SAMVĀD: PARTNERS

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JUDGEMENT ON STRESSED ASSETS CIRCULAR - ADDS TO THE "STRESS" OF THE LENDERS?

WHERE IT ALL STARTED?

The circular on "Resolution of Stressed Assets – Revised Framework" ("**Circular**") dated February 12, 2018 by RBI was issued under the Banking Regulation Act, 1949 ("**BR Act**") and the Reserve Bank of India Act, 1934 ("**RBI Act**") subsequent to the enactment of the Insolvency and Bankruptcy Code, 2016 ("**IBC**"), in order to substitute the existing guidelines for resolution of stressed assets. The Circular directed lenders to refer any loan account with an aggregate exposure of INR 2000 crore and above defaulting on or after March 1, 2018 ("**Reference Date**") to the process under IBC as financial creditors, if such default persisted for 180 days from the Reference Date or 180 days from the date of default after the Reference Date.

Due to the stringent timelines and compulsory direction to IBC imposed by the Circular, several companies from the power and telecom sectors had challenged the Circular, arguing that the time given by the RBI was not enough to tackle bad debt. For instance, the players in the power, telecom sector had argued that the RBI's monolithic approach was unfeasible since the sector was firefighting external factors that were beyond their control, and it was not the case of a promoter or companies willfully committing fraud on the law. Power companies had approached the Allahabad High Court against the Circular, which had refused to grant them interim relief in August, 2018. Shipping and sugar sector companies had also similarly approached other High Courts against the Circular for similar reasons. Recently, the Supreme Court of India ("**SC**") while dealing with various clubbed petitions and transferred cases on the issue, declared the Circular ultra vires the BR Act.

QUESTIONS BEFORE THE COURT:

The questions before the bench comprising of Justice R.F. Nariman and Justice Vineet Saran (collectively "**Bench**") were **(A)** constitutional validity of the Banking Regulation (Amendment) Ordinance, 2017 and the Banking Regulation (Amendment) Act, 2017 introducing Sections 35AA and 35AB of the BR Act; and **(B)** 'ultra vires' nature of the Circular under the BR Act and the RBI Act.

WHAT DID THE COURT SAY?

The Bench **upheld the constitutional validity** of Sections 35AA and 35AB of the BR Act which means that the RBI had the powers to issue the Circular and can issue such similar circulars in the future as well. The Bench **upheld the powers of the RBI to issue circulars/directions** under Section 35A to banks/NBFCs to move under the IBC against

debtors in certain specified circumstances which means that the RBI has the mandate under existing provisions of the BR Act to issue directions in relation to IBC.

However, the Bench further ruled that the pre-requisites for RBI to direct banking institutions to move under the IBC are (i) that there is a Central Government authorisation to do so; and (ii) that it should be in respect of specific defaults and thus Section 35AA by necessary implication, prohibits this power from being exercised in any manner other than the manner set out in Section 35AA. This implies that Section 35AA was to be used only in respect of specific defaults cases by specific debtors and not in general for all debtors. Going forward RBI can issue directions under Section 35AA only in respect of specific cases where default subsists after examining the sectoral issues, and not take a 'one-size-fits-all' approach.

The Bench further held that the general powers of RBI to issue directions in relation to stressed assets are derived from Section 35AB read in conjunction with Section 35A, thus distinguishing the RBI's powers under Section 35AA and 35AB, while the former is in respect of 'specific default cases', the latter is in respect of 'resolution of stressed assets' in general.

Based on the above approach, the Hon'ble Supreme Court declared the Circular as beyond the parent laws (i.e. BR Act and the RBI Act) and hence struck it down entirely.

RBI's REACTION:

The RBI vide a press-release dated April 4, 2019, issued a statement which read "*the order of the Supreme Court mandates RBI to exercise its powers under Section 35AA "in respect of specific defaults by specific debtors". The powers of RBI under Section 35AA and other sections of the Banking Regulation Act, 1949 are, therefore, not under doubt.*" The statement further stated that the RBI will issue a revised circular "*In light of Hon'ble Supreme Court order, the Reserve Bank of India will take necessary steps, including the issuance of a revised circular, as may be necessary, for expeditious and effective resolution of stressed assets.*"

TAKE AWAYS FROM THE RULING

- Revival of earlier schemes? In light of the Supreme Court judgement in *State of U.P and Ors. v. Hirendra Pal Singh and Ors.* in our view, the automatic reinstatement of the earlier circulars/schemes *inter alia* S4A, JLF and CAP, SDR and CDR, may not be possible and RBI will need to issue fresh circulars.

- "One Day" Rule "Tossed" Away: The Circular mandated lenders to report defaulting accounts on a weekly basis which led to borrowers becoming 'defaulters' even if they had defaulted in their payments by just one day. One of the concerns the industry is struggling with is whether the earlier reporting requirements automatically revive in light of the Circular being struck down. The conundrum becomes especially relevant for lenders as there were reporting obligations under the Circular vis-à-vis the account

classification which were previously mandated. We understand that most banks are being cautious and continuing with the reporting obligations set out in the Circular till further clarity from RBI on the same.

- Debt to Equity conversions: Another cause of confusion is that the earlier schemes such as the strategic debt restructuring scheme required inclusion of a mandatory provision in the loan agreements with respect to the conversion of debt to equity. Since there is no clarity on the revival of the earlier schemes, the jury seems to be out on this one too.

- Hurried resolutions: The Circular mandated lenders to proceed under IBC after the expiry of 180 days from default if no resolution was reached. The lenders now should be able to take a more nuanced approach in dealing with stressed assets especially when arriving at a feasible resolution requires more time.

- The undoing of the Pocket Veto: The Circular mandated that a resolution could only be arrived at unanimously. Essentially even a single lender could block the resolution. In contrast, IBC allows for a more flexible approach wherein only two-thirds majority is required for passing a resolution plan.

IMPLICATIONS ON THE CURRENT LANDSCAPE

IBC proceedings:

The order of the Hon'ble Supreme Court also raises a doubt on the validity of the various actions initiated with respect to 12 corporate debtors and the second list of 29 corporate debtors. In our view, it should be possible to establish the validity of such actions.

Further, in our view, it should be possible to continue with the proceedings already commenced under the IBC if the same was not commenced specifically under the Circular. This will however need an in-depth analysis from a factual background perspective.

Despite the quashing of the circular, banks will however, continue to have the option of referring such defaulting borrowers under the IBC, in case the resolution plan fails.

The verdict could delay the process of stressed assets resolution, which had of late picked up pace since banks will now have the choice of devising resolution plans or going to the National Company Law Tribunal under the IBC. The urgency that the Circular had introduced in the banking system could be impacted.

Way forward:

The Indian Banks' Association in its recent communication to the RBI has urged RBI to (a) make only a small relaxation in the new norms for stressed assets by requiring consent of 90% of lenders for approving a resolution plan instead of 100% mandated in the Circular with a total

of 270 days for implanting the plan; (b) set up a mechanism similar to the JLF that was in place before the Circular; (c) to fix upgradation provision for the accounts if 10% of the outstanding debt is paid (as against the 5% recommendation by the Association of Power Producers); and (d) to require that the assets be classified as "stressed category" on 30 day default. On the flip side, power companies have sought different treatment going forward to help the sector to revive in 18-24 months with a suggestion for approval of only 60% of the creditors for implementing any resolution plan.

Since the RBI has released a statement that it will shortly issue another circular, it would be advisable to adopt a cautious and coordinated industry-based approach till such circular is issued.

This is an update for general information purposes only and does not constitute legal advice. Please contact us if you require further clarifications on this subject.

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