Vinod Kothari, ACS
Vinod Kothari & Company
Practising Company Secretaries
Kolkata

vinod@vinodkothari.com

Soma Bagaria
Legal Advisor
Vinod Kothari & Company
Practising Company Secretaries
Kolkata

soma@vinodkothari.com

Resolution versus creditor rights: India strongly needs to tame SARFAESI Act

Corporate failure is inevitable in the working of a liberalised economy open to global competition and the volatilities of present day business world. An environment that protects the interests of creditors and debtors, classes of creditors, interests of other stakeholders is essential for a congenial business environment.

Law-making in India has recently been increasingly creditor-driven. Whether by way of the enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act, 2002 ("SARFAESI Act"), or amendments to the Sick Industrial Companies (Special Provisions) Act, 1985 ("SICA"), law-making has moved towards a non-judicial and faster enforcement of security interests by creditors. No doubt, effective collateral rights are the key to any well-laid system. However, the social objective of resolution and restructuring cannot be left completely at the mercy of a creditor-led system. As laws have given preponderance to the SARFAESI Act, SICA seems to have become extremely vulnerable to creditor's discretion.

This article discusses the settled international principles of corporate insolvency versus resolution, some recent rulings of courts which seem to make SICA overshadowed by SARFAESI proceedings, and gives some thought on the necessity of maintaining a balance between the needs of a workout and restructuring on one hand, and enforcement of security interests and liquidation on the other.

This article also focuses on corporate debt obligations - hence, individual insolvency, where considerations are different, is not discussed here. In addition, the fallout of the 2007-08 crisis has indicated that there are different considerations applicable to liquidation of financial enterprises such as banks and insurance companies. These also are not under our purview in this article. Hence, this article is focused on corporate insolvency of non-financial firms.

INSOLVENCY, CREDITOR RIGHTS AND RESOLUTIONS - NEED FOR BALANCE

Without dwelling on the legal difference between the two, insolvency is inability to pay one's obligations. When such an insolvency arises, there may either be an enforcement of creditors' rights, or there may be a holistic liquidation of the business and distribution of its assets among claimants. Enforcement of creditors' rights may be claims against the debtor, or personal claims, and claims against assets. The latter is mostly restricted to secured obligations. Creditors' claims against collateral or assets over which they have a charge is referred to as enforcement of security interests.

Whether arising out of insolvency proceedings or independently, there may often be a workout or resolution of creditors' claims, by way of settlements. Settlements may be

> World Bank's Principles for Effective Insolvency and Creditor Rights Systems, 2005 say that effective insolvency principles should "strike a careful balance between liquidation and reorganization, allowing for easy conversion of proceedings from one procedure to another."

informal - such as creditors' schemes or arrangements, or may be formal - such as the proceedings before the Board for Industrial and Financial Reconstruction ("BIFR").

Legal systems of countries have struck a very fine and yet efficient balance between enforcement of creditors' rights, liquidation and workouts. Creditors' rights essentially work on "might is right" principle - the one who has clear and first security interest will have the first claim on the assets backing up the debt. Court-administered winding up proceedings, on the other hand, are based on principles of equitable distribution, with *pari passu* being a guiding rule. Liquidations are a holistic remedy, while enforcement of creditors' claims is a topical remedy. Restructuring or resolutions try and avoid both enforcement of security interest and liquidation, with the idea that if a business is viable and can be nursed back to health, it is too much of a societal cost to wind it up. After all, recreating a business is a huge cost. Besides, a business establishment has lots of lives dependent on it - workers, vendors, buyers, and so on. Therefore, a wise society cannot afford to kill a business that is defaulting, but is still internally healthy, any more than humanity can afford to send sick people to morgue rather than to nursing homes. It is only where a business is found unviable that it is sent for liquidation.

World Bank's Principles for Effective Insolvency and Creditor Rights Systems, 2005[1] say that effective insolvency principles should "strike a careful balance between liquidation and reorganization, allowing for easy conversion of proceedings from one procedure to another."

RESTRUCTURING AND INSOLVENCY LAWS IN INDIA: ERA OF AD-HOC LAW MAKING

The last three decades or so have seen successful attempts of ad hoc law-making, and persistently overlooked the need for a comprehensive reform. We currently have the SICA with a resolution stance, SARFAESI with enforcement of secured claims stance, debt recovery tribunals ("DRTs") law with enforcement of unsecured claims stance, and general insolvency laws buried in the Companies Act, 1956 ("Companies Act"). Each of the special laws have non-obstante provisions, and each bar the jurisdiction of civil courts. Surprisingly, while public policy demands that the need for resolution should have overtaken enforcement, it is seen that SARFAESI has been constantly making inroads into SICA, as we see later in this article.

The SICA in India has been modelled on the basis of Chapter 9 of the US Bankruptcy code. While the actual working of the law has been lamented, there is no doubt that provisions pertaining to restructuring have served as useful purpose all over the world.

Obsession with non-performing asset problem

Somehow, the lawmakers in India never got to the tough task of insolvency law reform, and have tinkered with the law over last 3-4 decades. In fact, it is clear that the lawmakers were obsessed with the spectre of mounting non-performing loans on bank balance sheets, and therefore, most lawmaking was (a) inspired by the thought that the borrower is unduly delaying the repayment of the bank debt by resorting to a slow civil system, and (b) therefore, there was a need to tighten recovery laws. In essence, the clear stress of lawmaking has been recovery. This could not be deemed inappropriate, as borrowers used years of nationalised banking to their advantage to deliberately turn entities into "sick".

Thus, in 1981 the Tiwari Committee and in 1991 the Narasimham Committee were unequivocal about the need to bypass the civil system and use special tribunals to recover loans. Hence, DRTs were born. The second Narasimham Committee report made elaborate references to an "asset reconstruction fund", but eventually, asset reconstruction companies came out of the combo piece of law that was enacted in 2002 - the SARFAESI Act. While the DRT law was concerned with recovery of any dues of banks, the SARFAESI Act is limited only to secured debt, but then it launched a completely non-judicial method of recovery, where it is the borrower who has the right of first redressal but there is no need for the lender to take any adjudication at all.

Evidently, banks have been happy using the SARFAESI Act, and thus, attention has been quite scanty on the need for a comprehensive insolvency and resolution law.

Proposals for a code on insolvency laws in India

Significant recommendations and suggestions have been made

[1] http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2009/04/20/000334955_20090420051400/Rendered/PDF/481660WP0FINAL10Box338887B01PUBLIC1.pdf

regarding a law on insolvency of companies which have acknowledged that India does not have a clear policy and comprehensive law on corporate bankruptcy. The two eminent recommendations have been made by the 'Report of The Advisory Group on Bankruptcy Laws' (chaired by Dr. N. L. Mitra)[2] ("Advisory Group") and 'Justice Eradi Committee on Law Relating to Insolvency of Companies'[3] ("Eradi Committee").

The Advisory Group highlighted the importance of having a whole-some bankruptcy policy of the country that would facilitate efficient servicing of the sick companies that require timely intervention of restructuring as well as maximises the protection of the interest of the creditors and the investors with quick liquidation procedure and well laid down game rule for dispensation of the claims. This would have ideally balanced and aligned the interests of the company, creditors and the investors, thereby making the process smooth and acceptable at all ends. The need for a separate bankruptcy code was emphasized not only in relation to domestic entities but also cross-border entities, i.e. Indian entities having entities or ventures outside India and likewise, non-Indian entities having entities and ventures in India.

The Eradi Committee concentrated on the winding up procedure, highlighting the requirement to file statement of affairs, list of creditors, asset value, etc. that typically assist in speedy winding up process. The Eradi Committee also addressed the need to rank the dues of the employees *pari passu* with the secured creditors.

Unfortunately, no cue has been taken from the recommendations made by the Advisory Group and the Eradi Committee and India has not made any progress to form a bankruptcy code. In 2002, the Companies Act was amended, purportedly in a bid to make winding up process smoother. However, the National Company Law Tribunal (NCLT), which was to takeover jurisdiction over corporate insolvency from the courts, has never been constituted, and the provisions of the law, till date, remain in animated suspension.

Speed of resolution is only one of the many issues concerning a corporate insolvency policy. Other significant issues are balance between resolution and liquidation, and the question of conflicting priorities.

Conflicting priorities

One of the most significant issues in corporate insolvency is priority of claims - as it is most natural that in every case of insolvency, there will be several unsatiated claims, each wanting a primacy over the other. This issue, barring extremely general provisions of the Companies Act[4], has been left completely to the discretion of various law-makers.

The result is a complete chaos. First of all, legislations emanating both from Centre and State governments have been conferring an overriding priority to the claims under the respective laws - such as sales-tax, excise, customs, employee provident funds, employees state insurance, and so on. Second, while workers have been granted parity with secured creditors in a liquidation proceeding, the SARFAESI Act grants no such protection if enforcement of security interest happens

[2] http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/20811.pdf
[3] http://pib.nic.in/focus/foyr2000/foaug2000/eradi2000.html

[4] Sections 529, 529A and 530 of the Companies Act

before commencement of winding up, even though such action may leave the entity with no option but winding up.

Thus, where the law has left a complete void, the courts are left to lay down the law. In *Central Bank of India* v. *State of Kerala*[5], the Apex Court was concerned with resolving mutually conflicting provisions of Central and State laws, demanding a first security interest on the assets of the failed corporate. This is only one example - there are scores of rulings where conflict of laws on security interests have come before courts.

SICA ABATEMENT PROVISIONS: NEGATING THE VERY SPIRIT OF REVIVAL PROCEEDINGS

We have noted above that creditor-inspired law-making has been pushing ahead with strengthening the SARFAESI Act, while completely overlooking the very need for revival under SICA. It is not difficult to understand that revival is more of a social concern than creditors' interest. If creditors' interests were to run supreme, creditors would be interested in enforcement rather than revival. In fact, the spirit of Chapter 9 of US Bankruptcy Code and SICA is the same - moratorium on creditors' actions so as to enable revival. Against this principle, the provisions of SICA for abatement of SICA proceedings sound counter-intuitive.

Provisions regarding abatement of reference before BIFR

The second and the third proviso to Section 15(1) of SICA provide two situations wherein the reference before SICA shall abate. The said provisions read as hereunder:

"Provided further that no reference shall be made to the Board for Industrial and Financial Reconstruction after the commencement of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, where financial assets have been acquired by any securitisation company or reconstruction company under sub-section (1) of section 5 ofthat Act:

Provided also that on or after the commencement of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, where a reference is pending before the Board for Industrial and Financial Reconstruction, such reference shall abate if the secured creditors, representing not less than three-fourth in value of the amount outstanding against financial assistance disbursed to the borrower of such secured creditors, have taken any measures to recover their secured debt under sub-section (4) of section 13 of that Act." [emphasis supplied]

> One of the most significant issues in corporate insolvency is priority of claims - as it is most natural that in every case of insolvency, there will be several unsatiated claims, each wanting a primacy over the other. This issue, barring extremely general provisions of the Companies Act , has been left completely to the discretion of various law-makers.

To clarify, Section 5(1) of the SARFAESI Act provides for acquisition of financial asset of any bank or financial institution by a securitisation company or a reconstruction company; and Section 13(4) of the SARFAESI Act provides for actions that a secured creditor may take to enforce its security interest subject to fulfilment of conditions set out in the SARFAESI Act.

SICA: a vulnerable statute

(a) Abatement on action by secured creditors under section 13(4) of the SARFAESI Act

The reading of the aforesaid provision suggests that where a reference is pending, i.e. the applicant company has not been declared as a sick company, any action taken by the secured creditors under Section 13(4) of the SARFAESI Act shall abate the reference before the BIFR. Such being the case where an action by secured creditors under Section 13(4) of the SARFAESI Act has the effect of abating the reference before the BIFR, it is surprising that such action has been made unconditional and not appealable under SICA.

This is because it is held by courts that BIFR/AAIFR will not determine the legality or otherwise of the action taken by three fourths majority of the secured creditors, as the same comes under the domain of the DRT. The net result of this is that the BIFR has to per-force vacate the reference under SICA, without questioning the action of the creditors.

In the case of *Alpine Industries Ltd.* v. *AAIFR*[6], where the reference abated under the third proviso of Section 15(1) of SICA, an appeal was filed before the Delhi High Court on the ground that the BIFR/AAIFR shall have made independent inquiry into the action being taken by the secured creditors under Section 13(4) of the SARFAESI Act and that where such action was taken against one unit, the reference before BIFR

[5] http://indiankanoon.org/doc/857240/. This was followed in case of *State of Kerala* v. *The Official Liquidator of Poysha Industrial Company Ltd*, decided on 11 August, 2010, available at http://indiankanoon.org/doc/1321835/.

[6] *http://www.indiankanoon.org/doc/1206913/, decided on March 1, 2011*

shall continue in relation to other units of such company. It was held:

"Once the measures have been taken, which is not disputed in the present case as one of the unit had been taken over, whether the action was by 3/4th of the secured creditors or less in violation of section 13 (9) of SARFAESI Act, 2002 is not to be re-determined independently by BIFR." [emphasis supplied]

In the recent case of *Chemstar Organics India Ltd.* v. *Bank of Baroda & Ors*[7] against abatement of the reference before the BIFR on the ground that action was taken by secured creditors under section 13(4) of the SARFAESI Act, an appeal was made before the Court against the decision of the AAIFR, that did not determine whether the secured creditor who took action represented the requisite three fourths majority. The High Court refused to interfere with the decision of the AAIFR on the ground that this question would be determined by the DRT.

Court rulings simply interpret the law - hence, the real question is, is it a good law to make the revival of a company subject to the discretion of 75% of secured creditors?

(b) Abatement of acquisition of loan by an asset reconstruction company

Even more outrageous is the provision of SICA that provides for abatement based on sale of a financial asset to an asset reconstruction company (ARC). This provision exists in the second proviso to Section 15(1) of SICA, providing that on any such sale/assignment of any non-performing loan by one of the lenders to any ARC, the debtor company's chances of revival will be completely frustrated, as the reference to BIFR shall stand abated.

In an interesting, but critical decision of the Bombay High Court in case of *Paper Prints (India) Pvt. Ltd* v. *Phoenix ARC Pvt. Ltd*[8], the Division Bench of the High Court interpreted the second proviso to section 15 (1) of the SICA to suggest that where any financial assets have been acquired by an ARC, the reference before BIFR shall abate. The Division Bench held that the Second Proviso and Third Proviso to section 15(1) of SICA are independent, and there is no presumption as to taking of action by any particular percentage of secured creditors under the second proviso. Under the second proviso, once the "financial assets" have been acquired by an ARC, reference shall not be made at all.

Interestingly, while the abatement provisions pertaining to action under section 13 of the SARFAESI Act might have

needed overwhelming majority of the creditors to join in action, the proviso pertaining to transfer of assets to an ARC does not even require creditors to join in company. Technically, even if one creditor sells one loan given to a sick company to an ARC, however small such a loan is in relation to total assets of the borrower, the revival proceedings stand nipped in the bud.

These two provisions have the effect of making revival discretionary upon creditors, which is completely contrary to the whole spirit of SICA and the social need for revival.

NEED FOR COMPREHENSIVE INSOLVENCY LAW REFORM

Globally, most countries have realised the need for a comprehensive code on insolvency and enforcement of security interests. Corporate failure is inevitable in the working of a liberalised economy open to global competition and the volatilities of present-day business world. As uncertainty in prices, interest rates, commodities and stocks increases in general, corporate failures will increase. An environment that protects interests of creditors and debtors, classes of creditors, interests of other stakeholders, etc., is essential for a congenial business environment.

The present scenario in India is completely chaotic, wherein SARFAESI Act is constantly being made powerful at the cost of social considerations. Use of SARFAESI Act is fairly acceptable in case of security interests on non-core assets, but where the assets in question are the core assets of the borrower, enforcement of security interests cannot be given a free play under "might is right" principle. Hence, India urgently needs to write insolvency and creditors' rights laws that talk to each other, and not talk at each other.

[7] *http://www.indiankanoon.org/doc/153758448/, decided on September 17, 2012 differed from the decision of the Madras High Court in case of M/s India Radiators Ltd v. India Bank &Ors, (Division Bench of the Madras High Court), WP(C) No.29330/2010 decided on 13.06.2011.*

[8] *http://indiankanoon.org/doc/57289971/, decided on July 20, 2012.*