By Prof. Scott Pryor

Re-Secure in India

Government Acts Quickly to Restore Priority of Secured Claims

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Until 2016, the nation of India had no comprehensive means to reorganize the debts of an insolvent corporation. Debts, even debts owed to India's largest banks, were largely uncollectible. Bad loans — "non-performing assets" (NPAs) in Indian terms — cluttered the balance sheets of banks that rendered many of them of questionable solvency. Propped up for decades by the Reserve Bank of India (India's combination of the U.S. Federal Reserve and Federal Deposit Insurance Corp.), the situation called for a legislative solution.

A *Very* Brief History of the IBC

The creation of a new pro-business government following India's 2014 parliamentary elections created a window of opportunity. In 2016, the Insolvency and Bankruptcy Code (IBC) became law and is comprised of five parts.

Part I contains the definitions applicable across the IBC. Part II provides the substantive law for India's Corporate Insolvency Resolution Process (CIRP), the rough equivalent of chapter 11 of the U.S. Bankruptcy Code. Part II also contains the law for corporate liquidations. Part III, providing for personal bankruptcy, has not yet been implemented. Part IV of the IBC created the Insolvency and Bankruptcy Board of India (IBBI).

Among the many administrative and institutional responsibilities of the IBBI are licensing insolvency professionals and issuing regulations implementing the IBC. The IBBI has promulgated a substantial regulatory regime laying out details for the process of resolving corporate debt (CIRP Regulations). The IBC underwent two rounds of amendments in its first two years, but those changes did not address the substance of the CIRP.

Compare and Contrast

The differences between the CIRP and chapter 11 are numerous, but so are the similarities. A very quick trip through the timeline of a CIRP will illustrate some of the common and dissimilar features of the two bodies of law.

A CIRP is triggered by a default and initiated by an application.[1] The "Adjudicating Authority," a two-person bench of the National Company Law Tribunal (NCLT), which functions in some respects like a U.S. bankruptcy court, considers the application and any objections and either allows or denies the application.[2] Thus, initiation of the CIRP process is similar to a petition for an involuntary bankruptcy case under the Bankruptcy Code.[3]

Admission of the application leads to a moratorium[4] (an equivalent to the automatic stay), but does not effect as clear-cut a cleavage with the pre-CIRP existence of the debtor as does chapter 11. Thus, the property of the pre- and post-admission of the debtor is not distinguished[5] and claims are not frozen as of the admission date.[6]

Admission of the application leads to the appointment of an interim resolution professional.[7] The IBC gives the resolution professional a variety of duties comparable to a bankruptcy trustee, but there is a marked difference: The resolution professional calls into being a Committee of Creditors (CoC).[8] Unlike the creditors' committee under chapter 11,[9] the CoC is composed of *financial* creditors,[10] most of which will be secured. As the name suggests, financial creditors are banks, commercial equipment lessors and other sorts of lenders.[11] All other creditors are *operational* creditors.[12] Remarkably, nowhere in the original CIRP provisions was there specific mention of secured creditors.[13] As we will see, therein would lie a problem.

The NCLT carries some of the responsibilities of a bankruptcy court in a chapter 11, but others are assigned to the CoC.[14] Among the powers of the CoC is oversight of the resolution professional, who, in turn, (1) maintains the business operations of the debtor and (2) takes the lead in soliciting resolution plans.[15] The Indian model for resolution of corporate debt is thus creditor-in-control, not debtor-in-possession. Anyone may submit a resolution plan — *except* the share-

1 *See* Insolvency and Bankruptcy Code, 2016 (IBC) ss. 7, 9 and 10, *available at* indiacode.nic.in (unless otherwise specified, all links in this article were last visited on July 29, 2019).

2 *Id.*

3 *Cf. with* § 303 of the Bankruptcy Code (although admission of an involuntary petition is conditioned on proof of insolvency, not mere default).

4 IBC s. 14(1).

5 IBC s. 25.

6 *Id.*

7 IBC s. 17.

8 IBC s. 21(1).

9 11 U.S.C. § 1103.

10 IBC s. 21(2).

11 IBC s. 5(7), (8).

12 IBC s. 5(20), (21).

13 The presence and treatment of secured creditors is expressly addressed in the liquidation provisions of Part II of the IBC. *See* IBC ss. 52, 53.

14 IBC ss. 22 (appoint permanent resolution professional), 27 (replace resolution professional), 28 (authorize resolution professional to obtain interim financing, issue new securities, change management of the debtor, etc.) and 30 (approve resolution plan).

15 IBC s. 29.

holders of the debtor and a very large swath of related parties.[16] Most insolvency professionals and academics in India believe that the concern about the potential for abuse of a CIRP by insiders was overblown and led to the exclusion of too many potential plan proponents. In any event, the resolution professional submits all qualified resolution plans to the CoC, which chooses one for final approval by the NCLT.

By What Standard?

Not only has India adopted creditor-in-control management during a CIRP, it has afforded a subset of all creditors — the financial creditors acting as the CoC — the power to select a resolution plan from those that are submitted.[17] In other words, unlike chapter 11, only a select subset of creditors has the right to vote in a CIRP.

The CoC's power to choose among resolution plans is not untrammeled. IBC s. 30(2) contains six mandatory elements for a resolution plan. Significant additional requirements are found in CIRP Regulations 37 and 38.[18] While the Supreme Court of India has charged the CoC to treat all creditors equitably,[19] the IBC and CIRP Regulations require only that operational creditors get at least the liquidation value of the debtor's assets.[20] However, the CIRP Regulations provide a benefit to operational creditors by requiring payment of their dividend ahead of financial creditors and, in any event, within 30 days of final approval.[21] Financial creditors might get more than their share of liquidation value, but often they will have to wait for it.

What Was the Problem?

It is not clear why the CIRP provisions of the IBC failed to mention secured creditors much less to address treatment of their charges in collateral. The Report of the Bankruptcy Law Reforms Committee (the "BRLC Report") in 2015[22] had grouped all creditors into two classes — financial and operational — and only gestured toward standards for approval of a resolution plan.[23] Everyone presumably thought that the reality of security was too obvious to require mention in the definition of financial debt. The BRLC Report became the basis for the IBC.[24]

Regrettably, the failure of the CIRP provisions to address the property interests of secured creditors opened the door to evisceration of those interests. The decision of the National Company Law Appellate Tribunal (NCLAT) in the *Essar Steel* bankruptcy walked through the door.[25] The rapid legislative action to clarify the CIRP provisions — even as the NCLAT decision was on appeal to the Supreme Court of India — demonstrates the utility of a parliamentary form of government.

The 116-page appellate decision in *Essar Steel* covered a range of issues, but only two need be addressed in this article. First, the NCLAT held that all financial creditors are equal. In other words, the presence or absence of security for a financial debt is irrelevant. All financial creditors form a single class and must receive an equal percentage. The appellate panel reached this conclusion by observing that the definition of "financial creditor" makes no distinction between those that are secured and others who are not.[26] The decision looked no further than statutory construction, disregarding international norms that mandate recognition of security inside an insolvency proceeding as well as outside.[27] Nor did the decision address the constitutional protection of security as a property interest recognized by the Supreme Court of India 13 years earlier in *ICICI Bank Ltd. v. Sidco Leather Ltd.*[28] In any event, the appellate panel held in this case that the unsecured Standard Chartered Bank was entitled to the same percentage as well-secured financial creditors like the State Bank of India.

Second, and even more remarkably, the *Essar Steel* appellate panel held that there should be no distinction between distributions to (mostly secured) financial creditors and operational (unsecured) creditors. The panel's willingness to look beyond the CIRP's text on this issue stands in contrast to the narrow focus above. The panel initially considered the Supreme Court's *Swiss Ribbons* decision from early 2019 that upheld the constitutionality of the IBC. In the course of the court's lengthy opinion, it quoted from the UNCITRAL Guidelines for the general principle of "ensuring equitable treatment to similarly placed creditors."[29] Nothing in *Swiss Ribbons* turned on this observation. The appellate panel in *Essar Steel*, however, seized on the truism of equal treatment but ignored what is found only a few paragraphs later the same UNCITRAL Guidelines:

> *Clear rules for the ranking of priorities of both existing and post-commencement creditor claims are important to provide predictability to lenders*, and to ensure consistent application of the rules, confidence in the proceedings and that all participants are able to adopt appropriate measures to manage risk. To the greatest extent possible, those priorities should be based upon commercial bargains and not reflect social

16 IBC s. 29A(a)-(i) (lengthy list of disqualifying factors) and (j) (extension of disqualification to wide range of "connected" persons).

17 IBC s. 30(4) (approval of resolution plan requires affirmative vote of financial creditors holding at least 66 2/3 percent of the voting share of financial debt).

18 *Compare with* 11 U.S.C. §§ 1123 (contents of reorganization plan) and 1129 (standards for plan confirmation).

19 *See Swiss Ribbons Pvt. Ltd. v. Union of India*, ¶¶ 45-47 (SC 2019), *available at* sci.gov.in/supremecourt/2018/4653/4653_2018_Judgement_25-Jan-2019.pdf.

20 IBC s. 30(2)(b). Data published by the IBBI indicates that operational creditors frequently get more than liquidation value of the debtor. *See* Insolvency and Bankruptcy Board of India Corporate Insolvency Resolution Processes Yielding Resolution Plans: As on Dec. 31, 2018, *available at* https://www.ibbi.gov.in/webadmin/pdf/whatsnew/2019/Feb/Copy%20of%20For%20website-publication-resolution%20data%20Dec-2018%20Amended_2019-02-22%2022:54:14.pdf.

21 CIRP Reg. 38(1)(b), *available at* egazette.nic.in/(S(qxw0hkcrzgchoanufmum1glg))/Search1.aspx.

22 *See* The Report of the Bankruptcy Law Reforms Committee Vol. 1 at 4.3.3 (November 2015), *available at* https://www.ibbi.gov.in/uploads/resources/BLRCReportVol1_04112015.pdf ("Liabilities fall into two broad sets: liabilities based on financial contracts, and liabilities based on operational contracts.").

23 *See id.* at 5.5.3.

24 *See* Report on the Joint Committee [of Parliament] on the Insolvency and Bankruptcy Code, 2105 (April 2016), *available at* https://www.ibbi.gov.in/uploads/resources/16_Joint_Committee_on_Insolvency_and_Bankruptcy_Code_2015_1.pdf.

25 *Standard Chartered Bank v. Satish Kumar Gupta, Resolution Professional (In re Essar Steel Ltd.)* (NCLAT July 2019), *available at* https://ibbi.gov.in//webadmin/pdf/order/2018/Oct/33945_2018_Judgement_04-Oct-2018_2018-10-04%2015:36:20.pdf.

26 *Id.* at ¶ 164 ("If both Section 5(7) and Section 5(8) are read together, it is evident that there is no distinction made between one or other 'Financial Creditor.' … [A]ll of such persons form one class, *i.e.*, 'Financial Creditor' and they cannot be sub-classified as 'Secured' or 'Unsecured Financial Creditor.'").

27 *See, e.g.*, "Principles for Effective Insolvency and Creditor/Debtor Regimes," World Bank (Nov. 19, 2015), *available at* worldbank.org/en/topic/financialsector/brief/the-world-bank-principles-for-effective-insolvency-and-creditor-rights; "Legislative Guide on Insolvency Law," UNCITRAL 13 (2005), *available at* uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf.

28 67 SCL 383 (SC 2006) ("While enacting a statute, the Parliament cannot be presumed to have taken away a right in property. Right to property is a constitutional right. Right to recover the money lent by enforcing a mortgage would also be a right to enforce an interest in the property.").

29 *Swiss Ribbons*, *supra* n.19 at ¶ 45.

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and political concerns that have the potential to distort the outcome of insolvency.[30]

The NCLAT decision simply ignored the principle of the consistency of treatment of *similarly situated* creditors commended by international norms. The panel next looked to the standards for approval of a resolution plan under the CIRP. IBC s. 30(2)(b) is equivalent to the "best interests" test of chapter 11.[31] A resolution plan must provide operational creditors with at least as much as they would receive in a liquidation under the IBC. In turn, the liquidation priorities of IBC s. 53 provide that secured creditors recover before most unsecured creditors.[32]

This cross-reference should have been enough to recognize security in a CIRP. However, the appellate panel initially observed that IBC s. 53 is written in terms of priorities in the "proceeds from the sale of the liquidation assets." Because the funds received under a resolution plan are not technically from a "sale," the panel asserted that the liquidation priorities were immaterial in a CIRP.[33] The panel did not comment on the fact that its reading would render IBC s. 30(2)(b) surplusage.

A Swift Response

Within days, the State Bank of India, other members of the CoC and the resolution professional of *Essar Steel* appealed to the Supreme Court of India.[34] The alarm caused by the NCLAT decision across India's banking sector also led to a swift reaction from the government. On July 17, fewer than two weeks after the *Essar Steel* decision, India's cabinet recommended seven amendments to the IBC. Fifteen days later, both houses of India's parliament had passed the legislation.[35]

The amendment relevant to "re-securing" secured creditors provides that operational creditors (and dissenting financial creditors) shall receive the larger of what they would have received (1) "as if" the assets of the debtor had been liquidated under the IBC or (2) "as if" the proceeds to be received under the resolution plan were disbursed under the liquidation provisions.[36] Such a distribution will be deemed "fair and equitable" as a matter of law.[37] This clarification will deal with both problematic aspects of the appellate judgment in *Essar Steel*. For good measure, the amendment will also apply to any resolution plan that is on appeal.[38]

Conclusion

Foreign direct investment in and lending to Indian corporations is not for the faint of heart. Prospective lenders will need to consider all risks with care. Yet with the recent amendments to the IBC, at least the position of secured creditors is on firm ground. abi

30 *See* "Legislative Guide on Insolvency Law," *supra* n.27 at 13 (emphasis added).
31 *See* 11 U.S.C. § 1129(a)(7).
32 *See* IBC s. 53(1)(b), (c) (providing for limited equality of priority between secured debt and amounts-due unpaid workers).
33 *Standard Chartered Bank v. Gupta*, *supra* n.25 at ¶¶ 167-70.
34 *See* "Essar Steel Lenders Move Supreme Court Against NCLAT Order," *Financial Express*, July 13, 2019, *available at* financialexpress.com/industry/essar-steel-insolvency-lenders-move-supreme-court-against-nclat-order/1642729. On July 22, 2019, the Supreme Court of India stayed the decision of the appellate panel. Further proceedings were set for Aug. 7, 2019. *See* "SC Orders Status Quo on NCLAT Verdict in Essar Steel Insolvency Case," *Business Standard*, July 22, 2019, *available at* business-standard.com/article/companies/sc-orders-status-quo-on-nclat-verdict-in-essar-steel-insolvency-case-119072200218_1.html.
35 *See* "The Insolvency and Bankruptcy Code (Amendment) Bill 2019," *available at* prsindia.org/billtrack/insolvency-and-bankruptcy-code-amendment-bill-2019 (last visited Aug. 7, 2019).
36 *See id.*, *available at* prsindia.org/sites/default/files/bill_files/Insolvency%20and%20Bankruptcy%20Code%20%28Amendment%29%20Bill%2C%202019_0.pdf.
37 *Id.* In contrast to 11 U.S.C. § 1129(b)(2)(A), "fair and equitable" for operational creditors comes only after payment of all financial debts.
38 *Id.*