

## The Genesis of Higher Haircuts in Resolution Plans



*The financial offer made by an investor in the resolution plan depends on several facts such as economic and market conditions, deepening of financial markets, valuation of available assets, and legal impediments in implementation of the Resolution Plan among others. Any potential investor will look into the value of the assets of the CD and benefits it will generate on its acquisition. The IBC entrusts this responsibility of commercial wisdom on the CoC in a transparent manner which has also been affirmed by the Supreme Court in its various judgments. However, 90% to 96% haircuts in some recent cases have raised doubts on working of CoC. The author has deliberated on this issue and also suggests some way forward. **Read on to know more...***



**Ashok Kumar Gulla**  
The author is an Insolvency Professional (IP). He can be reached at [ashok.gulla@rbsa.in](mailto:ashok.gulla@rbsa.in)

### 1. Background

The basic requirement for a Corporate Debtor to be admitted for initiation of Corporate Insolvency Resolution Process (CIRP) is proven default in payment of debts due to financial stress. This results in deterioration of the performance of the CD and consequent erosion in the value to various stakeholders. To come out of this problem, the Code provides for inviting resolution plans from Prospective Resolution Applicants (PRAs) which provides financial offer to Financial Creditors (FCs), Operations Creditors (OCs) and Other Stakeholders and also a blueprint for revival of the CD. But before inviting Expression of Interest (EOI) for resolution plans, the Resolution Professional (RP) is required to run the Corporate Debtor (CD) as a Going Concern (GC) for value maximisation. Thus, the main objective<sup>1</sup> of the IBC can be achieved only if a viable and feasible Resolution Plan is received and the same is voted by the CoC and approved by the Adjudicating Authority (AA).

<sup>1</sup> "The first order objective is resolution. The second order objective is 'maximisation of value of assets of the Corporate Debtor (CD) and the third order objective is promoting entrepreneurship, availability of credit and balancing the interests. This order of objective is sacrosanct," *Binani Industries Ltd. Vs. Bank of Baroda*, Company Appeal (AT) (Insolvency) No. 82 of 2018, NCLAT (<https://nclat.nic.in/Useradmin/upload/744324065bebc1bd0ef4a.pdf>)

Here, the moot question is what should be financial offer that is considered reasonable and acceptable. This issue has been raised at various forums and still continue to be debated especially where the offer amount is low compared to the claims admitted from FCs and OCs. The matter is again debated especially in high value accounts where the haircut is above 90% of the admitted claims. On the issue of acceptance of the Resolution Plan, the IBC trusts on CoC provided it is approved with minimum 66% of vote share<sup>2</sup>. The supremacy of the commercial wisdom of the CoC has also been reiterated by the Supreme Court in several of its judgements. Most recently on May 13, 2021, in the matter of *India Resurgence ARC Private Limited Vs M/S Amit Metaliks Limited & Ors*, the Supreme Court held that the AA may not adjudicate on the commercial wisdom of the CoC. The Court observed<sup>3</sup> “The NCLAT was, therefore, right in observing that such amendment to Sub-section (4) of Section 30 only amplified the considerations for the CoC while exercising its commercial wisdom so as to take an informed decision in regard to the viability and feasibility of resolution plan, with fairness of distribution amongst similarly situated creditors; and the business decision taken in exercise of the commercial wisdom of CoC does not call for interference unless creditors belonging to a class being similarly situated are denied fair and equitable treatment.” The Court also cited similar judgement in the matter of *CoC of Essar Steel India Limited v. Satish Kumar Gupta and Ors.*(2020) as precedence.

However, in regard to various Resolution Plans put up for approval of the AA recently, the question regarding approving of resolution plan with a high hair cut and value offered in plan being less than liquidation value has again arisen. The most latest judgement in this regard was passed by NCLAT, New Delhi on July 19, 2021 in which the Appellate Tribunal ordered stay<sup>4</sup> on AA's judgement dated June 08, 2021 approving the resolution plan submitted by Twinstar Technologies in CIRP of Videocon Group. It was argued that the haircut of 90-96% has been taken and the amount offered in the resolution plan was close to the

liquidation value.

In this connection, Fair Value (FV) and Liquidation Value (LV) of the CD plays a vital role. The valuation is carried out as on the Insolvency Commencement Date (ICD) by the two Registered valuers that helps members of CoC to decide on the financial offer. However, in most cases the valuation of assets arrived at is low compared to the claims admitted.

**Any potential investor will look into the value of the assets available and what benefits it will generate after taking into account various impediments in the implementation of the Resolution Plan.**

This raises the question about the factors that go into the determination of the financial offer in the Resolution Plan. It is the interplay of economic and market conditions, deepening of financial markets, availability of investors to invest in stress assets, valuation of available assets and assumptions that go with valuation, information asymmetry and legal impediments in the implementation of the Resolution Plan. Any potential investor will look into the value of the assets available and what benefits it will generate after taking into account various impediments in the implementation of the Resolution Plan. The AA do not have the available information on the market dynamics and nitty-gritty of valuation to come to the conclusion whether the haircut is reasonable. An attempt has been made in this article to deliberate on these issues.

## 2. Fair Value (FV) and Liquidation Value (LV)

Regulation 35 of the IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016; provides a three step procedure for determination of FV and LV<sup>5</sup>. Furthermore, Regulation 2 (hb) defines FV and Regulation 2 (k) defines LV. Generally, as a common practice, three methodologies are adopted by the Registered Valuers to

<sup>4</sup> Business Standard (2021): NCLAT stays NCLT's nod to Twinstar's resolution plan for Videocon Group, July 19 [https://www.business-standard.com/article/companies/nclat-stays-nclt-s-nod-to-twinstar-s-resolution-plan-for-videocon-group-121071900823\\_1.html](https://www.business-standard.com/article/companies/nclat-stays-nclt-s-nod-to-twinstar-s-resolution-plan-for-videocon-group-121071900823_1.html)

<sup>5</sup> Fair Value and Liquidation Value, Chapter IX, Resolution Plan, Section 35 of the IBC, 2016. <https://ibbi.gov.in/uploads/legalframework/af0143991dbbd963f47def187e86517f.pdf>

<sup>2</sup> Section 30 (4) of the IBC, 2016.

<sup>3</sup> Supreme Court (2021): Civil Appeal No. 1700 of 2021, Para 12 (<https://indiankanoon.org/doc/174927818/?type=print>)

arrive at Fair and Liquidation Value i.e. Cost Basis Approach, Market Approach and Income Approach.

Various assumptions and disclaimers are made by Valuers in arriving at the valuation especially in cases where complete information with regard to the assets are not available with the CD. Assumption are also made where the legal ownership of assets is disputed before authorities resulting in lower valuation of such assets. Some machineries may be having better upkeep but the value is adjusted with depreciation owing to the policy. Hence, valuation is best estimate depending on various assumptions. The price at which the asset is sold may not be same as valuation and depends on the various other factors that include economic environment, market conditions, legal issues and information asymmetry.

**“The resolution applicants are not provided these Valuation Reports and they are expected to carry their own due diligence before submitting a Resolution Plan.”**

The members of CoC while receiving the resolution plan (s) are provided the valuation reports from the two valuers to look to the FV and LV and negotiate with the Resolution Applicant to maximize the financial offer. The resolution applicants are not provided these Valuation Reports and they are expected to carry their own due diligence before submitting a Resolution Plan.

### 3. Claims Admitted and Actual Realization

As per the provisions of the IBC, the Interim Resolution Professional (IRP)/ Resolution Professional (RP) is required to collate claims from FCs, OCs and other Creditors as on the ICD. The amount of claims admitted is generally higher than the available value of assets of the CD.

The claims from FCs include interest debited and accrued since the account has become irregular and thereafter classified as Non- Performing Asset (NPA) with FCs (i.e.Banks) and the interest component increases the claim amount by around 20-30% in normal instance as it takes around 2-3 years to initiate CIRP after the accounts has become irregular followed by declaration of NPA by the lending bank/s. This includes time taken by banks to



decide on filing application for initiating CIRP after examining possibility of unilateral and multilateral restructuring of the credit facilities. Further, while the IBC provides time of 14 days for initiation of CIRP after filing of application by FCs, but in practice it takes a long time at AA to order for admitting the CD into CIRP. Thus the amount of claim admitted get inflated to the extent of interest accrued and charged since the CD was in default, while at the same time the value of the assets deteriorates during this period. The longer the time spent, higher the mismatch between claims admitted and value of assets.

The CD avails credit facilities from FCs for acquiring fixed assets and also for meeting working capital. The credit facilities availed for meeting working capital include financing of current assets that include raw materials, stock in process, finished goods and receivables. It is generally observed that these current

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assets get fast depleted and realization become difficult in the case of CD in default due to various reasons. This could be due to operating losses incurred either declared or suppressed prior to commencement of CIRP that first impact depletion of the current assets. Realization of current assets goes first to fund these losses. Further, trade receivables become difficult to realize as CD loses its

bargaining power especially when these debtors are more than 6 months old. The valuers while arriving at valuation of current assets, thus have to put some discount to arrive at its realization owing to the uncertainty regarding their realization based on the market analysis.

The fixed assets that are available also suffer and deteriorate on account of normal depreciation and poor maintenance. Some of the machineries become obsolete and lose value. If the activity is stopped or at a low level, the condition of the plant and various assets is adversely impacted. There are instances of pilferage of various assets prior to the commencement of CIRP. All these factors impact valuation and overall recovery.

**“If the claims increase by 20% due to accrued interest and value of assets goes down by 20% during the same period, the overall impact will be more than 40% alone due to these two factors.”**

The CDs which are admitted in CIRP do not maintain in most cases updated books of accounts. There is information asymmetry. Besides, the balance sheets contain lot of qualifying remarks and disclaimers by the auditors and thus cannot be fully relied. The complete details of the fixed assets are not available. The location of some of the fixed assets are not properly available. Details of the various parties from whom any dues are recoverable are also not available along with supporting documents. The Valuers takes all these factors into consideration and accordingly provides estimate of FV and LV.

There are some instances of mismanagement and diversion of funds by the management for which the RP is required to determine and file an application under Sec 43, Sec 45, Sec 50 and Sec 66 of the IBC for Preferential, Undervalued, Extortionate and Fraudulent (PUEF) transaction with the AA. There are also instances of bogus entries with regard to account receivables. The purpose is to bring back such amount to CD so that the amount for stakeholders is enhanced. However, a number of such applications are pending with the AA. The problem is to get such amount identified and recovered as in most cases other parties from whom the amount is to be recovered are either not in existence or not in a position to pay back.

Hence, while the claims admitted get enhanced due to accumulated liabilities during the period of financial stress before commencement of CIRP but during the same period, the assets show deterioration. If the claims increase by 20% due to accrued interest and value of assets goes down by 20% during the same period, the overall impact will be more than 40% alone due to these two factors. Thus the claim admitted and value of assets available find large variation. The resolution applicants after carrying due diligence provide their financial offers based on the value of assets that are available and factor adequate discount due to information asymmetry and legal impediments. This partly explains higher hair cut in the resolution plans in relation to claims admitted.

#### 4. Economic and Market Environment

The economic environment at present is subdued with lower GDP growth and limited fresh investments in various sectors. The situation has been further impacted due to Covid-19 pandemic. Hence, economic environment is not at present conducive for potential investors to acquire stress assets. Various industries are suffering due to low demand and excess capacity. This has created dearth of getting serious PRAs to submit resolution plans. In this situation, PRAs due to limited competition have got better bargaining powers to get plans approved by CoC which are favourable to them.

The market for purchase of stressed asset in India is still at its infancy and there are not sufficient investors/ hedge funds/ sovereign funds to acquire these assets. The financial market in India especially for acquiring stress assets is yet to develop of which one of the main reason is transparency in disclosures of financial information in the audited financial statements. Many of the stress asset funds floated abroad are not active in India due to lack of complete transparency in the financial statements and also legal impediments in approval and implementation of the plans. As large number of accounts are in stress and admitted in CIRP, hence sufficient funds are required to revive these companies which is difficult without specialized funds created for the purpose.

The PRAs do not have readily available funds to meet the

financial offer. Further, financial institutions do not readily provide 'Line of Credit' or prior arrangement with the PRAs to meet the shortfall to acquire these assets. No separate scheme is presently available with banks to have a prior arrangement with the prospective investors to fund those assets. The time required to submit such resolution plan is around 1 month or in case of any extension could go at most to three months. During this period, it is difficult for PRAs to get the tie up of funds from banks and hence not able to submit a resolution plan. There have been instances when the PRAs whose plan was approved could not arrange funds leading to further litigations. Hence, there are not many serious bidders to submit a resolution plan.

**“Deliberations of CoC on resolution plan/s are not disclosed which sometimes casts doubt whether the CoC has acted diligently after considering all the factors.”**

Banking and Financial Institutions (FIs) do not encourage restructuring as a part of the Resolution Plan wherein the new investors will be given sufficient time to make the payment. The preference of the FCs is to come out of these stress assets through upfront payment by the Resolution Applicant and only limited time is given for remaining payment. It has been observed while a number of PRAs submit EOIs but only very a few submit resolution plans. There are not many investors who have got available funds/credit lines to take the resolution plan to its logical end. The restructuring of debt or taking over of debt by FIs will boost the stressed asset acquisition market. Further, Asset Reconstruction Companies (ARCs) do not still have active participation.

It has been observed that in most cases either single resolution plan is received while some other get 2 to 3 plans. In case of single resolution plan, the PRA have got better bargaining power and tries to carry out hard negotiation on the offer amount. The time taken in CIRP is longer and number of litigations have damped the enthusiasm of many investors to participate in the submission of the resolution plans. Hence, the potential investors put discount on the offer amount to provide for

various uncertainties.

### **5. Liquidation Value and Actual Realisation during the Liquidation can be different**

The important decision that CoC have to take while considering the Resolution Plan for approval is whether it will be beneficial for the creditors to accept the plan or to allow it to go for liquidation. Negotiations with the resolution applicants are mainly to ensure that the offer is much above than what the recovery will be through liquidation. The members of CoC are often not fully aware about the recovery expected to come through in case the CD is admitted into liquidation. However, some estimates can be made that help CoC to decide on the acceptability of the resolution plan/s presented before it for consideration.

The members of CoC have got FV and LV as on ICD while as actual liquidation process takes another 2-3 years in case the CD goes into liquidation. Hence, the liquidation costs will be additional burden which have to be first met before making any distribution to creditors as per Section 53 of the IBC. Further, there could be further deterioration in the value till the assets are fully sold in liquidation due to time gap between CIRP and liquidation.

The members of CoC try to understand how much actual realisation will come under liquidation based on the LV arrived as on ICD. There may be instances where it will be decided by the members of CoC that the realisation during the liquidation will be still lower than the LV and offer made in the Resolution Plan. However, these deliberations are not known and disclosed during the meetings of CoC and this sometimes casts doubt whether the CoC has acted diligently after considering all the factors. Besides, there have been instances where the realizable value as on the Liquidation Commencement Date (LCD) were lower than the valuation arrived as on ICD, thereby establishing that with time, value of asset deteriorates. The exception may be only value of immovable property such as land. It is also to be noted here that the claim amount as on LCD further increases specially in case of financial creditors due to additional interest component claimed since the commencement of CIRP (in most cases, liquidation commences around 1-2 year after CIRP) whereas the

value of assets deteriorates.

## 6. Reasons for Higher Hair Cuts in Resolution Plans

The factors that go into higher hair cuts in CIRP may be summarised as follows:

**“A panel of experts drawn from professionals from Industry, Valuation, Accounts and Audit and Legal may be constituted to provide their views to the AA if offer in the CoC approved Resolution Plan is too low.”**

- a) Delays in deciding to file CIRP application and then admission by the AA.
- b) Mismanagement including instances of preferential, undervalue, extortionate and fraudulent transactions.
- c) Information asymmetry that includes books of accounts not complete and proper records not available/missing.
- d) Market conditions not conducive with limited demand.
- e) Financial market for stress assets yet to develop.
- f) Legal issues takes long time and hampers timely approval and implementation of the approved Resolution Plan.

## 7. The Way Forward

The issues regarding hair cut in the Resolution Plan are of wide ramifications and any adverse findings could dampen

the spirit of the IBC. Necessary safeguards and transparency needs to be built up in the system so that the IBC achieves its objective in resolving the stress assets. Some of the suggestions for improvement are as follows:

- a) As per the present practice all resolutions plans received by RP are deliberated and negotiations are held between the CoC and PRAs on the offer amount. The members of CoC while approving the Resolution Plan do not disclose the reason. Going forward, members of CoC may disclose the justification as why the Plan was approved with higher haircut so that the same is known to the AA and they are well apprised of the various dimensions in which CoC have gone before taking such a decision. The reasons for rejecting other resolution plans should also be recording in writing.
- b) A panel of experts drawn from professionals from Industry, Valuation, Accounts and Audit and Legal may be constituted who will, if required, provide their views on such matters where the offers are too low so that they examine the issue from different perspective and provide the report to AA.

The market for stress assets need to be widened and necessary policy changes are required at the level of the Reserve Bank of India (RBI) and Central Government to ensure more resolution plans. The operational efficiency at various levels need to be emphasised.

