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The Creditors' Cloud – A Clarion Call?

Ashu Kansal & Manmayi Sharma

A few months after the enactment of the Insolvency & Bankruptcy Code, 2016 ('IBC'), the apexcourt of the country upheld the "paradigm shift" that was brought about by its provisions in implementing a 'Creditor-in-Possession' regime for the resolution of debts and restructuring of defaulting corporate entities.

THE DISCUSSION PRIME

A Creditor-in-Possession regime is one in which all decisions towards insolvency resolution of the corporate debtor are made by a 'Committee of Creditors' (CoC), which primarily comprises of the Financial Creditors of a company. The CoC may either agree on a 'resolution plan' or liquidate the assets of the corporate debtor, when resolution is not feasible. This substantially negates the role of shareholders in making any such management decisions for the corporate debtor as the primacy of the creditors takes its place. This gets furthered keeping in mind a recent notification by the Ministry of Corporate Affairs (MCA), clarifying thatshareholder approval will not be required during consideration and implementation of a resolution plan under the IBC. Thus, upon the admission of insolvency proceedings against a corporate debtor, the CoC has a decisive say on the fate of the corporate debtor.

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A Creditor-in-Possession regime only further emphasizes the fact that debts due to creditors represent a negotiated and fixed return, whereas the investment of shareholding membersis speculative, and holds little or no value once a company turns insolvent. Shareholders with no value for their investment will tend to make high risk decisions as compared to creditors who will be incentivized to formulate a viable resolution plan that will give them their due returns, without destroying the asset base of the company.

Less than a year into the implementation of the IBC, it seems that such a division between the creditors and shareholders may be too simplistic. The contention arises from the fact that certain creditors could also take the role of shareholder of a company when they secure part of their dues against the equity of a borrower company. This is done by implementing certain debt recovery mechanisms such as 'debt for equity swaps' or 'share pledges' as part of loan agreements with the borrower company. These debt recovery mechanisms are in fact, backed by circulars issued by the Reserve Bank of India.

A 'Debt-equity swap', is a mechanism that is encouraged by banks and financial institutions – toallow them the opportunity to bring down the scale ofnon-performing assets (NPAs) in their books. Upon invocation of a debt-equity swap that is agreed to by the parties to a loan agreement, a part of the debt is exchanged for a pre-determined amount of equity or stock in the borrower's company. Similarly, once a share pledge is invoked, certain shares that are pledged with the creditor as security against a loan amount are transferred to the creditor to enable recovery of its debt exposures.

As described above, in a Creditor-in-Possession regime, after the initiation of insolvency proceedings, all powers of management of the shareholders and promoters of a corporate debtor stand transferred to a Resolution Professional, who carries out the business of the Corporate Debtor, whilst obtaining relevant approvals from the CoC. In this scenario, a question arises as to whether creditors who have exercised debt recovery mechanisms ('equity holding creditors') can form part of the CoC to take decisions for insolvency resolution of the corporate debtors, despite holding management stakes in it?

This scenario recently arose for consideration before the National Company Law Tribunal (NCLT), in the matter of SREI v. Canara Bank and Anr.1 The NCLT had to decide whether SREI, a financial creditor who is also a substantial shareholder of the Corporate Debtor i.e. Deccan Chargers Holding Ltd. ('DCHL') can have a place in the CoC that is constituted as part of the insolvency proceedings.By its judgment dated 16.11.2017, the NCLT held that SREI cannot be part of the CoC of DCHL, being a major shareholder – holding 24.5% equity shareholding in DCHL, and thus having the power to exercise control in the management of the Corporate Debtor. It came to this decision in concurrence with the view of the Resolution Professional of DCHL that SREI is a 'Related Party' as per Section 5(24)(j) of the IBC. This Section defines a 20% threshold limit for shareholding in the Corporate Debtor, due to ownership or voting agreement, for categorization as a 'Related Party'.

The NCLT has gone by the book in ousting any shareholder participation in a Creditor-in-Possession regime, and by recognizing the threshold limits that delineate control by a Related Party over the management of a company. The strongest reason for such exclusion of equity-holding creditors is that it goes against the basic rationale for implementing a Creditor-in-Possession regime. Upon insolvency of a borrower company, the shares of an equity-holding creditor carry almost no value, and thus, there isn't much chance for recovery of debt. Those shares also stand bottom-most in priority when it comes to repayment – whether out of liquidation or through a Resolution Plan. Thus, the equity-holding creditors will seek to make as much recovery as possible by making high-risk decisions, which will be at odds with the interests of other creditors who would want to make maximum recovery by preserving the asset base of the Corporate Debtor.

However, there could be points to compel a slightly lenient view in favour of accommodating the shareholding interests of a creditor. These are explained below to argue that,equity-holding creditors should be included in the CoC in certain scenarios that may arise in insolvency proceedings.

Firstly, the primary objective for the enactment of the IBCi.e. the need to facilitate faster and smoother debt-recovery, to encourage all categories of creditors to invest. And thence, the initial credit that is extended by an equity-holding creditor to a borrower company cannot be forgotten, merely because the mode ofits recovery has changed. More important is that the creditor should be allowed to realize their amount-whether secured by shares or by a conventional mortgage of properties, or by guarantees.After all, any security is meaningful only if the pledged asset value is at least equal to the debt, so that the lender can recover the amount. Primarily, the shareholding by an equity holding creditor represents security

[1]C.A. No. 153/2017 in C.P. (IB) No. 41/7/HDB/2017

[2]Section 5(7), Insolvency& Bankruptcy Code, 2016 ('IBC')

interest and hence, a mode of debt recovery.

The Creditor-in-Possession regime, however, functions as a blanket rule against all equity-holding creditors, regardless of whether their shareholding in a company crosses the20%benchmark, which would make them a 'Related Party'. Using such a broad brush against equity holding creditors is impractical as they should be allowed to participate in the CoC to the extent that the debt owed tothem represents a 'financial debt' as per the IBC.2 This is a practical demand, which does not contravene the primacy of a Creditor-in-Possession regime and ensures that the premise of 'security interest' is not erased for such equity-holding creditors. In any case, given the current provisions of the IBC, creditors should be careful not to secure over 20% shareholding interest in a company, so that they do not flout the definition of 'related party' as noted by the NCLT.

The current rule to oust equity-holding creditors from the CoC may dis-incentivize creditors from accepting informal debt recovery mechanisms such as share pledges or debt for equity swaps as security against their loans.It is rightly argued against the shareholding interests of creditors, that any ownership of equity comes with an investment risk. If a company doesn't perform well, the creditor must bear proportionate losses to recovery of debt through its equity shareholding. However, adefault amount of merely Rs. 1 Lakh could force a company into a Creditor-in-Possession regime, even though its business can adequately service its debts to most of the other creditors. This would mean that the equity-holding creditor has no standpoint in the controlling CoC and is also given the lowest priority(as is given to shareholders) in the insolvency proceedings. This not only negates the priority claim of a Financial Creditor out of insolvency proceedings; but may also motivate some creditors to use the IBC as a tool to arm-twist certain lenders out of the recovery of their legitimate dues. Such a scenario would, in no way constitute a proportionate risk to shareholding. Additionally, the equity holding creditor will be put through a much greater disadvantage, for risks that are unrelated to the company's success in which it holds shares.Thus, it maybe required in certain scenarios that a distinction is made between shareholding attained by an acquisition of shares for investment vis. a vis. the ones obtained for recovery of a part of the outstanding dues.

THE CLOSING STATEMENT

The above reasons clearly establish strong grounds for important indicators for the requisite distinction. Equity-holding creditors should be considered for a seat in the CoC with voting right when their shareholding still holds financial value, although insolvency proceedings have been admitted for a default to a certain creditor.

Additionally,the debt owed to them should represent as a financial debt, regardless of whether the shareholding percentage brings an equity-holding creditor within the scope of a 'related party' under Section 5(24)(j) of the IBC.Undoubtedly, there are certain issues that must be addressed - the position of equity-holding creditors within the IBC ought to be re-examined.

Some definite quantitative and qualitative guidelines can be prescribed by the IBBI to provide adequate representation of the financial creditors in the CoC. A blanket ban for such financial creditors might not only discourage the debt recovery mechanisms but also restrict the option of raising debts by pledge of equity.

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