AVM RESOLUTION PROFESSIONALS

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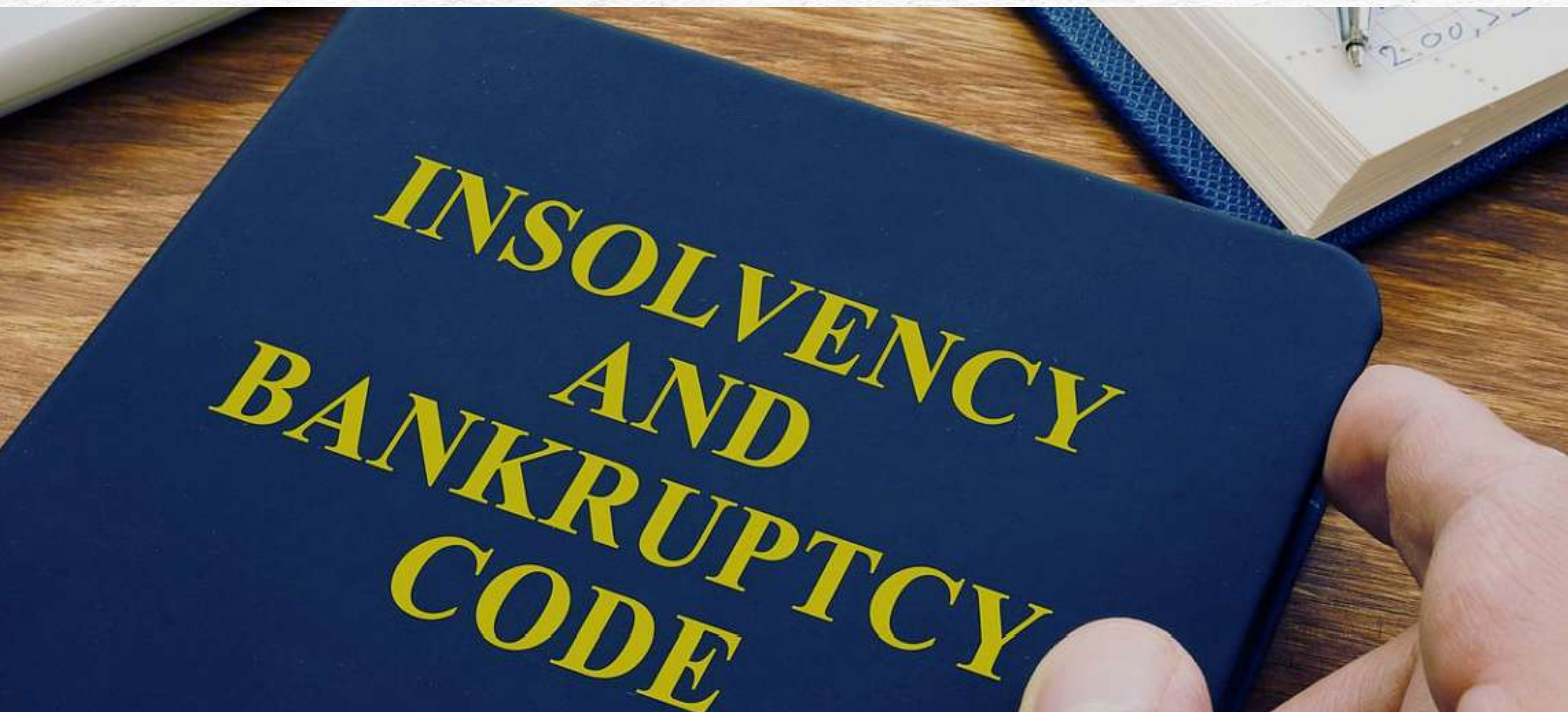

THE BAD BANK FOR A GOOD EXPERIENCE

Introduction

With the expected operationalization of "The Bad Bank" getting ever closer, it is important to understand the implications of the Bad Bank on the resolution regime prevailing under IBC. Bad bank is an idea which catches steam every year before the Budget. Chief Economic Adviser Arvind Subramanian in Economic Survey Report 2017, had suggested the creation of Public Sector Asset Rehabilitation Agency (PARA) which will work as a "Bad bank" to absorb the losses from the PSBs. This year Finance Minister, Nirmala Sitharaman while presenting the Budget on February 1, 2021 proposed the setting up of Bad bank.

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Structure

At the time of writing this article, there is no public confirmation regarding the structure of the Bad Bank, it is expected it would be a joint venture between the public and private sector banks without equity contribution from the government but with a sovereign guarantee to meet regulatory requirements. Public sector banks, led by Canara Bank, together are expected to pick up a 51 per cent stake in the bad bank. In an exchange filing earlier, the state-owned Canara Bank said its board had given in-principle approval to be the lead sponsor of the bad bank, with a 12 per cent stake in the entity.

The Budget proposed to set-up two entities- an Asset Reconstruction Company Limited (National Asset Reconstruction Company) and an Asset Management Company (India Debt Management Company Ltd) Although, details of the proposed functioning of ARC and AMC for stressed assets are yet to be released for defining the mechanism, however, the broad framework is likely to be the ARC taking over the stressed asset from the lenders and giving to AMC to manage the entity to infuse value addition and prevent value erosion while prospective investors and buyers are scouted for final sell off. This would clearly translate into creating an exception to applicability of IBC for cases dealt with by the ARC and AMC. Additionally, the current restrictions emerging from court rulings in IBC preventing an investor to bid an ailing company for reselling to another investor would be eased out.

Need

The government has tried various recovery mechanisms from time to time. The failure of such mechanisms has led to the clamor of setting up a bad bank. The recovery rate under the IBC was around 20% which meant the lenders had to take a haircut of about 80%. The Bad Bank is seen as an initiative which will clean up the books of the banks and help in better recovery under IBC by consolidating all the claims.

Past experience

The first Bad Bank of Grant Street National Bank was created in 1988 by US-based Mellon Bank. It merely served as a mechanism to resolve or liquidate bad debt to recover the maximum amount of money. Various countries like Malaysia, Ireland, Spain, and Germany have structured their own Bad Bank models based on their country-specific policies.

IBBI Updates

The Insolvency Professionals to act as Interim Resolution Professionals, Liquidators, Resolution Professionals and Bankruptcy Trustees (recommendations) Guidelines, 2021.

(IBBI) on June 1, 2021 issued guidelines for Insolvency Professionals to act as Interim Resolution Professionals, Liquidators, Resolution Professionals and Bankruptcy Trustees (Recommendations) Guidelines, 2021, (Guidelines).

Click here for the guidelines.

The Insolvency and Bankruptcy Board of India invites comments from the public on the Regulations notified under the Insolvency and Bankruptcy Code, 2016

IBBI in an endeavour to engage stakeholders in the regulation making process, has invited comments from stakeholders on the regulations already notified under the Code till date. The comments received between 17th June, 2021 and 31st December.

Click here for Information Brochure

Pre-Pack Insolvency Resolution Process

The Central Government has promulgated an ordinance allowing the use of pre-packs as an insolvency resolution mechanism for MSMEs. Pre-pack is a type of restructuring in which creditors and debtors collaborate on an informal agreement before submitting it for approval. The Prepack regime tries to balance the interest of the creditors and the promoters/directors of MSMEs by creating a hybrid of creditor in control and debtor in possession. It has been done keeping in mind the importance of promoter to an MSME.

The emphasis on settlement being proposed by the corporate debtor is to provide brevity to the process. This will also reduce unnecessary litigation, which will help MSME specially in these pandemic times.

Please stay tuned for future issues for detailed discussions on the PPIRP regime.

The Malaysian model of setting up two AMCs, 'Danaharta' to take over bad loans and 'Danamodal' to infuse capital into weak banks, successfully fulfilled its objective. Danaharta, which was a completely government-backed AMC, provided for the issue of special government bonds in return for the purchase of distressed assets from Malaysian financial institutions after the Asian crisis. The Bad Bank of Ireland, National Asset Management Agency (NAMA) was legislatively established in 2009 as a consequence of the crisis in its real estate sector. The scheme provided for the transfer of bad assets to the NAMA at a discounted value and a payment in the form of government bonds for the same. After the transfer, a statutory liquidation was mandated within a period of seven to ten years, to obtain a maximum fiscal return. Similar to NAMA, in 2012, Spain established a Bad Bank called The Management Company for Assets Arising from the Restructuring of the Banking Sector (SAREB), which acquired real estate-related assets from various banks.

While these are some of the positive examples of the impact of "Bad Banks" in foreign jurisdiction, there are certain examples closer to home which provide a cautionary tale of how these institutions may not always work out. The Chinese government set up Huarong Asset Management along with 3 other similar vehicles to absorb the bad debts post Asian financial crisis. Although the term was fixed initially, but it has been continuously prolonged and mandate expanded. China has also created "bad banks" in every district to mask over the problem of large NPAs.

India's "primary experience" with bad bank was when the IDBI Bank transferred bad loans worth over Rs 9,000 crore in 2004 to a wholly-owned special purpose vehicle but neither did IDBI recover substantial amounts via its bad bank nor did IDBI Bank's lending record improve.

Functionality

The basic way a Bad Bank functions is that the bad bank buys all NPAs or some of the larger ones of public sector banks (PSBs). The balance sheet of the sellers shrink as these assets are off their balance sheets. This saves capital for banks which can start fresh lending. Besides, banks are lending agencies and should ideally spend time more on business rather than recovery. It is stated that loans greater than Rs 500 crore that have not been declared fraudulent will be transferred to the bad bank.

Various banks have identified the NPAs which they will transfer to the Bad Bank. It is also expected that the Swiss challenge method will be used wherein the NARCL will provide the opening bid which can be matched by other players in the distressed asset acquisition market.

Impact on IBC

Bad Banks work in a manner to facilitate resolution, perhaps even better than IBC, as the percentage of haircut that the creditors might endure would be lowered. This is because CIRP entails a collective decision making with the voting power being proportional to the percentage of the debt, and this can be avoided with Bad Banks, as the value at which the NPAs are sold are left to the judgement of the experts, which can further be monitored. Hence, the Bad Bank would supplement the IBC in the recovery and resolution process.

The same thought was shared by IBBI Chairman MS Sahoo, who stated: “the ‘bad bank’ will, in many ways, deepen the use of IBC. It will specialize in resolution of stress, which, in turn, will build business acumen to distinguish between financial stress and economic stress and then adopt the right strategy to resolve the stress. It will also develop professional capability to evaluate feasibility and viability of resolution plans to approve the best of them. Further, the process of decision-making by the committee of creditors will be smooth as the ‘bad bank’ will have in most cases the voting power required for the decision. Thus, the ‘bad bank’ will be better placed to use the IBC, and this will improve outcomes from IBC processes”.

Conclusion

Bad Banks will not really address the problem of large number of NPAs but it will merely transfer it to another entity which makes the balance sheets of banks look better. In turn, banks may find it easier to raise capital in the market. A certain amount of NPAs are bound to exist in any system as some firms will fail. Therefore, a bad bank can keep absorbing the NPAs at a written-down cost from banks, and this will be a perennial stream. This may not be the idea of a bad bank as such a bank is supposed to deal with a stock of NPAs and not the subsequent flows. Else, it creates the economic moral hazard on the part of both the banks which lend and the customers who borrow as this becomes a perverse win-win situation for everyone. Hence following the footsteps of successful examples abroad, the tenure of the bad bank should be limited so as to avoid such moral hazard.

Insolvency Quiz

1) Is Sec 9(3)(c) directory or mandatory?

a) Directory

b) Mandatory

2) Is Public announcement given by IRP treated as financial information?

a) Yes

b) No

3) Can RP raise Interim Finance without prior permission of Committee of Creditors?

a) Yes

b) No

4) Is RP obliged to give copy of Resolution Plan to suspended Board of Directors?

a) Yes

b) No

CASE ANALYSIS- LALIT KUMAR JAIN VS UNION OF INDIA

TRANSFERRED CASE (CIVIL) NO. 245/2020

Apex Court held: Notification dated 15.11.2019 for initiating CIRP against the personal guarantors of the corporate debtor is legal and valid- Approval of resolution plan relating to a corporate debtor does not discharge the liabilities of personal guarantors to the corporate debtor.

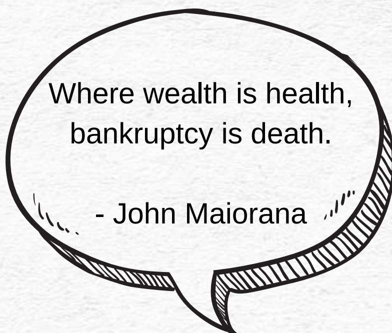
Facts

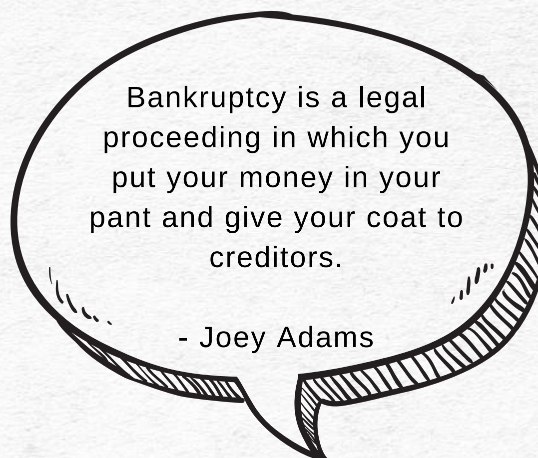
Provisions for initiating CIRP proceedings against the personal guarantors to the corporate debtor were brought to force, vide notification dated 15.11.2019 (impugned notification), by the Central Government with effect from 01.12.2019. The impugned notification brought into force Section 2(e), Section 78 (except with regard to fresh start process), Sections 79, 94-187 (both inclusive); Section 239(2)(g), (h) & (i); Section 239(2)(m) to (zc); Section 239 (2)(zn) to (zs) and Section 249.

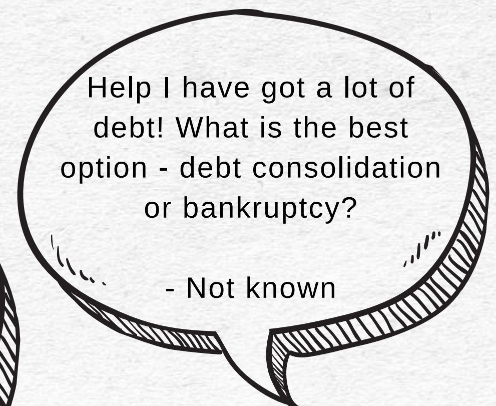
Various applications were filed before the different high courts challenging the vires and validity of the said notification and the related rules and regulation. The Hon'ble Supreme Court while exercising its powers vested under article 139A transferred the cases pending before various High Courts, under the same cause, to itself as they involved interpretation of common questions of law. However, during the course of submission the counsel to the parties stated that the challenge would be confined to the impugned notification. Hence, the dictum of the Hon'ble Apex court does not comment upon the validity of the rules and regulations as they have not been challenged.

The focal ground for challenging the notification is that the executive government could not have selectively brought some provision of the code in force and applied to a specific sub-category i.e. personal guarantors to corporate debtor.

Insolvency Quotes







Q. Whether the impugned notification has been issued in excess of the authority conferred upon the Union of India? Do the powers conferred by section 1(3) permit the UOI to extend the provision of the code only as far as they relate to personal guarantors?

Arguments raised by the Petitioners

- Section 1(3) of the code only empower the CG to notify the point(s) in time when different provisions of the Code can be brought into effect but does not permit the Central Government to notify parts of provisions of the Code, or to limit the application of the provisions to certain categories of persons. Section 1(3) is a conditional legislation, where the legislature has enacted the law and the only function of the executive is to bring the law into operation. The impugned notification, however, limits the application of the provisions to the personal guarantors to corporate debtors and is therefore, ultra vires the proviso to Section 1(3) of the Code. The executive cannot perform its task outside the power granted to it, choosing the subjects to which the law is to apply.

- Section 2 of the code is descriptive and merely declares the subjects to which the code would apply. It certainly cannot clothe the executive with power to apply the code selectively at its discretion to different subjects.

- The provisions brought into force by the impugned notification only classify debtors as either individual or Partnership firm, however, the provisions have been enforced specifically for the personal guarantors. Hence, the notification to enforce the provisions only for personal guarantors is unconstitutional.

- Section 2(g) of the code defined individual as “individuals” other than persons referred in section 2(e)- which relates to personal guarantors of the corporate debtor. Further, part III of the code is applicable only to individuals and partnership firms, and since the personal guarantors are not considered within the definition of individual, the provisions of part III does not permit initiation of insolvency proceedings against personal guarantors. Therefore, the notification is ultra vires, arbitrary and discriminatory.

- Prior to the issuance of the impugned notification, insolvency proceedings against individuals could be initiated as per provisions of Presidency Towns Insolvency Act, 1909 (“PTI Act” hereafter) and the Provincial Insolvency Act, 1920 (“PIA” hereafter), and the CG has not yet brought section 243 of the code into effect, which repeals the two aforementioned acts. Therefore, enforcing the provisions for initiating insolvency proceedings against the personal guarantors, without repealing the earlier two acts, has the illogical effect of creating two self-contradictory legal regimes for insolvency proceedings against personal guarantors to corporate debtors.

- The provisions of part III of the code, which are partially enforced by the impugned notification specify a singly procedure for insolvency proceedings of a personal guarantor, irrespective if the creditor is FC or OC, which brings them on an equal footing and amounts to collapsing the classification created by the parliament in part II.

- Section 96 (interim moratorium) and 101 (moratorium) of the code enumerate that any pending legal action or proceeding in respect of any debt shall be deemed to have been stayed, which results into illogical consequence of staying the CIRP against corporate debtor when the insolvency proceedings are initiated against the personal guarantor.

- The RP while recommending the approval/ rejection of insolvency application does not have to consider whether the amount of debt owed by the CD has been discharged or extinguished. Further, all the claims against the debtor are extinguished on conclusion of CIRP, except to the extent admitted in the CIRP. Furthermore, the impugned notification allows creditors to raise claims in the insolvency process of the guarantor without adjusting the amount realized by them in the CIRP of corporate debtor.

- The liability of the surety is co-extensive with that of principal debtor and where the resolution plans, duly approved by the Committee of Creditors proposes to extinguish and discharge the liability of the principal borrower to the financial creditor, the liability of guarantors under the personal guarantee would also stand completely discharged.

- The rules for insolvency process for personal guarantor define the term “Guarantor” whereas the code does not define the term. It is pointed that the section 239(1) empowers Central Government to make rules to carry out provisions of the code but those rules cannot define a term which is not defined in the code.

Submissions by Respondents

- Section 1(3) of the Code confers wide powers enabling the Central Government to operationalize the Code in a subject-wise and (not necessarily in a contiguous manner) – particular sections, provisions or parts.

- Section 1(3) has two distinct dimensions. Parliament firstly conferred on the Central Government not only the power to determine the date on which the Code will come into force, but also empowers it to appoint different dates for different provisions of the Code.

- Two decisions[1] of Constitution Bench of SC were referred which permit notification of provisions bringing into force legislation in phases. Further, the phase wise implementation is done to study its impact on the subject matter. Hence, discretion exercised by the executive government is not fettered.

- The executive has the power to bring into force any one provision of a statute at different times for different purposes, and that the government can exercise this power to commence a provision for one purpose on one day and for the remaining purposes on a later date.

- Section 2 of the Code is not a definition clause – but rather acts as a lever to provide a mechanism for a phased and limited interpretation of the Code.

[1] Basant Kumar Sarkar v. Eagle Rolling Mills Ltd. **and** Bishwambhar Singh v. State of Orissa

- Amendments in 2018 substituted the pre-amended definition in Section 2(e) by introducing three different class of creditors, 2(e)- Personal Guarantors; 2(f)- Partnership Firms; 2(g)- Individuals other than 2(e). The intention behind the amendment was to distinguish the personal guarantors from individuals. The classification was made after detailed deliberations and in the light of the report of the Working Group on Individual Insolvency.

- Reliance was also placed on report of the Bankruptcy Law Reforms Committee ("BLRC"), which recognized that personal guarantors were a category of entities to whom individual insolvency proceedings applied, and acknowledged the link between them and corporate debtors and found that under a common Code, there could be synchronous resolution.

- Sections 2(e) and 2(g) when read together, would indicate that personal guarantors are also individuals.

- Section 60(2) was amended whereby the application relating to insolvency proceedings of the personal guarantor to corporate debtor is to be filed before the NCLT. The intention was to have a unified adjudication through the same forum and unifying both processes under one forum enables the adjudicating body to have a clear vision of the extent of debt of the corporate debtor, its available assets and resources, as also the assets and resources of the personal guarantor. This would result in maximizing the value of assets and promoting entrepreneurship, which is one of the main purposes of the Code.

- Section 30 of the code states that the resolution plan approved by AA shall bind all stakeholders. However, at the same time, in the event a resolution plan permits creditors to continue proceedings against the personal guarantor, then such personal guarantors would continue to be liable to discharge the debts owed to the creditor by the corporate debtor, which would be limited of course to the extent of debt that did not get repaid under the resolution plan. Any release/ discharge of the principal borrower (corporate debtor) by approval of resolution plan/ liquidation will not discharge the guarantor.

- The liability of guarantor is co-extensive, joint and several with that of the principal borrower unless the contrary is provided by the contract. A discharge of the principal borrower does not absolve the surety from its liability. Further, the creditor also has the liberty to proceed against the principal borrower and all sureties simultaneously.[2]

- The continuation of a financial creditor's claim against a guarantor would not lead to double recovery of a claim as the financial creditor would be able to recover only the balance debt which remains outstanding and unrecovered from the principal borrower. There are enough safeguards against double recovery.

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[2] Bank of Bihar Ltd. v. Dr. Damodar Prasad & Anr

Analysis and Conclusion

Various judgements cited by the petitioners and respondents regarding the delegation of legislative powers and conditional legislation were discussed by the apex court. Further, the apex court observed the method that has been followed by the CG to bring into force different provisions of the Act on various dates; to fulfil the objectives underlying the Code, having regard to its priorities.

The Apex court noted that before the amendment of 2018, all individuals (personal guarantors to corporate debtors, partners of firms, partnership firms and other partners as well as individuals who were either partners or personal guarantors to corporate debtors) fell under one descriptive description under the unamended Section 2(e) and the unamended Section 60 contemplated that the adjudicating authority in respect of personal guarantors was to be the NCLT. But because section 2 brought all three categories of individuals within one umbrella class, it would have been difficult for the Central Government to selectively bring into force the provisions of part –III only in respect of personal guarantors. Hence, the 2018 Amendment Act altered Section 2(e) and subcategorized three categories of individuals.

Further, the amendment bill of 2018 was analyzed whereby the section 2(e) was substituted and individuals were divide into 3 categories. The intention of sub-dividing the term “individual” was that firstly, section 60 of the code contemplated that the AA for personal guarantors was to be the NCLT and secondly, term individual was divided into 3 categories to enable the CG to enforce the provision of part III specifically for personal guarantors.

The apex court observed that section 243 of the code has not yet been enforced however, the non-obstante provision under Section 238 gives the Code overriding effect over other prevailing enactments. Hence, if any proceeding were to be initiated against personal guarantors it would be under the Code.

Based on the detailed discussion, the apex court held that the impugned notification is not an instance of legislative exercise, or amounting to impermissible and selective application of provisions of the Code. There is no compulsion in the Code that it should, at the same time, be made applicable to all individuals, (including personal guarantors) or not at all. There is sufficient indication in the Code- by Section 2(e), Section 5(22), Section 60 and Section 179 indicating that personal guarantors, though forming part of the larger grouping of individuals, were to be, in view of their intrinsic connection with corporate debtors, dealt with differently, through the same adjudicatory process and by the same forum (though not insolvency provisions) as corporate debtors. The impugned notification was issued within the power granted by Parliament, and in valid exercise of it. The exercise of power in issuing the impugned notification under Section 1(3) is therefore, not ultra vires; the notification is valid.

Further, the Hon’ble Supreme Court also held that, the approval of a resolution plan does not ipso facto discharge a personal guarantor of a corporate debtor from his liabilities under the contract of guarantee. The release or discharge of a principal borrower from the debt owed by it to its creditor, by an involuntary process, i.e. by operation of law, or due to liquidation or insolvency proceeding, does not absolve the surety/guarantor of his or her liability, which arises out of an independent contract.

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