25

Debt Default, Recovery, and Resolution in a Pandemic

What to expect in the New Normal

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That the year 2020 has presented a unique challenge to legal regimes governing debt recovery and resolution around the world, is an understatement. Conventional wisdom on robust contract enforcement, legal certainty, strong creditor protection and speedy resolution can no longer be applied with the same conviction. Policymakers around the world have taken steps to allow households and businesses some 'breathing space' from the recovery of dues. Standstills have become the norm, debt recovery the exception.

Policymakers and central banks have primarily used five tools from their arsenal to effectuate this approach: fiscal stimulus to households and businesses, monetary policy measures (including liquidity injection through banking channels), statutory moratoria on debt repayment and suspension of parts of bankruptcy laws. States have also used soft nudges to pre-empt a deluge of litigation and bankruptcies.[1]

This article critically analyses three sets of developments in India in connection with standstills and forbearance during the pandemic. First, the moratorium imposed by the Reserve Bank of India (RBI), as the banking regulator, on the recovery of debt by lenders regulated by it. Second, the temporary suspension of the Insolvency and Bankruptcy Code, 2016 (IBC) in its entirety, and third, forbearance offered through court judgements.

How will these forbearance measures affect the state of debt recovery in India? Will they impact all kinds of borrowers and credit segments equally? What will their impact be on credit discipline and overall contract enforcement in India? This article attempts to unravel the seen and unseen effects of these developments for the credit market in India.

RBI MORATORIUM ON DEBT RECOVERY: SOME HITS AND MISSES

On March 27, 2020, the RBI announced a 'COVID Regulatory package' comprising several measures to help the financial sector and borrowers deal with the impact of the global pandemic.[2] A key measure was allowing all lending institutions (banks, NBFCs, etc.) to grant a 'moratorium' on installments and interest on term loans falling due until end of May, 2020.[3] The RBI, in exercise of its powers as a banking regulator, declared that the deferment of such installments and interest will not be classified as 'defaults', and will not be subjected to a classification downgrade in the lenders' books.

The measure, taken within two days of the announcement of a nationwide lockdown, was well-timed and underpinned by a largely sound design. It offered immediate payment relief to a large segment of the borrowers of banks and RBI-regulated lending institutions. It covered term loans, credit cards and borrowings through cash credits and overdraft facilities, which accounts for over 96 per cent of the outstanding loan portfolio of banks (Table 1). Most importantly, refraining from a regulatory *diktat,* RBI left it to the lenders to design the moratorium as per their own policies as long as they transparently disseminated the offer and consistently applied it, to their borrowers. The presumption was that in a competitive lending sector, each lender is incentivised to offer the best deal to its borrowers.

Table 1: Loan portfolio of banks

Type of loan/ advance	Rs. (in lakh crore)
Term loans	57.43
Cash Credit/ Overdraft	36.07
Bills payable/ discounted	3.6
Total	**97.1**

Source: RBI (as on March 31, 2019)

The measure was challenged in the Supreme Court (SC) on the ground that it was ineffective as it was designed to merely 'defer' payment obligations that became due during the six-month period beginning March 1, 2020 and ending August 31, 2020 (RBI Moratorium Period). The interest on these loans continued to accrue and compounded and would be payable by the borrowers after the moratorium period. While the SC adjourned the case to early August after holding a couple of hearings, it questioned the regulator's wisdom in allowing the interest to be compounded. The court's intervention in this matter is problematic for several reasons. Two are explained below.

First, the basis for the court's intervention remains unclear. The question before the court is essentially a policy related question, namely, whether the banking regulator is empowered to relax its norms on asset classification if borrowers failed to repay their loans during the RBI Moratorium Period. Note that the RBI circular merely 'permits' lenders to grant the moratorium and assures them that the loan will not be downgraded in the lender's books if the borrower defaults during the RBI Moratorium Period. Questioning the wisdom of the banking regulator, on grounds other than the constitutionality of the measures, is tantamount to questioning the regulator's policy. This is a slippery slope which the court must resist even in the most tempting of times.

Second, postponement of the matter to early August – nearly towards the end of the RBI Moratorium Period - created tremendous uncertainty for all the stakeholders involved. Borrowers are likely to decide whether or not to avail of the moratorium depending on the pay-out that they will have to make once the moratorium is lifted. It hindered the ability of lenders to accurately assess the extent of the waiver that the court will ask of them, and consequently make appropriate provision for the defaults. Even if the government were to absorb the loss, estimation of this loss would have to wait until the court's decision. This left every decision maker in the dark on the size of the moratorium at a macro-economic level and at the level of a household.

Apart from the SC challenge, two other issues may limit the impact of the RBI measure. First, the non-applicability of the moratorium on the interest and principal repayments on bonds issued by lenders, such as non-banking financial companies (NBFCs) and housing finance companies (HFCs). Most of these lenders raise capital through bond issuances, which were subscribed by banks and other financial institutions such as mutual funds and pension funds. While the moratorium applied to the loans advanced by NBFCs and HFCs to their borrowers and resultantly starved them of cash flows, it did not simultaneously defer the NBFCs' and HFCs' obligations to service the interest and principal repayments falling due during the RBI Moratorium Period. At a time when the NBFC sector was already struggling with financial distress, the RBI measure tightened the noose further.

Second, the moratorium spanned at least six months comprising more than one earnings and disclosure season. In the absence of any obligation to disclose the extent to which the moratorium has been availed of, the disclosures of the lending entities have largely varied in quality and detail. Resultantly, the volume, kind and value of borrowers who have actually availed of the moratorium, continues to remain unclear. Data on these aspects is extremely valuable not only to depositors and shareholders of these lending entities, but can serve as high frequency indicators of the manner in which the economy is coping with the lockdown, the number and kinds of defaults and bankruptcies to expect at the end of the moratorium.

TEMPORARY SUSPENSION OF THE IBC: RECOVERY Vs. RESOLUTION

On June 5, 2020, the Central Government promulgated an ordinance suspending the IBC, in its entirety, for a period of six months, which could be extended upto a year.[4] Effectively, if a default is committed between March 25, 2020 and September 24, 2020 (IBC Suspension Period), such default could not be used to trigger the IBC at any point in time in the future.

Several countries, such as the UK, Germany and France have suspended parts of their bankruptcy laws dealing with the obligation of the debtor to file for bankruptcy or creditor filings. Some others, such as Australia, have made other adjustments, such as increasing the duration of the statutory notice preceding the invocation of the bankruptcy law. However, India is one of the few countries to have suspended its entire bankruptcy law. This has two critical implications for debt recovery and resolution in India.

First, it leaves two options open for the reorganisation of the corporate debtor, namely, the regulations for the resolution of stressed assets specified by the RBI in June, 2019 (hereafter, RBI Resolution Framework), and the provisions of the Companies Act, 2013, dealing with schemes of arrangement and compromises.[5] These are not optimal. The RBI Resolution Framework binds only RBI-regulated entities and no other creditors such as foreign lenders, mutual funds, bond holders, vendors, employees, etc. The latter is largely untested in India in the context of financial distress.[6]

This leaves debtor firms – the very firms that the suspension of the IBC intended to protect - in a rather low-equilibrium. To take an example, if the IBC were not suspended, a rational debtor could consider opting for the RBI moratorium at the cost of allowing the compound interest to accrue. If the debtor were unable to repay it at the end of the RBI Moratorium Period, the debtor could have sought reorganisation of the debt under the IBC. However, with the IBC now suspended, it is unclear if this choice would be open to debtors.

Second, large parts of the RBI moratorium period and the IBC Suspension Period overlap with each other, effectively suspending both *debt recovery* and *debt resolution* for some time in India. Consequently, the mechanism available to a creditor entirely depends on *when* the default was committed and *by whom.*

Tables 2 and 3 illustrate this proposition. Under the current legal architecture, two options are available to creditors for the recovery of their debt, namely, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI), pursuing the claim before a Debt Recovery Tribunal (DRT) or in a civil suit or arbitration. SARFAESI allows some types of creditors, namely banks, financial institutions and NBFCs to enforce the underlying security to recover their debt.

The Recovery of Debts and Bankruptcy Act, 1993 sets up specialised tribunals, called DRTs to allow banks and financial institutions to pursue their claims. For the sake of simplicity, Tables 2 and 3 classify the recovery mechanism before a DRT as a suit as the process for recovery under this mechanism is largely similar to that of a civil suit.

For the purpose of reorganisation, creditors have the choice of pursuing a petition under the IBC, a scheme of arrangement or compromise under the Companies Act, 2013 and the RBI Resolution Framework as discussed above.

Table 2 envisages a scenario where a corporate debtor defaults on a term loan due to a bank or NBFC. It is clear that if the default is committed anytime between March 1, 2020 upto August 31, 2020, the only relief available to the creditor is reorganisation under a scheme of compromise or arrangement as it does not require a default to have been committed.[7] This is because during this time, the RBI Moratorium Period runs concurrently with the IBC Suspension Period. Therefore, for example, even if the default is committed *prior* to the date of the ordinance suspending the IBC, that default cannot be used to invoke the IBC due to the ongoing RBI Moratorium Period.

Table 2: Scenario: Borrower defaults on term loan from bank or NBFC

Date of default (2020)	Recovery mechanisms		Resolution/ reorganisation mechanisms		
	SARFAESI[8]	Suits/ arbitration	IBC	Scheme of arrangement or compromise	RBI Resolution Framework
March 1 - 24	✗	✗	✗	✓	✗
March 25 – August 31	✗	✗	✗	✓	✗
September 1 - 24	✓	✓	✗	✓	✓

Table 3 envisages a scenario where a bond issuer defaults to a bond holder, such as a mutual fund or a pension fund.

Table 3: Scenario: Bond issuer defaults to a bond holder

Date of default (2020)	Recovery mechanisms		Resolution/ reorganisation mechanisms		
	SARFAESI[9]	Suits/ arbitration	IBC	Scheme of arrangement or compromise	RBI Resolution Framework
March 1 - 24	✓	✓	✓	✓	✗
March 25 - August 31	✓	✓	✗	✓	✗
September 1 - 24	✓	✓	✗	✓	✓

A combined reading of Tables 2 and 3 shows that for defaults committed anytime between March 1, 2020 to September 24, 2020 (which could be extended to March 24, 2021), recovery and reorganisation mechanisms for creditors in India will differ substantially for different kinds of borrowers and creditors, depending on the timing of the default and the kind of creditor.

One of the objectives of the IBC and several subsequent reforms implemented by the Government and the RBI was to equalise all credit relationships in so far as concerns the recovery and reorganisation options available to them. These policy developments have substantially, even if temporarily, disrupted this agenda.

COURTS: FORBEARANCE Vs. CONTRACT SANCTITY AND PRUDENTIAL NORMS

Even before the policy announcements described above, several debtors and creditors had begun approaching courts seeking relief from debt or a waiver from the enforcement of covenants by creditors, especially covenants that allowed the lender to invoke a pledge of shares underlying the credit. The field is now occupied by court orders granting debt forbearance waiving regulatory prudential norms on a case-by-case basis and inconsistent judgements.

For example, in one of the early cases in the lockdown before the Bombay High Court, the court passed an order injuncting IDBI Trusteeship Company from selling the shares of Future Retail Ltd., which were pledged as a security for the debentures issued by a Future group company.[10] The reason underlying this relief was a sharp decline of over 60 per cent in the value of the equity stock of Future Retail since the beginning of March, due to the nationwide shutdown. Thereafter, the Bombay and Delhi High Courts have passed similar orders restraining creditors from invoking pledges[11], and restraining lenders from classifying loans that had defaulted prior to the lockdown, as non-performing assets.[12] In a more recent case, however, the Delhi High Court allowed IDBI Trusteeship to sell the pledged shares of Zee Entertainment Enterprises Ltd. ignoring the impact of the pandemic on the business or the price of the shares.

These orders are deeply problematic because they are likely to have a long-lasting impact on the sanctity of debt contracts. Similarly, judicial intervention on the manner in which a bank must classify the asset in its books, erodes prudential norms and can potentially adversely affect the financial health of the bank, which in turn, jeopardises depositors and savers. Finally, these orders create deep rule of law issues as none of the orders mentioned above seek to rely on the law or terms of the debt contract, but are driven by the court's notion of what is just and equitable depending on the exigencies of the situation and the gravity of the pandemic.

These orders will have two tangible effects. First, it will increase the implicit cost of credit in the country. Given the liberal attitude of courts in granting forbearance (even for defaults committed before even the first COVID-19 positive case was detected in India), lenders will seek to build in other forms of security, such as personal guarantees and escrow mechanisms to secure repayment. Second, from the debtors' perspective, boiler plate clauses in debt contracts, including in particular, clauses relating to material adverse changes and effects, will be negotiated more vigorously. The objective will be to widen the scope of these contractual terms to allow scope for forbearance.

CONCLUSION

A 40,000 feet view of the legislative, regulatory and jurisprudential developments in the credit space in 2020, indicates that while they might work in the short run to shield debtors from the immediate shock of the pandemic, the long-term impact will be hard to quantify. Policymakers and regulators must do everything in their power to elicit better and timely disclosures from lenders on the impact of the RBI moratorium and the suspension of the law.

Given that all debt recovery and resolution mechanisms are nearly entirely suspended, a sensitisation initiative for both lenders and borrowers on the manner in which they could deal with financial distress as economic activity resumes, would also be in order. While lenders would have to be sensitised against the disproportionate use of the bankruptcy threat, borrowers, especially small and micro enterprises, sole proprietors, etc. would need to be familiarised with the concept of bankruptcy and the need to destigmatize the idea of bankruptcy. They would also need support on dealing with financial distress, the legal remedies available to them and the need for transparency and fairness in their dealings.

Could this have been done differently? The answer seems to be mixed. While policymakers got many things, such as the timing of the RBI moratorium and the suspension of the IBC largely right, there was scope for more nuanced interventions. For example, there is near consensus on the view that the IBC should not have been suspended in its entirety and debtors should have been given the option to use the legal framework to voluntarily reorganise themselves. Similarly, this time can be gainfully used to build the ecosystem necessary to support individual insolvency so that as economic activity resumes, individuals, micro and small sized unincorporated entities can use the law for the purpose which all bankruptcy regimes are meant to serve – give a new lease of life to debtors. After all, the essence of capitalism is to reward success and accept failure with equanimity.

NOTES

[1] For example, the UK government issued an advisory nudging people to refrain from exercising their contractual rights, in particular with respect to asking for or making payment. Similarly, the state of New York imposed a moratorium on COVID-related commercial or residential evictions from tenanted properties.

[2] Notification dated March 27, 2020 bearing number RBI/2019-20/186 DOR.No.BP. BC.47/21.04.048/2019-20 issued by the RBI.

[3] This was subsequently extended to August 31, 2020.

[4] Since the provisions of the IBC governing individual insolvency have not been notified, this effectively means suspension of the IBC with respect to corporate debtors only.

[5] These regulations, titled Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions 2019, were notified by the RBI on June 7, 2019.

[6] Umakanth Varottil (2017), "The Scheme of Arrangement as a Debt Restructuring Tool in India: Problems and Prospects", NUS Working Paper, 2017/005, March, http://law.nus.edu.sg/wps.

[7] It might be argued that the circular declaring the RBI moratorium period does not pre-empt lenders from approaching the court for default, especially if the lender's policy does not grant the moratorium to a specific borrower. However, it would be difficult for a court to accept this proposition, given that the banking regulator has directed all lenders to allow forbearance for certain kinds of loans.

[8] If the bank or NBFC is a secured creditor.

[9] If the bond holders are secured and the bonds are held by a bank or a NBFC that is eligible for relief under SARFAESI.

[10] *Rural Fairprice Wholesale Limited & Anr. v. IDBI Trusteeship Services Limited & Ors.* (March 30, 2020).

[11] For example, in *Idea Toll & Infrastructure Pvt. Ltd. and Anr. v. ICICI Home Finance Company Ltd. and Anr.*, the Bombay High Court restricted ICICI Home Finance, from invoking the pledge of collateral and selling the shares of MEP Infrastructure Developers, in respect of defaults committed by MEP prior to the lockdown.

[12] *Transcon Skycity Pvt Ltd & Ors v. ICICI Bank Ltd. And Ors.* (April 11, 2020); *Anant Raj Ltd. v. Yes Bank Ltd.* (April 6, 2020).