How bankruptcy got redefined in India

- Bankruptcy in India has always been a mess and lenders knew they could do little more than kiss their money goodbye. It's still early days, but IBC might change that
- It took two years of courtroom battles to find a buyer for ailing Essar Steel. Will business exits become easier now?

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The Essar Steel plant is a 9.6 million-tonne single-location flat steel manufacturing unit in Hazira, Gujarat, and is unlike most other steel plants, which are often based near iron ore reserves (Photo: Dinodia)

On 16 December, the day it closed its acquisition of Essar Steel India Ltd, ArcelorMittal SA, the world's largest steel company and the new owner of the steel mill, held a closing party at The Oberoi in Mumbai. The prevalent mood was one of relief. A collective sigh was almost palpable.

It had taken two years to get to that evening, involving courtroom battles in Ahmedabad and higher benches in New Delhi, and then the Supreme Court. Over those two years, there had been nearly 30 meetings of the Committee of Creditors (CoC), while its core committee—which recommended key decisions to the larger group—had met over a hundred times.

Aditya Mittal, the chairman of ArcelorMittal Nippon Steel India Ltd, has spent over two decades working with his father and steel magnate L.N. Mittal, training in the elder Mittal's strategy of buying quality but distressed steel mills across the world and reorganizing them into productive businesses. This acquisition of Essar Steel—hailed as a triumphant homecoming of the Mittals after several false starts—was driven almost entirely by Aditya Mittal. He had set up a large cross-functional team out of ArcelorMittal Belgium, while also spending considerable time in India, liaising with lenders, and attending every ruling on the case at the Supreme Court.

In a country where the idea of bankruptcy is still nascent and the legal process to wind down a business while paying back lenders is still riddled with all manner of uncertainty and doubt, perhaps that level of devotion is necessary. A member of Essar Steel's CoC recounted his conversation with the Mittal scion that evening at The Oberoi. “Aditya told me that when he first saw the Essar Steel asset, he straightaway fell in love with it. He said his love was just a tad lower than his love for his wife."

But love doesn't come cheap, or even easy. ArcelorMittal, along with joint venture partner Nippon Steel Corp. of Japan, had paid ₹42,000 crore to win over those who had lent money to the erstwhile owners of the steel plant. Another ₹7,469 crore was shelled out just to qualify for the bid. (The latter was used to repay debts of Uttam Galva Steels Ltd and KSS Petron Pvt. Ltd, bankrupt firms with tangential links to the Mittals.) They had also committed to a capital infusion of ₹8,000 crore into the plant after taking over as the new owners.

The questions at the end of this long ordeal, in what was perhaps India's most high-profile, big-ticket bankruptcy resolution, are: will the many cases that swirled through the country's court system as a result of this distress sale radically change how business exits unfold? Will it result in more certainty for creditors? And will it lead to more money getting pumped into Indian businesses?

Evolution of IBC

When Standard Chartered Bank and State Bank of India filed insolvency proceedings against Essar Steel in August 2017, the company had an outstanding debt of ₹54,550 crore. It was the single biggest defaulter on the Reserve Bank of India is India's original “dirty dozen" list of bad loans. Banks, which were laden with bad loans that were eating into their profits and starving them of capital, were going to test the new Insolvency and Bankruptcy Code (IBC), which had been passed in Parliament the previous year.

The law was clear in what it wanted to achieve—quick resolution and maximum value recovery. But IBC also had a history of failed insolvency laws to contend with— the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA), and the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 (Sarfaesi). Bankruptcy in India had always been a mess and lenders knew they could do little more than kiss their money goodbye.

It's still early days, but IBC might change that. A second member of the Essar Steel CoC told *Mint*, on condition of anonymity, “If the Essar case didn't happen, the danger of IBC going the SICA way would have been greater. But with Essar, we got such an eye-catching weighty deal, and there were bidders competing for it."

JSW Steel Ltd and Vedanta Ltd had also made overtures for the asset, while Mauritius-based Numetal fought ArcelorMittal's bid tooth and nail all the way till the Supreme Court. The reason for the pitched battle is simple. While the Indian economy may be in the midst of a slowdown, much hope rides on its long-term prospects. And India currently has per capita steel consumption of only 70kg a year, less than half the average of many other developing nations. Due to a confluence of such factors, steel emerged as the unlikely test bed for India's new bankruptcy law.

"Nobody could brush this case aside," said the CoC member quoted above. "It was a lot of money coming back into the banking system and the government was forced to sit up and take notice. Look at how many amendments have come from the Cabinet and the number of landmark judgments from the Supreme Court that have come through in the course of this case. I could see the change myself in other insolvent companies, where promoters were watching the Essar Steel resolution, and they realized that losing their businesses was now a real possibility."

The long turnaround

Alvarez and Marsal (A&M), turnaround management experts who were appointed as the resolution professional adviser in this case, dedicated a team of 25-30 people, at varying times, to Essar Steel.

Nikhil Shah, managing director at A&M India, who leads the turnaround practice, said: "At the start, the company didn't have sufficient working capital to continue operations as all the critical suppliers said they would stop supplying goods and services unless they were paid in advance, because they didn't want to take additional credit risk. We met the top 30 suppliers to assure them that Essar Steel was a going concern and that payments would be made on time. We had to build back the company's credibility. Due to these efforts, over two plus years of the case, the plant saw operational expenditure of over ₹55,000 crore."

Nandini Chopra, MD at A&M India who leads the corporate finance practice, was tasked with finding buyers for the steel business, one of the largest in India. Chopra carried out an extensive outreach that covered most global steel manufacturers in the US, Europe, China, Russia, Brazil, Japan, South Korea and the large domestic firms.

There were repeated site visits, probably the most massive gatherings the small Gujarati town of Hazira, where the steel mill is based, has seen in quite some time.

Unlike most other steel plants in India, which are often based near iron ore reserves, the bulk of which is in the eastern part of the country, the Essar Steel plant is a 9.6 million-tonne single-location flat steel unit in Gujarat. But the Ruia family—the original owners—had built an ecosystem around the plant that was efficient enough to make the plant cost-competitive. They had built a 253km slurry pipeline from iron ore mines in Dabuna (Odisha) to a pellet plant in the coastal town of Paradip. These pellets were then shipped around to Hazira, where the Ruias operated a port terminal adjacent to the steel mill. For prospective bidders, this arrangement was a cause for worry. Only the steel plant was on sale in the deal, not the supporting infrastructure.

“To address this uncertainty," Shah said, “we gave them as much information about the inter-dependency and the criticality of that inter-dependency between these different assets. We said that if they couldn’t use the Hazira port, the nearby Adani port was an alternative. The most critical asset was the slurry pipeline. There were worries that someone else would acquire that which would impair the recovery value of Essar Steel."

This month, ArcelorMittal emerged as the highest bidder for this pipeline, offering lenders upfront cash of ₹2,200 crore to extinguish all outstanding debt.

Landmark court rulings

Through the Essar Steel case, courts gave several key rulings which cleared the grey areas at the edge of IBC. Section 29A was included in the code in 2017 to prevent defaulting promoters from buying back their assets for cheap. But the wording of the section also barred bidders with links to other defaulting assets. This hugely complicated the bidder vetting process for A&M India, which had to examine accounts of nearly 3,000 legal entities linked to the three top bidders. At the end of this process, ArcelorMittal and Numetal were both found ineligible. ArcelorMittal settled this by paying off dues of Uttam Galva and KSS Petron, but the court’s judgement proved fatal for Numetal, which couldn’t erase traces of its links to the Ruias in its bidding consortium.

The courts also later turned down an offer from the Ruia family under Section 12A to pay back all dues to lenders in full and withdraw the case from IBC, establishing a cut-off date for future resolution cases. Finally, after ArcelorMittal had been declared the winning bidder, the National Company Law Appellate Tribunal threw a spanner in the works, ruling that secured financial creditors should be treated on a par with unsecured operational creditors when distributing resolution proceeds. This would have drastically reduced the recovery for banks, paid out more to operational creditors and shaken the very foundations of project finance in the country. In November, the apex court again stepped in to calm the storm, and upheld the supremacy of financial creditors over other classes of lenders.

“One of the outstanding things in the Essar Steel case is the promptness with which the Supreme Court has settled legal questions," said Sitesh Mukherjee, partner and head of disputes at Trilegal. “The court showed a lot of commercial awareness—and this is something commercial courts in India need to display— about the major points of bankruptcy resolution."

Satish Kumar Gupta, Chairman of Monitoring Committee and resolution professional, Essar Steel, said: “Essar Steel has been a challenging and complex resolution process and during its course, a number of legal precedents have been set. CoC along with executive management of Essar Steel has performed its role remarkably under ‘creditors- in-control’ regime to take suitable measures to enhance overall value of Essar Steel. Most of key management team has been retained by ArcelorMittal which shows their confidence in capability of management team of Essar Steel. It has turned out to be a great outcome for creditors and for IBC as a transparent resolution framework for stressed assets gains a lot of credibility with Indian and global investors."

Still miles to go

The Essar case apart, IBC has hardly been a runaway success. But it has at least brought in some much-needed credit discipline, something its predecessors were unable to achieve. In May this year, on the third anniversary of IBC, credit rating agency Crisil Ltd estimated that recovery through the IBC process was roughly ₹70,000 crore in FY19, or twice the ₹35,500 crore recovered through other resolution mechanisms such as the Debt Recovery Tribunal (DRT), Sarfaesi Act and the Lok Adalat in FY18.

More importantly, almost ₹2.02 trillion of debt pertaining to 4,452 cases had been disposed of even before admission into the IBC process, as borrowers made good the amounts in default to the creditors. The rate at which non-performing assets were piling up on banks' balance sheets slowed as well. “The ultimate lesson for us bankers is that if we want to recover money, we need assets on the ground," said the second CoC member.

While a lot has been achieved through the Essar Steel case, there are still big legal questions within IBC that need clarity.

“I believe the next big question that needs to be tested in courts under IBC is whether the new owner of an asset gets immunity from the Prevention of Money Laundering Act," said the second CoC member quoted above. JSW Steel's resolution plan to take over bankrupt Bhushan Power and Steel Ltd (BSPL) is stuck in courts on this very question, where some of BPSL's assets have been attached by the Enforcement Directorate as part of fraud investigations into its erstwhile promoter Sanjay Singal. “While the Cabinet has already amended the IBC to give resolution applicants this immunity, the proof of the pudding is in the eating," said the first CoC member.

Lawyers that *Mint* spoke to said IBC still needs to clarify how government licences and concessions of insolvent companies should be dealt with. Another is the question of personal guarantees given by promoters. Earlier, these were enforceable at DRTs but now banks can combine them under the IBC case for bankrupt firms.

Meanwhile, the battle for Essar Steel doesn't seem to have fazed the Mittals. The first CoC member had also met ArcelorMittal owner L.N. Mittal, at The Oberoi party. “LN Mittal said that when he acquired Arcelor, he had to work with four-five heads of state, including France's (Jacques) Chirac and (Valdimir) Putin in Russia. He closed that deal in six months. Essar took 866 days. But the two years was worth it. It laid the foundations for IBC, not just for us with Essar but for everybody else."