Strengthening Informal Restructuring for Firms

Centre for Insolvency & Bankruptcy

A. Full Statement of Problem

The global health crisis has distressed the corporate sector in a number of countries, affected both by a tightening of credit and weaker consumer demand. As countries now move from the initial crisis containment phase, a period of sustained corporate debt (and operational) restructuring can be expected in order to repair corporate balance sheets and to realign the corporate sector to the post-crisis economy. The insolvency law is one important tool to support orderly corporate debt restructuring. But insolvency law solutions are not sufficient to address the scale of debt distress that can be expected to arise in the wake of a financial crisis.

In such a crisis formal insolvency procedure may not be apt because of the following reasons:

First, the court system lacks capacity to deal with numerous complex insolvency cases at the same time. The recent pandemic has brought to light corporate solvency issues that outstrip the capacity of formal judicial mechanisms.

Second, in this sort of scenario, if the system is based on liquidation or even on the sale of businesses as a going concern, the market for distressed assets or for distressed businesses can collapse.

Third, in such crises, even reorganization procedures face serious difficulties, as lenders are not interested in acting as financiers for reorganizing businesses.

Thus, the resolution of debt problems through non-judicial means seems to be less disruptive and more effective than formal insolvency procedures. A framework of informal workouts is better equipped to deal with all these difficulties, especially if the enabling legislative framework is in place.

Out-of-court debt restructuring involves changing the composition and/or structure of assets and liabilities of debtors in financial difficulty, with limited judicial intervention, and with the objective of promoting efficiency, restoring growth, and minimizing the costs associated with the debtor's financial difficulties. Restructuring activities can include measures that restructure the debtor's business (operational restructuring), and measures that restructure the debtor's finances (financial restructuring). Out- of-court debt restructuring performs an important role in all insolvency systems. In numerous situations of financial difficulty, the debtor and the creditors can protect their respective interests more effectively if an informal solution is implemented.

There are various methods of informal workouts ranging from purely contractual workouts that are enhanced by the existence of norms or other types of contractual or statutory arrangements to “hybrid procedures” where the involvement of the judiciary or other authorities is an integral part of the procedure, but is less intensive than in formal insolvency proceedings. Treatment of indebtedness problems can be represented by a continuum, with informal workouts at one extreme and formal insolvency proceedings at the other. Between the informal arrangements for debt rescheduling between the debtor and its creditors, to the fully formal reorganization or liquidation procedures, there are numerous intermediate solutions. This continuum is based on the degree of judicial intervention and the degree of “formality” in general. It does not necessarily imply successive stages of treatment of a debtor’s situation; rather, it illustrates the existence of different options that may be used, alternatively or occasionally, in certain sequences and that may present some overlapping elements. This continuum provides a simple perspective of the possibilities available to policy makers in charge of insolvency law reform, and provides debtors and creditors with a panoramic view of the range of options at their disposal in a given legal system

B. Problem in Indian Context

A scheme of arrangement (SoA) is a hybrid mechanism that lies along the spectrum mentioned above as it provides greater sanctity to a contractual arrangement among creditors and the debtor, but at the same time falls short of a formal insolvency proceeding.

The scheme of arrangement is widely used for restructuring a company either when it is in debt or when it has to undergo a restructuring of its finances due to insolvency.[1] Owing to its peculiar features, the SoA has come to play a significant role in debt restructuring.there is a rising wave of use of SoAs for debt restructuring not only in the origin country (i.e. United Kingdom (UK)), but also in other countries such as Singapore that have adopted the concept. However it has been used sparingly for debt restructuring in India. This clearly indicates that the presence of an efficient restructuring mechanism in the legal rules is by itself inadequate to ensure its full utilisation.

Surprisingly, while India introduced recent reforms that brought about a paradigm shift in its approach towards corporate insolvency, the SoA did not receive any attention whatsoever as part of the process. Apart from making some minor changes to the rules relating to SoA,the concept remained largely untouched, signifying its isolation as a corporate rescue mechanism in India.

Given the breadth, severity and complexity of corporate restructuring in the midst of current crises, and because enforcement and insolvency systems are often not fully effective, enabling framework topromote restructurings via SOA may be necessary and desirable to preserve asset values and to induce corporate restructuring.

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[1]Shikha N. Takeover through Scheme of Arrangement: A Changing Trend in the UK. Vikalpa. 2013;38(1):87-103. doi:10.1177/0256090920130107.

C. Need Gap

The World Bank Principles and the UNCITRAL Legislative Guide have highlighted the importance of[2] informal arrangements for restructuring. Both texts treat informal debt restructuring as an integral part of an efficient creditor-debtor regulatory system. Out-of-court restructurings constitute the subject matter of principles B3, B4 and B5 of the World Bank Principles for Effective Insolvency and Creditor Rights Systems. Principle B3 establishes the conditions that a legal system should satisfy to foster informal debt restructurings[3]; Principle B4 deals with debt restructuring processes[4]; finally, Principle B5 touches upon the specific questions that affect financial institutions in the context of debt restructuring, but Principle B5 has been divided and integrated into the analysis of Principles B3 and B4, to provide a more succinct analysis of the issues involved.[5]

In its 'Principles and Guidelines', the World Bank even explicitly says:

> '[**Principle 26:***Informal workout procedures] (…) A country's financial sector (possibly with the informal endorsement and assistance of the central bank or finance ministry) should promote the development of a code of conduct [framework] on an informal out-of-court process for dealing with cases of corporate financial difficulty in which banks and other financial institutions have a significant exposure- especially in markets where enterprise insolvency has reached systematic levels. An informal process is far more likely to be sustained where there are adequate creditor remedy and insolvency laws. The informal process may produce a formal rescue, which should be able to quickly process a packaged plan produced by the informal process. The formal process may work better if it enables creditors and debtors to use informal techniques.'*

Other organisations which underline the importance of informal procedures are, among others, UNCITRAL (see for instance the 'UNCITRAL Alternative approaches to out-of-court insolvency processes'), the European Commission (see 'Helping businesses overcome financial difficulties: a guide on good practices and principles on restructuring, bankruptcy and a fresh start'), the Asian Development Bank (see 'ADB's Good Standard Practice'), the IMF (see the project 'Reports on the Observance of Standards and Codes'; or ROSCs)as well as INSOL International. In 2000, the latter introduced the so-called 'Statement of Principles for a Global Approach to multi-creditor workouts' [hereinafter: Statement of Principles] which, according to the documents at the time of publication, was at least endorsed by the World Bank, the Bank of England, many international commercial banks and consultancy agencies, as well as the British Bankers' Association (with 320 banks as members; established in more than 60 countries).

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[2] Dr. Neeti Shikha & Urvashi Shahi,*Restructuring in COVID-19: Reinventing the old wheel*, The Daily Guardian (11 July,2020) https://thedailyguardian.com/restructuring-in-covid-reinventing-the-old-wheel/

[3]http://pubdocs.worldbank.org/en/919511468425523509/ICR-Principles-Insolvency-Creditor-Debtor-Regimes-2016.pdf. Last accessed on 10 September 2020

[4] Ibid at page 20.

[5] Supra at 1, page 22

In India, formal restructuring is provided under the Insolvency and bankruptcy Code 2016. For informal/semi formal workouts, Indian law presently provides only two routes to debt restructuring. First, the RBI's June 7 Circular, which provides an out-of-court restructuring option. Second, a scheme of arrangement under the Companies Act, 2013, could also be used for debt restructuring through the NCLT. Restructuring isn't particularly easy under the June 7 Circular. The Circular applies only to RBI-regulated lenders and requires them to enter into an intercreditor agreement (ICA). Non-RBI regulated entities (such as mutual funds) are not bound to sign the ICA and may not cooperate. Such lenders may therefore hold up the entire restructuring process.hence the only viable option is under the scheme of arrangement under the Companies Act 2013. The concept of SoA has since been well entrenched under Indian company law, and is an important tool for both corporate restructuring in general and debt restructuring in particular.[6]

Benefits of using Scheme of Arrangement as a debt restructuring mechanism

Firstly, the SoA offers the widest flexibility to parties to conduct debt restructuring coupled with other forms of corporate restructuring that is incapable of being implemented through other methods.[7]

Secondly, the "debtor-in-possession" approach followed in the SoA offers considerable attraction to parties to resort to that mechanism in contrast to the CIRP where the management gets divested of their ability to manage the business. Similar to Chapter 11 of the US Bankruptcy Code, this approach offers "carrots" to the debtor company's management to submit itself for debt restructuring under the SoA method at an early stage when the company's business remains viable rather than to delay matters until the CIRP is invoked when they lose control over the affairs of the company.

Further, the BLRC (Interim report) noted that SoA would be helpful in facilitating complex and hybrid rescue mechanisms such as "pre-packaged rescues", similar to the practice that has evolved in the United States and the UK.Since the government is hell bent to introduce a prepack mechanism in India very soon, SOA would provide an enabling framework for its effective implementation. Creditors and debtors will have to resort to the SoA to give effect to "pre-pack rescue" options that involve a sale of the business or assets of the debtor company or its amalgamation or reconstruction with another company.

While there is recognition of the benefits of the SoA as a debt restructuring tool, there has been no effort whatsoever to enhance its attractiveness. In other words, the mechanism has effectively been abandoned from a law reform perspective.

Given the lasting importance of the SoA as a debt restructuring option, the Indian policymakers cannot afford to ignore the mechanism while they bring about drastic changes to adapt the

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[6] Neeti Shikha,*The Changing Trend of Schemes of Arrangement and Approaches towards Its Efficacy*,Indian J. Int'l Econ. L., 2011

[7]*Supra* at 1.

insolvency regime to post COVID economic order. It is still timely to rejuvenate the SoA so that to enable parties to derive the benefits of that enduring mechanism.

Recommendation

In this light, some possible reforms and approaches that policymakers and adjudicators may adopt in considering the SoA are listed below-

1. The moratorium for SoA that existed under the Companies Act 1956 must be reinstated, albeit with somewhat different features. Rather than to provide the court with the discretion to the NCLT to grant the moratorium, it could be made automatic for a short span of time, say 90 days. Any extension thereof can be made at the discretion of the NCLT. This will enable companies to resort to workouts with creditors without fear of enforcement action by holdouts. At the same time, a temporary automatic moratorium coupled with extensions at the discretion of the NCLT would ensure that recalcitrant debtors do not abuse the protection. Moreover, guidelines may be formulated to stipulate the parameters on which NCLT exercises its discretion to extend the moratorium so that there is clarity and certainty to all players. Further, creditors may retain the right to approach the NCLT to vacate the moratorium granted. The scope of the moratorium can be like that set out in the I&B Code. In the absence of a moratorium under the CA 2013 (which is altogether inexplicable), the SoA would continue to be the less preferred option for debtors in comparison with the CIRP under the I&B Code.

2. The possibility of cramdown across all classes may be considered. Currently, the SoA is the only restructuring option that requires classification of creditors while seeking their approval to the scheme. Not only are classification issues complex and unwieldy, but also strengthens the hands of holdouts if they constitute a majority within a class, as that class can effectively hold up the entire scheme. Hence, suitable modifications may be considered in the cramdown provisions under which a class of creditors is not allowed to veto the scheme so long as all other classes approve it with the requisite majority and that the scheme enjoys the overall support of all the creditors as a whole.Given that the classification requirements are a hurdle in the SoA and that the alternative option of the CIRP provides for cramdown across all classes, it is likely that parties will prefer to delay their restructuring until a default scenario (so as to invoke the I&B Code provisions) rather than to facilitate an early restructuring (by relying upon the SoA).

3. The approval of such a scheme is dependent on the approval of 75% in value of each such class of creditors or members, which highly impairs the ability of the courts in cramming down a class of creditors. However, if the classification of creditors is inserted into the provisions of CA, with the approval contingent on 75% of all the creditors/members, then it might effectively reduce the time involved in such an arrangement.

4. Under Section 230 of Companies Act 2013, once the scheme is approved by the requisite majority, it has to be submitted to the courts for approval, where in the past, the courts

have not sanctioned the scheme in the past, as the scheme was unfair or not reasonable,[8] which has the potential to interfere with the commercial wisdom of the members/creditors who voted on such a scheme. However, in the case of *Miheer Mafatlal v Mafatlal Industries (1996)*¸ the SC laid down the broad contours of the courts in reviewing such schemes and explicitly held it to be peripheral and supervisory and not appellate. Further, even recently, in the context of IBC, the Supreme Court in the case of *Essar Steel v SK Gupta* had held that the courts/NCLT must not interfere with the commercial wisdom of the Committee of Creditors. Hence, restriction of the powers of the courts, in the form of proviso to Section 230(7) of the CA or a guidance, will be effective in removing the inefficacy of the schemes at this juncture.

5. More clarity must be provided regarding the loan classification norms for restructuring arising out a SoA. As discussed earlier, the reason for the popularity of the RBI frameworks for restructuring is the fact that banks and financial institutions may available regulatory forbearance and favourable treatment regarding recognition of NPAs in the case of debt restructuring following those frameworks. This has driven the creditor community in India towards the RBI frameworks, and caused them to obviate the scheme process. In order to address these distorted incentives of the banks and financial institutions, the RBI must clarify the loan classification norms for the SoA. To avoid any regulatory arbitrage, the RBI must clarify that the treatment provided to restructuring carried out under its frameworks would also be provided to restructuring under SoA. This will enable the creditors to take advantage of several features of the scheme that are lacking in the RBI frameworks.

6. In the process of getting a scheme sanctioned, certain approvals from various authorities such as official liquidator, regional director of companies, income tax authorities etc. are required. Discussion with experts has brought to light that these approvals take very long and delays the sanction of the scheme, making this otherwise very useful instrument less attractive for restructuring. It is suggested that in the long run, efforts should be made to have a single window clearance for these approvals. In the meantime, a timeline may be prescribed to each of these authorities to submit their observations and sanctions, failing which, it should be considered as their deemed approval.

Conclusion

The law relating to debt restructuring in India has followed a trajectory that is considerably at variance with other jurisdictions in the Commonwealth. Even though substantive legislative provisions relating to SoA in India bear close resemblance with those in countries such as the UK and Singapore, their operation in practice has been vastly different. This is due to the different trajectory that restructuring and insolvency laws have taken in India over the past few years.

Moreover, the institutional considerations and the efficiency of regulators and adjudicators in handling restructuring cases in an efficient manner have suffered from deficiencies in the Indian

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[8] Ajanta (P.) Ltd., In re [2017] 77 taxmann.com 232 (Gujarat); also Aditya Birla Money Mart Ltd., In re [2016] 76 taxmann.com 270 (Gujarat)]. Also see Cello Pens (P.) Ltd., In re [2017] 83 taxmann.com 399 (NCLT - Ahd.)

context. One cannot lose sight of these historical considerations while recommending proposals for the future. More importantly, the recent reforms culminating in the I&B Code have moved India towards a creditor-controlled insolvency regime. Hence, while countries such as the UK and Singapore are seeking to transition towards a regime that adopts features of Chapter 11 from the US, the Indian approach has been diametrically opposite as it has moved away from such an approach.

Given this situation, rather than reverting to a system that borrows from Chapter 11, it is argued that policymakers in India must consider an approach that brings about a rebalancing, whereby the interests of the debtors, creditors and other stakeholders are considered so as to establish an equitable regime that balances the various interests without conferring undue benefits or advantages over any particular category. In this context, an "integrated co-determination model of control" appears attractive. In such an arrangement the management would not be ousted, but would rather act together with the trustee to negotiate a restructuring with the creditors and to preserve the company's business and assets. The trustee would be co-opted on to the board of the debtor and would join its controlling team.While this could be an elegant model, it would be necessary to iron out some operational matters, including possible conflicts of interest and information asymmetry between the trustee and the debtor's management.Given the idiosyncrasies of the Indian restructuring and insolvency framework, it calls for novel solutions.

Covid-19 has impacted firms by reducing demand for their products and services,disrupting the supply of inputs and tightening the provision of credit. The G-30 report has also stated that while illiquidity has characterized the Covid-19 economic crisis, insolvency may come to bear on many businesses as economic strain from the pandemic continues. In such a scenario, it becomes important to incentivize creditors to restructure debts and use all existing restructuring tools, including schemes, in order to save viable businesses while also maximizing their recovery. As an immediate measure policy makers should place enabling environments to promote debt restructuring via existing mechanisms like SOA as early as possible.