Indian Bankruptcy Regime – 2019 Year in Review

By **NALLINI PURI** *and* **SURYA KIRAN BANERJEE**

The (Indian) Insolvency and Bankruptcy Code, 2016, which overhauled a patchwork of disparate laws and judicial fora to establish a single law and single court system to hear bankruptcy cases promised to effect a much needed clean-up of India's ailing financial system. Banks' balance sheets were stressed with non-performing loans owing to a practice of 'ever-greening' of loan accounts by largely state-owned banks that were either sympathetic to promoter-owned businesses, or beholden to them owing to the absence of effective legal remedies.

As discussed in Issue 8 of the journal, the provisions of the Code departed so fundamentally from the preceding regime that the Code was met with resistance from various quarters, including operational creditors wanting to be treated on par with financial creditors, unsecured creditors who wanted security granted to secured creditors to be partially or completely ignored, and most importantly, the existing controlling shareholders of defaulting entities who faced the prospect of losing businesses that were in their families for generations.

This article aims to briefly discuss two of the most significant developments in bankruptcy law and practice in India in 2019, setting out the opportunities and challenges that lie ahead.

Essar/ArcelorMittal – A Landmark Judgment

The insolvency of Essar Steel, a large Indian steel producer, involved a number of bidders competing to acquire Essar Steel's plants in India. The 27 month process, significantly longer than the 6-9 month time period prescribed under the Code, exposed a number of lacunae in the Code, resulting in challenges by bidders, dissenting financial creditors, operational creditors and the controlling shareholders of Essar Steel. Several amendments were made to the Code during the process to plug gaps uncovered in the process.

In its long-awaited judgment approving the US$6 billion acquisition of Essar Steel by ArcelorMittal, the Supreme Court of India in November 2019 upheld key principles of bankruptcy resolution, bringing the Indian bankruptcy regime in line with those of major global economies. The key takeaway is that the court gave legal backing to the commercial realities of financing transactions, and resolved points of law that we expect will materially speed up resolution processes going forward – though the broader issue of overall case timelines, discussed below, remains an issue.

Standard of Review by the Courts – Primacy of the Financial Creditors' Committee

The first point of law that the court resolved is the role of the courts in reviewing resolution plans proposed by the committee of financial creditors that is tasked with controlling the resolution process. The court limited the scope of its review to checking for legal and procedural compliance – including in respect of the requirements that the creditors' committee take into account the desirability of the distressed entity continuing as a going concern, that they attempt to maximize the value of the distressed entity's assets and that they consider the interests of all stakeholders (including operational creditors) in arriving at the resolution plan. In refusing to undertake a substantive in-depth review of the merits of the commercial decisions made by the committee of creditors, the court has confirmed that the committee of financial creditors does genuinely control the process as contemplated by the Code. The court also included a direction to lower courts to similarly limit their review. This is useful seeing as lower courts have struggled to reconcile the overarching theme of financial creditor control under the Code with what they view as a conflicting requirement of due process as regards the rights of other creditors/stakeholders, resulting in a more detailed judicial review than is commercially expedient.

Creditor Classes

The court rejected the argument that all creditors be treated equally, upholding the rule of priority. The court held that creditors that were not similarly situated were not entitled to receive the same amount or percentage of resolution proceeds. A caveat to this remains in place - dissenting financial creditors and operational creditors must receive at least the amount they would have received in a liquidation of the distressed entity.

The court observed that treating creditors equally would perversely incentivise secured creditors to vote for liquidation, a process in which a strict waterfall would be followed. The court also sought to distinguish between operational and financial creditors with reference to their role in the broader economy, commenting that refusing to respect the primacy of financial creditors would destabilize the banking system and that operational creditors should instead seek to limit their exposure to any particular entity by, for example, agreeing stricter payments or by halting supplies.

The takeaway is that the creditor committee is now largely free to determine the allocation of recovered funds amongst the different classes of creditors and to have regard to the security held by any particular creditor. Given past experience with the Code, we would expect that the question of whether the safeguards have been complied with will be litigated by operational creditors and other stakeholders, resulting in certain delays. The court has sought to limit this possibility by restricting any remedy it can grant in any such litigation to requiring the committee of creditors to revisit the issue.

Maximum Time Period for Resolution

The court struck down the mandatory requirement under the Code, introduced by an amendment in August 2019, to complete all resolution proceedings within 330 days of filing (including extensions and the time taken in legal proceedings). The court held that the time limit was an unreasonable restriction on the parties' fundamental right to carry on business guaranteed by the Indian constitution. Instead, the court has allowed extensions beyond 330 days to be granted in exceptional cases where, broadly speaking, the timeline could not be met because of delays occasioned by the court itself. While it is correct that a litigant should not be prejudiced due to constraints on the capacity of the courts, the ruling is likely to prolong insolvency proceedings well beyond the 330 day cap absent significant investment in court infrastructure in India. A side note – the delay in the ArcelorMittal/Essar case was largely due to court constraints.

PEFORMANCE TILL DATE

2,542
insolvency proceedings initiated under the Code from 1 December 2016 to 30 September 2019, with a general upward trajectory in the number of new cases initiated each quarter (369 in Q3 of 2019).

116
cases have been withdrawn following settlements with creditors.

Of the 1,497 pending cases,
535
cases have been pending for more than 270 days.

156
cases (14.93% of closed cases) have resulted in approved resolution plans, with financial creditors recovering 41.53% of the value of their claims or 183.9% of the liquidation value of the debtor.

587
cases (56.17% of closed cases) have ended in liquidation orders. The data is skewed as a majority of these cases involved small entities, in respect of which no resolution plan was submitted for the court's consideration.

The average time taken to resolve the 156 resolved cases was
374 days
300 days if the matter ended in liquidation.

Source: Insolvency and Bankruptcy Board of India, Insolvency and Bankruptcy News, Vol 12, p. 14 (July-September 2019).

Insolvency of Financial Services Providers

An important lacuna in the Code was the absence of a framework to resolve distressed situations involving financial services providers such as non-bank finance providers, insurance companies, and pension and mutual funds (or to manage their liquidation if a resolution is not feasible). High-profile distress situations involving IL&FS (a non-bank finance provider) and Dewan Housing Finance Corporation, which saw a lack of coordination amongst creditors and a multiplicity of proceedings, highlighted the issues posed by the absence of a coherent resolution framework for financial services providers. In response, the Indian government introduced temporary rules in November 2019 to govern such situations. The rules are a stop-gap measure until a comprehensive framework is put in place.

Broadly speaking, the rules apply the Code as-is to financial services providers, with some modifications if the distressed entity is a systemically important non-banking finance company. The modifications contemplate a more involved role for the appropriate financial sector regulator. For example, an insolvency resolution process in respect of systemically important non-banking finance companies can only be initiated by India's central bank, the Reserve Bank of India (as opposed to financial or operational creditors). Interestingly, the low payment default threshold for initiating insolvency proceedings remains the same – though in recognition of the systemic importance of the debtor and the fact that the Reserve Bank initiates proceedings, a moratorium becomes available immediately upon the filing of the petition (instead of when it is admitted by the court).

The rules contemplate that the Reserve Bank will influence the administration of the debtor during the resolution process through an administrator proposed by it, who may be assisted by an advisory committee of three or more experts constituted by the Reserve Bank. The Reserve Bank will also play a role in selecting the resolution applicant to whom the restructured business will be transferred - the resolution applicant must demonstrate that it is a 'fit and proper person' that will able to conduct the business following resolution. The approval of the committee of creditors is still required for a resolution plan to be approved.

Importantly, given a recent court decision failing to distinguish between assets of a financial services provider and those held by it on a pass-through basis, the rules exclude third party assets in the custody of the financial services provider from any moratorium during the pendency of insolvency proceedings. The consent of the Reserve Bank will also be required before voluntary liquidation proceedings are commenced.

While the rules are a step in the right direction, a lot will depend on the contours of the comprehensive framework that replaces the rules, as well as on how it is implemented in practice. The approach of the regulators tasked with overseeing insolvency proceedings relating to financial services providers will be key.

Continuing Gaps in the Legal Framework

As discussed in Issue 8 of the journal, there are gaps in the Code as compared to the bankruptcy regimes in developed economies such as the U.S., the U.K. and the E.U., which lead to uncertainty on how individual cases will be dealt with under the Code.

For instance, a comprehensive framework for cross-border insolvency based on the UNCITRAL Model Law on Cross-Border Insolvency, proposed by the Insolvency Law Committee in October 2018, remains to be notified. The Code currently requires the Indian government to enter into bilateral arrangements with other governments to govern cross-border insolvencies involving the respective jurisdictions. This is administratively cumbersome and difficult to achieve in practice – as a result of which no such arrangements have been entered into till date. This led to complications in the high profile insolvency of Jet Airways, a struggling Indian airline, that was subject to simultaneous Dutch and Indian insolvency proceedings in 2019. The insolvency court glossed over the lack of a binding legal framework by approving a 'Cross-Border Insolvency Protocol', negotiated between the Indian resolution professional appointed under the Code and the Dutch trustee, to govern the mode and extent of cooperation between the two insolvency professionals. As the protocol has no basis in law, it is unclear whether it sets a precedent to govern subsequent cross-border insolvencies. It is likely open to higher courts to refuse to recognize overseas

insolvency proceedings in the absence of enabling Indian law – as the court of first instance did in the case of Jet Airways. Given this uncertainty, it is important for investors looking to invest in Indian debt to game out potential scenarios if the debt is governed by foreign law or if the assets of the debtor against which recourse will be sought in the event of a default are located outside India.

Another gap in the Code is the lack of provisions dealing with group insolvencies. The insolvency regime prescribed by the Code is entity specific and does not contemplate group insolvency scenarios. This came into focus when several Videocon entities were simultaneously subject to insolvency proceedings. On a petition filed by a lender, the court ordered the consolidation of insolvency proceedings relating to 13 Videocon entities on the basis that they had common control, directors, assets and liabilities, creditors and debtors, financing arrangements, and were otherwise interdependent and were in essence a single economic unit. The court noted that these entities were so inextricably linked that a consolidated insolvency process would result in value maximization. The court also noted that a failure to consolidate proceedings would render the possibility of restructuring (or the maximization of value in such restructuring) bleak, which outcome outweighed any downsides of consolidation. Proceedings relating to two other Videocon group entities were not consolidated despite having common financing arrangements on the basis that their assets and liabilities could be separately identified. The key takeaway is that the precise test applied by the court is unclear. As with cross-border insolvency, the court's approach in the Videocon case is problematic as it is not based on the Code – and therefore remains open to challenge.

The Insolvency and Bankruptcy Board of India has set up a committee to propose amendments to the Code to provide for group insolvencies. The committee has based its proposals on E.U. and U.S. law, but the proposals are preliminary in nature. Of interest to lenders is that, in addition to providing for cooperation between the insolvency professionals of different group entities, the committee has also proposed a consolidation of insolvency proceedings – which may result in the subordination of the claims of creditors of certain group entities. Separately, the provisions relating to group insolvency are not expected to cover cross-border groups – so that may remain an area of uncertainty even after the cross-border and group insolvency rules are notified.

The unavailability of pre-packs under the Code has also resulted in value leakage. Again, the Indian government is looking at this, but is yet to notify the relevant rules. In the interim, banks have been directed by the Reserve Bank of India to enter into inter-creditor agreements to give effect

to restructuring outside of Code proceedings. Subject to certain conditions being met, this can be binding on dissenting creditors.

Opportunities

Perhaps the most significant opportunity in the distressed debt space in India in the coming years has resulted from arguably the biggest setback to the Code. In April 2019, the Supreme Court of India struck down as unduly broad a circular of the Reserve Bank of India that compelled India's largest banks to initiate bankruptcy proceedings against defaulting debtors. The Reserve Bank subsequently issued a revised direction to banks requiring them to resolve distress within a specified timeframe, failing which banks must either refer the account to Code proceedings or make enhanced provisions against the debt on their balance sheets.

Banks, keen to avoid the additional provisioning requirement but reluctant to commence insolvency proceedings owing to the practical difficulties and delays associated with such proceedings, have opted instead to sell their exposure to the debt to third parties. This has led to the creation of a robust secondary market in debt, both in respect of borrowers in the shadow of insolvency and those already subject to Code proceedings. This should be a potential area of interest for investors looking at India.

There also continue to be opportunities for creditors looking to extend interim finance to distressed borrowers. This is because distressed borrowers are likely to find it challenging to obtain funding on commercially acceptable terms from banks (who are discouraged from providing this funding by India's central bank).

Overall, there are several areas in which there is still considerable uncertainty as to what the law is, how it will be applied in particular circumstances and how long the process will take, and investors should therefore exercise caution and obtain appropriate advice before investing. However, the developments in 2019 are encouraging in that they reflect a growing trend of amendments aimed at converging Indian insolvency law with the practice in developed jurisdictions, a trend that will undoubtedly increase the attractiveness of the opportunities in India. ■

▼ **Nallini Puri** is a partner based in Cleary Gottlieb's London office. Nallini's practice focuses on mergers and acquisitions, with a focus on the Emerging Markets in general, and India in particular. Having lived, studied and worked at a leading law firm in India prior to joining Cleary Gottlieb, Nallini has a deep understanding of the Indian market, the regulatory regime and the issues associated with doing deals in India. She has advised various corporate clients and private equity funds on cross-border investments, including in India. Nallini joined Cleary Gottlieb in 2008 and became a partner in 2018.

▼ **Surya Kiran Banerjee** is an associate in Cleary Gottlieb's London office, and his practice focuses on cross-border M&A, private equity and restructuring transactions. He has acted for clients across Europe, Asia and the Americas, and has significant experience on transactions involving India.

Surya joined Cleary Gottlieb in 2017, having previously worked at a leading law firm in India. He received a Master in Law and Finance degree from the University of Oxford, and a law degree from the National Law School of India University.