

Sick Industrial Companies in India: Some Legal and Conceptual Issues



The aim of this article is to suggest a better measure for sickness in industrial companies in India. This is necessary as the existing government policy for tackling the problem of industrial sickness appears to be not effective in controlling the growing incidence of industrial sickness in India. Definition given in the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) cannot capture the initial stage of sickness, when appropriate remedial measures could have turned around a sick company. Measures suggested in this article may help to get early symptoms of sickness following which, possible remedial measures could be taken by the management of the company and its lending banks.

Introduction

Incidence of industrial sickness is pervasive to all segments of economy ruled by the market force. Sickness in industrial companies in India is thus not an exception. In this article, the issue of sickness in Indian manufacturing companies with specific reference to the SICA which was enacted to meet the problems of industrial sickness in India and the government policy related to it is discussed. The objective is to analyse the weakness of the existing policy, so that a better policy for handling this problem can be formulated.

Industrial Sickness and the Government Policy

Unlike what happens in a market driven economy, where firms with unsatisfactory performance level are allowed either to restructure or to exit, the Government of India in the pre-liberalised regime usually discouraged such a market driven solution to the problem of industrial sickness. Partly, this was due to the basic limitations of the government policy that had a so called socialist tilt, which discouraged the *laissez-faire* solution. But largely, this was due to the political pressure from the organised labour unions that did not allow the government to develop an exit policy with respect to a non-viable unit. At the early stage, the idea was to takeover the loss making private sector firms and continue to run them under the auspices of the government. Some of them were reconstructed but, in most of the cases, status of



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performance did not change. These loss making public sector enterprises were often funded from the budgetary allocation of the government on a continued basis, ignoring and overruling the basic criterion of long term viability. The central government and the Reserve Bank of India allowed banks to grant concessional credit for the poorly performing firms. The government also set up a financial institution (Industrial Reconstruction Corporation of India) in 1971, with the avowed objective of financing the sick companies and acting as a principal reconstruction agency. All these steps which thwart a market driven solution to the problem of industrial sickness, however, failed to produce desired results. The root of the problem was that the economic efficiency and the viability were never considered a serious issue while promoting and nurturing a sick unit. This was partly due to the political populism, but largely it was due to lack of the right kind of vision for running the units. Result was drainage of funds from the public exchequer.

The SICA, BIFR and Reorientation of the Policy

By mid 1980s, the government started relaxing the control over the industries, thanks to the reorientation of the government policy in this regard. Industrial climate started changing slowly. Nevertheless, many of the industries could not cope with such a changing climate. They became morbid and ultimately many of them had to wind up the business. Sickness became a familiar phenomenon in Indian industries. The Government of India could not escape this reality. Since 1980's, as the economy was opening up, the symptoms of sickness were surfacing. The initial reaction was to take over such industries under government management so that the social cost of sickness could be minimised. Gradually, however, nationalisation as a solution was agreed to be ineffective. At the same time, in the absence of proper bankruptcy laws and exit policy for labour, restructuring through market driven forces was also found to be inoperative in the country. Ultimately, wisdom that prevailed was of intervening in the process as the facilitator of revival. The Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) was the outcome of such an endeavour. In order to operationalise the provisions of SICA, Central Government constituted in 1987 the Board for Industrial and Financial Reconstruction (BIFR) which was conceived as the main agency for restructuring and rehabilitating the sick industrial companies. The main objective of the Act, as laid down in SICA, was to detect sickness following

certain predetermined norms and to suggest remedial measures after going through proper hearing of the individual cases. The Act also empowers the BIFR to formulate effective steps for either restructuring or rehabilitation or exit by recommending for winding-up. SICA was thus a retreat for the earlier policy of providing outright state support for running the sick units. At the same time, it did not empower the BIFR to wind up a company. Under the existing law, the BIFR can go through the financial statements of a company, to assess whether the unit can be declared as a sick industrial company. It also assesses the strength of a proposed rehabilitation package, so that a scheme for revival of the company can be worked out. In case such a package is offered and the BIFR finds it viable, the company would get a path for revival through government intervention. But, unlike what was the practice in the pre-SICA regime, when the government used to bail out a company by offering funds from its exchequer, under the new regime, the government does not take such steps. Again, exit by winding up, which was never conceived as a solution for the sick units in the pre-SICA regime, was incorporated as a logical possibility under the present dispensation. BIFR could not, however, tackle the problems of industrial sickness effectively. Main reasons are: (a) SICA defines industrial sickness only to capture the reality of terminal sickness when it has reached a stage of moribundity. The SICA definition thus fails to capture the initial stage of sickness when appropriate remedial measures could have turned around the company; (b) The BIFR is not adequately manned to handle the problems of terminally sick companies; (c) Rate of disposal of case in the BIFR is very slow; (d) The provisions of SICA keep a wide scope for utilising them by the sick companies as a protective shield for getting immunity from the repayment obligation to its creditors. Result is, increase in the magnitude of sickness in Indian industries.

Intensity and Severity of Sickness

The intensity of sickness (IS) is defined as a ratio of accumulated losses to networth. For calculating severity of sickness index of various states, other factors have been considered, namely sick industrial units as a percentage of total units of a state (U) and number of workers as a percentage of total factory workers of a state (W). Thus, severity of sickness index of a state is $(IS \times U \times W)$. Statewise distribution of number of cases registered with BIFR as sick industrial company as reflected from the BIFR data is given in Table 1.

Table 1: State-wise Distribution of Cases Registered with BIFR as on 6-8-2010¹

States	No. of Units Registered	Total No. of Factories	Net Worth (₹ Crore)	Accumulated Losses (₹ Crore)	Intensity of Sickness	No. of Workers	Total No. of Factory Workers	No. of Workers/Sick Unit	Severity of Sickness Index
	(1)	(2)	(3)	(4)	(5) (4 ÷ 3)	(6)	(7)	(8) (6 ÷ 1)	(9)
Haryana	158	4707	743.31	1548.09	2.08	38366	400895	243	0.007
Himachal Pradesh	49	1160	148.22	217.8	1.47	9297	72095	190	0.008
Jammu & Kashmir	6	672	12.3	63.15	5.13	411	42219	69	0.001
Punjab	276	10178	2365.71	4553.82	1.92	54050	435386	196	0.006
Rajasthan	228	6337	3016.98	4353.19	1.44	53880	278541	236	0.010
Uttar Pradesh	360	10717	4887.76	8667.33	1.77	176919	589695	491	0.018
Chandigarh	11	294	35.23	42.18	1.20	1661	8209	151	0.009
NCT Delhi	371	3198	7975.26	15878.25	1.99	90380	146920	244	0.142
Uttaranchal	44	1474	245.05	354.16	1.45	7498	97687	170	0.003
Andhra Pradesh	528	16741	5223.81	10021.23	1.92	219450	862414	416	0.015
Karnataka	299	8443	2929.16	5709.33	1.95	119121	567836	398	0.014
Kerala	150	5584	981.79	2366	2.41	51688	308641	345	0.011
Tamil Nadu	540	21042	3792.54	8378.13	2.21	165830	1283478	307	0.007
Pondicherry	17	703	53.34	117.83	2.21	2310	40494	136	0.003
Assam	19	1859	771.52	1728.88	2.24	16818	113132	885	0.003
Bihar	52	1783	817.9	1974.9	2.41	15966	62319	307	0.018
Jharkhand	46	1615	1749.78	5190.43	2.97	258518	289898	5620	0.075
Manipur	3	69	3.44	12.1	3.52	192	2442	64	0.012
Meghalaya	4	90	126.41	154.34	1.22	889	4574	222	0.011
Nagaland	4	104	56.69	194.35	3.43	1326	2494	332	0.070
Orissa	73	1822	1023.18	1747.58	1.71	28954	145276	397	0.014
Tripura	2	340	5.95	20.84	3.50	1414	20696	707	0.001
West Bengal	412	5987	10028.05	18705.6	1.87	620737	732237	1507	0.109
Goa	30	522	278.36	711.47	2.56	3984	37617	133	0.016
Gujarat	557	15107	8773.4	18140.03	2.07	226099	797443	406	0.022
Madhya Pradesh	252	3165	2059.64	5784.24	2.81	81013	194046	321	0.093
Chhatisgarh	29	1854	423.85	690.47	1.63	3852	118228	133	0.001
Maharashtra	1157	18304	18123.32	34716.27	1.92	348377	953097	301	0.044
Dadra & Nagar Haveli	11	1014	111.48	146.77	1.32	1423	67469	129	0.001
Grand Total (all India)	5688	144885	76763.43	152188.76	1.98	2600423	8675478	457	0.023

¹ Source: BIFR website www.bifr.nic.in

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As the data indicates, Maharashtra accounts for the higher percentage of units registered under the BIFR followed by Gujarat, Tamil Nadu and Andhra Pradesh. Intensity of sickness is the highest in Jammu & Kashmir. Severity of sickness index is the highest in the state of Delhi. In terms of the number of workers involved per unit of sick industrial units, Jharkhand tops the list with 5,620 workers per sick unit. Considering both the factors, one may conclude that the severity of the problem is most pronounced in Jharkhand, Madhya Pradesh, Bihar and Goa followed by West Bengal, Maharashtra and Gujarat, although this is not reflected in the number of cases registered with the BIFR.

Slow Pace of Disposal at BIFR and its Consequences

Table 2 furnishes the relevant information in regard to the rate of disposal of cases at BIFR. Number of pending cases was 303 at the end of 1987, i.e. the year when the BIFR started its operation. By the end of 2005, the cumulative number of pending cases increased to 2,147. The number decreased to 1,039 by the end of 2009, mainly due to declining number of cases referred to BIFR for registration. This is largely due to the poor rate of disposal shown in the last column of Table 2. Some companies take advantage of this weakness of the BIFR. Knowing that the time taken for deciding on sickness of a case is quite long, by the time a case is rejected as non-maintainable, audited accounts for the next financial year are prepared in a desired manner and on the basis of it, a fresh reference is made with a view to get protection under Section 22 of SICA and deny the obligation to its creditors with impunity for one more year. Audited statements, as known, are prepared only on the basis of certain standard norms. These are, of course, maintained by every company. But then, there are cases where the accounts do maintain the standard norms, but utilise certain universally approved provisions of the accounting system in manipulating the statement of accounts in the desired way. Technically speaking, the BIFR can hardly consider these cases as non-maintainable,

thanks to window dressing and no irregularities can be found from the statement of accounts per se. Even if the case is again rejected as non-maintainable, the company can prefer an appeal under Section 25 of SICA to the Appellate Authority for Industrial and Financial Reconstruction (AAIFR), the appellate body of the BIFR. So long as the adjudication of AAIFR is not received, the company can go on enjoying the protection under Section 22 of SICA. One thus understands that the basic purpose of SICA – that of either restructuring for revival or for winding up through liquidation has largely been defeated. By suitably utilising the provisions of SICA, a company can block with impunity a considerable sum of loan capital as non performing. The creditors can hardly get a relief and the defaulters can hardly be penalised. It is because of the way the provisions of SICA have been formulated. It thus appears that SICA has been converted to a useful weapon in the hands of the ill-motivated promoters and management of industrial companies, to safeguard their own interest at the cost of the interest of the creditors and general shareholders.

Table 2: Year-wise Rate of Disposal of Cases at BIFR upto 2009²

Year	Cases Registered	Cases Disposed	Cumulative Pending Cases		Average	Disposal Rate (%)
			Beginning of the Year	End of the Year		
1987	311	8	0	303	152	5
1988	298	42	303	559	431	10
1989	202	109	559	652	606	18
1990	151	91	652	712	682	13
1991	155	80	712	787	750	11
1992	177	83	787	881	834	10
1993	152	138	881	895	888	16
1994	193	165	895	923	909	18
1995	115	121	923	917	920	13
1996	97	206	917	808	863	24
1997	233	138	808	903	856	16
1998	370	111	903	1162	1033	11
1999	413	148	1162	1427	1295	11
2000	429	343	1427	1513	1470	23
2001	463	296	1513	1680	1597	19
2002	559	374	1680	1865	1773	21
2003	430	339	1865	1956	1911	18
2004	399	155	1956	2200	2078	7
2005	180	287	2200	2093	2147	13
2006	118	472	2093	1739	1916	25
2007	78	371	1739	1446	1593	23
2008	57	287	1446	1216	1331	22
2009	64	418	1216	862	1039	40

¹ Source: BIFR website www.bifr.nic.in (as on December 2009)

Weakness in the Definition of Sickness in SICA

In other countries, particularly in the developed countries of the world, there is hardly any rigidity in defining sickness, as it happens to be in India. Filing for the bankruptcy is voluntary. It may file for the bankruptcy when it fails to repay its loan obligations to the creditors. A firm may file for the bankruptcy; a restructuring of the company can also be envisaged. In order to operationalise any of such schemes, various committees are appointed by the Bankruptcy Court to look after the interest of the stakeholders, particularly the major creditors. Bankruptcy court is, of course, empowered to sanction a restructuring plan, even if it is not approved by the creditors and other concerned parties. But then, the creditors have ample scope for entering into the process, even when a company is in the process of filing for bankruptcy or for restructuring. In India, the procedure is different. The provisions for seeking bankruptcy (in the form of liquidation) or for restructuring, are very much there in Indian legal framework; but then, a company can maintain the *status quo* as well by utilising the provisions under the SICA. Thus, it may be held that the existing bankruptcy laws in India are not foolproof. As mentioned, SICA was enacted in 1985 and in accordance with SICA, 'sick industrial company' means a company (being a company registered for not less than five years) which has at the end of any financial year, accumulated losses equal to or exceeding its entire net worth. In 2002, Companies Act was amended to include National Company Law Tribunal (NCLT) to take up the job of handling the problem of industrial sickness in India. In terms of Section 2 (46 AA) of Companies (Second Amendment) Act, 2002, 'sick industrial company' is an industrial company which has: (i) the accumulated losses in any financial year equal to 50 per cent or more of its average net worth during four years immediately preceding such financial year; or (ii) failed to repay its debts within any three consecutive quarters of demand made in writing for its repayment by a creditor or creditors of such company. NCLT, has, however, not been operationalised. Be that as it may, an examination of the above definitions suggests that regulatory authorities in India have, by and large,

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defined industrial sickness only to capture the reality of terminal sickness. Since the signs of disease usually precede the moribundity, intervention for revamping the unit should have been taken at the stage when the unit was morbid. A definition that identifies sickness when the company is in the terminal stage of sickness, fails to capture the right type of strategy to turnaround the company at the right time. This problem cannot be addressed properly, unless the issue of sickness is given reconsideration.

Better Measure for Industrial Sickness

The *sine qua non* of industrial sickness is that production fails to maintain cost – effectiveness, as a result of which the firm or a group of firms cannot maintain competitive efficiency. As the firm fails to meet the sunk cost, it has to close its operation. Those who cannot survive are to face the reality of getting sick unless they take up turnaround management. In order to adapt turnaround management, the firm should get a signal that there is some threat to the existing business. Whether this is reflected in the financial data of the company is the basic issue which, as we understand, has not been addressed properly in the existing literature of industrial sickness. The financial ratios based on which various models following ALTMAN's model were developed, were selected on the basis of a *priori* considerations. These ratios do not have macro foundation. Moreover, the financial ratios used in the various models are so complicated that it becomes difficult to operationalise them in the Indian context. The existing models, thus, may not provide a robust set of financial ratios for analysing firm level sickness. Keeping in view of these shortcomings, two empirical models have been developed considering company level (micro) financial ratios, which have macro foundation and proper mapping with the macro indicators. These ratios can be culled easily from the balance sheet and profit and loss account of a company even by a lay person, without having much knowledge of the financial statement of a company. The first model is based on multiple discriminant analysis, based on which a Z score has been worked out. Based on this Z score, one would be able to classify an Indian manufacturing company as either 'healthy' or 'sick'.

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The other model (predictive model) based on binary logistic regression analysis, would be appropriate in the Indian context for reasonably predicting probability of an Indian manufacturing company becoming sick or otherwise in future. We have checked the validity of these two models by considering a panel data of another 50 'healthy' companies and 50 'sick' companies and found them robust.

The Discriminant Model

The discriminant function derived as $Z = 0.728 X_1 + 0.084 X_2 + 0.305 X_3 + 0.900 X_4$

The model shows cut-off discriminant score of 0.432342. Companies exceeding the score are sick and companies falling short of the score are healthy. The model correctly classifies 97% before one year, 95% before two years, 93% before three years, 90% before four years and 86% before five years of original grouped companies.

The Predictive Model

$$P(\text{Healthy}) = \frac{1}{1 + e^{-Z}}$$

where, $Z = 9.5909 - 46.9134X_1 - 15.5178X_2 + 126X_3 - 14.3800X_4$

With probability of 0.72, 97% of the companies have been found to be correctly classified into their respective predetermined group. Variables are:

- X1 = Power and fuel/total income
- X2 = Current liabilities and provisions/total assets
- X3 = Other fixed costs/total assets
- X4 = Total borrowings/total assets

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Finding signals of sickness is important for studying the problem of industrial sickness. If a unit is found to have symptoms of sickness or morbidity, one would try to recognise the problem in terms of certain basic financial indicators.

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One will find from the above that the models are very simple and user-friendly. Even a lay man can use the models. What he has to do is to find out three items, namely, current liabilities and provisions; total borrowings and total assets from the balance sheet of a company and three items, namely, power and fuel, other fixed cost comprising of selling and distribution expenses and commissions; and total income from the profit and loss account of a company. If the Z score from the discriminant model is found to be more than 0.43, the company could be safely classified as sick and if the value of P (Healthy) is above 0.7, it could be safely concluded that the probability of that company remaining healthy is bright.

Conclusion

Finding signals of sickness is important for studying the problem of industrial sickness. If a unit is found to have symptoms of sickness or morbidity, one would try to recognise the problem in terms of certain basic financial indicators. Following this, one can suggest the possible remedial measures for turnaround. Definition of sickness given in the SICA cannot capture the initial stage of sickness when appropriate remedial measures could have turned around a sick industrial company. Alternative measures of sickness thus assume importance. The discriminant model as worked out, will help the management of a company to know about its status of health. If the Z score is nearer to 0.43, management may take up the turnaround management. Again, success of implementing remedial measures for turnaround would be known from the predictive model. If the value of P (Healthy) is more than 0.50, the management of a company can safely invest for its turnaround. ■