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SCHEME FOR SUSTAINABLE STRUCTURING OF STRESSED ASSETS

Reserve Bank of India ("**RBI**"), after due consultation with banks introduced a scheme to weigh down bad loans and their stressed corporate clients and at the same time, ease the pressure on company balance sheets. With this motive RBI has introduced, on June 13, 2016 the Scheme for Sustainable Structuring of Stressed Assets ("**S4A Scheme**") to offer adequate deep financial restructuring opportunities to large borrowers.

The S4A Scheme is an optional framework for resolution of large stressed accounts for projects. The S4A Scheme aims to strengthen the lenders' ability to deal with large stressed assets facing genuine hardship and offers a realistic chance for reworking the financial structure of such entities. The S4A Scheme provides for a relaxed platform for the Strategic Debt Restructuring ("**SDR**") Mechanism introduced earlier by RBI for reviving stressed accounts and providing banks an option to initiate change of ownership. The SRD Scheme gave the lenders the power to revive the stressed company, and recover their dues by selling it to a new promoter within 18 months which was practically quite difficult for the Lenders to find buyer of such stressed entities within such short span of time frame.

In view of all the practical difficulties to implement SDR Scheme, RBI has introduced the S4A Scheme to facilitate partial applicability of SDR Scheme and partially the bad debts to be retained as it is basis depending on the cash flows of the Company to sustain such debts and repay the partial loans as per the existing loan documents and repayment schedule.

Eligibility for Applicability of S4A Scheme

To be eligible to opt for the S4A Scheme a borrowal account must meet the following conditions:

Firstly, the project shall have commenced commercial operations;

Secondly, the total exposure in the account of all the institutional lenders should be more than Rs.500 Crores; and

Thirdly, the debt should be sustainable. if the Joint Lenders Forum ("**JLF**") or consortium of lenders concludes through their independent techno-economic viability exercise that debt of the principal value amongst the current funded and non-funded liabilities owed to institutional lenders can be serviced over the same tenor as that of the existing facilities if even if the future cash flows remain as their current levels. Also, for this scheme to be applicable sustainable debt should not be less than 50% of the current funded liabilities.

The resolution plan may involve one of the following options with regard to the post resolution ownership of the borrowing entity:

(a) the current promoter continues to hold majority of the shares or shares required to have control;

(b) the current promoter has been replaced with a new promoter, in one of the following ways:

(i) through conversion of a part of the debt into equity under SDR mechanism, which is thereafter sold to a new promoter;

(ii) in the manner contemplated as per prudential norms on change in ownership of borrowing

entities (outside SDR scheme);
(c) the lenders have acquired majority shareholding in the equity through conversion of debt into equity either under SDR or otherwise and
(i) allow the current management to continue or
(ii) handover management to another agency/professionals under an operate and manage contract.
However where malfeasance on the part of the promoter is established, through a forensic audit or otherwise, this S4A Scheme shall not be applicable if there is no change in promoter or the management is vested in the delinquent promoter.

Bifurcation of Dues

In furtherance of the above mentioned circumstances, the JLF or consortium of lenders shall after an independent Techno Economic Viability ("**TEV**"), bifurcate the current dues of the borrower into Part A and Part B as described below:

Part-A

Part A would include determination of the level of debt (including new funds required to be sanctioned within next six months and non-funded credit facilities that will crystallise within the next 6 months) that can be sufficient to service (both principal and interest) within the respective residual maturities of existing debt from all sources, based on the cash flows available from the current as well as immediately prospective level of operations. In such a case, the rate of interest, the securities and the repayment schedule shall not change for servicing such Part A debt.
Where there is more than one debt facility, the maturity profile of each facility shall be that which exists on the date of finalising the resolution plan. For the purpose of determining the level of debt that can be serviced, the assessed free cash flow shall be allocated to servicing each existing debt facility in the order in which its servicing falls due. The level of debt so determined shall be referred to as Part A in the guidelines issued by RBI.

Part-B

The difference between the aggregate current outstanding debt from all sources and Part A would be reckoned as Part B under the S4A Scheme.
Even after bifurcation, the security position of the lenders shall not be diluted and Part A portion of the debt would continue to have at least the same amount of security cover as it was available before this resolution.

The Resolution Plan

The resolution plan shall have the following features:
(a) There shall be no fresh moratorium granted on interest or principal repayment for servicing of Part A.
(b) There shall not be any extension of the repayment schedule or reduction in the interest rate for the servicing of Part A, as compared to repayment schedule and interest rate prior to this resolution.

(c) Part B shall be converted into equity/redeemable cumulative optionally convertible preference shares. However, in cases where the resolution plan does not involve change in promoter, the banks may at their discretion, also convert a portion of Part B into optionally convertible debentures. All such instruments shall continue to be referred to as Part B instruments.

Valuation

For the purpose of S4A Scheme, the fair value of the Part B instruments shall be arrived at as per the following methodologies:

(a) The S4A Scheme contemplates that the valuation of the equity shares should be marked to market at least on a weekly basis. For equity shares which are not listed on any stock exchange or for which current quotations are not available, should be valued at the lowest value using either:

- "break–up value" method – which is determined from the company's latest audited balance sheet (without considering 'revaluation reserves'). In case the latest audited balance sheet is not available, the shares should be valued at Re. 1 per company. The independent TEV will assist in determining the break-up value; or
- 'discounted cash flow method (DCF method)', under which the discount factor is the actual interest rate charged to the borrower plus 3%, subject to floor of 14%.

(b) the valuation for the redeemable cumulative optionally convertible preference shares/optionally convertible debentures should be on the Discounted Cash Flow (DCF) method, to be valued with a discount rate of a minimum mark up of 1.5% over the weighted average actual interest rate charged to the borrower by the lenders. Where there are preference dividends in arrears, the value determined as per the DCF method should be further discounted by at least 10% for year of such arrears (for example, 15% if the arrears are for one year and 25% if the arrears are for 2 years). Where the resolution plan does not involve change in the existing promoters or where the existing promoters have been permitted to operate and manage the company as minority owner, the lenders need to ensure that the existing promoters dilute their shareholdings by way of conversion of debt to equity or sale of certain portion of the promoter's equity to the lenders, at least in the same proportion as that of Part B to the total dues of the lenders. Additionally, under the S4A Scheme, a personal guarantee of the promoters, at least up to the amount of Part A, is mandatory. The existing promoter or the new promoter, as the case may be may have the right of first refusal in case the lenders decide to sell the share, at a price beyond some predetermined price.

Other Relevant Principles

(a) The JLF/consortium of lenders shall engage the services of any credible professional agencies to conduct the TEV and prepare the resolution plan.

(b) The resolution plan shall be agreed upon by a minimum of 75 percent of lenders by value and 50 percent of lenders by number in the JLF or consortium of lenders.

(c) At the individual level of the bank, the bifurcation into Part A and Part B shall be in the proportion of Part A and Part B at the aggregate level. Asset Classification and Provisioning

The S4A Scheme provides for two situations to be considered during 'Asset Classification and Provisioning':

- on the event there is a change in the existing promoter of the borrower, the asset classification and provisioning requirement would be as per the SDR scheme or 'outside SDR' scheme, as applicable;
- in case there is no change of promoter, asset classification as on the date of lender's decision to resolve the account under the S4A Scheme (i.e., the reference date) will continue for a period of 90 days from this date. If the resolution is not implemented within this period, the asset classification will be as per the extant asset classification norms, assuming there was no such 'stand-still'.

Conclusion

By introducing this S4A Scheme, the RBI illustrated its objective of providing the banks a greater flexibility to structure the stressed assets. The S4A Scheme envisages an independent monitoring and reviewing by experienced professionals/ individuals at different levels. However there are a few drawbacks under this S4A Scheme, as under this scheme only the projects where commercial operations have commenced are to be considered and the projects which are under implementation are ineligible. Further under this scheme, the current cash flows are the only basis to ascertain sustainable debt. Another major drawback is that the S4A Scheme does not allow the banks to change the terms and conditions of the loan.

LIABILITY OF BANKS WITH REGARD TO FRAUDULENT TRANSACTIONS

There are certain liabilities casted upon Banks with regard to Frauds related to negotiable instruments, cheque and other instruments. Whether bank can escape from its liability by establishing that the inaction on the part of the customer in not informing the bank about the irregularities in the account and deliberately withholding such information from the bank constitute negligence and operate as estoppels against the customer from claiming the amount, on the ground of adoption or acquiescence?

CONTRACTUAL LIABILITY

The relationship between a bank and its customer arose for consideration before the Supreme Court of India in the case reported as **Bihta Co-operative Development and Cane Marketing Union Ltd and Anr. vs. Bank of Bihar and Ors.**, AIR 1967 SC 389.

In the above case, a suit was filed by the Society for illegal withdrawal of Rs. 11000/- from the bank. The suit was decreed by the trial court and affirmed by the High Court. The case then came before the Supreme Court of India. The plea taken by the bank was that if the customer chooses to dispense with the ordinary precautions and permits a forgery to be committed and if owing to the negligence of such precautions, it is put into the power of any dishonest person to increase the

amount by forgery, the customer must bear the loss. For this argument, reliance was placed on a decision of House of Lords given in the case of **London Joint Stock Bank Ltd v. Macmillan and Arther,** 1918 AC 777**.**

The Supreme Court of India was, however, of the opinion that what was said in *Macmillan's* case above would not be applicable because the accepted principle of law that if signature on the cheque is genuine and there is a mandate by the customer to pay then the banker has no obligation but to discharge the liability but if the signatures on the cheque or at least one of the signature is not genuine, then there is no mandate on the part of customer to pay and there would no question of any negligence on the part of the customer, such as, Waving the cheque book carelessly so that a third party would easily get hold of it would afford no defense to the Bank.

The same has been upheld in a subsequent judgment, **Canara Bank v. Canara Sales Corporation and Ors.** 1987 AIR 1603 Also, the Apex Court observed that, the relationship between the customer of a bank and the is that of a creditor and debtor. When a cheque which presented for encashment contains a forged signature the bank has no authority to make payment against such a cheque. The bank would be acting against law in debiting the customer with the amounts covered by such cheques. When a customer demands payment for the amount covered by such cheques, the bank would be liable to pay the amount to the customer. The Apex Court held that the bank can escape liability only if it can establish knowledge to the customer of the forgery in the cheques and **Inaction for a continuously long period cannot by itself after a satisfactory ground for the bank to escape its liability**. There is a duty of the customer to inform the bank of irregularities when he comes to know of them and such a duty will not exist when the customer is unaware of such fraudulent transactions.

Also, in the case of **In Babulal Agarwalla v. State Bank of India, Bikaner and Jaipur**, AIR 1989 Cal 92 the Calcutta High Court applied the ratio of the Bihar Co-Operative case. The court held that,

"*The mandate of the customer to bank to pay the cheque signed by him for the bearer, which is statutorily recognised by Section 85(2) of the Negotiable Instruments Act, ceases as soon as it is proved that the cheque paid by the bank was a forged one because a forged cheque is no cheque issued by the customer. There is no mandate of the customer to the bank to pay on such a forged cheque. Therefore, the protection given to the bank by Section 85 is not available to the bank in respect of a forged cheque. The bank is not liable to debit the said amount of the cheque even if it is found that the customer did not take proper care to keep the cheque or the relevant cheque book in proper custody. It was held that the bank cannot avoid the liability by merely proving that it made payment in due course according to the apparent tenor of the cheque or by verifying the signatures in the cheque with the specimen signature and finding no apparent discrepancy. It was observed that the bank can avoid the liability only if it can prove that there was ratification or estoppel.*"

Section 85(2) of the Negotiable Instruments Act, 1881 states that;

Cheque payable to order:

- Where a cheque payable to order purports to be indorsed by or on behalf of the payee, the drawee is discharged by payment in due course.
- Where a cheque is originally expressed to be payable to bearer, the drawee is discharged by payment in due course to the bearer thereof, notwithstanding any indorsement whether in full or in blank appearing thereon, and notwithstanding that any such indorsement purports to restrict or exclude further negotiation.)

The same ratio was also upheld by the Jammu and Kashmir High Court in the case of **Citizen Cooperative Bank Ltd. And v Ritesh Mittal AIR 2003 J K 67.**

Conclusion

Hence, it is understood that the Bank is Liable Contractually as there exist a contractual relationship established between the banker and a customer. In order to escape its liability the Bank has to establish that the customer had knowledge of the forgery in the cheques and it was a duty of the customer to inform the bank of irregularities when he comes to know of them but such a duty will not exist in case where the customer is unaware of such fraudulent transactions.