LEGAL RECOURSES AVAILABLE TO LENDERS AND BORROWERS IN CASE OF DEFAULT

At the prima facie viewing of numerous Loan Agreements, it is noted that there are a number of standard clauses which stand as the backbone of these agreements. One such clause contained therein is an "Consequences of Event of Default" clause. This type of clause is designed to protect the lender from non-repayment of the loan and provide them with contractual rights under the loan agreement as well as placing certain financial consequences on the borrower. Loans act as tremendous liabilities which are time sensitive in nature, and the repayment can be a cumbersome process for some in case of unemployment, job loss and other misfortunes .borrowers are often tagged as "loan defaulters" in such circumstances and the banks or non -banking financial institutions(FI's) then have to initiate recovery proceedings of their dues in case of such occurring default.

- RBI- Prudential Framework for Resolution of Stressed Assets Directions 2019

  The Reserve Bank of India (RBI) introduced the Prudential Framework for Resolution of Stressed Assets Directions 2019 ("prudential framework")[1] which provides fresh directions to lenders on the resolution of stressed assets. The directions are issued by the reserve banks to the banks in terms of provisions of section 35AA of the banking regulation Act,1949[2] for initiation of insolvency proceedings against specific borrowers under the Insolvency and Bankruptcy Code,2016. The lenders have to rapidly recognize incipient stress in loan accounts, immediately on default by classifying such assets as special mention accounts (SMA).

  The framework provides choices to the lenders as to how to deal with their borrowers not only can they implement internal Resolution process and reach their desired consensus , the decision to proceed under the IBC in respect of stressed accounts is at the discretion of the lenders of the stressed borrower.

  The implementation of the resolution plan plays a vital role as all lenders must put in place Board-approved policies for resolution of stressed assets, including the timeline for resolution. since default with any lender is a lagging indicator of financial stress faced by the borrower, it is expected that the lenders initiate the process of implementing a resolution plan (RP) even before a default. In case of any default on part of borrower, the lenders have to undertake a review of the borrower account within thirty days from such default to decide on the resolution strategy, including nature of RP, the approach for implementation of the RP etc . the lenders may also choose to initiate legal proceedings for insolvency or recovery. The RP may involve any action / plan / reorganization including, but not limited to, regularisation of the account by payment of all over dues by the borrower entity, sale of the exposures to other entities

[1] Reserve Bank of India, Prudential Framework for Resolution of Stressed Assets Directions 2019,June 7th 2019

[2] power of central government to authorize Reserve Bank for issuing directions to banking companies to initiate insolvency resolution process.

/ investors, change in ownership and restructuring. The RP shall be clearly documented by the lenders concerned.

In case of accounts where the aggregate exposure of lenders is Rs. 1 billion and above, if the Plan involves restructuring/ change in ownership it would require independent credit evaluation ("**ICE**") of the residual debt (i.e. aggregate fund based and non-fund based debt envisaged to be held by all the lenders as per the Plan) by credit rating agencies ("**CRAs**") specifically authorised by RBI for this purpose. Accounts with aggregate exposure of Rs. 5 billion and above will require 2 (two) ICEs and the other accounts will require 1 (one) ICE. The borrowers who have committed frauds/ malfeasance/ wilful default will be ineligible for restructuring. However, in cases where the existing promoters are replaced by new promoters, and the borrower company is totally delinked from such erstwhile promoters/ management, lenders may take a view on restructuring such accounts based on their viability, without prejudice to the continuance of any criminal action against the erstwhile promoters/ management.

The regulatory exemptions available in case of restructurings under the Prudential Framework are set out hereinbelow:

- Acquisition of non-statutory liquidity ratio securities by way of conversion of debt is exempted from the restrictions and the prudential limit on investment in unlisted non-statutory liquidity ratio securities prescribed by the RBI.
- Acquisition of shares due to conversion of debt to equity during a restructuring process will be exempted from regulatory ceilings/ restrictions on capital market exposures, investment in para-banking activities and intra-group exposure. However, these will require reporting to the RBI and disclosure by banks in its annual financial statements and it will be subject to compliance with the provisions of section 19(2) of the BR Act.

The introduction of the Prudential Framework showcases the RBI's continued focus on time-bound resolution of stressed assets and is intended to provide a fair amount of flexibility to lenders to use their commercial and economic judgment to put in place a resolution strategy.

➢ <u>Conversion of Debt into Equity under RBI Provisions</u>

The Reserve Bank of India has notified the following conditions on Conversion of Debt into Equity[3]:

a) Securitization Companies / Reconstruction Companies (SC/RCs) are permitted to convert a portion of debt into shares of the borrower company as a measure of asset

[3] RBI/2013-2014/460

reconstruction provided their shareholding does not exceed 26% of the post converted equity of the company under reconstruction.

b) Securitization Companies / Reconstruction Companies (SC/RCs) are required to obtain, for the purpose of enforcement of security interest, the consent of secured creditors holding not less than 60% of the amount outstanding to a borrower as against 75% hitherto.

[4]Now while reviewing the shareholding of the post converted equity of the borrower company under reconstruction by Asset Reconstruction Companies (ARCs), RBI has decided to exempt ARCs meeting the criteria set out with a cap of 26% subject to compliance with the provisions of the SARFAESI Act, 2002, and the various guidelines/ Instructions issued by Reserve Bank of India from time to time as applicable to ARCs as well as Foreign Exchange Management Act, 1999, Reserve Bank of India Act, 1934, Companies Act, 2013, SEBI Regulations and other relevant Statutes. The extent of shareholding post conversion of debt into equity shall be in accordance with permissible Foreign Direct Investment (FDI) limit for that specific sector.

Further, the RBI release adds that ARCs that meet the conditions mentioned below are exempted from the limit of shareholding at 26% of post converted equity of the borrower company:

- The ARC shall be in compliance with Net Owned Fund (NOF) requirement of ₹ 100 crore on an ongoing basis.
- At least half of the Board of Directors of the ARC comprises of independent directors.
- The ARC shall frame policy on debt to equity conversion with the approval of its Board of Directors and may delegate powers to a Committee comprising majority of independent directors for taking decisions on proposals of debt to equity conversion.
- The equity shares acquired under the scheme shall be periodically valued and marked to market. The frequency of valuation shall be at least once in a month.

➢ <u>Securitization and Reconstruction of Financial Assets and Enforcement of Security Interests Act, 2002 (SARFAESI)</u>

Any action initiated by the banks or FI's must be pursued in accordance with the procedure laid down by the law. Initially as a first step after someone defaults on the loans, they start receiving communications from the banks or financial institutions and then depending on the terms and conditions of the loan, the lender would enlist them as a Non-performing Asset(NPA) s which would then transpire into appropriate legal action. The Limit prescribed for classes of secured creditors under the Act is Rs One lac (1 lac) that is, the provisions of this Act are applicable only for NPA loans with outstanding above Rs. 1.00 lac and by the recent notification, NBFC's having asset size

[4] RBI/2017-18/101

of Rs 100 crore or more and security interest on other debts amounting to 50 lac or more can now be recognized as financial institution under SARFAESI[5].

Once the borrower's account has been classified as NPA, or repayment has been overdue for 90 days, the Banks or FI's may initiate action under the SARFAESI Act .A demand notice shall be sent by the secured creditor to the borrower to discharge his full liabilities within sixty days from the date of notice.[6] When the sixty day period concludes, without any discharge by the borrower, actions can be taken by the secured Creditor wherein they can take possession of the secured assets, take over the management of the assets, appoint any person to manage the secured assets or require any person who has acquired any of the assets from the borrower to pay the secured creditor[7].

- **Securitization of financial assets:** Acquire financial assets by issuing bonds or Agreements.
- **Reconstruction of financial assets:** Take necessary measures for debt restructure, settlement, sale etc. as per guidelines issued by RBI from time to time.
- **Enforcement of security interest:** Enforcing security interest by the creditor with the intervention of the court. The Act not only pays attention to the remedies provided to the creditor but also highlights the rights of the borrower, as the actions taken by the creditor under S.13(4) are appealable , therefore the borrower can appeal the actions of the secured creditor in Debt Recovery Tribunal[8], DRAT[9], writ in High Court and SLP in Supreme Court. It is also imperative to note that if the DRT or the Appellate tribunal or High Court hold that the possession of the Secured assets by the creditor are not in accordance with the provisions of the Act and the rules made thereunder then the judicial authority may direct the secured creditors to return such assets to the concerned borrowers and the borrowers shall be entitled to the payment of such compensation and costs by the Appropriate judicial Authority[10].

➢ <u>Recovery of Debts due to Banks and Financial Institutions Act, 1993 (DRT Act)</u>

Alternatively, bank and financial institutions may initiate recovery proceedings before the Debt Recovery Tribunal under the Recovery of Debts due to Banks and Financial Institutions Act, 1993(DRT Act) when the pecuniary limit for filing application for recovery of debts is rupees Twenty lacs (20,00,000/-)[11] or more . Summary procedure is adopted by the DRT for adjudication of the dispute and evidence is taken on Affidavit. The defendants (borrowers) have been given the right to file Counter claims

[5] Ministry of Finance, Department of Financial services, Notification dated 24 february,2020.
[6] Section 13(2) of the SARFAESI Act,2002 read with Rule(b) and 3 of the Security Interest Enforcement Rules, 2002
[7] Section 13(4) of the SARFAESI Act,2002
[8] Section 17 of the SARFAESI Act,2002
[9] Section 18 ,of the SARFAESI Act,2002
[10] Section 19 of the SARFAESI Act,2002
[11] Ministry of Finance, Department of Financial services , Notification dated 6th September, 2019 .

or claim of set off[12] against the claimed amount. The final order is passed by the tribunal directing the borrowers to pay the amount. In case the borrower does not pay the ordered amount, a recovery certificate is ordered to be issued against the borrower which is duly executed by the Recovery Officer of the DRT. Any person aggrieved by the order passed by DRT may file an appeal before the debt recovery appellate tribunal[13] , however DRAT does not entertain the appeal unless the Appellant deposits with the Appellate Authority, 75% of the amount or such other lesser amount directed by the appellate tribunal.[14]

- Insolvency and Bankruptcy Code,2016

Another source of Comfort for the lenders lies in the insolvency resolution process governed by the Insolvency and bankruptcy code of India(IBC), 2016 which can be initiated when the secured creditor is of the knowledge that the debtor has committed a default and would not be in a financial position to indemnify such losses. The unique selling point of IBC is that its applicability only arises to Companies, i.e. the corporate debtors can only be companies and not individuals[15]. Any Entity who provides loans or funds, bonds etc. to the corporate is known as the financial creditors[16] and wherein any [17]corporate debtor commits a default, a financial creditor, operational creditor or the corporate debtor himself may initiate the corporate insolvency process (CIRP).

While the provisions thereby made under IBC are for protection of creditors against the defaults committed by the corporate debtor, the Ministry of Finance have introduced a few new provisions amidst the Covid-19 Pandemic which will act as relief gates for the debtors. The Finance ministry has now increased the threshold for defaulting companies under the Code with immediate effect to Rs.1 crore from Rs.1 lakh earlier[18]. The creditors had the right to file a case under IBC if a company defaulted on payment of Rs1 lakh or above, now this limit has been raised to Rs 1 crore, providing rights to debtors during such hard times.

The newly promulgated IBC ordinance also comes as a relief for corporate debtors as it states that insolvency proceedings have been suspended for a period of 6 months from 25th March which may extend up to one year[19] providing ample time to debtors to get their bearings in order.

The process to initiate the CIRP is to primarily file an application with the Adjudicating Authority along with evidence of default, and the Financial creditor can initiate the proceedings before the NCLT in cases of default. If the Adjudicating Authority is

[12] Section 19 (6) ,(8) of the DRT Act
[13] Section 20 of the DRT Act
[14] Section 21 of the DRT Act
[15] Section 2, IBC 2016
[16] Section 5(7) , IBC 2016
[17] Section 6, IBC 2016
[18] Notification, F.No.30/9/2020-insolvency, Ministry of Corporate Affairs
[19] Insolvency and Bankruptcy Code(Amendment) Ordinance,2020 (No.09 of 2020) dated June 5th, 2020.

satisfied that the default exists, it admits that the application and appoints the Interim insolvency professional(IRP). The resolution professional then forms the Company of Creditors(Coc) who decide what is to be done with the corporate debtor. If the insolvency is resolved, it approves a resolution plan with sixty-six percent of votes. As one of the main objective of the Code was to provide speedier resolution, the Code broadly specifies : a) 24 days for the Adjudicating Authority to admit or reject an application for initiation of CIRP; b) seven days for an applicant to rectify defects in the application for CIRP; c) 30 days for the IRP to discharge his duties; and e) 180 days for creditors to complete a CIRP (extendable to a maximum of 270 days from the insolvency commencement date). This mandates that the CIRP shall be completed within a period of 330 days from the insolvency commencement date, including any extension of the period of CIRP and the time taken in legal proceedings in relation to such CIRP. The secured creditors have also been given preferences when it comes to distribution of Assets of the corporate debtor[20] and have been given due priority at the time of payments of debts[21].

At a glance we can see that laws have been made in order to provide the lenders/creditors the upper hand when it comes to debt recovery process but it is equally important to know that borrowers/loan defaulters are entitled to all the rights for self-preservation as well. First and foremost, the borrower is entitled to obtain all relevant information about the loan, incidence of default and details of interest and other charges levied by the lender. Needless to mention, the borrower is entitled to liquidate the loan liability and obtain release of security. However, that does not mean that banks or FIs have a right to misbehave with the defaulters through recovery agents.in case there is any misconduct on the part of the banks or FI's the defaulter has legal rights against the same. A suitable remedy for a borrower in the event of harassment or coercion by the bank or recovery agents, is that the borrower may approach the banking ombudsman under the relevant framework of the Reserve Bank of India (RBI). For continued harassment in certain cases the borrower may also file a police complaint or move civil court for an injunction by filing a suit.

It is difficult to shed the tag of being a "loan defaulter" considering the borrower's credit score may get impacted and it also may affect their ability to raise loans in the future. That being said, steps for recovery of debts are in place according to appropriate laws which will support the lenders in their misfortunes, but the lenders cannot have a complete walkover when a borrower defaults.

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[20] Section 52, IBC 2016
[21] Section 178, IBC 2016