CHANGING SCENARIO OF DEBT RECOVERY MECHANISM: A COMPARATIVE STUDY

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ABSTRACT

With the increasing levels of non-performing assets in India over the years, reforming the legal framework for debt recovery and bankruptcy has become a sheer necessity. This research paper provides an analysis of debt recovery mechanism in India and what changes have been bought in the legislations regarding debt recovery. The purpose was to examine the debt recovery mechanism present in the country for the speedy recovery of debt due. What changes have been brought in this regard has also been discussed. How legislations has changed. There is a comparison between past regime and new regime from the time of independence till now and developments are also discussed. How RDDBFI act and SARFAESI act helped in the recovery of the debt. While the insolvency law framework and processes have been subject to universal denunciation, there has to date been little systematic study of how Indian insolvency and insolvency-related laws have been implemented in practice.

INTRODUCTION

In an environment where the present NDA Government in India has failed to get key bills approved in the Upper House of Parliament, it is disheartening to note that the government has lost an occasion in the freshly passed Insolvency and Bankruptcy Bill (the "Bill"). This Bill was one of a little number of legislations where the government was able to construct political consensus and gather enough votes to ensure safe passage.

India had abundant acts in place to punish the defaulters like the Indian Contract Act, the Recovery of debts due to Banks and Financial Institution Act 1993, the Securitizations and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA). The Government decided to substitute the existing insolvency laws with new rigid laws which would take care of the existing defaulters in a time bound manner.

The proposed bankruptcy legislation seeks to address the difficulties faced currently in the

perspective of insolvency and winding up. The provisions of the Code are pertinent to companies, limited liability entities, firms and individuals (i.e. all entities other than financial service providers).

After passing the bankruptcy code in Parliament for time-bound settlement of insolvency cases in non-financial firms, the finance ministry has released a draft bill to set up a resolution corporation to address similar issues among financial firms.[1]

The honourable Finance Minister Mr. Arun Jaitley quoted that "A systemic vacuum exists with regard to bankruptcy situations in financial firms. This code will provide a specialized resolution mechanism to deal with bankruptcy situations in banks, insurance firms and financial sector entities. This code, together with the Insolvency and Bankruptcy Code 2015, when enacted, will provide a comprehensive resolution mechanism for our economy,"

The planned legislation will not only advance the ease of doing business in India, but also facilitate a better and rapid debt recovery mechanism. It is widely alleged that this legislation, when implemented in letter and spirit, will change the negative insight of NPAs, recovery and litigation associated with India.

The new bankruptcy law will be a useful mechanism for international creditors and investors from the perspective of PE funds rolling to grow their investments in India.

The Government has formulated a plan to restore the prevailing bankruptcy laws and reinstate them with one that will facilitate stress-free and time-bound closure of businesses. The draft legislation, since the report issued in November 2015 by a panel headed by former law secretary Mr. T.K. Viswanathan, has undergone through several changes, including changes suggested by the Joint Parliamentary Committee in April 2016. The Insolvency and Bankruptcy Code, 2016 has now been passed by the Lok Sabha and the Rajya Sabha.

Bankruptcy and insolvency are not synonyms - rather bankruptcy is an outcome of being insolvent.[2] Insolvency and Bankruptcy is entry enclosed in the seventh schedule under concurrent list in the Indian Constitution, allowing both State and Central Governments to

[1] M.Guruprasad, economics for everyone- the insolvency and bankruptcy code in India and the National company law tribunal https://www.indiainfoline.com/article/article-latest/economics-for-everyone-the-insolvency-and-bankruptcy-code-in-india-and-the-national-company-law-tribunal-117111600570_1.html last accessed on 20 Jul., 18 at 2.49 pm

[2] Ashish Pandey, The Indian Insolvency and Bankruptcy Bill: sixty years in making, file:///C:/Users/HP/Downloads/Vol8-1-TIIBB.pdf last accessed on 20 July 2018 at 2.58 pm

extend the legislative framework. The concurrent list is an essential element of the Indian Constitution in ensuring the strength of federalism. Both Parliament and the State Legislatures have the ability to legislate on the matters covered in the concurrent list. Twofold control on certain subject matters was first envisaged in The Government of India Act, 1935. The constitutional place in India on concurrent power for the States and Union in dealing with insolvency and bankruptcy is analogous to United States.

OBJECTIVES BEHIND THIS CODE

In spite of all the legislations present, there was no single window exists for the resolution and multiple agencies worked and results in overlapping effect. The laws which were prevail could not match the market realities and not able to achieve confidence among Banks and other creditors. We have needed an umbrella, under which all legislations could functioned properly.

The sound framework on insolvency law would have achieves following objectives, helps in attaining the goals of lawmakers.

- **Removes ambiguity** - multiplicity of laws creates the ambiguity, multiple debt recovery governing bodies cause confusion. Parallel proceedings on the same debtor by the different creditors under different machinery lead resolution nowhere. The framework should remove this ambiguity.
- **drawing the line between malfeasance and business failure** - this code must drawn the line between a wrongful conduct and a genuine business failure. Due weak insolvency regime, rich debtors have ability to erase the line, and convert their malfeasance into a genuine business failure.
- **To setup fast track mechanism** – the main issue with former insolvency regimes is a slow resolution process and it would take minimum 4 to 5 years. The creditors should have their debt back as earlier as possible. To boost up the insolvency proceedings, this code has enacted which shall have a speedy resolution.
- **Avoid destruction of value** – it can also provide flexibility to the parties to arrive at the most efficient solution to maximize value during negotiation. More the negotiations done between the creditors and debtors, chance of rearrangement will be stronger.

- **Credit availability to market** – its main objective is to increase credit availability in the market to promote entrepreneurship and encourage new start-ups in the country.

EVOLUTION OF FRAMEWORK AND SUBSEQUENT DEVELOPMENT

- **Between 1947 and 1990**

Till the year 1985, the legal framework for dealing with corporate insolvency and bankruptcy subsist of only one law - The Companies Act, 1956. The Companies Act was based on recommendation of Bhabha Committee that was put up in the year 1950 and defer its report in the year 1952. Personal bankruptcy was adjudicated by two outmoded laws - The Presidency Towns Insolvency Act, 1909 and The Provisional Insolvency Act, 1920. The previous relates to individuals dwelling in the erstwhile presidency towns of Calcutta, Bombay and Madras. The latter covers all other individuals. Section 425 of the Companies Act provided a common framework for involuntary dissolution as well as voluntary dissolution. A variety of other sections including Sections 433, 443, 444, 455, 463, 466, 481 and 488 contained elaborated procedures for the resolution process. Despite various sections addressing the resolution process, the original Act of 1956 was incompetent of dealing with corporate insolvencies. The Act failed to provide any provision either for the insertion of insolvency cost or for super- priority of insolvency cost. It transfer most matters to courts, which in turn, relegated the due process to an official liquidator, generally a official professional appointed by the court with an exceptionally limited understanding of the company's business. Inexperienced liquidators with inadequate knowledge of technology, auction theory, organizational behaviour and financial engineering, affected prolonged resolution timelines and suboptimal revival for the betterment of creditors and workmen.

The panorama of subpar recovery in a very remote future dissuaded affected parties from commencing dissolution proceedings under Companies Act (Patwari, 2014). The power to judge on merits of dissolution was assigned exclusively to the judiciary by Companies Act but the courts were not provided with any legislative structure to assess merits. Lack of a supporting legislative framework resulted in a unstable legal process with each High Court interpreting individual cases differently and notifying orders, often contrary to another High Court.

The provisions of Companies Act 1956 were proving insufficient as explained earlier. It was

in this context that the first legislative measure to deal with insolvency and bankruptcy was declared in the form of The Sick Industrial Companies Act, 1985 ("SICA"). SICA was an end product of reports by various committees appointed by the Government and the Reserve Bank of India since 1975.[3] These included Tandon Committee of 1975, Rai Committee of 1976 and Tiwari Committee of 1981. Under SICA, a sick industry was defined as an industrial company with five years of history whose net worth is zero or negative, having 50 or more workers and recognized in accordance with Industrial and Dispute Act, 1951. SICA allowed companies to make an indication to a quasi-judicial body called Board for Industrial and Financial Reconstruction ("BIFR"). BIFR adjudicated the reference in the presence of the company and creditors. An appellate authority was also instituted in the form of Appellate Authority for Industrial and Financial Reconstruction ("AAIFR").

- **Development after 1990 and till 2010**

The most critical mechanism for debt recovery that is available for all secured and unsecured creditors involves filing a petition in a civil court of proficient jurisdiction and this mechanism remnant available today. However, a sequence of laws were enacted in the 1990s and 2000s to facilitate debt recovery for specific classes of creditors given the high pendency of cases in the civil courts and understanding of abuse with laws such as SICA. The Recovery of Debt Due to Banks and Financial Institutions Act ("RDDBFI Act") was enacted in 1993 to make it feasible for banks and financial institutions to recover debt. The RDDBFI Act is available to both secured and unsecured creditors, but they need to be banks or notified financial institutions.[4] This Act provided for the establishment of DRTs and DRATs and any cases pending before the civil courts that involved debt of over Rs. 10, 00,000 were mechanically transferred to the DRTs.

SICA was proving to be a blockage for creditors in recovering dues from promoters with forged designs and financial institutions were facing immoderate delays in securing a final decree from courts on civil suits. In order to accelerate the recovery process, RDDBI was enacted with provisions allowing Banks to file an application before a specifically constituted Debt Recovery Tribunal asking for a 'Certificate of Recovery'. Certificate of Recovery had the same effect and standing as a Decree of a Civil Court. RDDBI Act failed to make any improvement in the jumbled insolvency landscape, chiefly due to the fact that SICA had

[3] Supra note 2

[4] Aparna ravi, The Indian Insolvency Regime in Practice- An analysis of Insolvency and Debt recovery proceedings, https://ifrogs.org/PDF/201511Ravi_lessonsfromcaselaw.pdf accessed on 20 July 2018 at 4.03 pm

primary over RDDBI. If a case was pending before BIFR, DRTs were incompetent of issuing a certificate of recovery.

In addition, DRTs lacked powers for considering rehabilitation or dissolution and were therefore a site of the last choice with promoters who deliberately indulged in 'Forum Shopping' to suit their personal interests. Finally, DRTs were found to be exhaustive with a large number of pending cases. Considering these drawbacks and with the intent to accelerate resolution of non-performing assets, the Government introduced a new legislation called The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI) in 2002. The SARFAESI Act provided a legal machinery for expedite recovery of secured assets through entrusting Banks and Financial Institutions to recover their non-performing assets without involvement of the court.

Approximately the same time when SARFAESI Act was introduced, Reserve Bank of India introduced a Corporate Debt Restructuring Scheme ("CDR Scheme") that provided vast guidelines for debt restructuring by Banks. The CDR Scheme, first introduced in 2001, was amended multiple times over the next fifteen years and became a operational document rather than a statute. The first extensive report in this regard was presented by Sachar Committee in the year 1987 that emerged in a major amendment to Company Act in 1988. The government introduced two additional amendments in 1993 and 1997, but failed to accomplish the majority mandatory for passage of these amendments.

The Company Act was amended in 2002 incorporating some of its suggestions. This was followed by Chandra Committee report in 2002 and Irani Committee report in 2005 that resulted in another amendment in 2006. The cumulative nature of improvements, important changes in other regulations that impact Company Act without an amendment to Company Act, and slow execution of changes enacted by amendments have resulted in slow improvement of reforms.

- **<u>Development after 2010</u>**

It was clear by the year 2010 that a single, comprehensive framework is mandatory to effectively tackle barrier in insolvency and bankruptcy proceedings. The economic rationale and design characteristic of a new legislative framework were covered in the first volume and the draft bill was laid out in the second volume. A modified version of this bill, incorporating

public comments, was scheduled in Parliament in late 2015.

In summary, the legal and regulatory framework for concerns with insolvency and bankruptcy situations was dreadfully inadequate from 1947 until the most recent introduction of the new Bill. There were interference made by the Government during this period, but these interventions failed to obtain the desired results due to the subsistence of multiple laws and lack of harmonization of varied regulations. An insufficient environment for dealing with insolvency resulted in the expansion of a bank-oriented economy in India. Capital markets were cautious of the ever changing regulatory regime, the impact of new laws on the recovery of debt and enforceability of security interests. Hence, there was exceptionally limited participation of private players in the corporate debt space and lending activity was chiefly controlled by Public Sector Banks. Absence of free market competition in the corporate debt market resulted in enormous mispricing of individual debtor risk which has culminated in the form of high NPAs.

Changes brought up in SARFAESI Act and DRT act

A considerable change now brought about by the Enforcement Act is the amendment in the SARFAESI Act that allows secured creditors to take over collateral alongside which a loan had been provided, upon failure in repayment. It has further been provided that this procedure will have to be completed within 30 days by the District Magistrate.

Another fascinating amendment brought about to the SARFAESI Act is the change in the definition of the term 'debt securities'. It has now been provided that debt securities would signify securities listed on Indian stock exchanges. It can thus be said that the assistance of remedies under the SARFAESI Act and the DRT Act have been extended to debt securities listed on Indian stock exchanges. An amendment brought about by the Enforcement Act to section 2 and section 13 the SARFAESI Act now enables a debenture trustee to execute its security with respect to listed debt securities under SARFAESI Act in the occurrence of non-payment of debt after 90 days' notice of non-payment has been served on the borrower. For this provision to apply, such debt is not mandatory to be classified as a non-performing asset (NPA). According debenture trustees the same rights as other secured creditors is a constructive step. However there are certain issues that remain with admiration to the same. Currently listed debt securities have been excluded from the NPA requirement under the Enforcement Act and the SARFAESI Act. However prerequisite that an account should be

classified as an NPA before banks and financial institutions implement their security under the SARFAESI Act still remains. There may be a scenario where a non-payment in respect of all debts by a borrower will enable some secured creditors to invoke SARFAESI Act provisions former than others.

Another amendment now broadens the definition of financial assets and includes hire purchase, financial lease and conditional sale within its scope. Further secured creditors are now enabled to take over a company and reinstate its business on attainment of controlling interest in the borrower company.

The Enforcement Act has proclaimed for creation of a central database to incorporate records of property registered under various registration arrangements with this central registry. This includes incorporation of registrations made under Companies Act, 2013, Registration Act, 1908 and Motor Vehicles Act, 1988. Registration of security interest with the Central Registry will be obligatory for enforcement of security under the SARFAESI Act and will act as public notice.

Other key amendments

Changes to the ARC Framework

(i) Ownership and Control of ARCs:

Till now, ownership and control of an asset reconstruction company had to be an assortment of and no benefactor could hold a controlling interest (more than 49%) in an ARC or assign a majority of its board of directors. These limitations have been removed and sponsors are now approved to hold up to 100% equity in an ARC as well as exercise majority control above its board. Respectively, the Reserve Bank of India (RBI) has also been given superior powers of omission over an ARC's operations as well as, the right to appoint RBI officers as observers to the board of directors of an ARC and if necessary, change/ replace its directors.

(ii) Eligible Purchasers of Security Receipts:

Until now, only 'qualified institution buyers' (i.e. banks, financial institutions, insurance companies, state finance corporations, mutual funds and foreign portfolio investors) were allowed to procure security receipts issued by ARCs. With the amendment, the scope of qualified investors has been widened to incorporate non-institutional investors as recognized

by RBI from time to time.

With non-performing assets (NPAs) and stressed assets of Indian banks exceeding INR 8 trillion (approx. USD 125 billion), these changes to the ARC framework could help remove distressed assets from the balance sheets of Indian banks by developing a robust secondary market for distressed debt in India. Removal of the sponsor ownership restrictions could incentivize more players to set up ARCs and allow existing ARCs to raise necessary capital to expand their portfolios. Further, the widening of the investor base for security receipts may possibly generate more interest in these instruments and allow banks to off-load their NPAs on an arms' length basis, as opposed to self-funding securitization transactions to restructure their exposure.

B. Wider group of SARFAESI Eligible Lenders

Until recently, the benefits under the SARFAESI Act and the DRT Act were accessible to a limited group of lenders – i.e. scheduled commercial banks, International Finance Corporation, Asian Development Bank and identified Housing Finance Companies. The government has made two considerable additions to this group:

NBFCs: On 5 August, 2016, the Ministry of Finance has particularly notified and named those non-banking financial companies (NBFCs) with an asset amount of more than Rs. 500 crores, as SARFAESI qualified lenders.

Listed Debt Securities: The benefits of the SARFAESI Act and the DRT Act have been comprehensive to the listed bond market in India. Debenture trustees chosen in respect of debt securities listed in accord with applicable SEBI regulations have been exclusively included as 'secured creditors' under the SARFAESI Act, and consequent changes have been made to several provisions of both the SARFAESI Act and the DRT Act. These changes potentially permit lenders that do not separately have rights under the SARFAESI Act or the DRT Act (such as domestic funds, mutual funds, insurance companies, foreign portfolio investors and other investors in the corporate debt market) to benefit from such rights when acting through a debenture trustee in respect of listed bonds.

C. Central Registry for Security Interests

Once the amendments are notified, all secured creditors (including creditors who do not have enforcement privileges under the SARFAESI Act) will be requisite to register their security interests with the Central Registry of Securitization Asset Reconstruction and Security Interests of India (Central Registry). This will help in implementation of the Bankruptcy Code and will enlarge overall transparency in deference of security interests over a debtor's assets.

D. Increasing efficacy of SARFAESI and DRT Proceedings

While the SARFAESI Act and DRT Act are proposed to accelerate recovery of secured debt, there have been various procedural issues which have limited the efficiency of these legislations. Accordingly, various modifications have been made to both the legislations to deal with this predicament. For instance:

timelines for diverse steps in the adjudication procedure before the debt recovery tribunals such as filing of written statements, passing of orders, appeals, etc. have been abridged; and

The cost on a borrower to setback recovery timelines through prolonged appeals and proceedings has been augmented. Borrowers will now be obligatory to deposit at least 25% of the outstanding amounts with the debt recovery appellate tribunal (DRAT) under the DRT Act to desire an appeal. Previously, (a) this floor of 25% on the deposit compulsion applied only to appeals made under the SARFAESI Act, and (b) borrowers could request the DRAT for a waiver of the entire deposit compulsion under the DRT Act.

KEY AREAS THAT HAVE NOT BEEN ADDRESSED

While a much needed momentum has been provided to debt recovery and enforcement laws with the said Amendment Act (and the Insolvency Code), the Legislature still falls short of addressing the following realistic concerns of secured creditors:

♦ **Observance to 13(2) Notices - a Moral Obligation**

On non-payment being committed by the borrower, be it in relation to interest payment or principal repayment, the secured creditor is necessary to provide a notice on the borrower in terms of Section 13(2) of the Act ("13(2) Notice"). In case the borrower fails to acquit his liabilities (in full) to the secured creditor within 60 days of overhaul of the aforesaid notice, the secured creditor is allowed to resort to measures provided under Section 13(4) of the Act,

viz., taking custody of the secured asset or taking over the management of the borrower etc.

The alarming threat of the core security being wasted away, still gives nightmares to secured creditors functioning with negative balance sheets, even after the Amendment.

While Section 13(13) of the Act does provide that the borrower shall not shift (by way of sale, lease or otherwise, other than in the ordinary course of its business) any of its secured assets after receipt of the 13(2) Notice, without the former written consent of the secured creditor. It is an understood fact that the prohibition under Section 13(13) is more of a moral responsibility. The secured creditor is authorized to appoint a manager to manage the secured asset taken over by the creditor; However, this power is accessible only after the lapse of the aforesaid 60 days' notice period. The secured creditor is more apprehensive about recovery; and the deterrent in the form of fine and/or imprisonment for breach of any provisions of the Act by the borrower is of little comfort to it.

♦ **Enforcement of Pledge Still Outside the Purview of the Act**

Pledge of movables, for example, over shares of the borrower company or of its affiliate and associate companies, is one of the favored security interest formed by the borrower under the Loan agreements today. However, despite the Amendment, pledge of movables (within the meaning of Section 172 of the Indian Contract Act) is still disqualified from the purview of the Act (Section 31 of the SARFAESI Act). Therefore, the enforcement process for pledge continues to be subject to the peril of protracted litigation in Indian Courts.

♦ **Dichotomy of Laws and Forums**

The DRT and the Appellate Tribunals were established under the DRT Act. As per the DRT Act, for recovery of debt from a borrower, a bank or financial institution needs to make an application to the DRT having jurisdiction over the borrower's area of residence or business or, post Amendment, over the area of bank branch where the debt is pending.[5] Appropriately, such applications can be made by only those financial institutions that have been informed by the Central Government in this respect and to which the DRT Act has been made relevant.

CONCLUSION

[5] Ritunjay gupta and kunal mimani, Surf easy with SARFAESI, http://www.jsalaw.com/wp-content/uploads/2017/09/78-taxmann.com-3131.pdf last accessed on 22 July 2018 at 12.28 am

The objective of the legislature in the direction of simplifying recovery procedures for creditors requires to be appreciated. However both the houses of the Parliament passed the Insolvency and Bankruptcy Code, 2016.The subsistence of dual laws diverse and forums i.e. NCLT and DRTs to deal with the debt recovery trouble of secured creditors may effect in more time being spent in resolving uncertainty and create opportunity for litigation. In view of the same, the legislators may need to offer some more clarifications on the excising recovery configuration for creditors.

The amendments are possibly the most considerable set of changes to the SARFAESI Act since its performance in 2002. The Bankruptcy Code and the amendments to the SARFAESI Act collectively reflect a clear legislative intent to move the needle in a distressed situation towards the creditors by plugging diverse loopholes available to borrowers.

We believe that the enclosure of listed bonds within the SARFAESI Act could considerably deepen the listed debt market in India by generating concentration from a wider variety of investors – including retail investors, insurance companies, domestic funds and foreign portfolio investors. If adequate liquidity is generated in the market, traditional lenders could also discover subscribing to listed debt in light of the simpler process and cheaper transaction costs allied with a transfer of these instruments.

While the amendments are a welcome move, they fall short of creating a level playing field for all participants in the Indian debt market. The entire external commercial borrowing (ECB) framework, which is relatively more synchronized than the listed bond framework, continues to stay outside the scope of the SARFAESI Act. In an environment where foreign companies, individuals and retail investors holding listed bonds would eventually benefit from the self-help remedies under SARFAESI Act, it is uncertain why regulated foreign banks, bilateral or multilateral financial institutions and other eligible ECB lenders should have to resort to conventional court-proceedings to recover their dues.

Government needs to tackle these shortcomings in the Bill on priority, by way of an amendment. The timeframe for declaration plan sanction needs to be considerably extended from the current 180 days. The revised timeline should not be analogous across defaulting firms and must integrate a classification based on total assets, the harshness of default and number of creditor claims. Creditors committee should have obligatory representation from employees. The bonafide of any disputes regarding claim of an operational creditor should be

recognized by Adjudicating Authority. Union Government should take active part in the insolvency procedures and protect the integrity of the bankruptcy resolution method by instituting a program similar to The United States Trustee Program. Detailed criteria, including minimum recommendation, need to be laid down for the rendezvous of key executants like IPRs and Liquidators.

The eventual efficiency of the Bill will be judged based on the reliability of the proposed resolution process, harmonization amongst its various provisions and future experimental results. In the absence of the above- suggested amendments, the Bill will fail to increase ease of doing business, will not go faster GDP growth as contemplated, and will only result in higher cost of equity capital for businesses.