Lucrative Defaults by Hungry Corporates

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The implementation of the Insolvency and Bankruptcy Code, 2016 has led to aggressive competition to acquire firms that have been subjected to the resolution process. This suggests that the default that required the creditors to bring these firms to the National Company Law Tribunal was not due to poor fundamentals. Moreover, the decision of the original promoters to try and enter the fray as bidders for defaulting firms indicates that they too do not see the firms and the activities they are engaged in as unviable. Yet, there is much pressure on the government to favour those who seek to game the system.

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The deadline for the completion of the resolution process under the Insolvency and Bankruptcy Code (IBC), 2016 for the first set of cases taken up has neared or even passed. The IBC provides for a time limit of 180 days (extendable by 90 days) once a case of default is brought to the National Company Law Tribunal (NCLT), following a joint decision of creditors accounting for a dominant share of claims on a company. If no resolution plan drawn up under the supervision of a resolution professional can be agreed upon, liquidation must follow to recover whatever sums are possible.

Initial Experience

While the NCLT has considered a number of cases since its constitution, its role assumed importance when, on 13 June 2017, the Reserve Bank of India (RBI) mandated proceedings against 12 large defaulters, holding accounts with outstanding amounts of more than ₹5,000 crore, of which at least 60% had been classified as non-performing as of 31 March 2016. These bad loans accounted for around 25% of the non-performing assets (NPAs) recognised at that time.

In most cases, the estimated value of assets on liquidation is low, and does not capture the true value of the company. Put simply, the aggregate of the individual value of a set of stripped assets tends to be much lower than the value of those assets when combined for production. So, if the IBC process and the intervention of the NCLT lead, through bidding, to an offer of a takeover by a third party which is acceptable to the creditors, the recovery against bad loans technically written off by financial creditors would be much higher. Since this was to occur in a time-bound fashion, it seemed to be a significant initiative to address the NPA problem in the banking system. The IBC was combined with legislative amendments that strengthened the powers of the RBI to order the launch of proceedings to recover the loans gone bad. These measures, it was argued, through enforced resolution or liquidation if necessary, offered a way in which the abysmal record of recovery could be corrected and the pressure on the government to bail out banks with taxpayers' money could be reduced. In the case of 11 public sector banks out of a total of 21, of the loans technically written-off between April 2014 and December 2017, recovery rates varied from nil to just above 20%, and in the case of another three, the rate ranged between 23% and 29%. The average recovery rate for all 21 banks was a pathetic 10.8%. By facilitating and accelerating the recovery effort, the IBC process was expected to raise the rate significantly.

The context in which this new strategy was launched needs recalling. Unlike the period prior to the 1990s, the NPAs that accumulated in the books of banks in recent years were not equitably distributed across different categories of borrowers, big and small, priority and non-priority. Rather, because of a change in the lending strategy during the period of the credit boom after 2003, the NPAs are now concentrated in the hands of large borrowers, primarily corporate borrowers.

The fact that these now-declared-bad loans were largely in the hands of the corporates made the IBC route of resolution and recovery potentially effective. The NCLT and the parallel appellate body could be made the sites of recovery, which could not have been the case if these loans were also in the hands of non-corporate small and medium borrowers. That these loans were the focus of the redesigned recovery strategy became clear when the RBI mandated proceedings against 12 large defaulters.

Defaulters' Bid for Control

The initial experience with the first phase of this multistep process involving the recognition, technical write-off and provisioning, and recovery of NPAs, is revealing for a number of reasons. First, in cases where the assets on offer were

of special interest to particular bidders, the rates of recovery have been rather high. This was true of the acquisition of Bhushan Steel by Tata Steel and of Electrosteel by Vedanta. Bhushan Steel owed its financial creditors around ₹56,000 crore, whereas the Tata Steel bid returned ₹35,200 crore upfront to the financial creditors, besides giving them a 12.3% stake in the company in lieu of returning the remaining debt. That was substantial relative to the estimated liquidation value of ₹15,000 crore to ₹20,000 crore, and far better than the average 10% recovery rate reported on aggregate write-offs in the recent past. The Tatas clearly had a special interest in the deal since its valuation of the company was far higher than that of JSW Group, the other keen bidder. The latter offered the creditors only ₹29,700 crore.

Another high defaulter acquisition that moved through was that of Electrosteels by Vedanta Resources, marking the foray of the latter into steel from metals like copper and zinc. Vedanta acquired a 90% stake in return for ₹1,805 crore in equity and ₹3,515 crore as debt. With its access to mines near the location of the steel plant, this was a good investment for Vedanta. Electrosteel will reportedly use the money to fully settle over the ₹13,000 crore it owes lenders, which is a virtual bonanza for the latter. Things really seemed to be moving well.

The evidence that the assets were valuable despite the defaults emerged also from the battle between bidders who were often taken to the courts. Essar Steel, one of the largest defaulters with around ₹44,000 crore in questionable debt, when put up for sale, elicited expressions of interest from five bidders. Interestingly, besides Tata Steel, ArcelorMittal, Vedanta, Sumitomo, and Steel Authority of India, the interested parties include the Ruias, who are the original promoters of Essar Steel.

This effort of the defaulting promoters to regain control of the companies concerned at a discount did muddy the water. The original IBC bill did not prevent promoters from making bids for resolution at the NCLT. Some justified the Ruia bid on the grounds that extraneous factors may have led to distress for no fault of the original promoters. But, if the Committee of Creditors (CoC) has taken the firm to the NCLT, it is clearly because they saw the incumbent management as incapable of resolving the crisis faced by the firm. And, if promoters regain control, much of the debt their company owes will be forgiven, with the losses being carried by the financial and operational creditors. Recognising the travesty involved, the government was forced to amend the IBC bill to prohibit promoters from bidding under the NCLT process.

But, that did not end the battle for the acquisition of Essar Steel. When the first round of bids were actually submitted, there were only two contenders: Numetal Mauritius and ArcelorMittal. However, the resolution professional held the bidders ineligible, as they themselves were seen as defaulting promoters. Numetal was rejected because Rewant Ruia, who was the son of one of the founders of the defaulting Essar Group, was a stakeholder. And, ArcelorMittal was declared ineligible because it was a co-promoter of and held a 29% stake in Uttam Galva, which was also a debt defaulter. This paved the way for a second round of bids, in which four other companies that expressed interest, Nippon Steel and Sumitomo Metal Corporation, Tata Steel, Vedanta and Steel Authority of India, besides Numetal and Arcelor, were eligible to submit bids.

In response, Numetal declared that the VTB Bank of Russia, the leader in the consortium, would buy the 25% stake owned by the trust controlled by Rewant Ruia. In practice, it is JSW Steel that acquired this stake. In the related case, Arcelor Mittal's Uttam Galva stake was sold back to its promoters, the Miglani family. Based on these adjustments, ArcelorMittal and Numetal approached the Ahmedabad bench of the NCLT against the resolution professional's decision to disqualify them.

Interestingly, the court ruled in favour of these two bidders on the grounds that the CoC and the resolution professional "omitted to follow" procedures prescribed under the relevant sections of the IBC for disqualifying bidders.

Problems of this kind also affect the insolvency proceedings in the case of Binani Cement, which was not among the 12 top defaulters, but owed its creditors around ₹6,000 crore. The CoC decided to accept a bid made by Dalmia Bharat, valued at around ₹6,900 crore. This involved rejecting a higher revised offer that was submitted by UltraTech after the bidding process was closed. Binani had worked out a deal with UltraTech Cement for the sale of its stake, which offers more money to settle their dues to creditors and others. However, the CoC had rejected the offer on the grounds that once the bidding process had been closed, even if a final decision had not been arrived at, it had no choice but to accept the highest offer from the official bidding process. Binani had approached the Calcutta High Court with a request to stall and reverse the CoC's majority decision. Binani's case was strengthened because one of the creditors, Exim Bank, reportedly told the court that, though the CoC's claim was that its decision was unanimous, it had voted on the resolution plan under protest because the resolution professional had not brought up UltraTech's revised bid for discussion. Meanwhile, the NCLT has ordered the CoC to reconsider UltraTech's revised offer.

Wilful Default

This intense competition for acquisition of assets put up for sale suggests that private sector operators, most often from within the same industry, see the prices at which these assets can be acquired as a bargain. This suggests that the large-scale debt defaults by the original promoters were either due to mismanagement or because of some form of diversion of funds away from the borrowing companies. If the latter is true, the default is wilful. This could also explain the interest on the part of some of the promoters to bid for the assets they forfeited at a discount. The government has done well to frame a resolution process that can maximise returns to the creditors. It must ensure that this happens even if there are efforts to subvert the process as happened in the case of Essar and Binani. If not, it would be a case where some private corporates default, others buy those assets at a deep discount, and the banks, most often in the public sector, are burdened with the losses resulting from predatory practices.