Tooling up

Deprived of adequate insolvency protection, Indian companies in distress are struggling to restructure

Raghavendra Verma in New Delhi reports

India's third-largest airline, Kingfisher Airlines, is desperately seeking financial stability after suffering a series of losses – most recently US$90 million between July and September 2011 – and accumulating a debt of US$1.5 billion since its inception in 2005.

According to its chairman, Vijay Mallya, the airline needs US$150 million for its working capital requirements and has requested concessions on the interest payable on its loans.

Kingfisher's lenders include 13 Indian banks, mostly government-owned, that in December 2010 implemented a voluntary financial restructuring package of US$260 million. The leader of the lending consortium, State Bank of India, which has a US$290 million exposure to the airline, has stated that no further restructurings are planned.

Since early November hundreds of Kingfisher's flights have been cancelled – though the airline denied that it was due to a funds shortage – and fuel suppliers are reported to have stopped giving the airline credit for aviation fuel.

In the US, American Airlines is also in financial distress but its troubles appear less harrowing. On 30 November its parent company, AMR Corporation, filed for protection in the US Bankruptcy Court for the Southern District of New York. It did so under chapter 11 of the United States Bankruptcy Code (Chapter 11), which allows it time to restructure.

Kingfisher has no such option as Indian law has no equivalent to Chapter 11 bankruptcy protection. Indeed, Sanjay Buch, a Mumbai-based M&A partner at Crawford Bayley & Co, says: "In practical terms there are no effective bankruptcy laws available in India."

There are no effective bankruptcy laws available in India

Sanjay Buch,
Partner
Crawford Bayley & Co

Mutual agreements

Kingfisher's only hope is to persuade its creditors to agree to further concessions in a new corporate debt restructuring (CDR) package.

The CDR scheme covers multiple banking accounts where the total outstanding debt exceeds US$2 million. It was put together by the Reserve Bank of India (RBI) in 2001, as a voluntary and non-statutory system, based on similar systems in the UK, Thailand, South Korea and Malaysia.

Under the CDR scheme, if 75% of a company's creditors agree to a debt restructuring package, the package becomes binding on the rest of the lenders. All parties sign a legally binding stand-still agreement for 90 or 180 days, during which creditors agree to commit themselves not to take any legal action and debtors promise to not approach any other authority for relief.

A panel of the CDR Standing Forum – a body representing all banks and financial institutions in the mechanism – which is called the CDR Empowered Group, examines the viability and rehabilitation potential of the company and approves the restructuring package.

Shishir Mehta, a Mumbai-based partner at Khaitan & Co, says: "CDR has enabled timely restructuring of companies under stress." He adds that it has facilitated the revival of several Indian companies such as JSW, Maytas, Ispat Industries, Wockhart and Essar Steel.

Fragmented laws

However, the legal community still sees the need for a well-defined law for corporate insolvency protection in India.

According to Rajiv Luthra, the managing partner of Luthra & Luthra, Indian corporate insolvency laws are fragmented, incomplete and outmoded and do not facilitate transparent and predictable allocation of risk. "We do not even have settled definitions for basic terms like insolvency, bankruptcy or liquidation," he adds.

Payel Chatterjee, a Mumbai-based associate at Nishith Desai Associates, points out that the "Indian bankruptcy process is very costly and time-consuming and does not ensure an optimal outcome for insolvent firms to reorganize".

A 1985 law, the Sick Industrial Companies (Special Provisions) Act (SICA), provides insolvency protection through the Board for Industrial and Financial Reconstruction

Shortage of skills?

India's limited pool of restructuring professionals may be inadequate to cope with a rising tide of distressed companies. Rebecca Abraham reports

The financial press in India recently reported that the value of referrals under the corporate debt restructuring (CDR) mechanism rose to ₹289 billion (US$5.5 billion) in July-September from ₹56.7 billion in April-June. Observers believe that this five-fold increase may be just the tip of the iceberg.

Although restructurings under the CDR mechanism are driven by bankers, the need for restructuring professionals – both accountants and lawyers who specialize in turnaround and transformation – is mounting.

Maneesha Dhir, a Delhi-based partner at Dhir & Dhir Associates, a law firm that specializes in insolvency and reconstruction, says "there is a shortage of people with requisite knowledge" in this niche area.

This view is shared by both Shardul Shroff, managing partner of Amarchand Mangaldas in Delhi, and Rajiv Luthra, managing partner of Luthra & Luthra, who in separate conversations with *India Business Law Journal* expressed concern about the shortage of lawyers in India with the required skill and experience to do the restructuring work.

Accountants preferred

The reason for this shortage may lie in the makeup of India's restructuring regime. While restructurings under the CDR mechanism remain voluntary, the Board for Industrial and Financial Reconstruction (BIFR) – a quasi-judicial body established under the Sick Industrial Companies (Special Provisions) Act, 1985 – has long provided a formal forum for eligible companies.

Senthil Ramamoorthy, a Chennai-based partner at Dua Associates, points out that "a lot of BIFR work is done by chartered accountants". He explains that clients often find it easier to work with accountants as they understand the financials of a company better.

A large part of the work at the BIFR involves putting together a rehabilitation package and this is where the skills of an accountant are invaluable. As a result, companies are also often represented at the BIFR by accountants and not lawyers.

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Rajiv Luthra
Managing Partner
Luthra & Luthra

(BIFR), which is a quasi-judicial body established under the act. But SICA applies only to manufacturing industries. Service providers such as airlines and information technology companies are outside its scope.

Explaining why the law distinguishes between sectors, NL Mitra, a Bangalore-based senior partner at FoxMandal Little, says that in 1985 industry was seen as "completely manufacturing-oriented and the service sector came much later".

In 2000, in his capacity as director of the National Law School of India University in Bangalore, Mitra chaired an advisory group on bankruptcy laws constituted by the RBI.

Wasted efforts?

Under SICA, a company is considered sick and can apply for the protection of the BIFR if it has eroded its entire net worth or if it defaults on payment for three consecutive quarters and has accumulated losses during the previous four years of more than 50% of its net worth.

The BIFR is mandated to revive potentially viable units and ensure the closure of unviable units so that the investments locked up can be released. However, in the opinion of Abizer Diwanji, a Mumbai-based executive director and head of financial services at KPMG India, "BIFR lacks professional expertise in conserving cash, managing working capital and dealing with equity conversion options, which are necessary to turn around a business."

The biggest criticism of the system adopted by the BIFR under the provisions of SICA is that during restructuring, control of the company is left in the hands of the old management. "If the same people who were responsible for the downfall of the company take over the revival process, there is a lack of confidence [among the creditors]," says Diwanji.

Ensuring that all parties concerned have confidence in the process is vital, particularly because in India there is a common perception that a sick company cannot survive and its assets can be got cheaply. Mitra says that "inept management has been found to be the biggest problem in most of the companies under distress", and that less than 10% of companies were revived by the BIFR.

Furthermore, according to Mitra, "the enactment of SICA was a bureaucratic solution to a problem created by the controlled economy [of that time] where competition was not allowed, entrepreneurship was missing, costs were high

Professional liquidators

The lack of reconstruction expertise among lawyers is apparent in the company courts, where companies enter into compromises with their creditors under the Companies Act.

Dhir says "there is a crying need for the person sitting at the helm" of liquidation proceedings to be better informed. This will ensure that "the restructuring and rehabilitation happen in a manner that is appropriate for the company" rather than in an ad hoc manner that can take many years.

The government appears well aware of this as the Companies Bill, 2011, which was recently tabled in the parliament, introduces the concept of appointing professionals – such as company secretaries, chartered accountants and cost accountants – as company liquidators for the first time in India. When this happens, Dhir believes the Indian system will be "in sync with the worldwide insolvency practice".

Other challenges

A lack of expertise will not be the only problem to plague companies seeking to turn themselves around over in the months ahead. The bigger challenge will be obtaining the funding to do so.

The ongoing restructuring of Chennai-based Southern Petrochemicals Industries Corporation (SPIC) provides an example of this. SPIC – a giant in the industrial landscape of pre-liberalization Tamil Nadu – has shed several non-core assets as required by its creditors and by the terms of its restructuring package put together under the CDR mechanism.

While SPIC recently announced that it would come out of CDR in the next two to three years, its future is in the hands of India's largest asset reconstruction company, ARCIL, which has purchased outstanding SPIC loans from several banks over the years.

Identifying sectors

Restructuring such as this will be increasingly needed to rescue companies in core sectors such as power, telecommunications and aviation. These sectors attracted large inflows of investments over the past several years, but are now grappling with escalating losses.

India's textiles industry, which accounts for 4% of the country's GDP, 14% of industrial production and around 12% of exports, is also facing troubled times, on account of volatile cotton and yarn prices, closure of dyeing units because of environmental concerns, and plummeting demand.

Textile companies in southern India alone suffered working capital losses of ₹110 billion between January and March and are currently seeking better terms from banks on their vast outstanding loans.

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> Senior Partner
> FoxMandal Little

and many companies could not break even."

A report submitted in 2001 to the RBI and the Ministry of Finance by the advisory group on bankruptcy laws recommended the disbanding of the BIFR, but the recommendation was not acted on.

From its office in New Delhi, the BIFR strongly rejects any criticism of SICA. YK Gaiha, a retired bureaucrat who is a member of the three-member board of the BIFR, believes SICA is a perfect law that provides sufficient powers to the board.

However, Gaiha admits that the revival process under SICA is long. He says this is because "it is difficult to arrange the required finances" and also because a major concern of the BIFR is "the employment of industrial workers".

But the bottom line is that SICA does not provide for a time-bound procedure for the implementation of a restructuring plan. Mehta at Khaitan & Co believes this is a serious handicap and restrains the BIFR from achieving positive results.

Mehta says "the BIFR is often misused by sick companies to defeat the interests of creditors and contractors by extending its proceedings long after the prospects of revival have faded away, merely to avoid a possible legal action".

To counter such abuse of SICA and to control the bad debts of the banks, in 2002 the government enacted the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI).

SARFAESI gives Indian banks and government-notified financial institutions overriding powers to realize their debts

Practitioner's perspective

Charting a course

Neerav Merchant explains the options available for insolvency and bankruptcy of companies in India


Neerav Merchant

A buoyant economy and a foreign investment regime that is regularly being liberalized have made India a preferred destination for investments in many sectors. But while US$24 billion in foreign investment poured into India in 2010, the current uncertainty in global markets has turned the spotlight on exits, insolvency and restructuring laws.

Bankruptcy or insolvency involves a legally declared inability or impaired ability to pay one's creditors. Unlike the US, India does not have a single or comprehensive source of insolvency law. Personal insolvency is regulated by the Provincial Insolvency Act, 1920, while corporate insolvency is dealt with by three separate acts: the Companies Act, 1956; the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA); and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest, Act, 2002 (SARFAESI).

Winding up

Winding up necessarily results in a company's liquidation. The Companies Act prescribes three methods for winding up a financially distressed company: (a) voluntary winding up; (b) winding up by the court; and (c) winding up subject to the supervision of the court.

Once a winding-up order is made against a company, or an official liquidator is appointed, all civil legal proceedings are stayed. Creditors have to file a proof of claim in the winding-up proceedings to prove their claim.

However, despite the stay, a creditor may ask the court to allow a specific civil proceeding which may have commenced before the winding-up proceedings were initiated, or even ask the court to allow initiation of new proceedings. The courts are open to considering such applications.

Generally, funds from the liquidation of a company are first applied towards pending workmen's compensation payments, then for tax arrears or other dues payable to a government body. Remaining funds are used for: employees' wages/salaries; accrued holiday remuneration due to employees; amounts due to employees under the Employees' State Insurance Act, 1948; amounts payable on account of death or disablement of any employee under the Workmen's Compensation Act, 1923; amounts due to any employee from a provident fund or any fund for the welfare of employees; and payments to secured creditors, unsecured creditors and others.

It is possible to implement a Chapter 11 kind of a law in this country

Abizer Diwanji
Executive Director
KPMG India

by liquidating long-term assets of companies that default on their loan repayments. Using SARFAESI, 75% of the creditors of a company, even one under BIFR protection, can force the liquidation of a company's assets to recover their dues.

According to K Ravi Ranjan, a senior associate at New Delhi-based Kanth & Associates, the enactment of SARFAESI has diluted the protection available to companies under SICA. He therefore advocates a putting in place Chapter 11-type secure protection for all Indian businesses.

Chapter 11

In the US, once a company files for Chapter 11 protection, it is assigned a committee representing the creditors and stockholders, which along with the bankruptcy court develops its revival plan. During the whole process, the company retains ownership and control of its assets. However, while implementing the plan, a trustee or ad hoc committee of creditors is given control of the day-to-day management.

If the parties do not reach an agreement or the agreed plan fails to revive the business, the company can file for liquidation of its assets under chapter 7 of the US Bankruptcy Code.

Many companies successfully restructure themselves under Chapter 11. They include General Motors, which filed for Chapter 11 in June 2009 and came out of it in November 2010.

Turning around

SICA is India's equivalent to chapter 11 of the United States Bankruptcy Code. It provides for the restructuring of a sick industrial company – generally one which has accumulated a loss equal to or exceeding its entire net worth at the end of any financial year – under the supervision of the Board for Industrial and Financial Reconstruction.

For a company to qualify for restructuring under SICA, it must have been registered for at least five years and have a factory licence. However, SICA may be repealed under the Sick Industrial Companies (Special Provisions) Repeal Act, 2003. It is also likely that the provisions relating to sick industrial companies may be incorporated into the Companies Act or a new piece of company law legislation, which is also on the anvil.

Cashing out

SARFAESI is ground breaking as it empowers banks and financial institutions that have been notified by the government to recover non-performing assets without going to court. An asset is non-performing if the interest on it or instalments of the principal remain unpaid for more than 180 days.

SARFAESI provides three methods for recovery of non-performing assets: taking possession; selling; and leasing the assets underlying the security interests.

Ripple effect

In a globalized world, insolvency in one country can have repercussions in several others. In a recent case of a bankruptcy of a major international company, individual administrators were appointed to protect creditors' interests and to help the company function and revive.

This required the administrators to take control of the company's assets in different jurisdictions, coordinate a multijurisdictional effort to sell its property, and do all things necessary for the realization of the company's property.

In another case, a major multinational company was unable to pay off its debts due to the global financial crisis. Instead of liquidation, the company chose to use the corporate debt restructuring (CDR) mechanism provided by the Reserve Bank of India, to protect its creditors' rights and get time to revive itself.

The CDR mechanism is a voluntary process that is not backed by any legislation.

It came into force in 2001 to ensure that the Indian legal system does not hamper a quick revival of bankrupt companies. The CDR mechanism has not been as effective as was envisaged as many companies continue to drag their feet over their commitments to the creditors.

India has tried to be proactive in reviving sick companies; however, the tardiness of the Indian legal system hampers this at times. One would like to believe that the proposed amendments to the Companies Act will help rectify the problems and create a robust and expedient insolvency framework. But for now, one will have to wait and watch.

Neerav Merchant is a Mumbai-based partner at Majmudar & Co, advising clients in relation to commercial disputes (arbitration and litigation), real property and general commercial law. The firm has offices in Mumbai, Bangalore, Hyderabad, New Delhi and Chennai.

[Indian] businessmen tend to keep a part of their wealth unaccounted
Sarabjeet Singh
Partner
BMR Advisors

Lehman Brothers filed for Chapter 11 during the 2008 financial crisis but was finally acquired by the Japanese financial services firm Nomura Holding. At the time, the three Lehman companies in India – Mumbai-based Lehman Brothers Services India, Lehman Brothers Financial Services (India) and Lehman Brothers Structured Finance Services – had a positive net worth, and the new owners chose to appoint the international advisory firm KPMG to administer them. KPMG continues to play that role.

Diwanji, who has been involved with the operations of Lehman Brothers, argues that "the successful functioning of the company in India through an independent operator proves that it is possible to implement a Chapter 11 kind of a law in this country."

However, this kind of law, too, has its challenges. "When a company is in liquidation or bankruptcy protection the income tax appraisal takes much longer, the banking regulator becomes more conservative, and it is usually difficult to settle issues with private creditors," says Diwanji.

Corporate deceit

There are several reasons why Indian creditors tend to be suspicious of sick companies.

Sarabjeet Singh, a partner at Gurgaon-based consultancy firm BMR Advisors, says that being declared bankrupt in India is often associated with being a fraud. Furthermore, "businessmen tend to keep a part of their wealth unaccounted, which acts as a cushion for them during financial troubles in their companies."

According to Rajesh Kunnath, who is chief financial officer of Times Internet, a Times of India group company, most corporate business in India gets transacted through unlisted companies. These companies need to file only a section of their directors' report and restricted financial statements with the Ministry of Corporate Affairs. As a result, Kunnath believes "many promoters prefer to transact a large part of their business through the related unlisted companies."

The lack of publicly available information about such companies also makes decision making a challenge for creditors. Kunnath says, "there is so much cross-holding and confusing disclosures by Indian companies that it makes it almost impossible to track the real owners."

It [is] almost impossible to track the real owners [of an unlisted company]
Rajesh Kunnath
Chief Financial Officer
Times Internet

The BIFR is often misused … to defeat the interests of creditors and contractors
Shishir Mehta
Partner
Khaitan & Co

Mounting debt

The losses on account of such corporate gymnastics and business failures get passed on to the investors and creditors. India's finance minister, Pranab Mukherjee, told the parliament in November that at 31 March more than 4,000 big defaulters – which owe more than US$200,000 each – owed US$10 billion to Indian banks and financial institutions.

Commenting on the management of asset quality in a report published on 14 November, the RBI said "the recoveries have not kept pace with slippages". The report on the trend and progress of banking in India for the year ended 30 June, added that the "rising interest rates and substantial amount of restructuring done during the [2008 global financial] crisis, if not done with due care, are likely to put further pressure on asset quality of banks."

Emphasizing the seriousness of the situation, the RBI said that the gross non-performing assets of all Indian banks stood at 2.35% at 31 March 2011. However, under the extreme assumption that all "standard advances" that were restructured during the 2008 global financial crisis slipped back into non-performing assets, this figure could go up to 5.01%.

According to the same report, "asset quality remained particularly robust in China", where non-performing assets are only around 1% of total loans. In Mexico the figure is around 2%, and in Malaysia and Brazil it is around 3%.

On 9 November, six days before the release of the RBI report, the international ratings agency Moody's downgraded the Indian banking sector to negative from stable. This could have a major negative impact on the overall economy.

On the anvil

The government has made some efforts to address the problem of poor-quality assets. According to Avijit Roy, a New Delhi-based partner at Corporate Law Group, the government is keen to replace the BIFR with a National Company Law Tribunal, and has provided for this in the Companies Bill, 2011, which was recently presented in parliament. He says that if this happens the "change of management, infusion of capital and concession should happen in a time-bound manner".

A National Company Law Tribunal for adjudicating on restructuring and revival proposals was on the drawing boards in 2003-04, after a 2002 amendment to the Companies Act, but such a tribunal was not formed at that time.

Kunnath at Times cautions that a similar situation could emerge after the enactment of the new companies law but he adds that "if we have this tribunal functioning, with its proper constituents, we can start thinking in terms of a fair Chapter 11-like framework."

In the meantime, what will happen to Kingfisher airlines? The airline clearly needs a step-by-step reorganization plan to protect its ongoing operations if it is to live up to its advertising slogan: "Fly the good times with Kingfisher!" ■

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