IBC Ordinance: End of the road for dishonest promoters, but has anyone thought of the collateral damage?

BY SHAILESH MENON & RAKHI MAZUMDAR, ET BUREAU | NOV 30, 2017, 09.30 PM IST

A week ago, President Kovind gave his assent to a carefully-worded Ordinance that barred ousted promoters of an insolvent company from regaining control.

A section of respondents believes Section 29A of IBC could hurt "honest" promoters of debt-stressed companies (trapped in unfavourable business cycles).

While the Ordinance - Section 29A of the Insolvency and Bankruptcy Code - has not specifically disarmed any class of participants, the decision to disallow "willful defaulters" from participating in asset-bids would mostly hurt promoters of debt-ridden companies, experts opine.

The Ordinance intends to checkmate sly, unscrupulous promoters who are trying to buy back their assets paying a fraction of what they originally owed lenders. All they have to do is to place relatively higher bids (than other bidders) for their assets. And if they bid successfully, they regain control of their assets, and also get all debt waived off.

"We've seen promoters buying back their companies very cheaply despite their outstanding debt running into hundreds of crores. Lenders are forced to take massive haircuts in such cases," explains Anil Bhattar, COO of Radisson Consulting, a firm specialising in bankruptcy cases.

"Dishonest promoters, prior to this ordinance, viewed Bankruptcy Code as a means to settle their debt cheaply and regain control of their business. Section 29A may help to prevent such practices," Bhattar adds.

Related

- **Not just defaulters, insolvency heat may now singe personal guarantors too**

Big Change:
The end of Five-Year Plans: All you need to know

ET spoke to over a dozen experts (mostly bankers, lawyers, bankruptcy professionals and consultants), to gauge their views about Section 29A.

Leave out gaping loopholes, broader consensus is that the Ordinance will hinder dishonest promoters from having it all their way.

That said, a section of respondents believe Section 29A of IBC could hurt "honest" promoters of debt-stressed companies (that have got trapped in unfavourable business cycles). Several clauses in the Ordinance would adversely affect the fortunes of companies that are genuinely looking for a second chance, they argue.

"One of the objectives of the Code, as stated in the BLRC, was to draw the line between malfeasance and business failure... to give debtors a second chance but penalise those who act with mala fide intent in default. Section 29A, at some levels, goes against that spirit," says Dinkar Venkatasubramanian, partner at Ernst & Young, a consulting firm.

■

"Many promoters of distressed companies were trying to keep their accounts 'performing' with banks for a long period of time and had proposed restructuring plans before the commencement of CIRP. They were trying to meet their obligations…This ordinance could be harsh on such promoters," says Dinkar.

"Section 29A will keep away wilful defaulters - and rightly so," he further adds.

Banking industry's stressed loans were over 12% of their total assets in December 2016 - up from 9.8% in March 2014. Total bad loan exposure of Indian banks exceed Rs 8 lakh crore, as per a recent ET report. The RBI put out its first list of 12 defaulters (monikered 'the dirty dozen' by industry-watchers) to be tried under the new bankruptcy law in June this year. Beyond that, several lenders, in their own capacities, have initiated bankruptcy proceedings against smaller corporate defaulters to recover their loans. National Company Law Tribunal (NCLT), the quasi-judicial body that oversees bankruptcy proceedings in India, has admitted over 300 cases relating to corporate loan defaults till date.

"The day a company is dragged to NCLT, the promoters are seen as thieves. All debt-stressed promoters are seen as willful defaulters. This is not right… companies fail in all parts of the world. Promoters alone cannot be blamed for corporate failures," says a top fund manager, whose funds have done well lending to debt-stressed companies.

While a large majority of financial services industry believe, defaulting promoters are unmitigated villains of this debt-mess, a few out there view it differently. Their reasons go back to the days of the Lehman Crisis, global economic meltdown and years of policy perversions and inertia.

External factors that caused debt pile-up!

The period between 2005 and early-2008 is considered the coming-of-age era for most Indian companies. It all started when India Inc. started tapping public markets for working capital and capex funds. When they found fair winds in business, they decided to cross Indian shores. They set up operations abroad, acquired companies and rubbed shoulders with multinational giants. This second level of expansion - their overseas ventures - was mostly done using debt capital (as debt is considered relatively cheaper than diluting equity).

But by mid-2008, the fair winds had stopped and businesses around the world found it difficult to sail through or stay afloat. Then came the collapse of banking behemoth Lehman Brothers.

The world was staring at a "possible, protracted economic slowdown." But Indian businesses were oblivious to the shifting winds in world economy. They pooh-poohed the premise of "bad business years ahead." Promoters of large Indian companies were comforted by their beliefs that our country was "relatively insulated" from global shocks. This was their mistake - a gross misreading of global macros.

"Even in 2009-2010, Indian companies were upbeat about their prospects," says the equities head of a foreign brokerage.

"Take for instance road-paving companies; they assumed 7 - 8% inflation and 8 - 10% growth in traffic as granted. They bid for road projects at crazy valuations. Banks went along with their (companies') projections; they loaned these companies large sums of money without any risk consideration," the equity head says.

■

By 2011, Indian economy was feeling the heat of an overbearing economic crisis. Crude prices shot up. Inflation surged, but growth faltered. Interest rates moved up north and demand crashed. The union budget threw up wide deficits, prompting the government to reduce public spending. A look at the progress of 'central sector projects' (above Rs 150 crore) would drive home this point quite adequately.

Out of 755 central sector projects (in October-December 2013), 264 were running delayed schedules; 95 projects were logging an average of 16 - 20 months delay in completion. All the 27 coal projects were running behind schedule, 12 out of 15 steel projects were delayed, 56 of 60 petroleum projects marking time over-runs, 56 of 57 power projects marked delayed status and 19 out of 32 road-highway projects were witnessing time over-runs. Cost escalation across 249 extremely delayed projects breached Rs 1.89 lakh crore during this period.

The situation worsened even more a year later - in end-2014. 346 out of 773 projects lagged behind schedule, triggering a cost over-run of Rs 2.16 lakh crore. Public spending gathered spending only in 2015, when the government rolled out additional projects to take the overall tally to 1085 projects. The government also managed to rein in delays a wee-bit - at around 350 projects.

"Spending on core sector is important as it percolates down (in the form of business orders) to the private sector. Public spending acts as prime catalyst to steel, cement, power and construction companies," says the research head of a leading domestic broking outfit.

"Many companies suffered due to the inaction of UPA government between 2011 and 2014. These companies had built capacities taking into consideration big government orders. When government stopped spending, they didn't have enough money to service their debt (taken to fund capex)," the research head adds.

Low government support apart, Indian companies also had to manoeuvre through bureaucratic and legal tangles. Starting 2011, the Courts started imposing mining ban across Indian states. India's iron ore shipments plunged from nearly 168 million tonnes in 2011 to a mere 18 million tonnes in 2012-13. This impacted companies like Essar Steel and Bhushan Steel, which had set up large, capital-intensive plants to meet future demand.

Bhushan Steel's New Patrapara block got de-allocated in September 2012. While disruption in these key steelmaking inputs raised its input costs, the onslaught of cheap imports from countries like China, Korea, Japan and Russia added to their woes, according to a source close to Bhushan Steel Limited.

The threat was serious enough to force the government into action. Albeit a bit late, in May this year, the government slapped anti-dumping duty on 47 steel products from half a dozen countries including China, Japan, Korea, Russia and Indonesia to protect the domestic industry from import competition.

Bhushan Steel had borrowed from banks to construct an integrated steel plant in Odisha. The construction began in 2005, and the company was assured of supplies of iron-ore and coal needed to make steel. The mining ban, and later the fracas over coal block allocations, scuttled the company's growth plans.

Essar Steel also had their share of run-ins with policy-makers when their pre-allotted quota of gas supply was stopped in mid-2011. Earlier that year, Essar had expanded its steel manufacturing capacity from 4.6 million tonnes to 10 million tonnes - mainly on the back of bank funding. The company's capacity utilisation remained at 35% due to gas supply shortage. Cheap Chinese steel import, and a price crash a few months down, added to the company's woes. The group, eventually, failed to service bank debt taken primarily for capex.

"Companies like Essar had gold-plated their capex. They got all their projections wrong… They could've set up a smaller plant, at much lower cost. In a way, they misused bank debt," says the corporate business head of PSU bank.

Essar may or may not have misused debt, but at some level even lenders need to shoulder the blame. The loaned money to these groups without drawing out any risk matrices. According to K M Jayarao, executive vice chairman of Ambit Flowers ARC, banks need to change their mindset and behave like PE firms; they need to create specialized groups to cater to loans in key sectors.

"They need to spot the first signs of weakness in any company, identify whether it due to a general business failure and take steps, if necessary by restructuring the loans and setting conditions on them early on. Promoters too need to agree to conditions," adds Jayarao.

Policy tangles, scams, slowdown…

When irregularities around telecom spectrum and coal block allocation surfaced, bureaucrats stopped giving approvals to business expansion projects. Environment, land acquisition and local body clearances were hard to come by. Inflation, exchange rate fluctuation, high tender values and high cost of environmental safeguards & rehabilitation measures weighed heavy on Indian promoters.

Even Visa restrictions were not favourable for Indian companies importing foreign technology. Electrosteel Steels faced the brunt of an obtuse Visa policy when they were building a plant at Siyaljhori in Bokaro district of Jharkhand, using equipment from China and Chinese construction workers.

"Indian promoters, who are under stress now, bit more than what they could chew… The macro environment did not support their growth path. They did not realise that until it was too late," says the MD of a mid-sized private bank.

Madan Sabnavis, chief economist at Care Ratings, adds: "These promoters were over-ambitious with their investments. They built a lot of capacities, but were not able to sell enough. Crash in commodity prices and tepid demand also hit them hard," Sabnavis adds.

A corporate debt pile-up is not a new trend in India. In fact, there is one big debt stress every decade. Whenever banks have turned liberal with credit, promoters have exercised their option to borrow in bagfuls.

"Till about a year ago, we did not have a legal framework to curb corporate loan defaults. Bankruptcy code fills that gap now," says Saurabh Mukherjea, CEO of Ambit Capital.

"Our regulatory system is not stable enough for long-term capex plans. Rules change too frequently. This is bad for companies in capital intensive sectors such as telecom, steel and mining," says Mukherjea.

"Also, our cost of capital is way above emerging-market averages. At such high cost, it is not feasible for companies to borrow for long-term capital-intensive projects," he adds.

The way forward

Section 29A gives more teeth to the bankruptcy code, to distance dishonest promoters who have willfully defaulted on corporate loans. But it has lot many loopholes too.

"The problem is on practical side. This may encourage back-door entry by dishonest promoters using clean frontmen," says Rajesh Narain Gupta, managing partner at SNG & Partners, a law firm.

"Some promoters may challenge this before Court - also the Supreme Court on constitutional grounds. This issue becoming contentious cannot be ruled out," he adds.

"The real problem lies with those set of promoters who have suffered genuine losses, without their being fraudulent in any manner. This category may also include a lot of SME and SSME enterprises," Gupta warns.

Jyoti Singh, insolvency & disputes partner at Phoenix Legal, feels that Section 29A (H) clause (which bars all resolution applicants who have executed an enforceable guarantee) could be challenged in court.

"If this clause stays, then 98% of Indian promoters would not be able to submit resolution plan, even if they don't fall under other restrictions in section 29A. In India, banks ask promoters for personal guarantees while approving loans," Singh reasons.

Diwakar Maheshwari, Partner at law-firm, Khaitan & Co, begs for more clarity around Section 29A. "Some clarity would be required on the implementation of the newly inserted Section 29A in view of certain pre-existing overlapping provisions introduced earlier this month," says Maheshwari.

Most bankers, whom ET consulted, supported the insertion of Section 29A in the bankruptcy code. The amendments are targeted at those who abused the system, they opined.

"These promoters were given a long rope in the past and were warned several times that they would lose their prized asset if they don't regularise their accounts," says the former MD of a leading PSU bank.

"There is a worry about good promoters having to pay the price for wrongdoings of a bad promoter... But the situation had reached a stage where we cannot do much. Promoters should not be allowed to regain their business at the cost of banks taking a steep haircut," the former MD sums up.