February 2018, through the Circular directed lending banks to consider all companies which default on loans or interest payments, even for a day, as defaulters. The Circular further directed banks to initiate insolvency proceedings under the IBC against companies with loans above INR 20 billion that have been in default for over 180 days.

Further, through the Circular, the various schemes / mechanisms that had been issued by the RBI to deal with stressed assets were abolished. In summary, banks were left with the route under the IBC as the sole remedy for assets that could not be resolved within the prescribed 180 day timeline.

The Circular struck directly at the decades old practice of “ever-greening” of loans by Indian banks, and left them with no choice but to pursue resolution under the IBC against these big companies.

The Circular stirred a hornet’s nest with the Government as well as with banks and corporates. From the perspective of the Government, referring an additional gamut of assets to the National Company Law Tribunal (the relevant tribunal for dealing with insolvency cases under the IBC, the ***NCLT***) pursuant to the Circular meant a potential unmasking of the loopholes in the IBC – which was hailed as a “game-changing”

legislation introduced by the current dispensation – something that it wanted to avoid. Whilst not specifically spelt out, stemming from this a new regime called "Project Sashakt" was introduced by the Government in conjunction with a few public sector banks to provide banks with a "self-help" mechanism to deal with large stressed assets before those are mandatorily referred under the IBC pursuant to the Circular. It remains a different tale that no significant assets have so far been resolved under the aegis of Project Sashakt. Moreover, some also viewed the Circular as one of the major reasons for the stand-off between the previous RBI governor and the Government which ultimately led to the governor's untimely exit.

The banks' concerns were centered primarily on the exposure of the value of the feigned assets in their books, and their resultant classification as "non-performing" due to the stringent regime specified under the Circular. The fact that ever-greening of such assets was not possible any longer added to their woes.

Most affected were promoters of defaulting companies. Their key concern was that they had to cede control whereas earlier they could have just worked hand in glove with the banks to postpose calling of a default. Companies in battered sectors such as power, shipping and sugar, which constituted the majority of the debt impacted due to the Circular, claimed that the crisis in these sectors was attributable to external factors which will need structural and regulatory reforms to be remedied. Referring these companies under the IBC will likely push them into liquidation. These companies, therefore, challenged the Circular in various courts, and in some cases sought an exemption from the applicability of the Circular. All these cases were ultimately consolidated and transferred to the Supreme Court.

The Supreme Court ruling

The Supreme Court gave its order on these cases on 2 April 2019 whereby it struck down the Circular on the basis that the RBI had acted beyond its powers while issuing the Circular. Whilst endorsing the RBI's power to issue directions generally in relation to stressed assets, the court said that the RBI can direct banks to initiate proceedings under the IBC only: (a) after obtaining prior authorization of the Government; and (b) in respect of specific defaults. Although the Government had, through an order in May 2017, authorized the RBI to direct banks to initiate proceedings under the IBC, such authorization was read by the Supreme Court as having been given (in line with (b)) only for specific defaults by specific companies. The Circular, to the contrary, was held to be in the nature of an omnibus direction to banks on how to deal with defaulting companies with loans above INR 20 billion.

The Supreme Court further said that all actions taken by banks so far in terms of the Circular, including triggering of proceedings under the IBC, must fall along with the Circular. However, there will be no impact on the 12 companies (popularly known as the "dirty dozen") and, thereafter, the additional 29 companies, which were specifically directed by the RBI in 2017 to be taken to the NCLT. These companies, in aggregate, contributed to around 65 per cent. of the distressed assets in the system.

Analysis of the ruling

The order is a rare instance of intervention by the Supreme Court in matters of economic policy – it usually adopts a "hands-off" approach in such cases.

The order is being hailed by the power sector (and borrowers in other sectors alike). With the threat of IBC proceedings mitigated, the power sector expects to get flexibility to restructure their debts. However, the question is was it possible to deal with the issues of this sector in a bespoke manner rather than upending all that had happened since February last year? A number of cases which were referred to the NCLT under the Circular had already reached various stages of resolution. In addition, studies showed that the Circular had at least a salutary effect on borrowers' behaviour.

Since the introduction of the Circular, there was a steady drop in the number of defaults in loans as well as interest payments. Equally, banks were

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driven to resolve stress more quickly. A prime example is the Jet Airways case where a resolution plan was put in place, and also implemented to some extent, by banks within a period of under three months.

Whilst fears that the clock may turn back to the era of ever- greening and consequent piling up of stressed assets may be exaggerated, lending banks may not now be incentivized to deal with the stressed asset problem head-on. The quashing of the IBC proceedings initiated under the Circular will mean that defaulting borrowers will take the banks back to the drawing board to etch out resolution plans. Those defaulters whose cases had still not been referred under the IBC will try every trick in their closet to reach some sort of "resolution" with the banks. Although the Supreme Court has said that the banks will continue to have the option to refer defaulting borrowers to the IBC in case a resolution plan fails, there may well be no real imperative for banks to do so now.

There are also some other open issues around the Supreme Court's order which require clarification. It is unclear from the order if the various schemes / mechanisms for resolution of stressed assets which were in existence prior to the Circular have now automatically been re-instated for use by banks? Also, the Circular contained a number of provisions other than the mandatory referral to IBC – most important being the provision which provided that all companies which default on loans or interest payments even for a day should be considered as defaulters – it is unclear if those provisions have also been struck down (though it seems that until any clarification is issued in relation to this aspect, the safer view would be that the entire Circular has been struck down)?

All eyes are now on the RBI to see how it proposes to deal with the stressed asset problem, and with the uncertainties around the Supreme Court order. The RBI governor (seemingly more pliant than his predecessor!), while announcing the monetary policy recently, indicated that the RBI remains committed to enhance the resolution of stressed assets in spite of this setback and that it will soon issue revised circulars in compliance with the Supreme Court order.

We would expect the RBI to now announce something only after prior consultation with the Government. However, with general elections around the corner, it is not clear where this issue lies on the list of priority for the Government.

Some points to take back

Given the significance that has been bestowed on the IBC for dealing with the stressed asset problem in the Indian system, no dilution in its scope or effect is expected in the medium to long run. To the contrary, all authorities – be it the Government, the RBI and even courts – have so far been, and are expected to continue to, uphold the primacy of IBC.

In addition, RBI's powers to issue directions to deal with stressed assets have also been upheld by the Supreme Court. All the court has done, in effect, is to highlight to the RBI that such directions should be issued within the four corners of the law. The Circular has been struck down, not for any substantive reasons, but purely on technical grounds.

Be that as it may, the order could potentially have the result of further delaying resolution of stressed assets. Therefore, the key question to consider in all of this is why did the RBI not get it "right" the first time itself? It is not unusual in the Indian context for regulators to issue policies which are broader in their scope than the mandate of the regulator, thereby making such policies susceptible to legal challenge. Further, policies are often issued on a "trial and error" basis.

The policy around foreign investment in the e-commerce sector is a telling recent example. Though issued after much deliberation, the policy was not able to achieve its objectives and it was only after a couple of years and following significant levels of foreign investment in the sector that a "clarification" was issued which, in effect, significantly altered the regime. But, as it is often said, this forms part of the wider risk around investing in India.

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

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