Supreme Court of India's judgment in *Essar Steel* case: a shot in the arm for India's insolvency law

Abhishek Saxena
Phoenix Legal, New Delhi
abhishek.saxena@phoenixlegal.in

Aashna Kothiyal
Phoenix Legal, New Delhi
aashna.kothiyal@phoenixlegal.in

This article provides a brief background leading up to the enactment of India's current insolvency law, the Insolvency and Bankruptcy Code, 2016. It also discusses the most recent landmark judgment of the Supreme Court of India in *Committee of Creditors of Essar Steel India Ltd v Satish Kumar Gupta & Ors* Civil Appeal No 8766-67 of 2019 and analyses its significance for development of insolvency jurisprudence and will be a useful guide to international clients and law firms involved in insolvency proceedings in India.

Introduction

In 2016, India enacted a new law to provide for reorganisation and insolvency resolution of corporate persons, partnership firms and individuals, namely, the Insolvency and Bankruptcy Code, 2016 (IBC). The objects of the IBC as mentioned in its preamble provide a good indication of the problems it sought to address and those that had concerned the legal regime before its enactment. The objects are:

> 'to consolidate and amend the laws relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximisation of value of assets of such persons, to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders including alteration in the order of priority of payment of government dues and to establish an Insolvency and Bankruptcy Board of India, and for matters connected therewith or incidental thereto.'

The array of legislation applicable to the subject matter addressed by the IBC, conflicting judicial precedents and lengthy and slow judicial process meant that reorganisation and insolvency resolution was rarely swift, leading to value destruction and resulting in promoters' interest taking precedence over those of other stakeholders of businesses. As a result, lenders, particularly banks were saddled with huge non-performing assets on their books. Because of the delay and, frequently, an inability to recover debt in a timely manner, credit flow was choked and entrepreneurship stifled. Gaps in the law and its delayed enforcement allowed the system to be played by unscrupulous business promoters. This often resulted in a peculiar phenomenon of sick companies, affluent promoters and unhappy other stakeholders. This was reflected in the World Bank's 2016 *Doing Business* ranking,[1] which compares business regulation for domestic firms in 189 countries. It ranked India at 136 on insolvency resolution with four years and three months being the average time taken to resolve an insolvency, and a recovery rate of 25.7 cents on a US dollar, as opposed to Singapore's 89.7, the UK's 88.6 and the US's 80.4.

The IBC drew on relevant legislation in the UK and US. The most striking features of the IBC are that it provides a 330-day timeframe (amended from 270 days previously provided) for an insolvency resolution process during which the management and control of the corporate debtor is taken away from the promoters and its board of directors and vested in the resolution professional (RP) appointed under the IBC. Failure to achieve resolution within the timeframe leads to a compulsory liquidation of the corporate debtor and distribution of the realised proceeds among its stakeholders in line with a specified distribution. The RP is required to receive claims against the corporate debtor after which it is required to constitute a committee of creditors (CoC) comprising financial creditors which is empowered to accept, reject or modify resolution plans submitted to resolve the corporate debtor's financial situation. This was a first for India where promoter groups had typically exercised excessive control leaving the lenders/financial institutions powerless.

The enactment of the IBC has been received with much hope and enthusiasm. However, despite some early success and promise, the implementation of the law has faced regular challenges with frequent litigation. It appeared that the IBC was also headed in the direction of its predecessor legislation and would not live up to its promise. Frequent litigation resulted in the cases filed under the IBC not being resolved within the 270-day timeframe and recovery percentages in resolved cases being low. While some initial troubles were to be expected, given the draconian consequences of the new law for the promoters of businesses, the resilience and guile shown by certain promoters was not. They tried a large number of means to block the implementation of the law with a view to holding on to their companies. They were aided in their efforts by the slow judicial process and the courts' failure to appreciate fully the objects of the IBC which had envisaged limited court involvement in the entire insolvency resolution process. Credit, however, must be given to the government which promptly amended the IBC to respond to each attempt at derailing its intended functioning, and to the Supreme Court of India (the Supreme Court) which delivered rapid and progressive rulings, setting the precedents for smooth implementation of the law. If it had not been for them, the situation would have been worse.

Against this backdrop, this article seeks to discuss the Supreme Court's most recent landmark judgment in *Committee of Creditors of Essar Steel India Limited v Satish Kumar Gupta & Ors.*[2] (*Essar Steel* case) which can arguably be regarded as a milestone for India's evolving insolvency jurisprudence and landscape.

Background to the *Essar Steel* case

Following close on the heels of the IBC, with a view to deal with the non-performing assets/bad loans (NPA) problem faced by India's banking system, in 2017, India's central bank, the Reserve Bank of India (RBI) set up the Independent Advisory Committee (IAC), comprising a majority of its independent directors, to advise it on NPA cases that may be referred for resolution under the IBC. The IAC recommended 12 accounts, each with NPAs of more than INR 50bn (approx. US$700m), totalling 25 per cent of the total NPA of India's banking system, for immediate reference to the IBC. The RBI issued directions to the relevant lenders to these NPA accounts to initiate corporate insolvency resolution processes (CIRP) under the IBC against these 12 companies. Essar Steel India Ltd (Essar Steel) was one of these 12 companies which had a total debt outstanding of approximately INR 450bn.

The run-up to the Supreme Court judgment: NCLT and NCLAT judgments

Following the RBI direction, an application for initiating CIRP against Essar Steel was filed by State Bank of India (SBI), a financial creditor of Essar Steel, before the adjudicating authority under the IBC ie, the National Company Law Tribunal (NCLT) in July 2017. A separate application had already been filed before the NCLT by Standard Chartered Bank (SCB), also a financial creditor of Essar Steel. The NCLT admitted the applications, appointed a RP to take over the affairs of Essar Steel and declared the commencement of a moratorium as provided for under the IBC. Accordingly, the CIRP against Essar Steel was commenced. The interim RP appointed by the NCLT invited proof of claims from various creditors to Essar Steel and constituted the CoC.

In the course of the CIRP, the resolution plan submitted by ArcelorMittal India Private Ltd (ArcelorMittal), part of the ArcelorMittal Group – the world's leading integrated steel and mining company, was approved by the CoC and ArcelorMittal was declared the highest evaluated resolution applicant. Under the IBC process, the NCLT by its judgment dated 8 March 2019 approved ArcelorMittal's resolution plan with the observation that the claims of the operational creditors must get similar treatment as compared to the claims of the financial creditors on the principle of equity and fair play as well as the Wednesbury Principle of Unreasonableness and the Doctrine of Proportionality. The NCLT, while noting its jurisdictional limitations under the IBC,[3] suggested that if a reasonable formula for apportionment could be worked out so that 85 per cent of the amount offered by the resolution applicant was distributed among the financial creditors and the remaining 15 per cent is distributed among the rest of the operational creditors, then the entire claim of the operational creditors could substantially be paid off or at least the operational creditors could get 50 per cent of their admitted and undisputed claims.

An appeal against the above NCLT judgment was filed before the appellate authority ie, the National Company Law Appellate Tribunal (NCLAT) which, by an interim order, directed the CoC to take a decision on the suggestion made by the NCLT. The CoC decided to appeal against the direction of the NCLAT on the ground that the CoC cannot be directed on how to distribute the financial package offered by ArcelorMittal. The matter reached the Supreme Court which stayed the NCLT's above-mentioned judgment dated 8 March 2019, and directed the NCLAT to decide the appeal against the NCLT judgment expeditiously.

Consequently, the NCLAT by its final judgment dated 4 July 2019,[4] held that:

- There can be no difference in the matter of payment of dues between a financial creditor and an operational creditor and a resolution plan must treat them equally. Accordingly, the NCLAT redistributed the financial package under the ArcelorMittal's resolution plan approved by the CoC such that all financial creditors and operational creditors receive 60.7 per cent of their admitted claims.
- Consideration of securities and security interest are irrelevant at the stage of resolution for the purpose of distribution of the financial package and irrespective of the security created in favour of the creditors each financial creditor whether secured or unsecured be paid 60.7 per cent of its admitted claims.
- Operational creditors with an admitted claim equal to or more than INR10m be paid 60.268 per cent of their admitted claims.
- The profits generated by the corporate debtor during the CIRP would be distributed equally among the corporate debtor's financial creditors and operational creditors.
- A subcommittee or core committee cannot be constituted under the IBC, and the CoC alone is to take all decisions.
- Claims which have not been decided by the RP, NCLT or NCLAT can be decided by an appropriate forum.
- Certain additional claims of operational creditors, some of which were delayed and/or without sufficient proof, can be admitted resulting in a significant increase of the admitted claims of the operational creditors.
- Section 53 of the IBC, providing for order of priority for distribution of liquidation assets among various stakeholders, is only applicable during the liquidation stage and not during the CIRP.
- The CoC has no power to decide the manner of distribution between the creditors, due to conflict of interest between financial and operational creditors.
- Financial creditors in whose favour guarantees were executed, as their total claim stands satisfied to the extent of the guarantee, cannot proceed against the principal borrower for such claims.

The NCLAT judgment led to an outcry for reasons which are apparent from the decision summarised above. By equating financial and operational creditors and secured and unsecured creditors, the NCLAT judgment seemed to have upended the fundamental principal of the lending business. By overriding the commercial decision of the CoC on grounds of equity and fair play, the judgment struck at the very foundation of the IBC which had sought to move insolvency resolution from a judicial to commercially-driven outcome and to minimise judicial intervention which had been the bane of the earlier regime. Huge trepidation was expressed about the continuing efficacy of the IBC.

Not surprisingly, the CoC swiftly moved to appeal the NCLAT judgment before the Supreme Court.

The Supreme Court judgment

The Supreme Court, as in the past, supported the IBC with a swift decision of far-reaching implication that not only steadied the IBC but also went a long way in restoring investor confidence. The following is a summary of the key points of the Supreme Court judgment:

Primacy of CoC in insolvency resolution process

The Supreme Court affirmed the key principle of the IBC that the CIRP is in the hands of the CoC, which in its commercial wisdom, has the right to decide how the insolvency is to be resolved. Neither does the IBC state that the corporate debtor is to be revived or liquidated, nor does it empower the NCLT/NCLAT with the jurisdiction or authority to evaluate the commercial decisions of the CoC. The CoC alone is required to analyse the 'feasibility and viability of the resolution plan' and other requirements prescribed by the IBC. Such evaluation must take into its ambit all aspects of a resolution plan, including distribution of funds among the various classes of creditors.

Equality between secured and unsecured creditors

The Supreme Court held that there is a difference between equal and equitable treatment. The equitable principle cannot be extended to treating non-equals equally as it weakens the very objective of the IBC (which is to resolve stressed assets) and such equitable treatment is only applicable to similarly situated creditors. Therefore, equitable treatment is to be accorded to each creditor depending on the class to which it belongs: secured or unsecured, financial or operational and a resolution plan can therefore provide for differential payment to different classes as long as the provisions of the IBC and its regulations have been met. The Supreme Court held that the CoC can classify creditors and decide to pay secured creditors amounts which can be based on the value of their security, which they would otherwise be able to realise outside the process under the IBC, thereby defeating the CIRP itself.

Jurisdiction of the NCLT (adjudicating authority) and the NCLAT (appellate tribunal)

The NCLT and the NCLAT's jurisdiction is circumscribed by the provisions of the IBC.[5] The NCLT and the NCLAT have limited powers of judicial review, with the limitations being provided in the IBC, which cannot infringe the business decision of the majority of the CoC.

The Supreme Court held that the NCLT cannot exercise discretionary or equity jurisdiction outside the IBC provisions while considering approval of a resolution plan. While the NCLT cannot interfere on merits with the commercial decision taken by the CoC, it can undertake a limited judicial review to check that the CoC decision has ensured the following: (i) continuation of the corporate debtor as a going concern during the CIRP; (ii) maximisation of the value of its assets; and (iii) balancing the interests of all stakeholders including operational creditors.

Use of corporate debtor's profits during CIRP to pay off creditors

The Supreme Court set aside the NCLAT direction that the profits of the corporate debtor during the CIRP be distributed among all financial and operational creditors on a pro-rata basis of their claims, provided that such amount did not exceed the admitted account of their claims. The Supreme Court held that the request for proposal for inviting a resolution plan, which was accepted by ArcelorMittal and the CoC, did not provide for this outcome and hence profits made during the CIRP could not be applied towards the payment of debt of any of the creditors.

Constitution of subcommittees by CoC

Subcommittees can be appointed for the purpose of negotiating with resolution applicants, or performing other ministerial or administrative acts. This was held to be subject to the limitation that all subcommittees' actions must be approved and ratified by the CoC. The Supreme Court, however, clarified that: (i) certain decisions required to be taken only by the CoC as provided under section 28 of the IBC ie, for the creation of a security interest over the corporate debtor's assets, change in the capital structure of the corporate debtor, recording any change in the ownership interest of the corporate debtor, undertaking any related party transaction, etc; and (ii) power of the CoC to approve the resolution plan, under section 30(4) of the IBC, cannot be delegated to any other body.

Termination of personal guarantees and decision on undecided claims

The NCLAT had held that the rights of creditors against guarantees extended by the promoter/promoter group of the corporate debtor were terminated once the guaranteed debt was paid, pursuant to approval of the resolution plan providing for payment to the lenders. The Supreme Court set aside the NCLAT judgment on the grounds that, in accordance with the IBC, once a resolution plan is approved by the CoC, it is binding on all stakeholders, including guarantors and the guarantees are not terminated since the IBC specifically provides for the resolution plan to be binding on the corporate debtor and the guarantor. The resolution plan would therefore limit the guarantor's right of subrogation towards the creditor. Therefore, if the resolution plan does not provide for payment of the lenders' entire debt, the lenders can pursue the guarantors for the remaining debt.

With respect to undecided claims it was held that a successful resolution applicant cannot suddenly be burdened with undecided claims after their resolution plan has been approved as this would cause uncertainty about the amounts payable by a prospective resolution applicant who successfully takes over the corporate debtor's business. Furthermore, all claims are to be submitted and decided by the RP so that a prospective resolution applicant is aware of what must be paid in order for it to then take over and run the corporate debtor's business.

Supreme Court judgment and principles of insolvency and finance

In reaching certain of its decisions in the judgment, the Supreme Court helpfully referred to and affirmed certain general principles recognised by those in insolvency and finance.

In accordance with the UNCITRAL *Legislative Guide on Insolvency Law*,[6] if an insolvency law adopts a prescriptive approach to the range of options available or to the choice to be made in a particular case, it is likely to be too restrictive. A non-intrusive approach that does not prescribe limitations is likely to provide necessary flexibility, allowing for the most suitable of a range of possibilities for a particular debtor. The Guide also mentions that it is highly desirable that the law should not require or permit the court to review the economic and commercial basis of the creditors' decision, including issues of fairness that do not relate to the approval procedure, but rather to the substance of what has been agreed. Nor that it be asked to review particular aspects of the plan in terms of their economic feasibility. While the IBC reflects the above principles and limits the powers of the adjudicatory and appellate authorities, the NCLT and the NCLAT were increasingly reviewing the CoC's commercial decisions. The Supreme Court referred to and affirmed the above UNCITRAL principles by giving primacy to the commercial wisdom of the CoC and protecting it from court intervention.

In the *Essar Steel* case, the Supreme Court held by a majority that the CoC, in its commercial wisdom, had decided that the payment of debts due to the secured financial creditors would be made according to value of the security provided by the corporate debtor to such financial creditors. In keeping with the International Monetary Fund's paper on *Development of Standards for Security Interest*,[7] creation of security reduces credit risk by increasing the creditor's likelihood of being repaid, not only when payment is due, but also in the event of a default by its debtor.

This increased likelihood of repayment produces wider economic benefits. First, the availability of credit is enhanced and borrowers obtain credit in cases where they would otherwise have failed without a security interest. Second, credit is also made available on better terms involving, for instance, lower interest rates and longer maturities. A security right has little or no value to a secured creditor unless it is given appropriate recognition in the grantor's insolvency proceedings.[8] While noting the above principle, the Supreme Court also highlighted the distinction between a financial creditor and an operational creditor by stating that if a corporate debtor defaults, an operational creditor has an immediate exit option, by stopping the supply to the corporate debtor whereas a financial creditor can only exit on their long-term loans, either on repayment of the full amount or on default, by recalling the entire loan facility and/or enforcing the security interest which is a time-consuming process usually involving litigation. By overturning the NCLAT judgment, the Supreme Court reaffirmed what had already been upheld in its *Swiss Ribbons* judgment,[9] albeit in different words, that only similarly situated creditors will be treated in the same way.

Conclusion

The Supreme Court judgment could not have come at a more opportune time. Doubts had started to be raised about the efficacy of the IBC and trepidation being voiced as to whether the IBC would also meet the fate of predecessor legislation. Perhaps the best illustration of this flagging confidence in the IBC was reported in January 2019. This was SEI's decision to put its entire loan to Essar Steel on sale in the secondary market because of the delay in conclusion of the Essar Steel insolvency resolution and its lack of confidence in quick resolution in the foreseeable future. The SBI, India's largest bank, was the biggest lender to Essar Steel, and took this action, even though it stood to recover around 90 per cent of its outstanding debt under ArcelorMittal's resolution plan.

While the Essar Steel CIRP took 835 days to conclude as against the original IBC requirement of 270 days, it nevertheless reflects a huge improvement over the average time of four years and four months taken under the predecessor legislation. Although it took longer, for various reasons, it may not be as bad an outcome as it seems. Essar Steel was a trophy asset which saw intense competition. As reported in the press, a member of Essar Steel's CoC recounted his conversation with Aditya Mittal, who drove the ArcelorMittal acquisition of Essar Steel and is part of the promoter group at ArcelorMittal: '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.' The IBC provided a completely different solution to the problem than its predecessor legislation. With no prior jurisprudence, it was a 'trial and error' process in dealing with issues and challenges made during the progress of the *Essar Steel* case. Lastly, the Ruia family, the former promoters of Essar Steel, fought hard to avoid losing what was considered to be a crown jewel of their business empire.

Various beneficial outcomes arose from the Supreme Court judgment that included lenders to Essar Steel, mainly banks, recovering a substantial portion of their outstanding debt, hitherto an uncommon outcome; a defaulting promoter losing its business; positive messaging for international investors and India's bond markets. The most important outcome however, was that the Supreme Court judgment provided an unequivocal reaffirmation of the IBC's objects outlined above and established a clear precedent for the courts to exercise judicial restraint and act according to IBC provisions. The Supreme Court decision resolved some key issues which had been holding up the progress of various other CIRPs and it is hoped will expedite conclusion of these and future CIRPs. It also sent a clear message to the promoters of the defaulting companies that they could no longer take defaults lightly and there was now a real possibility of them losing their companies. The IBC had already brought an improvement in the credit culture, as reflected by the fact that since the introduction of the IBC, approximately 3,300 cases have been disposed of by the NCLT based on out-of-court settlements between corporate debtors and creditors involving claims in excess of approximately INR 1,230bn (approx. US$3220m). It is hoped the Supreme Court judgment will help firmly establish and deepen its roots.

Glossary of acronyms

ArcelorMittal	ArcelorMittal India Private Ltd
CIRP	Corporate insolvency resolution process
CoC	Committee of creditors
Essar Steel	Essar Steel India Ltd
Essar Steel Case	Committee of Creditors of *Essar Steel India Limited v Satish Kumar Gupta & Ors* Civil Appeal No 8766-67 of 2019
IAC	Independent Advisory Committee
IBC	Insolvency and Bankruptcy Code, 2016
NCLAT	National Company Law Appellate Tribunal
NCLT	National Company Law Tribunal
NPA	Non-performing assets
RBI	Reserve Bank of India
RP	Resolution professional appointed under the IBC
SBI	State Bank of India
SCB	Standard Chartered Bank
Supreme Court	Supreme Court of India

Notes

1 World Bank Group, *Doing Business 2016*, available at: https://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB16-Full-Report.pdf, last accessed 9 February 2020.

2 Civil Appeal No 8766-67 of 2019.

3 According to section 30(5) of the IBC, a resolution plan once approved by the CoC is required to be submitted to the adjudicating authority ie, the NCLT which is required to, in keeping with section 31, satisfy itself that the resolution plan meets the requirements referred in section 30(2) of the IBC. Once it is satisfied that it complies with all such requirements under the IBC, the NCLT is required to approve the resolution plan which is binding on the corporate debtor and its employees, members, creditors, guarantors and other stakeholders involved in the resolution plan.

4 *Standard Chartered Bank v Satish Kumar Gupta, RP of Essar Steel Ltd & Ors Company Appeal* (AT) (Ins) No 242 of 2019.

5 Section 31 read with section 30(2) of the IBC for NCLT and section 32 read with section 61(3) of the IBC for NCLAT.

6 United Nations Commission on International Trade Law's *Legislative Guide on Insolvency Law*, available at: https://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf, last accessed 9 February 2020.

7 Pascale De Boeck and Thomas Laryea, Counsel, IMF Legal Department, *Development of Standards for Security Interest*, available at: https://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/pdb.pdf, last accessed 9 February 2020.

8 United Nations Commission on International Trade Law's, *Legislative Guide on Secured Transactions*, available at: https://www.uncitral.org/pdf/english/texts/security-lg/e/09-82670_Ebook-Guide_09-04-10English.pdf, last accessed 9 February 2020.

9 *Swiss Ribbons Pvt Ltd and Ors v Union of India (UOI) and Ors* AIR2019SC739.

Abhishek Saxena is co-founding partner based at Phoenix Legal's New Delhi office. He focuses on cross-border deals and has advised on a number of projects in diverse sectors such as financial services, IT, industrial, oil and gas, power, automotive, infrastructure, manufacturing, retail, hospitality and aviation.
Aashna Kothiyal is an associate at Phoenix Legal.