Report of

The Committee on Industrial Sickness and Corporate Restructuring

Submitted to
The Union Minister of Finance
Government of India

(July 1993)

There are sick companies, sick banks, ailing financial institutions, and unpaid workers. But there are hardly any sick promoters. There lies the heart of the matter.

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July 13, 1993

Dr Manmohan Singh,
Union Minister of Finance,
Government of India.

Dear Mr Finance Minister,

It gives me great pleasure to submit the **Report of the Committee on Industrial Sickness and Corporate Restructuring.** You had set-up this Committee to make a persuasive case for creative restructuring to meet the challenge of industrial sickness in India, and outline innovative, yet implementable, reforms to facilitate the process of industrial and corporate reorganization. I hope that the Report will measure up to your brief, and create an environment for accelerating the process of economically viable and commercially meaningful corporate restructuring of sick industrial firms.

With regards,

Yours sincerely,

Omkar Goswami

Omkar Goswami
(Chairman)

Encl: Report of the Committee on Industrial Sickness and Corporate Restructuring.

Preface

On April 8, 1993, a group of economists and lawyers were invited to make a presentation on various aspects of industrial sickness and corporate restructuring for the benefit of the Minister of Finance, Government of India. After the presentation, the Finance Minister requested that the group be constituted into a formal committee, and that this committe submit a detailed report on industrial sickness and issues in corporate restructuring. This was subsequently formalized by an office order (No. B.13017/8/93–Adm.III, dated May 27, 1993).

The members of this Committee on Industrial Sickness and Corporate Restructuring are:

1. Dr T.C.A. Anant, Delhi School of Economics.
2. Mr Naval Bhatia, Advocate.
3. Mr Hanumantha Charya, National Council of Applied Economic Research.
4. Dr Tamal Datta Chaudhuri, Industrial Reconstruction Bank of India.
5. Dr Shubhashis Gangopadhyay, Indian Statistical Institute, Delhi.
6. Dr Omkar Goswami, Indian Statistical Institute, Delhi (**Chairman**).
7. Mr Kirti Uppal, Advocate.

Unfortunately, Dr Gangopadhyay had to go abroad immediately after the formation of the Committee, and was away throughout the period. Nevertheless, he can escape neither accolades nor criticism for many of the ideas and recommendations in this report – as these were adopted from joint research that he has been doing with Dr Anant and Dr Goswami for the past two years.

Acknowledgements

Members of the Committee are jointly and individually indebted to a large number of people and organizations. Regarding the latter, the Committee is indebted to the Board for Industrial and Financial Reconstruction (BIFR), the Ministry of Finance and its Banking Division, Ministry of Industry, Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India (ICICI), Industrial Reconstruction Bank of India (IRBI), Industrial Finance Corporation of India (IFCI), State Bank of India (SBI), Reserve Bank of India (RBI), DSP Financial Consultants, JM Financial & Investment Consultancy Services, CRISIL, Housing Development Finance Corporation (HDFC), the Ahmedabad Textile Labour Association, and the Indian Cotton Mills Federation (ICMF).

It is almost impossible – and certainly very space consuming – to exhaustively list the number of people who have helped the Committee and its members in different capacities. Nevertheless, it is necessary to publicly acknowledge some people for their unstinting support to the work of the Committee and other related research. In particular, we wish to thank (in lexicographic order): Ritu Bhalla, S.H. Bhojani, Arvindbhai Buch, Shitin Desai, Sarala Gopalan, G.P. Gupta, R.R. Gupta, D.R. Mehta, Dilip Mookherjee, Kalpana Morparia, S.S. Nadkarni, T.M. Nagarajan, P. Jayendra Nayak, T. Panduranga Rao, R.H. Patil, N. Ramani Raj, Deepak Satwalekar, Manish Sharma, M.M. Srivastava, S.S. Tarapore, S.J. Thaker, and N. Vaghul. The Committee jointly and severally are particularly in debt to Praveen Kumar, Pradeep Godbole, and Gurudeo Yadwadkar of IDBI for helping us time and again in many different ways. Penultimately, three of us in the Committee (Anant, Gangopadhyay, and Goswami) owe a great deal to Rakesh Mohan of the Ministry of Industry. He initiated a project on industrial sickness two years ago – thus giving an opportunity to learn about the subject, and eventually contribute to this Committee. Finally, we thank Shanto Ghosh for excellent research assistance.

Contents

1 : Introduction

1.1 The long term success of India's economic reform process depends upon sustained growth in industrial output and investment. Without this, there cannot be a genuinely competitive industrial base from where India can launch an export drive to systematically reduce its debt service obligations over time.

1.2 The prospects of industrial growth and investment depend upon the signals that India gives to the rest of the world as well as her own entrepreneurs. The reforms initiated since July 1991 have already started sending positive signals. People realize that there has been a serious attempt at macroeconomic management, reducing the fiscal deficit, cutting unwarranted subsidies, reorienting the import regime away from quotas to tariffs, introducing floating exchange rates on trade account, eliminating a number of hitherto sacred barriers to entry, and at restructuring the fiscal system to gradually bring import duties in line with other competing developing nations. Three years ago, even the most die-hard reformer would have scarcely anticipated the changes that have occurred since July 1991.

1.3 The focus should now be on rapid industrial sector reform. This is not just eliminating licensing and other barriers to entry. It requires giving signals to potential entrepreneurs (irrespective of their origin) about the scope for operational flexibility – in the choice of output, of markets, and in the use of labour and capital. **Industrial restructuring involves commercially reorganizing ailing but economically viable firms, facilitating the withdrawal of unviable ones, and re-utilizing the land and labour thus freed in the best possible manner.** Encouraging such reorganization will give strong signals about flexibility and India's commitment to rapid industrial growth. It is here that India needs to show marked success – to prove that we can liberate ourselves from the fetters of rigid dogma, and chart out areas of future growth and more meaningful employment.

1.4 **The Committee is unanimous in its view that the various barriers to industrial and corporate restructuring serve no economic goal.** By preventing reorganization at the appropriate time, these barriers choke off future growth opportunities, and so foster an uncompetitive environment which rapidly leads to gross and pervasive industrial sickness. For exactly the same reasons, **these barriers are anti-labour: although the restraints seek to protect labour in the short run, these actually harm long and medium term employment by eliminating growth possibilities.** Equally, these barriers go against the economic interests of any non-myopic government. They result in a systematic drain of scarce public funds, foster a climate of budgetary support, and eventually justify high tariffs, quotas, sectoral and product reservations to sustain inefficient firms. Indeed, **barriers to restructuring have only one over-riding purpose: they maintain an army of inefficient promoters and managers in the public and the private sector, who justify their incompetent existence on the ground that their firms "protect" employment.**

1.5 A caveat is in order. Although the Committee was given no brief as such, it decided to focus on industrial and corporate restructuring in the private sector. There are two reasons for this. First, except for occasional scale effects, there is no basic difference in economic, commercial, and legal principles between reorganizing the affairs of a private sector firm and a public sector company. The distinction lies in political will – particularly the ability to create a consensus that shapes the will. This "will" needs to come to bear soon enough, because the government can no longer afford to maintain inefficient, loss making public sector units through constant budgetary support. Moreover, the scale deterrents in reorganizing sick public sector units are hardly deterrents at all. So long as there is a desire to reorganize, it can always be done by a combination of (i) strictly one-shot budgetary outlays through carefully computed drafts on the National Renewal Fund (NRF) and (ii) innovative financing through the sale of unproductive assets and unutilized land.

1.6 Secondly, industrial sickness – and the need for restructuring, reorganization, and strategic withdrawal – is as pervasive in the private sector as it is in the public. Decades of high tariffs, quotas, licensing restrictions, barriers to entry, and irrational excise duties have been instrumental in fostering widespread inefficiencies in large and medium scale private sector factories. These have nurtured a perverse environment in which, irrespective of ownership, an inefficient firm is never penalized for being systematically uncompetitive. Therefore, focusing on the private sector in no way trivializes the problem of industrial sickness. Besides, the relative absence of political compulsions makes it easier to restructure, reorganize or withdraw private sector companies relative to the public sector enterprises. Conversely, if we cannot create a climate that encourages commercial restructuring and reorganization of financially sick but economically viable private sector firms, and facilitates the withdrawal of unviable ones, then one cannot hope for any meaningful restructuring of public sector companies in the years to come.

1.7 The report is organized as follows. Chapter 2 gives a brief description of the extent of industrial sickness in India. Chapter 3 examines the Sick Industrial Companies (Special Provisions) Act (SICA) and the performance of India's premier restructuring agency, the Board for Industrial and Financial Reconstruction (BIFR). Chapter 4 relates the financial sector with the industrial sector: how the earlier practices of banks and financial institutions led to bad appraisals, poor rehabilitation packages, and created barriers to industrial restructuring. Thereafter, it focuses on incipient sickness: detection, norms, and possible remedial measures. Chapter 5 examines various barriers to reorganization: land, labour, management, and corporate and tax laws. Chapter 6 concludes with a summary of findings and policy recommendations.

2 : Dimensions of Industrial Sickness

2.0.1 At an elementary level, industrial sickness refers to an industrial or manufacturing firm performing systematically worse than the average, not covering its fixed costs, and frequently reneging on its debt repayment obligations. **There can be no second opinion about the growth of industrial sickness (so defined) in India. It is pervasive across ownership (public or private sector), across industries, across states, and across scale (small, medium, and large).** On at least two counts the problem of long term "sickness" is more severe in India compared to all developed and most industrializing nations. First, being a poor country, India can ill afford to lock up scarce financial as well as real resources in persistently loss-making firms. Second, in most other countries such firms cannot survive (in the Indian terminology, "remain sick") for long: these either have to reorganize their assets, liabilities, product-mix, capital stock and labour force, or retreat from the industry. **It is a sad reflection of our notion of opportunity cost of scarce resources that we maintain and exacerbate sickness without economically viable restructuring or planned withdrawal.**

2.0.2 Section 2.1 gives some facts about sickness in the private corporate sector – where the problem is as widespread as in the public sector. Section 2.2 gives some data on public sector sickness. Section 2.3 highlights a number of research findings on various aspects of industrial sickness, and so sets the stage for the policy issues in subsequent chapters.

2.1 Industrial sickness in the private sector

2.1.1 Industrial sickness arises out of bad financial structure and/or chronically inefficient use of factors of production and/or poor market positioning. Its outcome is the locking up of scarce investible funds in sub-optimal activities. Given this outcome, **an appropriate way of looking at sickness is to examine the amount of outstanding credit locked up in sick industrial units. During 1982-1989, outstanding credit to sick units has risen from Rs.2585 crores to Rs.9353 crores: an increase of 18.4% compound per year.** By December 1989, almost 75% of this was locked up in sick large and medium scale industrial units. Chart 2.A and Table 2.1 give the data.

2.1.2 **What is significant is the spread of sickness among large and medium scale units.** While their numbers have increased at a modest rate of 4.8% per year, **the amount of outstanding credit locked in these companies has grown at 17.65% during 1982-1989; and real outstanding credit has risen by 11% per year over inflation.** The average unpaid credit per large and medium sized sick company has almost trebled: from Rs.1.24 crores in 1982 to Rs.3.05 crores in 1989. **Not only are more large and medium scale units getting sick, but these companies are also locking-up increasing amounts of nominal and real bank credit.**

CHART 2.A
Industrial Sickness : Outstanding
Credit Locked up in Sick Firms

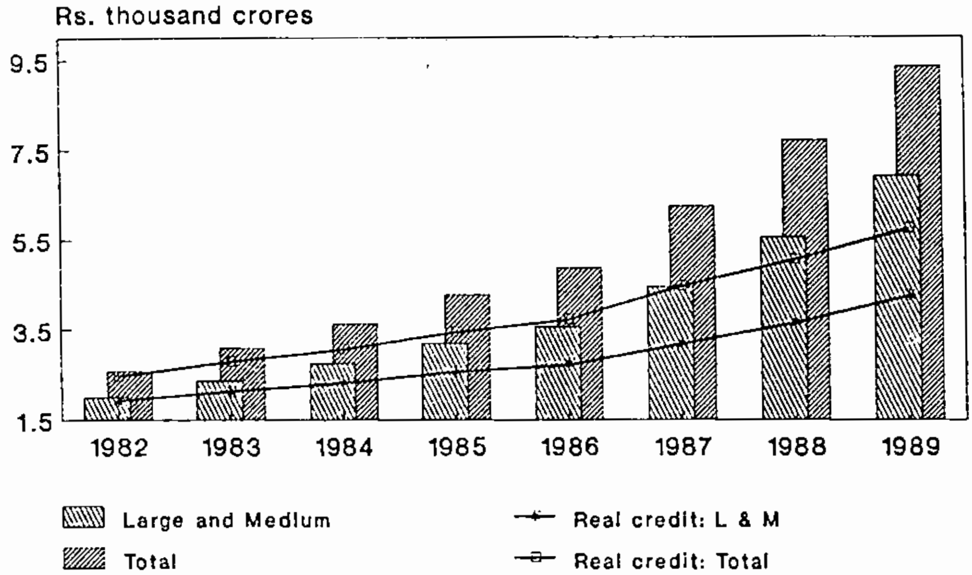

Table 2.1: Industrial sickness according to scale, all-India, 1980-89, rupees crores

(1)	No. of firms	Outstanding credit	Real outstanding credit
Large and medium scale sick units			
1982	1622	2016	1933
1983	1747	2372	2141
1984	1832	2758	2327
1985	1823	3200	2581
1986	1964	3568	2726
1987	1839	4459	3185
1988	2011	5564	3656
1989	2269	6926	4262
Rate of growth	4.8%	17.6%	11.3%
Total (large, medium, and small)			
1982	60173	2585	2478
1983	80110	3101	2799
1984	93282	3638	3070
1985	119606	4271	3444
1986	147740	4874	3723
1987	206098	6256	4469
1988	242584	7705	5062
1989	221097	9353	5755
Rate of growth	18.6%	18.4%	12.0%

2.1.3 The industry-wise distribution of outstanding credit to large and medium scale sick companies as of September 1989 (Table 2.2) shows that textiles dominates in no uncertain terms. It is followed by engineering (narrowly defined). If the engineering industry is broadly defined to include engineering, production of iron and steel, and electrical and non-electrical machinery and transport equipment, then it is an even closer second. Comparisons yield a more meaningful analysis of the industry-wise distribution of sickness. If one examines the *share* of total outstanding bank credit that is accounted for by the sick companies in any industry, then the jute industry is the worst hit: the sick units take up more than 57% of the total outstanding credit.

Table 2.2 : Industry-wise distribution on non-small scale sick units, September 1989

	% distribution of outstanding credit in sick units	Outstanding credit in sick firms as % of outstanding credit in industry
Textiles	33.60%	20.29%
Engineering	22.55%	17.65%
Chemicals	5.39%	3.79%
Paper	5.15%	12.71%
Iron and Steel	4.79%	7.80%
Jute	4.75%	57.23%
Sugar	3.20%	25.03%
Rubber	2.50%	14.14%
Cement	1.27%	6.82%
Electrical	1.21%	1.65%
Miscellaneous	15.59%	0.89%
TOTAL	100.00%	4.13%

2.1.4 **Three states – Maharashtra, West Bengal, and Gujarat – have the largest cluster of large and medium scale sick units.** In 1990, the three states together accounted for 54% of outstanding bank credit. Maharashtra was the worst off, thanks to a huge presence of sick textile mills as well as engineering firms. West Bengal's status derives from a large number of sick engineering units and jute mills. Gujarat's is due to the state of the Ahmedabad textile industry.

Table 2.3 : State-wise dispersion of sick large and medium scale units, 1990

States	Outstanding credit	Share of outstanding credit
Maharashtra	1302.0	27.5%
West Bengal	690.9	14.6%
Gujarat	568.7	12.0%
TOTAL	4734.3	

2.2 Losses in the public sector

2.2.1 It is almost impossible to give a comprehensive quantitative picture of sickness in the public sector undertakings. The *Public Enterprises Survey*, published annually by the Bureau of Public Enterprises covers only a small portion of the public sector in India, namely the commercial non-departmental enterprises of the central government. The *Survey* data exclude (1) nationalized banks and government owned public financial institutions, (2) departmental economic enterprises of the central government, such as posts and telegraphs and railways, (3) departmental economic enterprises of the state governments, such as irrigation, (4) non-departmental economic enterprises of state governments, such as State Electricity Boards, State Road Transport Corporations, or State Textile Corporations, and (5) establishments of local governments. Despite these omissions, the data highlight wide-spread industrial sickness.

2.2.2 **As of 1989-90, there were 98 loss making central government non-departmental companies, and their total losses amounted to Rs.1,959 crores.** Although there was a drop in the number of losing units between 1988-89 and 1989-90 (from 106 to 98), the losses rose from Rs.1,923 to Rs.1,959 crores. Thus, **the average loss per losing company increased from Rs.18.14 crores to almost Rs.20 crores – a 10% increase over the year.**

2.2.3 Activity-wise analysis indicates that production of **fertilizers, transport equipment, consumer goods, agro-based products and textiles are loss leaders in manufacturing.** In non-manufacturing activities, public sector construction companies, technical and engineering consultancy firms, and tourism corporations incur consistent losses. **None of these are activities where public sector involvement can be justified by invoking the possibility of market failures.**

2.2.4 In 1989-90, manufacturing activities of central government owned, commercial non-departmental enterprises generated sales of Rs.82,516 crores, or 78% of the total turnover (manufacturing and services). Total net profits were Rs.3,392 crores, which translated to a seemingly reasonable 4.11% net profit to sales ratio. The story changes quite dramatically if the twenty-odd petroleum based units are excluded from manufacturing. The total sales in 1989-90 halves to Rs.40,308 crores; net profits plummet by a staggering 85% to Rs.492 crores; and the net profit to sales ratio slumps to a mere 1.22%. **Fertilizers, transport equipment, consumer goods, agro-based products and textiles companies – accounting for 11.6% of manufacturing sales – suffered net losses to the tune of Rs.821 crores. Their net loss to sales ratio was 8.6%.**

2.2.5 The public sector's net profit to sales ratio from non-manufacturing activities in 1989-90 was even more modest: 1.65% versus 4.11% in manufacturing (including petroleum). The losing units posted a net loss of Rs.218 crores out of a sales turnover of Rs.1,306 crores: a net loss to sales ratio of 18.43%. **These losses were exclusively due to companies in the construction and consultancy business.** Thanks to a massive increase in the losses in public sector technical consultancy, total losses in non-manufacturing activities increased by 69% between 1988-89 and 1989-90. No less disheartening is the performance of some non-loss making public sector activities. In 1989-90, trading and marketing could only earn a net profit of 0.84% on a sales revenue of Rs.15,627 crores. Similarly, the steel sector sold Rs.8,483 crores worth of goods, but earned a net profit to sales ratio of 0.6%. Table 2.4 is self-evident.

Table 2.4 : Activity-wise break-up of sales, net profits, and net profits to sales ratios, central government commercial non-departmental enterprises, 1988-89 and 1989-90, rupees crores

Activities	Net profits		Sales turnover		Net profit % sales	
	88-89	89-90	88-89	89-90	88-89	89-90
Manufacturing						
Steel	186.01	51.29	7540	8483	2.47%	0.60%
Minerals & metals	39.72	310.6	1902	2715	2.09%	11.44%
Coal & lignite	51.64	166.86	6634	7331	0.78%	2.28%
Power (NTPC)	461.47	638.83	1740	2459	26.52%	25.98%
Petroleum	2563.66	2899.53	36512	42208	7.02%	6.87%
Fertilizers	−240.58	−288.38	3833	3405	−6.28%	−8.47%
Chemicals & pharm	26.30	37.67	1625	1809	1.62%	2.08%
Heavy engineering	75.44	48.90	3695	4136	2.04%	1.18%
Medium & light engg.	36.68	59.33	3156	3825	1.16%	1.55%
Transport equipment	− 66.97	− 88.78	2746	3414	−2.44%	−2.60%
Consumer goods	−258.50	−232.26	1266	1479	−20.42%	−15.70%
Agro-based	− 2.72	− 3.74	40	60	− 6.80%	−6.23%
Textiles	−317.28	−208.06	1013	1192	−31.32%	−17.45%
Total loss makers	**−886.05**	**−821.22**	**8898**	**9550**	**−9.96%**	**−8.60%**
Total manufacturing	**2554.87**	**3391.79**	**71702**	**82516**	**3.56%**	**4.11%**
Total excl. petrol	**− 8.79**	**492.26**	**35190**	**40308**	**−0.02%**	**1.22%**
Non-manufacturing						
Trading & marketing	92.52	131.89	14841	15627	0.62%	0.84%
Transportation	92.41	77.73	3287	4039	2.81%	1.92%
Construction	−107.93	−114.45	653	681	−16.53%	−16.81%
Consultancy	− 20.13	−103.09	527	625	−3.82%	−16.49%
Tourism	− 0.55	0.16	142	160	−0.39%	0.10%
Financial	65.98	128.15	668	966	9.88%	13.27%
Telecommunications	316.4	264.3	1291	1431	24.51%	18.47%
Sec.25 companies	− 0.04	5.25	26	33	−0.15%	15.91%
Total loss makers	**−128.65**	**−217.54**	**1348**	**1306**	**−9.54%**	**−18.43%**
Total non-manf.	**438.66**	**389.94**	**21435**	**23562**	**2.05%**	**1.65%**
GRAND TOTAL	**2993.53**	**3781.73**	**93137**	**106078**	**3.21%**	**3.57%**
• Excl. petrol	**429.87**	**882.2**	**56625**	**63870**	**0.76%**	**1.38%**

2.2.6 The accumulated losses of 43 loss-making public sector companies stood at Rs.9,511 crores in 1989-90. The six loss leaders – National Textile Corporation's subsidiaries, the Fertilizer Corporation of India, Hindusthan Fertilizers, IISCO, Delhi Transport Corporation, and the National Jute Manufactures Corporation – accounted for 54% of the accumulated losses.

Table 2.5 : Accumulated losses of some loss-making public sector enterprises, 1989-90

Company	Accumulated losses (Rs. crores)
NTC (excluding Tamil Nadu & Pondicherry)	1481
Fertilizer Corporation of India	1217
Hindusthan Fertilizers	950
IISCO	602
Delhi Transport Corporation	448
National Jute Manf. Corporation	445
Indian Drugs & Pharmaceuticals Ltd	346
Engineering Projects	346
Hindusthan Shipyard	273
Hindusthan Paper	259
Hindusthan Steelworks	229
Scooters India	212
Heavy Engineering Corporation	190
Nagaland Pulp and Paper	171
Central Inland Water	166
Cement Corporation of India	155
Cochin Shipyard	145
Western Coalfields	144
Indian Road Construction Corporation	139
Elgin Mills	135
South Eastern Coalfields	114
Mazagaon Docks	109
Tannery & Footwear Corporation	102
Cycle Corporation	98
Vayudoot	80
Paradeep Phosphates	78
British India Corporation	77
Bharat Gold Mines	69
Bharat Pumps	62
Burn Standard	59
Bharat Ophthalmic Glass	56
Tyre Corporation of India	56
Mining & Allied Machinery Corporation	54

Company	Accumulated losses (Rs. crores)
Mandya National Paper	52
National Bicycle Corporation	50
Bengal Chemicals & Pharmaceuticals	50
Project & Development India Limited	49
Richardson Cruddas (1972)	46
Biecco Lawrie	44
Bharat Refractories	41
National Instrument	39
Braithwaite & Company	39
Hotel Corporation of India	34
TOTAL (43 companies)	9511

2.2.7 Table 2.6 gives an illustrative list of nationalized companies having negative accumulated reserves and, hence, qualifying as large and medium scale sick units. Of these, two mammoth entities account for two-third of the negative accumulated reserve: the NTC subsidiaries (excluding Tamil Nadu and Pondicherry), and IISCO!

Table 2.6 : An illustrative list of nationalized companies with negative accumulated reserves, 1989-90, rupees crores

Companies	Accumulated reserves
NTC (excl. Tamil Nadu & Pondicherry)	−1401.45
IISCO	− 578.35
Elgin Mills	− 134.32
Cycle Corporation	− 89.34
Tannery & Footwear	− 85.38
British India	− 76.33
CIWTC	− 57.25
Tyre Corporation	− 52.99
Bengal Chemicals	− 50.19
National Bicycle	− 49.54
Mandya National Paper	− 47.83
Richardson Cruddas	− 46.34
Biecco Lawrie	− 43.60
Bharat Refractories	− 40.87
Braithwaite	− 39.13
Burn Standard	− 36.85
Bharat Process	− 33.52
Bengal Immunity	− 28.04
Cawnpore Textiles	− 17.06
Jessop & Company	− 14.56

Companies	Accumulated reserves
Hooghly Docks	− 14.34
Bharat Brakes	− 14.26
Smith Stanistreet	− 13.43
Weighbird	− 6.88
Bird Jute	− 3.67
TOTAL	−2975.52

2.3 Some research findings

2.3.1 This section summarizes some of the research findings that are germane to this report.[1] The conclusions are based on a very large time-series cum cross-section analysis of textile mills and engineering firms, covering the period 1970-1990.

2.3.2 Analysis of the textile and engineering industries (sectors with the most sickness) clearly indicates that there are distinct differences in attributes between the sick (i.e. those registered with the Board for Industrial Finance and Reconstruction (BIFR) and healthy companies. These differences have existed across decades. In other words, **sickness has its history: the companies which are under BIFR today can be identified as problem cases well back into the past.**

2.3.3 **The major difference between BIFR and healthy companies lies in interest cost and wage cost, i.e., in fixed costs, and not so much in variable costs.** BIFR companies have always had higher debt-equity and total liability-equity ratios compared to the non-BIFR firms. Their debt portfolio has been always skewed towards current liabilities, and away from deferred liabilities. Consequently, **the BIFR firms have always suffered from less insurance against bad sales realizations than the non-BIFR companies.**

2.3.4 **BIFR firms have always had higher unit wage costs. Again, this is not only true today, but has been so for the last twenty-one years.**

2.3.5 **There seems to be no difference in the structure of unit variable (or raw material and consumable) costs − the proxy for technical efficiency − between the BIFR and healthy firms.** Indeed, there are "healthy" firms that have higher variable costs (and lower variable profits) than the industry average. This **does not imply** that sick firms (or, for that matter, healthy companies) are internationally competitive. Indeed, the finding reflects the generally uncompetitive nature of India's market structure for factory output. In a less protected scenario, firms cannot systematically have higher variable cost and higher fixed costs, compared to other firms in the industry, and yet continue to survive. In India, such firms not only survive, but often do so outside the ambit of SICA and BIFR. It implies that

[1] This is a summary of work done as a part of a research study funded by the Ministry of Industry: T.C.A. Anant, Shubhashis Gangopadhyay, Omkar Goswami, *Industrial Sickness in India: Characteristics, Determinants, and History, 1970-1990*, Studies in Industrial Development, Ministry of Industry, Paper No.6, October 1992.

our market structures and past government policies – high tariffs, quantity restrictions on imports, price regulations on inputs, and barriers to domestic competition – provided sufficient cushion to production and cost inefficiencies. In a more economically competitive situation, many of the seemingly healthy firms have the potential of turning sick. Tables 2.7 and 2.8 highlight these findings for textiles and engineering – the two industries that have the greatest amount of funds locked up in sick units.

Table 2.7 : Textiles – BIFR firms versus healthy companies

Indices	1970-75	1976-80	1981-85	1986-90	1970-90
Wage / Sales	+ 42%	+ 45%	+ 67%	+ 106%	+ 63%
Interest / Sales	+ 19%	+ 27%	+ 31%	+ 141%	+ 51%
Fixed Cost / Sales	+ 38%	+ 41%	+ 58%	+ 115%	+ 61%
Variable Cost / Sales	– 4%	– 3%	+ 2%	+ 6%	Same
Total liability / Sales	– 2%	+ 9%	+ 17%	+ 164%	+ 43%
Total liability / Equity	+ 13%	+ 51%	+ 66%	+ 94%	+ 54%

Table 2.8 : Engineering – BIFR firms versus healthy companies

Indices	1970-75	1976-80	1981-85	1986-90	1970-90
Wage / Sales	+ 34%	+ 17%	+ 19%	+ 53%	+ 28%
Interest / Sales	+ 69%	+ 74%	+ 130%	+ 183%	+ 118%
Fixed Cost / Sales	+ 42%	+ 31%	+ 47%	+ 89%	+ 51%
Variable Cost / Sales	– 3%	– 2%	+ 5%	+ 7%	+ 2%
Total liability / Sales	+ 63%	+ 72%	+ 118%	+ 169%	+ 104%
Total liability / Equity	+ 25%	+ 27%	+ 29%	+ 40%	+ 35%

2.3.6 **Interest and wage costs are both statistically significant determinants of industrial sickness: increases in such costs raise a firm's probability of being sick.** For instance, a percentage increase in wage costs in composite textile mills can increase the probability of being sick by anything between 0.8% to 1.4%. By its very nature, interest payment is not only a more committed cost compared to wages but is also compounded. **Hence, the percentage increase in the probability of being sick given a percent change in interest cost is much greater than the corresponding elasticity with respect to wage costs** – varying from 1.6% to 2.8%.

2.3.7 The role of history is very important. **BIFR companies have shown very different attributes from healthy firms not only in the present, but also over the distant past. Moreover, sickness has a high degree of persistence – which underscores the importance of bad financial structure and high unit fixed costs.**

2.3.8 Decades of "development" financing certainly played a positive role in catalyzing fairly rapid industrialization in India from the late 1960s. However, it also created an environment where everyone believed that soft loans with generous interest rate concessions were obligatory for industrial development. When these subsidized funds were bolstered by high tariff walls, quotas, and product/sector reservations, the upshot was widespread inefficiency in the use of scarce resources. Eventually, firms started to make losses and default on interest payments. Once again, it was deemed obligatory to rescue these companies by pumping in subsidized "developmental" funds. In the process, **very little attention was paid to the opportunity cost of loanable funds, to how these could be put to best economic use, and to alternative methods of promoting new firms or reorganizing existing ones.**

2.3.9 The negative effects of "rehabilitation" through subsidized funding become clear from an economic analysis of the operating agency (OA) reports that are prepared by financial institutions at the behest of BIFR. Logically, rehabilitation can succeed if the projects (i) avoid attributes that cause sickness, and (ii) do not suggest improbable targets which have never been achieved even by the healthier firms. The OA reports indicate quite the opposite. **In almost all industries and sub-sectors, these reports exhibit a peculiar blend of over-optimism with many characteristics of acute sickness.** For instance, most rehabilitation projects have been structured on the assumption that more loans will bail out the company. Consequently, these projects typically end up with extremely high debt-equity and total-liability to equity ratios – usually quite a bit higher than the average for the BIFR firms. **Thus, by opting for "additional loan route" to "rehabilitation", the OA reports often propose worse financial structure with even poorer insurance against bad future sales realizations.** These translate to yet higher interest cost per rupee sales – which further increases the possibility of debt defaults in years of bad sales. These negative aspects are covered up by excessive optimism: wage costs are often targeted at levels below the healthy firms, as are variable costs.

2.3.10 Things are considerably worse if one questions the assumptions on the basis of which OAs build forecasts. **There is sufficient evidence to suggest that many OA reports use inflated sales forecasts to impart a false viability to the rehabilitation projects, so as to generate the "stipulated" debt service coverage ratio (DSCR) of 1.33. Often, slightly lower sales projections suffice to generate negative net present values at very modest discount rates. With such assumptions, these packages typically fail to rescue sick firms, and instead bequeath scarce loanable funds and immense arbitrage possibilities to private promoters at very low costs.**

3 : SICA and the Working of BIFR

3.0.1 The Sick Industrial Companies (Special Provisions) Act of 1985 (SICA) lays down the legal framework for reorganizing the affairs of a sick industrial company. It was framed to allow "timely detection of sick and potentially sick companies", to expeditiously provide "preventive, ameliorative, remedial and other measures", and to enforce such measures.

3.0.2 This chapter addresses two important issues: (i) the definition of sickness given in SICA, and (ii) the performance of the Board for Industrial and Financial Reconstruction (BIFR) since 1987. Regarding BIFR, this chapter only looks at the administrative functioning of the Board: delays in decision-making, the seemingly endless loops that proposals go through, the effects of adopting a consensus approach, and the problems of mistaking reorganization for "rehabilitation".[1]

3.1 Why the definition of sickness is a barrier to restructuring

3.1.1 SICA was framed to promote fast reorganization of sick industrial firms – a process that was earlier replete with long delays due to multi-point administrative clearances and tardy High Court procedures.[2] For an industrial company to be sick,[3] SICA requires it to

a) be registered for at least seven years,
b) incur cash losses for two consecutive years, including the current year, and
c) have cumulative losses that wipe out its net worth.

3.1.2 The proposed amendment to SICA (passed by the Rajya Sabha in August 1992, but not as yet by the Lok Sabha) has altered the criterion somewhat: firms only need to be registered for five years, and cash losses for two successive years has been eliminated.

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[1] Chapter 4 examines the other aspect of BIFR performance: whether it has consistently made correct and economically justifiable decisions.

[2] The backdrop to the legislation was provided for by the *Tewari Committee Report (1985)*. It observed that (i) industrial sickness was increasing over the years, (ii) there was a multiplicity of conflicting laws, (iii) there was hardly any coordination among the different agencies involved in restructuring, and (iv) the existing institutional framework was inimical to making quick decisions regarding a growing number of sick firms. Accordingly, the *Tewari Committee* recommended the need for a new enabling law, and also presented a model bill. Much of SICA is a recognition of several aspects of this bill.

[3] Section 3(n) of SICA defines "industry" as those activities specified in the First Schedule of the Industries (Development and Regulation) Act of 1951 (IDR Act). It excludes "ancillary undertakings" as defined in section 3(aa) of the IDR Act, as well as "small scale industrial undertakings" under section 3(j). In the original SICA, public sector firms were also excluded. This has been subsequently amended to accommodate central and state public sector industrial enterprises.

3.1.3 The preamble of SICA states an important objective of the Act: "timely detection of sick and potentially sick companies". However, the definitions (existing and proposed) are inconsistent with this. To illustrate this, Table 3.1 highlights some indices from a sample of 34 sick (BIFR) and 30 healthy textile mills, as well as 18 sick and 26 healthy firms in the engineering industry.

Table 3.1 : Comparing sick and healthy companies, textiles and engineering, 1987-1990

Indices	Existing SICA definition	Proposed SICA definition	Healthy firms
TEXTILES			
Pre-depreciation operating profits (Rs. crores)	− 7.5	− 6.1	16.5
Net worth (Rs. crores)	−21.2	−18.5	90.5
Debt-equity ratio	8.4	7.6	3.9
ENGINEERING			
Pre-depreciation operating profits (Rs. crores)	− 5.7	− 4.5	10.8
Net worth (Rs. crores	−15.2	−12.5	63.7
Debt-equity ratio	5.4	4.6	2.7

Source T.C.A. Anant, Shubhashis Gangopadhyay, Omkar Goswami, *Industrial Sickness in India: Characteristics, Determinants, and History, 1970−1990*, Paper #6, Studies in Industrial Development, Ministry of Industry, October 1992.

3.1.4 Since the proposed SICA definition is "looser" than the original SICA criterion of sickness, one would expect it to detect sickness at an earlier stage. **But, the detection is still very late in the innings. When a company reaches the state where accumulated losses are large enough to wipe out its equity base and reserves, it becomes extremely difficult, if not impossible, to design and implement a viable rehabilitation scheme.** The data bear this out. Even if one accepts the proposed SICA criterion, a typical textile mill is officially identified as "sick" when its aggregate losses have surpassed net worth by a staggering Rs.18.5 crores, when its annual pre-depreciation operating losses have exceeded Rs.6 crores, and when its long term debt is 7.6 times its equity. Analogously, an engineering firm is considered to be "sick" only when aggregate losses have eroded its net worth by Rs.12.5 crores, when annual losses average Rs.4.5 crores, and when the debt equity ratio has risen to 5.4. **In fact, things are worse than what these debt-equity ratios suggest. An economically meaningful measure of corporate debt is long term debt plus the excess of current liabilities over current assets. By this canon, the debt-equity ratio of an average BIFR textile mill at the time of getting "sick" as per the new SICA criterion is not 7.6 but 14.2, which makes rehabilitation an even more remote possibility.** When such extremal criteria combine with BIFR's predisposition towards rehabilitation using subsidized public funds, these give perverse signals to the promoters of sick firms.

3.1.5 Here lies a contradiction. **On the one hand, SICA gives BIFR a *carte blanche* to design any restructuring package that it deems fit**: rehabilitation, mergers, acquisition, outright sale, workers' cooperative, asset restructuring, hiving off unproductive divisions, and much more. The Act also overrides all other Acts barring the Foreign Exchange Regulation Act (FERA) and the Urban Land (Ceiling and Regulation) Act (ULCRA).[4] **On the other hand, its definition systematically identifies patients that are beyond cure.** Thus, while the Act gives a variety of restructuring options, it simultaneously selects candidates on whom such powers can never be exercised profitably.

3.1.6 **The SICA definition is tantamount to intervening too late with poor chances of rehabilitation.** It makes sense if the purpose is winding up of terminally sick, cash drained companies. However, the rhetoric of restructuring repeatedly uses the word "rehabilitation". For instance, the preamble to SICA speaks of "timely detection" and "speedy determination ... of the preventive, ameliorative, remedial and other measures which need to be taken". Yet, the definition eliminates "timely detection" which, in turn, reduces the prospect of devising "preventive, ameliorative, remedial and other measures". The numerous instances of failed rehabilitation schemes illustrate the fundamental contradiction between the SICA criterion and successful amelioration.

3.1.7 Since the SICA definition identifies mostly terminally sick firms, it is logical to expect winding up to dominate BIFR decisions. Quite the reverse is true. As of July 1992, 1010 cases were admitted by the BIFR (considered "maintainable"), and allocated to its various benches. Of these, only in 242 cases winding up has been recommended, or show cause notices for winding up issued.[5] In other words, **despite the extremal nature of the SICA definition, only 24% of the cases have been, or are being, sent for winding up.** Here lies another contradiction. **While SICA prescribes a very severe measure of sickness, BIFR — the agency implementing the Act — generally avoids prescribing extreme unction.**

> **The definitions of sickness in SICA and in the proposed amendment (passed by the Rajya Sabha in August 1992) are serious barriers to reorganizing unhealthy industrial companies because these primarily identify terminally sick firms. This ensures very delayed intervention and, so, reduces the likelihood of commercial viable reorganization, reconstruction, or rehabilitation. Matters worsen when such extreme, late-detection criteria combine with BIFR's preference for rehabilitation using heavily subsidized public funds.**

3.1.8 There is yet another problem with the SICA definitions: **they are "backward" looking and based on the historical book value of a firm's assets, not its future earning potential, nor its current realizable market value.** The negative net worth criterion simply implies that the *historical* value of a company's assets is less than its cumulative liabilities. In other words, as per the SICA definition, what matters is that the *book value* (and not the

[4] Indeed, on point of law, SICA is probably the world's most powerful legislation to aid industrial restructuring.

[5] All BIFR data are from BIFR, *Review of Disposals*, September 1992.

market value) of the firm is less than its current financial obligations.[6] **If there are no barriers to asset reorganization, sale, or withdrawal from an industry, then firms can realize the market value of their assets – which can often be substantially higher than the book value.** Besides, the sale of unproductive or underutilized assets at their market price need not have anything to do with their historical or current use. For instance, all sick textile mills in Bombay are situated on prime properties land whose housing value far exceeds their use as cloth manufacturing units. **It is quite possible that a market driven valuation of land and other assets can suffice to meet all the current claims on the "sick" firm.** In other words, in the absence of restrictions on asset reorganization and sales, the firm is not truly sick. Unfortunately, SICA, with its emphasis on net worth and, hence, book value, precludes such an economically meaningful valuation. **Thus, the SICA definition creates a situation where the "seemingly sick" firms exceed the quantum of truly sick ones.**

3.2 BIFR: an overview

3.2.1 **There are several areas where BIFR's practices and procedures need revamping, so that the Board can speed up its decision making process and, so, play a vital role in industrial and corporate restructuring.**

3.2.2 Presently, BIFR is at a cross-road: between being an organization that facilitates innovative, fast-track restructuring, and one that gets overwhelmed by bureaucratic apathy, by mandatory references, and interminable procedural loops. Unless there is a radical departure from past practices, BIFR will rapidly lose credibility in the eyes of banks, financial institutions, labour, and the firms they seek to rehabilitate. To prevent this, the Board must conscientiously grade its past performance, and devise alternatives that can make it an active agency for industrial change. **This is all the more important with public sector industrial companies coming under the fold of SICA and BIFR.**

3.2.3 BIFR was established in 1987. Prior to SICA, the process of restructuring, rehabilitation or winding up was severely complicated due to divergent approaches followed by different institutions. This was compounded by the long procedural delays in courts, and the overlapping jurisdiction of a number of central and state-level acts. A *raison d'etre* of SICA was to accelerate the process of restructuring via BIFR, and impart it with much needed coherence and consistency. **BIFR was visualized as a fast facilitation agency, with a single-point reference and rapid disposal.**

3.2.4 **Since SICA introduces a first-round hurdle by identifying companies at very late stages, it is vital to sanction the restructuring or winding up schemes as quickly as possible, and so reduce further losses and depreciation of productive assets. Has BIFR measured up to this task?**

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[6] This obvious economic concept is well understood by the legal profession in other developed countries. For instance, decades earlier, the late Judge Frank of the United States Courts of Appeals for the Second Circuit had clearly stated that, "Value is the present worth of future anticipated earnings. It is not directly dependent on past earnings" – suggesting that for properly valuing a (sick) company, prospective earnings have to capitalized at a rate that reflects the opportunity cost: Edward I. Altman, *Corporate Financial Distress*, John Wiley, New York, 1983, pp.63-64.

3.2.5 First, some facts about procedures and case data. From its inception until July 1992, BIFR has received 1673 references, including 57 from central and state public sector industrial companies. Of these, 1221 were registered. Section 15(1) of SICA makes it mandatory for a sick firm (satisfying the sickness criterion given in section 3(o) of SICA) to make a self-reference to BIFR. References can also be made independently by the central or state governments, banks and financial institutions, or the Reserve Bank of India (RBI) under section 15(2). After registering a case, the Board conducts a *prima facie* enquiry. Typically, this culminates in a hearing which involves representatives of the company, trade unions, financial institutions and banks, and state and central governments. The parties are first heard to decide whether the firm is sick as per section 3(o) of SICA. In the period from 1987 to July 1992, approximately 27% of the cases were dismissed at this stage as "not maintainable".

3.2.6 For an officially sick company, BIFR examines the feasibility of turnaround. This can be done in two ways. The company may propose a rehabilitation proposal on its own, and convince BIFR that the scheme will turn its net worth positive within seven to ten years. If the proposal is accepted by all parties, then BIFR sanctions the scheme under section 17(2) of SICA. Most 17(2) schemes concern companies that started the process of formulating a rehabilitation package with banks and financial institutions even before turning formally sick. In such cases, the companies and financial institutions use the powers of SICA to circumvent other legal barriers. Section 17(2) proposals have two characteristic features: these are endogenously determined, and do not require fresh commitment of subsidized funds or large scale rescheduling of payments.

3.2.7 When there are no feasible 17(2) proposals, and when BIFR believes that it is "in public interest" to rehabilitate the company (this is always the case), the Board appoints an operating agency (OA) under section 17(3) of SICA. The operating agency is usually a financial institution (IDBI, ICICI, IFCI, or IRBI) or, occasionally, a scheduled bank.[7] The OA is supposed to examine the turnaround possibility of the firm, and then submit a report to the BIFR (the OA report) which either formulates a rehabilitation proposal with all its conditions, projections, and attendant costs, or demonstrates unviability and recommends that the firm be wound up. When an OA approved rehabilitation scheme under section 17(3) is sanctioned by BIFR, it is called a section 18(4) scheme.[8]

3.2.8 Finally, if all proposals are rejected by one or more party, BIFR can recommend winding up under section 20 of SICA. Here, BIFR can opt for one of two modes: forward its winding up opinion to the relevant High Court (section 20(1) of SICA); or back it up with sale of assets, and remit the proceeds to the High Court for distribution (section 20(4) of SICA).

[7] The proposed amendments to SICA (passed by Rajya Sabha in August 1992) broadens OA to include state level institutions and professionals ("any other person as may be specified by general or special order as its agency by the Board").

[8] Chapter 4 examines several such schemes.

3.3 Pattern of decisions of BIFR

3.3.1 The BIFR process is very time consuming. There are numerous opportunities for multiple loops in the procedures which results in the case shuttling several times between BIFR and the OA at any given stage. This is in addition to the delay caused by the possibilities of appeal at every stage in the proceedings. Chart 3.A (next page) illustrates a delay profile of a random sample of 565 cases that were decided upon by BIFR. **The mean delay is 749 days; and for 19% of the cases, it took more than three years to arrive at a decision.** These statistics *underestimate* the delays, for they do not account for the "pending" cases – those that have remained undecided until date.

3.3.2 BIFR's low disposal rate also shows up in Table 3.2 below. The Board's performance leaves much to be desired even if one adopted an excessively generous grace period of three years: 43% of the maintainable cases registered in 1988 remained undecided in 1990; 41% of the 1989 cases were pending in 1991; and 64% of the maintainable cases of 1990 were in limbo as of July 1992. **Such procrastination effectively reflects an *ex post* (and possible *ex ante*) disregard towards the opportunity cost of time – a critical factor in restructuring seriously sick companies.**

Table 3.2 : Annual disposal rate of cases within BIFR

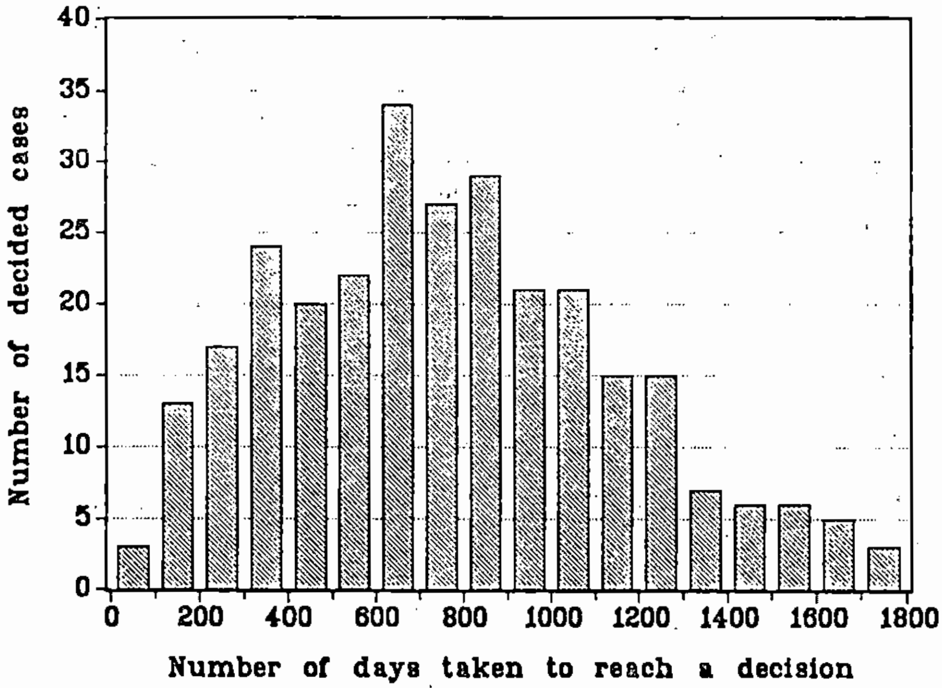
Registered Year	Disposed Number	1987	1988	1989	1990	1991	July 1992	Pending
1987	266	2%	16%	41%	64%	78%	85%	**15%**
1988	215		4%	24%	57%	77%	82%	**18%**
1989	166			4%	26%	59%	67%	**33%**
1990	127				6%	24%	36%	**64%**
1991	137					1%	7%	**93%**
1992	103							**100%**

3.3.3 **The main reasons for such delays are:**

a) **the quasi-judicial nature of BIFR proceedings, which depends on consensus at almost all stages, and**

b) **BIFR's clear preference for rehabilitation over winding up, unless repeatedly proven otherwise.**

CHART 3.A : DISTRIBUTION OF DELAYS IN MAKING DECISIONS WITHIN BIFR, 1987 to 1992



3.3.4 When a rehabilitation scheme is prepared under section 17(3) and eventually sanctioned under section 18(4), it implies that no alternative, endogenously formulated programme could pass muster under section 17(2). This being so, there is always at least one unwilling party in any 18(4) scheme. Since these schemes are imposed upon all claimants "in public interest", these are couched in the rhetoric of "sacrifices for the public good". **The combination of "consensus" and "sacrifice" is usually fatal for the company. Sacrifice brings with it all types of free-rider problems, as agents try to wriggle out of their commitments. Consensus gives any claimant the right of veto, and implies that the BIFR process can be only as fast as the slowest party.**

3.3.5 **All the concerned agencies know how to use the veto power and delay the proceedings for their own advantage.** When a financial institution is convinced that a company is beyond repair, it vetoes all other schemes until BIFR is driven to a winding up decision under section 20. Various political compulsions persuade state governments to ask for fresh hearings to introduce their proposals. Promoters veto original OA reports on the ground that they have better schemes; three months later they usually present something that is unviable and unacceptable to BIFR. Consultants prepare estimates of productivity and profitability that often exceed those of the best firms in the industry. Representatives of labour wish to introduce a scheme, generally involving heavy write-offs and workers' cooperatives. Throughout the process, the debates are carried out without sufficient analysis or understanding of discounted cash flows, balance sheet projections, the market position of the firm, and the status of the industry.

3.3.6 As the deliberations meander on, the delays create their own complication. Soon, someone complains that the proposed scheme is out-dated, and BIFR asks the OA to prepare a fresh scheme, which goes through the same loops. Chart 3.B explains the system.

3.3.7 The other reason for delays is BIFR's preference for exhausting all possibilities of rehabilitation. Table 3.3 shows that rehabilitation dominates winding up; and Table 3.4 shows that the option to wind up is taken at very late stages. Of the 911 references registered until 1991, 132 cases were disposed under section 17(2), while OAs were appointed in another 650 cases: **thus, BIFR decided on examining rehabilitation proposals for almost 86% of the cases that were registered until 1991.** The option to wind up an economically unviable company is taken at much later stages — typically as a last resort. In the first three years after registration, the emphasis is on rehabilitation. It is only when various proposals fail to get consensus, and firm's position degenerates even further, that BIFR looks at winding up as a possibility.

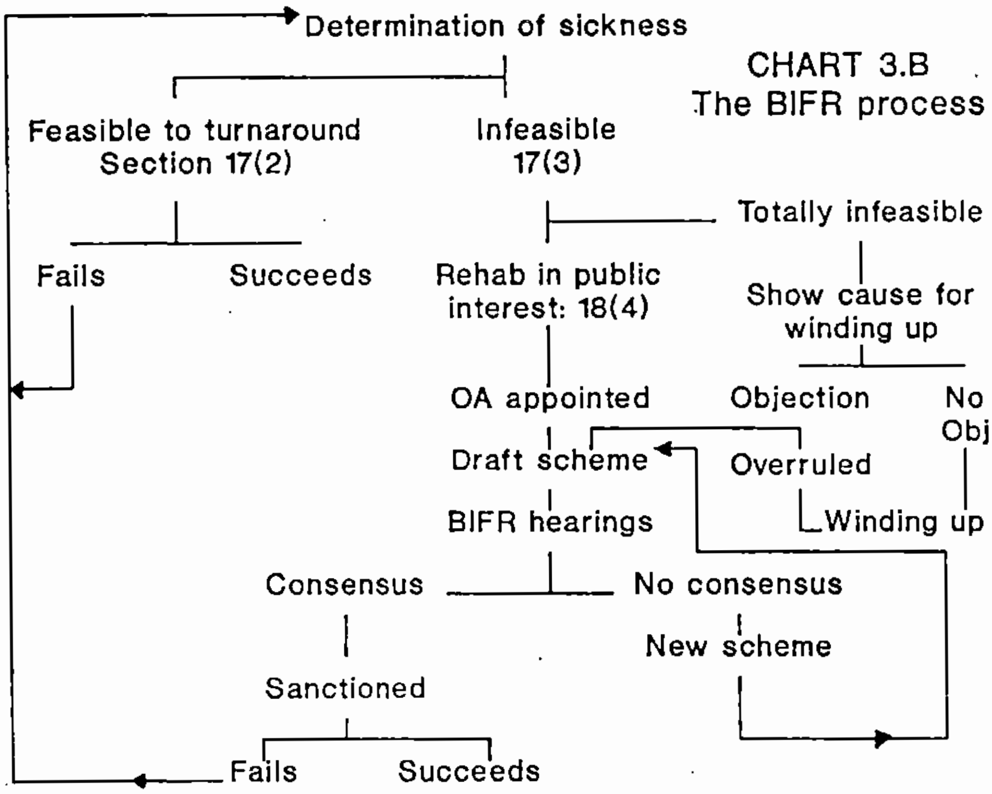


Table 3.3: Disposal of BIFR cases as of July, 1992

Year	17(2)	18(4)	Rehabilitation: 17(2) + 18(4)	Winding up: 20(1)	Pending	Number of cases[1]
1987	12%	43%	55%	30%	15%	266
1988	16%	36%	52%	30%	18%	215
1989	25%	28%	53%	14%	33%	166
1990	15%	15%	30%	6%	64%	127
1991	4%	2%	6%	1%	93%	137
Total	14%	29%	43%	19%	38%	911

Note: 1: Excludes cases dismissed as non-maintainable under section 17(1).

Table 3.4: Rehabilitation versus winding up in BIFR

Disposed / Registered		1987	1988	1989	1990	1991	1992	Pending
1987	311							39
17(2) + 18(4)		6	31	40	40	21	8	
Winding up		0	8	24	22	15	10	
1988	298							40
17(2) + 18(4)			4	43	48	19	5	
Winding up			4	10	23	23	5	
1989	202							55
17(2) + 18(4)				6	31	40	9	
Winding up				0	6	14	4	
1990	151							82
17(2) + 18(4)					7	18	12	
Winding up					0	5	3	
1991	155							126
17(2) + 18(4)						1	8	
Winding up						0	1	
Total	1117							342
17(2) + 18(4)		6	35	89	126	99	42	
Winding up		0	12	34	50	57	23	

3.3.8 BIFR's distinct preference for rehabilitation over winding up stems from the belief that firms should be "saved" at all costs — all possibilities should be exhausted before judging a case to be a lost cause. If a firm genuinely has the potential of being saved and revitalized, the discounted flow of future earnings should exceed the salvage price of its assets. If this is so, then one expects the promoter or any other entrepreneur to furnish a realistic reorganization plan, and convince the secured creditors of its bona fides. Such proposals are rare among the so-called rehabilitation schemes sanctioned under section 18(4) of SICA.

3.3.9 It has been argued by some BIFR members that they purposely stress upon rehabilitation because of two reasons. First, the preamble of SICA states the need to take "ameliorative" and "remedial" measures "in public interest" — which ought to be interpreted as rehabilitation. Second, they feel that there is need to counteract the eagerness of banks and institutions to get rid of bad cases, and opt for winding up.

3.3.10 However, just the reverse is true. **Bad accounting norms and poor provisioning among secured creditors induces banks and institutions to continue their exposure in sick firms, and support otherwise untenable rehabilitation projects.**[9] Unsatisfactory provisioning implies that many loans to sick units have not been sufficiently written down in the books of banks and institutions. Winding up immediately forces secured creditors to fully provide for such exposure, and write down the value to zero. Since this looks awful in the account books, most banks and institutions have been traditionally reluctant to push for winding up of unviable cases. **Until tainted accounts are clearly identified and properly**

[9] This is discussed in detail in Chapter 4.

provided for — a process that will take another three years if the Narasimham Committee Report is faithfully implemented — banks will continue to be biased towards servicing questionable industrial accounts (via rehabilitation), instead of writing them off as bad debts (through winding up). Given this inherent bias, the BIFR need not be an additional guardian of rehabilitation.

3.3.11 **The Board's partiality towards rehabilitation has had three serious consequences:**

a) **It has lengthened the process:** increased the number of rehabilitation proposals that are presented and contested by various parties.

b) **It has prevented BIFR from credibly using the threat of winding up to force quick consensus:** Winding up under section 20 of SICA is an area where BIFR and the Appellate Authority (AAIFR) does not require consensus. **The most expeditious way of forcing parties to behave responsibly is to use a time-bound threat of winding up.** This is particularly true if the threat is section 20(4): where BIFR can sell the assets of the company "in any such manner as it may deem fit", and forward the proceeds to the High Court for distribution.

c) **It has given tremendous opportunities to unscrupulous promoters and, occasionally, state governments to delay matters.**

3.3.12 In theory, delays are supposed to be capped: SICA stipulates cut-off dates for all parties. A sick company has to make a BIFR reference within 60 days of finalization of audited accounts [section 15(1)]; the OA has to submit its first report by 60 days [section 16(3)]; appeals to AAIFR must be made within 45 days of a BIFR order [section 25(1)]. However, **there are no bounds on the time taken by BIFR and the Appellate Authority (AAIFR).** Until quite recently, all appeals were pending for more than a year because the new AAIFR bench was not appointed!

3.3.13 To conclude, even in a purely administrative context, BIFR definitely needs many changes in its style of functioning. Votaries of status quo might have had some basis if BIFR succeeded in either turning around many operationally viable companies, or swiftly liquidated and sold the assets of several unviable ones. Unfortunately, BIFR's success record is not very impressive.

3.3.14 Whatever data are available within BIFR confirm the general view that Board has been unsuccessful in rehabilitating firms. Between 1987 and July 1992, 1010 cases were registered, allocated, and considered maintainable by BIFR. First, the clear cases. **Of the 1010 firms, only 49 — less than 5% — have officially turned around.**[10] BIFR declared 64 schemes to have clearly failed: these had to be re-opened. Of these, 19 had to be wound up — again emphasizing the fact that firms are often "rehabilitated" when these should have been wound up. For the rest, the picture is grim enough. In 1991, BIFR published follow-up data on 164 of the 203 rehabilitation schemes sanctioned in the year. Of these 164 companies,

[10] Of these, 27 were merger cases — which underscores the importance of mergers, and the need to remove barriers to merging of companies in the Income-Tax Act of 1961.

62 continued making losses; for another 39 firms the schemes failed and had to be re-opened. Thus, **62% of the sanctioned schemes had failed one way or the other**. This failure rate suggests the need for major changes in (i) the way BIFR appraises projects, and (ii) its administrative structure and manner of functioning. The former is analyzed in Chapter 4. The latter is discussed in the next section.

The BIFR process is very time consuming. The main reasons for delays are:

a) the quasi-judicial nature of BIFR proceedings, which depends on consensus at almost all stages, and

b) BIFR's clear preference for rehabilitation over winding-up, unless repeatedly proven otherwise.

The combination of "consensus" and "sacrifice" is usually fatal for a sick company.

BIFR's partiality towards rehabilitation has had three serious consequences:

a) It has lengthened the process.

b) It has prevented BIFR from credibly using the threat of winding up under section 20(4) of SICA to force quick consensus

c) It has given tremendous opportunities to unscrupulous promoters and, occasionally, state governments to delay matters.

3.4 Suggestions for change

3.4.1 All suggestions made here are driven by a fundamental premise:

The responsibility of industrial and corporate reorganization must shift from secured creditors and the State – as it is presently the case – to the defaulting debtor firms.

Without this, there can be no real reform in corporate and industrial restructuring. Further, **BIFR's approach must be anchored in the changed economic environment: to move away from the primacy of protection and nurturing the sick, to commercial viability subject to some socio-economic constraints.**

3.4.2 **The problems of BIFR stem from a confusion about its role.** Is it an arbitrating body that facilitates speedy reorganization? Or is it a body of experts in finance, industry, management, mergers, taxation, and corporate law trying to formulate schemes of industrial restructuring? As it stands, with the present composition of BIFR, it is very unlikely that the Board will be able to consistently perform the latter role.[11] There are practical limits to the ability to staff either the BIFR benches or the secretariat with top class financial and technical professionals, who can consistently give well reasoned, expert opinions. Even if such staffing were possible, BIFR would only duplicate the appraisal work that is done by the financial institutions – who at least ought to have the monetary stake to avoid making incorrect decisions.[12] This leads to the first suggestion.

The only operationally significant basis for BIFR should be that of being a fast-track facilitator and, occasionally, an arbitrator.

3.4.3 This leads to a number of suggestions that can be implemented in the very short run, and will expedite the purely administrative process within BIFR. These suggestions can be immediately implemented.

First, a BIFR hearing should be a forum for decision-making, not for seeking clarifications, explanations, or stating the Board's reservations about the preparation of a scheme. These can be settled well before a hearing.

Second, BIFR should dictate an abridged version of its decision in the presence of all parties before formally closing or adjourning a hearing. This synopsized version should highlight the basic decisions and indicate the date when the full text will be sent to all parties.

Third, BIFR should end each hearing with the bench members giving a specific date for the next hearing, if it is necessary. Not giving specific dates after hearings, and relying on bench officers has played a role in increasing the time delays.

3.4.4 Presently, the BIFR consists of a Chairman and six other members. With public sector firms having entered the fold of SICA, this is wholly inadequate. This short-staffing at the bench and secretariat level is yet another reason why (i) hearings get delayed and (ii) cases are often determined without sufficient analysis and sound briefing.

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[11] Section 4(3) of SICA states that BIFR members should have "special knowledge" in, and "professional experience of not less than fifteen years in science, technology, economics, banking industry, law, labour matters, industrial finance, industrial management, industrial reconstruction, administration, investment, accountancy, [or] marketing". Most of the present members of BIFR are retired or seconded officers from the Civil Services.

[12] As the financial sector reforms get implemented – particularly transparency of accounts, new health codes, better recognition of tainted accounts, and more adequate provisioning – the incentive for banks and institutions to formulate economically sound reorganization packages will be greater than ever before.

The government must fill the existing vacancies in BIFR at the bench level by appointing eight members who are experts in finance, taxation, and corporate law. It is quite likely that recognized experts in the field will not wish to serve for longer than two years. Nevertheless, it is far better for the future of industrial reorganization to employ experts for two years than to get generalists who are willing to serve for five.

3.4.5 It is unlikely that the government will meet much success in staffing the BIFR secretariat with acknowledged experts in finance, taxation, industrial management, and corporate and commercial law. Therefore, it is necessary to simultaneously implement two remedial measures.

First, there has to be a systematic upgrading of human resource and skills within the BIFR secretariat with experts being frequently brought in to conduct highly focused workshops and seminars on appraisal, on discounting, on cash flow analysis, and on industrial and corporate law.

Second, the BIFR must empanel a large number of experts on finance, taxation, corporate law and industrial management, and seek their opinion on various matters concerning corporate reorganization. Outside expertise can only enhance – certainly never diminish – the stature of BIFR.

3.4.6 **BIFR should recognize the power of winding up under section 20, especially as an instrument for expediting the process of decision-making and arbitration.**

It is absolutely essential that BIFR use the provisions of section 20(4) more frequently – not only to expedite the sale of economically unviable firms, but also as a threat to force the pace of decision-making and consensus among various parties.

3.4.7 BIFR has observed that in the few instances it had ordered winding up under section 20(4) and had asked the OA to manage the sale, the proposals were turned down by the operating agencies. The financial institutions (as OAs) argue that they do not have the expertise to sell such companies. **In its present state, BIFR should not take upon its organization the task of selling companies: it neither has the expertise nor the manpower.** Moreover, the sale department of BIFR will run the risk of ending up like the offices of the Official Liquidators of High Courts – riddled by delays, procedural wrangles, and charges of corruption. Thus, there is tremendous need for promoting and encouraging alternatives. The new Companies Bill (tabled in May 1993) explicitly recognizes the need for such alternatives. Section 518(1b) of the Bill allows for a panel of professional liquidators, "comprising of chartered accounts, advocates, and other such professionals" from which a High Court can select an Official Liquidator. Thus, we now have a legal climate for the use of professionals in winding up.

To execute more 20(4) cases, the BIFR must enlist the services of bona fide professional valuers and auction houses who will undertake the task on a commission basis, and so maximize the sales revenue. At a later stage, it may be worthwhile for the financial institutions to consider floating independent, commercially oriented firms of valuers and auctioneers.

3.4.8 There is a possible legal ambiguity in section 20 of SICA that requires clarification and, if necessary, amendment. A necessary condition for the success of section 20(4) sales is that it should be completely free of the pre-sale and sale procedures outlined in Part XIII, Chapters I through III, of the new Companies Bill. The ambiguity is as follows. Section 20(4) states that (i) *notwithstanding anything contained in section 20(2) and 20(3)*, BIFR can sell the assets of a sick company that is recommended to be wound up, and (ii) the sale proceeds must be forwarded to the concerned High Court for distribution according to section 529A "and other provisions of the Companies Act" (section 593 in the new Bill). The first part implies that section 20(1) is binding. However, if this is so, then once the opinion of winding up is forwarded to the High Court, the case goes outside SICA and enters the realm of the Companies Act. That being so, the courts can insist that sales under 20(4) of SICA be structured according to the time-delaying, detailed, strictly sequential procedures laid down by the Companies Act (Bill), the Companies (Court) Rules and the Civil Procedure Code. Second, "all other provisions of the Companies Act" is ambiguous. It does not say that distribution should be governed "*only* by those provisions of Companies Act that define distribution of sales proceeds of a company that is being wound up". These ambiguities need to be removed.

3.4.9 The above suggestions can be implemented very quickly. ***However, we will not proceed very far in industrial restructuring unless we radically alter the form, content, and scope of SICA.*** **The proposed amendments to SICA passed by Rajya Sabha in 1992 are minor, piecemeal changes that do not address the basic issues in industrial restructuring: speed, voluntary references, early detection, facilitation and quick arbitration, and incentive compatible behaviour of all claimants to these firms. Listed below is the logical** sequence of this reform.

The preamble to SICA needs to be altered.

3.4.10 As it now stands, there are too many phrases which allow judicial and quasi-judicial misinterpretation that rehabilitation is the primary role of SICA, BIFR, and AAIFR. **Three phrases need to be omitted: "preventive", "ameliorative", and "remedial" — all closely associated with "rehabilitation"**. Instead, it is necessary to incorporate the basic idea that SICA is meant to promptly decide, through a **single facilitating agency**, the case for **reorganizing ailing companies either through feasible reconditioning of its assets and liabilities, or through rapid winding up and quick sale and distribution of its assets.** Changing the preamble is not a semantic issue in India. Unlike many other countries, the judiciary in India places much importance on preambles. It is necessary that the draft be immunized from frequent economic misinterpretation. In an increasingly complex industrial and trading world, one cannot afford to be loose with words, and so create scope for ultimately detrimental interpretation.

3.4.11 **There is absolutely no valid reason why it should be mandatory for a sick industrial company to make a self-reference to BIFR.** The only thing this does is increase the scope of government intervention in corporate activity.

> **A sick company's own reference to BIFR should be voluntary, not mandatory. Section 15(1) of SICA states that when a company becomes sick, it "shall" make a reference to the Board. This has to be changed to "may".**

First, voluntary reference does not prevent others from referring the case to BIFR. Section 15(2) of SICA allows the central and state governments, Reserve Bank of India, and the secured creditors of a company to make a reference to BIFR. Second, all other things being the same, **making the company's own reference voluntary will reduce the number of cases that get registered with BIFR and, hence, lessen the administrative burden. Third, and more significant, it will give freedom to the firm and the secured creditors to work out a reorganization package outside of BIFR if they so choose — and freedom to choose is a cornerstone of basic economic reform.**

3.4.12 In this chapter, it has been clearly demonstrated that the existing and proposed definitions of sickness are wholly inadequate in recognizing firms at early stages of their malaise. **There is an urgent need for a criterion that allows for early detection.** However, the problem with early detection is that it will immediately result in more cases, even when references are voluntary. Given the present procedures of BIFR, the Board will get overwhelmed by this growth in references, and rapidly degenerate to the levels of Courts. Hence, **a definition that detects incipient sickness can work only if the scope of BIFR and SICA is fundamentally restricted to what matters the most — single-point facilitation and fast arbitration.**

3.4.13 Once this is accepted — as indeed it should — it automatically follows that one will need a radically different SICA to aid fundamentally different ways of reorganization. **What is urgently needed is an overhauled SICA that combines five features in an integrated and consistent manner.**

a) **The onus of reorganization must shift from the state, BIFR, and secured creditors to the defaulting debtor.**

b) **It should be possible for the secured creditors to detect incipient sickness and facilitate the debtor firms to take corrective measures well before the net worth of these firms turn negative.**

c) **BIFR should be geared towards facilitation and quick arbitration.**

d) **References should be voluntary, giving the firm and its claimants the freedom to choose without third-party intervention.**

e) **The basis for industrial reorganization should be economic viability, subject to social constraints, and not the other way around.**

3.4.14 These principles can be integrated in a consistent way only the new SICA follows the outline and principles given in page 30 below.

3.4.15 Because the new definition identifies ailing companies at their very incipient stages, the probability of an endogenously prepared scheme failing to get consent and being sent for winding up is far lower than if the company came for a panacea when its net worth turned negative.[13]

3.4.16 The proposal outlined in page 30 only *looks* radical, and that too in comparison with the present law and its procedures. In fact, the suggestion is hardly "radical", merely "rational". This is the way in which restructuring is done in most industrial countries. It is incentive compatible. It substitutes an exogenously determined, often unpalatable package for an endogenously determined one. It limits the scope of BIFR and, thus, increases its efficacy. And, it being endogenous, it promotes creative restructuring, mergers, and acquisitions, instead of thrusting packages that are justified by the notion of (non-implementable) sacrifices. Without this enactment, the changes will be cosmetic.

3.4.17 To create further scope for debate, the Committee has prepared a draft bill that seeks to amend SICA along these lines. This is given in the Appendix that follows the chapter.

3.4.18 There is constitutional barrier which ensures that SICA (a centrally legislated Act) cannot override the Urban Land (Ceiling and Regulation) Act (ULCRA). ULCRA is legislated under Article 252 of the Constitution under the consent and request of two or more state governments, and cannot be overridden by any centrally legislated Act. **However, there is no legal or constitutional reason why SICA cannot override FERA – another centrally legislated act.** The only reason why FERA dominates SICA is the archaic fear of foreigners taking over our national industries – which has played no mean a role in stymieing the industrial and technological growth of the country. In the present environment of economic reform and liberalized industrial activity, there is no economic rationale for this kind of xenophobia.

[13] There is a minor risk. If a firm knows that it can get a second chance, it can ensure failure in the first stage to gain the extra time of sixty days. However, this downside is trivial compared to the fact that it now takes an average of 749 days to arrive at a BIFR decision (excluding the time taken for appeals at the AAIFR).

The existing definition of a sick industrial unit as under SICA should be drastically changed. One cannot have multiple definitions of sickness depending upon whether a firm is evaluated by banks and financial institutions, or by SICA. **It makes no sense to have two successive interest defaults as an index for provisioning of a doubtful account, and simultaneously have negative net worth as the criterion of sickness for the same account. The new SICA should eliminate the negative net worth criterion altogether.**

In its place, the focus should be on incipient sickness — when rehabilitation is not only feasible, but can be done at much lower economic and social cost. Therefore, integrate the financial and industrial sector by using the definition suggested by the Narasimham Committee Report. **The definition of sickness should be (i) default of 180 days or more on repayment to term lending institutions, or (ii) irregularities in cash credit or working capital for 180 days or more.**

Given this definition, SICA should legislate the following procedure:

a) When a company is thus sick, the secured creditor would have the option of moving High Courts or Recovery Tribunals to recover the secured assets of the company. It would now be up to the firm to seek time-bound protection from the BIFR.

b) If the company refers to BIFR, the Board would instruct the management/promoter to prepare a reorganization plan within 90 days that can satisfy the secured creditor(s).

c) If creditors representing three-fourths of the secured debt were satisfied by the plan, it would become a sanctioned scheme of the BIFR. If not, then the Board would give the firm one last attempt to prepare an alternative plan within another 60 days in consultation with the secured creditors, government, and labour.

d) If the second plan were not accepted by creditors representing more than three-fourths of the secured debt, then BIFR would automatically recommend the company to the Recovery Tribunals (if the company is considered economically viable) or to be wound up under what is presently section 20(4) of SICA.

e) There should be a deeming provision in the amended SICA which states that once the 150 (90 + 60) days deadline passes without any scheme being sanctioned, then it would be deemed to be "non-restructurable" or "non-viable". If the former, it should go to recovery courts for attachment of security; if the latter, it should be wound up under what is presently section 20(4) of SICA.

There is a strong case for having SICA override FERA. Getting SICA outside FERA will encourage foreign investors to takeover potentially viable sick companies and, if nothing else, raise the market price and bid values of these otherwise poorly utilized industrial assets. This may sound like a radical suggestion. However, it will attract foreign capital and equity — investing in existing plant is cheaper than sinking funds in a greenfield location. **If it is generally agreed that getting foreign exchange and foreign equity is in India's national interest, then getting such funds to revitalize hitherto moribund companies must likewise be in the national interest.**

3.4.19 Penultimately, there is an urgent **need for creating fast-track recovery tribunals, without which one cannot shift the onus of restructuring on to the defaulting debtors.** In this, there is great merit in adopting the recommendations made by the Reserve Bank of India's *Committee on Legal Aspects Relating to the Operations of Banking and Financial System* (1992).

There should be five Recovery Tribunals only for recovering corporate debts to secured creditors. These tribunals must be self-financing: salaries and expenses paid by the banks and financial institutions. The presiding officers should have experience in commercial litigation. The tribunal should only cover cases exceeding Rs.50 lakhs. There should be a "complete code for recovery", i.e. consistent and closed, which can then maintain an independent jurisdiction of these tribunals, and so circumvent the problems of overlapping jurisdiction.

3.4.20 Finally, a few paragraphs of warning. Disenchanted by the past performance of BIFR, many have argued that the Board be *de facto* re-oriented towards being a fast winding up court or tribunal. In the present framework, this looks like an attractive short term panacea to industrial sickness. It is not. First, there are many firms which can be reorganized without resorting to winding up. These companies should gain the benefits of *rapid* restructuring that SICA confers. Second, given its present organizational structure, one cannot profit ably align BIFR towards winding up under section 20(4) of SICA. The only winding up that is expeditious is under section 20(4). Yet, BIFR does not have the expertise, the personnel, the organizational incentives, and the orientation to behave commercially — quickly sell the assets of an economically unviable firm under section 20(4).

3.4.21 Therefore, it is suggested that, in the short run, **the government should utilize BIFR and SICA more creatively.** SICA is a very powerful facilitating act, and the government must use its overriding provisions to expedite restructuring. For the immediate future, this can be done by implementing some of the suggestions outlined earlier:

- **put a 150-day cap on BIFR decision making, barring which the deeming provision comes into play,**

- **fill the benches with energetic, reform-oriented professionals who believe in the need for rapid restructuring,**
- **instruct BIFR to use (or threaten to use) the 20(4) provisions more often, and**
- **ask BIFR to immediately enlist the services of professional valuers and auctioneers on commercially attractive commissions.**

3.4.22 However, even in the slightly longer term, there is no alternative to redrafting SICA to incorporate the principles and provisions stated in paragraphs 3.4.9 through 3.4.15. This move will send signals to the world of our determination to restructure firms, and of our commitment to developing an economically viable, competitive, and growing industrial sector in the years to come.

Appendix to Chapter 3
The Proposed Sick Industrial Companies (Special Provisions) Amendment Act, 1993[1]

PREAMBLE

An Act to make special provisions with a view to securing the timely detection of sick and potentially sick companies owning industrial undertakings, the prompt determination, by a Board of experts, of restructuring such ailing companies either through economically viable reconditioning of assets and liabilities, or through winding up and quick sale of assets, and other measures which need to be taken with respect to such companies, and the expeditious enforcement of the measures so determined, and for matters connected therewith or incidental thereto.

CHAPTER I
Preliminary

1 **Short title, extent, commencement and application**

(1) This Act may be called the Sick Industrial Companies (Special Provisions) Amendment Act, 1993.

(2) It extends to the whole of India.

(3) It shall come into force on such date as the Central Government may, by notification in the official Gazette, appoint and different dates may be appointed for different provisions of this Act and any reference in any provision of this Act to the commencement of this Act shall be construed as a preference to the commencement of that provision.

(4) It shall apply to all the scheduled industries.

2 **Declaration**

It is hereby declared that this Act is for giving effect to the policy of the State towards securing the principles specified in clauses (b) and (c) of Article 39 of the Constitution.

3 **Definitions**

(1) In this Act, unless the context otherwise requires,

(a) "Appellate Authority" means the Appellate Authority for Industrial and Financial Reconstruction constituted under Section 5;

[1] The year 1993 is notional. It is hoped that the bill can be introduced this year and, hence, 1993.

(b) "Board" means the Board for Industrial and Financial Reconstruction established under Section 4;

(c) "Chairman" means the Chairman of the Board or, as the case may be, the Appellate Authority;

(d) "company" means a company as defined in Section 3 of the Companies Act, 1956 (1 of 1956), and includes Government companies as defined in Section 617 of that Act;[1]

(e) "industrial company" means a company which owns one or more industrial undertakings;

(f) "any other company" means a company defined under Section 3(d) above, but not an "industrial company" under Section 3(e) above or Section 3(g) below;

(g) "industrial undertaking" means any undertaking pertaining to a scheduled industry carried on in one or more factories by any company but does not include (i) an ancillary industrial undertaking as defined in clause (aa) of Section 3 of the Industries (Development and Regulation) Act, 1951 (65 of 1951); and (ii) a small scale industrial undertaking as defined in clause (j) of the aforesaid Section 3;

(h) "Member" means a Member of the Board, or, as the case may be, the Appellate Authority and includes the Chairman thereof;

(i) "notification" means a notification published in the official Gazette;

(j) "operating agency" means any public financial institution, State level institution, scheduled bank or any other person as may be specified by general or special order as its agency by the Board;

(k) "prescribed" means prescribed by rules made under this Act;

(l) "public financial institution" means any of the following institutions, namely: (i) the Industrial Credit and Investment Corporation of India Limited, a company formed and registered under the Companies Act, 1913 (7 of 1913); (ii) the Industrial Finance Corporation of India established under Section 3 of the Industrial Finance Corporation Act, 1948 (15 of 1948); (iii) the Industrial Development Bank of India, established under Section 3 of the Industrial Development Bank of India Act, 1964 (18 of 1964); (iv) the Industrial Reconstruction Bank of India established under Section 3 of the Industrial Reconstruction Bank of India Act, 1984 (62 of

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[1] These sections of The Companies Act will have to be altered when the new Companies Bill of 1993 gets legislated as an Act.

1984); (v) such other institutions as the Central Government may, by notification, specify; provided that no institution shall be so specified unless it has been established or constituted by or under any Central Act, or not less than fifty-one per cent of the paid-up share capital of such institution is held or controlled by the Central Government or by any one or more of the institutions mentioned in sub-clauses (i) to (iv) or partly by the Central Government and partly by one or more of the institutions mentioned in sub-clauses (i) to (iv);

(m) "Reserve Bank" means the Reserve Bank of India constituted under Section 3 of the Reserve Bank of India Act, 1934 (2 of 1934);

(n) "scheduled bank" means a bank for the time being included in the Second Schedule to the Reserve Bank of India Act, 1934 (2 of 1934);

(o) "scheduled industry" means any of the industries specified for the time being in the First Schedule to the Industries (Development and Regulation) Act, 1951 (65 of 1951);

(p) "sick industrial company" means an industrial company (being a company registered for not less than five years) which has either (i) failed in its obligations to pay interest on term loan taken from public financial institutions for a period exceeding 180 days period in any financial year; or (ii) whose overdraft or cash credit account(s) have been out of order for a period exceeding 180 days in any financial year.

(q) "State level institution" means any of the following institutions, namely: (i) State Financial Corporations established under Section 3 or Section 3-A and institutions notified under Section 46 of the State Financial Corporations Act, 1951 (63 of 1951); (ii) State industrial development corporations registered under the Companies Act, 1956 (1 of 1956); (iii) such other institutions, being companies and not being public financial institutions, engaged in the development or financing of industrial undertakings, as the Central Government may, by notification, specify; provided that no institution shall be so specified unless not less than fifty-one per cent of the paid-up share capital thereof is held by any State Government or Governments or by any institution or institutions mentioned in sub-clauses *(i)* and *(ii)* or partly by one or more public financial institutions or institutions mentioned in sub-clauses (i) and (ii) and partly by one or more State Governments.

(2) Words and expressions used and not defined in this Act shall have the meanings, if any, respectively assigned to them in the Companies Act, 1956 (1 of 1956). Words and expressions used but not defined either in this Act or in the Companies Act, 1956 (1 of 1956), shall have the meanings, if any, respectively assigned to them in the Industries (Development and Regulation) Act, 1951 (65 of 1951).

(3) Any reference in this Act to any other enactment or any provision thereof, shall, in relation to an area in which such enactment or such provision is not in force,

be construed as a reference to the corresponding law or the relevant provision of the corresponding law, if any, in force in that area.

CHAPTER II

Board and Appellate Authority for Industrial and Financial Reconstruction

This chapter consists of eleven sections (4 through 14). Only sections that require change are stated in full. Otherwise, the sections should be identical to those in the Sick Industrial Companies (Special Provisions) Act, 1985.

4 **Establishment of Board.** No change. Same as SICA, 1985.

5 **Constitution of Appellate Authority.** No change. Same as SICA, 1985.

6 **Terms of office, conditions of service.** No change. Same as SICA, 1985.

7 **Removal of Members from office in certain circumstances.** No change. Same as SICA, 1985.

8 **Secretary, officers and other employees of the Board.** No change. Same as SICA, 1985.

9 **Salaries, etc., be defrayed out of the Consolidated Fund of India.** No change. Same as SICA, 1985.

10 **Vacancies, etc., not to invalidate proceedings.** No change. Same as SICA, 1985.

11 **Members of staff to be public servants.** No change. Same as SICA, 1985.

12 **Constitution of Benches of Board or Appellate Authority**

(1) The jurisdiction, powers and authority of the Board or the Appellate Authority may be exercised by Benches thereof.

(2) The Benches shall be constituted by the Chairman and each Bench shall consist of not less than two Members. The Central Government may provide the Board and the Appellate Authority with such other officers and employees as may be necessary for the efficient performance of the functions of the Board and the Appellate Authority.

(3) If the Members of a Bench differ in opinion on any point, the point shall be decided according to the opinion of the majority, if there is a majority, but if the members are equally divided, they shall state the point or points on which they differ, and make a reference to the Chairman of the Board or, as the case may be, the Appellate Authority.

13 **Procedure of Board and Appellate Authority.** No change. Same as SICA, 1985.

14 Proceeding of Board and Appellate Authority. No change. Same as SICA, 1985.

CHAPTER III

References, inquiries and schemes

15 Reference to Board

(1) Where an industrial company has become a sick industrial company under Section 3(q) of the Act, the Board of Directors of the company may make a reference to the Board for (i) obtaining permission to submit a corporate and debt reorganization plan to the Board within 90 days of registration of the case with the Board, and (ii) requesting a stay from attachment proceedings for the period of 90 days from registration of the case with the Board, for the express purpose of obtaining relief while the company prepares and submits its corporate and debt reorganization plan.

(2) Without prejudice to the provisions of sub-section (1), the Central Government or the Reserve Bank or a State Government or a public financial institution or a State level institution or a scheduled bank may, if it has reasons to believe that an industrial company has become, for the purposes of this Act, a sick industrial company, make a reference in respect of such company to the Board for (i) attachment of assets in lieu of debt defaults, and/or (ii) submission of debt and corporate reorganization measures within a period of 90 days from registration of the case with the Board.

Provided that a reference shall not be made under this sub-section in respect of any industrial company under section 15(2) by (a) the Government of any State unless all or any of the industrial undertakings belonging to such company are situated in such State; or (b) a public financial institution or a State level institution or a scheduled bank unless it has, by reason of any financial assistance or obligation rendered by it, or undertaken by it, with respect to, such company, an interest is such Company.

16 Directions of the Board on receiving references under section 15(1) or 15(2)

(1) Upon receipt of a reference from the sick industrial company under section 15(1), or from the Central Government or the Reserve Bank or a State Government or a public financial institution or a State level institution or a scheduled bank under section 15(2), the Board will register the case within 15 days of receipt of the reference(s).

(2) Upon registration of the reference under section 15(1), the Board will

(i) instruct the sick industrial company to prepare a debt and corporate reorganization plan, and submit such a plan to the Board within 90 days, and

(ii) grant the sick industrial company stay from attachment of property or assets in lieu of default for the same period of 90 days while the company prepares and submits its debt and corporate reorganization plan, and

(iii) inform the sick industrial company that there will be a hearing to decide on all aspects of the debt and corporate reorganization plan, which will be no later than 30 days after the company submits the reorganization plan to the Board, or 120 days from the date of registration, whichever is less.

(3) Upon registration of the reference under section 15(2), the Board will

(i) inform the sick industrial company that it has received and registered such a reference; and

(ii) inform the company's lead financial institution to either take up the role of the operating agency or to appoint a suitable operating agency, and

(iii) instruct the sick industrial company prepare a debt and corporate reorganization plan in consultation with the operating agency, and jointly submit such a plan to the Board within 90 days, and

(iv) grant the sick industrial company stay from attachment of property or assets in lieu of default for the period of 90 days while the company and the operating agency prepares and submits its debt and corporate reorganization plan, and

(v) inform the sick industrial company and the operating agency that there will be a hearing to decide on all aspects of the debt and corporate reorganization plan, which will be no later than 30 days after the company submits the reorganization plan to the Board, or 120 days from the date of registration, whichever is less.

(4) Irrespective of whether the reference was made under section 15(1) or 15(2), at the hearing of the sick industrial company's debt and corporate reorganization plan

(i) the Board will ascertain whether such a plan is approved by secured creditors accounting for 75 percent of the secured debt, and if so

(ii) the Board will sanction the debt and corporate reorganization plan as the sanctioned scheme.

(5) However, if, at the hearing, the sick industrial company's debt and corporate reorganization plan is not approved by secured creditors accounting for 75 percent of the secured debt, then the Board will instruct the company (under section 15(1) references) or the company and the operating agency (under section 15(2) references) to formulate a fresh debt and corporate reorganization plan and submit it to the Board within a further period of 60 days.

(6) At the fresh hearing of the new corporate and debt reorganization plan prepared under section 16(5) above,

(i) the Board will ascertain whether such a plan is approved by secured creditors accounting for 75 percent of the secured debt; and if so

(ii) the Board will sanction the debt and corporate reorganization plan as the sanctioned scheme.

(7) However, if at the second hearing, the sick industrial company's debt and corporate reorganization plan is not approved by secured creditors accounting for 75 percent of the secured debt, then it will be deemed that the firm has no viable reorganization plan. Hence, the Board will

(i) either de-register the case and refer it to the appropriate recovery court or recovery tribunal, or

(ii) recommend winding up of the sick industrial company under section 18 below.

17 Preparation of reorganization schemes

(1) When the Board orders a reorganization scheme to be prepared under sections 16(2)(i), or 16(3)(iii), or 16(5), the sick industrial company or the operating agency can provide for any one or more of the following measures, namely:

(a) the financial reconstruction of the sick industrial company, provided this is economically feasible and commercial viable;

(b) the proper management of the sick industrial company by changes in, or take over of, management of the sick industrial company;

(c) the amalgamation or merger of (i) the sick industrial company with any other company or (ii) any other company with the sick industrial company;

(d) the sale or lease of a part or whole of any industrial undertaking of the sick industrial company;

(e) the rationalization of managerial personnel, supervisory staff and workmen in accordance with law;

(f) such other measures as may be appropriate, economically feasible, and commercially viable.

18 Winding up of sick industrial company

(1) Where the Board, after hearing the case for the second and final time under section 16(7), and after ascertaining that the reorganization plan has twice failed

to carry secured creditors representing 75 percent of the secured debt, may opine that the sick industrial be wound up, and record and forward its opinion to the concerned High Court.

(2) The High Court shall, on the basis of the opinion of the Board, order winding up of the sick industrial company and may proceed and cause to proceed with the winding up of the sick industrial company in accordance with the provisions of the Companies Act, 1956 (1 of 1956).

(3) For the purpose of winding up of the sick industrial company, the High Court may appoint any officer of the operating agency, if the operating agency gives its consent, as the liquidator of the sick industrial company and the officer so appointed shall for the purposes of the winding up of the sick industrial company be deemed to be, and have all the powers of, the official liquidator under the Companies Act, 1956 (1 of 1956).

(4) Notwithstanding anything contained in sub-sections (2) or (3), the Board may sell the assets of the sick industrial company in such manner as it may deem fit, and forward the sale proceeds to the High Court for orders for distribution in accordance with the provisions of Section 529-A the Companies Act, 1956 (1 of 1956).

19 Suspension of legal proceedings, contracts, etc.

(1) Where in respect of a sick industrial company, a debt and corporate reorganization scheme is being prepared for submission under Section 16, or where an appeal under Section 21 relating to an industrial company is pending, then, notwithstanding anything contained in the Companies Act, 1956 (1 of 1956), or any other law or the memorandum and articles of association of the industrial company or any other instrument having effect under the said Act or other law, no proceedings for the winding up of the industrial company or for execution, distress or the like against any of the properties of the industrial company or for the appointment of a receiver in respect thereof and no suit for the recovery of money or for the enforcement of any security against the industrial company or of any guarantee in respect of any loan, or advance granted to the industrial company, or no suit for the recovery of dues to any local authority such as municipal boards, providers of public utilities, etc., or eviction proceedings under the Rent Control Act shall lie or be proceeded with further, except with the consent of the Board or, as the case may be, the Appellate Authority.

(2) Where in respect of a sick industrial company, a debt and corporate reorganization scheme is being prepared for submission under Section 16, or where an appeal under Section 21 relating to an industrial company is pending, then, notwithstanding anything contained in the Companies Act, 1956 (1 of 1956), or any other law or the memorandum and articles of association of the industrial company or any other instrument having effect under the said Act or other law, the sick industrial company will not be permitted to sell or dispose off the assets of the company except with the consent of the Board or, as the case may be, the Appellate Authority.

(3) Only during the period of consideration of any scheme under Section 16, or an appeal under section 21, the Board or, as the case may be, the Appellate Authority, may by order declare with respect to the sick industrial company concerned that the operation of all or any of the contracts, assurances of property, agreements, settlements, awards, standing orders or other instruments in force, to which such sick industrial company is a party shall remain suspended or shall be enforceable with such adaptations and in such manner as may be specified by the Board or, as the case may be, the Appellate Authority.

(4) Any declaration made under sub-sections (1) and (2) with respect to a sick industrial company shall have effect notwithstanding anything contained in the Companies Act, 1956 (1 of 1956), or any other law, the memorandum and articles of association of the company or any instrument having effect under the said Act or other law or any agreement or any decree or order of a court, tribunal, officer or other authority or of any submission, settlement or standing order and accordingly,

(a) any remedy for the enforcement of any right, privilege, obligation and liability suspended or modified by such declaration, and all proceedings relating thereto pending before any court, tribunal, officer or other authority shall remain stayed or be continued subject to such declaration; and

(b) on the declaration ceasing to have effect (i) any right, privilege, obligation or liability so remaining suspended or modified, shall become revived and enforceable as if the declaration had never been made; and (ii) any proceeding so remaining stayed shall be proceed with subject to the provisions of any law which may then be in force, from the stage which had been reached when the proceedings became stayed.

(5) In computing the period of limitation for the enforcement of any right, privilege, obligation or liability, the period during which it or the remedy for the enforcement thereof remains suspended under this section shall be excluded.

CHAPTER IV

Misfeasance proceedings, appeals and miscellaneous

20 **Misfeasance proceedings.** No change. Same as SICA, 1985.

21 **Appeal**

(1) Any person aggrieved by an order of the Board made under this Act may, within 21 days from the date on which a copy of the order is issued to him, prefer an appeal to the Appellate Authority; after this date the appeal is null and void.

(2) On receipt of an appeal under sub-section (1), the Appellate Authority may, after giving an opportunity to the appellant to be heard, if he so desires, and after making such further inquiry as it deems fit, confirm, modify or set aside the order appealed against.

(3) The enquiry of the Appellate Authority under section 21(2) above must be completed by a period of 60 days from receipt of the appeal, after which it will be deemed that the Board's original decision (the decision that was being appealed to the Appellate Authority) is binding.

22 Bar of jurisdiction. No change. Same as SICA, 1985.

23 Delegation of powers

The Board may, by general or special order, delegate, subject to such conditions and limitations, if any, as may be specified in the order, to any Member or Secretary or other officer or employee of the Board or other person authorized by the Board to manage any industrial company or industrial undertaking or any operating agency, such powers and duties as it may deem necessary.

24 Returns and information

(1) The Board shall furnish from time to time to the Central Government such returns as the Central Government may require.

(2) The Board may, for the purpose of efficient discharge of its functions under this Act, collect from or furnish to the Central Government, the Reserve Bank, the scheduled bank or any other bank, the public financial institution, the State-level institution, or the sick industrial company and, in case of amalgamation, the other company, such information as it may consider useful for the purpose in such manner and within such time as it may think fit.

25 Power to seek the assistance of Chief Metropolitan Magistrate and District Magistrate. No change. Same as SICA, 1985.

26 Protection of action taken in good faith. No change. Same as SICA, 1985.

27 Saving of pending proceedings.

Where a receiver or an official liquidator has been appointed in any proceeding pending immediately before the commencement of this Act, in any High Court for winding up of an industrial company such proceeding shall not abate but continue in that High Court, and no proceeding in respect of such industrial company shall lie or be proceeded with further before the Board.

28 Effect of the Act on other laws

(1) The provisions of this Act and of any rules or schemes made thereunder shall have effect notwithstanding anything inconsistent therewith contained in any other law, except the provisions of the Urban Land (Ceiling and Regulation) Act, 1976 (33 of 1976), for the time being in force or in the Memorandum or Articles of Association of an industrial company or in any other instrument having effect by virtue of any law other than this Act.

(2) Where there has been under any scheme under this Act an amalgamation of a sick industrial company with another company, the provisions of Section 72-A of the Income-tax Act, 1961 (43 of 1961), shall, subject to the modifications that the power of the Central Government under that section may be exercised by the Board without any recommendation, by the specified authority referred to in that section, apply in relation to such amalgamation as they apply in relation to the amalgamation of a company owning an industrial undertaking with another company.

(3) Nothing in the Monopolies and Restrictive Trade Practices Act, 1969 (54 of 1969), shall apply in relation to (a) the modernization or expansion of a sick industrial company, or (b) the amalgamation or merger of a sick industrial company with another company as a result of a scheme sanctioned in accordance with the provisions of this Act.

29 Penalty for certain offences

(1) Whoever violates the provisions of this Act or any scheme, or any order of the Board, or the Appellate Authority and whoever makes a false statement or gives false evidence to the Board or the Appellate Authority, shall be punishable with simple imprisonment for a term which may extend to three years and shall also be liable to fine.

(2) No court shall take cognizance of any offence under sub-section (1) except on a complaint in writing of the Secretary or any such other officer of the Board or the Appellate Authority or any such officer of an operating agency as may be authorized in this behalf by the Board or the Appellate Authority.

30 Offences by companies

(1) Where any offence, punishable under this Act has been committed by a company, every person who, at the time the offence was committed was in charge of, and was responsible to, the company for the conduct of the business of the company, as well as the company, shall be deemed to be guilty of the offence and shall be liable to be proceeded against and punished accordingly:

Provided that nothing contained in this sub-section shall render any such person liable to any punishment, if he proves that the offence was committed without his knowledge or that he had exercised all due diligence to prevent the commission of such offence.

(2) Notwithstanding anything contained in sub-section (1), where any offence punishable under this Act has been committed by a company and it is proved that the offence has been committed with the consent or connivance of, or is attributable to any neglect on the part of, any director, manager, secretary or other officer of the company, such director, manager, secretary or other officer shall also be deemed to be guilty of that offence and shall be liable to be proceeded against and punished accordingly.

Explanation: For the purposes of this section,

(a) "company" means any body corporate and includes a firm or other association of individuals; and

(b) "director", in relation to a firm, means a partner in the firm.

31 **Power to remove difficulties.** No change. Same as SICA 1985.

32 **Power to make rules.** No change. Same as SICA 1985.

4 : Appraisal, Financial Sector Reforms, and Industrial Restructuring

4.0.1 This chapter focuses on the close correlation between financial sector reforms and industrial restructuring. It argues that past practices of banks and term lending institutions – **economically unsound project appraisal, inappropriate discounting at opportunity costs, poor identification and inadequate provisioning of tainted portfolios, and insufficient capital adequacy – not only prevented early detection and cure of unhealthy companies, but also induced the secured creditors to increase their exposure in palpably sick companies.**

4.0.2 Section 4.1 examines a sample of rehabilitation packages that were prepared by financial institutions (as operating agencies or OAs) and sanctioned by the BIFR under section 18(4) of SICA. Section 4.2 looks at the issue of early detection.

4.1 Faulty project appraisal

4.1.1 Chapter 3 showed that the procedures of BIFR contributed to the high failure rate of section 18(4) rehabilitation schemes. There is a far more fundamental reason for failure. **Even if there were no delays in BIFR, many of these projects would fail in a wider economic sense: they are wrongly conceived and incorrectly appraised in the first place.** This is a very strong assertion. It is *not* being said that schemes fail because of poor assumptions, faulty projections, and procedural delays. Instead, **it will be shown that many rehabilitation projects are poorly framed, are incentive incompatible, and have high failure risks, even in the best possible world where all forecasts come true, and where BIFR decides with alacrity.**

4.1.2 The scheme of this section is as follows.

a) Explain the minimum condition that must be satisfied before any rehabilitation (or even a brand new) scheme is approved by the financial institutions, banks, or BIFR.
b) Prove that in the past even the minimal criterion was not satisfied.
c) Analyze why this was so: specifically, the role of the rehabilitation guidelines prescribed by the Reserve Bank of India (RBI), and the financial sector's bad accounting practices.
d) Suggest an improved method of appraisal, and make some policy-oriented recommendations.

The minimal assessment norm

4.1.3 A sick industrial company must belong to one of three states.

a) **Very bad in average variable cost as well as average fixed cost compared to healthy firms.**[1] These are firms with inappropriate technology, obsolete plant and machinery, bad product-mix, poor marketing, high labour cost, high interest burden, and bad financial structure. Unless there are overwhelming non-economic reasons, the correct decision is to (i) allow these concerns to rapidly exit from the industry, and (ii) maximize the sale value of all dismantled assets, particularly land, to pay as much as possible to labour and secured creditors in the shortest time.

b) **Very bad in average fixed cost compared to healthy companies, but no worse off in unit variable cost**: firms with high burden of committed payments compared to sales. Because of fixed payment obligations, these units are poorly insured against bad states; they are excessively leveraged with high debt-equity and total liability-to-equity ratios; and they have high unit wage cost – a fixed commitment in the unionized sector. With early detection, these companies can be turned around. Here, restructuring entails cleaning up of the books – part write-down of debt, part conversion of debt to equity, occasional write-down of equity. This might have to be accompanied by labour rationalization, sale of unproductive assets, and some extra support to finance relatively modest balancing investments. The point is that the greatest adjustments are financial, not technical.

c) **Very bad in average variable cost, but with relatively good financial structure and low unit fixed cost compared to the healthier firms in the industry**. If restructuring is feasible, it must focus on large investments in plant, machinery and technology. Financial adjustments are relatively minor, more in the nature of corrections to smooth out the new debt obligations.

4.1.4 Chapter 2 (Tables 2.7 and 2.8, page 11) shows that (c) is a rarity among the BIFR companies. Most firms belong to (a) or (b). Significantly, firms belonging to (b) – bad financial structure, but passable average variable cost – account for a substantial portion of the BIFR cases.

4.1.5 All BIFR companies carry outstanding debt: unpaid past principal and interest defaults.[2] In addition, many rehabilitation packages envisage fresh term loans to finance modernization, rationalizing labour, payment of unpaid labour dues, purchase of balancing equipment, and so on. *For purely analytical reasons*, suppose one took an extreme view that all past debts are sunk costs.[3] **Despite this extreme assumption, from the lender's viewpoint, a minimum requirement is that the project must, at least, repay the fresh loans at opportunity cost.** This cost is not the price of borrowing funds, but the benefit forsaken

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[1] In extreme cases, the going market price may be insufficient to even cover the average variable costs.

[2] Usually, the interest default is "funded" and re-issued as a funded interest term loan (FITL) at a subsidized interest rate which is 6.5% points below the "normal" rate.

[3] Of course, financial institutions must *not* adopt this view – which rewards bad entrepreneurs for years of non-performance, and creates incentives for firms to fall sick.

by not deploying these in their best (highest risk-return) use.[4] For our purposes, it suffices to evaluate fund flows as net present values, discounted at the market rate of interest.[5] In other words, if L is the loan, and R the discounted net present value of repayment flows (principal as well as interest) evaluated at opportunity cost, then the rate of return on loans, r_L must be such that

$$r_L \equiv \frac{R}{L} - 1 \geq 0.$$

4.1.6 Two other concepts need stating: (i) return on equity, and (ii) return on promoter's contribution. In most rehabilitation schemes, equity, E, consists of three components: old equity, promoter's contribution to the project, P, and write-off/conversion of past debt. The flow that services this equity is the so-called "surplus" in a cash-flow statement: the residual after meeting all debt, interest charges, reliefs and sacrifices, and all operating and fixed costs. Discounting this stream at the opportunity cost of equity funds yields its net present value, S. **The opportunity cost of equity funds is the rate of return on risk free investment plus an industry-specific premium on risk.** For the project to be attractive to the *firm*, the opportunity cost return to equity, r_E, cannot be negative. Thus,

$$r_E \equiv \frac{S}{E} - 1 \geq 0.$$

Similarly, one can calculate the return on promoter's contribution, r_P evaluated at the opportunity cost of equity providing funds. This is nothing other than

$$r_P \equiv \frac{S}{P} - 1 \geq 0.$$

4.1.7 The matrix gives the outcomes involving r_E, r_P, and r_L, and their implications.

	$r_L \geq 0$	$r_L < 0$
$r_E \geq 0$	From the institution's and the firm's point of view, the minimum requirement is satisfied, provided all assumptions hold. Zone 1.	Firm gains at the expense of the financial institution. Zone 2.
$r_E < 0$	Institution carries unacceptably high default risk, since a firm is unlikely to pay the institutions while taking a loss on its equity. Zone 4.	Project should never have been considered in the first place. Zone 3.

[4] Until recently, the financial institutions evaluated loans at 12% or thereabouts, on the ground that the base rate was 9% or less. A spread of 3% points was considered sufficient to cover all administrative costs plus risk. In no economy can administratively determined interest rates for borrowing funds be the proxy for opportunity costs — far less so in a capital scarce one.

[5] It can be argued that, with imperfect capital markets, market prices do not reflect long-term, social opportunity costs. But, all it requires is a two-step procedure. The institutions can evaluate their fresh exposure at market prices and, thereafter, *explicitly* write-off a part of past debt, or set it off against equity, to conform to the "true" shadow price. To bring parity across borrowers, all new loans need to be evaluated at the market rates; adjustments due to imperfections, externalities, and social needs must be explicit, *and only on past debt.*

	$r_L \geq 0$	$r_L < 0$
$r_P \geq 0$	From the institution's and the promoter's point of view, the minimum requirement is satisfied, provided all assumptions hold. The firm might make a loss on equity. Zone 1.	Promoter gains at the expense of the financial institution. The firm may lose, but not the promoter. Zone 2.
$r_P < 0$	Institution carries even higher default risk, since a promoter will certainly not pay the institutions while taking a loss on his equity contribution. Zone 4.	Project should never have been considered in the first place. This is worse than $r_L < 0$ & $r_E < 0$. Zone 3.

4.1.8 Do project appraisals always satisfy this minimal assessment norm? Far from it. **Very few section 18(4) rehabilitation programmes prepared by financial institutions and endorsed by BIFR satisfy the minimal criterion, that both $r_L \geq 0$, and $r_E \geq 0$.** To err in favour of the schemes, relatively modest discount rate are used: 15% for loans, and 20 per cent for equity funds. These are underestimates of the opportunity cost of term loans and equity funds during 1990-1991 – the years when the rehabilitation schemes were sanctioned. The sample consists of sanctioned schemes of 22 firms: 14 composite textile mills, and 8 engineering companies. Chart 4.A and Chart 4.B (next page) plot the outcome. These illustrate major deficiencies in appraising rehabilitation projects. The Appendix to the chapter gives the data and the results in greater detail.

Financial institutions and BIFR have often sanctioned rehabilitation schemes that fail to meet the minimal criterion: (a) evaluate fresh exposure at market rates of interest, and simultaneously (b) secure the opportunity cost rate of return on equity funds. In 6 out of 12 cases, firms were forecasted to earn returns on equity that much exceeded opportunity costs, while the financial institutions lost out on their new exposure. Only one project covered equity as well as fresh loans.

Financial institutions and BIFR have done worse: only in two projects requiring fresh funds did the scheme cover the loan as well as promoter's contribution at opportunity costs. For 8 out of 12 cases, the promoters more than adequately covered their contribution, while the institutions took a hit on their fresh exposure.

These cases exemplify the fact that projects have been appraised without proper discounting of fund flows.

CHART 4.A : Return on fresh loans versus return on equity, discounted at opportunity costs, Rs. lakhs

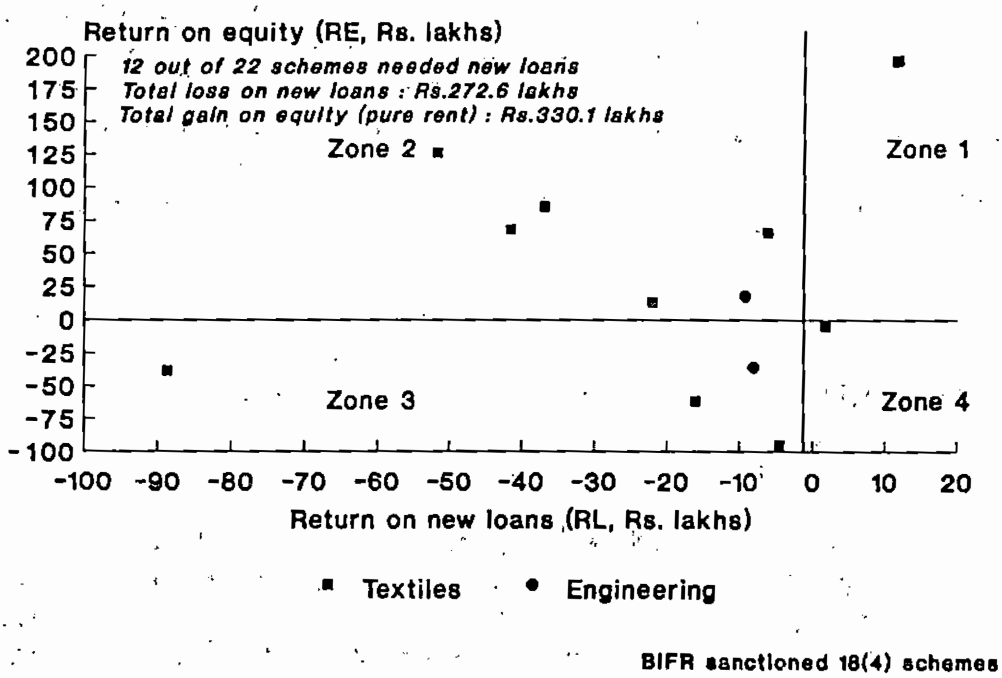
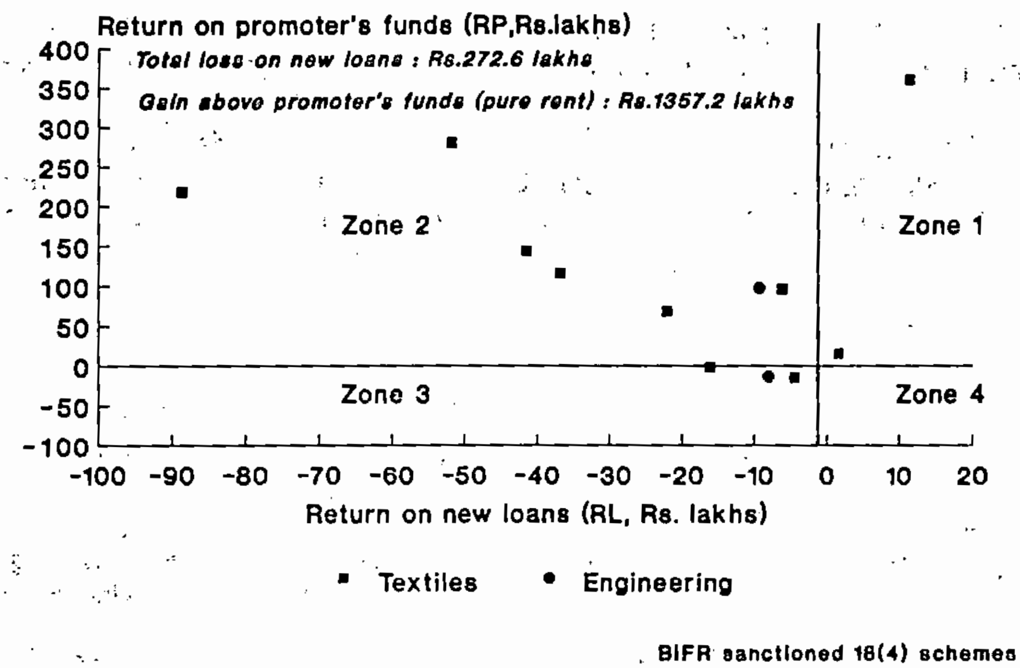


CHART 4.B : Return on fresh loans versus return on promoter's funds at opportunity costs, Rs. lakhs



4.1.9 **Until recently, financial institutions and banks did not evaluate projects by using proper discounting rates to calculate sensible net present values, or use internal rates of return.** In the era of "development" finance, there was no felt need for using these analytical tools. An example illustrates this. There is an inflexible standard that is insisted upon by the BIFR: a safe rehabilitation project is one that generates a debt-service coverage ratio (DSCR) of 1.33. **There are numerous instances where BIFR has sanctioned rehabilitation schemes so long as the simple, undiscounted annual average of the DSCRs equalled 1.33![6]** Schemes sanctioned on the basis of a simple average DSCR run high default risks. The firms can, and do, default in the early years; these cumulate and reduce the later DSCRs as well.

4.1.10 Until now, the critique of appraisal has had nothing to do with the questionable assumptions often used estimate sales forecasts and fund flows in the rehabilitation proposals. Excessively favorable assumptions compound the problems that arise due to not discounting at opportunity cost. **Many rehabilitation schemes appear viable because of over-optimistic assumptions regarding the sales forecasts.**

4.1.11 According to the Indian Cotton Mills Federation (ICMF), the average number of working days in textile mills is 325. A sample of 13 OA reports shows a mean of 339 days: 14 days greater than the industry average. For six of these mills, projections are based on 350 working days, and for another on 356! With such assumptions, the OA reports arrive at massive sales targets – recoveries that have never occurred in the recent history of the Indian textile industry. When such projections are buttressed by sacrifices and generous loan and waiver schemes, the projects are always "viable" with the simple average DSCR is always greater than 1.33.[7] **When the assumptions are scaled down modestly, the rehabilitation packages swing from positive to negative net present values even at a 12 per cent rate of discount.[8]**

4.1.12 To understand why financial institutions, banks, and BIFR have disregarded notions of opportunity cost, net present value, and internal rate of return, one has to turn to

a) the "sacrifices" enshrined in RBI's guidelines for rehabilitation, and
b) the accounting standards that were followed in the financial sector.

These became barriers to proper appraisal, resulted in excessive exposure even in terminal cases, increased future risks of sick firms, and reduced the likelihood of successful turnaround.

Sacrifices, RBI guidelines, accounting norms

4.1.13 The Tewari Committee Report (1985) on industrial sickness had argued that the primary effort should be rehabilitation – which would inevitably require sacrifices from

[6] For most projects, the DSCR during the first three to four years is less than 1, thereafter rising to about 1.5. When simple averaging produces 1.33, the discounting procedure yields less – often less than unity.

[7] See T.C.A. Anant, Shubhashis Gangopadhyay, Omkar Goswami, *Industrial Sickness in India: Initial Findings*, Paper #2, Studies in Industrial Development, Ministry of Industry, March 1992.

[8] Ibid., pp.56-64.

the state and central governments, banks and financial institutions, management, and labour. The recommendations regarding sacrifices were subsequently adopted by the RBI, and became the basis for preparing and sanctioning operating agency reports. Box 4.1 (page 52) outlines the sacrifices that banks, financial institutions, state and central governments are routinely called upon to make. In addition, there are sacrifices by management as well as labour.[9]

4.1.14 There are several problems with subsidies that distort prices — and sacrifices that reduce interest charges are no exceptions.

a) **Sacrifices distort the cost of capital in a rehabilitation project.** Most units are projected to reach positive net worth *only* because of the subsidized cost of loanable funds.

b) **Interest rate reducing sacrifices create large arbitrage opportunities and give perverse signals to promoters and management of sick companies.** BIFR's rehabilitation packages give firms the benefit of easier credit, reduced outflows, and lower rates. **These translate to an arbitrage of 5 to 8 percentage points.** Since this is common knowledge, the owners have every incentive to make a poorly functioning non-BIFR firm a BIFR one as quickly as possible. **Moreover, there is something perverse about a situation in which well managed, profitable, expanding companies must pay higher interest charges on term loans than chronically mismanaged, loss-making units.**

4.1.15 Proponents of sacrifice speak of the social need to prevent industry from closing down, to protect labour, and to give firms breathing space to repay past dues. They consistently fail to realize that the combination of BIFR delays, consensus, and sacrifices gives promoters the signal that everyone will accommodate to keep the firm going, and do so at prices well below the opportunity cost of funds. Chart 4.B illustrates that the promoters's assumptions are valid: **financial institutions suffer sizeable losses and, in doing so, bequeath large rents to promoters.**

4.1.16 The arbitrage opportunities that these sacrifices create are factored in by the promoters while negotiating the project. This is why they often agree to schemes where realistic forecasts yield negative net present values. **Promoters realize that the arbitrage donated by banks, institutions, government, electricity boards, and municipal authorities allows them to recoup their contribution with remunerative returns within a few years. Once this is done, most promoters start reneging on repayments; then, the project fails.**

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[9] For management these involve (i) waiver or reduction in remuneration, (ii) foregoing interest on any unsecured loans made to the firm, (iii) writing-off loans made to the firm, (iv) bringing in fresh funds as promoter's contribution to equity, (v) agreeing to management changes and to appointment of outsiders as overseers on the board, and (vi) providing personal guarantees and/or pledge of shares. For labour: (i) agreeing to rationalization/retrenchment of surplus staff, (ii) deferring or phasing out retrenchment compensation, (iii) wage stabilization or reduction during rehabilitation, (iv) not making fresh wage or payment demands, and (v) agreeing to increasing productivity along recommended lines.

Box 4.1 : Sacrifices by various claimants during rehabilitation

Banks and financial institutions

1) Interest on term loans to be reduced.

2) All penalties and damages for non-repayment may be waived.

3) Unrealized interest can be funded (or capitalized) at a subsidized rate, subject to review. The interest can be 10%, 6% or even 0% per year in exceptional cases. The normal repayment of funded interest is three to five years, extendable to six to seven years.

4) The irregular component of a firm's cash credit (other than unadjusted interest, which is funded as (3) above) must be converted into a working capital term loan (WCTL). On this subsidized interest may be charged.

5) The cash losses of a company consist not only of irregularities in the cash credit account, but also of non-payment of workers and other statutory dues, and overdue creditors. The latter liabilities are supposed to be shared between the participating banks and institutions on a fifty-fifty basis. Anticipated cash losses during the rehabilitation periods are to be borne by the financial institutions, who are also supposed to provide the margin money for additional working capital.

6) Additional assistance for working capital is on commercial rates, which may be reduced if state governments offer concessions. The costs of rationalizing the labour force is met by the financial institutions and banks on a fifty-fifty basis.

State governments

7) Exemption or deferment of sales tax, purchase tax and electricity duty for two to five years or when net worth becomes positive, whichever is earlier. The deferment is either free, or at simple interest of 12%, with a moratorium of one to two years after BIFR sanctions the scheme. Consideration of sales tax loans at subsidized interest rates.

8) Deferment of octroi duty and water charges.

9) Deferment of energy dues, including turnover tax or sales tax on electricity.

10) Waiver of compound interest and penal charges levied on state dues.

11) Deferment of recovery of past state excise dues.

12) Deferment of interest payment, or funding of interest on outstanding term loan dues of State Financial Corporations at subsidized rates.

13) Exemption from power cuts, preference in power connections, and protection from unilateral disconnection.

14) State governments to provide guarantees for fresh loans, if asked for. Moreover, state governments must not insist on bank guarantees for arrears of dues.

15) Protection from revenue recovery action.

16) Price preference, quota reservations, and assistance in the supply of controlled raw materials.

17) Equity contribution, even where the sick unit is not taken over by the state government.

Central government

18) Exemption or deferment from central excise duty for two to five years.

19) Income tax relief for a specified period.

20) Deferment of provident fund, and waiver of penalties on non-payment of PF and ESI dues. Also, exemption from paying the minimum 8.33% bonus.

21) Preferential supply of canalized items.

4.1.17 **Faulty assumptions aside, pumping in more funds via the sacrifice approach often worsens the already poor financial structure of sick firms, and exposes it to even greater risks in the future.** Rehabilitation can succeed if it

a) avoids attributes that caused sickness in the first place, and

b) is not based on improbable targets.

Detailed analysis of several OA reports and sanctioned 18(4) schemes indicates quite the opposite.[10] In most cases, these projects exhibit a peculiar blend of over-optimism with characteristics of acute sickness. Since most rehabilitation proposals follow the loan route – pumping in more credit at subsidized rates – these translate to unacceptably high debt-equity and total-liability to equity ratios, even by the standards of BIFR firms. In other words, **the schemes propose a worse financial structure with poorer insurance against bad future states.** These are covered up by excessive optimism: wage costs are targeted at unrealistically low levels (often below those of healthy firms), as are variable costs. The legion of failed BIFR cases under 18(4) highlight such errors.

4.1.18 **Until recently, poor financial sector practices have been barriers to early identification and treatment of industrial sickness. These have also forced a particular type of error - that of supporting doubtful rehabilitation cases, when economic logic suggested otherwise.** In the past, banks as well as financial institutions followed very unsatisfactory methods of detecting bad accounts and provisioning for them.[11] The loans advanced to sick units were insufficiently written down in the books of the secured creditors. Inadequate provisioning meant that creditors could neither give part write-offs on old debt to assist a financially strained but operationally viable company,[12] nor demand winding up of unviable, terminally sick companies – in effect making it a bad debt that required immediate and full provisioning, which hurt the account books even further. In other words, there were strong managerial incentives to support very unhealthy, contaminated, as well as terminally sick accounts.

4.1.19 The suggestions of *Narasimham Committee* have finally induced commercial banks and financial institutions to opt for better health codes to detect incipient sickness, and to provide for doubtful loans in a manner that approximates the Bank of International Settlements (BIS) standards. Some of the changes are listed below:

a) A non-performing asset (NPA) will now be defined as an advance where (i) interest on term loans has not been repaid for more than 180 days (two successive quarters),

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[10] See Chapter 2 of T.C.A. Anant, Shubhashis Gangopadhyay, Omkar Goswami, *Industrial Sickness in India: Characteristics, Determinants, and History, 1970-1990*, Ministry of Industry, Studies in Industrial Development, Paper No.6, October 1992.

[11] This was recognized by the *Report of the Committee on the Financial System (Narasimham Committee)*, December 1991, Chapter V. It says, "the capital ratios of Indian banks are generally low and some banks are seriously under-capitalised ... it is necessary to have their assets on a more realistic basis and on the basis of their realizable value. Banks and DFI [development financial institutions] have not been following a uniform practice in respect of income recognition, valuation of investment and also provisioning against doubtful debts".

[12] The RBI was conscious of this, and mandated against write-offs in its guidelines for rehabilitation.

or (ii) overdrafts and cash credit accounts remain out of order for over 180 days, or (iii) bills purchased or discounted are not settled for over 180 days.

b) To mitigate the strain of providing for NPAs in one year, the government has decided to reach the 180 day cut-off over three years: four quarters up to 31 March 1993, three quarters for the year ending 31 March 1994, and two quarters thereafter.

c) Income from NPAs will be booked only when actually received, and not on an "accrual" basis.

d) A four-tier asset classification: **Standard:** Not a NPA; **Sub-standard:** NPA for two years or less. This carries a general provision of 10 per cent of total outstanding loans. **Doubtful:** NPA exceeding two years. In such cases, provision for 20 per cent in the first year, 30 per cent for the second and third, and 50 per cent thereafter. **Loss assets:** Asset is not collectable. Should be completely written -off.

e) An eight-tier health code classification: (1) satisfactory, (2) irregular, (3) sick, but under rehabilitation, (4) sick and non-viable, (5) through (8): various forms of protested accounts.

4.1.20 It will take at least three years for these changes to be operationalized, and for the new classifications to stabilize and filter down to all branches. When this happens, there will be very little incentive left for banks or institutions to unnecessarily maintain operationally unviable industrial portfolios. At that point, there will be better appraisal with discounting at market prices, and sufficient sensitivity analysis.

It is very important to closely monitor, indeed accelerate, the pace of financial sector reforms. The faster we implement reforms in the financial sector, quicker will we be able to restructure her industrial sector. It is in India's interest to implement the Narasimham Committee reforms as early as possible. Given this, and the possibility that commercial banks as well as RBI might prefer to go slow on these reforms, the Ministry of Finance must force the pace, and ensure that the books are thoroughly cleaned by 1995.

Remedial suggestions

4.1.21 **For any operationally viable firm, it is possible to design restructuring schemes that reduce the losses (through implicit write-offs) to financial institutions, and simultaneously secure a good return on equity for the firm.** The principles are simple:

Take any rehabilitation case where

a) the projected return on equity is greater than the opportunity cost rate of return;
b) the financial institution's return on fresh loans is at less than opportunity cost; and
c) the gains in (a) can compensate the loss in (b).

In such cases, alternative schemes can be constructed where

i) there are no write-off on new loans;
ii) there is an explicit partial write-off on past debt;
iii) the new loans and the non-written off portion of past debt are evaluated at market rates of interest;
iv) the explicit partial write-off on past debt under the scheme is less than the implicit write-off conferred through interest rate subsidies; and
v) the firm continues to earn a surplus which, when discounted at the opportunity cost of equity funds (risk free return plus risk premium) equals the value of equity.

4.1.22 In the Appendix to this chapter, these principles are illustrated using a case study of a textile mill whose rehabilitation project was sanctioned by BIFR under section 18(4) of SICA.

Industrial restructuring requires financial sector reform. It is necessary to closely supervise financial sector reform, particularly how institutions appraise projects.

All projects must be evaluated at proper opportunity costs. There should be no implicit write-off on new loans through interest rate or allied subsidies. If a firm is operationally viable and has proper management, then banks and institutions should consider partial write-offs and one-time settlements. These should only be made on past debts, not on new loans.

Any write-off by financial institutions that gives a firm a return which exceeds the opportunity cost rate of return on equity funds is excessive: it has basically gifted rents to private promoter's at the expense of public funds. This must stop.

The RBI's guidelines for rehabilitation must be altered to abjure the notion of sacrifices, and instead address the basic issues in appraisal:

i) no write off on new loans;

ii) if a partial write off is necessary, it should be explicit, and only on past debt;

iii) the non-written off exposure to be charged and discounted at market rates of interest.

Finally, whenever write offs are taken, these should be in the form of debt-equity conversions: the financial institution should adjust the write off against some equity of the sick company. Debt-equity conversion dominates outright writing off: in good future states, the secured creditor holds profitable equity (which it can sell elsewhere or back to the company), while in bad states it is no worse than a write-off.

4.1.23 These recommendations are fairly straightforward. After the *Narasimham Committee Report*, the financial sector appreciates the need for restructuring itself. These suggestions integrate financial sector reform with industrial sector restructuring; and, as such, should be readily accepted by all concerned.

4.1.24 **Development finance emphasized the need for disbursing cheap loans irrespective of proper project appraisal and loan recovery.** For instance, government fiats resulted in vast amounts of term loans being advanced in the heyday of "mini" plants. Money was disbursed even more generously when mini plants were located in backward areas. No realistic market determined prices could justify the setting up of mini paper, or mini cement plants. Yet these were set up in legions without any worthwhile economic or technical analysis about their feasibility even in the medium term. Moreover, the promoters of such firms enjoyed the benefits of huge debt-equity leverages ranging from 5:1 to 7:1, which was further sweetened by fiscal concessions granted by the state and central governments. These plants suffered from acute diseconomies of scale, and started incurring losses after the first few years of operation — by which time the promoter had already recouped his meagre capital many times over. Inevitably, the firms would get sick, renege on term loan repayments and other statutory dues and, after July 1987, would be registered as BIFR companies to get the arbitrage benefit of subsequent rounds of subsidized finance. Not surprisingly, most mini cement and mini paper plants are BIFR cases, and have no hope of recovery under any realistic scenario. **These bear testimony to the worst aspect of development finance: where loan disbursement and overarching government diktats regarding "appropriate" technology and location dominated sound banking practice — proper project appraisal and recovery potential.**[13]

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[13] In the past, when projects were passed by the Director General of Technical Development (DGTD), or Controller of Capital Issues (CCI), or administrative ministries, banks and financial institutions considered that the first level of appraisal was satisfactorily completed. So, with minimal further appraisal, the Project Finance

4.1.25 In the interim, before banks and term lending institutions can build up a strong appraisal base, the government should consider a risk minimizing alternative.

The funds advanced by financial institutions for any project – new, ongoing, as well as rehabilitation – can be in the form of a demand loan while the project is being implemented. If the project is implemented on schedule without any cost overruns, the demand loan is automatically converted into a term loan with its appropriate repayment schedule. Otherwise, financial institutions can opt for recalling their demand loans which, in any case, will carry a higher interest rate.

This, plus a substantially lower leverage than before (i.e. higher promoter's contribution), will reduce the risk of funding intrinsically bad projects, lessen the possibilities of arbitrage, and ensure better control and discipline among both borrowers and lenders. Simultaneously, financial institutions will have a second chance to evaluate the borrower's project viability and stream of future earnings. Moreover, this mechanism will select good borrowers and weed out the leverage seekers. It will automatically create an environment for proper project appraisal and cost control, reduce time overruns, and force borrowers to get need based term loans and working capital. It will also prevent entrepreneurs from swapping term loans for working capital requirements.

4.1.26 Finally, it must be stated that proper appraisal is not a very difficult exercise. It really involves three steps. First, the need to get a good independent appraisal about the technical, economic, and commercial feasibility of a project. In this, all tradeable products should be evaluated at international border prices. If the project shows profits despite the border price assumption, then it is probably a robust one. There are a number of reputed organizations that can do such an appraisal, of which CRISIL is one. Second, the cash flows have to subjected to rigourous sensitivity analysis. For instance, if a 10% fall in projected sales realization can turn the NPV from positive to negative, then the project is highly questionable. Third, in the cash flow analysis, all loans ought to evaluated at opportunity cost. Proper utilization of these three principles should invariably result in good appraisals. And there is no dearth of technically competent personnel in India to undertake such tasks.

4.2 Early detection and the health code

4.2.1 It goes without saying that the earlier one detects irregularities in an account and takes remedial action, the lesser are the chances of the case becoming terminally sick. Thus, early detection and quick action are paramount in combatting the problem of industrial sickness. This was recognized in 1977. According to the Industrial Policy Statement of 1977, "The cost of overcoming sickness in industry becomes very much more manageable if sickness

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Departments sanctioned the loans. *With the dismantling of the role of DGTD and CCI, there is an urgent need for banks and financial institutions to have competent technical and economic expertise in project appraisal – which does not exist in any measure in these institutions.*

can be diagnosed at an early date". Three years later, the government announced that "Various all-India financial institutions have set up arrangements to detect sickness in undertakings at an early stage with a view to taking necessary corrective action. To ensure this the Government propose to introduce a checklist to serve as 'an early warning system' for identifying symptoms of sickness" (Industrial Policy Statement, 1980).

4.2.2 Despite a universal recognition of the need to detect incipient sickness, neither banks nor financial institutions have any **objective** method of distinguishing such malaise. And, in the absence of objective norms for measuring sickness, there is a corresponding absence of well defined, uniformly applicable methods of combatting it.[14]

4.2.3 Because of the scarcity of objective criteria for determining incipient sickness, the scheduled banks use four surrogate methods to gauge the health of a borrower. These are:

a) the Health Code System (hereafter HCS);
b) the Quarterly Review Statement (QRS); and
c) the Irregular Statement (IS); and
d) the Non-Performing Assets (NPA) system of the Narasimham Committee.

These systems draw information from one or more of the following sources: (i) information available within the bank itself; (ii) information submitted by the borrower; and (iii) secondary information available within the banks regarding the firm, the industry, and the economy.

4.2.4 The HCS classifies borrowers into one of eight health code categories prescribed by the RBI. These can be grouped as:

Health Code 1	Satisfactory;
Health Code 2	Irregular;
Health Code 3 & 4	Sick: either viable and under nursing, or non-viable;
Health Code 5 to 8	Various forms of protested accounts.

Detecting **incipient** sickness clearly relates to any move from Health Code 1 to 2. **Unfortunately, the HCS has been unsuccessful in detecting incipient sickness.** An important reason for this is the lack of **objectivity**. Expressions such as "satisfactory conduct", "punctual submission", "safety of advance not in doubt", "overdrawn for a temporary period", "slow/negligible turnover", "persistent delay", or "grave feature observed" are purely subjective phrases, with no quantifiable content.

4.2.5 The Quarterly Review Statement (QRS) is supposed to be prepared for borrowers **other than** (i) branch level sanctions, (ii) identified difficult borrowers, (iii) sticky accounts, (iv) units under nursing, (v) sick units, and (vi) suit filed, decreed bad and doubtful

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[14] That there has been poor monitoring of large borrowal accounts is revealed in a RBI circular dated June 22, 1993 (IECD.No.1718/08.13.01/92-93) sent to all scheduled commercial banks. It says: "In order to enable us to review the efficacy of these [early warning/incipient sickness] guidelines, we shall be glad to learn the precise system that has been put in place in your bank for the purpose of monitoring large borrowal accounts (Rs.1 crore and more), particularly in the matter of verification and valuation of stocks held as security, realisability of book debts, and intercorporate investments made by such borrowers." The letter highlights three aspects of detecting incipient sickness. First, that commercial banks do not follow a uniform guideline, if they follow any guideline at all. Second, the RBI does not really know what each bank is precisely doing regarding detection and provisioning. Third, it suggests that neither the banks nor the RBI have a credible, clearly defined, quantifiable data base on incipient sickness.

accounts. Because the QRS excludes all accounts other than the "satisfactory" ones, its coverage is inadequate and does not serve the purpose of identifying sick accounts. Moreover, the inputs to the QRS are supplied largely by the borrowers. Since most borrowers are reluctant to provide correct information in proper time, the QRS is hardly objective, always inadequate, and never up-to-date.

4.2.6 The Non-Performing Assets (NPA) system was recommended by the Narasimham Committee in December 1992, and has been only recently introduced in the banks. To recapitulate, a NPA is defined as an advance where (i) interest on term loans has not been repaid for more than 180 days, or (ii) overdrafts and cash credit accounts remain out of order for over 180 days, or (iii) bills purchased or discounted are not settled for over 180 days. The NPA system has a four-tier asset classification:

Standard: Not a NPA.

Sub-standard: NPA for two years or less. This carries a general provision of 10 per cent of total outstanding loans.

Doubtful: NPA exceeding two years. In such cases, provision for 20 per cent in the first year, 30 per cent for the second and third, and 50 per cent thereafter..

Loss assets: Asset is not collectable. Should be completely written-off.

The provisions of the NPA system are being implemented in stages. For instance, up to March 1993, for the purpose of provisioning, the norm was one year's default instead of 180 days. Since the NPA has been recently introduced, it is yet to stabilize.

4.2.7 At present, then, **the Irregular Statement (IS) is the most commonly used instrument for detecting incipient sickness.** Being a monthly statement, the IS provides the management of commercial banks with six opportunities to examine the health of a borrower within any 180 day period. Moreover, the system of submitting IS by branches is well entrenched, and forms the basis for action taken by commercial banks – *ad hoc* or otherwise. Thus, **reforming the IS is a practical way of addressing early detection.** A drawback of IS as it stands today is that it is a "flash report": it depicts the health of the unit on a single day – the date of the statement. To detect incipient sickness on a regular basis, one needs to convert the characteristic of a "flash report" into a "flow report". It is possible to design such an early warning signal on the basis of information available with the bank. The sequence of events that results in undesirable performance is as follows:

a) Lower sales realization and/or diversion of funds leading to reduced flows routed through the bank. This is a very common occurrence.
b) Dishonouring of bills due to poor quality of products, bad market conditions, wrong selection of buyers, which worsens the problems of fund availability.
c) These result in accounts becoming "irregular": cheques drawn by the borrower start to bounce.

4.2.8 A Committee member has done considerable research in preparing a **Revised Irregular Statement (RIS)** which addresses precisely this issue.[15] In this approach, the existing classification in the first two categories of the HCS ("satisfactory" and "irregular") is replaced by four categories:

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[15] Hanumantha Charya, *Health Code as Sickness Identifier*, mimeo, NCAER, April 1993.

a) Satisfactory	Same as HCS classification number 1.
b) Irregular	Different from HCS classification number 2. It defines accounts overdrawn for 5 to 20 days, or where one to 4 cheques have bounced, or where one to 2 bills or inward cheques have been dishonoured.
c) Suspect	Accounts that are irregular for more than 20 days, or where 5 or more cheques have bounced, or where 3 or more bills or inward cheques have been dishonoured. If a case is "irregular" for more than three months, it automatically becomes "suspect".
d) MIR	Managerial Input Required: Accounts which are classified as "suspect" on three or more occasions during the previous six months.

The proposed system is not only transparent (quantitative norms replace qualitative judgements), but is also very easy to implement. All that it needs is regular up-dating from a bank's cash credit ledger (CCL), with minor revisions in the ledger format.

4.2.9 Note, that there is a great degree of similarity between the RIS outlined above and the NPA system. **Indeed, the RIS is an improvement over the NPA system: the RIS monitors on a monthly basis, while, by definition, the time unit in the NPA is 180 days.** Therefore, it is a better (faster tracking) method of detecting incipient sickness.

4.2.10 As a test case, the RIS was applied to evaluate accounts of nine major branches of public sector banks. The results show that **the existing Irregular Statement (IS) routinely underestimates irregularity to the extent of 19% of total commercial bank lending!** Nearly half of this is of a severe nature, and belongs to the "suspect" category. **In contrast, the underestimation by the RIS system is negligible – around 1% of total lending.**

4.2.11 The comparison between the RIS and the manner in which the RBI implements its Health Code System (HCS) is even more revealing. Given below is the comparison between the RIS and the HCS of the RBI.

Table 4.1 : Comparing the Revised Irregular System (RIS) with RBI's Health Code System (HCS)

	RIS	HCS (RBI)
A. Regular	32.0%	64.0%
B. Irregular	32.0%	17.3%
C. Suspect	8.0%	2.0%
D. Management inputs required	9.0%	N.A
E*. Recognized sick/weak	19.0%	16.7%
TOTAL	100.0%	100.0%

* : Health Code 3-8. N.A: Not applicable

4.2.12 The exercise clearly shows that, **compared to the RIS, that the Health Code System of the RBI seems to overestimate the number of satisfactorily performing accounts. Borrowers appearing as "suspect" under RIS are classified as "satisfactory" by the RBI's HCS.** More importantly, **the RIS classification is quicker in detecting sickness**

(monthly monitoring versus half-yearly review under the HCS), and is more objective. Under the RIS, one can demarcate an irregularity covering 60 to 75 days, or two consecutive "suspects" as a case of incipient sickness (as against 180 days of the NPA classification). **It is also easy to implement. The RIS classification uses only three parameters: duration of irregularity, dishonour of inward cheques and bills, and of outward cheques.** For finer detection, banks can make small changes in their ledger format to take into account other information such as changes in sales and receivables.

> **The RBI should closely examine the Revised Irregular System (RIS) and compare it with its own health code classification. If it is the case that the RIS identifies problems earlier without any great informational cost, the RBI should seriously consider adopting it to monitor incipient sickness.** The RBI argument that the new NPA system has just been introduced, has not "stabilized" and, therefore, one ought not to consider alternatives is meaningful if, and only if, RBI can convince others that the NPA system does a good job of identifying nascent disorder. If it does not, then the argument to remain with it merely because it has been recently introduced will be a poor one.

4.2.13 **A fundamental problem of our scheduled banks and financial institutions is that they do not keep minimal track of the credit-worthiness of the promoters.** It is often the case that a promoter defaults on the repayment dues of one of his companies and, yet, continues to get the benefit of additional credit facilities (as a creditor of good standing) from a different bank, as the promoter of yet another company. This is another reason why there are many sick companies but hardly any sick promoters. Earlier, neither banks nor financial institutions were terribly bothered about this anomaly. **Presently, with the commercial banks having to make heavy provisions as per the Narasimham Committee norms, there is a growing demand to debar defaulting promoters from simultaneously utilizing multiple bank and term lending facilities.**

4.2.14 **In this milieu, there is a strong case to be made for creating a common information base that deals with the credit-worthiness of large borrowers in both their corporate and individual capacities.** This concept is not at all new. At one end of the spectrum, it is a fact of life in the "unorganized" credit markets. At the other end, foreign banks operating in India use such information extensively in evaluating and monitoring projects. Issues around this concept have been already discussed by Indian bankers. In a meeting of the Governor of RBI with the Chief Executives of all scheduled banks and financial institutions on October 28, 1992, the Governor had noted that "in the event of bad behaviour on the part of a group [of promoters], there should be arrangements for exchange of information among banks and institutions ... the Bundesbank in Germany as well as the Federal Reserve of the USA share information with banks in case of defaults of companies beyond a certain level." In other words, there is a groundswell of opinion that defaulting promoters should not have access to cheap credit thanks to inadequate information flows.

In the first instance, all financial institutions should create a common information pool about firms that have defaulted on term lending dues, and list the names of promoters of such firms. In addition, all scheduled commercial banks should prepare a similar list of irregularities in cash credit and working capital repayment for accounts exceeding Rs.10 crores. This list can be ranked according to risk – the frequency and magnitude of defaults – and should be updated every quarter.

This data base, with its promoter risk ratings, should be available to all financial institutions and scheduled banks, and ought to form a basis for making lending decisions and project risk appraisals.

It will be useful to have an independent and reputable credit rating organization like CRISIL to take up this task.

At a later instance, the Government might wish to consider that the credit risk of promoters be clearly stated in the prospectus of every company issuing shares or debt instruments in the market.

4.2.15 Equally, it is important to recognize that defaults are not necessarily malafide in intent. These could also be due to outdated as well as industry-specific (instead of firm-specific) working capital norms. The norms devised by the Tandon and Chore Committees were in a regime of rigid price and quantity controls. Not only was the industry structure per force more stable than what it is now or will ever be, but also there was no attempt to distinguish the credit-worthiness across firms in any industry.

In today's fluid and much more competitive environment, it is necessary to get away from rigid industry-specific norms, and, instead, device more flexible company-specific, technology specific, demand-specific, and product-specific guidelines. As in other cases, it may be too difficult for banks and financial institutions to formulate such proactive guidelines. Therefore, it may be necessary to ask rating agencies to prepare such norms.

Appendix to Chapter 4

A: Examples of Unsatisfactory 18(4) Rehabilitation Schemes

	Returns	Comments
TEXTILES		
Mill A		
Implicit write-off on fresh loans (L)	-17.9%	RL < 0
Implicit write-off on past debts (D)	-14.4%	RD < 0
Return on equity funds (E)	65.2%	RE > 0
Return on promoter's contribution (P)	530.4%	RP > 0
Implicit write-off on L (Rs. lakhs)	-41.59	
Implicit write-off on D (Rs. lakhs)	-50.93	Zone 2 (E)
Implicit write-off on L & D (Rs. lakhs)	-92.52	Zone 2 (P)
Return over E (Rs. lakhs)	67.20	
Return over P (Rs. lakhs)	143.20	
Mill B		
Implicit write-off on L	-4.3%	RL < 0
Implicit write-off on D	-5.2%	RD < 0
Return on E	-75.1%	RE < 0
Return on P	-32.8%	RP < 0
Implicit write-off on L (Rs. lakhs)	-4.61	
Implicit write-off on D (Rs. lakhs)	-2.93	Zone 3 (E)
Implicit write-off on L & D (Rs. lakhs)	-7.54	Zone 3 (P)
Return over E (Rs. lakhs)	-95.42	
Return over P (Rs. lakhs)	-15.42	
Mill C		
Implicit write-off on L	-14.5%	RL < 0
Implicit write-off on D	-9.1%	RD < 0
Return on E	-13.4%	RE < 0
Return on P	605.2%	RP > 0
Implicit write-off on L (Rs. lakhs)	-88.82	
Implicit write-off on D (Rs. lakhs)	-12.17	Zone 3 (E)
Implicit write-off on L & D (Rs. lakhs)	-100.99	Zone 2 (P)
Return over E (Rs. lakhs)	-39.13	
Return over P (Rs. lakhs)	217.87	
Mill D		
Implicit write-off on L	-7.2%	RL < 0
Implicit write-off on D	-1.5%	RD < 0
Return on E	185.9%	RE > 0
Return on P	1901.2%	RP > 0
Implicit write-off on L (Rs. lakhs)	-6.26	
Implicit write-off on D (Rs. lakhs)	-0.81	Zone 2 (E)
Implicit write-off on L & D (Rs. lakhs)	-7.07	Zone 2 (P)
Return over E (Rs. lakhs)	65.06	
Return over P (Rs. lakhs)	95.06	
Mill E		
Implicit write-off on L	-11.0%	RL < 0
Implicit write-off on D	-6.1%	RD < 0
Return on E	18.2%	RE > 0
Return on P	451.4%	RP > 0
Implicit write-off on L (Rs. lakhs)	-22.09	
Implicit write-off on D (Rs. lakhs)	-0.49	Zone 2 (E)
Implicit write-off on L & D (Rs. lakhs)	-22.57	Zone 2 (P)
Return over E (Rs. lakhs)	12.71	
Return over P (Rs. lakhs)	67.71	

	Returns	Comments
Mill F		
Implicit write-off on L	NA	
Implicit write-off on D	2.5%	RD > 0
Return on E	-66.8%	RE < 0
Return on P	NA	
Implicit write-off on L (Rs. lakhs)	NA	
Implicit write-off on D (Rs. lakhs)	6.63	
Implicit write-off on L & D (Rs. lakhs)	6.63	
Return over E (Rs. lakhs)	-96.86	
Return over P (Rs. lakhs)	48.14	
Mill G		
Implicit write-off on L	1.9%	RL > 0
Implicit write-off on D	-6.7%	RD < 0
Return on E	34.8%	RE > 0
Return on P	91.2%	RP > 0
Implicit write-off on L (Rs. lakhs)	11.45	
Implicit write-off on D (Rs. lakhs)	-77.61	Zone 1 (E)
Implicit write-off on L & D (Rs. lakhs)	-66.16	Zone 1 (P)
Return over E (Rs. lakhs)	194.73	Scheme failed
Return over P (Rs. lakhs)	359.73	due to over
		optimistic
		forecasts
Mill H		
Implicit write-off on L	NA	
Implicit write-off on D	0.7%	RD > 0
Return on E	-49.1%	RE < 0
Return on P	3.6%	RP > 0
Implicit write-off on L (Rs. lakhs)	NA	
Implicit write-off on D (Rs. lakhs)	1.58	
Implicit write-off on L & D (Rs. lakhs)	1.58	
Return over E (Rs. lakhs)	-709.73	
Return over P (Rs. lakhs)	-225.73	
Mill I		
Implicit write-off on L	-7.9%	RL < 0
Implicit write-off on D	-14.4%	RD < 0
Return on E	79.8%	RE > 0
Return on P	150.8%	RP > 0
Implicit write-off on L (Rs. lakhs)	-36.91	
Implicit write-off on D (Rs. lakhs)	-66.64	Zone 2 (E)
Implicit write-off on L & D (Rs. lakhs)	-103.55	Zone 2 (P)
Return over E (Rs. lakhs)	84.59	
Return over P (Rs. lakhs)	114.59	
Mill J		
Implicit write-off on L	-5.6%	RL < 0
Implicit write-off on D	-14.4%	RD < 0
Return on E	-38.8%	RE < 0
Return on P	-2.1%	RP < 0
Implicit write-off on L (Rs. lakhs)	-16.18	
Implicit write-off on D (Rs. lakhs)	-24.26	Zone 3 (E)
Implicit write-off on L & D (Rs. lakhs)	-40.45	Zone 3 (P)
Return over E (Rs. lakhs)	-62.11	
Return over P (Rs. lakhs)	-2.11	
Mill K		
Implicit write-off on L	NA	
Implicit write-off on D	-8.4%	RD < 0
Return on E	-34.5%	RE < 0
Return on P	52.2%	RP > 0
Implicit write-off on L (Rs. lakhs)	NA	
Implicit write-off on D (Rs. lakhs)	-59.33	
Implicit write-off on L & D (Rs. lakhs)	-59.33	
Return over E (Rs. lakhs)	-308.13	
Return over P (Rs. lakhs)	200.87	

	Returns	Comments
Mill L		
Implicit write-off on L	-12.8%	RL < 0
Implicit write-off on D	-4.0%	RD < 0
Return on E	49.7%	RE > 0
Return on P	282.1%	RP > 0
Implicit write-off on L (Rs. lakhs)	-51.83	
Implicit write-off on D (Rs. lakhs)	-39.78	Zone 2 (E)
Implicit write-off on L & D (Rs. lakhs)	-91.62	Zone 2 (P)
Return over E (Rs. lakhs)	125.95	
Return over P (Rs. lakhs)	279.95	
Mill M		
Implicit write-off on L	3.2%	RL > 0
Implicit write-off on D	-12.7%	RD < 0
Return on E	-4.1%	RE < 0
Return on P	14.1%	RP > 0
Implicit write-off on L (Rs. lakhs)	1.59	
Implicit write-off on D (Rs. lakhs)	-34.65	Zone 4 (E)
Implicit write-off on L & D (Rs. lakhs)	-33.06	Zone 1 (P)
Return over E (Rs. lakhs)	-5.15	
Return over P (Rs. lakhs)	14.85	
Mill N		
Implicit write-off on L	NA	
Implicit write-off on D	-5.2%	
Return on E	-57.4%	
Return on P	-53.5%	
Implicit write-off on L (Rs. lakhs)	NA	
Implicit write-off on D (Rs. lakhs)	-64.44	
Implicit write-off on L & D (Rs. lakhs)	-64.44	
Return over E (Rs. lakhs)	-1748.71	
Return over P (Rs. lakhs)	-1492.71	
ENGINEERING		
Firm 1		
Implicit write-off on L	NA	
Implicit write-off on D	-24.4%	RD < 0
Return on E	396.8%	RE > 0
Return on P	760.0%	RP > 0
Implicit write-off on L (Rs. lakhs)	NA	
Implicit write-off on D (Rs. lakhs)	-72.54	
Implicit write-off on L & D (Rs. lakhs)	-72.54	
Return over E (Rs. lakhs)	207.44	
Return over P (Rs. lakhs)	229.52	
Firm 2		
Implicit write-off on L	NA	
Implicit write-off on D	-6.5%	RD < 0
Return on E	-64.4%	RE < 0
Return on P	-41.0%	RP < 0
Implicit write-off on L (Rs. lakhs)	NA	
Implicit write-off on D (Rs. lakhs)	-11.63	
Implicit write-off on L & D (Rs. lakhs)	-11.62	
Return over E (Rs. lakhs)	-48.70	
Return over P (Rs. lakhs)	-18.70	
Firm 3		
Implicit write-off on L	NA	
Implicit write-off on D	4.8%	RD > 0
Return on E	-30.0%	RE < 0
Return on P	179.0%	RP > 0
Implicit write-off on L (Rs. lakhs)	NA	
Implicit write-off on D (Rs. lakhs)	6.51	
Implicit write-off on L & D (Rs. lakhs)	6.51	
Return over E (Rs. lakhs)	-15.21	
Return over P (Rs. lakhs)	22.79	

	Returns	Comments
Firm 4		
Implicit write-off on L	NA	
Implicit write-off on D	2.4%	RD > 0
Return on E	-62.9%	RE < 0
Return on P	94.0%	RP > 0
Implicit write-off on L (Rs. lakhs)	NA	
Implicit write-off on D (Rs. lakhs)	42.45	
Implicit write-off on L & D (Rs. lakhs)	42.45	
Return over E (Rs. lakhs)	-538.89	
Return over P (Rs. lakhs)	154.11	
Firm 5		
Implicit write-off on L	-31.0%	RL < 0
Implicit write-off on D	-18.6%	RD < 0
Return on E	15.4%	RE > 0
Return on P	276.0%	RP > 0
Implicit write-off on L (Rs. lakhs)	-9.29	
Implicit write-off on D (Rs. lakhs)	-17.85	Zone 2 (E)
Implicit write-off on L & D (Rs. lakhs)	-27.14	Zone 2 (P)
Return over E (Rs. lakhs)	17.60	
Return over P (Rs. lakhs)	96.60	
Firm 6		
Implicit write-off on L	NA	
Implicit write-off on D	-5.6%	RD < 0
Return on E	-45.0%	RE < 0
Return on P	265.3%	RP > 0
Implicit write-off on L (Rs. lakhs)	NA	
Implicit write-off on D (Rs. lakhs)	-24.61	
Implicit write-off on L & D (Rs. lakhs)	-24.61	
Return over E (Rs. lakhs)	-56.99	
Return over P (Rs. lakhs)	50.67	
Firm 7		
Implicit write-off on L	-12.4%	RL < 0
Implicit write-off on D	-7.0%	RD < 0
Return on E	-61.0%	RE < 0
Return on P	-37.7%	RP < 0
Implicit write-off on L (Rs. lakhs)	-8.08	
Implicit write-off on D (Rs. lakhs)	-3.17	Zone 3 (E)
Implicit write-off on L & D (Rs. lakhs)	-11.25	Zone 3 (P)
Return over E (Rs. lakhs)	-35.90	
Return over P (Rs. lakhs)	-13.87	
Firm 8		
Implicit write-off on L	NA	
Implicit write-off on D	0.9%	RD > 0
Return on E	-43.1%	RE < 0
Return on P	48.8%	RP > 0
Implicit write-off on L (Rs. lakhs)	NA	
Implicit write-off on D (Rs. lakhs)	2.05	
Implicit write-off on L & D (Rs. lakhs)	2.05	
Return over E (Rs. lakhs)	-74.39	
Return over P (Rs. lakhs)	32.22	

B: A Superior Appraisal Scheme

It has been shown in Chapter 4 that many appraisals and sanctions concerning rehabilitation under section 18(4) of SICA were poorly conceived: even in the best case scenario, these would have resulted in the promoters earning rents at the expense of financial institutions. It was also asserted that one can certainly improve upon any 18(4) rehabilitation scheme where

i) the projected return on equity is far greater than the opportunity cost rate of return;
ii) the financial institution's return on fresh loans is at less than opportunity cost; and
iii) the gains in (i) can compensate the loss in (ii).

In such cases, it is possible to construct an alternative restructuring scheme where

i) there are no write-off on new loans;
ii) there is an explicit partial write-off on past debt;
iii) the new loans and the non-written off portion of past debt are evaluated at market rates of interest;
iv) the explicit partial write-off on past debt under the scheme is less than the implicit write-off conferred through interest rate subsidies; and
v) the firm continues to earn a surplus which, when discounted at the opportunity cost of equity funds (risk free return plus risk premium) exactly equals the value of equity.

To prove this, an example is cited below. It relates to a textile mill in Ahmedabad. Note that we are **not** questioning the technical, marketing, commercial, and price/cost assumptions that have been used to build the cash flows over the duration of the project.[16] The base project is the section 18(4) rehabilitation scheme prepared by a financial institution and sanctioned by BIFR.

Explanation: Year 0 is the year in which the project was sanctioned by BIFR. Year 1 is the year to which all future flows are discounted. To err on the side of safety, the flows at the end of the first post-sanction financial year are not discounted.[17] Thus, in the example shown here, given any flow in year t as F_t and a discount rate r_i where i indexes the type of fund (loan or equity), the Year 1 discounting is:

$$\sum_{t=1991=1}^{2000=10} \frac{F_t}{(1+r_i)^t} + F_{1990}.$$

All flows on loans and debts are discounted at 15%. The "surplus" flows are discounted at 20%. Naturally, this exercise can be conducted for any set of discount rates. Of course, the higher the discount rate(s), more of the past debt will have to be written-off.

[16] These have to be routinely questioned. But, here, our focus is different. We wish to prove that, ***given any set of technical, cost, sales, and price assumptions***, it is often possible to construct a "better" restructuring scheme: lower write-offs on term debt can be supported by opportunity cost return on equity funds.

[17] Often schemes are sanctioned in the middle of a financial year. Thus, the first post-sanction flows are often for periods less than a full year. By not discounting the flows of first post-sanction column, we err on the side of safety.

The method is simple. First, use the discount rates to see how much implicit write-off is being given on fresh loans (L), on past debts (D), and on both. Simultaneously, calculate the gain on equity (discounted value of surplus versus value of equity) and promoter's contribution (discounted value of surplus compared to the contribution), Second, evaluate everything without any write-off. In this case, it generates a surplus stream whose present discounted value is less than equity. Therefore, it is not incentive compatible, and the surplus requires to be scaled upward to just cover equity. This will involve a certain write-off on past debts, but none on fresh exposure. Third, compare the new write-off with the old one. If the new write-off is less than the old, then the alternative scheme dominates the base proposal.

Improving on BIFR's rehabilitation schemes – an example

Textile Mill A

Year	0	1	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Old equity	0												
Outstanding debt written off	76												
Promoters contribution	27												
Total equity	103												
Total outstanding debt (D)	354	169.39			31.00	50.00	50.00	50.00	50.00	31.00	31.00	31.00	30.00
Interest on one component of D @ 6%		17.32	4.56	4.56	4.56	3.99	2.85	1.71	0.57				
Interest on another component of D @ 9.39%		116.35	26.10	26.10	25.28	22.38	19.46	16.55	13.64	10.72	7.82	4.91	2.00
Total interest on D		133.68											
Modernization loan (L1)	167	77.60			19.00	19.00	19.00	19.00	19.00	18.00	18.00	18.00	18.00
Rehabilitation loan (L2)	31	14.93			4.00	4.00	4.00	4.00	3.00	3.00	3.00	3.00	3.00
Special loan (L3)	35	10.00							6.00	6.00	6.00	6.00	6.00
Total new term loans (L)	233	102.53											
Interest on L1 @ 11.5%		64.05		19.20	18.11	15.92	13.74	11.55	9.37	7.24	5.17	3.10	1.03
Interest on L2 @ 11.5%		15.00	3.56	3.56	3.33	2.87	2.41	1.95	1.55	1.20	0.86	0.51	0.17
Interest on L3 @ 6%		9.82		2.10	2.10	2.10	2.10	2.10	2.10	2.00	1.63	1.28	0.92
Total interest on L		88.87											
Surplus/deficit		170.20	47.00	32.00	23.00	25.00	28.00	3.00	8.00	54.00	56.00	58.00	58.00
Total of D and int on D	354	303.07	30.66	30.66	60.84	76.37	72.31	68.26	64.21	41.72	38.82	35.91	32.00
Total of L and int on L	233	191.41	3.56	24.86	46.54	43.89	41.25	38.60	41.02	37.44	34.66	31.89	29.12
Total of D and L & interest	587	494.48											

Textile Mill A													
Year	0	1	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Suppose there is no implicit write off													
Total of D and int on D: the discounted surplus must equal the principal.	Scale up 1.17	354.00	35.81	35.81	71.06	89.20	84.46	79.73	75.00	48.73	45.34	41.94	37.38
Total of L and int on L: the discounted surplus must equal the principal.	Scale up 1.22	233.00	4.33	30.26	56.65	53.43	50.21	46.99	49.93	45.58	42.19	38.82	35.45
Total of D + L + interest		587.00	40.15	66.07	127.72	142.63	134.68	126.72	124.93	94.31	87.54	80.76	72.83
New surplus		91.74	41.07	21.45	2.66	2.63	6.88	-16.86	-11.70	38.85	41.94	45.04	46.29
The superior scheme													
Re-scaling surplus so that surplus discounted at 20% is exactly equal to equity. So, equity funds earn their opportunity cost return.	Scale up 1.12	103.00	46.11	24.08	2.99	2.95	7.73	-18.93	-13.14	43.62	47.09	50.56	51.97
Required write-off on past debt (D) without any write-off on new loans (L)		*(A)* 13.07	5.04	2.63	0.33	0.32	0.84	-2.07	-1.44	4.77	5.15	5.52	5.68
Proportion of D that should be written off without any write-off on L	4.0%												
Total write-off (on L and D) as per scheme sanctioned by BIFR *(B)*	92.52												
Effective saving: *B* − *A*	79.45												

Note to the table: In the scheme prepared by the OA and sanctioned by BIFR, the total implicit write-off is Rs.92.52 lakhs (Rs.41.59 lakhs on new loans, L, and Rs.50.93 lakhs on past debts, D). This write-off is due to pumping in and re-scheduling of highly subsidized funds. Thanks to the write-off, the equity of the firm earns Rs.67.2 lakhs over its opportunity cost; alternatively, the promoter earns Rs.143.2 lakhs over his minor contribution of Rs.27 lakhs. Thus, public funds are effectively donated to the promoter as huge rents above opportunity costs. The alternative scheme aims to construct an **explicit** write-off on **only** past debt (D), such that the net present value of the surplus (free funds) to the company whose net present value at its opportunity cost of 20 per cent discount exactly covers equity. This write-off is only Rs.13.07 lakhs on D, and none on fresh exposure. The firm covers its opportunity cost of equity, and the financial institutions save Rs.79.45 lakhs. Hence, it dominates the sanctioned scheme.

5 : Barriers to Restructuring
Land, Labour, Law, and Management

5.0.1 There are many good reasons for a profitable and financially sound firm to opt for corporate restructuring. From a social point of view, the need for restructuring is far greater for ailing firms. These companies have certain common features: current liabilities exceed current assets, the debt burden is very high compared to future income, poor management, inefficiencies in labour use, workers not being paid their statutory dues, and an excess of unproductive but saleable fixed assets. Without proper reorganization (either reorganization or winding up), these firms bleed the economy, and also deprive workers of their dues.

5.0.2 **The wide-ranging provisions of SICA allows BIFR to approve almost any type of industrial restructuring it sees fit**: rehabilitation, change in management and board of directors, mergers and amalgamation, sale or lease of whole or part of the company, altering the debt and equity structure, reducing rights of existing shareholders, reorganizing the firm as a workers' cooperative, selling of shares of sick company to another industrial company, and so on. **Furthermore, section 32(1) of SICA clearly states that it overrides all law other than the Foreign Exchange Regulation Act of 1973 (FERA), and the Urban Land (Ceiling and Regulation) Act of 1976 (ULCRA).**[1]

5.0.3 Despite such overarching powers of SICA, a combination of many factors – consensus seeking, veto powers of parties, slow BIFR procedures, the failure to use the threat of winding up, poor appraisal, and bad project assumptions – have made it difficult for BIFR to recommend even the simplest forms of restructuring, and ensure its subsequent implementation. This chapter follows up on the recommendations made in the Chapters 3 and 4. It identifies other major barriers to industrial and corporate restructuring, and suggests short and medium term remedial measures. Section 5.1 begin with an orientation: the primary feature of any barrier to restructuring. The subsequent sections are arranged according to themes: management (5.2), land (5.3), labour (5.4), taxation, mergers, promoter's contribution, and restructuring of debt to equity (5.5), and corporate law and problems in winding up of completely unviable companies (5.6).

5.1 What are barriers to restructuring?

5.1.1 A little reflection suggests that **barriers to industrial and corporate restructuring encourage firms to pay the factors – labour, financial institutions, and banks – less than their due share, and remain unpunished for doing so.** A sick firm invariably

[1] To quote section 32(1): "The provisions of this Act and of any rules or schemes made thereunder shall have effect notwithstanding anything inconsistent contained in any other law except the provisions of the Foreign Exchange Regulation Act, 1973 (46 of 1973) and the Urban Land (ceiling and Regulation) Act, 1976 (33 of 1976)". In reality, the Central Board of Direct Taxes (CBDT) has already challenged this by notifying that the Income Tax Act will have overriding effect over any order passed by BIFR under section 17(2) of SICA. This will be discussed later in the chapter.

reneges on paying long term secured creditors, and defaults on provident fund and other labour contributions.

5.1.2 If a firm is operationally viable, then a properly designed financial, management, and asset restructuring package can allow it to reorganize, and, hence, make factor payments in the future. In such instances, barriers to restructuring worsen the existing problems, and so ensure non-payment to labour and creditors.

5.1.3 Economically unviable firms – where variable costs exceed sales – also default on loan repayment, wage payments, and employees' dues. Such firms requires radical surgery: winding up, and sale of assets at the highest possible price, to obtain the maximum terminal payment to secured creditors and involuntarily unemployed workers. Here, barriers to restructuring prevent labour from getting the benefits of a price that can secure terminal benefits that are as close as possible to the net present value of forfeited wages.

Irrespective of ideology, industrial and corporate restructuring has to be thought as methods that maximize future payments to labour and to secured creditors. Conversely, barriers to restructuring help inefficient capitalists maintain their stranglehold over the assets of a company, and encourage them to renege on their obligations to banks, financial institutions, the government, and the workers. Well meaning, employment and industry protecting barriers always have perverse effects: these neither protect labour payments in the long run, nor prevent asset stripping, arbitrage seeking, and debt defaults in the short.

5.2 Change in management or directorship

5.2.1 This section relates to firms that are financially sick but operationally viable. In many cases, after repeated repayment defaults, banks and institutions lose confidence in the existing management, and demand management change as a precondition for corporate reorganization. BIFR itself has recognized the role of poor management. Describing the sorry state of the composite textile mills, BIFR states that

> The blame for this state of affairs [sickness] has rested in no small measure on the management which was family-type non-professional, and even operating at times as absentee management. The management structures continued to be weak ... The perceptions of management were static in regard to technology, products, markets and changing labour management relationship. In short, management attitudes were complacent and were not equipped to cope with the changing demands of the industrial scene. (BIFR, *Industrial Sickness – Case Studies*, *vol. I(2), Textiles*, p.1.)

5.2.2 Over and above unintended omissions and neglect, there are instances of wilful acts of asset stripping, strategic debt defaults, and non-payment of statutory dues. Since these are very difficult to prove in courts, the creditors ask BIFR to implement a change in management due to "loss of faith" – a portmanteau term that covers all.

5.2.3 **It is very difficult, if not impossible, for secured creditors to force a real change in management — more so when existing management thinks otherwise.** Consider pre-SICA cases, where secured creditors want a change in the management of ailing companies whose net worth is not yet negative. **Courts repeatedly take the view that debt default is no ground for creditors demanding a change in management.**[2]

5.2.4 The Companies Act of 1956 and the amended Companies Bill of 1993 (tabled in Parliament in May 1993) outline when and why a chairman, director, whole time executive director, or a manager of a company can be disqualified, removed or replaced.[3] Removal can be sought if a person (a) is an undischarged insolvent; (b) has been convicted of moral turpitude; (c) is of unsound mind; (d) has not paid any call regarding shares of the company held by him; (e) has failed to disclose information or interest in any contract or transaction made by him on behalf of the company; (f) has suspended payment to creditors of the company (relates to managing and whole time executive directors); and (g) is fraudulent in commercial dealings — malfeasance, misfeasance, "non-feasance" (section 24 of SICA), or breach of trust.

5.2.5 Cases of "undischarged insolvency", "moral turpitude" and "unsound mind" are rare. Since "proper" information disclosure depends upon the majority view of the board, it is very difficult for a third party such as a bank or financial institution to effect a directorial change through (e). Creditors cannot ask for removal of director(s) under (d), for this has no bearing upon the dealings between the firm and its lenders. So, removing management hinges upon either defaulting on loans (f), or proven fraud (g).

5.2.6 Non-payment to creditors is easy to prove, and there have been attempts to invoke section 267-ECA (section 291-PCB) to remove whole time executive directors, particularly managing directors of defaulting companies. However, courts take the view that since the liability of a joint-stock company is limited, corporate defaults made under the tenure of any managing director do not come under this section. It only covers defaults of such people on their personal account. Besides, a lender cannot dictate the replacement. It is a simple matter for firms — particularly family dominated companies — to go through the motions of a *de jure* change, while *de facto* control remains in the same hands.

5.2.7 Fraud, malfeasance, misfeasance, and breach of trust are fuzzy concepts, and virtually impossible to prove. In any case, since the BIFR is a quasi-judicial body, the affected

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[2] According to courts, banks or financial institutions are lenders to, not owners of, a firm. Hence, default requires filing for recovery, not appealing for change of management. Without proof of malfeasance, misfeasance, or deliberate intent, courts rarely ever rule in favour of changing management, particularly when this moved by secured creditors.

[3] With the introduction of the new bill, there has been a great deal of confusion in quoting sections, as the numbers in the existing act do not correspond to those in the proposed bill. To avoid this, we shall use ECA to identify section numbers of the existing Companies Act of 1956, and PCB for the proposed Companies Bill of 1993.

director can always challenge this in court. This ensures the case dragging on interminably through repeated stay orders.[4]

5.2.8 There is yet another way in which the Companies Act itself gives enormous scope for inefficient promoters to resist changes in management and the board: **oppression of minority by majority under sections 397 and 398 of ECA (sections 403 and 404 of PCB).** When financial institutions, as large shareholders, try to force a change in management upon an unwilling promoter, the promoter invariably gets a "small" shareholder to file a stay-petition at the Company Law Board (CLB) under oppression of minority by majority.[5] Usually the CLB grants stays that are long enough for profitable asset stripping.

5.2.9 BIFR can recommend change in management of a SICA company (since SICA overrides The Companies Act). However, BIFR's quasi-judicial nature ensures that it can only recommend, not order. Besides, nothing can prevent anyone – including a *mala fide* promoter or his agent – to file a writ petition under Article 226 of the Constitution to stay the BIFR proceeding, on the ground that management changes infringe upon his legal rights. The standard court procedure is to first grant the stay, and then examine the case at leisure.

5.2.10 Thus, the law and its implementation work against the simplest type of corporate restructuring – changing the management or directors of a sick industrial company. This flows from an asymmetric relationship where a sick company's powers to legally resist changes demanded by creditors exceed those of the banks or financial institutions.

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[4] There have been instances where BIFR has taken decisions that are inimical to changing management of sick firms. In one case, when the lead financial institution wanted a change in management because of "loss of confidence" in the promoter, BIFR wanted it to furnish *documentary evidence* to support the claim – despite BIFR itself having initiated misfeasance proceedings against the same promoter four years earlier under section 24 of SICA!

[5] This allows a group of 100 shareholders or one representing a tenth of the share capital, whichever is less, to complain to the Company Law Board that a company's affairs are being conducted in a manner oppressive to any member or members: that the majority has effected material changes in the management or control of the company which is likely to be prejudicial to public interest, the company, and the shareholders.

The Companies Act should be amended so that secured creditors can implement *de facto* changes in management and/or the Board of Directors in instances of repeated debt defaults. As they stand, sections 267-ECA and 291-PCB are not good enough.

Unfortunately, the PCB has not addressed this problem. It should consider putting in an amendment or inserting a separate section that strengthens the hands of secured creditors. There must be a clause that when a company defaults on repayments to secured creditors in excess of 180 days, the creditors may (either singly, or jointly):

a) secure a change in management, which can include the entire board of the company,

b) appoint a person of their choice as executive or managing director, or chief executive, and

c) unless (a) and (b) are executed within a given time frame, stop giving any further funds, including working capital, attach properties and assets, or attach equity shares in lieu of default.

Such a provision should be incorporated in every section of the PCB that specifies removal of directors, managing directors, or managers.

The penal provisions for non-compliance under sections 33 and 34 of SICA should be implemented by BIFR. Deviating from any of BIFR's directives can be penalized by simple imprisonment of three years and an unspecified open-ended fine. The Board has never invoked such penalties. To signal its intent in preventing systematic defaults, BIFR should occasionally implement these penalties, and publicize them.

5.3 Sale of surplus land

5.3.1 Often, cash strapped but operationally viable companies own considerable vacant land within the factory premises. This is true for all composite textile mills located in Bombay, Ahmedabad, Kanpur, and Calcutta; all jute mills located in or around Calcutta, and most of the engineering and fabricating companies that were established in the 1950s or earlier.

5.3.2 **Since such lands are unutilized by these firms, and command high prices for alternative commercial use in urban areas, their sale can generate substantial additional funds for repaying whole or part of outstanding debts and also for meeting the costs of rationalizing the labour force. Land sale is the most profitable and economically meaningful way of generating internal resources for (i) reorganizing viable companies or (ii) getting the best value for unviable firms.**

5.3.3 A few examples suffice to prove the point. The are many others.

a) A group of 15 textile mills in Ahmedabad are closed since the mid-1980s. These mills together own approximately 85 hectares of re-usable property, some in exclusively industrial, and others in commercial-cum-residential areas. Some 28,600 workers are affected by the closure of these textile mills, and have not yet been paid their dues, which amounts to Rs.86.7 crores, or Rs.30,300 per worker.[6] The total outstanding liabilities of these 15 units were Rs.155.2 crores. After detailed examination, it has been found that with (i) proper fragmentation of plots to allow for more promoters and developers and (ii) appropriate allocation between industrial and commercial uses, land sales alone could fetch Rs.84 crores. Ignoring the sale of other assets, a proportional distribution of these proceeds between the first claimants — workers and secured creditors — would go a long way in paying the workers' dues. Moreover, property sales and industrial redevelopment can create additional employment. It was estimated that sale would eventually create a demand for 40,000 jobs.

b) India United Mill, a sick, nationalized textile mill under the Maharashtra North subsidiary of the National Textile Corporation (NTC), has a finishing unit that cover 6 to 7 acres of prime, upper class residential area of Bombay island. The finishing unit is totally inoperative: no cloth is processed or finished there. The current market value of the land is approximately Rs.55 to Rs.60 crores. This can (i) can not only secure a generous voluntary retirement scheme for the "displaced" workers, but (ii) also pump in fresh finance to NTC — to modernize its spinning without budgetary support from the government.

5.3.4 **Unfortunately, very few land sales have taken place, thanks to two major barriers: the Urban Land (Ceiling and Regulation) Act of 1976 (ULCRA), and local municipal and state-level deterrents. The first problem is that SICA cannot override ULCRA. The second is that the states which have the greatest incidence of industrial sickness — Gujarat, Maharashtra, Uttar Pradesh, and West Bengal — have all accepted, and implemented ULCRA.**

5.3.5 According to ULCRA, there is no legal distinction between "persons", "individuals", and "companies". Section 3 of ULCRA bans persons (or companies) from holding any vacant land in excess of the ceiling limit. The ceiling limit varies according to categories of urban area. For category A (which covers Greater Bombay, Calcutta Urban Area, and Delhi Urban Area), the ceiling is 500 square metres. For category B (in which fall Ahmedabad, Kanpur, and Bangalore), this is 1,000 square metres. For C and D these are 1,500 and 2,000 square metres respectively. Virtually all textile mills have vacant landholding that is substantially greater than any of these limits.

5.3.6 Section 6 of ULCRA states that firms holding excess vacant land have to file a detailed statement to the appropriate state authority within a specified time period. On this basis, the state authority must prepare a final land statement, which states the exact amount, specification, location, and lay of the vacant land. This is the document which forms the basis for the government's notifying the firm of its intent to purchase excess vacant land.

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[6] The data are from Barjor E. Mehta, *Urban rejuvenation through property development: Re-using land of textile mills under liquidation in Ahmedabad City*, Centre for Environmental Planning and Technology, Ahmedabad.

5.3.7 Section 11 states the price for acquiring such land. If the land was income earning (which is rarely the case), the government has to pay 8.33 times the average income realized in the last five years. Otherwise, it can acquire the property by paying Rs.10 per square metre in urban categories A and B, and Rs.5 per square metre in C and D! The payment schedule is tantamount to state expropriation: Rs.25,000 or 25% whichever is less in the first year after sale, and the balance in 5% state government bonds redeemable after 20 years!

5.3.8 Here lies the first problem: conflicting views about who should get the first cut of the proceeds of land sale. The state governments argue that (i) the land was sold at low prices to the firms for industrial purposes, (ii) the firms have failed in their objective of producing industrial output and providing gainful employment, and often failed in paying workers their statutory dues. Hence, shareholders of such firms have no rights to any benefits from the capital gains of land sales. The first cut should go to the state. In rare instances where state governments allow sale of surplus land, it is acquired and then auctioned off by the government, and part of the proceeds is loaned to the company for rehabilitation.

5.3.9 Companies believe otherwise. The land is usually their freehold asset whose market value can be realized to reduce current and long term liabilities, to pay for labour rationalization, and even to generate some surplus. The enormous differential between the market and the government's offer price for urban land heightens this conflict. Thus, a prisoner's dilemma: companies rarely voluntarily disclose the amount of excess land under section 6 of ULCRA. Without a firm filing a return, there is no basis for determining the amount of vacant land. It continues to remain unutilized, with no claimant getting any benefit of its market value.

5.3.10 There is a more serious problem. Section 20 of ULCRA outlines the powers of exemption. If the state government is convinced that the excess land is being used, or is proposed to be used in a manner useful to public interest, or if its purchase causes "undue hardship" to the firm, then it can exempt such land from government acquisition. In theory, therefore, if a company can prove that the commercial sale of such land is necessary for running the unit and paying workers and creditors their dues, then the state government can consider an exemption.

5.3.11 Except in Gujarat — and that, too, only in recent times — such exemptions are rarely given. Political considerations, especially the fear of being labelled as "pro-industrialist", play a major role in refusing waivers under section 20, even when these are recommended by the BIFR. For instance, in West Bengal, not a single section 20 application has been cleared by the state government since 1976. West Bengal is only an extreme case of an all-India implementation problem. Recently, some of the ULCRA states (again, Gujarat is the notable leader) have agreed to section 20 dispensations for rehabilitation purposes, particularly if a scheme is sanctioned by BIFR. While this is a step in the right direction, implementation in the problem states has been tardy. In West Bengal, this decision was taken 9 months earlier. As yet, no case has been implemented.

5.3.12 Other barriers to re-development and sale of surplus land of sick units are enshrined in local, municipal level restrictions. These regulate the type of sales and end-uses of land within urban limits. Some of the regulations are well meaning and are intended to limit pollution, maintain positive externalities of zoning, deter excessive construction activity, and prevent traffic and infrastructural congestion. However, often such regulations impose excessively restrictive conditions: after meeting these, there is very little "free" land left to be sold at commercial rates.

5.3.13 Consider Bombay, where there are several sick, operationally unviable textile mills located on prime urban land on Bombay Island. Although the conditions imposed by the Development Control Regulations (DCR) of the Maharashtra State Government (February 1991) are improvements over the earlier DCR, these continue to rule out meaningful commercial sale of land. The new DCR defines a higher floor space index (FSI -- roughly the ratio of allowable built-up area to open area). However, it specifies how the land has to be physically allocated. According to section 58 of the new DCR, the land of sick and/or closed textile mills in Bombay can be developed and sold (given ULCRA permission) provided the open and post-demolition land is redeveloped as follows: approximately a third for playground, parks, or other open use; another third for low cost urban housing to be developed by the state's public sector housing corporation; and the final third for residential and commercial use, to be developed and sold by the firm or its developer at commercial rates.

5.3.14 It is certainly very important to earmark a third of the land is earmarked for low cost housing for deprived sections of society. However, if this is in the *same physical location* where another third is being developed at commercial rates, then there will very few buyers of the high priced commercial/residential property, and the prices will crash. Simultaneously creating affordable housing for the underprivileged, and getting the maximum value for the development rights requires physical dissociation of one from the other.

If a part of the surplus land of any factory is earmarked for low income housing,

a) this tradeable right should be allowed to be allocated elsewhere on a proportional basis, or

b) the market value of this right should be handed over to a specific low cost housing fund administered by the state government.

To explain: In the case of (a), suppose the area allocated for low income housing is one acre. In the original zone, the market price of an acre of development rights is, say, Rs.10 crores. If this is shifted to an area where the price is Rs.5 crores per acre, then the builder, developer, or the firm that sold the land right must buy two acres of land for low income housing. It is not necessary for the firm that is developing the excess land for high income residential/commercial property to build the low income flats. Typically, low income houses require one kind of expertise, and high income another. Instead, the proportional right can be given to reputable corporations that specialize in low cost housing. Option (b) is simpler: transfer the market value of the land earmarked for low income housing to a low income housing fund of the government.

5.3.15 The extent of redevelopment and private sale of land permitted under the DCRs in Maharashtra, Gujarat, Uttar Pradesh and West Bengal continue to be governed by a state's interpretation of ULCRA, and its use of section 20. **In this respect, Gujarat has taken the lead. It has circulated a notification which (i) allows firms under rehabilitation or perma-**

nent closure to ask for section 20 exemptions, and (ii) instructs the appropriate government agency to normally grant these exemptions. However, the other three problem states have shown remarkable reticence in realizing the latent value of land. ULCRA exemptions are rare in Maharashtra, and are unheard of in Uttar Pradesh and West Bengal.

5.3.16 There is yet another problem with ULCRA. Rehabilitation schemes have been sanctioned by BIFR assuming land sales. The expected sale value is often factored in as a "source of funds". When the land sales fail to materialize (because of the state government's not giving permission under ULCRA), the promoters claim that the scheme has failed, and immediately start defaulting on repayments.

The Central Government should take the lead by asking the Union Territories to grant exemption under sections 20 and 21 of ULCRA, particularly for BIFR schemes.

The Central Government should try to convene a conference of the ULCRA states, and attempt to persuade these states of the need to amend sections 20 and 21 to incorporate an additional clause: exemption will be given when land sale is recommended by the BIFR, subject to regional master plans. This is a must for the industrial states. ULCRA is based on section 252 of the Constitution,which gives the Parliament the power to legislate for two or more states, given their consent. Therefore, the Union Government should convince at least the minimum number of states needed to amend ULCRA of the need to amend this serious barrier to industrial restructuring.

Given the problem of land sale in the ULCRA states, the OAs as well as BIFR should not factor in uncertain sale proceeds in estimating either the "means of finance" or the "sources of funds" in the projected cash flows of a 18(4) rehabilitation proposal.

When land sales come into being, there will be a tremendous need for financial intermediation. Sellers will need up-front payments to finance voluntary retirement schemes (VRS), modernization, and finance repayment dues, while buyers will realize the value at a much later date. This needs involvement of banks and financial institutions who have commercial sense, ample funds, credibility, and expertise in housing finance. **The government must involve the Housing Development Finance Corporation (HDFC) and other reputable financial intermediaries in formulating a specific, clearly sequenced, commercially viable plans for urban redevelopment through sale of excess land.**

Corporate reorganization via land sales needs a success story – either in Bombay, or in Ahmedabad, or both. In the former, the prices are better, but the state government is as yet unprepared to give permission. In the latter, the prices are lower, while the state government is quite willing to aid the process.

5.4 Restructuring the labour force

5.4.1 Except in some states, there is hardly any evidence of labour force presenting insuperable hurdles to *private sector* restructuring.[7] **Nevertheless, there is a major barrier to restructuring the workforce, which is entirely due to prevailing practices among state governments.** Given below are two relevant sections of the Industrial Disputes Act (IDA), 1947.

> **Industrial Disputes Act**
>
> **Section 25(N)**
>
> No workman employed in any industrial establishment to which Chapter VB applies, and who has been in continuous service for at least one year (interpreted as 240 days) in that establishment can be retrenched without (a) being given three months' notice in writing indicating reasons for retrenchment; and (b) the period of the notice having expired; and (c) prior permission being sought from the appropriate government agency in a prescribed manner, clearly stating reasons for retrenchment, a copy of which has to be sent to the workman. Further, "an order of the appropriate Government or the specified authority granting, or refusing to grant permission, shall ... be final and binding on all parties concerned, and shall remain in force for one year from the date of such order" [section 25N(5)]. If permission for retrenchment is granted, then the workman will be entitled to receive, at time of retrenchment, compensation equivalent to 15 days' average pay for every completed year of continuous service.
>
> **Section 25(O)**
>
> This outlines the procedure for permanently closing down an industrial undertaking. An employer who intends to close down such an undertaking (a) must apply to the appropriate government authority in the prescribed manner at least 90 days before intended date of closure; and (b) must clearly state reasons for the closure; and (c) simultaneously serve a copy of this to the representatives of the workmen. Similar to section 25(N), "an order of the appropriate Government or the specified authority granting, or refusing to grant permission, shall ... be final and binding on all parties concerned, and shall remain in force for one year from the date of such order" [section 25O(4)]. If permission for retrenchment is granted, then the workmen will be entitled to receive, at time of retrenchment, compensation equivalent to 15 days' average pay for every completed year of continuous service.
>
> NB: 1) Workman means any person employed in any industry for hire or reward who is not (i) subject to the Air Force Act, 1950, the Army Act, 1950, or the Navy Act, 1957; or (ii) employed in the police or in prisons; or (iii) employed mainly in a managerial or administrative capacity; or (iv) drawing wages exceeding Rs.1600 per month [section 2(s) of the IDA].
>
> 2) "Retrenchment" is termination by the employer of the services of a workman for any reason whatsoever, other than as a punishment inflicted as disciplinary action, but excludes (i) voluntary retirement; (ii) retirement at superannuation; (ii) termination of service because of non-renewal or expiry of a time-bound contract; or (iv) termination on ground of continued ill health. Chapter VB of the IDA outlines special provisions and procedures that have to be followed during lay-off, retrenchment, and (permanent) closure of an industrial unit [section 2(oo)].

5.4.2 The problem is that state governments – the "appropriate Government" of the IDA – have consistently refused to grant permission either under 25(N) or 25(O). This

[7] Usually, workers in the private sector agree to real sacrifices: (i) voluntary agreements to rationalization and retrenchment of surplus staff; (ii) phasing out of what is often a meagre retrenchment compensation; (iii) wage freeze; (iv) bans on fresh demands during a given period; and (v) agreeing to relocation, redefinition of work, and increasing productivity and working hours. Unlike promoters, state governments, banks, and even the institutions, in most of 17(2) and 18(4) cases, labour generally agrees and adheres to the terms of the sanctioned schemes.

unfortunate reality has been recognized by the *Report of the Inter-Ministerial Working Group on Industrial Restructuring (J.L. Bajaj Committee)*, March 1992. A section of the report is worth quoting.

> It is a matter of common knowledge that the State Governments or even the Central Government are reluctant to allow retrenchment or closure of industrial undertakings ... The ground reality is, however, very different, for a terminally sick unit cannot continue to produce [profitably] or pay its labour. As a consequence, the unit remains in a state of suspended animation for years, though on paper it may be shown to have been locked out ... the workers are deprived of their current wages and do not also have any possibility of receiving their terminal benefits (p.90, para 9.5)

5.4.3 As a consequence, several thousands of textile workers in the cities of Bombay and Ahmedabad have been deprived of their terminal benefits and arrears of pay in the last five years, when mills have declared lock-outs to escape the barriers imposed on retrenchment and closures. Most of these workers have been reduced to the level of lumpen proletariat, eking out a meagre existence as peddlers and vegetable sellers.[8]

5.4.4 In this regard, the recommendations of the *Bajaj Committee* are very sensible, and seek to protect the real rights of the workers. However, these are consistently vetoed by representatives of organized, politically affiliated trade union, who are willing to turn a Nelson's eye to *de facto* unemployment and consequent lumpenization, but always prevent measures that recognize involuntarily unemployment, and give such workers their fair dues.

5.4.5 **One seriously needs to ask why should there be any need for prior state government approval.** India has enough labour laws (including provisions in the IDA) and court judgements that prevent any employer from victimizing unionized workers, or from unjustly or illegally laying-off or retrenching labour. In such an environment, it is almost impossible for an honest entrepreneur to unfairly retrench workers. Therefore, it is quite unnecessary to have yet another sanctioning authority – namely, the state Labour Commissioners under sections 25(N) and 25(O) of the IDA. Equally, it is well known that dishonest entrepreneurs with political connections can easily circumvent sections 25(N) and 25(O) by declaring an indefinite lock-out and, so, force labourers to quit. In such cases, these two sections are effectively irrelevant. So, **in the "best-case scenario", sections 25(N) and 25(O) are redundant; and in the "worst-case-scenario", these are irrelevant. Hence, it makes sense to eliminate them altogether.**

[8] For instance, the illegally laid-off workers in textile mills cannot even get the benefits of the Textile Workers' Rehabilitation Fund. Only workers retrenched from "closed" mills (i.e. those which obtained section 25(O) approval) can get retrenchment benefits from the fund.

The government must try to amend sections 25(N) and 25(O) of IDA such that there should be no need for applying to the appropriate government.

In theory, any retrenchment or labour rationalization recommended by BIFR under a sanctioned scheme overrides the provisions of 25(N) and 25(O) of the IDA. However, this needs to be clearly notified and publicized, since Labour Commissioners of many state governments seem to be unaware of it.

Furthermore, the government should amend the compensation for retrenchment and closure from 15 days' wages to one months' wages per year of completed service. Fifteen days' wages is a niggardly amount. If the government wants workers to agree to being laid-off, it must make the minimum payoff more attractive.

Chapter VB of the Industrial Disputes Act, which governs lay-off, retrenchment, and closure, applies to undertaking having 100 or more workers. This should be raised to 300 or more.

5.5 Converting debt to equity, mergers, and taxation

5.5.1 In Chapter 4, a case has been made for devising financial restructuring packages that reduce the debt-equity ratio of operationally viable firms. Specifically, commercially viable but financially leveraged companies should be reorganized in a way that reduces future debt burdens. It was suggested that this can be done by

a) evaluating rehabilitation schemes at proper opportunity costs,
b) having no implicit write-off on new loans through interest rate subsidies,
c) considering, if necessary, partial explicit write-offs only on past debts, not on new loans, and
d) converting this written-off amount to equity held by the financial institution or bank.

It was also stated that the debt-equity conversion route dominates a straight write-off: if the firm turns around, the secured creditors hold good equity; if it does not, conversion is no worse than a write-off.

5.5.2 Section 18(2.d) of SICA allows alteration of the capital structure; section 18(2.f) allows reduction of the interest or rights of shareholders in the sick firm; and section 18(2.l) allows transfer of issue of shares in the sick company at face value or at discount to any industrial company or person(s).

5.5.3 Methods of reducing debt-equity ratio can be divided into two groups:

i) where banks and institutions write-off some of the debt (through sacrifices), provided the promoter comes in with fresh equity; and
ii) where the institutions invoke the conversion clause in the loan documents, i.e. in addition to the promoter's contribution, the financial institutions directly swap some debt for equity shares, which they then retain or later sell to outside shareholders.

Both reduce the debt-equity ratio. The second inflicts an additional penalty on the existing promoter for previous defaults.

5.5.4 The first method has quite popular in BIFR. In fact, BIFR has steadily increased the requirement for promoter's contribution from the paltry proportions laid down by the RBI. Before permitting any rescheduling of old loans, funding of interest, and fresh project financing, BIFR insists upon the promoter coming in with either unsecured loans, or equity, or zero-rated non-repayable debentures that convert to equity of a specified date.

5.5.5 There are three problems with this approach. First, it does not penalize existing promoters for having repeatedly defaulted in the first place. Quite often, the stock of accumulated debt to the institutions and banks reflects the promoter's managerial and entrepreneurial inabilities. Second, the promoter's contribution often does not materialize, especially in the case of questionable promoters. These promoters agree to the contribution only to buy time for asset stripping. Third, the apparent "penalty" inflicted by insisting on higher promoters' contribution is nullified by simultaneously bequeathing interest rate subsidies. Indeed, the arbitrage opportunities via interest subsidies invariably exceed the cost of greater promoters' funds.

5.5.6 Until quite recently, RBI disallowed converting past term loan dues of a sick industrial company. In January 1992, the RBI issued a notice that permitted financial institutions and banks to convert funded interest and/or term debt to equity.[9] The new RBI notice signals an important change in the central bank's views of financial restructuring. After years of insisting on sacrifices, the RBI has recognized that operationally viable firms can be restructured without necessarily opting for concessional loans and implicit write-offs.

5.5.7 Despite these instruments and RBI's approval, there have been very few instances where institutions have insisted upon debt-equity conversion. There are several reasons for this. First, there is the problem of inertia in the financial institutions: it requires a mental change to switch from "pumping in more so-called developmental funds" to restructuring via debt-equity conversion. Second, converting unpaid interest to equity immediately raises the tax burden of the banks or institutions. Unpaid interest is not taxable, but its capitalized equity equivalent is an investment of a bank/institution: hence, its notional income is taxable. One can get around this by converting part of the unpaid principal, instead of the unpaid interest. However, there is a second tax problem. Income tax authorities usually do not allow the equity so converted to be written down in the first few years. Thus, banks and

[9] RBI, letter number IECD.No.45/IRD/IA-A/91-92, dated January 2, 1992. The gist of it is as follows: (a) although conversion is normally of funded interest and/or term debt, it can be extended to all term liabilities; (b) the conversion can be either as equity or as quasi-equity, such as zero-based debentures, cumulative convertible preference shares, etc; (c) the company should turn-around and have continuous net profits within three to five years of the conversion; (d) after conversion, the gross cash flow of the sick firm should be at least 1.5 times the repayment installments, and provide for at least 12% return on equity from the seventh or eighth year of the rehabilitation package; (e) converting debt to should only be for companies listed in the Stock Exchange; and (f) after conversion, banks cannot hold more than 30% of the paid-up capital of the company, or more than 30% of its own paid-up capital and reserves, whichever is less, under section 19(2) of the Banking Regulation Act, 1949.

financial institutions not only fail to reap any tax breaks from the conversion, but also lose first charge on repayment of dues by virtue of converting a loan to equity.

For a financial institution, the best way to reduce the debt burden of the company is to:

a) **insist on fresh equity contribution from the promoter;**

b) **convert a proportion of past dues to equity, which is then held by the financial institution, or sold to third parties – this lowers the debt burden and also reduces the control of the promoter and his share of future profits of the company; and**

c) **evaluate the residual exposure at market rates of interest.**

This can be done in three simple steps.

1. **Calculate the entire exposure (old debt plus new proposed loans) at market rates.**
2. **Estimate the write-off that needs to be given on past debt such that the firm earns a return on equity exactly equal to its opportunity cost, while the remaining exposure earns a return at its market price.**
3. **Evaluate the market price of shares of the company, and convert the write-off into purchase of an equivalent number of existing shares.**

To prevent promoters from reneging on their contribution, no rehabilitation scheme should be sanctioned without such funds being placed in escrow accounts. It is said that promoters do not have requisite funds to pay up in one instalment. This is a specious argument. If the project is truly viable, and the promoter a person of integrity, then someone will always certainly agree to loan the funds.

The Central Board of Direct Taxes (CBDT) should remove all tax hurdles that prevent banks and financial institutions (custodians of public funds) from converting debt to equity of sick companies, particularly when this is recommended by the BIFR.

5.5.8 It is apparent the world over that mergers and acquisitions is the dominant route of industrial and corporate restructuring. There are scale economies, marketing and organizational synergies in mergers, and these will be exploited more and more. India can be no exception. **In fact, the successes of BIFR have been the merger cases under section 17(2), and not those sanctioned under section 18(4) rehabilitation.**

5.5.9 For some peculiar reason, the CBDT has ruled that the provisions of SICA that override the Income-Tax Act of 1961 are limited only to schemes sanctioned under 18(4) of SICA, and not to 17(2) proposals: "orders passed by BIFR under section 17(2) will not have the effect of overriding the provisions of the Income Tax Act" (Ministry of Finance, CBDT, circular no.523 of October 10, 1988). Consequently, merger scheme that are endogenously designed under section 17(2) by the companies with their investment bankers, without any additional funding, get no benefits from sections 41(1), 72A, 79, and 115J of the Income Tax Act.[10]

5.5.10 Either mergers are important, or they are not. **They cannot be important for a sick company whose net worth is not expected to turn positive within reasonable time [case of section 17(3) going to 18(4)], and unimportant for potentially viable sick companies [section 17(2) cases].** Given that mergers will play the key role in industrial restructuring in the widest sense of the term, it is necessary that CBDT restructure itself to encourage such mergers.

Given the importance of mergers, the CBDT must play a more facilitating and positive role. Merger proposals that are endogenously designed and passed under section 17(2) of SICA must get all the benefits under from sections 41(1), 72A, 79, and 115J of the Income Tax Act, and enjoy the overriding status of SICA as do schemes under section 18(4).

Moreover, the government should consider appointing a committee to prepare a policy-oriented report on barriers to mergers, and what laws and provisions need to be changed to facilitate the process of merging companies. The committee should consist of an economist and two to three experts in corporate mergers and taxation.

5.5.10 **High Stamp Duties are major barriers to amalgamation.** Peculiarly, two of the states that have the highest incidence of industrial sickness – Maharashtra and West Bengal – and, hence, the greatest need for promoting mergers, also happen to have the highest Stamp Duties. For instance, the new amendment to the Stamp Act in Maharashtra states that mergers and amalgamation are to be treated as conveyancing and/or sales, and attract 10% Stamp Duty on the *current* value of the assets. **Unfortunately, mergers are constrained by the address of the registered office of the sick (or transferee) company, irrespective of the location of the healthy (or transferor) firm. Therefore, there is little hope that firms will merge in states with low Stamp Duties and, thus, force a long term equilibrium of Stamp Duties across states.**

[10] Section 41 deals with profits chargeable to tax. Section 115J involves special provisions relating to certain companies. Sections 72A and 79 refer to set-off and provisioning of losses in cases of merger.

Although Stamp Duties are state subjects, **the central government should use its powers of persuasion to convince the industrial states with high Stamp Duties to reduce these in their own economic interest.** For this, it will be necessary to (i) first, do a study on the rates and effects of Stamp Duties in six states – Maharashtra, Gujarat, West Bengal, Karnataka, Tamil Nadu, and Uttar Pradesh – which can be done by the National Institute of Public Finance and Policy, and (ii) convene a conference of these states, and start a dialogue about rationalizing Stamp Duties.

5.5.11 **What is often required in mergers is the use of quasi-equity instruments, which provide capital without eroding ownership or voting rights:** the more powerful firm does not wish to dilute its ownership by merging with the sick company. Unfortunately, there are only a few quasi-equity instruments that can be used in India. Essentially, these are limited to zero-coupon convertible debentures, preference shares, and cumulative convertible preference shares.

5.5.12 Such strictly limited scope of using quasi-equity instruments to finance restructuring, mergers, and amalgamation, is because **neither the existing Companies Act, nor the proposed Companies Bill, allow for non-voting shares.**[11]

To aid mergers and financial restructuring of sick companies, an additional amendment should be tagged on to the new Companies Bill: notwithstanding sections 110-PCB through 112-PCB, companies should be allowed to issue share carrying varying rights to voting and dividend, up to a maximum of 25% of their total paid-up share capital. There is a need to ensure that non-voting shares are not used as instruments to perpetuate the existence of inefficient promoters and management. This can be easily done by clause whereby non-voting shares would automatically become ordinary voting shares in the event of the company not declaring dividends for two or three years.

5.5.13 Those who believe that this instrument will be misused by promoters to retain control over companies fail to realize that, over time, markets give proper signals. In the long run, investors will avoid bad promoters and select good ones. **The correct way of protecting investors (indeed, anyone) is to ensure that their contracts with the company are honoured. Limiting the number and type of contracts between two free entities – a firm and its investor – is a convoluted and undesirable way of protecting the latter from the former.**

[11] Sections 85-ECA through 87-ECA (corresponding to 110-PCB to 112-PCB) state that there can only be two kinds of shares (equity and preference), and that equity share must carry voting rights.

5.6 Problems in winding up

5.6.1 **The greatest barrier to industrial restructuring is that it is virtually impossible to liquidate and wind up an unviable firm.** There are multiple barriers: of law, of legal interpretation, of legal procedures, and of implementation. **The upshot is that the two most important claimants to the assets of a firm – its workers and the secured creditors – rarely ever get even a small fraction of their outstanding dues.**

5.6.2 First, some facts. A sample of 1857 companies that were "in winding up" shows that[12]

42% of the cases .... 0-10 years;
27% of the cases .... 10-20 years;
19% of the cases .... 20-30 years;
12% of the cases .... over 30 years.

This sample clearly underscores the terrible delays in winding up unviable companies, and in releasing their unutilized assets.

5.6.3 The Companies Act of 1956 defines three types of winding up: (i) those ordered by the Court; (ii) voluntary winding up; and (iii) those under the supervision of the Court. The Companies Bill eliminates the third category. Given our emphasis on BIFR, we shall focus on the first type of winding up.

5.6.4 BIFR is empowered to recommend winding up under section 20(1) of SICA. Once the order is forwarded to the concerned High Court, the matter is out of SICA's jurisdiction, and is governed by The Companies Act, and local High Court procedures and practices. A properly sequenced flow of legal procedures is needed to understand the various problems in winding up an unviable BIFR firm.

5.6.5 BIFR decides upon winding up under section 20(1) of SICA and forwards its opinion to the High Court. The BIFR's opinion is binding upon the Court. In rare instances of very efficient High Courts, the minimum delay between BIFR forwarding its opinion and the Court passing the winding up order is two to three months. **On an average, the delays run up to three years.** Often, these occur when a petitioner – who is usually the promoter or his agent – files a writ petition under Article 226 of the Constitution to stay the order, on the claim that his legal rights have been infringed.

5.6.6 Moreover, **the High Court usually does not know whether a winding up case forwarded to it is being appealed at the AAIFR.** If there is an appeal, then the Court cannot proceed until AAIFR upholds BIFR's decision. **It is always in the promoter's interest to extend the hiatus between BIFR's decision and the passing of the winding up order in Court.** During this period, the firm is totally unprotected, unpoliced, and in limbo – outside the pale of SICA and also of the winding up provisions of The Companies Act. Longer is the gap, greater is the scope to strip assets and sell off as much moveable property and inventory as possible.

[12] Ajeet N. Mathur, *Industrial Restructuring in India and the National Renewal Fund*, Asian Development Bank, January 1993, p.17.

Section 450-ECA (520-PCB) explicitly allows the Court to appoint a provisional liquidator until such time it passes the winding-up order. This practice should be encouraged. As soon as BIFR forwards its recommendation, the High Court should immediately appoint a provisional liquidator to take custody of the company's property under section 456. This measure should reduce the asset stripping that invariably occurs before the winding-up order is passed.

5.6.7 The Court passes the winding up order, files a copy of it with the Registrar of Companies, and appoints the official liquidator (OL). Usually, within a month the OL takes formal possession of the physical premises of the company, and appoints security guards to protect the assets.

5.6.8 The most trivial aspect of possession is taking charge of the premises. In most states, there is no opposition to the OL taking physical possession.[13] **A common source of delay is the acquisition of all financial, transactional, and asset records.** Section 454-ECA (524-PCB) requires that the OL submit a statement of affairs of the company: details of assets and their fungibility, all its liabilities, names, addresses, occupation of all its creditors, details of secured and unsecured debt, and full particulars of directors, promoters, controlling interests, and management. To prepare this statement, the OL needs to possess all books of accounts and negotiable instruments of the company. Notices have to be issued to the erstwhile directors and management to hand over all such material. Directors invariably fail to respond, and finally show cause notices are issued. Although the OL is supposed to submit the statement within 21 days, extendable up to three months, in fact the process takes at least six months. Generally, the average delay is two years. When directors refuse to respond despite the show cause notice, the OL requires permission of the Court to initiate prosecution, which takes another three to four months. In the event of prosecution, the case gets dragged on for another three to five years before the directors hand over the books of account.

[13] West Bengal, however, is different. There are several cases where workers and mobs have prevented the OL from taking possession – often at the behest or instigation of the management. Bailiffs have had to return after being prevented from entering the factory gates; and the district magistrates have been often "advised" by local political leaders to go slow in aiding the OL.

The basic reason for directors delaying the process is to buy time to alter accounts, inflate their claims, and maintain unofficial control over the company's assets. These delays can be reduced by lowering the incentive to procrastinate. **Section 20(4) of SICA empowers BIFR to sell the assets of a company that is to be wound-up, and transfer the sale proceeds to the concerned High Court for distribution to claimants. BIFR should implement this in every case of winding-up.** When this is done, the earlier directors will submit the books of accounts with alacrity to realize their claims as quickly as possible.

5.6.9 The next round of delays occurs at the time of preparation of accounts, detailed listing of all assets and inventories, and valuation of assets. Chartered accountants are supposed to scrutinize accounts of the company from its incorporation – a time-consuming process that takes at least two years. Moreover, it is very difficult to make a thorough listing of assets and inventories, especially if plants and fixed assets are located in different places. Sometimes, accountants face resistance from the office of the OL to proper itemization of inventories and assets: the gains from under-reporting are immense. There are also long delays in valuation. In best possible situations, this takes eighteen months. Usually, the valuation is arbitrary, and there are considerable difference between the estimate of the officially appointed valuer and that of the secured creditors. Often the OL, or the High Court, or some claimant questions the valuation process, and it has to start all over again.

The delays in preparing audited accounts, listing inventories and assets, and valuation are due to two reasons: (i) lack of proper accounts, and (ii) there is no incentive for a reputable firm of chartered accountants or valuers to work at the rates offered by the OL, more so because this requires much more effort compared to examining the records of a healthy company. **This may be remedied by (i) giving the chartered accountants and valuers substantially larger fees for their work; (ii) stating clear cut-off dates; and (iii) asking the accountants and valuers to work in close cooperation with the secured creditors.**

5.6.10 The next step is in two parts. Notices have to be sent to debtors of the company to repay their debts. Thereafter, the OL advertises for sale, gets tenders, and the High Court then sells the assets of the company. **When a company's debtors refuse to pay – as they often do – recovery proceedings have to be filed in the High Court. Getting a decree often takes three to four years, depending on the High Court.** Even when all the company's debtors are well-behaved, there are still long delays in advertising and opening of tenders in Court. In the Calcutta High Court (which, incidentally, is reasonably efficient), delays mount up to an average of two years.

5.6.11 The sale process is fraught with delays, and guided by poor precedence, judgements and guidelines. **The most glaring is the insistence that the wound up firm should be sold as a "going concern" with additional preference being given to workers' cooperatives.** There is a broad consensus among lawyers and secured creditors that **the value of sale realized as a "going concern" is less than half of what can be realized by selling assets separately in the dismantled, unbundled state.** This "sacrifice" is considered worthwhile for protecting the workers.

5.6.12 Economic logic suggests that the "going concern" diktat cannot protect workers even in the short run. Firms wind up because they have excessively high debt burden, *and* are operationally unviable, *and* because all claimants have failed to devise feasible rehabilitation programmes. **When a firm is operationally unviable and cannot get a consensus to reorganize its debts and labour force, the act of selling it as a "going concern" can hardly make the firm turn-around and, so, protect labour.** There are no guarantee that a private buyer will not take advantage of the lower price, declare a lock-out, and so effectively retrench workers and strip the assets. This is a fig leaf of social consciousness. Courts fail to realize that **the best way of protecting the workers' interests in a firm that is being wound up is to realize the highest possible sale value. This is invariably better achieved through the sale of dismantled assets.** Thus, the ruling on sale as "going concern" is yet another example of a well meaning judgement that is totally inimical to the interests of workers.

5.6.13 In almost all cases, the sale process goes through many rounds of bidding, claims, counter-claims, and re-advertising – a sequence of events that can take more than three to four years. Often this occurs despite bids exceeding the reservation price: someone ask for leave of the Court to get an even better price that never materializes.

It is very necessary for the judiciary to appreciate that attempts to sell wound-up firms as "going concerns" can be counter-productive. Professional valuers should be asked to estimate the total value of (i) dismantled sales and (ii) sale as a "going concern". Once bids crosses the greater of the two values, it should be awarded to highest bidder of the day, irrespective of what the buyer wishes to do with the assets. The High Courts should also insist that the successful bidder deposit a bank guarantee covering the bid before formally awarding the sales.

5.5.14 **The settlement and distribution of sales proceeds among claimants is, by far, the longest, most tedious, and most contentious and adversarial process.** It first involves listing of "all claims against the company, present or future, certain or contingent, ascertained or sounding only in damages" (528-ECA or 591-PCB) — a process that takes years, and is contested at each step. Thereafter, the claims are ranked and dealt with according to (i) overriding preferential payments (529A-ECA or 593-PCB) and (ii) lower order preferential claims (530-ECA or 594-PCB).

5.5.15 Since workers have *pari passu* charge with secured creditors (under 529A-ECA or 593-PCB), their representatives (or claimed representatives) do everything possible to inflate the claims. This leads to major delays and disputes between workers and secured creditors, especially if the labour roster and muster rolls are incomplete, as these often are. This stage in the proceeding takes no less than four years, often much more. **When all the delays are cumulated, the total time taken in liquidation is rarely less than ten years — a time horizon in which the only thing that remains saleable is the land.**

5.5.16 The new Companies Bill of 1993 has attempted to address these issues, and has introduced changes that can remedy some of the malaise in winding up. In the final analysis, however, one has to recognize that **no amount of changes in the Companies Act can accelerate the winding up process so long as the matter is under the OL and constantly adjudicated by the High Courts. The Companies (Court) Rules defines 102 strictly sequential procedures that have to be followed in winding up by court. In addition there is the Civil Procedure Code, and local delays in getting dates coupled with easy — virtually automatic — facility for adjournments.** In such a milieu, winding up can be delayed in myriad ways.

To truly reduce the problem of delays in winding up, there must be five fast track Winding-up Tribunals, situated in Bombay, Calcutta, Madras, Delhi, and Bangalore. These tribunals should only examine winding-up cases and, to that extent, expedite the process. The presiding officers should know Company Law as well as commercial litigation – which is often not the case at present. The Government should investigate the possibility of barring jurisdiction of Civil Courts over the affairs of the Winding-up Tribunals.

The government should seriously consider introducing summary procedures in winding up cases.

In addition, the government must strengthen the process of recovering debt from working, viable companies. This can be done by implementing a recommendation made in Chapter 3: the setting up of five Recovery Tribunals only for recovering corporate debts to secured creditors to cover cases exceeding Rs.50 lakhs. There should only be summary procedures, and a "complete code for recovery", which may then be used to prevent the overlapping jurisdiction of Civil Courts.

6 : Conclusion and Summary of Recommendations

6.1 In writing this report, we found that **the problem of industrial sickness is closely linked with wider issues of industrial and financial sector reform.** Consequently, the range of this report is vast: SICA and the working of BIFR, how projects are appraised by financial institutions, financial sector practices, opportunity costs and asset reorganization, corporate law, land and labour laws, the role of the Reserve Bank, financial instruments needed in debt-equity conversion, critique of development finance, and, above all, the principles of incentive compatibility. **Our basic – though unstated – premise has been that one cannot view the problem of industrial sickness in isolation.** Thus, one cannot have one class of norms for industrial companies, another set of independently derived ones for banks and financial institutions, a third for labour, a fourth for land, and a fifth for corporate taxation, and so on, and yet claim to provide incentive compatible solutions to the problem of industrial sickness. Therefore, we have freely utilized or modified recommendation made by various other committees such as the Bajaj Committee, the Narasimham Committee, and others. **What we have recommended throughout the report should be viewed as a part of a *package* that will not only go a long way in ameliorating problems of industrial sickness but, more importantly, will create a much more economically rational, market driven, competitive industrial structure which is governed by far fewer contradictory and perverse signals than before.**

6.2 **The Committee strongly believes that the barriers to industrial and corporate restructuring serve no economic goal.** By preventing reorganization at the appropriate time, these barriers choke off future growth opportunities, and so foster an uncompetitive environment which rapidly leads to pervasive industrial sickness. Furthermore, **these barriers are anti-labour: although the restraints seek to protect labour in the short run, these actually harm long and medium term employment by eliminating growth possibilities.** Equally, these hurdles go against the economic interests of any non-myopic government. They result in a systematic drain of scarce public funds, foster a climate of budgetary support, and eventually justify high tariffs, quotas, sectoral and product reservations to sustain inefficient firms. **If anything, barriers to restructuring serve only one overriding purpose: they maintain an army of inefficient promoters and managers in the public and the private sector, who justify their incompetent existence on the ground that their firms "protect" employment.**

6.3 **Irrespective of ideology, industrial and corporate restructuring has to be thought as methods that maximize future payments to labour and to secured creditors. Conversely, barriers to restructuring help inefficient capitalists maintain their stranglehold over the assets of a company, and encourage them to renege on their obligations to banks, financial institutions, the government, and the workers.** Well meaning, employment and industry protecting barriers always have perverse effects: these neither protect labour payments in the long run, nor prevent asset stripping and debt defaults in the short.

6.4 **The definitions of sickness in SICA and in the proposed amendment (passed by the Rajya Sabha in August 1992) are serious barriers to reorganizing unhealthy**

industrial companies because these primarily identify terminally sick firms. This ensures very delayed intervention and, so, reduces the likelihood of commercial viable reorganization, reconstruction, or rehabilitation. Matters worsen when such extreme, late-detection criteria combine with BIFR's preference for rehabilitation using heavily subsidized public funds.

6.5 There is yet another problem with the SICA definitions: **they are "backward" looking and based on the historical book value of a firm's assets, not its future earning potential, nor its current realizable market value.** As per SICA's negative net worth criterion, what matters is that the *book value* (and not the *market value*) of the firm is less than its current financial obligations. Without barriers to asset reorganization, sale, or withdrawal from an industry, firms can realize the market value of their assets — which can often be substantially higher than the book value. It is possible that a market driven valuation of land and other assets can suffice to meet all the current claims on a "sick" firm. Unfortunately, SICA, with its emphasis on net worth and, hence, book value, precludes such an economically meaningful valuation. **Thus, the SICA definition creates a situation where the "seemingly sick" firms exceed the quantum of truly sick ones.**

6.6 **The BIFR process is very time consuming.** The main reasons for delays are:

a) the quasi-judicial nature of BIFR proceedings, which depends on consensus at almost all stages, and

b) BIFR's clear preference for rehabilitation over winding-up, unless repeatedly proven otherwise.

The combination of "consensus" and "sacrifice" is usually fatal for a sick company. Further, BIFR's partiality towards rehabilitation has had three serious consequences:

a) It has lengthened the process.

b) It has prevented BIFR from credibly using the threat of winding up under section 20(4) of SICA to force quick consensus

c) It has given tremendous opportunities to promoters and, occasionally, state governments to delay matters.

6.7 **For any meaningful restructuring, the responsibility of industrial and corporate reorganization must shift from secured creditors and the State — as it is presently the case — to the defaulting debtor firms.**

6.8 **The only operationally significant basis for BIFR should be that of being a fast-track facilitator and, occasionally, an arbitrator.** In this context, as purely short term measures, BIFR and the government should implement some organizational changes. These are:

a) BIFR hearing should be a forum for decision-making, not for seeking clarifications, explanations, or stating the Board's reservations about the preparation of a scheme.

b) BIFR should dictate an abridged version of its decision in the presence of all parties before formally closing or adjourning a hearing. This synopsized version should highlight the basic decisions and indicate the date when the full text will be sent to all parties.

c) BIFR should end each hearing with the bench members giving a specific date for the next hearing, if it is necessary. Not giving specific dates after hearings, and relying on bench officers has played a role in increasing the time delays.

d) The government must fill the existing vacancies in BIFR at the bench level by appointing eight members who are experts in finance, taxation, and corporate law.

e) Moreover, there has to be an upgrading of human resource and skills within the BIFR secretariat with experts being frequently brought in to conduct focused workshops and seminars on appraisal, on discounting, on cash flow analysis, and on industrial and corporate law. Besides, the BIFR must empanel experts on finance, taxation, corporate law and industrial management, and seek their opinion on various matters concerning corporate reorganization.

6.9 **It is essential for BIFR to use the winding up provisions of section 20(4) of SICA more frequently — not only to expedite the sale of economically unviable firms, but also as a threat to force the pace of decision-making and consensus among various parties.** To execute more 20(4) cases, the BIFR must enlist the services of bona fide professional valuers and auction houses who will undertake the task on a commission basis, and so maximize the sales revenue. At a later stage, it may be worthwhile for the financial institutions to consider floating independent, commercially oriented firms of valuers and auctioneers.

6.10 The recommendations made in paragraphs 6.8 and 6.9 above can be implemented very quickly. **However, we will not proceed very far in industrial restructuring unless we radically alter the form, content, and scope of SICA.** The proposed amendments to SICA passed by Rajya Sabha in 1992 are minor, piecemeal changes that do not address the basic issues in industrial restructuring: speed, voluntary references, early detection, facilitation and quick arbitration, and incentive compatible behaviour of all claimants to these firms. Listed below is the logical sequence of this reform.

a) **The preamble to SICA needs to be altered. Three phrases need to be omitted: "preventive", "ameliorative", and "remedial" — all closely associated with "rehabilitation". Instead, it is necessary to incorporate the basic idea that SICA is meant to promptly decide, through a single facilitating agency, the case for reorganizing ailing companies either through feasible reconditioning of its assets and liabilities, or through rapid winding up and quick sale and distribution of its assets.**

b) **A sick company's own reference to BIFR should be voluntary, not mandatory.** Section 15(1) of SICA states that when a company becomes sick, it "shall" make a reference to the Board. This has to be changed to "may". Voluntary reference does not prevent others from referring the case to BIFR. Section 15(2) of SICA allows the central and state governments, Reserve Bank of India, and the secured creditors of a company to make a reference to BIFR. Making the company's own reference voluntary will reduce the number of cases that get registered with BIFR and, hence, lessen the administrative burden. More significantly, it will give freedom to the firm and the secured creditors to work out a reorganization package outside of BIFR if they so choose — and freedom to choose is a cornerstone of basic economic reform.

c) **There is an urgent need for a criterion that allows for early detection.** The problem with early detection is that it will immediately result in more cases, even when references are voluntary. Given the present procedures of BIFR, the Board will get overwhelmed by this growth in references, and rapidly degenerate to the levels of Courts. Hence, **a definition that detects incipient sickness can work only if the scope of BIFR and SICA is fundamentally restricted to what matters the most — single-point facilitation and fast arbitration.** As it stands, we have multiple definitions of sickness depending upon whether a firm is evaluated by banks and financial institutions, or by SICA. It is contradictory have 180 days' default on interest repayment as an index for provisioning of a doubtful account, and simultaneously have negative net worth as the criterion of sickness for the same account. **The new SICA should eliminate the negative net worth criterion altogether.** In its place, the focus should be on **incipient sickness**. Therefore, **the government should integrate the financial and industrial sector by using the definition suggested by the Narasimham Committee Report. The definition of sickness should change to (i) default of 180 days or more on repayment to term lending institutions, or (ii) irregularities in cash credit or working capital for 180 days or more.**

d) Given this definition, SICA should legislate the following procedure:

- **When a company is thus "sick", the secured creditor would have the option of moving High Courts or Recovery Tribunals to recover the secured assets of the company. It would now be up to the firm to seek time-bound protection from the BIFR.**
- **If the company refers to BIFR, the Board would instruct the management/promoter to prepare a reorganization plan within 90 days that can satisfy the secured creditor(s).**
- **If creditors representing three-fourths of the secured debt were satisfied by the plan, it would become a sanctioned scheme of the BIFR. If not, then the Board would give the firm one last attempt to prepare an alternative plan within another 60 days in consultation with the secured creditors, government, and labour.**
- **If the second plan is not accepted by creditors representing more than three-fourths of the secured debt, then BIFR would automatically recommend the company to the Recovery Tribunals (if the company is considered economically viable) or to be wound up under what is presently section 20(4) of SICA.**
- There should be a deeming provision in the amended SICA which states that once the 150 (90 + 60) days deadline has passed without any scheme being sanctioned, then it is deemed to be "non-restructurable" or "non-viable". If the former, it should go to recovery courts for attachment of security; if the latter, it should be wound up under what is presently section 20(4) of SICA.

6.11 **There is a strong case for having SICA override FERA.** Getting SICA outside FERA will encourage foreign investors to takeover potentially viable sick companies and, if nothing else, raise the market price and bid values of these otherwise poorly utilized industrial assets. This may sound like a radical suggestion. However, it will attract foreign capital and equity — investing in existing plant is cheaper than sinking funds in a greenfield location. **If it is generally agreed that getting foreign exchange and foreign equity is in**

India's national interest, then getting such funds to revitalize hitherto moribund companies must likewise be in the national interest.

6.12 **There should be five Recovery Tribunals only for recovering corporate debts to secured creditors.** These should be self-financing: salaries and expenses paid by the banks and financial institutions. The presiding officers should have experience in commercial litigation. The tribunal should only cover cases exceeding Rs.50 lakhs. There should be a "complete code for recovery", i.e. consistent and closed, which can then maintain an independent jurisdiction of these tribunals, and so circumvent the problems of overlapping jurisdiction.

6.13 The appendix to Chapter 3 presents a legal draft of an amended SICA that incorporates most of these suggestions.

6.14 **Past practices of banks and term lending institutions – unsound project appraisal, inappropriate discounting at opportunity costs, poor identification and inadequate provisioning of tainted portfolios, and insufficient capital adequacy – not only prevented early detection and cure of unhealthy companies, but also induced the secured creditors to increase their exposure in palpably sick companies.** Financial institutions and BIFR have often sanctioned rehabilitation schemes that fail to meet the minimal criterion: (a) evaluate fresh exposure at market rates of interest, and simultaneously (b) secure the opportunity cost rate of return on equity funds. Often, the institutions and BIFR have done worse: **in many so-called rehabilitation projects, the institutions had to shoulder large (opportunity cost) losses even on their fresh exposure, while the promoters earned substantial rents over the opportunity cost of equity funds.** The Appendix to Chapter 4 lists some such cases.

6.15 **Poor financial sector practices have been barriers to early identification and treatment of industrial sickness. These have forced a particular type of error - that of supporting doubtful rehabilitation cases, when economic logic suggested otherwise.** In the past, banks as well as financial institutions followed very unsatisfactory methods of detecting bad accounts and provisioning for them. The loans advanced to sick units were insufficiently written down in the books of the secured creditors. Inadequate provisioning meant that creditors could neither give part write-offs on old debt to assist a financially strained but operationally viable company, nor demand the winding up of unviable firms – in effect making it a bad debt that required immediate and full provisioning, which hurt the account books even further. Thus, there were strong managerial incentives to support very unhealthy, contaminated, as well as terminally sick accounts.

6.16 **It is, therefore, very important to closely monitor, indeed accelerate, the pace of financial sector reforms. The faster India effects reforms in the financial sector, quicker will she be able to restructure her industrial sector.** It is in India's interest to implement the Narasimham Committee reforms as early as possible. Given this, and the fact that commercial banks as well as RBI would prefer to go slow on these reforms, the Ministry of Finance must force the pace, and ensure that the books are cleaned by 1995.

6.17 **For operationally any viable firm, it is possible to design restructuring schemes that reduce the losses (through implicit write-offs) to financial institutions, and**

simultaneously secure a good return on equity for the firm. Take any rehabilitation case where

a) the projected return on equity is greater than the opportunity cost rate of return;

b) the financial institution's return on fresh loans is at less than opportunity cost; and

c) the gains in (a) can compensate the loss in (b).

In such cases, alternative schemes can be constructed where

i) there are no write-off on new loans;

ii) there is an explicit partial write-off on past debt;

iii) the new loans and the non-written off portion of past debt are evaluated at market rates of interest;

iv) the explicit partial write-off on past debt under the scheme is less than the implicit write-off conferred through interest rate subsidies; and

v) the firm continues to earn a surplus which, when discounted at the opportunity cost of equity funds (risk free return plus risk premium) equals the value of equity.

In the Appendix to Chapter 4 such a scheme has been constructed as an example.

6.18 **The RBI's guidelines for rehabilitation must be altered to abjure the notion of sacrifices, and instead address the basic issues in appraisal:**

i) **no write off on new loans;**

ii) **if a partial write off is necessary, it should be explicit, and only on past debt;**

iii) **the non-written off exposure to be charged and discounted at market rates of interest.**

6.19 **Whenever write offs are taken, these should be in the form of debt-equity conversions: the financial institution should adjust the write off against some equity of the sick company.** Debt-equity conversion dominates outright writing off: in good future states, the secured creditor holds profitable equity (which it can sell elsewhere or back to the company), while in bad states it is no worse than a write-off.

6.20 **For a financial institution, the best way to reduce the debt burden of the company is to:**

a) **insist on fresh equity contribution from the promoter;**

b) **convert a proportion of past dues to equity, which is then held by the financial institution, or sold to third parties — this lowers the debt burden and also reduces the control of the promoter and his share of future profits of the company; and**

c) **evaluate the residual exposure at market rates of interest.**

This can be done in three simple steps.

1. **Calculate the entire exposure (old debt plus new proposed loans) at market rates.**
2. **Estimate the write-off that needs to be given on past debt such that the firm earns a return on equity exactly equal to its opportunity cost, while the remaining exposure earns a return at its market price.**
3. **Evaluate the market price of shares of the company, and convert the write-off into purchase of an equivalent number of existing shares.**

To prevent promoters from reneging on their contribution, no rehabilitation scheme should be sanctioned without such funds being placed in escrow accounts. It is said that promoters do not have requisite funds to pay up in one instalment. This is a specious argument. If the project is truly viable, and the promoter a person of integrity, then someone will always certainly agree to loan the funds.

6.21 **The Central Board of Direct Taxes (CBDT) should remove all tax hurdles that prevent banks and financial institutions (custodians of public funds) from converting debt to equity of sick companies, particularly when this is recommended by the BIFR.**

6.22 It is apparent the world over that mergers and acquisitions is the dominant route of industrial and corporate restructuring. There are scale economies, marketing and organizational synergies in mergers, and these will be exploited more and more. India can be no exception. **In fact, the successes of BIFR have been the merger cases under section 17(2), and not those sanctioned under section 18(4) rehabilitation. Given the importance of mergers, the CBDT must play a more facilitating and positive role. Merger proposals that are endogenously designed and passed under section 17(2) of SICA must get all the benefits under from sections 41(1), 72A, 79, and 115J of the Income Tax Act, and enjoy the overriding status of SICA as do schemes under section 18(4).**

6.23 **High Stamp Duties are major barriers to amalgamation.** Peculiarly, two of the states that have the highest incidence of industrial sickness — Maharashtra and West Bengal — and, hence, the greatest need for promoting mergers, also happen to have the highest Stamp Duties. **Although Stamp Duties are state subjects, the central government should use its powers of persuasion to convince the industrial states with high Stamp Duties to reduce these in their own economic interest. For this, it will be necessary to (i) first, do a study on the rates and effects of Stamp Duties in six states — Maharashtra, Gujarat, West Bengal, Karnataka, Tamil Nadu, and Uttar Pradesh — which can be done by the National Institute of Public Finance and Policy, and (ii) convene a conference of these states, and start a dialogue about rationalizing Stamp Duties.**

6.24 **What is often required in mergers is the use of quasi-equity instruments, which provide capital without eroding ownership or voting rights:** the more powerful firm does not wish to dilute its ownership by merging with the sick company. Unfortunately, there are only a few quasi-equity instruments that can be used in India. Essentially, these are limited to zero-coupon convertible debentures, preference shares, and cumulative convertible preference shares. Such strictly limited scope of using quasi-equity instruments to finance restructuring, mergers, and amalgamation, is because **neither the existing Companies Act, nor the proposed Companies Bill, allow for non-voting shares. To aid mergers and financial restructuring of sick companies, an additional amendment should be tagged on to the proposed Companies Bill: notwithstanding sections 110-PCB through 112-PCB, companies should be allowed to issue share carrying varying rights to voting and dividend, up to a maximum of 25% of their total paid-up share capital.**

6.25 **Funds advanced by financial institutions for any project — new, ongoing, as well as rehabilitation — should be in the form of a demand loan while the project is being implemented.** If the project is implemented on schedule without any cost overruns, the demand loan is automatically converted into a term loan with its appropriate repayment schedule. Otherwise, financial institutions can opt for recalling their demand loans which, in any case, will carry a higher interest rate. This, plus substantially lower leverages than before (i.e. higher promoter's contribution), will reduce the risk of funding intrinsically bad projects, lessen the possibilities of arbitrage, and ensure better control and discipline among both borrowers and lenders. Simultaneously, financial institutions will have a second chance to evaluate the borrower's project viability and stream of future earnings. Moreover, this mechanism will select good borrowers and weed out the leverage seekers. It will automatically create an environment for proper project appraisal and cost control, reduce time overruns, and force borrowers to get need based term loans and working capital. It will also prevent entrepreneurs from swapping term loans for working capital requirements.

6.26 **It goes without saying that the earlier one detects irregularities in an account and takes remedial action, the lesser are the chances of the case becoming terminally sick. Thus, early detection and quick action are paramount in combatting the problem of industrial sickness.** Despite a universal recognition of the need to detect incipient sickness, neither banks nor financial institutions have any **objective** method of distinguishing such malaise. And, because of the absence of objective norms for measuring sickness, there is a corresponding absence of well defined, uniformly applicable methods of combatting it.

6.27 **Reforming the Irregular Statements (IS) routinely prepared by commercial banks is a practical way of addressing the issue of early detection.** In devising a Revised Irregular Statement (RIS), the existing classification in the first two categories of the presently used Health Code System, HCS, ("satisfactory" and "irregular") is replaced by four categories:

a) **Satisfactory**	Same as HCS classification number 1.
b) **Irregular**	Different from HCS classification number 2. It defines accounts overdrawn for 5 to 20 days, or where one to 4 cheques have bounced, or where one to 2 bills or inward cheques have been dishonoured.
c) **Suspect**	Accounts that are irregular for more than 20 days, or where 5 or more cheques have bounced, or where 3 or more bills or inward cheques have been dishonoured. If a case is "irregular" for more than three months, it automatically becomes "suspect"
d) MIR	Managerial Input Required: Accounts which are classified as "suspect" on three or more occasions during the previous six months.

The proposed system is not only transparent (quantitative norms replace qualitative judgements), but is also very easy to implement. All that it needs is regular up-dating from a bank's cash credit ledger (CCL), with minor revisions in the ledger format. There is a great degree of similarity between the RIS outlined above and the Non-performing Assets (NPA) classification, as proposed by the Narasimham Committee. **The RIS is an improvement over the NPA system: the RIS monitors on a monthly basis, while, by definition, the time unit in the NPA is 180 days.** It has been found that **the existing Irregular Statement (IS) routinely underestimates irregularity to the extent of 19% of total commercial bank lending!** Nearly half of this is of a severe nature, and belongs to the "suspect" category. **In contrast, the underestimation by the RIS system is negligible – around 1% of total lending.**

6.28 Comparison between the RIS and the manner in which the RBI implements its Health Code System (HCS) is even more revealing. **Compared to the RIS, that the Health Code System of the RBI seems to overestimate the number of satisfactorily performing** accounts. Borrowers appearing as "suspect" under RIS are classified as "satisfactory" by the RBI's HCS code. More importantly, the RIS classification is quicker in detecting sickness (monthly monitoring versus half-yearly review under the HCS), and is more objective.

6.29 **The RBI should closely examine the Revised Irregular System (RIS) and compare it with its own health code classification. If it is the case that the RIS identifies problems earlier without any great informational cost, the RBI should adopt it to monitor incipient sickness.**

6.30 A fundamental problem of our scheduled banks and financial institutions is that they do not keep minimal track of the credit-worthiness of the promoters. Therefore, it is suggested that, in the first instance, **all financial institutions should create a common information pool about firms that have defaulted on term lending dues, and list the names of promoters of such firms. In addition, all scheduled commercial banks should prepare a similar list of irregularities in cash credit and working capital repayment for accounts exceeding Rs.10 crores. This list can be ranked according to risk – the frequency and magnitude of defaults – and should be updated every quarter.** This data base, with its promoter risk ratings, should be available to all financial institutions and scheduled banks, and ought to form a basis for making lending decisions and project risk appraisals. **It will be useful to have an independent and reputable credit rating organization like CRISIL to take up this task.** At a later instance, the Government might wish to consider that the credit risk of promoters be clearly stated in the prospectus of every company issuing shares or debt instruments in the market.

6.31 Equally, it is important to recognize that defaults are not necessarily malafide in intent. These could also be due to outdated as well as industry-specific (instead of firm-specific) working capital norms. **The norms devised by the Tandon and Chore Committees were in a regime of rigid price and quantity controls.** Not only was the industry structure per force more stable than what it is now or will ever be, but also there was no attempt to distinguish the credit-worthiness across firms in any industry. **In today's fluid and much more competitive environment, it is necessary to get away from rigid industry-specific norms, and, instead, device more flexible company-specific, technology specific, demand-specific, and product-specific guidelines. As in other cases, it may be too difficult for banks and financial institutions to formulate such proactive guidelines. Therefore, it may be necessary to ask rating agencies to prepare such norms.**

6.32 The **Companies Act (even in its proposed form) and its implementation work against the simplest type of corporate restructuring – changing the management or directors of a sick industrial company.** This flows from an asymmetric relationship where a sick company's powers to legally resist changes demanded by creditors exceed those of the banks or financial institutions.

6.33 **The Companies Act should be amended so that secured creditors can implement *de facto* changes in management and/or the Board of Directors in instances of** repeated debt defaults. As they stand, sections 267 of the existing Companies Act (ECA) and 291 of the proposed Companies Bill of 1993 (PCB) are not good enough. There must be a clause that when a company defaults on repayments to secured creditors in excess of 180 days, the creditors may (either singly, or jointly):

a) secure a change in management, which can include the entire board of the company,

b) appoint a person of their choice as executive or managing director, or chief executive, and

c) unless (a) and (b) are executed within a given time frame, stop giving any further funds, including working capital, attach properties and assets, or attach equity shares in lieu of default.

Such a provision should be incorporated in every section of the PCB that specifies removal of directors, managing directors, or managers. Moreover, **the penal provisions for non-compliance under sections 33 and 34 of SICA should be implemented by BIFR.** Deviating from any of BIFR's directives can be penalized by simple imprisonment of three years and an unspecified open-ended fine. **The Board has never invoked such penalties.** To signal its intent in preventing systematic defaults, BIFR should occasionally implement these penalties, and publicize them.

6.34 Often, cash strapped but operationally viable companies own considerable vacant land within the factory premises. Since such lands are unutilized by these firms, and command high prices for alternative commercial use in urban areas, their sale can generate substantial additional funds for repaying whole or part of outstanding debts and also for meeting the costs of rationalizing the labour force. **Land sale is the most profitable and economically meaningful way of generating internal resources for (i) reorganizing viable companies or (ii) getting the best value for unviable firms.** Unfortunately, very few land sales have taken place, thanks to two major barriers: **the Urban Land (Ceiling and Regulation) Act of 1976 (ULCRA), and local municipal and state-level deterrents.** The first problem is that SICA cannot override ULCRA. The second is that the states which have the greatest incidence of industrial sickness — Gujarat, Maharashtra, Uttar Pradesh, and West Bengal — have all accepted, and implemented ULCRA.

6.35 **The Central Government should take the lead by asking the Union Territories to grant exemption under sections 20 and 21 of ULCRA, particularly for BIFR schemes.** The government should convene a conference of the ULCRA states, and attempt to persuade these states of the need to amend sections 20 and 21 to incorporate an additional clause: exemption will be given when land sale is recommended by the BIFR, subject to regional master plans. **ULCRA is based on section 252 of the Constitution, which gives the Parliament the power to legislate for two or more states, given their consent. Therefore, the Union Government should convince at least the minimum number of states needed to amend ULCRA of the need to amend this serious barrier to industrial restructuring.** Further, given the problem of land sale in the ULCRA states, the OAs as well as BIFR should not factor in uncertain sale proceeds in estimating either the "means of finance" or the "sources of funds" in the projected cash flows of a 18(4) rehabilitation proposal. More importantly, **when land sales come into being, there will be a tremendous need for financial intermediation** — and will need the involvement of banks and financial institutions who have commercial sense, ample funds, credibility, and expertise in housing finance. The

government must involve the Housing Development Finance Corporation (HDFC) and other reputable financial intermediaries in formulating a specific, clearly sequenced, commercially viable plans for urban redevelopment through sale of excess land. Finally, corporate reorganization via land sales needs a success story — either in Bombay, or in Ahmedabad, or both.

6.36 **Except in some states, there is hardly any evidence of labour force presenting insuperable hurdles to *private sector* restructuring. Nevertheless, there is a major barrier to restructuring the workforce, which is entirely due to prevailing practices among state governments, particularly the use of sections 25(N) and 25(O) of the Industrial Disputes Act.** State governments — the "appropriate Government" of the IDA — have consistently refused to grant permission either under 25(N) or 25(O). As a consequence, several thousands of textile workers in the cities of Bombay and Ahmedabad have been deprived of their terminal benefits and arrears of pay in the last five years, when mills have declared lock-outs to escape the barriers imposed on retrenchment and closures.

6.37 **One seriously needs to ask why should there be any need for prior state government approval.** India has enough labour laws (including provisions in the IDA) and court judgements that prevent any employer from victimizing unionized workers, or from unjustly or illegally laying-off or retrenching labour. In such an environment, it is almost impossible for an honest entrepreneur to unfairly retrench workers. Therefore, it is quite unnecessary to have yet another sanctioning authority — namely, the state Labour Commissioners under sections 25(N) and 25(O) of the IDA. Equally, it is well known that dishonest entrepreneurs with political connections can easily circumvent sections 25(N) and 25(O) by declaring an indefinite lock-out and, so, force labourers to quit. In such cases, these two sections are effectively irrelevant. So, in the "best-case scenario", **sections 25(N) and 25(O) are redundant; and in the "worst-case-scenario", these are irrelevant. Hence, it makes sense to eliminate them altogether.**

6.38 **The government must try to amend sections 25(N) and 25(O) of IDA such that there should be no need for applying to the appropriate government.** Also, while in theory, any retrenchment or labour rationalization recommended by BIFR under a sanctioned scheme overrides the provisions of 25(N) and 25(O) of the IDA, this needs to be clearly notified and publicized, since Labour Commissioners of many state governments seem to be unaware of it. **Furthermore, the government should amend the compensation for retrenchment and closure from 15 days' wages to one months' wages per year of completed service.** Fifteen days' wages is a niggardly amount. If the government wants workers to agree to being laid-off, it must make the minimum payoff more attractive. **Also, Chapter VB of the Industrial Disputes Act, which governs lay-off, retrenchment, and closure, applies to undertaking having 100 or more workers. This should be raised to 300 or more.**

6.39 **The greatest barrier to industrial restructuring is that it is virtually impossible to liquidate and wind up an unviable firm.** There are multiple barriers: of law, of legal interpretation, of legal procedures, and of implementation. The end product is that the two most important claimants to the assets of a firm — workers and secured creditors — rarely ever get even a small fraction of their outstanding dues.

6.40 It is always in the promoter's interest to extend the hiatus between BIFR's decision and the passing of the winding up order in Court. During this period, the firm is totally unprotected, unpoliced, and in limbo — outside the pale of SICA and also of the winding up provisions of The Companies Act. Longer is the gap, greater is the scope to strip assets and sell off as much moveable property and inventory as possible. **Section 450-ECA (520-PCB) explicitly allows the Court to appoint a provisional liquidator until such time it passes the winding-up order. This practice should be encouraged. As soon as BIFR forwards its recommendation, the High Court should immediately appoint a provisional liquidator to take custody of the company's property under section 456. This measure should reduce the asset stripping that invariably occurs before the winding-up order is passed.**

6.41 A common source of delay in winding up is the acquisition of all financial, transactional, and asset records. Section 454-ECA (524-PCB) requires that the OL submit a statement of affairs of the company: details of assets and their fungibility, all its liabilities, names, addresses, occupation of all its creditors, details of secured and unsecured debt, and full particulars of directors, promoters, controlling interests, and management. Directors often delay the process to buy time to alter accounts, inflate their claims, and maintain unofficial control over the company's assets. These delays can be reduced by lowering the incentive to procrastinate. **Section 20(4) of SICA empowers BIFR to sell the assets of a company that is to be wound-up, and transfer the sale proceeds to the concerned High Court for distribution to claimants. BIFR should implement this in every case of winding-up.**

6.42 The delays in preparing audited accounts, listing inventories and assets, and valuation are due to two reasons: (i) lack of proper accounts, and (ii) there is no incentive for a reputable firm of chartered accountants or valuers to work at the rates offered by the OL, more so because this requires much more effort compared to a healthy company. This **may be remedied by (i) giving the chartered accountants and valuers more remunerative fees; (ii) stating clear cut-off dates; and (iii) asking the accountants and valuers to work in close cooperation with the secured creditors.**

6.43 The sale process is fraught with delays, and guided by poor precedence, judgements and guidelines. **The most glaring is the insistence that the wound up firm should be sold as a "going concern" with additional preference being given to workers' cooperatives.** There is a broad consensus that the value of sale realized as a "going concern" is less than half of what can be realized by selling assets separately in the dismantled, unbundled state. This "sacrifice" is considered worthwhile for protecting the workers. Economic logic suggests that the "going concern" diktat cannot protect workers even in the short run. Firms wind up because they have excessively high debt burden, *and* are operationally unviable, *and* because all claimants have failed to devise feasible rehabilitation programmes. When a firm is operationally unviable and cannot get a consensus to reorganize its debts and labour force, selling it as a "going concern" can hardly make the firm turn-around and, so, protect labour. **The best way of protecting the workers' interests in a firm that is being wound up is to**

realize the highest possible sale value. This is invariably better achieved through the sale of dismantled assets. Thus, the ruling on sale as "going concern" is yet another example of a well meaning judgement that is totally inimical to the interests of workers.

6.44 In the final analysis, it has to be recognized that no amount of changes in the Companies Act or allied laws can accelerate the winding up process so long as the matter is under the Official Liquidator, and is being constantly adjudicated by the High Courts. The Companies (Court) Rules defines 102 strictly sequential procedures that have to be followed in winding up by court. In addition there is the Civil Procedure Code, and local delays in getting dates coupled with easy – virtually automatic – facility for adjournments. In such a milieu, winding up can be delayed in myriad ways. Therefore, **to truly reduce the problem of delays in winding up, there must be five fast track Winding-up Tribunals, situated in Bombay, Calcutta, Madras, Delhi, and Bangalore.** These tribunals should only examine winding-up cases and, to that extent, expedite the process. The presiding officers should know Company Law as well as commercial litigation – which is often not the case at present. The Government should investigate the possibility of barring overlapping jurisdiction of Civil Courts in the affairs of the Winding-up Tribunals. It should also seriously consider introducing summary procedures in winding up cases.

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