Feature

KEY POINTS

- "Loan-to-own" investing is a long-established means of distressed asset and business acquisition in the US. Its success depends primarily on the investor's voting and credit bidding rights under the US Bankruptcy Code.
- India's new Insolvency and Bankruptcy Code (IBC) is a "game changer" in debtor-creditor relations, dramatically shifting the historic balance of power in Indian corporate restructuring.
- The IBC may have other, secondary effects on distressed debt investment.
- Specifically, the IBC may impact (and be impacted by) existing debt-investment vehicles, banks' distressed debt pricing, claims-trading opportunities and continued promoter influence.

Authors Michael D Good and Pramod K Singh

Loan to own? Or liquidate? US and Indian distressed debt investing compared

India's 2016 Insolvency and Bankruptcy Code (IBC) is already creating a robust market for distressed assets in India. Will it have a similar impact on distressed debt investment? Is there a potential Indian market for US-style "loan-to-own" acquisition? This article compares distressed debt investing under US and Indian insolvency law, focusing on "loan-to-own" transactions.

India's recently enacted Insolvency and Bankruptcy Code (IBC) appears to be materially impacting the longstanding problem of non-performing Indian loans. It also creates potential new means of acquiring troubled Indian firms and business assets. The acquisition of distressed assets, primarily through so-called "loan-to-own" techniques, is long established under US bankruptcy law. This article will briefly survey and highlight recent developments. It will then discuss the potential impact of the IBC's relevant provisions on India's distressed debt and asset market.

INSOLVENCY AND "LOAN-TO-OWN" TRANSACTIONS IN THE US

In the US, there are essentially four ways to buy a firm:

- a stock purchase;
- a merger;
- an asset purchase; and
- a debt purchase (ie the "loan-to-own" play).

The loan-to-own investor acquires debt in a distressed company, often at a discount. Secured debt may be purchased alone, or along with debt or equity at other levels of the borrower's capital structure.

Once debt is acquired, the investor (using its rights as a secured creditor or its influence on management) pushes the borrower toward foreclosure or bankruptcy, where the investor's rights are based on the face amount of the debt purchased, rather than on the discounted amount the investor actually paid for the debt.

The critical feature of this acquisition structure is that the investor does not expect ordinary course payment, or even a collateral liquidation. Rather, the investor expects a borrower default (or the borrower has already defaulted). The lender will leverage its debt position to acquire the business for itself and realise value from the business' future operation and growth.

The US Bankruptcy Code's impact on a hostile acquisition based on purchased debt

Two specific features of the US Bankruptcy Code afford the debt investor two basic means of bankruptcy-related acquisition:

- the investor/creditor's ability to employ its vote to block any reorganisation over its objection (under s 1129); and
- the protection afforded credit-bids in the event of a bankruptcy asset sale (under s 363(k)).

Under s 1129, the debt investor swaps its debt into equity and acquires corporate ownership through a Chapter 11 plan it controls, often through the ownership and vote of the debtor's so-called fulcrum security, ie that position in the borrower's capital structure above which creditors are entitled by the going-concern valuation of a debtor's assets to be paid in full, but below which, when coupled with s 1129's so-called absolute-"priority rule", junior classes receive nothing.

Alternatively, the debt investor credit bids its secured debt at an asset sale to acquire business assets which collateralise, but are worth less than, the amount of the debt. The debt investor uses s 363(k)'s secured credit-bidding procedures to offer credit for distressed collateral equal to the face amount of its debt (rather than at the discounted amount it paid for the debt). By bidding credit that exceeds the current market value of distressed business assets, the debt investor:

- pays no additional money to acquire the assets; and
- discourages potential cash bidders from making competing bids.

"Loan-To-Own" investors v other creditors under US law

The debt investor's most important legal protections under the US Bankruptcy Code are:

- its ability to credit bid; and
- its ability to vote on the plan.

Without them, the debt investor risks being "crammed down" in a US bankruptcy – ie stuck holding long term debt against a company that successfully reduces the debt's principal amount and the interest rate, then pays the lower amount over many years.

Not surprisingly, these Code features have become battlegrounds between debt investors (seeking to capture corporate value) and other creditors of the enterprise (seeking to recover that value for themselves).

The "cause" battle (s 363(k))

Section 363(k) provides secured lenders with the right to credit bid at sales "unless the court orders otherwise for cause". What constitutes "cause", such that an investor holding secured debt may be denied the opportunity to credit bid?

Decisional law historically interpreted "cause" as:

- a *bona fide* dispute as to the extent, validity or priority of the creditor's lien in the property for which it seeks to credit bid;
- a *bona fide* dispute as to the allowed amount of the creditor's claim;
- a finding that determination of the creditor's security interest or lien status would substantially extend the sale process and diminish the collateral's value;
- the creditor's failure to follow court-established bidding procedures; and/or
- misconduct (eg collusive bidding or rushing a sale to preclude other bids).

Two relatively recent decisions have given "loan-to-own" investors further pause for thought. In *In re Fisker Auto. Holdings, Inc.*, the District of Delaware's Bankruptcy Court denied credit-bidding to a secured creditor and prospective acquirer of the debtor's assets, relying on earlier, Third Circuit authority to observe that credit-bidding rights may be denied "in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment". *In re Fisker Auto. Holdings, Inc.*, 510 B.R. 55, 59–60 (Bankr. D. Del. 2014).

The same year, the Eastern District of Virginia's Bankruptcy Court reached a similar result using similar reasoning, denying credit bidding because "[t]he credit bid mechanism that normally works to protect secured lenders against the undervaluation of collateral sold at a bankruptcy sale does not always function properly when a party has bought the secured debt in a loan-to-own strategy in order to acquire the target company". *In re The Free Lance-Star Publ'g Co. of Fredericksburg, VA*, 512 B.R. 798, 806 (Bankr. E.D. Va. 2014).

To date, neither of these decisions has been widely followed or even cited. They may not be applicable outside the bankruptcy context (eg in UCC or real property foreclosure sales). Nevertheless, *Fisker's* and *Free Lance-Star's* broadly-worded reasoning creates potentially significant uncertainty for US "loan-to-own" investors.

The voting battle (s 1126(e))

Lenders are generally entitled to vote on Chapter 11 plans. But a lender's vote can be "designated" (ie disqualified) if a court finds it was not solicited, procured, or cast in good faith, or is inconsistent with the Bankruptcy Code. See 11 U.S.C. 1126(e). Once disqualified, a lender's vote is excluded from the vote tally. The lender may be required to live for years with an unfavourable Chapter 11 plan.

Though a debt investor's protection of its interest is not typically subject to designation, at least one decision has found otherwise. In *In re DBSD N. Am., Inc.*, 634 F.3d 79, 104 (2d Cir. 2011), the Second Circuit Court of Appeals upheld disqualification of the debtor's indirect competitor (and part-owner of a direct competitor), which had bought an entire class of claims in the debtor's case "with the intention not to maximize its return on the debt but to enter a strategic transaction with [the debtor] and 'to use [its] status as a creditor to provide advantages over proposing a plan as an outsider, or making a traditional bid for the company or its assets'".

The Second Circuit's decision appears to be the only one of its kind. Other, subsequent decisions have focused on:

- the "drastic nature" of "bad faith" designation; and
- the requirement that, to be subject to such designation, a creditor must be "attempting to obtain a benefit to which [it is] not [otherwise] entitled".

See, eg *In re Lichtin/Wade, LLC*, 2012 WL 6576416, at *3–5 (Bankr. E.D.N.C. Dec. 17, 2012) but different facts – and a different judge – may yield a different result.

Other battles

Creditors and equity-holders may offer other forms of resistance to "loan-to-own" investors under US law. A full discussion is well beyond the scope of this article. Objecting creditors will often claim that:

- management and the board (and possibly the debt investor) have breached fiduciary obligations (or that the debt investor aided and abetted such breaches);
- the debtor's value is much greater than the debt investor claims;
- there was an inadequate effort to try to find a better transaction;
- the debt investor's secured loan should be equitably subordinated or recharacterised as equity; and/or
- any bankruptcy plan that implements the transaction proposed by the debtor is not undertaken in good faith.

If a debt investor holds liens on non-debtor assets as well as the debtor's assets, other creditors may assert the equitable doctrine of "marshaling", ie the doctrine that a senior creditor that can satisfy its debt from either of two funds may not deplete a fund on which a junior creditor relies exclusively to satisfy its debt.

In the end, the most effective objection such parties can offer is a better deal; ie another, higher and better offer for the same assets. *Fisker*, for example, involved such an offer. Often, the debt investor has built various forms of compensatory provisions and other protections against such offers into the loan acquisition documents. But if the value at stake is sufficient, such competing offers may be available.

DISTRESSED DEBT INVESTING IN LIGHT OF INDIA'S IBC

Section 16 of India's IBC implements the appointment of an interim resolution professional (IRP), who constitutes a committee of creditors (Committee), that appoints a Resolution Professional (RP) to manage the debtor's affairs. The IRP oversees the resolution process, assembling and making available appropriate information for prospective resolution applicants. The resolution process appears to be strictly time-bound. See *Surendra Trading Company v Juggilal Kamlapat Jute Mills Company Limited and Others*, Supreme Court, September 2017 (holding that 180 or 270 days for completion of the corporate insolvency resolution process (CIRP) is mandatory). However, recent instances in certain sectors like power and infrastructure involve breaches of this 270-day completion deadline due to certain systemic inefficiencies. It remains to be seen how these would be ultimately dealt with under the IBC.

Under this process, the appointed Committee is effectively in control of the Debtor, since it:

- appoints an RP to oversee the resolution process; and

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Biog box
Michael D Good is a practitioner with over two decades of experience in corporate bankruptcy and insolvency work and is managing principal of South Bay Law Firm in Los Angeles County, California. He is also Of Counsel at Alvarado Smith, a Professional Corporation, with offices in Orange County, Los Angeles, and San Francisco.
Email: mgood@southbaylawfirm.com

- votes up or down on any resolution plan put forward by any party.

Further, since the Committee comprises of all the *financial* creditors and their voting is determined based on the financial debt owed to them, the debtor's *financial* creditors (rather than its *operational* creditors) have predominant influence in this process.

The absence of promoter participation and appointment of an RP substituting the Board is a complete "game changer". First, the IBC's transfer of possession and control to creditors dramatically shifts the historic balance of corporate power in a restructuring. Litigation tactics and other delays employed by promoters made it difficult for creditors to get control of a commercial debtor's assets and auction them at the highest value for a timely recovery. Without adequate security or guarantees, creditors were forced to take significant haircuts and agree to settlements at a loss – to creditors, and to the Indian banking system.

Second, the IBC represents a "quantum leap" over other, previously available recovery mechanisms. The statute shifts the focus from recovery and/or settlement to resolution. For instance, "willful defaulters" were previously precluded from debt restructuring mechanisms, leaving banks to resort to time debt recovery mechanisms while the promoters remained in control of the assets. Genuine restructuring cases were stalled, resulting in eroded value and diminished recovery for secured lenders.

Under the IBC, a resolution plan can continue without the involvement of the promoters, and resolution applicants are free to bid for the debtor's assets without threat of promoter litigation. Willful defaulters have been specifically excluded, under s 29A, from presenting the plans. Promoters must now seek a resolution or restructuring directly from their financial creditors, or enlist investor support, while they control management.

Third, the IBC has created opportunities for third parties, including industry competitors and investors, to bid for stressed assets. Because it emphasises debt resolution rather than settlement, the IBC's resolution process is open to any entity able to execute an acceptable resolution plan, including the corporate debtor's competitors. The process is primarily intended to let lenders dispose of non-performing assets. But it also creates a new market for distressed assets.

Currently, most of the participation in this market comes from commercial competitors. Proceedings for Essar Steel and Binani Cements, for example, each involved competitors in the same business segment who were prepared to pay a premium for assets above that originally submitted in resolution plans.

Beyond creating a market for stressed assets, how will the IBC impact distressed debt investment in India? Is there a potential market in India for US-style "loan-to-own" acquisition?

The answer to these questions depends on a number of factors, including (but not limited to):

The IBC's impact on SARFAESI-advantaged debt investors

Most distressed debt investment in India has been accomplished through Asset Reconstruction Companies (ARCs), whose primary function is to acquire portfolios of non-performing banking assets. In general, the non-performing debt acquired by ARCs must be of a certain regulated grade of distress. Debts which are overdue over 61 days can be sold to ARCs (these are called "SMA-2 accounts", where the debts are 61-90 days overdue and "non-performing assets" where the debts are more than 90 days overdue).

Besides offering diversification across a portfolio of assets, ARCs benefit from certain enhanced security enforcement tools under India's Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI). SARFAESI allows certain lenders to enforce security or take certain other measures to protect their interests without judicial intervention provided the dues fall under the definition of debt under the said Act. These measures include the right to change the management and to take over the secured assets to realise their value. In light of the difficult security enforcement regime in India, these remedies are seen as desirable by debt investors. But even these remedies are not immune from dispute: Any action under these measures is almost routinely challenged under s 17 of SARFAESI while the debtor continues to be in possession.

Practically, and by comparison to the aggregate non-performing assets held by Indian banks, ARCs are few and far between. Only 24 ARCs were licensed as of 30 November 2017. See http://iveybusinessreview.ca/cms/6313/sharks-vs-builders-winning-indias-distressed-credit-space/ (9 April 2018) (last accessed 12 September 2018).

Besides ARCs, "non-banking finance companies" (NBFCs) provide financial services (including lending). NBFCs are commonly used for general financing transactions in India, and they far outnumber ARCs. Where distressed debt investment is concerned, the main benefit of NBFCs is that they can undertake a broad range of finance activities and have access to non-performing accounts before they reach the 61-day default stage (which is when ARCs can acquire such debt). This means they can acquire and aggregate debt with a better chance of recovery. From an enforcement perspective, SARFAESI s 13 enforcement rights have recently been extended to NBFCs meeting certain capital requirements.

Importantly, the IBC interdicts the SARFAESI rights of ARCs and NBFCs. Section 14(1)(c) of the IBC imposes a moratorium on "any action to foreclose, recover or enforce any security interest", including under SARFAESI. Whether SARFAESI's management replacement rights are so affected is not clear – and remains a question to be judicially determined.

Where ARCs and NBFCs are part of an IBC-sanctioned Committee (where decisions need to be undertaken by not less than 66% majority, by value and including unsecured creditors), ARCs and NBFCs may have leverage to affect the outcome of the insolvency process. Moreover, the IBC's tight time limits mean that if there is no timely resolution during the statutorily-prescribed periods, the debtor is liquidated. In such circumstances, secured creditors (including ARCs and NBFCs) can elect to receive proceeds in liquidation (by relinquishing their interest to the liquidation estate) or simply inform the liquidator and directly enforce their security interests under SARFAESI.

But these apparent advantages are, in fact, limited. First, unless an ARC or NFBC holds more than 34% of the debtor's obligations, that investor cannot directly block any resolution it deems unfavourable.

Biog box
Pramod K Singh is an advocate and Company Secretary with approximately 30 years of experience in corporate law, banking law, and capital markets, and is a principal with Lux Veritas Solicitors and Advocates in New Delhi, India. Email: pks@luxveritas.in

Second, SARFAESI-advantaged creditors will need to enforce their rights well before an insolvency is triggered under the IBC. Since, in most cases, the debtor is already on the verge of insolvency, this may be unrealistic.

For these reasons, the IBC's enactment may increase the attractiveness of direct investment in distressed debt through the qualifying permitted debt instruments, such as listed non-convertible debentures (which also benefit from SARFAESI), because a default under these instruments does not need to be tied to the debt being "non-performing" (ie having been significantly overdue).

Moreover, the IBC's apparent impact on SARFAESI rights may, in some cases, increase the attractiveness of investment in non-listed debentures: If an investor-creditor controls not less than 66% of the debtor's obligations directly or through such debentures, it is in a position to exert significant influence over the company's proposed resolution plan. In contrast, SARFAESI requires consent of 75% of the secured creditors to agree on the measures to be taken under that Act.

The IBC's impact on distressed debt pricing

Theoretically, ARCs are intended to relieve banks of non-performing assets. In practice, however, banks have been reluctant to absorb the big discounts typically demanded by ARCs. The IBC's remedies may reinforce this reluctance, since banks will not hesitate to push insolvent firms into liquidation if potential buyers try to suppress prices. If bidders or the indebted firm "cannot service even 5 percent or 7 percent of outstanding credit obligations, then I don't see any reason for reviving each and every enterprise", said Rajnish Kumar, chairman of State Bank of India, in a recent interview with Bloomberg. On the other hand, "[i]f the recovery could be more than 25 percent, then resolution is always an option". See https://www.bloomberg.com/news/articles/2018-05-07/banks-to-liquidate-insolvent-indian-assets-if-bid-prices-are-low (last accessed 12 September 2018).

These comments, if representative of the broader banking sector, suggest that debt investors seeking to maximise their returns may need to augment the acquisition through other means (eg through operational expertise), or offer incentives designed to improve lenders' recoveries.

Investment in operational claims

Under the IBC, unless operational creditors hold 10% or more of the aggregate debt amounts, such creditors cannot be part of the Committee. In such cases, the IBC allows operational creditors to attend Committee meetings but not to vote. In one case, however, the NCLT made an exception and allowed notices of the Committee meetings to be issued to an operational creditor. Moreover, where an operational creditor's disbursement of monies to the corporate debtor has been on the basis of time value of money, it may join the Committee as a financial creditor (see *Nikhil Mehta & Sons (HUF) & Ors v AMR Infrastructures Ltd*). Finally, the IBC requires any resolution plan to provide operational creditors recoveries at least equal to what they would have received in a liquidation.

These provisions suggest that debt investors with enterprise and/or asset valuation expertise may be able to obtain superior returns through the purchase of a bankrupt firm's operational debt. Whereas the IBC's provisions may effectively increase the price of bank debt, operational creditors are often more dependent on rapid payment of their trade obligations, and therefore willing to sell those obligations at a steep discount relative to their face value.

Further, because non-performing bank debt is typically concentrated in certain sectors, and further concentrated in large corporations, investors seeking to profit from operational debt may find better prospects in smaller to mid-sized companies, or in industries without high concentrations of non-performing bank debt.

Promoter influence

Despite the IBC's provisions to the contrary, promoters may exert continued influence.

First, as demonstrated in *Roofit Industries*, the IBC discourages "asset stripping" (ie selective bidding for individual assets rather than the enterprise). Subsequent amendments to the IBC's regulations also clarify that the resolution plan must consider the interests of all corporate stakeholders. Consequently, there is incentive to propose resolutions that preserve the firm as a "going concern".

Second, experience suggests it may be difficult to run a company in India without the promoters' support, as promoters are usually an integral part of the firm's existing management. Ongoing issues of regulation, labour unions, and legal matters can become difficult without promoter support. It is likely for this reason that the primary players in the "stressed asset investment" market developing under India's IBC are not investors, but similarly-situated competitors.

Third, a traditional promoter tactic – litigation – may be imported into the NCLT. "The Bankruptcy Code is being tested by the large promoters, with continuous and sometimes frivolous appeals", Raghuram Rajan, former governor, Reserve Bank of India recently wrote to a parliamentary panel. "Higher courts must resist the temptation to intervene routinely in these cases, and appeals must be limited once points of law are settled". See https://economictimes.indiatimes.com/industry/banking/finance/banking/big-promoters-using-ibc-to-file-frivolous-appeals-raghuram-rajan/articleshow/65776796.cms (last accessed 12 September 2018).

Consequently, debt investors seeking to acquire a firm away from promoters may need to bring additional, operational expertise to the table as part of any transaction.

CONCLUSION

The global economy's continued integration means investors and their advisors will need continued cross-border legal and business fluency. By comparing the US' and India's developing distressed investment contexts, the authors hope to offer a larger, cross-border perspective, and further that integration. ■

Further Reading:

- The Insolvency and Bankruptcy Code, 2016: the dawn of a new beginning? (2016) 8 JIBFL 483B.
- Trading places: distressed debt trading in the US and UK restructuring markets (2013) 7 JIBFL 433.
- LexisPSL: Restructuring and Insolvency: Checklist: Debt restructurings – points to consider when dealing with distressed debt.