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Resetting Insolvency and Bankruptcy Code

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This article is based on **“Reset the Code”** that was published in The Indian Express on 20/11/2019. It talks about the Supreme Court judgement on Essar Steel’s bankruptcy and reasons why companies are turning away from Insolvency and Bankruptcy Code.

Recently, the Supreme Court of India gave a **judgement on Essar Steel’s bankruptcy**. The judgement has brought the rigour and momentum back into the **Insolvency and Bankruptcy Code (IBC)** as an effective tool to deal with stressed assets in the economy.

The verdict has clarified on important aspects of insolvency resolution that had been interpreted in a variedly by the **National Company Law Tribunal** and **National Company Law Appellate Tribunal (NCLAT)**.

However, there is growing scepticism against IBC, that is making companies resolve the bigger cases outside the IBC process.

What is the judgement?

- SC has upheld the **primacy of financial creditors over operational creditors** in the repayments waterfall (in the event of liquidation of assets under IBC).
 - Financial creditors provide capital to an enterprise and their **interests are secured** in the form of collaterals on the firm’s assets.
 - Operational creditors are the main suppliers of goods and services (**unsecured creditors**).
 - SC held that operational creditors cannot claim equality or precedence over financial creditors.
- SC held that **Committee of Creditors (CoC) is supreme** when it comes to deciding on commercial issues, including the repayment waterfall, in an insolvency resolution.
 - The NCLAT sought to acquire the role of the Committee of Creditors (CoC) in an insolvency resolution.
 - Since CoC represents the lenders to the companies, therefore its interest will be of prime importance in resolution of a bad loan.

- These two clarifications should alone help in **quickening a number of other cases**, that are stuck in the insolvency courts across the country.

In spite of these clarifications, many creditors companies seek to bypass the IBC process.

Several factors have prompted this shift.

- **Delay in IBC:** Time-bound resolution process was one of the most appealing aspects of IBC. However, **delays** create little incentive for stakeholders to opt for this process. Out of nearly 1,500 cases that are currently going through the resolution process, 36% have crossed 270 days, while another 22% have crossed 180 days.
- **Low Recovery rate:** Barring a few cases, the recovery rates in IBC have not have been on expected lines.
 - The recovery rates under SARFAESI averaged around 33 %. In comparison, the recovery rate under IBC currently stands at 41 %.
 - However, the higher recovery rates are driven partly by the resolution of steel companies during a period that coincided with high global steel prices. Excluding steel, companies would significantly lower the recovery rates.
 - Also, recovery rates tend to be pro-cyclical (during high economic growth phases, businesses tend to be inclined to bid more for assets as expectations for higher returns).
 - Due to slowing Indian economy, not only recovery rates were low in the cases resolved, but more than half of the cases closed so far have ended up in liquidation as there have been no buyers.
 - Thus, there is little incentive to resolve bad loans through IBC.
- **Administrative hurdle:** Instances such as the enforcement directorate attaching property also make recovery process under IBC unprofitable.

Way Forward

- The provisioning norms for bad loans should be made more stringent to ensure banks have strong incentives to take companies through this process.

Provisioning is done to cover risk: Banks set aside money from profits to compensate a probable loss caused on **lending a loan**.
- There is a need for **clarity on the role of promoters**. As long as they are not willful defaulters and don't attract any other related disqualification, should be allowed to bid for their companies.
- The **strategy (Project Sashakt) proposed by Sunil Mehta Committee** to resolve the bad loans must be implemented in letter and spirit.

Project Sashakt was launched on the recommendations of **Sunil Mehta Committee**.

- Under the scheme, bad loans of up to ₹ 50 crores are required to be resolved within 90 days by the bank.

- For loans of ₹ 50-500 crore, banks will have to enter into an intercreditor agreement, authorizing the lead bank to implement a resolution plan within 180 days, which includes appointing turnaround specialists.
If the lead bank does not complete the process in time, the asset would be referred to the NCLT.
- For loans above ₹ 500 crores, the committee has recommended setting up an independent asset management company (AMC), supported by institutional funding or an alternative investment fund (AIF)

Addressing these issues would go a long way in ensuring that IBC is the preferred option for dealing with bad loans rather than being the last resort.

Drishti Mains Question

In spite of clarifications on Insolvency and Bankruptcy Code by the Supreme Court of India, many creditor companies seek to bypass the IBC process. Comment.