BEWARE – BANKS CAN NOW TAKE OVER COMPANIES TO RECOVER THEIR DEBT

Introduction

To address various issues surrounding distressed assets in the banking system, on February 26, 2014, the Reserve Bank of India (the "**RBI**") issued the Framework for Revitalising Distressed Assets in the Economy (the "**Framework**").

The Framework, *inter alia*, requires lenders to compulsorily form a Joint Lenders Forum (the "**JLF**") if the principal or interest payment in respect of a loan account is overdue between sixty-one (61) and ninety (90) days and if the aggregate exposure of the lenders in the loan account exceeds INR1,000,000,000 (Indian Rupees One Billion, approximately US$15,625,000). Further, the Framework requires the JLF to put in place a corrective action plan (the "**CAP**") (either under the Corporate Debt Restructuring Cell as set up by the RBI (the "**Cell**") or independent of the Cell).

By its circular dated June 8, 2015 (the "**Circular**"), the RBI has introduced a Strategic Debt Restructuring Scheme (the "**Scheme**") under which banks can convert existing loans into a majority equity stake in the borrower's company. The Scheme is based on the principle stipulated in the Framework that the shareholders or promoters must first bear the loss rather than the debt holders.

This paper discusses the requirements of the Scheme that banks must comply with while converting debt into equity.

Key Features of the Scheme

- How the Scheme works? The Scheme envisages a transfer of the majority equity stake held by the promoter in favour of the lenders. The Scheme is silent as to whether the conversion of debt into equity can be achieved by way of fresh issuance of shares. However, as the Scheme stipulates that pursuant to the conversion, all lenders in the JLF must collectively hold 51% (or more) of the equity shares issued by the borrower company, it may possible that such conversion can only be achieved by way of issuance of fresh shares.

- Requirements: The JLF must retain the option to convert either a part or the entire loan along with interest due during the initial restructuring, if the borrower company defaults, or does not meet the milestones or conditions of the restructuring package. However, from now on, this option should be included in the main loan agreement entered into between a borrower company and its lenders. The decision to invoke the Scheme must be approved by a majority of the JLF members, i.e., at least 75% of the creditors in value and 60% of the creditors in number. The JLF must obtain all approvals from the borrower company as may be required to enable the lenders to effectively exercise the option to convert the loan, including the approval of 75% of the shareholders. Pursuant to the conversion, all lenders in the JLF should collectively hold 51% or more of the equity of the borrower company. The JLF must consider appointing a suitable management team for the company it acquires under the Scheme.

- Timelines to be followed: The JLF must: (a) within thirty (30) days from review of the borrower's account, take a decision on a certain date (the "**Reference Date**") to invoke the Scheme; (b) within ninety (90) days from the Reference Date, approve the conversion package; and (c) within ninety (90) days from the date of approval of the conversion package, convert the debt into equity.

- Divestment of stake: The JLF must endeavor to divest to a new promoter the equity shares of the borrower company acquired under the Scheme. After the divestment, the asset classification of the account may be upgraded to "standard," subject to the conditions that: (a) the new promoter must not be from the existing promoter group; and (b) the new promoter acquires at least 51% of the paid-up equity share capital of the borrower company. If the new promoter is a non-resident, and if the Foreign Direct Investment Policy of India restricts it from acquiring 51% equity shares, the new promoter must own equity shares that are the higher of 26% of the paid-up equity share capital or up to the applicable foreign investment limit, with control over the management of the borrower company. Banks, while divesting their stake as above, may refinance the existing debt of the borrower company subject to conditions prescribed in the Scheme.

- Compliance with the Banking Regulation Act, 1949 (the "**Act**"): On exercising the Scheme and in compliance with the Act, a bank cannot hold shares exceeding 30% of the paid-up equity share capital of the borrower company or 30% of its own paid-up share capital and reserves, whichever is less. Further, banks must also comply with Section 6 of the Act which sets out the forms of business in which banking companies may engage.

- Pricing Formula: The conversion price of the equity shares of the borrower company must be at "Fair Value," which must not exceed the lowest of the following (but should always be more than the face value of the shares):

- Market value (for listed companies): The average of the closing prices of the instrument on a recognized stock exchange during the ten (10) trading days preceding the Reference Date; or

- Break-up value: Book value calculated from the company's latest audited balance sheet (not older than one (1) year) without considering revaluation reserves, if any, and adjusted for cash flows and financials post the earlier restructuring. In case the latest balance sheet is not available this break-up value shall be INR1 only.

Position when the Scheme is invoked in listed companies

- The lenders are exempt from making an open offer under the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (as amended).

- The Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 (as amended) do not apply to the pricing formula set out above. However, certain conditions prescribed by the SEBI do apply, namely, compliance of the Scheme with applicable company law, certification of the conversion price by independent valuers, lock-in of one (1) year for equity shares allotted, etc.

Other terms of the Scheme

- The Scheme provides that, going forward, lenders should include necessary covenants in all loan documentation, supported by necessary approvals from the borrower company, so as to enable the banks to invoke the Scheme in applicable cases.

- The lenders acquiring equity under the Scheme are exempt from the regulatory ceilings and restrictions on capital markets exposure, investment in para-banking activities, and intra-group exposure (subject to reporting and disclosure requirements as prescribed under the Scheme).

- The Scheme is also applicable to accounts which have been restructured before the date of the Circular, provided, that, an enabling clause (first condition indicated above) exists in the agreement between the borrower and the lender.

- Equity shares that the banks acquire under the Scheme shall: (a) be assigned a 150% risk weight for eighteen (18) months from the Reference Date, after which these shares shall be assigned risk weights as per the extant capital adequacy regulations; and (b) be exempt from the requirement of periodic mark-to-market prescribed under the prudential norms for classification, valuation and operation of investment portfolio by banks for eighteen (18) months from the Reference Date.

Conclusion

Although the Scheme enables lenders to take ownership and control of the borrower company to minimize the risk of insolvency of the company, it remains to be seen whether the Scheme will achieve its desired purpose. First, the threshold amount of INR1,000,000,000 could have been kept at INR500,000,000 so as to also cover loans in the SME segment. Second, the requirement of a 75% shareholders' resolution to effect the conversion may not be easy to comply with, because in many Indian companies, promoters own or control up to 75% of the equity of the company. Third, the divestment of the stake in a company may not be easy, especially if the promoter still holds shares in the company.

Recent news reports indicate that the State Bank of India plans to convert loans of two (2) borrower companies into equity. One will have to wait and watch how this pans out.