

## M&A Interactive

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### THE ECONOMICS OF MORALITY: THE 29A CONUNDRUM

Section 29A was introduced in the Insolvency and Bankruptcy Code 2016 (IBC) in 2017 to prevent certain kinds of persons, painted *tainted* under the law, from becoming contenders to revive a company undergoing the Corporate Insolvency Resolution Process (CIRP) under the IBC. Accordingly, these persons are not entitled to submit resolution plans during the CIRP. The promoter of the company under the CIRP (known as the corporate debtor) is one such restricted person.

The entire argument around restricting promoters from bidding for the assets of the Corporate Debtors was centered around the moral hazard of promoters bidding for their own assets at steep discounts, thereby benefiting at the cost of the lenders. While this view has been debated at length, empirical evidence in the Binani Cements CIRP and the Essar Steel CIRP may warrant a re-look at the economic feasibility of the restriction.

In Binani Cements, despite a bidder being selected as the H1 bidder (a colloquial term for the highest bidder), the promoter, backed by Ultratech Cement offered to pay the lenders an amount substantially higher than the amount offered by the H1 bidder. The same was challenged and made its way to the apex court, which finally permitted the lenders to consider the promoter's bid, albeit without laying down any procedural precedents. This court ruling permitted the lenders to accept Ultratech's bid in preference to the H1 bidder's bid. This approach questioned the sanctity of the CIRP process.

In another instance recently, the H1 bidder of Essar Steel cleared off all its dues to be eligible as a resolution applicant under Section 29A, as per the instructions of the apex court. Thereafter, the promoters of Essar Steel offered the lenders a settlement offer which was approximately 25% higher than the amount being offered by the H1 bidder. The promoters were barred from offering a competing bid due to Section 29A of the IBC. The promoters of Essar Steel sought withdrawal of the CIRP under the newly introduced Section 12A. The lenders of Essar Steel offered to proceed with the H1 bidder, thereby rejecting the offer of the promoters to withdraw the CIRP process under Section 12A of the IBC.

These two cases warrant a re-look into the economic viability of Section 29A.

- First, the benefit of a promoter (who has historically been in control of the corporate debtor) acquiring the corporate debtor cannot be over-emphasized. By virtue of the promoters traditionally being in control, the requirement of any diligence and any fact finding can be eliminated, and the CIRP process can proceed swiftly.
- More importantly, the moralistic argument of restricting a defaulting promoter to submit a resolution plan was based on the benefits derived by the promoters at the expense of the lenders. However, as has been seen in the above cases, the promoters offered a settlement which was substantially higher than that of the H1 bidder in both cases. In such a case, restricting the lenders from accepting such a higher bid turns around the argument. The promoters are willing to pay to the lenders sums higher than that offered by the highest bidder. Accordingly, the lenders are in a better position by accepting the offer made by the promoters as opposed to that of the highest bidder. The restrictions under Section 29A result in the lenders being devoid of this higher price being offered by the promoters.

The introduction of Section 29A to the extent of restricting promoters of the corporate debtor questions the commercial wisdom of the lenders to determine what is most beneficial to them. As an alternate to the current restriction, a middle ground could be adopted, which permits promoters to bid for the corporate debtor, while ensuring there are sufficient safeguards in place to ensure that the lenders are not short-charged.

- Firstly, the promoters may be permitted to bid for the corporate debtor only as long as such a promoter has defaulted only in respect of the corporate debtor, and not any other company, due to which such promoter is debarred from being a resolution applicant under Section 29A. This ensures that the promoters do not benefit from being a resolution applicant while lenders of the other company where they are defaulters are not paid out. Arcelor-Mittal's repayment of Uttam Galva's lenders before becoming the H1 bidder for Essar Steel is a case in point. Alternatively, the current situation, where the promoters are required to clear out the debts of other companies to become an eligible resolution applicant could also be permitted.
- Second, the bid of the promoters should be considered only in situations when there are other credible resolution plans only. This would ensure that the CIRP is not misused by the promoter to start off with a clean slate. The existence of other potential resolution applicants also ensures that the corporate debtor is appropriately valued by the bidders (including the promoters) to ensure that the creditors are not short-charged. A minimum number of credible resolution plans (say 3) could be required for the promoter's resolution plan to be considered. While the possibility of the promoter's offer (even if the only one) being more than the liquidation value exists, the possibility of the same being misused by promoters cannot be eliminated. Criteria for bids to be considered 'credible' would probably need to be explained to ensure lack of misuse.
- Third, the promoters should not be provided any waivers, such as past non-compliances, non-payment of stamp

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duties and levies, etc., which are sought in a resolution plan by the resolution applicants. This stems from the fact that the non-compliances occurred while the promoters were in control of the corporate debtor itself.

- Fourth, the CIRP should not be used by the promoters to the detriment of other minority shareholders. Accordingly, appropriate safeguards should be included to ensure that appropriate payments are made to the minority shareholders. In the absence of such a provision, the CIRP under the IBC may be misused by promoters to buy out the minority shareholders at substantially reduced valuation. Fair value norms may be prescribed to protect the minority shareholders.
- Last, to ensure that the promoter's resolution plan is not an innovative manner of 'ever-greening' of loans, the resolution plan of the promoter may restrict any deferred payments to creditors, and require for upfront payments to all creditors. While the lenders may be permitted to covert loans into equity, no debt should be permitted to be outstanding once the resolution plan is approved and implemented.

Ensuring a middle path permitting promoters from becoming a resolution applicant, although ensuring appropriate safeguards (such as the above) to protect the other stakeholders may make the IBC and the CIRP process much more economically viable for the promoters and the lenders, without compromising the sanctity of the process. The excess of the payments that the promoters are willing to make to the lenders cannot be foregone for the cost of morality. As Oscar Wilde once said:

*"Morality is simply the attitude we adopt towards people we personally dislike."*

– Abhinav Harlalka & Simone Reis

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