ISSN No. 2347-8327

RGNUL Financial and Mercantile Law Review

INSIGHTS:

The Regulatory Challenge of Financial Disintermediation and Market Volatility – Analysis, criticism and alternatives to the st-crisis strategies of managing systemic risk within the shadow banking sector.

- Max Bärnreuther, M.Jur. (Oxford), Maître en Droit (Panthéon-Assas)

Corporate Bankruptcy And Insolvency Resolution In India: Lacunae In The Present And Remedy For The Future

-Rohan Kohli

Protection of trade secrets - does India need a separate legislation

-Dheeresh Kumar Dwivedi

Volume III 2016 Issue 2

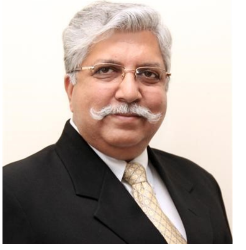
RGNUL FINANCIAL AND MERCANTILE LAW REVIEW

[MODE OF CITATION: 3 RFMLR 2 (2016)**]**

A publication of Rajiv Gandhi National University of Law, Punjab

APRIL 2016 VOLUME III

PATRON-IN-CHIEF'S MESSAGE



I am happy to say that the RGNUL Financial and Mercantile Law Review Volume III Issue II is ready and is being released.

The present volume aims to provide a better understanding of various complexities and nuances between law and economics to a wide range of readers such as academicians, legal practitioners and students. I sincerely believe that this volume would add to furthering quality research.

This volume contains articles covering different aspects relating to business and trade laws. In particular, it consists of articles on banking laws, insurance laws, company law, intellectual property law, etc. In this era of rapid globalization, the constant growth of laws regulating various related activities are highly desirable. However, it is essential to strike a balance between regulating by the force of law and fostering an environment to ease the carrying on of such activities. We, therefore, hope that this initiative will play a pivotal role in bringing clarity in the aforementioned field of law.

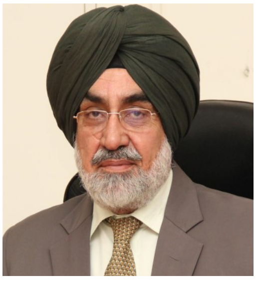
I, on behalf of all students and faculty of RGNUL, Punjab, express my gratitude to all the distinguished members of the Peer Review Board who have devoted their valuable time in reviewing the manuscripts and providing their valuable insight. I would like to appreciate the efforts made by the Faculty Editor and the entire student run Editorial Board. This issue of RFMLR, I hope, will be a trendsetter. I wish the journal all the best

Professor (Dr.) Paramjit S. Jaswal

Patron-in-Chief

RGNUL Financial and Mercantile Law Review

PATRON'S MESSAGE



I am immensely elated to present the RGNUL Financial and Mercantile Law Review Volume III Issue II. I take this opportunity to proudly shed some light on the impeccable success this journal has achieved in the quest to promote legal education.

The objective of this journal is to understand the various nuances of law and business with more clarity and at the same time, a multitude of different perspectives. I sincerely hope that this edition proves to play a vital role in finding legal solutions and identifying key issues in this complex field of law.

The RGNUL Financial and Mercantile Law Review has reached great heights with contributions from highly regarded members of the legal fraternity, the high standards of scrutiny and time bound delivery – all of which has made this journal internationally renowned. I would appreciate the hard work of the students in making this journal a success.

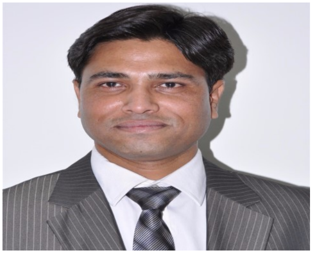
I would like to express my gratitude to all the distinguished members of the Peer Review Board who have joined this initiative and provided valuable insight. I would like to congratulate and appreciate the efforts made by Dr. Anand Pawar, the Editor-in-Chief and the entire Editorial Board for having furthered this initiative with utmost dedication and sincerity. I sincerely believe that the research papers will receive appreciation from the readers and experts; and, will be beneficial to all concerned.

Professor (Dr.) G.I.S Sandhu

Patron

RGNUL Financial and Mercantile Law Review

FOREWORD



It is with great pleasure that I place before you the third edition of RGNUL Financial & Mercantile Law Review. This law review was an endeavour on our part to better understand the financial market and regimes of India and South East Asia and to promote discourse between academia in India, West and South East Asia. We also suggest engaging with the legal industry in India and wanted to lend our pages thoughts and opinions, so that we could better understand what the industry needs.

Needless, to say turning out the third edition has been a mammoth challenge but also, a very rewarding one. We got an opportunity all over the world who were encouraging and helpful to say the least and many went out of their way to help us and to contribute to our endeavour; special thanks to goes out at this point to the advisory board who associated with us not and lent their name to our enterprise and without whom this review who have dead at its very inception. We would also like to thank our referees and contributors whose commitment to this review sees the light of the day.

The third edition of RFMLR has concentrated on open theme covering various areas such as Corporate law, International Trade Law, Intellectual Property Law, Insurance Law and Banking Law with papers received from all parts of India with enthusiasm. We wish the contributors continue to show us the dedication with future issues to come.

We hope the review makes for an interesting read and we would love to hear your opinions on how we can make it better. Please feel free to write in to us.

DR. ANAND PAWAR

EDITOR-IN-CHIEF

Table of Contents

INTELLECTUAL PROPERTY RIGHTS

PROTECTION OF TRADE SECRETS - DOES INDIA NEED A SEPARATE LEGISLATION?

DHEERESH KUMAR DWIVEDI*

Introduction

In this world of the free market, intellectual property[1] laws play a very vital role. They constitute the most important tool to survive in a rather competitive market. Intellectual property law ensures that rights of an owner of the intellectual property are not being infringed to his prejudice by a third party[2] so that he exclusively[3] enjoys the rightful fruit of his labour, skill and judgement. Since these rights are the creation of statutes,[4] which are limited in time and space,[5] they are legitimized by the state and thus protected by it.

---

* IV year, B.ALLB (Hons), National Law Institute University, Bhopal.

[1] Intellectual property refers to creations of the mind, such as, inventions, literary and artistic works, symbols, names, images and designs, used in commerce. The property is not in those works but in the information or knowledge reflected in them, the right to which can be sold or licensed for use. Intellectual property is divided into two categories: industrial property, which includes inventions (patents), trademarks, industrial designs and geographic indications of source, know-how or trade secret and copyright, which includes literary and artistic works such as knowledge, poems and plays, films, musical works, drawings, paintings, photographs and sculptures and architectural designs. *See* Indian Farmers Fertilizer Co-operative Limited v. Commissioner of Central Excise, (2007) 7 VST 6 CESTAT New Delhi at ¶ 16-19 [hereinafter referred to as 'IFFCO'].

[2] *Ibid*. at ¶ 19.

[3] "*Exclusive*" means "restricted to the person." *See* THE COMPACT OXFORD REFERENCE DICTIONARY, 284 (C. Soanes ed., Oxford University Press 2003).

All the Intellectual Property, except 'Trade Secret,' confers exclusive right on the owner. However, since existence of Trade Secrets depends on 'secrecy' of information, disclosure of same renders it unprotectable, giving whole world right to exploit the information. Hence, Trade Secrets are not themselves subject to fully exclusive rights of industrial property. See *WIPO Intellectual property Handbook: Policy, Law and Use, Patents, Introduction*, WORLD INTELLECTUAL PROPERTY ORGANIZATION, 150 , (Nov. 30, 2015); See also, David D. Friedman, William M. Landes, & Richard A. Posner, *Some Economics of Trade Secret Law*. JEP, 61-72 (1991).

4 CORNISH W., LLEWELYN D., & APLIN T., INTELLECTUAL PROPERTY: PATENT, COPYRIGHT, TRADEMARKS AND ALLIED RIGHTS, 9 (7th Ed., 2010).

[5] All the intellectual property rights, except Trademark and Trade Secret, are limited in time. Similarly, except Trade Secret, all the rights are limited in space i.e. they are territorial in nature. However, Trade Secret varies according to jurisdiction. *See* Md Zafar Mahfooz Nomani &

The existing legal regime on the protection of intellectual property rights is ineffective in so far as the protection of Trade Secrets[6] is concerned as these rights require registration with the government which entails a very expensive burden. Also, if a Trade Secret is to be registered either as copyright or as patent, it would automatically come into the public domain, rendering the secret public. Moreover, Copyright law also does not grant any protection whatsoever to Trade Secret as there can be no Copyright in an idea[7] and makes an action for the breach of trust or confidence independent of the Act.[8] Thus, it can be said that Trade secret is the creation of common law.[9]

Although, various international multilateral treaties to which India is a party provide for the protection of Trade Secrets,[10] the parliament has, in ignorance of its constitutional obligation,[11] so far not enacted any piece of legislation for the protection of Trade Secretes.[12] Consequently, Trade Secrets in India are being

Faizanur Rahman, *Intellection of Trade Secrets and Innovation Laws in India,* 16(4) JIPR (2011). [hereinafter referred to as 'Zafar & Rahman'].

6 Trade secret is also a form of intellectual property right. *See* Cattle Remedies v. Licensing Authority, 2007 (2) AWC 1093; IFFCO, *supra* note 1 at ¶ 17.

7 RG Anand v. Delux Films, AIR 1978 SC 1613. However, Trade Secrets can be obtained over a fully developed idea or substance of it. Also, to get protection under Trade Secret law, an idea or information need not to be novel. *See* Fraser v. Thames Television Ltd., [1984] QB 44.

8 COPYRIGHT ACT, §16 1957, provides that though no copyright can be granted otherwise than in accordance with the provisions of Copyright Act, 1957; unprotected works can still be protected for breach of trust or confidence.

9 MARGRETH MARGRETH BARRETT, INTELLECTUAL PROPERTY, 42 (2nd ed. 2001). [hereinafter referred to as 'Barrett'].

10 PARIS CONVENTION FOR THE PROTECTION OF INDUSTRIAL PROPERTY, art. 10bis July 12, 1967, 21 U.S.T. 1583, 828 U.N.T.S. 305. and AGREEMENT ON TRADE RELATED ASPECT OF INTELLECTUAL PROPERTY, art. 39.2 Apr. 15, 1994, 1869 U.N.T.S. 299; 33 I.L.M. 1197 (1994). Though Paris Convention does not talk about trade secret as such, it accords protection against 'unfair competition' and thereby guarantees protection from dishonest practices in industrial or commercial matters.

11 INDIAN CONST. art. 51(c) obliges the state to foster respect for international law and treaty obligations. Although Article 51 is merely one of the Directive Principles of State Policy, finding place under Part IV of the Constitution of India, nevertheless they are fundamental in governance of the Country and it is the duty of the state to apply these principles in law making. *See* INDIAN CONST. art. 37.

12 An attempt was made to bring a law for protection of Trade Secretes in form of Draft National Innovation Act, 2008. However, this bill has not yet seen the shine of the day. Draft bill can be accessed at http://www.dst.gov.in/sites/default/files/draftinnovationlaw.pdf, (Dec. 4, 2015).

protected either under common law action of breach of confidence, which is in effect breach of contract[13] or common law principle of equity[14] or in certain cases, under Criminal law.[15] This has resulted into the emergence of rather inconsistent and incoherent judge made law,[16] often made in ignorance of requirement and development of the market. As a result, India is lagging behind developed legal systems of the world in the field of protection of Trade Secrets which could prove a major hurdle in country's ***'Make in India'*** mission.

The present paper analyses existing legal regime governing the protection of Trade Secret in India. In part I of the paper, the author has discussed the various dimensions of the definition of the Trade Secret in India as given by various jurists. Part II of the paper seeks to identify various fields of law under which trade secret is protected. It has been divided into three sub-parts dealing with the law of contract, law of equity and criminal law respectively. Part III of the paper deals with remedies available for infringement of trade secret in India. As a conclusion, the author has highlighted the lack of legal protection accorded to Trade Secret and loopholes in the present Draft National Innovation Act, 2008 and strives to provide a solution for the same.

Part I: Defining the undefined: Meaning of Trade Secret

In common parlance, Trade Secret is 'information of commercial value kept secret.'[17] In the absence of any specific legislation governing Trade Secret in India, it has largely been defined by the courts. However, Draft National Innovation Act

---

[13] INDIAN CONTRACT ACT § 27, 1872, provides that a person can be restrained from disclosing confidential information by way of contract. However, such contracts must be reasonable; otherwise they can be declared to be void under section 27 of the Act. *See* Superintendence Company of India Pvt. Ltd. v. Shri Krishna Murgai, AIR 1980 SC 1717 [hereinafter referred to as 'Shri Krishna Murgai'].

[14] Fairfest Media Ltd v. Ite Group Plc & Ors., 2015(2) CHN (CAL) 704 [hereinafter referred to as 'Fairfest Media'].

[15] IPC, 1860 provides for theft and criminal breach of trust applicability of which is limited due to intangible nature of trade secret. Similarly, Information Technology Act, 2000 also contains penal provision for breach of confidence and data theft.

[16] Zafar & Rahman, *supra* note5 at P. 349.

[17] Prof. Chandni Raina, *Trade Secret Protection in India: The Policy Debate*, (Dec. 02, 2015). http://wtocentre.iift.ac.in/workingpaper/Trade%20Secret%20Protection%India20policy%20debate.pdf,

2008,[18] for the first time, has attempted to define trade secret or confidential information[19] as information of economic value which is kept secret by the owner through reasonable means.[20] This definition is *almostidentical* to the definition of 'confidential information' as given under Article 39.2 of Agreement on Trade-Related Aspects of Intellectual Property[21] which defines Trade Secret as:

> ***Article 39 (2)*** *Natural and legal persons shall have the possibility of preventing information lawfully within their control from being disclosed to, acquired by, or used by others without their consent in a manner contrary to honest commercial practices*[22] *so long as such information:*
>
> *(a) is secret in the sense that it is not, as a body or in the precise configuration and assembly of its components, generally known among or readily accessible to persons within the circles that normally deal with the kind of information in question;*
>
> *(b) has commercial value because it is secret; and*
>
> *(c) has been subject to reasonable steps under the circumstances, by the person lawfully in control of the information, to keep it secret.*

---

[18] DRAFT NATIONAL INNOVATION ACT, §2(3) 2008. It read as follows:

Section 2(3) "Confidential Information" means information, including a formula, pattern, compilation, program device, method, technique, or process, that:

(a) is secret in that it is not, as a body or in the precise configuration and assembly of its components, generally known among or readily accessible to persons within the circles that normally deal with the kind of information in question;

(b) has commercial value because it is secret; and

(c) has been subject to reasonable steps under the circumstances by the person lawfully in control of the information, to keep it secret.

Hereinafter referred to as 'Draft NI Act'

[19] There is a debate whether 'Trade Secret' and 'Confidential Information' can be used interchangeably or not. However, in light of treatment given to these terms by both the Draft NI Act and the courts, the author has used them interchangeably throughout the paper. See DRAFT NATIONAL INNOVATION ACT, §2(7), 2008 and IFFCO, *supra* note 1 at ¶19.

[20] Definition of 'Confidential Information' as given under §(3) of the Draft NI Act, 2008 is very much similar to the definition of 'Trade Secret' as given under the UNIFORM TRADE SECRETS ACT, §2(4) 1985.

[21] Hereinafter referred to as 'TRIPs'.

[22] For the purpose of this provision, "a manner contrary to honest commercial practices" shall mean at least practices such as breach of contract, breach of confidence and inducement to breach, and includes the acquisition of undisclosed information by third parties who knew, or were grossly negligent in failing to know, that such practices were involved in the acquisition. *See* footnote 39.2 of TRIPs, art. 39.2.

The courts have also made several attempts to define Trade Secret. Thus, the Delhi High Court[23] defines trade secret as information or formulae, technical know-how or a peculiar mode or method of business adopted by an employer which is unknown to others[24] and which if disclosed to a competitor, would be liable to cause a real or significant harm to the owner of the secret.[25] Similarly, in ***Indian Farmers Fertilizer Co-operative Limited v. Commissioner of Central Excise,***[26]'Trade Secret' was defined as a formula, practice, process, design, instrument, pattern or compilation of information used by a business to obtain an advantage over competitors within the same industry or profession. However, refusing to provide an exhaustive list of information that can be considered a Trade Secret,[27] the Court observed that customer's lists and information concerning the proposed contents of a mail order catalogue,[28] designs, drawings,[29] manufacturing process,[30] architectural plans, business strategies, business plans[31] are some of the examples of trade secret. However, 'every information of general knowledge of facts' or mere use of words like

---

[23] Burlington Home Shopping Pvt. Ltd. v. Rajnish Chibber, (1995) 61 DLT 6 [hereinafter referred to as 'Burlington Home'].

[24] Ambiance India Pvt. Ltd. v. Shri Naveen Jain, 122 (2005) D.L.T. 421, ¶ 6; *see also* American Express Bank, Ltd. v. Priya Puri, (2006) 3 L.L.N. 217.

[25] Coco v. A.N. Clark (Engineers) Ltd., (1969) R.P.C. 41 [hereinafter referred to as 'Coco v. Clarke']; Thomas Marshall, *supra* note 23.

[26] Indian Farmers Fertilizer Co-operative Limited v. Commissioner of Central Excise, (2007) 7 VST 6 CESTAT New Delhi at ¶ 19; *see* also Bombay Dyeing and Manufacturing v. Mehar Karan Singh, 2010 (112) BomLR 3759 at ¶ 39.

For dictionary meaning of the term, *see* BRYAN A GARNER, BLACK'S LAW DICTIONARY 1533 (8th Ed. 2004).

[27] Burlington Home, *supra* note 25; Mr. Diljeet Titus v. Mr. Alfred A. Adebare and Ors. 130 (2006) DLT 330 at ¶ 9 [hereinafter referred to as 'Diljit Titus']; *See also* MCCOMAS, W. R., DAVISON, M. R., & GONSKI, D. M., THE PROTECTION OF TRADE SECRETS: A GENERAL GUIDE 8 (6th Ed. Butterworths, Sydney 1981)[hereinafter referred to as 'McComas, Davison & Gonski'].

[28] Burlington Home, *supra* note 25.

[29] Saltman Engineering Coy. Ld., Ferotec Ltd. and Monarch Engineering Coy. (Mitcham), LD. v. Campbell Engineering Coy., Ld., 65 R.P.C. 203 [hereinafter referred to as 'Saltman v. Campbell'].

[30] Harvey Tiling Company (Pty.) Limited v. Rodomac (Pty.) Limited and Another, (1977) R.P.C. 399 (Supreme Court of South Africa).

[31] Michael Michael Heath Nathan Johnson v. Subhash Chandra, 60 (1995) DLT 757 [hereinafter referred to as 'Michael Nathan']; *Trade Secrets Are Gold Nuggets: Protect Them*, WIPO Magazine (Apr. 2002)
http://www.wipo.int/export/sites/www/sme/en/documents/wipo_magazine/04_2002.pdf,

'strategic or crucial policy decision',[32] 'trivial tittle-tattle',[33] immoral or scandalous material[34] or general concepts *perse*[35] cannot be labelled as Trade Secret. Further, information need not be in writing and even oral information is protected.[36] Hence, to claim breach of Trade Secret, one must establish that:

i. Information is secret;
ii. It has commercial value; and
iii. All reasonable steps have been taken to protect its secrecy.

i. Threshold of 'Secrecy'

Secrecy is the core of Trade Secret.[37] Information, formulae or a technical know-how to qualify to be trade secret, it must not be generally known[38] or accessible to the public.[39]However, the test of secrecy is 'relative' and not 'absolute'.[40] Thus, if information is known to some other selected people other than its originator, it is still considered secret.[41] Hence, information partially secret and partially public would be protected under the doctrine of '*Springboard*'.[42] The doctrine, first propounded by Roxburgh J. in ***Terrapin v. Builders' Supply Co.***,[43] ensures that a person who has obtained confidential information from the owner through improper means[44] does not use it without

32 Star India Private Limited v. Laxmiraj Seetharam Nayak & Anr, 2003 (3) BomCR 563 at ¶ 14.
33 Coco v. Clarke, *supra* note 26 at 48; McNichol v. Sportsman's Book Stores, (1928-30) Mac. C.C. 116.
34 Stephens v. Avery, (1988) 2 All ER 477 [hereinafter referred to as 'Stephens v. Avery'].
35 Cybertek Computer Products, Inc. v. Whitfield, California Superior Court, 203 U.S.P.Q. 1020 (1977). However specific implementation involving a particular combination of general concepts may still amount to trade secret. *See* Winston Res. Co. v. Minnesota Mining & Manufacturing Co. 350 F.2d 134 (9th Circuit 1965); *see also* Barrett, *supra* note 9 at P. 40.
36 Douglas v. Hello! Ltd. (No.2), (2005) 4 All E.R. 128 (Court of Appeal).
37 Michael Nathan, *supra* note 33. The Court denied injunction on the ground, *interalia*, of plaintiff not being able to establish the secrecy of information.
38 Thomas Marshall, *supra* note 23; Saltman v. Campbell, *supranote* 31.
39 IFFCO, *supra* note 1 at ¶ 12, 13, 14, 33.
40 K2 Ski Co. v. Head Ski Co. Inc., 506 F 2d 471 (9th Cir. 1974); Vestrgaard Frandsen A/S v. Bestnet Europe Ltd., [2013] UKSC 31.
41 Stephens v. Avery, *supra* note 36, Michael Nathan, *supra* note 33.
42 Rivendell Forest Prods. Ltd. v. Georgia Pacific Corp., 28 F 3d 1042 at 1046 (10th Cir. 1994).
43 Terrapin v. Builders' Supply Co., (1960) R.P.C. 128.
44 Though the Draft Act uses word 'improper means', it leaves it undefined. However, UNIFORM TRADE SECRET ACT, §1(1) 1985 gives inclusive definition of 'improper means'. It reads as follow:

an authorization of the owner in his detriment[45] to get 'head-start' or edge over other competitors in the market.[46] However, the fact that the trade secret can be obtained through reverse engineering[47] does not negate the secrecy of the Trade Secret.[48]

ii. Threshold of 'commercial value'

Information must have some commercial value i.e. it must provide some kind of economic or commercial advantage to its owner over his competitors who do not have it.[49] Thus, where a religious group had a trade secret regarding course of its religious practice and the information was obtained by another religious group through improper means who threatened to make it public, it was held that since trade secret cannot be based solely on spiritual advantage, unless it has some kind of commercial or economic advantage, it cannot be protected under the law.[50] However, if it can be established that the alleged trade secret had an economic advantage as well, it will be protectable by law.[51] Similarly, considering the eligibility of 'customer's list' as the Trade Secret, the Court of Appeal of California[52] held that where there are many potential customers in the market but only a few of them are actual purchaser, the customer list may be considered as the Trade Secret as its compilation requires investment of time and money. However, if the identity of customers is known

§ 1 (1) "Improper means" includes theft, bribery, misrepresentation, breach or inducement of a breach of a duty to maintain secrecy, or espionage through electronic or other means.

[45] Urmi Juvekar Chiang v. Global Broadcast News Ltd. & Anr, (2007) 109 (2) Bom LR 981.

[46] The principle was reiterated by the Delhi High court in Michael Nathan, *supra* note 33; Seager v. Copydex Ltd., (1967) 2 All ER 415 [hereinafter referred to as 'Seager v. Copydex'].

[47] "Reverse engineering" refers to a process of discovery by starting with the known product and working backward to find the method by which it was developed. The acquisition of the known product must, of course, also be by a fair and honest means, such as purchase of the item on the open market for reverse engineering to be lawful. *See* THE RESTATEMENT OF TORTS, §757, Comment (f) AMERICAN LAW INSTITUTE, 1939.

[48] Barrett, *supra* note 9 at P. 45.

[49] Wade Cook Seminars, Inc. v. Mellon, 1999 WL 211831(Wash App Div 1 1999); Barrett, *supra* note 9 at P. 48.

[50] Religious Technology centre v. Wollershiem, 796 F. 2d 1076 (9th Cir. 1986).

[51] Religious Technology centre v. Scott, 869 F. 2d 1306 at 1310 (9th Cir. 1989).

[52] Electro Optical Industries, Inc. v. Stephen White, 1999 WL 1986467 (Cal App 2 Dist 1999).

to everybody in the market, it cannot be said to have economic value and, therefore, cannot be protected under the law.[53]

iii. <u>Threshold of 'reasonable protection'</u>

To keep the Trade Secret as a Trade Secret in perpetuity,[54] a company must take 'all reasonable steps' to prevent it from being known to public as once it becomes public, though the company would have common law remedy of injunction, the trade secret would no longer be considered as a Trade Secret.[55] However, the obligation to take reasonable steps is not absolute[56] and is confined to 'what is reasonable under the circumstances'.[57] To evaluate the reasonableness of measures being taken, *cost-benefit analysi*s has been suggested as to whether the benefit from the protection of trade secret would outweigh cost involved in the security of Trade Secret.[58] Thus, where a company has marked 'confidential' on its pricing and strategic-plan data, it was held that company has exercised reasonable care to protect its confidential information and, therefore, is entitled to be protected under the law.[59] However, where a pharmaceutical company did not have any written agreement on confidentiality and Trade Secret with its employee nor any policy or procedure for protection of the same, protection of trade secret was held to be unavailable.[60] However, small companies are not required to take 'rigorously' reasonable steps to protect their Trade Secret and if a family-run cheese company limits access to its Trade Secrets to family members only, reasonable steps are said to have been taken.[61]

---

[53] ABBA Rubber Co. v. Seaquist (1991) 235 Cal.App.3d 1, 18-19, 286 Cal.Rptr. 518; American Paper & Packaging Products, Inc. v. Kirgan (1986) 183 Cal.App.3d 1318, 1326, 228 Cal. Reporter. 713).

[54] Unlike patent, copyright or trade mark, the attribute of protection of confidential information in the know-how or trade secret gives perpetual monopoly in such secret information which does not expire over a period of time as is usual for the protection in form of validity period granted to patents and copyrights. *See* IFFCO, *supra* note 1 at ¶ 20.

[55] IFFCO, *supra* note 1 at ¶ 20.

[56] Pioneer HiBred International v. Holden Found Seeds, 35 F 3d 1226, 1235 (8th Cir. 1994) ; Gates Rubber Co. v. Bando Chem. Indus. Ltd., 9 F 3d 823, 848-49 (10th Cir. 1993).

[57] E. I. duPont deNemours & Co., Inc. v. Christopher, 431 F. 2d 1012 (5th Cir. 1970).

[58] Barrett, *supra* note 9 at P. 45.

[59] LeTeune v. Coin Acceptors, Inc., 849 A.2d 451 (Md. 2004).

[60] Delcath Systems, Inc. v. Foltz, 2007 Ct. Sup. 804 (Conn. Super. Ct. 2007).

[61] Elm City Cheese Co. v. Federico, 251 Conn. 59, 78-86 (Conn. 1999).

Part II: Protection of trade secret in India

In the absence of any specific or general law dealing with Trade Secret, it is continued to be governed and protected by common law principle of equity and the private contract between the parties. Also, in some cases, protection of Trade Secret can be sought under provisions of Indian Penal Code and Information Technology Act. The justification of protection of Trade Secret or confidential information is rooted in agreement,[62] trust,[63] equity,[64] confidence, property[65] and bailment;[66] that the principle of equity demands that '*he who has received information in confidence shall not take unfair advantage of it.*' Thus, in a vast majority of Trade Secret cases the duty of confidence arises either out of the contractual relationship between parties, either expressly or impliedly[67] or independently in equity.[68] However, more recently, the contract has lost its monopoly in the protection of Trade Secret[69] and courts have recognized much wider equitable jurisdiction based on, not so much on 'contract' or 'property', but rather on 'good faith'.[70]

---

[62] Vokes v. Heather, (1945) 62 R.P.C. 135, CA; British Celanese v. Moncrieff, (1948) 65 R.P.C. 165 at 167, CA.

[63] Coco v. Clarke, *supra* note 26 at 46.

[64] Robb v. Green, (1895) 2 Q.B. 315, CA.

[65] Shree Gopal Paper Mills v. SKG Malhotra, AIR 1962 Cal 61[hereinafter referred to as 'Gopal Paper Mills'].

[66] Prince Albert v. Strange, (1849) 2 De G. & Sm. 652; Morison v. Moat, (1851) 9 Hare 241.

[67] Gurry on his treatises on 'Breach Of Confidence' observes that the contractual jurisdiction must be considered an important Fairfest Media quoting with basis of the action for breach of confidence. See TANYA APLIN , LIONEL BENTLY , PHILLIP JOHNSON , SIMON MALYNICZ & GURRY ON BREACH OF CONFIDENCE: THE PROTECTION OF CONFIDENTIAL INFORMATION 35 (OUP, 1984). [Hereinafter referred to as 'Gurry on Breach of Confidence'].

[68] Seager v. Copydex, *supra* note 48; affirmed by Lord Goff in Attorney General v. Guardian Newspapers Ltd. [1988] 3 All ER 545 [hereinafter referred to as 'Spycatcher case'].

[69] CORNISH, WILLIAM RODOLPH & LLEWELYN, DAVID, INTELLECTUAL PROPERTY, 304 (5th Ed. 2003) [hereinafter referred to as 'Cornish & Llewelyn'].

[70] Saltman v. Campbell, *supra* note 31. Taking one step forward, despite the presence of contract, equity was held to be separate and independent ground of jurisdiction. *See* Peter Pan v. Corsets Silhouette, (1963) R.P.C. 45; Cranleigh Precision v. Bryant, (1966) R.P.C. 81. However, Ungoed-Thomas J. gave an alternative interpretation by saying that it is 'the policy of the law' to enforce confidences created by the communication of confidential information which is the basis of the courts' jurisdiction. Once this policy is brought to mind, it is possible to regard the jurisdictional sources on which the courts rely as merely secondary mechanisms which provide the means by which the courts can enforce a confidence. *See* Argyll v. Argyll [1967] 1 Ch. 302.

In India, Trade Secret has been accorded protection under both, common law principle of breach of confidence and principle of equity.[71] In Gurry's treatise on 'Breach of Confidence',[72] the jurisdiction of courts for protection of Trade Secret or confidential information has been discussed in following words:

> *"Equity has two distinct roles in the breach of confidence action. The first of these is auxiliary to the legal jurisdiction which the courts have in the contract. ... Where an injunction is granted in aid of a legal right the court is still, by history, exercising an equitable jurisdiction. Thus, where an obligation of confidence is founded in contract and the court grants an injunction to restrain the confidant from misusing confidential information in breach of that obligation, the injunction is granted upon an exercise of the equitable jurisdiction. This auxiliary jurisdiction in equity has been frequently used by the courts in cases involving a breach of confidence and, in appropriate circumstances, an injunction will be granted to enforce either an express or an implied contractual obligation of confidence.*
>
> *The second role of equity is to provide a jurisdiction by which the courts will restrain a breach of confidence independently of any right at law."*

Hence, in case of infringement of trade secret, remedy can be sought under:

i. Law of contract,
ii. Principle of equity, and
iii. Criminal law

i. <u>Protection of trade secret under law of contract</u>

When confidential information is transferred by an owner to a recipient, it can be either expressly or by implication.[73] The express obligation of confidence is

---

71 The maintenance of secrecy which plays such an important part in securing to the owner of an invention uninterrupted proprietorship of marketable know-how, which thus remains at least a form of property, is enforceable at law. That statement may now be examined in the light of established rules making up the law of trade secrets. These rules may, according to the circumstances in any given case, either rest on the principles of equity, that is to say the application by the Court of the need for conscientiousness in the course of conduct, or by the common-law action for breach of confidence which is in effect a breach of contract. *See* John Richard Brady and Others v. Chemical Process Equipments P. Ltd. and Anr., A.I.R. 1987 Delhi 372 at ¶ 24 [hereinafter referred to as 'John Richard Brady'].

72 'Gurry on Breach of Confidence' *supra* note 69 at P.36.

73 Even in the absence of an express agreement, it is an implied term of an employment contract that an employee will not divulge a trade secret learned by virtue of his employment to a

often created by contract between the parties under which parties can clearly define nature of information to be kept confidential and extent of liability for its potential breach.[74] However, such contracts are subject to common law doctrine of 'restraint of trade'[75] and have to pass the test of 'reasonableness'.[76] This doctrine is based on 'public policy'[77] which opposes any kind of restriction on individual's right of being employed.[78]

---

competitor of his former employer. *See* American Buildings Co. v. Pascoe Building Sys, 260 Ga. 346, 392 S.E.2d 860 (1990) at 350.

[74] Contracts in India are governed by INDIAN CONTRACT ACT, §2 (h) 1872 of the Act defines 'contract' as an agreement enforceable by law. However, §10 of the Act provides that "all agreements are contracts if they are made by the free consent of parties competent to contract, *for a lawful consideration and with a lawful object*, and *are not hereby expressly declared to be void*." Hence, an agreement of confidentiality to be enforceable by law, it must not contain terms which are opposed to public policy of India. Further, it must also not be expressly declared void by the Act.

[75] The word 'restraint from exercising lawful profession, trade or business' do not mean an absolute restriction, and are intended to apply to a partial restriction, a restriction limited to some particular place, otherwise the first exception would have been unnecessary. *See* ABICHANDANI, R.K., POLLOCK & MULLA, INDIAN CONTRACT AND SPECIFIC RELIEF ACTS, 416, 419(11th Ed., Vol. I, N.M. Tripathi Limited, 1994) [hereinafter referred to as 'Pollock & Mulla'].

[76] Niranjan Shankar Golikari v. Century Spinning & Manufacturing Co., (1967) 2 S.C.R. 367 [hereinafter referred to as 'Niranjan Shankar Golikari']; Vancouver Malt & Sake Brewing Cp. Ltd., (1934) A.C. 181, 189-90; Peters American Delicacy Co. Ltd. v. Patricias Chocolates of Candies Pty. Ltd., (1947) 77 C.L.R. 574, 598. Reasonableness of restriction has to be seen in reference to interest of parties concerned and interest of the public. In determining this nature and extent of the business to be protected are material elements. *See* Nordenfelt v. Maxim-Nordenfelt Co., (1894) A.C. 535, 565 [hereinafter referred to as 'Nordenfelt v. Nordenfelt'].

[77] Pollock & Mulla, *supra* note 77 at P. 416.

[78] Niranjan Shankar Golikari *supra* note 78; HALSBURY'S LAWS OF ENGLAND, 15, Vol. 38, (3rd Ed); ESSO Petroleum Ltd. v. Harpers Garage Ltd., (1967) 1 All E.R. 699 at 707 [hereinafter referred to as 'ESSO Petroleum'].

Right to work has also been recognized as one of the fundamental right under INDIAN CONST. art. 19 (1) (g), which can be subjected to 'reasonable restriction under INDIAN CONST. art.19 (6).

Article 19 (1) (g) and Article 19(6) of the Constitution of India reads as follow:

Article 19(1) All citizens shall have the right

……..

(g) to practise any profession, or to carry on any occupation, trade or business.

(6) Nothing in sub clause (g) of the said clause shall affect the operation of any existing law in so far as it imposes, or prevent the State from making any law imposing, in the interests of the general public, reasonable restrictions on the exercise of the right conferred by the said sub clause, and, in particular, nothing in the said sub clause shall affect the operation of any existing law in so far as it relates to, or prevent the State from making any law relating to,

An agreement in restraint of trade has been defined as *"one in which a party agrees with any other party to restrict his liberty in the future to carry on trade with other persons who are not parties to the contract in such a manner as he chooses."*[79] This doctrine finds statutory recognition under Section 27 of Indian Contract Act, 1872[80] which declares all agreements in restraint of trade void *protanto*,[81] except in the case specified in the exception.[82] Hence, 'restraint of any kind' is void under Indian law,[83] irrespective of the fact whether it is absolute or partial.[84] However, the doctrine does not apply to contracts regulating trade during their existence provided that such restrictions are towards the absorption of the parties' service and not their sterilisation[85] and a covenant intended to protect the trade secret is not void merely because it would hamper competition in the market.[86] Further, the doctrine protects employee only against restrictions beyond the term of the contract and not during the continuance of the contract.[87]

(i) the professional or technical qualifications necessary for practising any profession or carrying on any occupation, trade or business, or

(ii) the carrying on by the State, or by a corporation owned or controlled by the State, of any trade, business, industry or service, whether to the exclusion, complete or partial, of citizens or otherwise

79 Petrofina (Great Britain) v. Martin, (1966) Ch. 146 [hereinafter referred to as 'Petrofina']

80 INDIAN CONTRACT ACT §27, 1872 reads as follow:

§ 27- Agreement in restraint of trade, void- Every agreement by which any one is restrained from exercising a lawful profession, trade or business of any kind, is to that extent void.

Exception 1.—Saving of agreement not to carry on business of which goodwill is sold.—One who sells the goodwill of a business may agree with the buyer to refrain from carrying on a similar business, within specified local limits, so long as the buyer, or any person deriving title to the goodwill from him, carries on a like business therein, provided that such limits appear to the Court reasonable, regard being had to the nature of the business.

81 But such contracts are not 'illegal'. *See* Haribhai Maneklal v. Sharafali Isabji, (1897) 22 Bom. 861 at 866.

82 Shri Krishnan Murgai, *supra* note 13; Percept D' Mark (India) Pvt. Ltd. v. Zaheer Khan and Anr., AIR 2006. SC 3426 [hereinafter referred to as 'Zaheer Khan']. *Seealso* Pollock & Mulla, *supra* note 77 at P. 418.

83 Madhub Chandrer Poramanick v. Rakcoomar Doss & Ors., (1975) 14 BLR 76.

84 Zaheer Khan, *supra* note 84.

85 ESSO Petroleum, *supra* note 80 at 707[per Lord Reid].

86 Schroeder (A) Music Publishing Co. Ltd. v. Macaulay, (1974) 3 All. E.R.616; Forster & Sons Ltd. v. Suggett (1918) 35 T. L. R. 87.

87 Zaheer Khan, *supra* note 84.

Therefore, the doctrine is to be applied to factual situations with a broad and flexible rule of reason.[88]

a) TEST OF REASONABLENESS

A contract on restraint of trade to be enforceable, it must be reasonable, so drafted as to ensure protection to the party restrained and at the same time not injurious to public interest.[89] Such contracts must prevail unless the breach of public policy is clearly established.[90] However, the burden of proof is on employers to show that restraint is necessary to protect their interest[91] against the servant who has acquired not merely knowledge of customers but influence over them[92] and once this onus is discharged, employee has to prove that contract is injurious to the public.[93] The reasonability of agreement depends upon nature of the agreement, the service to be rendered, and place of employment and availability of service of same nature.[94] Hence in India, such restrictions are put through private contracts between parties under private contracts of different character *viz.*, non-disclosure agreement, non-competition clause and agreement of non-solicitation of employee and employer where under employee is restrained from divulging the trade secret or know-how obtained during the course of employment. Thus, these agreements seek to bind current employee in lawful employment of the employer throughout the duration

---

[88] ESSO Petroleum *supra* note 80; Petrofina, *supra* note 81 at 180; Re Ravenseft Properties Ltd.'s Application, (1978) Q.B.52, 67.

[89] "The public have an interest in every person's carrying on his trade freely: so has the individual. All interference with individual liberty of action in trading, and all restraints of trade of themselves, if there is nothing more, are contrary to public policy, and therefore void. That is the general rule. But there are exceptions: restraints of trade and interference with individual liberty of action may be justified by the special circumstances of a particular case. It is a sufficient justification, and indeed it is the only justification, if the restriction is reasonable – reasonable, that is, in reference to the interests of the parties concerned and reasonable in reference to the interests of the public, so framed and so guarded as to afford adequate protection to the party in whose favour it is imposed, while at the same time it is in no way injurious to the public." Lord Macnaghten in Nordenfelt v. Nordenfelt, *supra* note 78, quoted with affirmation in Niranjan Shankar Golikari *supra* note 78.

[90] Underwood & Son Ltd. v. Barker, (1899) 1 Ch. 300, 305.

[91] Niranjan Shankar Golikari *supra* note 78.

[92] Herbert Morris Ltd. v. Saxelby, (1916) 1 A.C. 688; Niranjan Shankar Golikari *supra* note 78.

[93] Niranjan Shankar Golikari *supra* note 78.

[94] Sunilchand v. Aryodaya Spinning & Weaving Mills, (1963) GLR 795; V.N. Deshpande v. Arvind Mills Co. Ltd., (1946) 48 BomLR 90 [hereinafter referred to as 'Arvind Mills'].

of the contract[95] and unless terms of such contracts are harsh and unconscionable, are enforceable by the court of law.[96]

b) PROTECTING TRADE SECRET THROUGH 'NON-DISCLOSURE AGREEMENT'

Through these contracts, an employee is restricted from disclosing the confidential information or trade secret obtained from employer during the course of employment to any other person, unless mandated under any law in force. The effect of such clause being to prohibit the employee from disclosing the trade secret of the employer, such contracts are not restraint of trade and, therefore, valid.[97] In the case of ***Niranjan Shankar Golikari v. Century Spinning & Manufacturing Co.,***[98] the defendant was employed under a contract containing a negative covenant that he shall not disclose any information or trade secret of company obtained during the course of employment. Upon leaving the service, plaintiff sought to enforce the negative covenant under the apprehension that he might divulge plaintiff's trade secret. Granting injunction, Hon'ble Supreme Court held that *since the employer has proprietary rights in Trade Secret, negative covenant prescribing particular time frame, nature of employment and area are not restraint of trade and can be enforced by the court of law to protect the rights of the employer.*

Similarly, in ***Escorts Const. Equipment Ltd v. Action Const. Equipment P. Ltd***.,[99] where despite there being a non-disclosure agreement between plaintiff and defendant that defendant shall not disclose any Trade Secret or know-how to anyone, defendant left employment and started his own production of Pick-N-Carry Mobile Cranes based on trade secret and know-how of plaintiff. The injunction was granted and the defendant was restrained from manufacturing and selling Pick-N-Carry Mobile Cranes based on drawings and designs of the plaintiff. Also, where an employee was appointed under the express condition that he shall not disclose the trade secret of the

---

[95] Shri Krishnan Murgai, *supra* note 13.
[96] Niranjan Shankar Golikari *supra* note 78.
[97] Vfs Global Services Private v. Mr. Suprit Roy, 2008 (2) BomCR 446.
[98] Niranjan Shankar Golikari v. Century Spinning & Manufacturing Co. (1967) 2 S.C.R. 367.
[99] Escorts Const. Equipment Ltd v. Action Const. Equipment P. Ltd AIR 1999 Delhi 73.

company to other parties but later left the job, the injunction was granted restraining him from divulging the secret information.[100]

Also, in ***Burlington Home Shopping Pvt. Ltd. v. Rajnish Chibber,***[101] the defendant was an employee of plaintiff who was engaged in service of mail order and had developed a list of clientele/customers database by investing a considerable amount of money and time. Upon leaving employment, defendant took away with him the database and started using same for the purpose of his newly established business of mail order service. He was restrained from using it and the injunction was granted.

c) PROTECTING TRADE SECRET THROUGH 'NON-COMPETE CLAUSE'

Through these agreements, an employee is prohibited from taking up a business in competition, direct or indirect, of his employer during the term of his service. The object of such an agreement is to disable the employee from using the confidential information or know-how obtained during his course of employment with his ex-employer against his interest and unless their terms are unconscionable or excessively harsh and one-sided[102] such covenants cannot be regarded as a restraint of trade.[103] However, covenant restricting the party from competing with another party beyond the period of contract is void.[104] Thus where defendant was employed to exclusively work for plaintiff for period of three years as weaving master but left service in one year and joined another company in breach of negative covenant, granting injunction the court held that since the prohibition was confined to profession of weaving master during the existence of negative contract, it is reasonable and, therefore, valid.[105] Similarly, where an assistant engineer was restrained from leaving his employer or joining

---

[100] Shri Krishna Murgai, supra note 13.

[101] Burlington Home Shopping Pvt. Ltd. v. Rajnish Chibber, (1995) 61 DLT 6.

[102] Niranjan Shankar Golikari *supra* note 78; Gopal Paper Mills, *supra* note 67.

[103] Gaumount Corporation v. Alexender, (1936) 2 All E.R. 1686; Warner Bros. v. Nelson, (1937) 1 K.B. 209.

[104] Gujarat Bottling Co. Ltd. v. Coca Cola Co., (1995) 5 SCC 545 [hereinafter referred to as 'Gujarat Bottling'].

[105] Arvind Mills, *supra* note 96.

any other firm in India or elsewhere during the term of the contract, the contract was held to be valid.[106]

Further, in ***GEA Energy System India Ltd. v. Germanischer Lloyd Aktiengesellschaft,***[107] where restrictive clause only stated that *'defendant may not carry on a business which is prejudicial to the Plaintiff company'* and as such did not restrict the defendant in absolute terms from carrying on any business, the Madras High Court observed that the terms of the agreement were not one-sided and did not betray the weakness of any one party. Also, if an employee takes voluntary retirement or resigns the job, he is unilaterally repudiating the service contract and, therefore, negative covenant imposing restriction on competing the plaintiff particularly is enforceable.[108] Further, in the case of ***Jet Airways v. Jan Peter Ravi Karnik***,[109] Bombay High Court held that negative covenant restricting employee from competing employer for the unserved contractual period would be enforceable only if it is for the protection of certain proprietary interest of the employer.

However, where an employee was restrained from competing his employer for the period of five years after termination of his service, it was held that such restriction on the right of the employee is unreasonable and, therefore, void.[110] Moreover, as the doctrine of restraint of trade is not confined only to contracts of employment but is applicable to all kind of contracts,[111] a commercial or collaboration contract containing negative covenant will also have to pass the test of reasonableness. Thus where plaintiff was engaged in business of sale and manufacturing of B.R.C. and purchased the business of defendant, who sold but did not make 'loop' reinforcement, under a contract that defendant would not compete plaintiff in *'any business'* of sale or manufacturing road

---

[106] Lalbhai Dalpatbhai v. Pandya, (1965) 2 Lab. L.J. 284.
[107] GEA Energy System India Ltd. v. Germanischer Lloyd Aktiengesellschaft [2009]149CompCas689(Mad).
[108] V.V. Sivaram and others v. FOSECO India Limited, 2006 (1) KarLJ 386.
[109] Jet Airways v. Jan Peter Ravi Karnik, (2000) 4 Bom CR 487.
[110] Bramhaputra Tea Co. v. E Scarth, (1885) 11 Cal. 545.
[111] Zaheer Khan, *supra* note 84; Gujarat Bottling, *supra* note 106.

reinforcement for a specified period, the contract was held to be too wide in scope and, therefore, void.[112]

d) PROTECTION OF TRADE SECRET UNDER 'NON-SOLICITATION AGREEMENT'

A non-solicitation agreement is an agreement between employer and employee where under employee is prevented, during and after his employment, from soliciting clients and other employees of his employer or ex-employer for his own benefit.[113] Since a list of customers, clients etc. is considered as a Trade Secret,[114] non-solicitation agreements are designed to protect the interest of the employer from abuse of Trade Secret. Further, such contracts are intended to prevent the tortious act of inducement of breach of contract[115] and, therefore, are not hit by Section 27 of the Indian Contract Act.[116] To be valid, terms of these covenants must be reasonable in distance, time, protection and non-usage of Trade Secrets and goodwill imposed on former employees.[117] Thus, in ***Embee Software Pvt. Ltd. v. Samir Kumar Shaw,***[118] where three ex-employees of plaintiff left their employment and incorporated a separate company of their own, plaintiff sought an injunction against them under apprehension that since defendants are in possession of trade secret of plaintiff, they may misuse it and may solicit customers and clients of their ex-employer to break contractual relationship with plaintiff. It was held that though defendant cannot be prevented from practising trade or business of their choice, they cannot use the Trade Secret of the plaintiff to his prejudice and cannot induce customer and clients of the plaintiff to break the contract with plaintiff.

---

112 British Reinforcement Concrete Engineering Co. Ltd. v. Schelff, (1921) 2 Ch. 563.

113 NISHITH DESAI ASSOCIATES, *Employment Contracts in India: Enforceability of Restrictive Covenants*, (Dec. 06, 2015)http://www.nishithdesai.com/Research/Papers/Employment_Contracts_in_India.pdf,

114 Burlington Home, *supra* note 25.

115 Embee Software Private Ltd. Vs. Samir Kumar Shaw & Ors., AIR 2012 Cal 141.

116 WIPRO Ltd. v. Beckman Coulter International S.A., 2006 (3) ARBLR 118 (Del.).

117M/s. F L Smidth Pvt.Ltd. v M/s. Secan Invescast (India) Pvt. Ltd., (2013) 1 CTC 886.

118 Embee Software Pvt. Ltd. v. Samir Kumar Shaw, AIR 2012 Cal 141.

Similarly, in ***Wipro Ltd. v. Beckman Coulter International SA,***[119] plaintiff was working as a sole distributor of the defendant who later decided to undertake a direct operation in India and for which issued advertisement for employment, preferably to those who have had experience of working in the same field. Plaintiff alleged that the defendant, in breach of non-solicitation agreement, is soliciting its employees to leave plaintiff's employment. Holding that since employment contracts are different from commercial contracts, they have to be read liberally as, unlike former, later are a result of equal bargaining between two companies; the court observed that since instant contract was designed to restrict the employer i.e. plaintiff and defendant and not the employees, provisions of Section 27 would not get attracted. Hence, the court restrained the defendant from further soliciting plaintiff's employees for the period stipulated in the contract.

Further, in ***Desiccant Rotors International Pvt Ltd v. Bappaditya Satkar & Anr.,***[120] where the defendant, in breach of non- compete and non-solicitation agreement with plaintiff, joined plaintiff's competitor as marketing manager and started contacting plaintiff's customers, he was restrained from soliciting plaintiff's employees, customers and suppliers.

ii. Protection of trade secret under equity

Being a common law country, India does recognize common law principle of equity[121] that *'one who receives information shall not take unfair advantage of it'*.[122] This basis in equity constitutes an obligation of conscience arising from circumstances of communication, only breached by an abuse or 'unconscientious use' of the protected information.[123] This equitable

[119] Wipro Ltd. v. Beckman Coulter International SA, 2006 (3) ARBLR 118 (Del.).

[120] Desiccant Rotors International Pvt Ltd v. Bappaditya Sarkar & Anr., IA No. 5455, 5454 and 5454/2008 in CS(OS) No. 337/2008 (Delhi High Court).

[121] Courts in India are courts of both law and equity. *See* Modi Entertainment Network & Anr. v. W.S.G. Cricket Pvt. Ltd., (2003) 4 SCC 347 at ¶ 10.

[122] Seager v. Copydex, *supra* note 48; John Richard Brady, *supra* note 73.

[123] R v. Department of Health, ex parte Source Informatics Ltd., [2001] QB 423 [hereinafter referred to as 'Source Informatics'].

jurisdiction is founded on '*goodfaith*'[124] and '*conscienceofconfident*'.[125] Here, 'information' carries its general meaning[126] and includes Trade Secrets.[127]

Law of confidentiality of information has its origin in the principle of equity[128] and is the cousin of trust.[129] The House of Lords in ***Spycatcher's case***[130] observed that '*a duty of confidence arises when a confidential information comes to the knowledge of a person in circumstances when he has noticed, or is held to have agreed, that the information is confidential with the effect that it would be just in all circumstances that he should be precluded from disclosing or using the information.*' Hence, it is clear that the duty of confidentiality is independent of any contractual[131] or fiduciary[132] relationship between parties and '*nature of information*' is the relevant factor for establishing confidential obligation.[133]

a) ACTION FOR BREACH OF CONFIDENTIALITY

Where the relationship between parties imposes an obligation of confidence and where it is unconscionable to the recipient to reveal the information imparted under the said relationship, equity would protect such information from disclosure.[134] To prove breach of confidence, it has to be shown the

---

124 Seager v. Copydex, *supra* note 48; Zee Telefilms Ltd. and Film and Shot & Anr. v. Sundial Communications Pvt. Ltd. & Ors., 2003 (27) PTC 457 (Bom) at ¶ 10 [hereinafter referred to as 'Zee Telefilms']; COLSTON, CATHERIN & MIDDLETON, KIRSTY, MODERN INTELLECTUAL PROPERTY LAW, 205 (2nd Ed., Cavendish Publishing Ltd, 2005) [hereinafter referred to as 'Catherin & Middleton']; NORTH P., *Breach of Confidence: Is there a new Tort?*, [1972] JSPTL 149.

125 Source Informatics, *supra* note 125.

126 Catherin & Middleton, *supra* note 126 at 208.

127 Source Informatics, *supra* note 125.

128 TARAPOREVALA, V.J., LAW OF INTELLECTUAL PROPERTY, 635 (2nd Ed., Thomson Reuters, 2013) [hereinafter referred to as 'Taraporevala'].

129 Coco v Clarke, *supra* note 26; Taraporevala, *supra note* 130 at 636.

130 Spycatcher case, *supra* note 70.

131 It was held that even though the contract is silent on matter of confidence, law will imply to treat such confidential matter in confidential way as one of the implied terms of contract but such obligation is not limited to cases where parties are in confidential relationship. Saltman v. Campbell, *supra* note 31.

132 Lac Minerals v. International Corona Resources, (1989) 26 C.P.R. (3d) 97 (S.C.C.) [hereinafter referred to as 'Lac Minerals'].

133 Venables and Thompson v. News Group Newspapers Ltd., [2001] 1 All ER 908.

134 Stephen v. Avely, 1988 Ch. 449, 456.

information relied upon is confidential & identifiable, was handed over in the circumstance of confidence and has been used without the license.[135]

The test of cause of action for breach of confidential information was developed by Megarry J in ***Coco v. AN Clarke***[136] wherein it was observed that to make an action for breach of confidentiality it is necessary that the information itself is confidential, was imparted to confident under obligation of secrecy and such information was disclosed by confident without authority.[137]

Hence, to prove breach of confidentiality, it has to be established that:

1. Information is confidential,
2. There is an obligation of confidentiality, and
3. Breach of obligation to the detriment of confider.

- Confidentiality of information[138]

Confidential information is any information, written or oral, having, at least, some attractiveness to an end user and is capable of being realized.[139] However, in cases of trade secret, information has to be of qualitative standard[140] and not in public domain.[141] The information will be considered confidential not only to the original recipient of information but to another party as well where such party has knowledge that information imparted to him is confidential.[142]

Hence, in the case of ***Anil Gupta v. Kamal Das Gupta,***[143] where the plaintiff has developed an idea of '*Swayamvar*', a television programme and communicated it to the defendant, it was held that idea being novel was capable of being protected as confidential information and defendant was held liable

---

135 Zee Telefilms, *supra* note 126, quoting with affirmation to CMI Centres for Medical Innovation GmbH & Anr. v. Phytopharm Plc (1999) FSR 235.

136 Coco v. AN Clarke, [1969] RPC 41.

137 The test has been adopted by Indian courts as well. *See* Emergent Genetics India Pvt. Ltd. v. Shailendra Shivam and Ors., (2011) 125 D.R.J. 173, ¶ 33; Zee Telefilms, *supra* note 126 at ¶ 13.

138 For further detail, *see* Supra Part I (a).

139 De Maudsley v. Palumbo, [1996] FSR 447.

140 Catherin & Middleton, *supra* note 126 at 212.

141 Information had necessary quality of confidence where it was not something which is public property and public knowledge. *See* Spycatcher case, *supra* note 70.

142 Zee Telefilms, *supra* note 126 at ¶ 10; Interfirm Corp. v. Law Society NSW, 1977 RPC 137 at 141 [hereinafter referred to as 'Interfirm Corp.'].

143 Anil Gupta v. Kamal Das Gupta**,** 2002 (25) PTC 1.

for breach of confidence. However, in the case of ***Dunford and Elliot v. Johnson and Firth Brown,***[144] where plaintiff disclosed its shareholders certain confidential information which was communicated to the defendant for business purpose by shareholders without informing plaintiff, it was held that *'widespread dissemination of information drives a hole into the blanket of confidence and it is not reasonable to stipulate for confidentiality of information.'*[145]
With regard to the liability of the third party, it is necessary that such third party must be aware of the confidential character of information. Thus in ***Morrison v. Moat,***[146] where plaintiff and father of defendant were partners and plaintiff had given certain confidential information to defendant's father who before his death passed it to defendant, it was held that since defendant knew that the information was confidential, he is under obligation to not to disclose same and injunction was given restraining defendant from disclosing confidential information.

(1) Obligation of confidentiality

To bring an action for breach of confidence against confident, it is necessary that confident was under an obligation of confidence.[147] In ***Coco v. Clarke,***[148] it was held that information must have been communicated in circumstances importing confidence and there can be no binding obligation of confidence unless circumstances in which information was imparted are such that a reasonable man would reasonably believe that information was confidential. Such an obligation may be imparted directly[149] or indirectly, inferred from circumstances and to negate the existence of obligation of confidence, the burden of proof lies on the recipient of information.[150]

---

144 Dunford and Elliot v. Johnson and Firth Brown, [1977] 1 Lloyd's Rep. 505.
145 Hence, Lord Denning MR added fourth condition to Megarry J's three in Coco v. AN Clarke, that the stipulation for confidence must be reasonable.
146 Morrison v. Moat, (1851) 9 Hare 492.
147 Catherin & Middleton, *supra* note 126 at 221.
148 Coco v. Clarke, (1969) R.P.C. 41.
149 Express obligations of confidence are often created by contract. *See* supra Part II A.
150 Coco v Clarke, *supra* note 26 (per Megarry, J.) at p. 48; La Forest J in Lac Minerals, *supra* note 134 at p. 107-8.

Implied obligation of confidence can be created by circumstances under which information was communicated,[151] based on the test of reasonable man.[152] Emphasising on the importance of circumstances in which negotiation takes place, Megarry J observed that where a commercial or industrial information is given with some avowed common object in mind, the obligation of confidence gets created and burden of proof to hold contrary lies on confident.[153] Thus, in case of ***Sales v. Stromsberg,***[154] where plaintiff disclosed his design ideas to defendant only after receiving a letter from defendant thinking that defendant is interested in evaluating his designs, it was held that circumstances of the case are such as to create an implied obligation of confidentiality on part of defendant and unlicensed use of same by defendant would amount to breach of confidence.

(2) Breach of obligation

To establish the breach of confidence, it is necessary that obligation of confidence has been breached to the detriment of confider.[155] Here, potential loss as a result of defendant's use of information is sufficient to prove the detriment of confider.[156] Further, it must be shown that defendant's information has directly come from confider and not from any other independent source.[157] However, unlike Copyright and Patent, breach of

---

[151] It is both circumstances of communication and relationship of confider and confident which must be taken into account in determining the existence of an implied obligation of confidence, so that mere knowledge of information's secrecy is insufficient. *See* Mars UK Ltd. v. Teknowledge Ltd., [2000] SFR 138.

[152] Test of reasonable man was propounded by Megarry J in Coco v Clarke, *supra* note 26.

Test of reasonable man is of two kind, objective test and subjective test. In case of objective test, obligation of confidence is based on knowledge of relevant circumstances. However, if the action of breach of confidence is based on good faith, a subjective test of acceptance of obligation might have been expected. *See* Catherin & Middleton, *supra* note 126 at 223.

[153] Coco v. Clarke, *supra* note 26; *see also* Saltman v. Campbell *supra* note 31.

[154] Sales v. Stromsberg, 2006 FSR 89 at ¶ 68.

[155] Coco v. Clarke, *supra* note 26.

[156] NORMAN, HELEN E., INTELLECTUAL PROPERTY LAW, 69 (2nd Ed., Oxford, 2014).

[157] Catherin & Middleton, *supra* note 126 at 235.

confidence may consist in any disclosure or use which contravenes the limited purpose of disclosure.[158]

Further, to constitute the breach of confidence, *mensrea* of the defendant is irrelevant and he cannot take the defence of well-meaning motive[159] or that he could not appreciate the confidentiality of information in question[160] or that he has forgotten the source of information and thinks he has thought of it himself.[161] Thus, in the case of ***Lac Minerals v. International Corona,***[162] where plaintiff and defendant were negotiating for joint-venture agreement and during the course of that negotiation, plaintiff informed the defendant about certain adjacent property bearing minerals. Using that information, the defendant successfully put a bid for that property. It was held that the information supplied by plaintiff being confidential information given under circumstances creating the obligation of confidence, the defendant cannot use same to the detriment of plaintiff.

iii. Protection of trade secret under criminal law

Though there are no express provisions under Indian Penal Code, 1860[163] for the protection of Trade Secret, it is often sought to be protected under Section 378 and Section 408 of the Code. Another statute providing for the penal protection of Trade Secrets is Information Technology Act, 2000.[164]

Protection from 'theft'

Under provisions of IPC, Trade Secret is protected against theft. Section 378 of the Code defines theft as *dishonestly taking of a movable property* from the possession of any person without that person's consent.[165] However, the

---

158 However, if the question is one of misuse, it does not matter that the use will not disclose the information to further recipients. *See* ocular Sciences v. Aspect Vision Care, (1997) RPC 289.

159 Nichrotherm v. Percy, (1956) RPC 272 at P.281.

160 National Broach v. Churchill Gear, (1965) RPC 61.

161 Seager v. Copydex, *supra* note 48 at 418.

162 Lac Minerals v. International Corona 1990 FSR 441 (Canadian Supreme Court).

163 Hereinafter referred to as 'Code' or 'IPC'.

164 Hereinafter referred to as 'IT Act'.

165 378. Theft.—Whoever, intending to take dishonestly any moveable property out of the possession of any person without that per-son's consent, moves that property in order to such taking, is said to commit theft. ………………………

difficulty with the invocation of Section 378 in a case of infringement of trade secret is that unless it is tied with some tangible object, it cannot be stolen as only 'movable property'[166] can be stolen.[167] Hence in ***Pyarelal Bhargava v. State of Rajasthan,***[168]where a government servant in secretariat has removed certain files from office to show someone else, it was held that taking files from the possession of government with dishonest intention amounts to theft.

The question of theft of 'confidential information' was more recently examined by the Calcutta High Court in detail in ***Adventz Investments and Holdings Limited and Ors. v. Birla Corporation Limited and Ors.,***[169] where some of the employees of respondent were accused of stealing certain confidential documents from the premises of the company. It was alleged that they had stolen certain documents from the lawful possession of the company and also have copied certain other documents. Examining the nature of offence and more specifically answering the question whether stealing of documents and information can amount theft under the Code, the court held that as far as documents[170] are concerned, being a movable property under Section 22 of the Code, they can be subject matter of theft under Section 378 of the Code[171] and since accused have copied said documents by temporarily removing the

Explanation 5.—The consent mentioned in the definition may be express or implied, and may be given either by the person in possession, or by any person having for that purpose authority either express or implied.

166 §22 of the Code defines movable property as under:

Section 22. "Movable property".—The words "movable property" are intended to include corporeal property of every description, except land and things attached to the earth or permanently fastened to anything which is attached to the earth.

167 Avatar Singh v. State of Punjab, 1965 SCR (1) 103 wherein Hon'ble Supreme Court held that to constitute theft under § 378 of the Code, stolen property must be a movable tangible property as defined under § 22 of the Code and since electricity is an intangible or incorporeal object it cannot be stolen.

168 Pyarelal Bhargava v. State of Rajasthan, AIR 1963 SC 1094.

169 Adventz Investments and Holdings Limited and Ors. v. Birla Corporation Limited and Ors., 2015 CriLJ 3369.

170 'Document' has been defined under §29 of the Code. § 29 of the Code reds as follow:

§ 29. "Document".- The word "document" denotes any matter expressed or described upon any substance by means of letters, figures, or marks, or by more than one of those means, intended to be used, or which may be used, as evidence of that matter.

171 Court relied upon the decision of the Supreme Court in Pyarelal Bhargava v. State of Rajasthan, AIR 1963 SC 1094.

documents from lawful possession of the company,[172] same amounts to theft for purpose of the Code. However, so far as information is concerned, the court held that it cannot be the subject matter of theft as it does not qualify the definition of 'movable property' as given in the Code, an essential ingredient of theft. Hence, it is clear from above two decisions that unless trade secret or confidential information is attached to some movable object, offence of theft cannot take place

a) PROTECTION FROM 'CRIMINAL BREACH OF TRUST'

An action of criminal breach of trust[173] can be brought against a person who has been entrusted with trade secret by the owner. As Section 405 and 408 uses word 'property' and not 'movable property', it can be argued that even trade secret or confidential information can be subject matter criminal breach of trust.[174] Hence, if an employee of a company who is entrusted with Trade Secret of the company misuses it or misappropriates it, as per provisions of Section 405/408, he can be made liable for criminal breach of trust.

However, so far there is no case law to support the above proposition and when the same argument was made before the court in ***Pramod, Son of Laxmikant Sisamkar v. Garware Plastics and Polyester,***[175] the court did not decide the question. Here the petitioners were engineering graduates who were working with the defendants for a period of three years and had later left the company to join

---

172 Even temporarily depriving someone from lawful possession of his property amounts to theft. *See* Ram Ratan v. State of Bihar & Anr., AIR 1965 SC 926.

173 § 405. Criminal breach of trust.—Whoever, being in any manner entrusted with property, or with any dominion over property, dishonestly misappropriates or converts to his own use that property, or dishonestly uses or disposes of that property in violation of any direction of law prescribing the mode in which such trust is to be discharged, or of any legal contract, express or implied, which he has made touching the discharge of such trust, or wilfully suffers any other person so to do, commits "criminal breach of trust".

§ 408. Criminal breach of trust by clerk or servant.—Whoever, being a clerk or servant or employed as a clerk or servant, and being in any manner entrusted in such capacity with property, or with any dominion over property, commits criminal breach of trust in respect of that property, shall be punished with imprisonment of either description for a term which may extend to seven years, and shall also be liable to fine.

174 Trade secret or confidential information has for long been regarded as property, capable of being sold. *See* Evans Medical Supplies Ltd. v. Morearty, [1957] 1 WLR 288.

175 Pramod, Son of Laxmikant Sisamkar v. Garware Plastics and Polyester, 1986(3) BomCR 411.

some other organization. The contention of the defendants was that they had not handed over the documents in their custody and that the special technical knowledge that the petitioners had gained while in the service of the defendants would be used by them in the new organization. Dismissing the petition, the court observed that *"it is well settled that criminal prosecution is a serious matter and would amount to harassment of the accused and also to the abuse of the process of the court if without sufficient grounds it is allowed to proceed"*. It went on to state that the remedies should not be used to harass or seek personal vendetta or be used with an ulterior motive to pressurize the accused. Hence, it is still not clear whether an action can be brought under Section 405 or 408 of the Code for the protection of Trade Secret or not.

b) UNDER IT ACT, 2000

The growing use of information technology in communication and in the storage of proprietary information had prompted the parliament to enact the IT Act, 2000 and further amend it in 2008, providing for civil and criminal remedies against information theft through the electronic route and against its misuse. The law provides for strong enforcement measures and imposition of stiff statutory damages, penalties and imprisonment for, *interalia*, theft of confidential information such as unauthorized use of data/information obtained from computer systems, tampering of source code or its theft and unauthorised download of database or information in removal storage medium. Section 43[176] of the IT Act provides for payment of compensation for various offences given in

[176] § 43- Penalty and compensation] for damage to computer, computer system, etc. -If any person without permission of the owner or any other person who is incharge of a computer, computer system or computer network,-

………..

(b) downloads, copies or extracts any data, computer data base or information from such computer, computer system or computer network including information or data held or stored in any removable storage medium;

………

(j) steal, conceals, destroys or alters or causes any person to steal, conceal, destroy or alter any computer source code used for a computer resource with an intention to cause damage; he shall be liable to pay damages by way of compensation to the person so affected.

the Act. In addition Section 66[177] of the Act provides for imprisonment for a period of up to three years or a fine of up to Rs. 5 lakhs or both for the commission of any of the act referred in Section 43. Further, Section 72[178] of the Act prescribes penal provisions for disclosure of confidential information without the consent or authority of the owner.

In a recent judgment in the ***Arhan Technologies v. Endo Kogyo Co. Ltd.,***[179] where respondents were accused of stealing secret data and confidential information of appellant by unauthorized access to the computers system/network of the appellant, the adjudicating officer found them guilty under Section 43, 66B & 66C of the Act and imposed penalty of Rs. 60 for the misappropriation of confidential business information.

Part III. Remedies for infringement of Trade Secret

A right to sue for breach of confidence belongs only to the owner of confidential information[180] against those who have received information in confidence[181] or subsequently learnt that it was confidential information.[182] Further, the owner is entitled to claim equitable remedy[183] of injunction and damages. Thus, if there is

---

[177] § 66- Computer related offences. -If any person, dishonestly or fraudulently, does any act referred to in §43, he shall be punishable with imprisonment for a term which may extend to three years or with fine which may extend to five lakh rupees or with both.

Explanation. -For the purposes of this section,-

(a) the word "dishonestly" shall have the meaning assigned to it in § 24 of the IPC, 1860;

(b) the word "fraudulently" shall have the meaning assigned to it in § 25 of the IPC, 1860

[178] § 72. Penalty for breach of confidentiality and privacy.-Save as otherwise provided in this Act or any other law for the time being in force, if any person who, in pursuance of any of the powers conferred under this Act, rules or regulations made thereunder, has secured access to any electronic record, book, register, correspondence, information, document or other material without the consent of the person concerned discloses such electronic record, book, register, correspondence, information, document or other material to any other person shall be punished with imprisonment for a term which may extend to two years, or with fine which may extend to one lakh rupees, or with both.

[179] *Complaint no. 2 of 2013 dated Jan 28, 2013*, SECRETARY, INFORMATION TECHNOLOGY, MANTRALAYA, GOVT. OF MAHARASHTRA (Jun 18, 2013), http://www.naavi.org/cl_editorial_13/arhantech2.pdf

[180] Taraporevala, *supra* note 130 at 667.

[181] Interfirm Corp., *supra* note 144 at 141.

[182] Zee Telefilms, *supra* note 126 at ¶ 10.

[183] Catherin & Middleton, *supra* note 126 at 243.

disclosure of Trade Secret in breach of contract between parties, there is no difficulty in awarding damages[184] whereas if the action is based on purely equitable ground, damages can be awarded in lieu of, or in addition to, an injunction.[185]

Injunction

The injunction[186] is the most common remedy for infringement of Trade Secret in India. The Code of Civil Procedure, 1908 empowers a civil court to grant temporary injunction[187]whereby defendant is prevented from disclosing the trade secret.[188] Injunction being a discretionary remedy, it cannot be claimed as a matter of right[189] and plaintiff has to establish *primafacie* case, irreparable injury and balance of convenience in his favour.[190]

Thus, in the case of ***Zee Telefilms Ltd. & Film v. Sundial Communications Pvt. Ltd.,***[191] plaintiff had developed an idea of a television show 'Kanhaiya', and communicated it to the defendants with clear understanding that it was confidential and will not be used or exploited in any manner other than through the plaintiffs. However, in breach of their obligation, defendants started developing another television show based on plaintiff's idea. It was held that *though there was no non-disclosure agreement, circumstances of communication were such as to make information confidentiality and breach of same would entail liability.* Granting injunction, the

---

184 Indata Equipment v. ACL, (1998) FSR 248, CA.

185 Saltman v. Campbell, *supra* note 31; Catherin & Middleton, *supra* note 126 at 245.

186 Injunction has been defined as a judicial process whereby a party is required to do or to refrain from doing any particular act. *See* State of Orissa v. Madan Gopal Rungta, 1952 SCR 28.

Injunction is of two types, temporary injunction and perpetual injunction. Temporary injunction is granted under Order XXXIX of the Code of Civil Procedure, 1908 whereas perpetual injunction is granted under §52 of the Specific Relief Act, 1963.

187 Order XXXIX of the Code of Civil Procedure, 1908.

Interim injunction has been defined under the Specific Relief Act, §37 (1) 1963. It reads as follow:
Section 37. Temporary and perpetual injunctions.—

(1) Temporary injunctions are such as are to continue until a specified time, or until the further order of the court, and they may be granted at any stage of a suit, and are regulated by the Code of Civil Procedure, 1908 (5 of 1908).

…………

188 Purpose of temporary injunction being maintenance *statusquo,* it prevents defendant from disclosing trade secret and thus maintain the status quo. *See* Shiv Kumar Chadha Etc. v. Municipal Corporation Of Delhi, 1993 SCC (3) 161[hereinafter referred to as 'Shiv Kumar Chadha'].

189 Shiv Kumar Chadha, *supra* note 190.

190 Gujarat Bottling, *supra* note 106.

191 Zee Telefilms Ltd. & Film v. Sundial Communications Pvt. Ltd., 2003 (5) BomCR 404.

court observed that the plaintiffs' business prospect and their goodwill would seriously suffer if the confidential information of this kind was allowed to be used as it is not merely a matter of compensation in pounds, shillings or pence.

Similarly, in the case of ***Burlington Home Shopping Pvt. Ltd.v. Rajnish Chibber,***[192]it was held that if the defendant is allowed to use plaintiff's Trade Secret, it would cause irreparable injury to plaintiff which cannot be compensated in terms of money and, therefore, it is necessary to restraint defendant from using plaintiff's Trade Secret till the pendency of the suit. Also, in the case of ***Fairfest Media Ltd v. Ite Group Plc & Ors.,***[193] where the plaintiff passed on certain confidential information and Trade Secret of its business to the defendant under a non-disclosure agreement, defendant was restrained from disclosing the Trade Secret of the plaintiff to the third party. Further, in the case of ***Sunilchand v. Aryodaya Spinning & Weaving Mills,***[194] where defendant entered into an employment contract with plaintiff under the condition that he would not leave the service of the plaintiff for five years and would not disclose the Trade Secret of the plaintiff but left plaintiff's employment in one year, he was restrained from divulging plaintiff's Trade Secret. The court also observed that if an employment contract is not hit by Section 27 of the Indian Contract Act, 1872 and is valid, the court has the power to prevent the breach of such contract to protect the legitimate interest of the employer.

i. <u>Damages</u>

The object of awarding damages for infringement of Trade Secret or confidential information is to put the claimant in the position that he would have been in had there been no breach of confidence.[195] In certain cases, damages[196] can be awarded

---

[192] Burlington Home Shopping Pvt. Ltd.v. Rajnish Chibber, 61 (1995) DLT 6.

[193] Fairfest Media Ltd v. Ite Group Plc & Ors, 2015(2) CHN (CAL) 704.

[194] Sunilchand v. Aryodaya Spinning & Weaving Mills, (1963) GLR 795.

[195] Catherin & Middleton, *supra* note 126 at 245; Cornish & Llewelyn, *supra* note 71 at P. 331.

[196] Damages can include both actual loss caused by misappropriation and the unjust enrichment caused by misappropriation that is not taken into account in computing actual loss. *See* SREENIVASULU N.S, LAW RELATING TO INTELLECTUAL PROPERTY, 202 (1st Ed., Penguin Partridge 2013). *See also* § 45 of TRIPs.

in lieu of injunction for future injury.[197] The test to assess the quantum of future damages was evolved by Lord Denning MR in ***Seager v. Copydex*** wherein it was held that if information is such as can be obtained with the help of a consultant, the fee of such consultant would be sufficient.[198] However, if the information is such that it is novel, inventive and not available else-where, is a *TradeSecret*, the quantum of damages would be much higher, equivalent to the price payable by a willing buyer to willing seller, and will have to be calculated as notional royalty.[199] As a result, he went on to observe, the defendant would become the owner of the Trade Secret as thought it had been paid for.[200]

Part IV: Conclusion-A Case for Codification

Law relating to the protection of trade secret is still at a nascent stage in India since having no specific legislation directly dealing with the subject. In the era of globalization and information technology where intellectual property of a firm, especially Trade Secrets, form the core of its business activities,[201] such an important subject cannot be left at the mercy of common law and private contract. Further, India being a signatory to multiple international conventions protecting Trade Secret,[202] it is under constitutional obligation to bring its legal regime relating to the protection of Trade Secret in consonance with its international obligation.

---

197 Seager v. Copydex, *supra* note 48.

198 However, in such cases, information must be available for sale. *See* Dowson & Mason v. Potter, (1986) 2 All ER 418, CA.

199 *See also* Interfirm Corp., *supra* note 144 at 158.

200 However, it has been observed that the case does not lay down any general law. *See* Talbot v. General Television, [1981] RPC 1.

201 The importance of protection of intellectual property can be imagined from the fact that in 2002 up to 75% of the value of the Fortune 500 companies is attributable to their intangible assets including intellectual property (IP) and trade secrets. *See* Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, *'A Single Market for Intellectual Property Rights: Boosting creativity and innovation to provide economic growth, high quality jobs and first class products and services in Europe,'* at 4 (2011) (Dec. 03, 2015) http://ec.europa.eu/transparency/regdoc/rep/1/2011/EN/1-2011-287-EN-F1-1.Pdf.

202 PARIS CONVENTION FOR THE PROTECTION OF INDUSTRIAL PROPERTY, July 12, 1967, 21 UST 1583, 828 UNTS 305. And AGREEMENT ON TRADE RELATED ASPECT OF INTELLECTUAL PROPERTY, Apr. 15, 1994, 1869 UNTS 299; 33 ILM 1197 (1994).

Though in pursuance of the same, a bill named 'Draft National Innovation Act, 2008' has been drafted, but it is yet to see the light of the day. Further, the protection accorded to Trade Secret under the Act is not satisfactory and has many loopholes *viz.*, a) provisions for penalty on complainant in case the action of breach of confidentiality obligation fails[203] without carving out any exception for *bonafide* complainant[204] and b) providing for payment of reasonable royalty for misappropriation of trade secret in exceptional circumstances[205] till a period of time for which use could have been prohibited[206] goes against the very object of the Act as it would be tantamount to allowing the misappropriator to perpetually take unfair advantage of the trade secret of complainant by paying royalty for a limited time period.

Thus, India needs to bring a comprehensive Act in tune with the best established international practice for protection of trade secret. Therefore, it is suggested that the existing anomalies of Draft National Innovation Act, 2008 be corrected. Further, as recommended by the Law Commission in its 13th report,[207] Section 27 of the Indian Contract Act, 1872 also needs to be suitably amended so as to allow contracts reasonably restraining right of another party to carry on trade if such contracts are designed to advance protection of Trade Secret and are not against public policy of India. Moreover, it is also suggested that Indian Penal Code, 1860 too should be suitably amended to tackle the problem of theft and criminal misappropriation of intangible property like trade secret which is not possible under the current regime as the definition of property as given under the Code does not include intangible property.

---

[203] *Supra* note. 18, § 12(3).

[204] Though § 14 of the Act grants exemption for any act done by any person under the Act, it is not clear whether it includes bona fide complainant.

[205] Unlike UNIFORM TRADE SECRET ACT 1985, said provision does not define 'exceptional circumstances'.

[206] *Supra* note 18 § 12(4) .

[207] Law Commission has recommended that words "is to that extent void" should be substituted with words "is to that extent void, *except in so far as the restraint is reasonable having regard to the interest of the parties and to the agreement and to the public*." *See* 13th Report Law Commission of India on Contract, 78, (1958).

INTERNATIONAL TRADE LAW

CHANGING DEFININTION OF PUBLIC PROCUREMENT IN INTERNATIONAL TRADE: FROM THE PERSPECTIVE OF THE REVISED GPA

-LIPI SARIN*

Introduction

Public procurement or Government procurement can simply be defined as the process through which the public or local authorities purchase either goods or services or both from companies. Over the past decade, government procurement has come to be one of the most central pillars of International Trade. Various governments have gradually begun to recognise the concept of procurement as an essential aspect of economic development of their countries. One of the reasons could be the lack of properly well-defined rules and regulations that govern this sector. The absence of a "value for money" system in government procurement services resulted into the formation of the very first binding agreement under the WTO called as the Agreement on Government Procurement (GPA or the Agreement).

The Uruguay Round of multilateral trade negotiations resulted in the implementation of the Agreement on Government Procurement (GPA or "the agreement") on 1st January, 1994.[1] GPA is a plurilateral Agreement, which means that it is not binding on all the WTO members, but only on the parties that have signed it. It essentially controls and puts rules and regulations on the "purchasing activities of the public bodies" of these parties.[2] The fundamental objective of this plurilateral agreement is to encourage the development of government procurement markets amongst its parties. This goal is achieved by imposing rules and regulations on the participating members in order to prevent discrimination against the products and services of other members. This would in turn lead to a greater liberalisation of trade and expansion of the world economy.

---

* III Year, BA.LLB. (HONS), Hidyatullah National Law Univrity, Raipur.

1 *Government procurement - the plurilateral agreement on government procurement (GPA)* (2012): https://www.wto.org/english/tratop_e/gproc_e/gp_gpa_e.htm (last updated Apr. 20, 2016).

2 ROBERT D. ANDERSON & SUE ARROWSMITH, THE WTO REGIME ON GOVERNMENT PROCUREMENT: CHALLENGE AND REFORM 3 (1ST ED. 2011).

So far, the GPA is the only legally binding agreement under the WTO which deals with laws related to government procurement. The agreement aims to open public procurement to international trade and competition, with a specific focus on the principles of transparency and non-discrimination. [3] The scope of government procurement is limited to both goods and services, and is also inclusive of construction ser

vices. Further, the working of the GPA is based on its contribution towards administering the already existing agreements that come under the umbrella of the WTO. Market access by foreign companies to the domestic procurement markets of the fellow GPA parties, can be said to be one of the cornerstones of the Agreement.

Changing definition of public procurement: the revised agreement

We cannot solve our problems with the same thinking we used when we created them – Albert Einstein

i. What was the need of a new Agreement?

Over the past couple of years, the GPA has established itself as one of the key mechanisms in regulating international trade under the World Trade Organisation (WTO). The World Trade Organisation Committee on Government Procurement adopted the revised Agreement on Government Procurement (GPA) on 30th March, 2012.[4] After a series of informal plurilateral sessions and various negotiations, the protocol for amendment of the agreement was finally adopted by two-thirds of the 15 parties. The revised GPA, therefore, came into force nearly two years later after it was adopted, that is, on 6th April, 2014.[5]

[3] Agreement on Government Procurement, Apr. 15, 1994, 1867 U.N.T.S. 14, 33 I.L.M. 1143 (1994) [hereinafter as 'GPA'].

[4] *Government procurement - the plurilateral agreement on government procurement (GPA)* https://www.wto.org/english/tratop_e/gproc_e/gp_gpa_e.htm (last updated Apr. 20, 2016).

[5] *Revised WTO Agreement on Government Procurement to come into force on 6 April 2014*, WTO NEWS ITEM, https://www.wto.org/english/news_e/news14_e/gpro_11mar14_e.htm (last updated Mar. 11, 2014).

The reason for the coming of the new Agreement was mainly that the old Agreement failed to address a large number of procurement related issues, whether they were procedural or whether they questioned the very foundation of the International law that the GPA was derived from. Initially, the need to regulate a certain amount of transparency was first recognised at the Singapore Ministerial Conference of 1996. At the meeting, it was agreed upon by the ministers to "establish a working group to conduct a study on transparency in government procurement practices, taking into account national policies and, based on this study, to develop elements for inclusion in an appropriate agreement."[6] The conference was soon followed by the Doha Ministerial Conference in 2001, and it was eventually concluded in 2004 that the issues related to curbing of corruptive practices in government procurement would not form part of the Doha Work Programme.[7] Therefore, it can be said that the all the efforts taken by the WTO to enhance transparency and reduce anti-corruptive practices in government procurements had been unsuccessful so far.[8] This was one of the reasons why a new GPA was required. The inception of the revised GPA aimed to aimed to introduce all these changes, at least on a plurilateral level.

ii. Changes brought in the Revised Agreement

As already discussed, the revised Agreement adopted a more modern and flexible approach with respect to several of its provisions. A more streamlined perspective evolved along with the revised agreement, whether it was in terms of procedural provisions or provisions related to the transparency of the system. The renegotiated Agreement focuses upon procedural as well as transparency related changes in its provisions. Amongst these broad changes, the revised Agreement

[6] WTO Ministerial Conference, Singapore, Ministerial Declaration, ¶ 126, WT/MIN(96)/DEC (Dec. 18, 1996).

[7] WTO Ministerial Conference, Fourth Session, Doha, Ministerial Declaration, ¶ 126, WT/MIN(01)/DEC/1, (Nov. 20, 2001).

[8] *WTO: government procurement working group on transparency* https://www.wto.org/english/tratop_e/gproc_e/gptran_e.htm (last updated Apr 20, 2016).

seeks to mainly address the issues of a) Coverage or reciprocity and b) flexibility.[9] The former involves regulations related to the procuring entities covered by the Agreement and the latter involves accession related measures for developing as well as least-developed countries. Some of these measures, along with the other changes introduced in the revised Agreement are discussed in the paper henceforth.

a) PROCEDURAL CHANGES

Electronic Procurement- The scope of the Agreement has been discussed` in Article II, which has been drafted in a more comprehensive and specific manner in the new Agreement.[10] The Article lays down the four parameters upon which the scope of the application Agreement would be determined. Out of them, the first sub clause specifically is indicative of the "modernity" that the revised agreement seeks to achieve. It aims to do so by strongly implementing the already existing measures related to electronic public procurement.

According to the revised text of the Agreement, the usage of such modern electronic techniques is comparable to the old traditional methods of communication. This is made clearer by revising certain technical aspects of the Agreement, such as drawing a distinction between the terms "written" and "in writing".[11] Further, the Agreement provides for a control mechanism that can be applied to the methods of controlling electronic communications. The mechanism ensures that such electronic processes and techniques don't act as a hindrance to trade. This way the system of electronic procurement is not applied in a discriminatory manner. The procuring entities are required to use information

[9] Jianning Chen, *Accession to the GPA: current state of play, process and procedures, and benefits and challenges* (Sept. 18 2015), https://www.wto.org/english/tratop_e/gproc_e/symp092015_e/S7-5Chen.pdf

[10] GPA, *supra* note 3 at Art. II.

[11] GPA, *supra* note 3 at Art. 1(f).

technology systems available to them that "ensure their interoperability with other generally available smith and software."[12]

Furthermore, another significant change brought in the revised agreement is the revision of system of electronic auction in conducting the procurement process. It fixes a deadline for bid submissions which makes time management easy.[13] Therefore, it can clearly be seen that these revised provisions act as an encouraging factor to use electronic technology to deal with public procurement, which would not only help in reduction of time, but also increase the general overall efficiency of the system.

b) PRINCIPLES OF TRANSPARENCY AND NON-DISCRIMINATION

The fundamental principle of the GPA is to prevent the parties from taking protective measures which favour domestic suppliers and products, and discriminate against the foreign market. The level of importance given to transparency to ensure such fair and reasonable treatment has been increased manifold in the revised text of the agreement. The new and improved provisions of the Agreement, largely adopted from the EU's procurement rules and regulations, help in achieving a non-discriminatory and clearer framework under the umbrella of global trade. Where Paragraph 7 of the Preamble of the old GPA termed transparency as simply "desirable", the revised text of the agreement emphasises upon the "importance" of such transparency and how it acts as an essential factor in liberalising international trade. [14]

Anti-corruption- The Draft on United Nations Manual on Anti-Corruption policy defines corruption as "an abuse of (public) power for private gain that

---

[12] GPA, *supra* note 3 at Art. V. 3(a).

[13] Sue Arrowsmith, *The Revised Agreement on Government Procurement: Changes to the Procedural Rules and other Transparency Provisions,* in THE WTO REGIME ON GOVERNMENT PROCUREMENT: CHALLENGE AND REFORM 285–336 (2011).

[14] Preamble to the Revised Agreement on Government Procurement(GPA); *See also* Robert D. Anderson, William E. Kovacic & Anna C. Müller, *Ensuring Integrity and Competition in Public Procurement Markets: a Dual Challenge for Good Governance*, in THE WTO REGIME ON GOVERNMENT PROCUREMENT: CHALLENGE AND REFORM, 681-718 (2011).

hampers the public interest".[15]It is highly likely for government procurements, which already involve huge amounts of investment, to attract corruptive practices. In the past, the WTO has tried to curb such practices to increase and improve "the predictability and reviewability of their national procurement procedures, and subject them to the WTO dispute settlement mechanism."[16]

With the respect to the Agreement in question, one of the unique features introduced in the revised agreement is that of anti-corruption. According to the newly revised Preamble, the transparent measures are also extremely necessary in order to avoid corruption in the public procurement sector. With respect to corruptive practices, the Preamble of the newly revised Agreement states that the parties recognise "the importance of transparent measures regarding government procurement, of carrying out procurements in a transparent and impartial manner and of avoiding conflicts of interest and corrupt practices, in accordance with applicable international instruments, such as the United Nations Convention against Corruption."[17]

The widening of the scope of government procurement services in the new Agreement can therefore be determined by the text of the revised Preamble itself. Apart from the preamble of the revised Agreement, which seeks to curb corruptive practices, the emphasis on the removal of the corruption has been stressed upon in Article IV: 4 of the revised Agreement as well. It can be seen from the text of the Preamble that it recognises the importance of transparency in government procurements and requires the same to be implemented through Article IV: 4 in the revised Agreement. The Article reads as:

"A procuring entity shall conduct covered procurement in a transparent and impartial manner that: a. is consistent with this Agreement, using methods such as

---

[15] United Nations, *Draft United Nations Manual on Anti-Corruption Policy,* UNITED NATIONS 7 (Jun. 2001), http://www.unodc.org/pdf/crime/gpacpublications/manual.pdf.

[16] Krista Nadakavukaren Schefer, *Will the WTO Finally Tackle Corruption in Public Purchasing? The Revised Agreement on Government Procurement*, ASIL http://www.asil.org/insights/volume/17/issue/11/will-wto-finally-tackle-corruptionpublic-purchasing-revised-agreement#_ednref6 (last updated Apr. 15, 2013).

[17] GPA, *supra* note *3* at Preamble.

open tendering, selective tendering and limited tendering; b. avoids conflicts of interest; and c. prevents corrupt practices."

Therefore, from the text of the Preamble and the aforementioned Article, it can be seen that the GPA stresses on four basic principles. They are a) Transparency b) Impartiality c) avoiding conflict of interests, and d) prevention of corrupt practices.[18] These factors were not very well focused on in the previous Agreement.

Market Access-The WTO Director General welcomed the achievement of the much needed revision of the GPA and stated that it will "open markets and promote good governance in the participating member economies."[19] It has already been discussed in the introductory section that the revised Agreement aims to extend its market access commitments. The revised agreement has been expected to increase the value of market access commitments of the parties by $80- $100 million annually.[20] As of September, 2015, the parties to the agreement covered $1.7 trillion in procurements annually.[21]

It does so by increasing the number of procurement entities covered by the GPA to more than 500. Further, there is also an increase in the types of contracts covered by the increase. The contracts now cover "full range of construction services". Also, the various additional types of contracts that have been added include additional types of goods and services, such as for telecommunication

[18] Jean Heilman Grier, *Anti-corruption Provisions for Procurement in TTIP –The TTIP Procurement Chapter should incorporate strong anti-corruption provisions,* PERSPECTIVES ON TRADE, http://trade.djaghe.com/?p=416#sthash.L528hDqK.dpuf (last updated Feb. 5, 2014).

[19] Revised WTO Agreement on Government Procurement enters into force, WTO NEWS ITEM, https://www.wto.org/english/news_e/news14_e/gpro_07apr14_e.htm (last updated Apr. 7, 2014).

[20] DAVID A. GANTZ, LIBERALIZING INTERNATIONAL TRADE AFTER DOHA: MULTILATERAL, PLURILATERAL, REGIONAL AND UNILATERAL INITIATIVES 92-93 (2013).

[21] Azevêdo encourages WTO members to consider benefits of procurement pact, WTO NEWS ITEM, https://www.wto.org/english/news_e/news15_e/gpro_17sep15_e.htm (last updated Sept. 17, 2015).

services, etc. Another type of contract, which was specifically covered by the EU, Japan and Korea, was the Build Operate Transfer (BOT) contract.[22]

Accession to the Agreement- As already discussed earlier, the GPA is a plurilateral Agreement, which means that it is only binding on its signatories. Accession to the Agreement by its parties has become an easier and lucrative process since the emergence of the revised text of the Agreement. Apart from the perks such as the electronic procurement system and other procedural requirements, the revised GPA has adopted a more flexible and transparent approach towards the process of accession, particularly of developing countries.

Some of the newly enhanced transitional measures found in the new Agreement include provisions related to price preferences and offsets, establishing thresholds for public procurement at a higher level and increasing the Agreement's coverage by adding an additional number of specific procuring entities that come under the GPA.[23] The time period since the inception of the revised GPA, has witnessed multiple accessions to the Agreement by various countries. New Zealand and Montenegro were the first countries to have joined as member parties in early 2015.[24] Moldova was the next party to become a signatory to the Agreement, having completed the accession negotiations in 2015. Pakistan also became an observer party to the Agreement.

Special focus on the Developing Countries- The fundamental objectives of the WTO also include within their domain, the advancement of developing countries in the field of International Trade. The Preamble of the WTO lays down the foundation of this basic principle by recognising the need of the advancement of such economies. Therefore for the GPA, which falls under the umbrella of the WTO, one of the most significant features is that it takes into account the procurement needs of developing and least-developed nations, quite seriously. The new Agreement consists of provisions related to transitional measures, which are

---

[22] WTO, The Re-negotiation of the Agreement on Government Procurement (GPA),1994.

[23] GPA, *supra* note 3 at Art.V.3

[24] Johannes S. Schnitzer, *Expanding the Membership of the WTO Government Procurement Agreement: Montenegro and New Zealand Ratifying the Revised GPA*, PUB. PROCUREMENT L. REV 24 (2015).

beneficial for these nations.[25] The two cornerstone principles of the GPA are non-discrimination and transparency.[26] The revised Agreement tries to incorporate these very principles into its provisions which are aimed at enhancing the economy of developing as well as least-developed nations.

The flexibilities introduced for the developing countries are applicable to them based on two conditions. First, the provisions must be need based. This means that they are applicable according to the developmental needs of the economies. The second condition is that such provisions must be in agreement with the other parties. [27]Some of the transitional measures incorporated for these economies in the new Agreement include "price preference; offset; phase-in of covered entities or sectors; and gradual reduction of thresholds; deferred implementation of specific obligations."[28]

In a statement issued by the Director General of the WTO, Pascal Lamy, it was stated by him that one of the focuses of the revised Agreement was to enhance the number of accessions to the Agreement.[29] Article V of the Agreement provides for facilitation of the accession of developing countries to the GPA.[30] The provision recognises "special and differential" transitional measures that would be applicable to developing countries in particular. This kind of special and

---

[25] GPA, *supra* note 3 at Art. V; Revised WTO Agreement on Government Procurement enters into force, WTO NEWS ITEM, https://www.wto.org/english/news_e/news14_e/gpro_07apr14_e.htm; (last updated Apr. 7, 2014)

[26] Caroline Nicholas, *The revised WTO GPA: an emerging pillar of twenty first century trade and development,* (Sept. 18, 2015), https://www.wto.org/english/tratop_e/gproc_e/symp092015_e/S2-4Nicholas.pdf.

[27] Jianning Chen, Accession to the GPA: current state of play, process and procedures, and benefits and challenges, (Sept. 18, 2015), https://www.wto.org/english/tratop_e/gproc_e/symp092015_e/S7-5Chen.pdf.

[28] Jianning Chen, Accession to the GPA: current state of play, process and procedures, and benefits and challenges, (Sept. 18 2015) https://www.wto.org/english/tratop_e/gproc_e/symp092015_e/S7-5Chen.pdf

[29] Lamy hails new book on procurement as major step in analysis of governance, WTO NEWS ITEM, https://www.wto.org/english/news_e/sppl_e/sppl193_e.htm (last updated May 23, 2011)

[30] GPA, *supra* note 3 at Art. V.

differential treatment is especially beneficial for developing countries since they lack the ability or the resources to implement WTO Agreements, due to their lack of competitiveness in the market. Another reason how they prove to be useful for the developing countries in particular, is because they provide temporary market protection.[31]

The transitional measures, as mentioned above, are temporary measures. The flexible nature of these measures allows the countries to accede to the Agreement and work according to the needs of foreign competition but only for a certain amount of time. This enables a gradual adaptation process and helps the developing economies to ease into the foreign competition rules and regulations, at their own pace. The transitional measures therefore help in protecting the vulnerability of such economies in the global market.

As already discussed above, the transitional provisions include the following four measures:

(1) Price preferences
(2) Offsets
(3) Phased in additions of specific entities and sectors
(4) Thresholds which are set at a higher standard than those at permanent levels

The revised GPA sets out the implementation period of these transitional measures for developing countries as "only the period necessary to implement the specific obligation and not to exceed three years." However, for least developed countries, time period remains five years.[32] Since these measures are also flexible in nature, the developing countries exercise the liberty of negotiating their

---

[31] John Whalley, *Non-Discriminatory Discrimination: Special and Differential Treatment Under the GATT for Developing Countries*, ECO. J. 1318-1322 (1990).
[32] GPA, *supra* note 3 at Art. IV.

accession terms and conditions, with the fellow GPA parties.[33] The transitional measures have been briefly discussed as follows-

(1) Price preferences

Under this Agreement, the developing countries exercise the liberty to use price preferences.[34] This simply means that the domestic bidders are allowed to give preference between foreign and domestic bids. That is, a procuring entity may exercise this discriminatory power of choosing a domestic firm's bid over a foreign bid but on the condition that the "difference in the price does not exceed a specific margin of preference." The concept of using such price preference also requires for the procuring entities to exercise some limitations. Firstly, the procedural aspect of it, that is, applying for the price preference via applications etc., must be transparent. It must be described in the tender notice in clear details. Secondly, such price preferences are with regard to goods and services which have their sources of origin in that developing country that has applied for such preference.[35]

(2) Offsets

Offsets can be defined as "any condition or undertaking that encourages local development or improves a Party's balance-of-payments accounts, such as the use of domestic content, the licensing of technology, investment, counter-trade and similar action or requirement". [36]Even though the parties to the agreement are not allowed to enforce or impose any offsets, the revised GPA provides for the developing countries to adopt such offsets on the condition that any requirement

[33] Robert D. Anderson, *Reflections on Bagwell and Staiger in Light of the Revised WTO Agreement on Government Procurement*, in GLOBALIZATION IN AN AGE OF CRISIS: MULTILATERAL ECONOMIC COOPERATION IN THE TWENTY-FIRST CENTURY 23 (Robert C. Feenstra & Alan M. Taylor eds., 2014);

[34] GPA, *supra* note 3 at Art. V.3.a.

[35] GPA, *supra* note 3 at Art. V.3.

[36] GPA, *supra* note 3 at Art 1.1.

for, or consideration of, the imposition of the offset is clearly stated in the tender notice.[37]

(3) Phased in additions

The procuring entities and sectors that come under the ambit of the GPA are listed out in the coverage schedule of Appendix I.[38] The provisions and requirements that are laid down in the Agreement are only applicable to the procurement activities of the parties that are mentioned in their coverage schedule. Therefore, only such activities can be carried out as per the rules and regulations of the GPA. A significant part of the revised Agreement, the coverage schedule consists of four prominent aspects according to which the parties are required to follow up on their commitments by the Agreement. It is only when they follow the prescribed commitments is when they would be subjected to the rules and regulations of the revised GPA.[39] These commitments involve the procuring activities to be carried out only by those entities which purchase "covered" goods and services. As already discussed previously, these services also include construction services. Further, these goods and services are required to have a contract value above the permanent relevant threshold. They must not simply be listed as "exceptions to the coverage." To summarise, the four commitments as laid down in the revised Agreement, are as follows-

- the procuring entities covered by the Agreement
- the goods, services and construction services covered by the Agreement
- the threshold values above which procurement activities are covered by the Agreement
- exceptions to the coverage.

---

37 *Id.*

38 *Appendix 1, Coverage Schedules, Agreement on Government Procurement (GPA)*, available at http://www.unodc.org/pdf/crime/gpacpublications/manual.pdf; (last updated Apr. 20, 2016).

39 Coverage Schedules, *Agreement on Government Procurement (GPA)*, Apr. 20, 2016).http://www.unodc.org/pdf/crime/gpacpublications/manual.pdf;

Where in the previous Agreement, the coverage schedule of each party consisted of five annexes, it was made into a more comprehensive format in the revised Agreement, with 7 classified annexes.[40] They are as follows-

Annex 1: central government entities
Annex 2: sub-central government entities
Annex 3: other entities
Annex 4: goods
Annex 5: services
Annex 6: construction services
Annex 7: general notes.

With the advancement of the "Integrated Government Procurement Market Access Information Resource", which is an electronic portal regulating maters of trade under the WTO, there is more clarity and understanding on the coverage aspect of the Agreement.[41] It maintains records of applications and notices, making the system a more comprehensive and transparent one. All these measures have been strongly implemented and catered to, with the enforcement of the revised GPA.

The developing countries that gain accession to the Agreement are allowed to exclude some procuring entities from the coverage schedule after that, for a certain amount of time. This should only be restricted however, to a certain period of time after which such procuring entities or sectors must be "phased in" or added back to the schedule after being given the consensus of other GPA Parties. This measure provides the developing countries some time to themselves, during which they can negotiate with other entities to procure only after a certain amount of time.

(4) Thresholds set higher than the permanent levels

---

[40] *Id.*
[41] W.T. (2016b) *Integrated government procurement market access information (e-GPA) portal* https://e-gpa.wto.org/ (last updated Apr. 20, 2016).

The procurements of entities come within the ambit of the Agreement when the estimated contract value of the government procurements becomes more than the threshold that has been laid down in the Parties' annexes in Appendix I. In this regard, the developing countries can again exercise their negotiable powers and request the thresholds to be set higher than the permanent levels. This can happen initially, after they gain accession to the Agreement. Along with this, as per the text of the revised Agreement, the developing nations are also allowed more flexible measures such as extending an already agreed upon transition period.[42] They can also alter or extend any of the transitional measures, but that is only applicable in case of "special circumstances that were unforeseen during the accession process."[43] This is carried out by the Committee on Government Procurement once the developing country files for an application.

Provisions for Small and Medium Sized Enterprises-The revised GPA provides for new more efficient work programmes conducted by the WTO Committee on Government Procurement.[44] One of the prominent work programmes by the Committee have been that of focussing on the development of small and medium sized enterprises in the field of government procurement. Such industries form an integral part of a nation's economy and make a large contribution towards their countries' GDP. This can be seen from the example of the EU in which 99.8% of all registered companies consist of small or medium sized enterprises. In fact, out of every 10 such industries, nine of them are micro-enterprises with a very limited amount of workforce.[45]

Therefore, in some ways, these industries can be labelled as the backbone of their nations' economic development. Therefore on recognising the procuring needs of

---

42 GPA, *supra* note 3 at Art. V.6.
43 *Id*
44 Robert Anderson & William Kovacic, *Competition Policy and International Trade Liberalisation: Essential Complements to Ensure Good Performance in Public Procurement Markets*, PUB. PROCUREMENT L. REV. 67-101 (2009).
45 SMEs' Access to Public Procurement Markets and Aggregation of Demand in the EU, EUROPEAN COMM., (Feb. 5, 2014), http://ec.europa.eu/internal_market/publicprocurement/docs/modernising_rules/smesaccess-and-aggregation-of-demand_en.pdf.

these industries, the revised Agreement has focussed on encouraging their development by introducing measures that would enhance their procuring activities. Article VIII.1 of the GPA requires that a "procuring entity shall limit any conditions for participation in a procurement to those that are essential to ensure that a supplier has the legal and financial capacities and the commercial and technical abilities to undertake the relevant procurement."[46]

Conclusion

From the year 1994 until now, the GPA's continual growth has revolutionalised the way International trade is perceived today. The Revised Agreement has introduced a lot of necessary changes and has attempted to fill the vacuum that existed in the public procurement sector, which the old Agreement failed to address on various levels. The revised Agreement imbibes within itself the two essential principles of International Trade, as sworn by the preamble of the WTO itself: transparency and non-discrimination. The changes made in relation to these principles have further enhanced the credibility of this Agreement, which was seen to be lacking earlier. Whether it's the special and differential provisions for the inclusion of developing and least developing countries or the stringent anti-corruptive regulations, the public procurement sector has seemed to have improved manifolds.

The purpose of the revision of the agreement was mainly to "open markets and promote good governance in the participating member economies."[47] Other objectives that were sought to be achieved through this revision were to increase the coverage of the Agreement and make the Agreement more favourable towards the developing countries. The success of the revised agreement is undoubtedly visible through the increasing number of signatories since its inception, with a

---

[46] GPA, *supra* note 3 at Art. VIII.

[47] Revised WTO Agreement on Government Procurement enters into force, WTO NEWS ITEM, https://www.wto.org/english/news_e/news14_e/gpro_07apr14_e.htm (last updated Apr. 7, 2014).

significant number of accessions to the agreement still pending.[48] Montenegro and New Zealand were the first countries to have joined the revised GPA since its enforcement in 2014, later on followed by the pending accessions of Australia, Kyrgyz Republic, Tajikistan, China, Seychelles and Albania.[49]

A study of such expansion in the membership is pertinent in understanding the inevitable success that the Agreement has achieved over a course of time. The revised agreement has been expected to increase the value of market access commitments of the parties by $80- $100 million annually.[50] As of September, 2015, the parties to the agreement covered $1.7 trillion in procurements annually.[51] The revised text contributes towards the development of national policy with a special emphasis on the inclusion of developing economies. [52] It has been given a more liberal interpretation, especially with regards to the electronic procurement tools, provisions related to prevention of corruption in procurement, protection of environment, etc. In a way, the amendment to the agreement has brought along a change in the perspective of the relationship between international trade and competition.

Further, accession to the GPA by the Commonwealth of Independent States and some particular parts of Central and Eastern Europe, can be said to be particularly essential. This would not only help them secure a significant position in global trade but also ensure the concept of rule of law in their countries. In fact, the WTO Accession Protocols of countries like Mongolia, Russia, etc., make it mandatory for them to seek accession to the GPA. Eradication of corruption is the central

---

48 Roberto Azevêdo, *Use Trade as the Next Stimulus*, WALL ST. J, http://www.wsj.com/articles/roberto-azevedo-use-trade-as-the-next-stimulus- 1427830482 (last updated Mar. 31, 2015).

49 Parties welcome progress in GPA accession talks for Australia, Tajikistan, Kyrgyz Republic, WTO NEWS ITEM, https://www.wto.org/english/news_e/news16_e/gpro_17feb16_e.htm (last updated Feb.17, 2016).

50 DAVID A. GANTZ, LIBERALIZING INTERNATIONAL TRADE AFTER DOHA: MULTILATERAL, PLURILATERAL, REGIONAL AND UNILATERAL INITIATIVES 92-93 (2013)

51 Azevêdo encourages WTO members to consider benefits of procurement pact, WTO NEWS ITEM, https://www.wto.org/english/news_e/news15_e/gpro_17sep15_e.htm (last updated Sept.17, 2015)

52 *Id.*

goal of the national policy of these countries, and it is achieved through the new agreement, which puts great emphasis on it. Another reason for developing countries to join the GPA is that it re-affirms the faith of foreign investors, in their domestic policy. To be at par with international practice can only be seen as a boon for countries whose political and domestic regime is not as advanced yet. If they follow internationally accepted rules and obligations, their public procurement regime is better enhanced.

To encourage participation by these developing nations, an informal arrangement was agreed upon between the WTO Secretariat and the European Bank for Reconstruction and Development (EBRD). This involved conducting workshops to encourage participation by such countries. In fact, the revised Agreement has drawn in so much attention by various countries and due to the multiple accessions that have taken place in the past couple of years, the technical assistance activities have been improved and intensified further.[53] A huge part of the technical assistance was provided by the EBRD to Ukraine, Moldova and Montenegro.

Therefore, as seen from the various changes made, the revised GPA has introduced changes that have contributed towards the advancement of International Trade, specifically in the light of Public Procurement.

[53] Technical Cooperation Activities,WTO, https://www.wto.org/english/tratop_e/gproc_e/gptech_coop_e.htm

INSURANCE LAW

INSURANCE LAW CONTRACTS | POSITION OF FRAUDULENT DEVICES & FORFEITURE

SHRAYANSH NIRANJAN*

Introduction

Insurance Law Contracts unlike other contracts are one of Utmost Good Faith as the Insurer undertakes to indemnify all the risk and prospective losses of the Insured. The only method of ascertainment of Risk, which he so promises to make good, is the account of facts and circumstance as presented and deposed, by the Insured and Insurer stands alien as well ignorant to the situation and resultant risk in the present state of things. So, the duty cast upon Insured to observe good faith in Insurance contracts supersedes the general duty to observe good faith in all other types of Contracts in practice. We refer this as 'Utmost good faith'. Therefore, not just the present state of things but all the events and occurrences that can increase the Risk in future are to be mentioned at the time of execution of the policy.

Additionally as the law stands today this duty of disclosure and observing good faith is one of continuing nature and doesn't cease to be in force post formation of policy.

This comment will argue that the position of law with respect to 'utmost good-faith' in context of **Fraudulent Claims by way of Exaggerated Claims** and **Fraudulent Claims through Fraudulent Devices** to promote insured's interest is an area of ambiguity and merits its own special treatment vis-à-vis blatant breaches of 'uberrimæ fidei'. Three situations may arise when we talk of 'Utmost Good-faith' breaches-

Utmost Good Faith

1- Utmost Good Faith breach **at the time of 'Effecting' the Policy** covered under S.17[1]

---

* IV Year, BA.LLB.(HONS), Symbiosis Law School, Noida.

[1] The Marine Insurance Act, 8 Edw. 7 c.41 § 17 (1906); Indian Marine Insurance Act, §19 (1963).

[Duty of Disclosure]

Non Observance Effect- Insurance policy can be **avoided ab-initio**

2- **Post Contractual Breach** of Utmost Good Faith **covered under S.17** [Disclosing any material Alteration of Risk]

Non Observance Effect- Insurance policy can be **avoided ab-initio**

3- **Post Contractual Breach** of Utmost Good Faith **not covered under S.17** and governed by Common Law Principle- '**Fraud defeats the claim in entirety'.**

3.1- **Fraudulent Claims:** Dishonest Intention to defraud the Insurer

3.1.1**- Exaggerated Claims**

Claims made by way of deliberate overvaluation

3.1.2- **Fraudulent Devices**

Claims made by employing fraudulent devices that must have tended to yield a not insignificant improvement in the insured's prospects of success prior to any final determination of the parties' rights.

3.2- **Reckless Statements**: Not caring for the falsity or trueness of a Statement

Non Observance Effect- **Forfeiture of Present and Future Claims**

The following two propositions have always presented a challenge before the courts dealing with Insurance Law Contract Disputes-

a- How to distinguish b/w reckless statements and fraudulent devices, which attempt to achieve similar objectives of not insignificant improvement in insured's prospects of success?

b- How does the gravity of fraudulent devices employed be mapped to decide upon penalty or complete forfeiture of claim?

'Insurance is '*uberrimæ fidei*'. A contract of marine insurance is a contract based upon the utmost good faith, and, if either party not observes the utmost good faith, the other party may avoid the contract.'

This comment shall also delve into whether the objective test of The Aegeon[2] to include 'fraudulent devices' into 'fraudulent claims' and to provide similar treatment is good or bad in law. Further an analysis shall be made on aspects of Materiality and Proportionality.

How to maintain a balance that –

Neither a defrauder goes without sanction nor it encourages insurers[3], whose obligation is to indemnify upon the occurrence of the loss, to keep asking questions in the hope that the assured will slip up and make what can then be characterized as a recklessly false statement.

Analysis

This case comment argues that the whole area of law concerning the Fraudulent Devices and thereby resultant breach of Utmost Good Faith is a total mess and full of ambiguity.

Such cases presently observe similar treatment as in case of Fraudulent Claims made by way of Exaggerated Claims and will lead to Forfeiture of Present and Future claims.

iv. Pre *Aegeon*[4] Position of Law

a) **ARCHAIC LAW/CLASSICAL ARRANGEMENT FOR TREATMENT OF FRAUDULENT DEVICES-**

'The test was whether the matter misrepresented or concealed justified a defense to the claim.'[5] This means that if not for the concealment or misrepresentation done by the insured the courts wouldn't have favored to allow benefits under the insurance policy. In other words the insurer

[2] *See Agapitos v Agnew*, [2003] QB 556.
[3] *See* Galloway v. Guardian Royal Exchange (UK) Ltd, [1999] 1 Lloyd's Rep 209. [**Hereinafter 'Galloway'**]
[4] *See* Agapitos v Agnew, [2003] QB 556.
[5] *See* Royal Boskalis, [1997] LRLR 523.

has to prove that the fact concealed/misrepresented is so material to the case at hand that the decision of the court stands reversed if the fact stands as it is. Thus hiding or deceiving a fact so vital led to complete forfeiture of the claim (present and future) on ground of fraudulent devices employed to get a favorable outcome of the Case.

This test justified three things objectively-

a) The matter concealed/misrepresented stands **closely connected** to the main claim under the policy and is not one, which could be incidental to it.

b) The fraudulent device must have been **intended by the insured** to **promote** his **prospect of success**, and

c) The fraudulent device must have tended to yield a **not insignificant improvement** in the insured's **prospects of success** prior to any **final determination of the parties' rights**.

(1) Critique-

The above test was later overruled by a subsequent authority in the famous Aegeon[6] Case, which laid down a test that is discussed in the upcoming section. This Archaic arrangement is criticized for being one that can aid the fraudsters to leave without sanction for the fraudulent device so employed, as they can always take the plea that the decision of the Court is not primarily based upon the misrepresentation/fraud so done and it was just to aid their own chances of winning the litigation and speedy claim settlement.

v. Post Aegeon[7] Position of Law

Lord Justice Mance expounded the following test to include fraudulent devices as sub-specie of the Fraudulent Claim itself in ***Agapitos v Agnew*, [2003] QB 556-**

[6]GALLOWAY, s*upra* note *3*.
[7]*Ibid.*

There are many grounds on which an insurer can avoid having to meet a claim under a policy: nondisclosure; misrepresentation; breach of warranty or condition precedent; or fraud by the insured. What constitutes a fraudulent claim is well understood: a claim for a loss that did not occur, or which was caused or procured by the insured, or alternatively, a genuine claim that has been exaggerated.

There are ways in which an insurer can avoid a genuine-looking claim where it has considerable concerns about the insured's story, even though it is unable to prove the kinds of wrongdoing outlined above. An insured's lies to an investigator – told, perhaps, to conceal wrongdoing or a defence that might be available to an insurer, or to embellish an account about which the insured has anxieties – may, in themselves, defeat the insurance claim. This issue was explored by the Court of Appeal in Agapitos v Agnew [2003] QB 556. In giving the leading judgment (with which Lord Justice Brooke and Mr Justice Park agreed), Lord Justice Mance noted that 'such devices' are a not unfamiliar response to insurers' probing of the merits of a claim.

(1) Fraudulent devices

Strictly speaking, Lord Justice Mance's observations in Agapitos on "fraudulent means and devices" (meaning a fraud where an insured gives a false statement to embellish or improve the surrounding facts of a genuine claim) were expressed to be a tentative view and that they have been followed and approved by both the judiciary and commentators.

If a claim is found to be fraudulent, the insurer can avoid liability for that claim and any subsequent claim made under the same policy, even if the subsequent claim is genuine. Should the same remedy be available when it comes to otherwise genuine claims where the policyholder tells lies to the insurer?

It is not any lie, though, that will give an insurer a remedy. Lord Justice Mance contemplated "the possibility of an obviously irrelevant lie". The fraud, he said, must be "directly related to and intended to promote the claim". In such a case, the usual reason for the use of a fraudulent device "will have been concern by the insured about [the] prospects of success and desire to improve them by presenting the claim on a false factual basis".

Lord Justice Mance then turned to the question of the appropriate legal response to a fraudulent device used to promote a claim "which may… prove at trial to be otherwise good, but in relation to which the insured feels it expedient to tell lies to improve his prospects of settlement or at trial".

Giving a tentative answer to the question, Lord Justice Mance said that the law should treat the use of a fraudulent device "as a subspecies of making a fraudulent claim – at least as regards forfeiture of the claim itself in relation to which the fraudulent device or means is used". For this purpose, the law should treat as relevant any lie:

a) Directly related to the claim to which the fraudulent device relates; and
b) Which is intended to improve the insured's prospects of obtaining a settlement or winning the case; and
c) Which would, if believed, tend "to yield a not insignificant improvement in the insured's prospects… for obtaining a settlement, or a better settlement, or of winning at trial".

In ***Wisenthal v World Auxiliary Insurance Corporation (1930) 38 Ll L Rep 54,*** Mr Justice Roche told the jury: "Fraud… was not merely lying. It was seeking to obtain an advantage, generally monetary, or to put someone else at a disadvantage by lies and deceit. It would be sufficient, within the definition of fraud, if the jury thought that, in the investigation, deceit had been used to secure payment or quicker payment of the money that would have been obtained if the truth had been told".

So a lie to an investigator that is intended to improve the likelihood of the claim being paid, the amount of the payment or the speed of the payment is likely to constitute a "fraudulent device". Any such false statement will give the insurer a strong weapon to defeat the claim.

An insurer does not have to show that:

a) It was persuaded by the lie into taking action; or
b) That the lie was an attempt by the insured to conceal grounds on which the insurer could decline or limit the claim (although that would still be one reason to categorize a lie as a fraudulent device).

The insurer can rely on lies told by the insured's agents or representatives. However, it cannot rely on lies told after the start of legal proceedings, as the rules relating to contempt of court take over at that point.

The following section shall discuss how this test was applied to Versloot Dredging BV & Another v. HDI Gerling Industrie Versicherung AG and others[8].

vi. <u>Versloot Dredging BV & Another v. HDI Gerling Industrie Versicherung AG and others</u>

The Court of Appeal judgment in Versloot Dredging v HDI Gerling [2014] EWCA Civ 1349 -the court has dismissed the appeal of an insured whose claim was held forfeit after it was proved he made a fraudulent statement to bring what otherwise would have been a legitimate claim.

Although set in a marine context it has a wider application to property claims and also raises an interesting contrast to the casualty market.

a) THE CAUSE

The judge at first instance concluded that the cause of the casualty was unseaworthiness as a result of crew negligence, along with a lack of watertight integrity of the bulkheads and the defective state of the vessel's engine room pumping system, which was unable to cope with the rate of

[8]Versloot Dredging BV & Another v. HDI Gerling Industrie Versicherung AG and others, [2014] EWCA Civ 1349.

ingress of water.

All of the above causes were insured perils meaning, but for any misstatement, the claim would have succeeded.

b) THE FRAUDULENT DEVICE

The general manager of the vessel was alleged to have falsely claimed (1) that the bilge alarm had gone off at about noon on 28 January 2010 (2) that it had been ignored because it was commonly understood to have been caused by the rolling of the vessel in rough weather and (3) that he had been told both of these things by the Master of the vessel and its crew.

The general manager's statement, whilst not directly related to the amount of the loss, was false. He had in fact not spoken to the Master of the vessel at the time of giving the statement and his account of why the alarm was not investigated was, he later admitted, speculation. The courts held that as a result, the whole claim was forfeit.

c) THE APPEAL

The Claimants appealed the decision on the basis that the fraud was unconnected to the level of losses, which were legitimately claimed. The statement by the crewmember, whilst false, had no impact of the validity of the claim or the value.

The Court of Appeal applied the test in Agapitos v Agnew [2003] QB 556 . That test says that in order for the claim to be forfeit, the fraudulent device must be directly related to the claim and must have been intended to enhance the prospects of the claim's success.

The Claimants argued that forfeiture of the entire claim was disproportionate to the gravity of the fraud, however the Court of Appeal was reluctant to deviate from a common law doctrine, which has been in application, particularly in the insurance field, for over 150 years.

The Court of Appeal held that if a case by case basis for determining what portion of a claim were to be forfeit due to fraud were introduced, it would cause confusion and lead to inconsistency in application. Also, the Law Commission had looked at the issue as part of their insurance law reform proposals and it appeared they had no appetite to bring about any change. It was considered that a change in approach "might be seen to encourage policyholders to commit minor frauds in the expectation that such conduct would not affect the legitimate element of the claim".

The Court of Appeal held that deterrence of fraud is a legitimate aim and whilst forfeiture appears to be disproportionate in some circumstances, it is not disproportionate to the aim of discouraging and reducing insurance fraud. This doctrine arises as Lord Mance put it, "from a perception of appropriate policy and jurisprudence on the part of our 19th century predecessors, which time has done nothing to alter".

The Court of Appeal considered that the test under Agapitos v Agnew had been met and dismissed the appeal.

vii. Critique of the Present position of Law post *The Aegeon- 'A draconian law'*

a) DISPROPORTIONATE-

The fraudulent claims doctrine involves a **disproportionately harsh sanction** and is an anomaly. In seeking to penalise and deter it usurps the function of the criminal law but with a lesser burden of proof and lesser safeguards. The forfeiture of the whole claim, without even the return of the premium, provides insurers with a windfall and a powerful weapon. (The Bar Council in its response to the Law Commission said that The Aegeon had led to a sudden surge in insurers' lawyers pleading "fraudulent means and devices").

It does not apply to other civil claims for damages where there may well be asymmetry of information between claimant and defendant and where a claimant may have both motive and opportunity to put forward false evidence before litigation starts. The court should not, as a matter of policy, extend the doctrine of fraudulent claims so as to apply it to fraudulent devices. This would be so even if there were no logical divide between cases to which the fraudulent claims doctrine applies and those to which the fraudulent devices doctrine would apply.

b) GRAVITY AND CULPABILITY-

It ignores the gravity or culpability of the device and, as the judge said, makes no distinction between "a reckless untruth ... told on one occasion" and "a carefully planned deceit or conspiracy". The same consequence to the man who claims a large sum for a totally fictitious loss as it does to someone who has a house and contents claim worth £ 500,000 including the real loss of a computer, who provides an invoice for a similar one which he has not lost because he cannot be bothered to find the right one.

Nor is account taken of the consequences of the lie for the insurer, whether and for how long the insurer was deceived by it, or the size of the penalty or its impact on the assured. A doctrine which has the potential to inflict disproportionately harsh sanctions on an individual, when a downright lie in a non insurance civil claim would not have that consequence, cannot have struck a fair balance. Nor is there any statistical evidence, which justifies so disproportionate a rule in relation to fraudulent device, whatever may be the position in relation fraudulent claims.

c) FRAUDULENT CLAIM V. FRAUDULENT DEVICE-

But there is, in any event, a critical distinction between a fraudulent claim and a fraudulent device. In the former case the insured is seeking to obtain a benefit to which he is not entitled; in the latter he is not. In short, the claim in a case such as this was payable when it was made, before any fraud had even been considered. That is the central difference between a fraudulent claim, which is never properly payable either at all or, at any rate, in relation to the part fraudulently exaggerated, and a fraudulent device (where the claim may have been properly due and payable before the fraud occurred).

d) ENCOURAGING INSURANCE COMPANIES TO AVOID PERFORMANCE AND TO QUESTION ON TOTALLY TECHNICAL ASPECTS-

It would encourage premature resort to litigation to avoid the effect of the doctrine. It would also encourage insurers, whose obligation is to indemnify upon the occurrence of the loss, to keep asking questions in the hope that the assured will slip up and make what can then be characterized as a recklessly false statement.

Professor Clarke's ***The Law of Insurance Contracts 4th Ed at 27.2 B***[9], expresses the view that **the settlement of a claim is or is closely akin to a legal agreement and that it would be an unusual departure from principle to vitiate it on account of a lie which was not causative unless designed to uphold a clear overriding principle of public policy**. He also expressed the view that to do so would overlook the concerns expressed by ***Lord Mustill in Pan Atlantic [1995] 1 AC 501, 549D.*** Lord Mustill's concern was against allowing avoidance for non-disclosure without any reference to causation since "**to enable an underwriter to escape liability when he has suffered no harm would be positively unjust".**

Professor Clarke also expresses the view that the recognition of a fraudulent devices rule gives rise to concerns for the interests of consumers and small businesses and would potentially encourage insurers continually to attempt to question the insured after the loss in the hope of obtaining misstatements.

(1) What's happened since Agapitos?

How have the courts dealt with lies to insurers since the Agapitos case? The short answer is that there have been very few reported cases on this point. This is surprising, given Lord Justice Mance's observation that deceitful statements to insurers' investigators "are a not unfamiliar response" to investigations.

In Eagle Star Insurance v The Games Video Company (GVC) SA [2004] EWHC 15, which concerned the destruction of a ship, the insurer avoided having to indemnify the owner of the vessel. During the course of the insurer's investigation into the cause of the loss, the vessel owners presented fabricated documents about the supposed nature and value of the ship. The court concluded that these documents had been created and presented to try and bolster what the vessel owners had said about the ship's value: "They were asked for documents",

[9] CLARKE, THE LAW OF INSURANCE CONTRACT'S 27.2 B (4TH ED, 2002).

said Mr Justice Simon, "and they handed over the documents whose contents were deceitful. They used fraudulent devices in order to advance the claim, with the intention and expectation that the insurer would accept the documents at face value, be reassured and promptly pay the assureds".

The Commercial Court in ***Marc Rich Agriculture Trading SA v Fortes Corporate Insurance NV [2004] EWHC 2632 (QB)*** responded favourably to the insured's argument: an alleged failure by the insured to disclose information to an insurer did not constitute a fraudulent device. In recognising that Lord Justice Mance's comments in Agapitos were incidental rather than central to the decision – and given the developing nature of the relevant law – Mr Justice Cooke in Marc Rich dismissed the insured's application for summary judgment on certain aspects of the insurer's defence. However, the judge went on to say that "were the matter to come before me at trial, my inclination would be to say that Lord Justice Mance is right in the approach that he has adopted". Mr Justice Cooke would prefer the insured's arguments on non-disclosure during the insurer's investigations.

In ***Stemson v AMP General Insurance (NZ) Ltd [2006] UKPC 30***, the Privy Council allowed the insurer to rely on a fraudulent device defense. Following a fire at the insured property, the insured lied to the investigator about his intention to sell the property. That was a fraudulent device and remained so even though the insured admitted his true intention before the insurer's rejection of the claims.

Conclusion – Is it a Good Law?

The **public policy justification** for the rule as applied to both claims and devices. In either case its draconian consequence only applies to those who are dishonest. The importance of honesty in the claiming process is manifest. Most insurance claims get nowhere near litigation because insurers rely on their insured. It is true that, if the rule applies to claims and devices, insurers' scope for asserting an entitlement to avoid will be greater than if it only applies to claims. But insurers are entitled to protection from either type of fraud and the scope of the rule should not be determined by the fact that unscrupulous insurers might assert a fraudulent device without good reason to do so.

So the accepted position on fraudulent devices in property claims has been upheld. Insurance contracts, of course, carry the duty of utmost good faith. If an insured breaches their duty of utmost good faith to the insurer and inflates their claim, knowing that is not worth the stated value, the insurer can avoid liability for the whole claim.

This is in contrast to how fraudulent claims are dealt with in personal injury claims where the injured party owes no duty of utmost good faith to the insurer because its relationship is with the defendant. In all but the rarest of cases, a claimant in a personal injury claim does not lose the right to the 'good' part of the claim as a result of any dishonesty. This has arguably led to a win-win scenario for the dishonest claimant and an industry wide problem with exaggerated claims.

Fraud defeats the claim in entirety'- A Good Law

It should be seen that a law is Good only if it seeks to establish a proper balance between two conflicting set of interests and without providing an opportunity to abuse it by either party. Neither a defrauder goes without sanction nor it encourages insurers[10], whose obligation is to indemnify upon the occurrence of the loss, to keep asking questions in the hope that the assured will slip up and make what can then be characterized as a recklessly false statement. While adjudging on the proposition of public policy against Fraud the judges must take Materiality and Proportionality of the Device used into account for proper administration of Justice.

FUTURE-

Section 49 of the Criminal Justice and Courts Bill seeks to address this by introducing the concept of 'fundamental dishonesty' in personal injury claims so that where dishonesty is discovered the whole of the claim will be forfeit rather than just the fraudulent part.

---

[10] *See* Galloway v Guardian Royal Exchange (UK) Ltd [1999] 1 Lloyd's Rep 209.

THE INSURANCE LAWS (AMENDMENT) ACT, 2015: AN ANALYSIS

DEEYA RAY

Introduction

Insurance as a concept was first discussed in India in early works like the Manusmriti, Arthashastra and Dharmashastra. Therefore it has been a part of Indian society for a very long time. The Oriental Insurance Company was the first insurance company in the country and was set up in Kolkata back in 1818. It mainly catered to the European community's needs. In 1870, Bombay Mutual Life Assurance Society was set up as the first Indian Insurance Company. The National Insurance Company is the oldest existing insurance company in the country and it was established in 1906.[1]

The legal framework of the insurance sector in India has run a complete circle from being unregulated to completely regulated and presently, partly deregulated. A number of legislations govern Insurance Law in the country. The first law to govern all types of insurance was the Insurance Act, 1938.[2] It provided for strict state control over all insurance businesses. The Life Insurance Corporation then completely nationalized Life Insurance in India in 1956.[3] The General Insurance Business (Nationalisation) Act, 1972 was brought in with the objective of nationalizing 100 general insurance companies that were then merged to form four companies headquartered in the four metropolitan cities. These were, the National Insurance Company, the New India Assurance Company, the Oriental Insurance Company and United India Insurance Company.[4] It was not until 1999 that private insurance companies were also allowed. The Insurance Regulatory and Development Authority Act, 1999 was brought in that deregulated the insurance

---

1 Sree Visakh, *The Insurance Laws (Amendment) Bill: Analysis Time,* THE FORTUNE STROKE, http://www.fortunestroke.in/2015/03/the-insurance-laws-amendment-bill-2015.html (last updated Sept. 14, 2015) [**Hereinafter 'Visakh'**].

2 The Insurance Act 1938

3 The Life Insurance Corporation Act 1956.

4 The General Insurance Business (Nationalisation) Act 1972.

sector and allowed private companies to participate.[5]

The Act also provided for foreign investment in the insurance sector but this had a cap of 26% of equity share capital of the company. About 20 out of the 23 private life insurance companies had more than 22% foreign investment and about 14 out of the 17 private non-life insurance companies had more than 22% foreign investment.[6] The Insurance sector in India has seen low penetration because of the lack of funds to permit growth of the sector and therefore, a need for permitting an increase in foreign investment was seen. With this in mind, the Insurance Laws (Amendment) Bill 2008 was tabled which sought to increase the foreign investment cap from 26% to 49%.[7] This bill was amended and revised but the Parliament failed to pass it in the winter session of 2014. In order to show that they did in fact intend to bring in all the changes sought to be brought by the bill, the Central Government notified the Insurance Laws (Amendment) Ordinance 2014 on 26th December 2014.[8] This gave interim legal standing to the new amendments. It finally became a law on 20thth March 2015 as the Insurance Laws (Amendment) Act 2015 after it was granted Presidential assent.[9]

The present paper shall delve into problems faced by the insurance sector due to which the amendment has been brought in and then it shall look into the important changes brought by the new amendment and seek to analyse them.

Need for Amendment

Other than the need for funds for growth, there were a number of other problems in the insurance sector that necessitated changes. For starters, the Insurance

---

5 The Insurance Regulatory and Development Authority Act 1999.

6 Insurance Regulatory and Development Authority of India, Annual Report 2013-2014 (28 (Sept. 14, 2015) http://www.policyholder.gov.in/uploads/CEDocumenAR%20January%202015%20issue.pdf

7 The Insurance Laws (Amendment) Bill 2008.

8 The Insurance Laws (Amendment) Ordinance 2014.

9 A Harlalka, S Shah and S Reis, *49% FDI in Insurance: A Long Successful Battle* ,NISHITH DESAI ASSOCIATES, <http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/49-fdi-in-insurance-a-long-successful-battle.html?no_cache=1&cHasf4e4a14a7215b6ff739c2c> (last updated Sept. 14, 2015) [hereinafter 'Harlalka, Shah and Reis'].

Regulatory and Development Authority of India (IRDAI) that regulates the insurance sector did not have adequate powers. Other agents such as the Central Government directly regulated many aspects of the sector. An instance of this is that prior permission of the Central Government was required before a foreign insurance agent could insure property in India. Also, when agents sold wrong insurance policies to the buyers, they were rewarded with large sums from the insurance companies and the IRDAI did not have enough power to look into these situations.[10]

Another issue was that the only means by which common people could get insurance policies was through insurance banks or agents. Thus a long and tedious process would have to be followed in order to get policies processed and this also increased chances of fraudulent activities on the part of the banks and agents. Due to the nexus between the two groups, the policyholders would have to approach both of them and they kept putting the responsibility on the other party.[11]

Further, there was a lack of flexibility in insurance premiums. That is, most companies had fixed premiums and since a majority of people in the country work for daily wages, they were wary of taking such insurance policies.[12]

As per the 190th Law Commission Report in 2004, the grievance-redressal mechanisms were also inadequate. The Ombudsman scheme under the Redressal of Public Grievances Rules, 1998 and the remedy under the Consumer Protection Act 1986 were unsatisfactory and ineffective to deal with the complaints of the policy holders.[13]

Also, according to s.45, an insurance company could repudiate the contract if any

---

[10] VISAKH, *supra* note 1.
[11] *Ibid*
[12] Standing Committee on Finance, *Forty-first Report on the Insurance Laws (Amendment) Bill, 2008*, PRS INDIA, http://www.prsindia.org/uploads/media/1230002517/SCR%20Insurance%20Laws%20Bill.pdf (last updated Sept. 14, 2015).
[13] Law Commission of India, *190th Report on the Revision of the Insurance Act, 1938 and the Insurance Regulatory and Development Authority Act, 1999* LAW COMMISSION OF INDIA 3 (Sept. 14, 2015) http://lawcommissionofindia.nic.in/reports/InsuranceReport-2nddraft1.pdf.

claim was fraudulently made, even after two years. However, the insurance companies often misused this provision and refused to pay for claims by stating ill-substantiated excuses.[14] Thus, there was a need to bring in appropriate amendments to deal with these issues.

<u>The Insurance Laws (Amendment) Act 2015</u>

This Act makes amendments to three core insurance legislations:

(1) Insurance Act, 1938
(2) General Insurance Business (Nationalisation) Act, 1972
(3) Insurance Regulatory and Development Authority Act, 1999

The provisions of the Act have retrospective effect from 26th December 2014 (i.e. the day the Ordinance was passed).[15]

i. <u>Hike in FDI Cap</u>

The most important change has been that the foreign investment ceiling has been raised from 26% to 49% cumulatively.[16] The first 26% will be by automatic route, while for the remaining 23%, Foreign Investment Promotion Board (FIPB) approval is necessary.[17] This 49% includes direct and indirect FDI as well as FPI.[18]

These changes are in line with the 2015 budget and with the Ordinance. However, while the Ordinance had made it possible for insurance companies to issue different classes of shares like equity shares, preference shares and other

---

14 VISAKH, *supra* note 1.

15 The Insurance Laws (Amendment) Act 2015.

16 S Khaitan and S Shrivastava, *Insurance Reforms finally become and Reality* KHAITAN LEGAL ASSOCIATES, (Mar. 19, 2015) 1 http://www.ec3legal.com/publications/Legal-Update-on-analysis-of-Insurance-Laws-Amendment-Bill-2015-by-Khaitan-Legal-Associates.pdf; The Insurance Laws (Amendment) Act §3(iv) (b) (2015).[hereinafter 'Khaitan And Shrivastava']

17 Ramandeep Singh, *The Insurance Amendment Bill 2015: Summary* BANK EXAMS http://www.bankexamstoday.com/2015/03/the-insurance-amendment-bill-2015.html (last updated Mar 17, 2015).

18 HARLALKA, SHAH AND REIS, s*upra* note 9.

instruments, the amendment act says that only equity shares can be issued by Indian insurance companies for foreign investment.[19]

Therefore, foreign investments will substantially increase over the next couple of years. Foreign companies will only be happy to increase their ownership in Indian insurance companies that are valuable to them. The increase in FDI cap will help to increase penetration in the insurance sector.

ii. Introduction of the concept of 'Control'

The concept of 'control' has also been introduced. All Indian insurance companies have to be owned and controlled by Indians.[20] That is, more than 50% of the equity share capital has to be owned by Indian residents at all times. Control includes the right to appoint the majority of the board of directors or to control the policy decisions and management.[21] The definitions of ownership and control are in line with the definitions under the FDI Policy 2014.[22] This requirement of control by Indian residents may prove to be a disincentive for foreign joint venture partners because they may want a greater say in controlling Indian insurance companies since they cannot have majority ownership anyway. The foreign partners are often responsible for bringing in technical know-how and good practices, and taking all sorts of power away from them will leave them with no incentive to work for the benefit of the Indian joint ventures. This will thus have a negative impact on the hike in FDI Cap as well.

iii. FDI Cap applicable to all Insurance Intermediaries

Previously, the 26% cap on FDI was specifically for insurance companies, brokers, third party administrators, loss assessors and surveyors. There was some ambiguity with respect to other intermediaries. The new rules have however specified that this FDI cap will apply to all other insurance intermediaries.[23] However, the

[19] *Ibid.*
[20] KHAITAN AND SHRIVASTAVA, *supra* note 16.
[21] The Insurance Laws (Amendment) Act §3(iv)(b) Explanation (2015).
[22] HARLALKA, SHAH AND REIS, s*upra* note 9.
[23] KHAITAN AND SHRIVASTAVA, *supra* note 16; Consolidated FDI Policy 2015, 6.2.18.7.2(g) at p. 73.

problem that arises now is with respect to those intermediaries that already have more than 49% foreign investment as they did not have any restriction previously. It is yet to be determined whether these intermediaries will have to bring down their foreign shareholding or whether status quo will be granted.

iv. Foreign Reinsurance

Earlier, only domestic companies were allowed to provide reinsurance. The General Insurance Company was the only insurance company selling re-insurance in the country. However, the amendment has made it possible for foreign reinsurers such as Lloyds of London, to set up wholly owned branch offices in India and start reinsurance business.[24] This is obviously a welcome move as it will not only restrict the monopoly of General Insurance Company, but also lead to an increase in on-shore reinsurance activity in the country. However, the IRDAI is yet to set out guidelines and requirements that have to be fulfilled by these foreign reinsurers before they can start business.

v. Capital Availability

The act also allows for new and innovative ways of raising capital while being regulated and supervised by IRDAI. The four public sector general insurance companies in India, which previously had to be 100% government owned under the General Insurance Business (Nationalisation) Act 1972, are now allowed to raise capital. This is because of the need to expand the insurance business in the country in both rural and social sectors. The government equity however should not fall below 51% in these companies under any circumstances.[25] With more capital being made available and by making the insurance sector more capital intensive, there shall be a greater distribution to un-served or under-served parts of the country. There shall also be better methods of distribution that can be

[24]Trilegal, *Update: Insurance Laws (Amendment) Act, 2015 (*Apr. 10, 2015) http://www.trilegal.com/index.php/publications/update/insurance-laws-amendment-act-2015 (last updated Sept. 14, 2015; The Insurance Laws (Amendment) Act §3(vii)(d) (2015).[hereinafter as 'trilegal'].

[25]Ministry of Finance, *Major Highlights of the Insurance Laws (Amendment) Bill, 2015 Passed by Parliament* PRESS INFORMATION BUREAU http://pib.nic.in/newsite/PrintRelease.aspx?relid=117043 (last updated Mar. 13, 2015); The Insurance Laws (Amendment) Act §103 (2015).

developed by use of technology, which will lead to more efficient service delivery. It will also encourage innovation in product formulations that will meet the diverse insurance needs of all the citizens.

vi. Empowerment of IRDAI

The Act has given the IRDAI the authority to regulate qualifications, eligibility and other conditions that have to be fulfilled for agents that are assigned to insurance companies.[26] Agents are also enabled to work more broadly across different companies in different business categories as long as they do not fall in conflict of interest.[27] This is also regulated by the IRDAI. The scope of insurance intermediaries has been expanded so as to include insurance brokers, reinsurance brokers, corporate agents, insurance consultants etc.[28] The IRDAI has been given the power to regulate code of conduct and functions of the loss assessors and surveyors.[29]

Another very important function is that before a foreign company insures property in India, it has to receive the approval of the IRDAI.[30] Previously the approval of the Central Government was required. This will probably lead to more clarity with regard to such insurance covers and regulations that govern them. Obviously the IRDAI will be in a better position to judge than the central government.

IRDAI also has the power to withhold licenses of Indian insurance companies under two situations: (i) in case of a joint venture with a foreign insurer, if the foreign insurer is barred in their home jurisdiction and (ii) IRDAI can cancel a license if the company has not obtained the requisite approvals from IRDAI before amalgamation or transferring business.[31] This provision has a potential to be misused as it may lead to unnecessarily punishing the Indian insurance company for a fault of the foreign insurer in their home jurisdiction. In any case, the foreign

---

26 VISAKH, *supra* note 1; The Insurance Laws (Amendment) Act § 49 (2015).
27 *Ibid.*
28 The Insurance Laws (Amendment) Act § 105 (2015).
29 MINISTRY OF FINANCE, *supra* note 25; The Insurance Laws (Amendment) Act § 82 (2015).
30 KHAITAN AND SHRIVASTAVA, *supra* note 16; The Insurance Laws (Amendment) Act, §4 (2015).
31 KHAITAN AND SHRIVASTAVA, *supra* note 16 at p. 3; The Insurance Laws (Amendment) Act §6(v) (2015).

company will not have enough control over the insurance company and therefore, it may be a little harsh to cancel the Indian insurance company's license for no fault of their own since they are still complying with all laws and regulations that are applicable to them.

Further, the statutory cap on commission payable to agents has been done away with and the IRDAI has been given the authority to regulate this instead. In so regulating, it will have to take into account the nature and tenure of the policy and the interests of the agents.[32] This is also a welcome move as it will add flexibility as IRDAI will be able to determine the maximum commission that is permissible and will also be able to make changes whenever necessary.

vii. Consumer Welfare

According to the new Act, insurers will be responsible for the acts and omissions of their agents. They will also be responsible for any violations of the code of conduct that the agents are supposed to follow. Mis-selling is one of such practices and the insurer will be liable to pay a penalty of up to Rs.1 crore.[33] Obviously such provisions will benefit the consumers. The insurance companies will be more wary of mis-selling by their agents and will take stricter action and will not reward them for sales through such misrepresentation. However, it may also be argued that it is unfair to punish the insurance companies for the acts of their agents and it is too harsh a punishment. It may not always be practically possible for the insurance companies to monitor the agents to make sure they are always acting in accordance with the law. Both the risk as well as the cost of compliance shall be increased on the part of the insurance companies. However, at least now the insurance companies will be more wary while appointing their agents and overall, the consumers will be protected.

---

[32] TRILEGAL, *supra* note 24; The Insurance Laws (Amendment) Act 2015, s 101(xv)(jd).

[33] Kapil Mehta, *Insurance Amendment Bill: Necessary but not Sufficient* LIVE MINT, (Mar 11, 2015) http://www.livemint.com/Opinion/9BIRSbrpRVVGSvzuVZFNQP/Insurance-amendment-Bill-necessary-but-not-sufficient.html (last updated Sept. 14, 2015); The Insurance Laws (Amendment) Act §49 2015.

The Act has also amended s.45 of the Insurance Act 1938 that deals with repudiation of life insurance contracts. The old provision had said that a contract could not be repudiated 2 years after the policy was in effect except in cases of fraud. However, the new provision states that a contract cannot be repudiated 3 years after the policy has been in effect. The fraud exception has been done away with.[34] This provision is clearly pro-insured i.e. it serves the interests of the policyholders better. The insurance companies will have to increase safeguards and compliances so as to reduce the risk of issuing policies based on misstatements.

Multi-Level Marketing (MLM) distribution, whereby a scheme for the purpose of soliciting and obtaining insurance business through people not authorized for the said purpose, has been prohibited by the Act.[35]

Trading in Insurance has also been banned. The practice of assigning your life insurance to an unrelated person in return for money is called Trading in Insurance. After such trade, the assignee would be liable to pay subsequent premiums and also receive all benefits.[36] This would generally lead to a situation whereby the assignee would benefit the most if the assignor would die early. This would be a very unpleasant situation and would lead to public policy issues. Therefore, trading in insurance has been rightfully done away with.

The law recognizes partial assignments as opposed to total assignment. Such partial assignment can be made to pay off a loan. The amended law also gives special protection to spouses, children and parents who are recorded as nominees in life insurance policies. They are beneficially entitled to the policy proceeds and no other legal heir can claim such proceeds from them. Previously, an assignment would cancel nomination, but now, it will not cancel the nomination although it may affect the rights of the nominees to the extent of the loan.[37]

---

[34] MINISTRY OF FINANCE, *supra* note 25; The Insurance Laws (Amendment) Act §55 (2015).

[35] *Ibid*; The Insurance Laws (Amendment) Act §50 (2015).

[36] MEHTA, *supra* note 33; The Insurance Laws (Amendment) Act §45 (2015).

[37] *New Insurance Law Underwrites Customer Protection* THE TIMES OF INDIA, (15 March 2015) http://timesofindia.indiatimes.com/business/india-business/New-insurance-law-underwrites-customer-protection/articleshow/46573936.cms (last updated Sept. 14, 2015); The Insurance Laws (Amendment) Act §45 2015.[hereinafter as 'the Times of India']

The Act also proposes electronic processing of claims and more flexibility in paying premiums.[38] Electronic processing will help in improving payouts of claims and also detection of fraudulent claims more easily. The flexibility that is provided is basically that if the policyholder is unable to pay the total premium for a particular month, he may be allowed to pay as much as he can and this would have to be compensated for in the next month. Such a policy will attract more people to take insurance policies.

viii. Compulsory Divestment Removed

The provision that mandatorily required Indian Promoters to sell its stake in an insurance company in excess of 26% within 10 years from the start of business has been done away with.[39] The main objective of having the divestment policy was to reduce concentration of ownership in insurance companies. However, lawmakers did not give effect to this provision anyway. Further, it is a welcome omission because now Indian promoters are at par with foreign partners.

ix. Health Insurance

Health Insurance was previously regulated as a part of general insurance. But now, health insurance is sought to be regulated on a standalone basis.[40] The act defines 'health insurance business' including travel and accident cover and retains capital requirements at Rs.100 crore.[41] This has been done with the aim of giving health insurance more importance by giving it a more focused regulatory system. The high capital requirements will help make sure that non-serious players do not interfere.

x. Grievance Redressal and Appellate Process

The Act also proposes the setting up of an independent grievance redressal authority (perhaps in the form of the Financial Redress Agency).[42] This authority

---

38 VISAKH, *supra* note 1; The Insurance Laws (Amendment) Act § 26 (2015).

39 TRILEGAL, *supra* note 24.

40 *Ibid.*

41 MINISTRY OF FINANCE, *supra* note 25; The Insurance La*ws (Amendment) §3(iii),§ 3(vi).Act 2015.

42 MEHTA, *supra note 33*.

will have powers similar to that of a civil court and would consist of judicial and technical members.[43] It is yet to be seen whether such an authority is established. If it is, it would probably replace the existing ombudsmen scheme.

The Act also provides for appeals against the decisions of the IRDAI to the Securities Appellate Tribunal (SAT).[44] Thus the relationship between the IRDAI and the insurers will be more confrontational. Previously, the only appeal lay with the Central Government and it wasn't very effective. Since the powers of the IRDAI have been increased so drastically, this only seems fair as it provides checks and balances on the powers of the IRDAI. However, it would be interesting to see whether the insurance companies find the confidence to actually challenge the decisions of the IRDAI as there is very little precedent on the same.

Conclusion

The recent changes brought by the Amendment Act are a welcome move and are indicative of the parliament's intention to move towards the economic development of the nation. The act seeks to make the insurance laws more consumer-friendly and this is commendable in a country that claims to be a socialist welfare state. Most of these changes were being demanded by the insurance industry for a very long time. The increase in economic rights will incite foreign partners to bring more insurance products into the Indian market. However, a number of problems may also arise due to these changes. The act states that the policyholder now has to prove that no wrong statements were made at the time of issuance of policy. Before, the insurance company would have to prove there was a misstatement. This will obviously make the procedure for claiming insurance quite difficult. Further, the strict compliances provided by the Act coupled with the increased liability of insurance companies in case of non-conformity or other discrepancies may act as a deterrent to new companies that were contemplating entering the insurance sector.

In fact Mr. Varadarajan, a Supreme Court advocate, has commented that due to the increase in the number of practical problems faced by the insurers and the fact

---

[43] VISAKH, *supra note 1*.

[44] TRILEGAL, *supra* note 24; The Insurance Laws (Amendment) Act § 94 (2015).

that the effect of these provisions shall be tested by different judicial and quasi judicial bodies at different levels, there will be more litigations and though this may benefit the lawyers, it will be inconvenient for the parties concerned.[45]

However, the positives appear to outweigh the difficulties. An estimated $3.2 billion of additional investment is expected in the insurance sector. This will give the insurers the required funds.[46] The changes are in accordance with the evolving insurance sector in the country and the regulatory practices around the world. They are expected to facilitate the insurance industry attain its complete growth potential and add to the growth of the economy as a whole. The future of the industry may be held to be secure for the moment.

---

[45] THE TIMES OF INDIA, *supra* note 37.

[46] P Mahrotri, A Antony and U Krishnan, *India Insurance Bill may attract $3.2 billion from Investors,* BLOOMBERG (Mar 13 2015) http://www.bloomberg.com/news/articles/2015-03-13/indian-insurance-bill-may-attract-3-2-billion-from-foreigners (last updated Mar 13, 2015).

CORPORATE

PARALYZING SMALL INVESTORS UNDER THE GUISE OF MELIORATION: A CRITICAL EVALUATION OF SEBI ICDR FIFTH AND SEVENTH AMENDMENT NOTIFICATIONS

MALCOLM V. KATRAK & JIGAR S. PARMAR *

Introduction

Initiation of the capital market in India dates back to the 18th Century when the East India company securities were traded in the country. The birth child of the group of traders in Bombay called "The native Share and Stock Broker's Association" became the first official stock exchange renamed the Bombay Stock Exchange. Change of economic policies at the helm, resulted in another leading stock exchange establishment in Mumbai in the year 1992- the National Stock Exchange, which went on to become the largest stock exchange in India, with a market share of nearly 70% in equity trading and 98% in futures and options trading in India.[1] For a healthy growth of capital markets and to prevent malpractices in trading, the Government had decided to "set up a separate board for the regulation and orderly functioning of the Stock Exchange and the securities industry." This resulted in the formation of Securities and Exchange Board of India (hereinafter referred to as 'SEBI') as an interim administrative body to function under the overall administrative control of the Ministry of Finance of the Central Government, by a notification issued on the 12th April 1988.[2] SEBI as a statutory authority which was established through an ordinance promulgated on January 30, 1992 established as a body corporate having separate legal personality under Section 3of the SEBI Act, 1992.[3] The genesis of the SEBI Act can be viewed thoroughly through its preamble which imposes a statutory duty on SEBI to protect the interests of the investors in securities and promote the development

* IV Year, S.V.K.M's Pravin Gandhi College of Law, Mumbai.

1 For a detailed history see, e.g., *BSE - Heritage*, www.bseindia.com/about/heritage.asp (last updated Mar. 2, 2016).See *A Historical Perspective Of The Securities Market Reforms In India*, www.sebi.gov.in/chairmanspeech/histspeech.html (last updated Mar. 2, 2016).

2 Ministry of Finance, Dept. of Economic Affairs (Investment Division), *No. 1/44/SE/86*, GAZETTE OF INDIA EXTRAORDINARY (Apr. 12, 1988).

3 Securities and Exchange Board of India Act § 3 (1992). *See also*, Securities and Exchange Board of India Ordinance § 3 (1992).

of the securities market. The then Finance Minister Shri Pranab Mukherjee on the occasion of the 'SEBI Foundation Day' on 12th April, 2010 encompassed the reason for the formulation of SEBI in a few lines emulated herein *"…. …. It becomes incumbent not only for the Government but also for the regulator to safeguard the interests of the retail investors who typically invest their hard earned savings. Besides this is required to encourage retail participation for ensuring greater depth of the market and to promote the inclusive growth strategy of the Government… …"*[4] It becomes absolute through this, that the essence of SEBI is the protection of the investors, the Authors have laid emphasis on this Preamble and solitary vow of the regulatory authority throughout the paper to point out the fallacies of various amendment notifications and circulars. The contentions which the authors will put forward in the paper will picture an ex facie bad law provided by SEBI in the guise of generic application of Information and Communication Technology (ICT), Speeding up of the process and streamlining the process of application and payment of rights issues and public issues. The issues raised by the authors negate the propositions put forward by SEBI for bringing into effect such a law which affects the retail investors thereby violating the provisions of its own parent act and the provisions of the Constitution of India. In a new dawn, a rather dusky sky has risen with the ICDR seventh Amendment Notification[5] and ICDR fifth Amendment Notification[6] which pertains to the Disclosure in the Abridged Prospectus and the Price Information of past issues handled by Merchant Bankers' and the latter being an amendment pertaining to 'Streamlining the Process of Public Issue of Equity Shares and Convertibles'. Deduction of the paper is essentially into three parts viz. the Seventh Amendment pertaining to abridged prospectus, the Fifth Amendment pertaining to the Mandatory ASBA system and the Constitutionality of the Amendments r/w respective Circulars. The constants being the role of SEBI and its retail investor protection provisions and the scenario of the current Indian

---

4 Ministry of Finance, *Securities and Exchange Board of India Press Release No. 93 of 2010*; *Finance Minister Initiates Process of Disbursal of Disgorgement Proceeds to Investors*, (Apr. 12, 2010), http://www.pib.nic.in/newsite/erelcontent.aspx?relid=60264 (last updated Mar. 1, 2016).

5 Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) (Seventh Amendment) Regulations § 4, (2015).

6 Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) (Fifth Amendment) Regulations § 4 (2015).

Capital Markets. Research is also cumulated by the Authors to study the impact of Information and Communication Technology (hereinafter referred to as 'ICT') and its pace in societal diffusion. This paper holistically aims at the retail and small investors' participation in the capital markets for which it adopts an internal influence model. The aim of the paper is not to demean the role of the regulatory authority viz. the Indian Securities Market but to remind the regulatory authority of the necessity of retail investors and small investors in the bulls and bears market.

<u>Disclosures in the Abridged Prospectus- The Fallacy of the SEBI ICDR Seventh Amendment Notification</u>

While the Agricultural Revolution is often considered the starting point of man's transition from being a nomad relying on nature's bounty to a civilized being depending on the fruits of his labor. It also laid down the foundation of the concept of trade and the notion of a contract. At its nascent stage, the idea of an exchange was to trade one's own superfluous cultivation for other items of need, cattle or harvest. With the emergence of various civilizations, trade was now a very important aspect of human life and this led to a host of flourishing societies.[7] The idea of risk and return has been commissioned and recognized right from the Mesopotamian era, it was groomed by the Merchants of Venice, utilized to the optimum by the East India Company and ultimately made its way onto the Banyan tree at Horniman Circle, Bombay in the 1850's. Hence, the practice of making an investment with some amount of risk attached to it with the aim of making profitable returns has existed since the onset of the human civilization itself. Chartered Corporations established during the Colonial period can be termed as the genesis of modern companies. The surfacing of corporations can be attributed *inter alia* to the need of expanding commerce by raising more capital. The Promoters of these modern corporations then approached the common masses by way of Initial Public Offerings (hereinafter referred to as 'IPOs'). An IPO allows a company to generate capital from the public who as investors accede to risks which come with an open market. The dividend declared by the company acts as a prime motivator for the retail investors to subscribe to the shares of the

---

[7] B. Mark Smith, A HISTORY OF THE GLOBAL STOCK MARKET: FROM ANCIENT ROME TO SILICON VALLEY, 76-78, (University of Press Chicago, 2004)

company which can also be sold in the secondary market for profit making purposes. Though at a quick glance it seems to be a win-win situation for the investors as well as the companies, the South Sea Bubble shattered this myth. As Julian Hoppit puts it, the bubble was a spectacular rise and precipitous collapse of one company's share price. This forced the British Parliament to pass the famous Bubble Act for preventing the market from collapsing altogether. Therefore, it became a matter of paramount importance that these dealings between the corporations and the retail investors must be accompanied by regulations to safeguard the interests of the retail investors.[8] In the Indian context, the Harshad Mehta Scam forced the Government to recognize the eminent threats to the hard earned savings of the public and ultimately the SEBI Act was passed in 1992.[9]

When a company allots shares to its subscribers, it is the allotment of a unit into which the proprietary interests of a corporation are divided. These shares are considered to be 'movable property' under the Companies Act, 2013[10] as well as the Sale of Goods Act, 1930[11] and hence the transaction between the subscriber and the company is at its source, a contract between the two. Here, the offer comes from the subscriber in the form of an application the acceptance of which is at the discretion of the company. The primary basis of this offer comes after a careful reading of the Prospectus of the issuer. Though this document is not an offer in itself, it is an invitation to receive an offer and is governed by the contractual rule laid down in *Harvey* v. *Facey*.[12] From the perspective of a common man, the Prospectus of a Company is a document which aids him in the attainment of an informed decision. The statutory definition states that a "*Prospectus means any document described or issued as a prospectus and includes a red herring prospectus referred to in section 32 or a shelf prospectus referred to in section 31 or any notice, circular, advertisement or*

---

[8] Julian Hoppit, *The Myths of South Sea Bubble*, 12 Transactions of the Royal Historical Society, 141-65 (2002).

[9] Joint Committee to Enquire into Irregularities in Securities and Banking Transactions Observations/Conclusions/Recommendations, *Joint Parliamentary Committee Report - Harshad Mehta*, 2.7-2.8 (1992).

[10] Companies Act § 44 (2013), Gazette of India, Registered No. DL. N(04)/0007/2003-13, Part II § 1, 36 (2013).

[11] Sale of Goods Act § 2(7) (1930).

[12] Harvey v. Facey, 1893 AC 552 (PC).

other document inviting offers from the public for subscription or purchase of any securities of a body corporate".[13] Hence, any document by which the offer of sale is made to the public is deemed to be a prospectus issued by the company. The object of a prospectus is to make the subscriber aware of the risk he will opt for if he applies and is thereafter allotted the shares of the body corporate. In any contract the parties must always be *ad idem* and at its very core, a prospectus enables the public to understand the risk they are undertaking. It serves a mode for raising capital for the companies and is basically an invitation to attain offers so that the buyer does it so after being wholly informed of what he is entering into. However, this very document can also be employed for the purposes of defrauding the members of the public. Such instances may not only put a healthy economy into jeopardy but also discourage retail investors from investing in the capital market. Though the Indian Contract Act, 1872 as well as the Indian Penal Code, 1860 provide for general provisions regarding such deception, looking at the graveness and the specificity of the situation the provisions of Companies Act, 2013, the rules made thereunder, the SEBI Act, 1992 as well as the constantly revised rules under the Act lay down stringent provisions and the complete procedure that is to be followed. In furtherance of this Section 34 and Section 35 of the Companies Act, 2013 provides for criminal and civil liability upon the person who has authorized the issue of such a prospectus. The 5 categories of persons upon whom liability can be imposed include:-

All persons holding the position of the Director of the company at the time of the issue of the Prospectus

1. A person who has authorized himself to be named and is named in the prospectus as the director of the company or has agreed to become such a director, either immediately or after an interval of time;
2. Promoters of the Company;
3. Any other person who has authorized the issue of the prospectus;
4. Every person who is an expert referred to in section 26 of the Act.[14]

---

[13] Companies Act § 2(7) (2013).
[14] *Id.* § 35.

These remedies provide for an imprisonment ranging from 6 months to 10 years along with a fine. The civil liability extends to the payment of compensation to the person who has been affected by the untrue and misleading statement in the prospectus.

Section 26(1) of the Companies Act, 2013 read with Companies (Prospectus and Allotment of Securities) Rules, 2014 assign a catalog of information to be included in the prospectus. This exhaustive list consists of a wide array of information which has to be presented in the prescribed format and then submitted to the Registrar of Companies (hereinafter referred to as 'ROC') on or before the date of its publication. The ROC will thereafter register the prospectus only if the requirements under Section 26 have been met with. Such a Prospectus will furthermore not be valid if it is published 90 days after it is delivered to the ROC. The vastness of information encompassed in this document makes it a hard task for the retail investors to comprehend the information given and analyze it to reach at a conscious decision. Therefore, Section 2(1) of the Companies Act, 2013 lays down the concept of an Abridged Prospectus which has been defined as a '*memorandum containing such salient features of a prospectus as may be specified by the Securities and the Exchange Board of India*'.[15] Section 30 of the Companies Act, 2013 provides that no form of application for the purchase of any securities of a company shall be issued unless such form is accompanied by an abridged prospectus.[16] Hence, SEBI has been granted the power to ordain the features required to be mentioned in the Abridged Prospectus by virtue of Section 2(1) of the Companies Act, 2013 read with the Preamble of the SEBI Act which lays down that the protection of investors is a crucial reason for the very existence of SEBI as well as Section 30 and Section 11A of the SEBI Act which empowers it to make rules to carry out the purposes of the SEBI Act. The preamble of the SEBI Act provides that it is

[15] *Id.* § 2(1).
[16] *Id.* § 30.

'*An Act to provide for the establishment of a Board to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market and for matters connected therewith or incidental thereto*'[17]

Section 11 A lays down-

(1) Without prejudice to the provisions of the Companies Act, 1956, the Board may, for the protection of investors,—

(a) specify, by regulations—

(i) the matters relating to issue of capital, transfer of securities and other matters incidental thereto; and

(ii) the manner in which such matters shall be disclosed by the companies;

(b) by general or special orders—

(i) prohibit any company from issuing prospectus, any offer document, or advertisement soliciting money from the public for the issue of securities;

(ii) specify the conditions subject to which the prospectus, such offer document or advertisement, if not prohibited, may be issued.

(2) Without prejudice to the provisions of section 21 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956), the Board may specify the requirements for listing and transfer of securities and other matters incidental thereto.

And lastly section 30 empowers SEBI to make regulations consistent with the said Act and the rules made thereunder to carry out the purposes of the Act.[18]

All potential investors of the company receive the Abridged Prospectus which is attached to the application form from the bidding centers. The objective of an Abridged Prospectus is to retain the salient features of a prospectus enabling any probable investor to make a low risk investment with a surety of returns. SEBI

---

[17] *See*, Lafarge Umiam Pvt. Ltd. v. Union of India 7 SCC 338 (2011) (The Role of SEBI is 'pro-active' in contradistinction to courts which are primarily 'reactive', as the role of any other regulator is); Cf. SEBI v. Ajay Agarwal 3 SCC 765 (2010) (The Apex Court pointed out that SEBI is preeminently a social welfare legislation seeking to protect the investors who are small investors).

[18] *See* Kimsuk Krishna Sinha v. SEBI 100 SCL 197 (Del) (2010) (The Emphasis on these Sections is of extreme importance as they provide the power of issuance of regulations which under the provisions of the Act can be made only in accordance with Section 30 and 31 of the Act).

was formed for the protection of the investors and a condensed source of gathered facts would be a logical furtherance of the legislation and in line with the principles enshrined in the Directive Principles of State Policy. Hence, the importance of having adequate safeguards and rules not harming the interests of the prospective shareholders by having an investor friendly and a control free regime cannot be exaggerated. In pursuance of this goal, the SEBI (Issue of Capital and Disclosure Requirement) Regulations, 2009 (hereinafter referred to as the 'ICDR Regulations, 2009') were revised from its previous 2000 edition keeping in mind the evolving nature of the market.[19] Regulation 58(1) and Part D of Schedule VIII deals with the prerequisites of the information to be disclosed in the Abridged Prospectus as well as the format. These rules underwent a revolutionary modification vide notification dated 27th October 2015 issuing the SEBI (Issue of Capital and Disclosure Requirement) (Seventh Amendment) Regulations (hereinafter referred to as 'ICDR Seventh Amendment Notification') and Circular no. CIR/CFD/DIL/7/2015 dated 30th October 2015. The ICDR Seventh Amendment, Rule 3 (ii) relating to the 'DISCLOSURES IN ABRIDGED PROSPECTUS' General Instruction No. (II) Dictates that '*the abridged prospectus including the application form shall not exceed 5 sheets (printed both sides)*'.[20] The Circular, explaining the rationale behind the move states '*it has been observed that the abridged prospectus has become voluminous and thereby defeats the very purpose of abridged prospectus. With a view to address the issue, the disclosure requirements in the abridged prospectus have been rationalized in consultation with Investor Associations and market participants. The revised abridged prospectus improves the readability and contains relevant information for the investor to take well informed investment decision. Also, the investor has the option to obtain full prospectus from the market intermediaries associated with the public issue and can also download from the websites of stock exchanges, merchant bankers and SEBI*'.[21]Annexure I provides the revised format of abridged prospectus as per Regulation 58 (1) and Part D of

---

[19] Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations § 4 (2009).

[20] Supra note 5, § 58 (1).

[21] Securities and Exchange Board of India, *Disclosures In The Abridged Prospectus And Price Information Of Past Issues Handled By Merchant Bankers*, 1-2 (Oct. 30, 2015) pdicai.org/docs/SEBi_5112015122031929.pdf

Schedule VIII of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009.[22]

It is argued that these revised regulations create an unnecessary barrier to the information which is disclosed to the public in an abridged prospectus. Considering the reliance of the investors on the abridged prospectus, it is important to shed light on *the golden rule*.[23] The rule stipulates that all the relevant facts which may affect the decision of the buyer ought to be disclosed in the prospectus and any missing piece of information would be a fraud on the members of the public and thereby attracting liability for the same. The golden rule begins with the presumption that the public is at the mercy of the company promoters. Everything therefore must be stated with strict and scrupulous accuracy. Hence, the new regulation which requires that the information in the abridged version of the prospectus must be concentrated within 10 pages is against the very fabric of investor protection. By restricting the amount of data to be placed, it affords the corporations to exclude important aspects which are sanctioned by the very authority constituted to regulate such fraudulent acts. The underlying principle as spelt out in the Ordinance, assumes that a 40-60 page abridged prospectus is too voluminous for the general masses to make an informed decision. This fallacious approach carries a regressive undertone and hampers the process of investor education which is the need of the hour in the Indian Economy.

Absence or Reduction of Significant Inducing Elements

The new format requires the issuer to give a brief of the top 5 outstanding material litigations against it. Any pending regulatory action pending against the corporation must be summed up in 200-300 words. Also, in the case of any outstanding criminal litigation against any of the promoters of the company must be described in 200 -300 words. It is noteworthy that any the new format entirely overlooks disclosures of any pending litigations against the directors of the company. The reputation of a company and those who control it play a very

[22] *Id*, Annexure I, 3.

[23] The Golden Rule of framing a prospectus was first enunciated in the leading case of New Brunswick & Canada Railway & Land Company Ltd. v Muggeridge 3 LT 651 (1860). *But See, Rex v. Kyslant: A New Golden Rule for Prospectuses*, 45 HAR. LAW. REV., 1078-1083, (1932).

important role in the rise and fall of its stock prices. Restriction on the number of words to be used and neglecting the disclosures of Directors altogether presents an opportunity to the issuer company to provide relatively undermined information to the public.

Disclosure of information related to Internal Risk factors has been restricted to a minimum of 5 and a maximum of 10 issues and carries a limit of 500 words in total. Assessment of risk which threatens implementation the project for which the IPO has been issued ought to be given a prominent place as incomplete data regarding the internal risks which the project may face may play a decisive role in the investor's final decision. Putting a cap on the number of internal risk factors that may be highlighted in the abridged prospectus gives a free hand to the issuer company in providing selective information and concealing the decisive aspects under the full protection of the law.

Information related to group and subsidiary companies has also been given a cold shoulder in the new format. Accordingly, the new format does not require the company to disclose information about its subsidiaries and group companies. This ill afforded scheme completely ignores the very existence of any other group companies which may prove impactful in light of the increasingly *mala fide* usage of subsidiaries for willful fraudulent acts. There is no provision for disclosing the pending litigation against the subsidiaries of the issuer.

The earlier format of the prospectus required the body corporate to disclose related party transaction involving 'restated standalone summary statement of related party transactions' and 'restated standalone consolidated statement of related party transactions'. The new format has omitted the entire provision and no such requirement is now mandatory or even optional. Related-party transactions (hereinafter referred to as 'RPTs') refer to transactions between a company and its related entities such as subsidiaries, associates, joint ventures, substantial shareholders, executives, directors and their relatives, or entities owned or controlled by its executives, directors, and their families.[24] . Indian Accounting

[24] P. Srinivasan, *An Analysis of Related Part Transactions in India*, WORKING PAPER NO. 403 INDIAN INSTITUTE OF MANAGEMENT BANGALORE (Sept. 2013).

Standards considers parties to be related to each other "if one party has the ability to control or significantly influence the other in making financial and/or operating decisions in a particular reporting period".[25] As Selarka et. al. hypothecated in the working paper after using a sample of 1757 firms listed on the National Stock Exchange in 2014 that related party disclosures decrease the crash risk faced by the companies. It is based on the fact disclosure of related party transactions reduces the asymmetry in the market.[26]

The Notification and the Circular have negated the consequential aspects in an attempt to simplify the load of information to the public. The most palpable consequence of the new norms is that the companies can resort to concealment of major information which the public ought to know under the ploy of succinctness. Omission of vital and crucial parameters from the abridged version altogether routs the very purpose of the establishment of SEBI. The policy approach towards the investor's protection must not be hampered by extraneous and unnecessary limitations. Not only does the new format negatively affect the investors as to reduction of information to help them come to a sound decision but it also fundamentally builds up a scenario wherein non-disclosure and concealment can be used under garb of this new policy. The Supreme Court, in its observation that the SEBI Act qualifies as a social welfare legislation has made Securities and the Exchange Board of India the custodian and the protector of the common masses and hence, no policy which allows a free reign to the issuer in suppression of material facts behind the veil of compliance ought to be encouraged or practiced.[27]

---

[25] Ministry of Corporate Affairs, *Ind AS 18*, 271-281, (Mar. 3, 2016) www.mca.gov.in/Ministry/notification.pdf

[26] E. Selarka et. al, *Related Party Transactions and Stock Price Crash Risk: Evidence From India*, WORKING PAPER NO. 129 MADRAS SCHOOL OF ECONOMICS (Oct. 2015), www.mse.ac.in/pub/Working%20Paper% 2012 9.pdf

[27] R.H.Patil, *The Capital Market in the 21st Century*, 35 EPW, 4097, (Nov. 2000).

Application Supported by Blocked Amounts: A Herculean Blow to the Investors

The proliferation of the markets in the developing countries with the internationalization of financial markets and the advent of technology has raised some eyebrows with the increasing complex roles of the regulatory mechanisms. Pumping of money in these countries have diversified the investors' category which has affected the regulatory mechanisms being attracted to diametrically opposed techniques hampering all the institutes and mechanisms of raising medium and long-term funds. Change of power at the helm of affairs of the state and induction of new foreign policies have made India a boon for Non Resident Indians' (NRI) and High Net-Worth Individuals for investment but the encouragement of broader ownership of productive assets by small savers and retail investors enabling them to benefit from India's economic growth and wealth distribution is still astern in the capital markets. The deep in roads of Information Technology in the capital markets in India is at a slower pace rather than the fast paced positive intrusion in the other areas such as Banking.[28] Role played by the Government in recent years and positivism showered by the regulatory mechanisms such as the Securities and Exchange Board of India (SEBI) has injected perturbation for embracing of the technology once counted as retrograde to capital markets. Whilst these technological inroads, the regulatory authority pursuant to the ICDR Fifth Amendment Notification, issued a circular No. CIR/CFD/POLICYCELL/11/2015 dated November 10, 2015 pertaining to 'Streamlining the Process of Public Issue of Equity Shares and Convertibles'.[29] Organized Capital markets in India is quite narrow to analyze the role played by the Investors' regarding the capital in flow and adjudging the qualitative and quantitative factors attached towards the same, the regulatory authority with the aforementioned law has frustrated the retail category by clarifying that all investors applying in public issue shall use only Application Supported by Blocked Amounts (hereinafter referred to as 'ASBA') facility for subscribing to securities and for

[28] *Id.*

[29] Securities and Exchange Board of India, *Streamlining the Process of Public Issue of Equity Shares and Convertibles*, 1-2 (Nov. 10, 2015), www.sebi.gov.in/cms/sebi_data/attachdocs/1447148033366.pdf

making payment post allotment of the securities. Genesis of ASBA was for making an application to a public issue or rights issue along with an authorization to Self –Certified Syndicate Banks' (hereinafter referred to as 'SCSBs') to block the application money in a bank account. This instrument requires the applicant to give an authorization to block his application money in the bank account for subscribing to the public issues, debited only after the basis of allotment is finalized.[30] Raising bar of ASBA has made the growth of Information Technology in the capital markets, as Fama observes that Information Technology has made the capital market more resilient and dropped a tinge of sophistication. His school of thought can be guided through this research on First World countries with developed capital markets.[31] On the other hand, the observations by Singh et. al. using his multivariate regression analysis on cross sectional data from 63 countries concluded with a normative thinking of diluting capital markets with Information Technology.[32] Diffusion defined by Rogers being a process in which innovation is communicated through certain channels over time among the members of the social system, the pertinence of diffusion provides an image of how far information technology is fathered in a society.[33] The problem facing India and the Government is the acceptance of mass scale technology reforms in the Capital market system, the deep rooted ancient broker structure cannot be heaved away with a single blow. Diffusion is a sluggish process in developing countries, the portraying of an S-Curve with its slow beginning, rapid expansion and leveling off cannot be executed by milking away the retail investors. Inventory of cheques and paper modes of payment for placing of bids for the public issue are practices which the regulatory authority has cast out are detrimental to the objects of the SEBI which are to protect the interests of the investors in securities, promote the development of securities and regulate the securities market, the onerous duties. Regulatory authorities mass coerced deeds reminiscent the words of Vijay Joshi

---

[30] The Procedure is enumerated on the National Stock Exchange and Bombay Stock Exchange, www.nseindia.com/products/content/equities/ipos/asba_procedures.htm (last updated Mar. 9, 2016).

[31] E.F.Fama, *Efficient Capital Markets II*, 46 JOF, 1575-1617 (Dec. 1991).

[32] Singh A et. al., *Information Technology, Venture Capital and the Stock Market*: A paper prepared as a background paper for the International Labour Organization's World Employment Report (2000-2001).

[33] E.M.ROGERS, DIFFUSIONS OF INNOVATIONS (5th ed., New York Free Press 2004).

and IMD Little's description of Indian Stock Market as "a snake-pit, lacking in fairness and integrity, prone to speculative excess and showing scant regard for the interests of small investors."[34]

i. ASBA Facility as an Anomaly

Capital Market has to fulfill the country's economy, to liquefy capital by enabling a person who has invested money to a factory, to convert it into cash by disposing of his share in the enterprise to someone else. Transition of these markets can be amenable if institutional and legal changes are made which are undoubtedly identifiable and amendable, the SEBI ICDR Regulations, 2009 was a step in the right direction by amalgam of the Banking Sector and the Capital Markets which since years India had been longing. Regulation 2(1)(d) of the SEBI ICDR Regulations, 2009 peculiarly mentions SCSBs' to block the application money in the bank account, these SCSBs' are recognized by the SEBI as capable of providing ASBA services to the customers.[35] ASBA is truly an innovation made through the Book Building Route, introduction of e-forms from the website of Book Running Lead Managers website (BRLM) has induced an energy in the diffusion process. Patil rightly nuanced that India in the viewpoint of adoption of information technology in the tools of trading and in the settlement mechanisms as also in the efficiency of capital markets, not only is ranked in the top league but is considered to be way ahead of even developed countries. Applause for the transformation is rightly attributed by Patil to the National Stock Exchange (NSE) which battered the broker system with the adoption of new cheaper computerized techniques vis-à-vis the Bombay Stock Exchange (BSE) and the lobby of brokers, however the cause of the feat is the adoption of Information Technology through the modular basis of societal diffusion.[36] SEBI by the virtue of the provisions of Section 30 of the SEBI Act, 1992 brought into force the ICDR Fifth Amendment Notification, Circular dated November 10, 2015 which has under the guise of endeavoring to streamline the process of public issue of equity shares and Convertibles and the interest of attaining the healthy and sustained growth on the Indian Capital

[34] VIJAY JOSHI , INDIA'S ECONOMIC REFORMS, 1991-2001 (Clarendon Press Oxford, 1996).
[35] Supra note 19, § 2(1)(d).
[36] Supra note 27, at 4098-4099.

Markets made the usage of ASBA system mandatory. An ignoble decision for the retail investors and a noble decision for the High Net-Worth Individuals (HNI's) and other investor categories. The embracement of this type of technology for payment post allotment of securities obviates the alternative mode of payment which is paramountcy fact considering the prominent challenges which the Government of India is facing at present is Financial Inclusion, the noting of the Reserve Bank of India portrays that there are severe challenges within the areas of the country to make people reach within the financial inclusion and financial literacy programme.[37] Differing level of computerization and risk management practices of several market players affects the overall system of coagulation of sectors, the sole reason the mandatory rule of ASBA facility will hinder the steady growth of the Indian Securities Market, which is the fundamental objective behind the establishment of SEBI. The role of technology assumes prime importance in the capital market system and overtime it does take an S-Shape curve as provided by the Gompertz model of diffusion innovated by Chow[38], this model assumes the slow advancement of technology, eventual rapid usage and can be given as :-

$$\log \eta_{it} - \log \eta_{it-1} = \theta_i [\log \eta^*{}_i - \log \eta_{it-1}]$$

Where

η_{it} is used in Country 1 in the year t

η_i is post diffusion equilibrium

θ_i is the speed of adjustment

The Gompertz model portrays the slow adoption of technology on the very same basis a mutated model was provided Eziram et.al. to adjudge the impact of technology in the Nigerian system[39] and given as :-

$$\log X_{it} - \log X_{it-1} = \theta_i [\log X^*{}_i - \log X_{it-1}]$$

---

37 *Chapter IV: Credit Delivery and Financial Inclusion*, RESERVE BANK OF INDIA ANNUAL REPORT, 68-74 (2015).

38 G.C.Chow, *Econometrics* (McGraw Hill 1983) *Cf.* A.H.Hallet, *Professor Chow's Econometrics: A Review*, 3 JAE, 157-164 (1988).

39 C.B.Eziram et. al., *Capital Market Growth and Information Technology: Empirical Evidence from Nigeria*, 4 IJBEP, 8-9, 11 (2009). *See also*, A. Bhunia, *An Impact of ICT Growth of Capital Market: Empirical Evidence from Indian Stock Market*, 1 INFORMATION AND KNOWLEDGE MANAGEMENT, 7-14, (2011) (The Author concludes that the results of the Indian Stock Market are analogous to the impact of ICT in Nigeria utilizing the same mutated model of the Gompertz provided by Eziram).

Mutated model took the variables of stock brokers, market trade, stock market volume trade, turnovers through which resultant conclusions were reached which then indicate rightly the usage of information and communication have increased the capital market scenario which is directly proportional to the raise of bar in the investor category. The model was based on the increase and significant changes in the ICT system, however the lacking of the author regarding the comparison to the statistics of adoption of macro level technological change to the information technology untapped sectors is stubbed. Broad scheme of Technology flourishment is possible with the requisite digital systems in and outside the capital market sector firmly established, the Finnish have provided indicators to view the statistical data and information regarding the technical infrastructure, penetration rates and networks and the comparable use of Information and technology.[40] Computation of this data with the permutation and combination provides a holistic approach towards the capital market viz. the number of people with financial literacy and thereby gives a clearer picture of the mechanism for mandatory ASBA. Anomalies in the Indian Market, is the financial inclusion which is affirmed by the Reserve Bank of India in its Annual Report, which states the current situation of unbanked villages, which in its effect has banking phases yet to be completed. The identification of 4, 90,000 villages with a population of less than 2000 were allotted to banks in the ongoing Phase II and that the operational effect of the newly made bank accounts is possible only if all the Government payments are routed through the banks, which will remunerate the banks, howsoever the success of this system depends critically on the availability of proper network connectivity throughout the country.[41] A formation of the committee for a medium term path of financial inclusion is in its infancy, which provides for an inference of the situation regarding the financial inclusion of the country. Issuance of priority sector lending certificates (PSLC's) which essentially is a fragment of the Banking Sector, has not yet been fruitfully placed throughout the country, an implication that the country has not reached a stage where for the

---

[40] Statistics Finland, *On the road to Finnish Information Society II* (May. 1999) tilastokeskus.fi/tk/yr/tttietoti_en.html (last updated Mar. 4, 2016) *See also*, Nordic Council of Ministers, *Guidelines For Measuring Use Of Information And Communication Technology (ICT) In Enterprises- A First Step Towards Harmonized Nordic Surveys* (1998).

[41] Supra note 37, at 73-74.

advancement of Information and Technology a chunk of the category of the investors are rooted out of system.[42] The expansion of bricks and mortar branches of banks has accelerated but notwithstanding this development, the number of financial branches per 100,000 in rural and semi urban areas is still less than half than that of the urban and metropolitan areas.[43] Role played by registered sub-brokers initiates the formulation of bank accounts which in turn raises the number of retail and small investors market however without this financial inclusion of these investors the steady growth of the Indian securities market is hampered. Recognition of this practice by the Organization of Economic Co-operation and Development in its National Strategies for financial education Handbook enumerate the essentiality of Institutional Changes and Governing arrangements, urging the users to include financial education as their top priority.[44] In the words of the then Hon'ble Finance Minister Shri Pranab Mukherjee "…*In India where the majority of its population is financially excluded and coexisting with various other financially included sections of population which invest in capital markets and use other advanced financial products, we first need a tiered approach under National strategy for spreading awareness about basic financial products to link them to the formal financial sector, educating the existing users of financial products and services to make the informed choices*…". ASBA facility has advantages beyond any measure, encouragement of the use of ASBA facility is appropriate and a reasonable measure but the facility of mandatory use of the same is not viable. SEBI Act is pre-eminently a social welfare legislation, the unfortunate sketch which the regulatory mechanism provides is the one where SEBI itself eschews it.

Role Played by the Small and Retail Investors in the Capital Markets

The Statement of Objects and Reasons appended to the SEBI Bill, 1992 states inter alia: "*The capital market has witnessed tremendous growth in recent times characterized particularly by the increasing participation of the public. Investor's confidence in the capital market can be sustained largely by ensuring investor's protection*…" In the modern tradition of

---

[42] *Id.* at IV.21, 74.
[43] *Id.*
[44] Organization for Economic Co-operation and Development/ International Gateway for Financial Education Policy Handbook, *National Strategies for Financial Education and Expert Sub-Group on National Strategies for Financial Education*, POLICY HANDBOOK, 19-79 (2015).

finance, financial economic organizations are existing because of the function they serve, the paradigm of making a law is with the empirical research which contains the view of the current state of the society, the ignorance of which will ensue the making of laws which are arbitrary and capricious. In view of the ICDR Fifth Amendment Notification r/w the Circular dated November 10, 2015, SEBI has clarified that all investors in a public issue shall use only ASBA facility for subscribing to the securities. Under this Section the authors attempt to dissect the working of the ASBA system and infer its impact on the retail investors, the role of retail investors in the capital markets and their protection is the foundation which the authors have perused through the SEBI Act, 1992 and pursuant to that the authors adjudge the bearing of the low retail investors in the Capital Markets. For a developed capital market there is a need to expand the participation of retail investors, the healthy and sustained growth of capital markets will not be achieved without the adequate participation of the retail investors, the confidence of investors and proper attention to their interests no securities market can develop. A consumer of financial services i.e. an investor has been noted to require the protection of a greater degree than that of the consumer of tangible goods, as what he in fact buys, while investing is a 'promise', a 'hope' and his future consumption.[45] This promise which the report lays down can be achieved by rapid and healthy development of well-regulated structures. SEBI pursuant to the aforesaid, brought into force ICDR Regulations 2009 which repealed the erstwhile 'Securities and Exchange Board of India (Disclosure and Investor Protection) Guidelines, 2000' for bringing clarity and resolving certain identified lacunae in securities and investor protection laws, principally pertaining to issue of securities of a company to public, shareholders, and institutional investors through primary and secondary market. The step was widely criticized and the fall in the number of retail investors due to the formulation of the ASBA system was portrayed. The gradual fall in participation of the investors, in the public issues, reflects the inconvenience caused to the retail investors, lack of faith and low confidence in

[45] *Securities and Exchange Board of India Annual Report*, 4 (1988-89), www.sebi.gov.in/sebiweb/home/Annual-Reports.

the Indian Securities Market.[46] This ASBA mechanism terrified the retail investors of bulls and bears. Unfortunately SEBI on 14th August 2015 vide ICDR Fifth Amendment Notification passed a severe blow to the retail investors making the ASBA facility compulsory. ASBA has discouraged the small investor category from participating in the Indian Securities market, culminating in the frustration of the principal objectives of SEBI. This proposition can be considered through a hypothetical. A person in India lives where large portions are unbanked and such areas do not have any entity providing the ASBA facility, the harsh and extreme conditions, of the nature of the compulsory use of ASBA facility, will drive the person away from the capital market, though keen on investing the savings in public issues. Whereas previously, even in the case of non-availability of the ASBA centers in the rural and semi-urban areas of the country, the small investors therein had the option of placing their bids for the public issues by the traditional method of applying through cheques, which was secure as well as convenient for all. The problem arises when the regulatory authority amends its ways and instead of striving to achieve new heights of bulls and bears, tries to act as a sly wolf, trying to slowly shred the market to pieces. SEBI in its Approach Paper on comprehensive legislation for securities market back in the inglorious days of the Indian Capital Markets had emphasized the need for retail investors. Reproduction of a few extracts is extremely essential, through these extracts the authors create a foundation to nuance the emphasis on the provisos of the SEBI Act which the mandatory ASBA system contradicts to. "…*Awareness of, and interest in, investment opportunities available in the se curities markets has grown significantly in the recent years. This awareness and interest has, however, not yet crystallized into a committed, discerning and growing pool of investors. Some of the main constraining factors are high volatility in market prices, several undesirable practices and structural inadequacies which have led to a severe erosion of investor confidence. These have hampered sustained growth in the securities market… …For promoting sustained growth in the securities markets over a long period of time, it has now become necessary to evolve a comprehensive securities law with a unified set of objectives, development approach, a single administrative authority and an integrated framework to deal with all aspects of the securities markets… … To this end, it is necessary to promote markets which ensure… … …*

---

[46] *In U-Turn SEBI Chariman Says Not Concerned About Low Retail Investors in IPOs*, BUSINESS STANDARD (Dec. 2, 2015).

the markets must inspire confidence in both investors and issuers to actively participate in and rely more on the securities markets… … … Regulation would be kept to the minimum necessary to ensure adequate investor protection and to serve the interests of development of the markets."[47] Ironizing this sight for the development of the Indian Securities Market, the regulatory authority has stooped low with the ICDR Fifth Amendment, which is *ex facie* bad in law apart from being discriminatory, arbitrary and unreasonable.

Embracing SEBI under its womb, the International Organization of the Securities Market Commission (IOSCO) rather evidently put forward its view on the emerging markets and the role of institutional and retail investors in the markets, IOSCO which rather determined to put forward its stronghold on the concept of small investors joining its market raised the bar with its overview and emphasis on Investor Education, a study showing the reasons relating to the indulgence of the small investors in the markets. In 17 out 19 jurisdictions the problem of Information and Communication technology and connectivity were the reasons why population of the members of Emerging Market Committee (EMC) do not want to indulge in the markets.[48] The concept of 'one size fits all' cannot be the basis of generic law making procedure, the prejudice to the interests of the public at large outweighs the callousness of the amendment of the mandatory ASBA system.

Violations of the Provisions of Constitution and the pertinent question of *Cui Bono*

"A thousand years scarce serve to form a State; an hour may lay it in the dust." These words by Byron keep ringing when a question of *Cui Bono* is asked for the formulation of a law. The decisions of SEBI has writhed the investors, shattered the backbone. Words of passion and power, actions with supplementary backing

[47] Securities and Exchange Board of India, *Approach Paper on Comprehensive Legislation for Securities Market* (July. 1988).

[48] Public Reports: International Organization of Securities Commission, *Protecting The Small Investors: Combating Transnational Securities And Futures Fraud,* (Mar. 5, 2016) www.iosco.org/library/pubdocs/.pdf *See also*, Public Reports: International Organization of Securities Commission, *Report on Investor Education Initiatives Relating to Investment Schemes* (Feb. 2013) www.iosco.org/library/pubdocs/pdf/IOSCOPD404.pdf

of necessity are essentialities to withstand the shaky ground questions of *cui bono*.[49] If one has a bare reading of the SEBI Act, a defiance of the classical doctrine of Separation of Powers can be viewed, on this the Supreme Court observed, *"..The SEBI Act confers a wide jurisdiction upon the board. Its duties and functions thereunder, run counter to the doctrine of separation of powers. Integration of power by vesting legislative, executive and judicial powers in the same body, in future, may raise a several public law concerns as the principle of control of one body over the other was the central theme underlying the doctrine of separation of powers. Our constitution although does not incorporate the doctrine of separation of powers in its full rigor but it does make horizontal division of powers between the legislature, executive and judiciary. The Board exercises its legislative power by making regulations, executive power by administering the regulations framed by it and taking actions against any entity violating these regulations and judicial power by adjudicating disputes in the implementation thereof. The only check upon exercise of such wide ranging power is that it must comply with the Constitution and the Act…*"[50] With the wide ranging agitation against SEBI regarding the amendments viz. Mandatory ASBA mechanism and abridged prospectus, one can only assume that the time of these laws is limited, the likeliness of a writ petition is imminently rising and a more hopeful direction by the court that such amendments disruptive to the facilitation of capital market of the country. Lackadaisical attitude of SEBI with its SEBI notifications and SEBI circulars have resulted in the formation of unreasonable, irrational and arbitrary laws, thereby being in a total denial of the essence of 'Rule of Law'. The discretion of the statutory body is never unfettered, it is this discretion which is to be exercised in accordance with the law, if such discretion is exercised and influenced by extraneous consideration which it ought not to have taken into consideration, the decision cannot stand. Authors after deliberation gradate that the SEBI Fifth Amendment Notification and the Circular dated November 10, 2015 and SEBI Seventh Amendment and the Circular dated October 30, 2015 are arbitrary, unreasonable, discriminatory as it discriminates between the investors belonging to the retail category , which being the masses vis-à-vis high net-worth individuals and institutional investors category. "Article 14 does not require a fanatical

[49] *Cui Bono* is frequently translated, for what good, for what useful purpose, for whose use or benefit. BLACK'S LAW DICTIONARY, 377 (6th ed. 1991).

[50] *Clariant International Ltd.* v. *SEBI* AIR 2004 SC 4236.

approach"[51] said Alagiriswami J., continuing this he said: "*But the point we wish to make, and we cannot over-emphasize it, that Art 14. Enunciates a vital principle which lies at the core of our republicanism and shines like a beacon of light pointing towards the goal of classless egalitarian socio-economic order which we promised to build ourselves when we made a tryst with destiny on the fateful day when we adopted our Constitution. If we choose between fanatical devotion to this great principle of equality and feeble allegiance to it, we should unhesitatingly prefer to err on the side of the former as against the latter. We should be breaking our faith with this high and noble principle of which is pregnant with hope for the common man and which at once was a goal as well as a pursuit, for history shows that it is insidious encroachments made in the name of pragmatism and expediency that the freedom and liberty are gradually but imperceptibly eroded and we should not allow the same fate to overtake equality and egalitarianism in the name of expediency and practical convenience.*"[52] The point of convergence between an ultra vires law to that of an intra vires is the pertinent question of *cui bono*, for what good the draft has been made and on what basis was the same made. SEBI in pursuance of bringing about clinching changes through technology and adaptive approach has failed to apply and adhere to the principle enshrined under Article 39 (c) of the Constitution of India which states the state shall superintend that operation of the economic system does not result in the concentration of wealth and means of production to the common detriment. It is within the knowledge of SEBI that the abridged prospectus is essentially the most important document for the retail investor category as it is nominally the only reasonable source of authentic, material and relevant information about the issuer company based on which the smaller investors are in a position to take a sound investment decision, reduction of the pages of the same has not only made it difficult for the retail investors to take a sound and prudent investment decision but has also put their investment to a higher degree of risk, the cause for the discouragement of the retail investors in the Indian securities market. SEBI with its bravado in the ASBA process has faltered miserably the brunt of which has been on the retail investors using the traditional methods of investing. A concluding caveat the present situation is ideal for the growth of capital markets, the new amendments are nothing but hindrances on a rather smooth sailing road.

---

[51] Maganlal Chaganlal (P) Ltd. v. Municipal Corportaion of Greater Bombay & Ors.1974 AIR 2009.
[52] *Id.*

Conclusion

The assessment and review of the amendments of ICDR regulations, lays down the most telling story in the history of capital markets that 'markets agonize not with the falls or mega scams but with the lower level of participation.' It is truly a battle of Shakespearian proportions with the retail investors fighting for their rights, or survival to put it mildly and the regulatory authority who are pursuing vigorously financial sector reforms which they feel, will bring a massive transformation in the capital markets. The role played by SEBI which is statutorily constituted to be an autonomous regulator with independent legislative, executive and quasi-judicial powers, has been enthralling to say the least. The authors laud the role played by SEBI in boosting the capital markets however the paper urges SEBI to reflect to the fall of retail investor participation and their inconvenience and lack of faith in the Indian Securities Market. It is also of due importance and necessity that under the circumstances when laws *ultravires* to the constitution have been passed, the Union of India under the provisions of Section 17 of the SEBI Act, 1992 should have superseded SEBI. It is legally the duty and responsibility of the Union to intervene in the matters of SEBI under the provisions of Section 17 and to prevent any further violation of the tenets of the SEBI Act, 1992 and the Constitution of India. The words of J. Bronowski rightly ring the bells "We are all afraid- for our confidence, for the future, for the world. That is the nature of the human imagination. Yet every man, every civilization has gone forward because of its engagement with what it has set out to do. The personal commitment of a man to his skill, the intellectual commitment and the emotional commitment working together as one." The authors believe that the synthesis of the criticisms to the SEBI circulars r/w amendments and the ideas presented for the betterment of the capital markets shall go a long way in molding both the thought process of the regulatory authority and safeguarding the foundations of the Indian securities market.

CORPORATE BANKRUPTCY AND INSOLVENCY RESOLUTION IN INDIA: LACUNAE IN THE PRESENT AND REMEDY FOR THE FUTURE

ROHAN KOHLI*

The Background to the Bill

According to World-Bank estimate, it takes about 4.3 years on an average to resolve insolvency in India[1], nearly twice the time it takes to do so in its four neighbouring countries China, Nepal, Pakistan, and Sri Lanka[2]. This lengthy time period in resolving insolvency is further added to by a wide range of laws dealing on the topic, thus complicating the situation even further.

Collective Insolvency Legislations

At present, there are multiple contradictory elements in the legal scenario surrounding bankruptcy. To begin with, Chapter XIX of the Companies Act, 2013 serves as the nodal point, dealing with Revival and Rehabilitation of Sick Companies from sections 253 to 269. This act predominantly revolves around secured creditors, and recognises the presence of unsecured creditors in the revival of a company. The 2013 Act prescribes a period of one year for the finalisation of a rehabilitation plan for the company. Once a company is declared a sick company by the Tribunal under section 253, any secured creditor or the company may make an application to the Tribunal for rehabilitation and revival of the company. Along with this, the definition of "sick companies" has been changed from a previous "net worth erosion" to the inability to pay dues to creditors within 30 days of

* II year, BA.LLB. (HONS), National Law India University, Bhopal.

1 Time to resolve insolvency is the number of years from the filing for insolvency in court until the resolution of distressed assets.

2 It takes China 1.7 years, Nepal, 2 years, Pakistan, 2.7 years and Sri Lanka, 1.7 years on an average to resolve a bankruptcy case. The World Bank's Ease of Doing Business Index 2015 ranked India 137 out of 189 countries on the ease of resolving insolvencies based on various indicators such as time, costs, recovery rate for creditors, the management of a debtor's assets during the insolvency proceedings, creditor participation and the strength of the insolvency law framework. The World Bank, *World Development Indicators* (2015), data.worldbank.org/indicator/IC.ISV.DURS.

demand[3]. But this Chapter XIX has not been notified for commencement and the changes made in the Companies Act, 1956 have also not entered in force.

The law for rescue and rehabilitation exclusively for industrial companies remains the Sick Industrial Companies (Special Provisions) Act (SICA), 1985. Under SICA, a specialised Board of Industrial and Financial Reconstruction (BIFR) assesses the viability (industrial companies in distress make a reference to BIFR based on a test involving an erosion of their net worth by 100%) of the industrial company.[4] Once it has been assessed to be unviable, BIFR refers the company to the High Court for liquidation. The SICA was to be repealed in 2003, but the repealing act could not be notified as the National Company Law Tribunal proposed by a 2002 amendment to the Companies Act, 1956 got entangled in litigation.[5]

The Micro, Small and Medium Enterprise Development Act, 2006, is the nodal legislation for registering MSMEs but is absent on provisions for resolving insolvency and bankruptcy, which are dealt with in Companies Act itself.

Partnership firms are registered under the Indian Partnerships Act, 1932, administered by the Ministry of Corporate Affairs. Insolvency and bankruptcy resolution of partnership firms is treated the same as under individual insolvency and bankruptcy law.

---

[3]Companies Act § 253(1) (2013).

[4] See, Sengupta, Rajeswari & Anjali Sharma, *Corporate Insolvency Resolution In India: Lessons From A Cross-Country Comparison,* WORKING PAPER FRG IGIDR (2015). Sengupta and Sharma compare the number of new cases that file for corporate insolvency in the U.K., which has a robust insolvency law, to the status of cases registered at the BIFR under SICA, 1985, as well as those filed for liquidation under Companies Act, 1956. They compare this with the number of cases filed in the UK, and find a significantly higher turnover in the cases that are filed and cleared through the insolvency process in the UK.

[5] The changes made in the older Companies Act legislation, the CA 1956, have not entered into force as Chapter VIA of the CA 1956, which provided for the National Company Law Tribunal (NCLT) to exercise powers in relation to sick industrial companies could not be notified as the NCLT was subject to a long-drawn-out litigation. The Supreme Court, on 14 May 2015, delivered its judgment on the constitutionality of the NCLT. A few amendments to the operation of the NCLT are required before these provisions can be notified. See Madras Bar Association v. Union of India W.P.(C) No. 1072/2013

i. Debt Recovery Laws

The Recovery of Debt Due to Banks and Financial Institutions Act [6](RDDBFI Act) 1993 provides for the establishment of special Debt Recovery Tribunals (DRTs) to enforce debt recovery by these institutions only with Debt Recovery Appellate Tribunals (DRATs) as the appellate forum.[7]

Under certain specified conditions, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI) 2002 enables secured creditors to take possession of collateral without requiring the involvement of a court[8] or tribunal. The DRT is the forum for appeals against such recovery.[9]

The validity of various provisions of the SARFAESI Act was initially challenged in *Mardia Chemicals Ltd. v. Union of India.*[10] However, as discussed in Part III, validating the Act has not put an end to the controversies over SARFAESI's interactions with other laws, particularly SICA and ongoing proceedings in the BIFR.

[6] The RDDBFI Act is available to both secured and unsecured creditors, but they need to be banks or notified financial institutions.

[7] Any cases pending before the civil courts that involved debt of over Rs 10 lakh were automatically transferred to the DRTs.

[8] § 13 of the SARFAESI Act, 2002 allows secured creditors to take steps to enforce their security interest in respect of any debt of a borrower that is classified as a non-performing asset without the intervention of a court or tribunal, if certain conditions specified in the act are met.

[9] SARFAESI Act, 2002 intended to protect secured creditors by ensuring that their enforcement under the act would take precedence over any reference by a debtor to the BIFR.

[10] Chemicals Ltd. v. Union of India (2004) 4 SCC 311 (Para 34): The petitioners challenged the Act on the grounds that it allowed banks to take drastic measures for the seizure and sale of assets of a borrower and to take over the management or possession of secured assets. The primary contention was that it was a draconian legislation as it allowed secured creditors to take measures to recover debt due without the involvement of an adjudicatory authority. The Supreme Court rejected these challenges quoting widely from the legislative history on the impetus for the SARFAESI Act's enactment. The Court stated that banks faced tremendous difficulties in recovering debts due and that this was a major impediment to financial liquidity for industry and, as a consequence, economic growth.

ii. Other Mechanisms

Non-judicial mechanisms set up for banks to restructure loan contracts with debtors include Corporate Debt Restructuring (CDR), the Joint Lending Forum and the Strategic Debt Restructuring Forum, prescribed by the Reserve Bank of India (RBI).

To bring out a solution to this scenario, the Bankruptcy Law Reform Committee ("BLRC" or the "Committee") was set up by the Department of Economic Affairs, Ministry of Finance, under the Chairmanship of Mr. T.K. Vishwanathan (former Secretary General, Lok Sabha and former Union Law Secretary) to study the "corporate bankruptcy legal framework in India" and submit a report to the Government for reforming the system[11]. Out of the discussions of the committee, Interim Report of the Committee that was put out for public comments at the end of February, 2015. On 4 November, 2015 BLRC came out with the final report.

The Committee has chosen the strategy of repealing many existing laws on bankruptcy and insolvency, and writing a clean modern law which is a simple, coherent, and effective answer to the problems under Indian conditions.

The Report of the BLRC is in two parts:

i. Rationale and Design/Recommendations;
ii. A comprehensive draft Insolvency and Bankruptcy Bill covering all entities.

The draft Bill has consolidated the existing laws relating to insolvency of companies, limited liability entities (including limited liability partnerships and other entities with limited liability), unlimited liability partnerships and individuals which are presently scattered in a number of legislations, into a single legislation.[12]

---

[11] Bankruptcy Law Reform Committee, *Interim Report* (Feb. 2015).

[12] Press Information Bureau, Ministry of Finance, Government of India, *Summary of the Recommendations of the Bankruptcy Law Reforms Committee (BLRC)* (Nov. 4, 2015).

Litigation Problems in the Present Scenario

While studying about the present system in the country, the multiplicity of legislations on corporate bankruptcy becomes evident whenever litigation is initiated by companies. The myriad forums for insolvency resolution and several challenges to the existing legislations have created a situation which is extremely confusing and contradicting for any corporate entity to follow. Typically high courts in India receive cases which can be broadly classified under four heads:

i. Liquidation references from BIFR (refer to page 1 for conditions for a BIFR reference)
ii. Winding up petitions in High Courts under Companies Act, 1956
iii. Appeals from BIFR (typically in cases involving interpretations and challenges to specific provisions of SICA)
iv. Appeals from DRT and DRAT (typically involve the interpretation of the RDDBFI Act or the SARFAESI Act, and sometimes their conflict with each other or with Companies Act)

If we begin to evaluate such cases from 2002 onwards i.e. after the SARFAESI Act came into existence, we find a certain themes emerging which point out the reasons why the existing regime has not been able to succeed, firstly the existence of multiple forums and multiplicity of legislations, and secondly weak institutions that lead to inordinate delays, especially in liquidation of companies.

i. Parallel Proceeding Cases

BHEL v. Arunachalam Sugar Mills[13] illustrates a very important point that the majority of cases faced by High Courts are where proceedings were initiated by various parties and the court is left with to decide which proceeding and which legislation to be given predominance over the other. There were situations where the debtor company had made a reference to the BIFR under SICA while a secured creditor had filed a winding up petition in the high court[14] or initiated enforcement

[13] BHEL v. Arunachalam Sugar Mills Ltd. (High Court of Madras), OSA Nos 58, 59, 63, 64 and 81 of 2011, decided on 12 April 2011.

[14] See, for example, In re: Oswal Foods Limited (2008) 145 CompCas 259 (All), decided on 16 November 2006 involved a situation where the debtor company had made two references to the

action under the SARFAESI Act[15] and other cases where creditors had each initiated proceedings in different forum or under different statutes.[16]

i. Conflicts between SICA and Debt Enforcement Laws

Many of the cases that involved conflicts between the SARFAESI Act and SICA were relatively straightforward as they often involved a factual question of whether 75% of creditors had indeed sought enforcement action under the SARFAESI Act in which case the BIFR proceedings would need to abate.[17] In *BST and PSP Workers Union v. Union of India*[18] the BIFR had made a reference for liquidation in the high court while secured creditors had sought enforcement action under the SARFAESI Act, whereby the Kerala High Court held that as the secured creditors had not notified the BIFR of the SARFAESI enforcement action, the BIFR retained jurisdiction and the winding up order passed by the high court was valid.

BIFR, while a creditor filed a winding up petition in the High Court; In Re: Consolidated Steel and Alloys, CA Nos. 165, 385, 706 and 992/07 and 1031/08 in CP No 428 of 2002, decided on 7 November 2008, where the Delhi High Court actually failed to issue a winding up order following the BIFR's reference and creditors subsequently had to file a separate winding up petition in the court.

[15] Asset Reconstruction Co India P Ltd v. Shamken Spinners Ltd, AIR 2011 Del 17, decided on 22 November 2010; M/S Digivision Electronics Ltd v. Indian Bank and Ors. WP 13056/2005, decided on 7 July 2005.

[16] In Kritika Rubber Industries v. Canara Bank (Karnataka High Court), CA No 190/2008 in Co P No 167/1999, decided on 13 June 2013, one group of secured creditors had initiated an action in the DRT, while another group subsequently filed a winding up petition in the Karnataka High Court. The DRT decided in favour of the creditors and a recovery officer at the DRT ordered the attachment of the property securing the debt, which was subsequently sold in an auction. In the meantime, the high court had ordered the winding up of the debtor and appointed an official liquidator (OL) to oversee its liquidation. The OL, upon learning of the DRT's actions, sought an order to set aside the sale by auction, which the High Court allowed. An interesting fact in this case is that it appears that the parties to the DRT proceedings were unaware of the winding up petition in the high court. Indeed, one of the secured creditors claimed to have had no knowledge of the winding up petition (that was filed in 1999) until it received notice of the OLs action to set aside the sale authorised by the DRT (which occurred in 2008) (Para 3.3 and 32).

[17] See, for example, Triveni Alloys Ltd v. Board for Industrial and Financial Reconstruction and Ors, WP No 4481 of 2005 and 32594 of 2003, decided on 19 July 2005.

[18] CP 23 of 2006, decided on 03 August 2009.

The most recent decision of the Supreme Court that dealt with the conflict between rescue and rehabilitation and debt enforcement laws was in *KSL Industries v. Arihant Threads Ltd.*[19]

ii. <u>Conflicts between Winding up Proceedings and the SARFAESI Act</u>

The SARFAESI Act has also often clashed with winding up proceedings, wherein the primary question in most of these cases was whether enforcement action could proceed under SARFAESI in situations where a winding up petition had been filed in the high court. Here also there has been many contradictory judgments, on one hand where one high court held that the debtor's assets could be sold in an auction pursuant to a SARFAESI Act enforcement action without the leave of the Company Court where a petition had been filed for winding up[20], and on other hand high courts ruled that the consent of the official liquidator was required for such a sale *(BHEL v. Arunachalam Sugar Mills Ltd, Kritika Rubber Industries v. Canara Bank)*. The Supreme Court came to quite a different conclusion in *Official Liquidator, UP and Uttarakhand v. Allahabad Bank.*[21]

iii. <u>Conflicts between SARFAESI and RDDBFI Act</u>

Proceedings under SARFAESI does not require the intervention of a court or tribunal, while under the RDDBFI Act, it is compulsory. Can parallel proceedings under these two laws be instituted by creditors is a moot question. In *Bank of India v. Ajay Finsec Pvt Ltd and Ors*[22], the DRT ruled that banks and financial institutions

---

[19] Supreme Court, Civil Appeal No 5225 of 2008, decided on 27 October 2014. In this case, the conflict was between SICA Act, 1985 and the RDDBFI Act, 1993. The provisions in conflict were § 22 of SICA Act that provides for a stay of all proceedings against the debtor and § 34 of the RDDBFI Act that provides that the Act has overriding effect. The Supreme Court considered the objects of both laws in detail and decided that SICA Act took precedence over the RDDBFI Act.

[20] Indian Bank v. Sub-Registrar, Writ Appeal Nos. 1420 and 1424 of 2013 and OSA Nos. 34 and 35 of 2013, decided on 11 November 2014.

[21] Official Liquidator, UP and Uttarakhand v. Allahabad Bank, AIR 2013 SC 1823: This case involved the role of the Company Court and the official liquidator where the company subject to the winding up proceedings was also subject to recovery proceedings under the RDDBFI Act, 1993. The Supreme Court upheld the precedence of the RDDBFI Act and held that the Company Court did not have jurisdiction over matters that were pending before the DRT.

[22] Original Application No. 167 of 2001, decided on 28 November 2003.

may simultaneously pursue proceedings under the SARFAESI Act and RDDBFI Act. This view was also upheld by the Supreme Court in *M/S Transcore v. Union of India*[23], 24 where the Court stated that the two acts were complementary to each other. However, despite both these rulings, nearly two years after *Bank of India v. Ajay Finsec Pvt Ltd*, the Patna High Court held that the proceedings under the RDDBFI Act could not be initiated if SARFAESI Act enforcement action had begun.[24]

iv. Instances of Delay

The high courts and Supreme Court have typically adopted a pro-rehabilitation stance and been reluctant to order winding up proceedings.[25] In many of the liquidation cases reviewed, the issuance of a winding up order did not necessarily signal the close of the insolvency process. There were numerous instances of liquidators struggling over the priority of claims and payments many years after the winding up order had been passed.[26]

At a glance all these cases depict the significant problems of India's bankruptcy laws which have ended up creating insecurity and uncertainty for the creditors. The mere enactment of new consolidated bankruptcy legislation does not mean that all such problems will go away at once. The insolvency regime has to date been characterised by weak institutions, whether it is the high courts, the BIFR or

---

23 M/S Transcore v. Union of India AIR 2007 SC 712.

24 M/S Punea Cold Storage v. State Bank of India AIR 2013 Pat 1.

25 In Rishabh Agro Industries Ltd. (2000) 5 SCC 515, a Division Bench of the Supreme Court held that it was open to the directors of the company to explore the possibility of rehabilitation even after the winding up order had been passed. This judgment has since been cited in several later cases when former management of a debtor attempt to revive a company in the final stages of being wound up, for example In re: Oswal Foods Limited.

26 For example, in Mining & Allied Machinery Corpn v. The Official Liquidator (CA Nos 115, 426, 797/2012 and 1126/2011 and BIFR 510/1992, decided on 2 December 2014), nearly 10 years after the winding up order was passed, the Calcutta High Court was asked to consider whether contract labourers could be treated as workmen and, therefore, be entitled to proceeds from liquidation as secured creditors. In Official Liquidator, Suganti Alloys Castings Ltd v. Edupuganti Subba Rao (CA 160 of 1995, decided on 19 April 2006), while the Andhra Pradesh High Court passed the winding up order in 1990, the OL was struggling to complete the liquidation process as late as 2006.

the official liquidators, and a new law alone cannot fix these issues.[27] The new law will work effectively only when it interacts with the present legislations in a harmonious manner, without much room for discrepancies and controversies to emerge from.

<u>Proposed Institutional Infrastructure</u>

For any robust insolvency resolution process, proper institutional infrastructure is an absolute essential. Any such infrastructure includes regulators, adjudicators and tribunals which work in concert to provide a coherent solution for any aggrieved party.

i. <u>Tribunals</u>

Under Companies Act, 2013, and the Limited Liability Partnership (LLP) Act, 2008 the National Company Law Tribunal (NCLT) has jurisdiction over the winding up and liquidation of companies and LLPs respectively. Appeals from the order of NCLT shall lie to the National Company Law Appellate Tribunal ("NCLAT"). The Committee has chosen to continue with this existing institutional arrangement. NCLT has jurisdiction over adjudications arising out of firm insolvency and liquidation, while NCLAT will have appellate jurisdiction on

27 For a more detailed analysis, see Aparna Ravi, *The Indian Insolvency Regime in Practice – An Analysis of Insolvency and Debt Recovery Proceedings*, WORKING PAPER, FRG IGIDR (2015). Her analysis is based on a detailed review of 45 judgments of the High Courts and 15 judgments from the DRTs and DRATs, as well as a review of important judgments of the Supreme Court that have had a significant impact on the interpretation of existing insolvency legislation. All of the judgments she reviewed are from the period after June 2002, the year when the SARFAESI Act came into effect, and are intended to provide a picture of how a debtor in distress or a creditor seeking recovery goes through the legal system as it exists today. The judgments selected for the detailed review were chosen from a much larger group of high court and tribunal judgments with the goal of obtaining judgments that covered the various types of insolvency-related matters that were heard by the courts and tribunals.

the same.[28] Furthermore, the limitation period of 45 days has been prescribed for filing appeal to the NCLAT.[29]

The Supreme Court is the forum for appeal only on a question of law from NCLAT, with the limitation period extendable by 30 days.[30] Furthermore the NCLT has been given exclusive jurisdiction in the Bill, which includes freedom from any injunction granted over its matters.[31]

Furthermore an insolvency resolution process or bankruptcy proceeding of a personal guarantor of such corporate debtor can be filed at any point of time during the pendency of a corporate insolvency resolution process or liquidation proceeding of a corporate debtor before the NCLT.[32]

ii. The Insolvency and Bankruptcy Board[33]

One of the basic problems with regard to the existing bankruptcy framework is the lack of a regulator in the sector. This lacuna leads to an inordinate amount of work falling on the shoulders of the courts, which are already overburdened with the existing litigation. Thus the setting up of a regulator was one of the most important requirements of a unified law on bankruptcy, and the establishment of the Board will prove to be one of the biggest highlight of the Bill.

The Bill has given quite a free hand to the Board in respect to its powers and functions. This is evident by enacting provisions for constitution of various

---

[28] The Insolvency and Bankruptcy Bill § 60(1) (2015): The NCLT shall have territorial jurisdiction over the place where the registered office of a company is located and can entertain an application under this Act regarding such corporate debtor or corporate person.

[29] *Id.* § 61(1): An appeal against a liquidation order passed under § 33 may only be admitted on grounds of material irregularity or fraud committed in relation to such a liquidation order. § 61(2): This period could be further extended for a period not exceeding 15 days.

[30] *Id* § 61(3): An appeal lies to the Supreme Court within a period of 90 days. § 62: The limitation period may be extended by 30 days.

[31] *Id* § 63: Civil Court not to have jurisdiction. § 60(5): No injunction shall be granted by any court, tribunal or authority in respect of any action taken, or to be taken, in pursuance of any power conferred on the NCLT or the NCLAT.

[32] *Id* § 60(2)(a).

[33] Hereinafter referred to as "Board".

Committees by the Board for efficient discharge of its functions.[34] The Board has been given the powers of a civil court while trying a suit which extends to summoning witnesses, examining them on oath, examination of evidence. Section 196(1) gives a comprehensive list of all the powers and functions that the Bill has vested in the Board.[35]

The requirement of a performance bond by insolvency professional or an agency as a security is one such measure by which the Board efficiently exercises control over them.[36]

iii. Insolvency Professionals

Insolvency Professionals (IP) are vital to any efficient mechanism to resolve insolvency and bankruptcy. Under the Bill, an IP may assume any of the following roles:

1. Resolution professional (RP) to resolve insolvency for a firm or an individual[37];

2. Bankruptcy Trustee in an individual bankruptcy process[38];

---

34 These committees include and are not limited to Standards Advisory Committee, Financial Advisory Committee, Insolvency Professional Advisory Committee and Information Utilities Advisory Committee.

35 Including and not limited to registering agencies and professionals, fixing eligibility criteria, levying fees, specifying professional standards, monitoring performance, inspections and investigations, curriculum and examination of such professionals, maintaining and disseminating literature and records on bankruptcy, issuing guidelines, and grievance redressal. For a more comprehensive list, see § 196(1) and the analysis of Insolvency Professionals and agencies dealt with in the forthcoming headings.

36 As per § 206(2)(a), the concerned insolvency professional agency acts as a surety for the obligations of the insolvency professional and is to be jointly and severally liable for losses in relation to any person whose interests are prejudicially affected by any act of fraud or gross misconduct of the insolvency professional. Also the payment of claims in respect of losses shall be equal in amount, to at least the value of the assets of the corporate debtor or the debtor as on the insolvency commencement date or the insolvency commencement date of the debtor, as the case may be.

37 The IP may order a fresh start order process under Chapter II of Part III or the individual insolvency resolution process under Chapter III of Part III of the Bill.

38 The IP may participate in the individual bankruptcy process under Chapter IV of Part III of the Bill.

3. Liquidator in a firm liquidation process[39];

Entry barriers have been put up for a more efficient and centralised workflow. No person shall render his services as insolvency professional under the Bill without being enrolled as a member of an insolvency professional agency.[40] Every insolvency professional shall, after obtaining the membership of any insolvency professional agency, register themselves with the Board.[41] Any insolvency professional under the act is expected to take reasonable care and diligence, adhering to procedure of the law, as well as accounting and finance related functions.

iv. Insolvency Professional Agencies

The BLRC envisioned a network of IP agencies for optimal bankruptcy resolution environment in the nation, and for that purpose, a necessary regulatory governance process has to be followed by the professional IP agencies in carrying out the following functions:

i. Regulatory functions - drafting detailed standards and codes of conduct through bye-laws, that are made public and are binding on all members;[42]
ii. Executive functions - monitoring, inspecting and investigating members on a regular basis, and gathering information on their performance, with the over arching objective of preventing frivolous behaviour and malfeasance in the conduct of IP duties;[43]

---

39 An IP may take part in corporate insolvency resolution process under Chapter II of Part II, or in the liquidation of a corporate debtor firm under Chapter III of Part II of the Bill.

40 *Id* § 207(1).

41 *Id* § 207(2).

42 *Id* § 205(1) provides a detailed list of bye-laws to be drafted by IP agencies, which includes setting up various professional standards, enrolment of its members, membership laws, examination and curriculum for IPs as well as initiating disciplinary proceedings against member IPs. IP agencies must exercise minimal discretion in framing bye-laws, especially in the process of granting licenses to IPs.

43 This includes inspections, investigations, enforcement of orders and processing of complaints. Such functions include, and shall not be limited to all functions listed in § 204(1) of the Bill. The BLRC Report envisions the heads under this section to be a comprehensive list, but not an exhaustive one.

iii. Quasi-judicial functions - addressing grievances of aggrieved parties, hearing complaints against members and taking suitable actions.[44]

These three types of functions are envisioned to prove as a framework for efficient working of the system. But at the same time, the IP agencies are also required to follow all rules and regulations laid down by the Board from time to time. There is a presumption of the IP agencies working under good faith and in a professional manner with ethical conduct, for which the Board may have in regard these principles for the working of IP agencies. Furthermore, the Board shall have power, albeit not absolute, to grant certificate of registration to these IP agencies, which also extends to rejecting any application for the same, or renewing and cancelling an existing registration for any such reasons as have been listed out in Section 201(5).[45] Any insolvency professional agency which is aggrieved by any order of the Board may prefer an appeal to the NCLAT.[46]

v. Insolvency Information Utilities

The draft Bill lists out the establishment of information utilities which would collect, collate, authenticate and disseminate financial information from listed companies and financial and operational creditors of companies, along with an individual insolvency database with the goal of providing information on insolvency status of individuals.[47] The information utility shall be registered with the Board which reserves the power to grant registration, or renew or cancel an existing registration. Any appeal against the order of the Board lies to the NCLAT.

---

[44] Anybody who is aggrieved by an action of an IP may address their grievance to the agency of which the IP is a member as per § 204(1)(f).

[45] The reasons for such include making any false statement or misrepresentation, contravening any provisions of this Bill or any bye-laws, following the established principles of Administrative Law.

[46] *Id* § 202 of the Bill.

[47] Press Information Bureau, Ministry of Finance, Government of India, *Summary of the Recommendations of the Bankruptcy Law Reforms Committee (BLRC)* (Nov. 4, 2015).

vi. <u>Insolvency Resolution Process</u>

For any corporate entity facing insolvency, a definite insolvency resolution process is essential for establishing clarity and permanence.[48] A defined process not only lets the parties themselves prepare for bankruptcy and its future ramifications, but in doing so it also eases the burden off the courts as a large amount of their work gets already done by the aggrieved parties. To the extent this can be implemented, the costs involved decreases and the time involved also comes down drastically.

vii. <u>The Present Process in India</u>

Currently, the Companies Act 2013 permits the following parties to file an application before NCLT for a declaration that company is sick- (a) the company, (b) any secured creditor, (c) the Central Government, (d) the Reserve Bank of India, (e) State Government, (f) public financial institution, (g) a State level institution, (h) a scheduled bank.[49] Under the SARFAESI, 2002 also, debt enforcement rights are available for secured creditors only. To determine a company as sick or not, a period of 60 days has been prescribed for the NCLT under Section 253(7).

The existing process for insolvency resolution is found in Chapter XIX of Companies Act, 2013. Under this, the secured creditors of a company representing at least fifty percent of its outstanding debt may serve a notice, and on non-payment of dues, may apply to the Tribunal for declaring a company as sick. The Act also empowers NCLT to pass any order which shall be in power till 120 days. Furthermore a period of sixty days is prescribed to apply to NCLT for insolvency resolution after declaration of a company as sick.[50] The Tribunal has also been empowered to set up an interim administrator within 7 days of such application,

---

[48] When a company defaults on a debt payment, there are three kinds of legal procedures available to creditors and debtors that are common to all jurisdictions: (i) foreclosure or enforcement of the debt by a creditor or group of creditors, (ii) liquidation of the debtor and a distribution of its remaining assets to creditors, and (iii) a reorganisation or revival of the business, which results in a continuation of the business in some form or in the sale of the business as a going concern. For a more comprehensive analysis, see Djankov et al, *Debt Enforcement Around the World*, 116(6) JPE, 1105–49 (Dec.).

[49] Companies Act § 253(5) (2013).

[50] Companies Act § 254(3) (2013).

who must aid the court to examine every possible avenue for insolvency resolution, which includes convening meetings and appointing committee of creditors and taking over the management,[51] of the company if need arises. Furthermore the Act also provides for setting up a company administrator in a later stage, who may take over all assets, inventory, books, and all documents of the company; draft a scheme of revival and rehabilitation of the company which may include amalgamation with another company,[52] takeover of the company,[53] and other such measures[54], though they will have to be approved by the creditors of the sick company.

These provisions no-doubt are fraught with numerous questionable sections, which provide a very complicated approach to a much needed simple procedure. On one hand these and other provisions like creating a Rehabilitation and Insolvency Fund (Section 269), and stricter punishments and penalties (Section 267) show that the intent of the government is aligned towards creating a coherent law for bankruptcy; but at the same a great focus on court involvement in the process is counterproductive for any fast and easy process.

viii. Establishing a New Process[55]

Over time, insolvency law has evolved to incorporate a broader set of considerations such as asset preservation, a means to revive a debtor's business if it is viable and to consider the interests of other stakeholders in addition to financial creditors, including trade creditors and employees.[56] The UNCITRAL Legislative Guide on Insolvency, states nine broad objectives of an insolvency law

---

51 *Id.* § 256(1).
52 *Id.* § 261(2)(c).
53 *Id.* § 261(2)(d).
54 For the complete list, see Companies Act § 261 (2013).
55 For the three goals that a bankruptcy procedure should have (delivering an ex post efficient outcome, preserving the bonding role of debt by penalizing managers and shareholders adequately in bankruptcy states, preserving the absolute priority of claims), see Oliver Hart, *Different Approaches to Bankruptcy,* ANNUAL WORLD BANK CONFERENCE ON DEVELOPMENT ECONOMICS (June. 1999).
56 S. Paterson, *Rethinking the Role of the Law of Corporate Distress in the Twenty-First Century*, LSE LAW, SOCIETY AND ECONOMY WORKING PAPERS (2014).

regime all of which rest on having a collective mechanism for insolvency resolution:[57]

i. Provision of certainty in the market to promote efficiency and growth;
ii. Maximisation of value of assets;
iii. Striking a balance between liquidation and reorganisation;
iv. Ensuring equitable treatment of similarly situated creditors;
v. Provision of timely, efficient and impartial resolution of insolvency;
vi. Preservation of the insolvency estate to allow equitable distribution to creditors;
vii. Ensuring a transparent and predictable insolvency law that contains incentives for gathering and dispensing information;
viii. Recognition of existing creditor rights and establishment of clear rules for ranking priority of claims; and
ix. Establishment of a framework for cross-border insolvency.

The objectives outlined above are inter-related and rest on three fundamental characteristics that are shared by most well developed insolvency law regimes (either through statutory provisions or their implementation in practice): (a) a linear step-by-process for a debtor and creditors to follow when insolvency is triggered, which allows for predictability and certainty in terms of process and outcomes;[58] (b) a collective mechanism for resolving insolvency that helps preserve value and also serves to advance principles of equity and fairness by involving all stakeholders in the process; and (c) a time bound process for resolving insolvency that either ends in a rescue and restructuring of the debtor's business or a liquidation and distribution of the debtor's assets to various stakeholders.[59] It is worthwhile to note that the BLRC has taken these UNCITRAL objectives as a base point while formulating the new bankruptcy legislation.

---

[57] *Legislative Guide to Insolvency Law*, *Part I*, UNCITRAL, 10–14 (2015).

[58] Supra note 5.

[59] See Debanshu Mukherjee, Priyadarshini Thyagarajan and Anjali Anchayil, *The Place of a Collective Liquidation Processin an Effective Bankruptcy Regime: A Comparative Analysis*, WORKING PAPER, IGIDR.

ix. Insolvency Resolution under the 2015 Bill

The biggest highlight of the 2015 Bill is the Insolvency Resolution process ("process") that has been enunciated under Chapter II, along with a fast track process listed in Chapter IV under Part II of the Bill. For any robust process, a fair degree of certainty is required, which is quite evident in numerous ways under this Chapter. The category of people who are designed as corporate applicants have been listed in Section 5(3), namely shareholders and partners of corporate entity, managers, any financial supervisor of the corporate entity and any other person who has been employed by the corporate person. The Section 5 which contains definitions of all terms used in the Chapter is a highly resourceful section, which lists various definitions covering several heads exhaustively, for example financial debt, fraudulently, insolvency process period costs, related party, voting share etc.

The Bill lists out various instances where the process can be initiated by various different people under different circumstances. Where any corporate debtor commits a default, a financial creditor[60] (any person to whom a financial debt is owed), an operational creditor[61] (a person to whom an operational debt is owed) or the corporate debtor itself may initiate the process. Each of these may also propose a resolution professional to be appointed to act as the interim resolution professional. Though at the same time, certain situations bar these persons from initiating the process. For example a corporate debtor who is undergoing or completed 12 months previously a corporate insolvency resolution process, or a financial creditor whose resolution plan was approved 12 months before the date of making an application under this Chapter and who has violated any of the terms of such plan cannot initiate the process.

The point that stands out from all these provisions is the time period prescribed for the process to be completed. The time period prescribed is 180 days, extendible

[60] A financial creditor either by itself or jointly with other financial creditors may file an application along with proof of the default for initiating corporate insolvency resolution process against a corporate debtor before the adjudicating authority when a default has occurred.

[61] An operational creditor shall, on the occurrence of a default, deliver a demand notice or copy of an invoice demanding payment of the amount involved in the default to the corporate debtor, who shall respond within 10 days, failing which the operational creditor may file an application with the adjudicating authority.

to a maximum one-time period of 90 days, with a suitable safeguard of requirement of 75% of committee of creditors as a pre-requisite to any such extension. This is a paradigm shift from the present situation where creditors can seek for an extension indefinitely. This period is seen as a "calm period", where the creditors can hold-off their claims.

To streamline the process further and decrease vexatious litigation, the Adjudicating Authority has been given very wide powers, to appoint an IP (who shall exercise the management of the company for the process duration, including all powers exercised by the partners and board of directors, entering into any such contracts with other companies, control of all assets and securities of the company) under section 16 and to declare a moratorium under section 13. Such a declaration will prohibit the institution or continuation of suits or proceedings against the corporate debtor in any court, tribunal, arbitration panel or other authority; prohibit any transfer of assets or rights, prohibits any debt recovery action by the application of SARFAESI Act, and enforces the status quo of any property in question. Furthermore such a moratorium may continue till the process period ends.

A very detailed procedure for setting up of committee of creditors, its composition, its functions and their approval of insolvency professionals has been provided for[62], which provides the much needed certainty in the legislation. Furthermore to prevent any discrepancies that may arise from any interpretation of the legislation, very definite provisions have also been listed for IPs – their conduct in the insolvency resolution process, their duties[63], and their replacement by the committee (by a 75% vote of the creditors, with subsequent conformation by the Board) or a financial creditor or corporate debtor.[64] Along with all such powers, the committee of creditors also reserves the right of approving or rejecting

---

[62] For the full text, see §§ 21, 22, 24 of the 2015 Bill.

[63] For example, taking immediate custody of assets and records of the company, becoming the company's representative, auditing, submitting the final plan, etc. For a full list, see § 25 of the 2015 Bill, though some of the actions of the IPs need approval of committee of creditors under the conditions mentioned in § 28(1).

[64] In the event of any irregularities, failure of standard of care exercised, conflict of interest, misinformation, contravention of any law: § 27(1).

the final plan submitted by the IP (by a vote of 75% of the creditors the plan can be approved). The Bill has also provided for an added layer of security so that no undue haste by the creditors can happen as the approved plan again needs to be approved by the Adjudicating Authority. While this may seem as a cumbersome step, this is much needed, to prevent instances in future arising where creditors may exploit the autonomy granted to them, or prevent instances of collusion between IPs and the creditors. This provision under Section 31 provides just an added layer of security.

x. Fast Track Process

Under Chapter IV, a separate fast track process has also been provided (which may be initiated by a creditor or corporate debtor), which shall be completed within 90 days, extendable by a one time period of 45 days on a majority vote of no-less than 75% of the committee of creditors. Such a process has been made for those companies with assets and income below a certain level or a corporate debtor with such class of creditors or such amount of debt as may be notified by the Central Government, with the rest of the procedure same as the normal resolution process.

Liquidation Process

For many people bankruptcy and insolvency are one and the same. True to this they are almost used interchangeably in most times. But actually they are fundamentally different terms, two stages of a process. The first phase of the insolvency and bankruptcy process is the period of insolvency resolution during which insolvency is assessed and a solution is reached within a stipulated time period and when a solution is not reached within the specified time limit, the second phase of the process begins wherein the entity is declared bankrupt.[65] One possibility is to negotiate a debt restructuring, where the creditors accept a reduction of debt on a net payment value basis, and hope that the negotiated value exceeds the liquidation value. Thus liquidation happens after all other options have been explored, after a company has been declared as bankrupt. Such a sequence

[65] 1 The Report of the Bankruptcy Law Reforms Committee, 12, 63 (Nov. 2015).

with liquidation at the last is necessary because it involves destruction of capital of a company.

This textbook definition of liquidation is precisely what has been taken by the BLRC while formulating the Bill. An entire detailed Chapter III has been devoted to Liquidation Process. In the event that the Adjudicating Authority does not approve of the resolution plan submitted, or where the maximum period of 180 days passes by without any plan being submitted, or where the committee of creditors by a majority of not less than 75% pass a resolution in this aspect anytime during the duration of the process before submission of the plan, the Adjudicating Authority may initiate liquidation for the company. The last provision is especially important because many times the value of a company begins deteriorating with time and where circumstances show that no resolution can occur delay proves to be counterproductive.

When the Adjudicating Authority passes the order for liquidation, the IP who was earlier appointed to present a resolution plan, now steps into the shoes of a liquidator, until replaced (on a Board recommendation, or rejection of the IP's resolution plan). The powers of a liquidator extend to verifying creditor claims, seeking information from any information utility or any such system; control of assets and securities including their sale and transfer; drawing, accepting and making any negotiable instruments; settling claims; investigating financial affairs; reporting progress to the Authority; representing the company in any suit or proceedings; amongst others (for the full list, refer to Section 35: Powers and duties of liquidator, of the 2015 Bill). As a further safeguard, a liquidator trust is envisioned to be created by the liquidator as the fiduciary, for the assets of the company[66] as an immediate measure. Furthermore a short 21 day period has been

[66] Such assets which shall include any assets over which the corporate debtor has ownership rights, assets that may or may not be in possession of the corporate debtor, movable and immovable tangible assets, intangible assets including but not limited to intellectual property, securities (including shares held in a subsidiary of the corporate debtor) and financial instruments, insurance policies, contractual rights, and shall not include assets owned by a third party which are in possession of the corporate debtor (such as assets held in trust, bailment contracts, assets in security collateral held by financial services providers, personal assets of any shareholder or partner of a corporate debtor, assets of any Indian or foreign subsidiary of the corporate debtor). For the full list of assets and their specific nature, see § 36 of the 2015 Bill.

prescribed for the liquidator to accept creditor claims. The powers of the liquidator extend to accepting/rejecting (with reasons) the claims of the creditor along with a duty to avoid preferential transactions (here again the Bill provides appropriate safeguards by listing the characteristics of a preferential transfer in Section 43, and the relevant order that may be made by the Adjudicating Authority in Section 44) in one or more creditor's favour.

The Bill also has safeguards against any mistakes made by the liquidator by way of undervalued transactions by which the liquidator may apply to the Adjudicating Authority to have any such transaction made by him declared as void [67]extending to a period of 2 years for a related party and 1 year for anyone other than a related party, preceding the insolvency commencement date. Furthermore such an application may also be made by an aggrieved creditor, shareholder or a partner of a corporate debtor to establish status quo. Furthermore the Bill also prevents any such undervalued transaction arising due to fraud by a corporate debtor (Section 49), without prejudicing any interest in property which was acquired from a person other than the corporate debtor, and also prevents any extortionate credit transactions made to a corporate debtor (Section 50), to prevent misuse of law.

A secured creditor in the liquidation proceedings may relinquish its security interest to the liquidation trust and receive proceeds from the sale of assets by the liquidation.[68]

The detailed order of priority for division of proceeds from sale of trust assets has also been provided in Section 54, which provided a great deal of certainty to the Bill. The Committee has recommended keeping the right of the Central and State Government in the distribution waterfall in liquidation at a priority below the unsecured financial creditors in addition to all kinds of secured creditors for

[67] By such an order or decree, the Authority may compel any property transferred as part of the transaction, to be vested in the corporate debtor, or release or discharge (in whole or in part) any security interest granted by the corporate debtor, require any person to pay such sums, in respect of benefits received by such person, to the liquidator.

[68] § 53. The detailed manner has been described in § 54.

promoting the availability of credit and developing a market for unsecured financing (including the development of bond markets).[69]

i. Voluntary Liquidation

Another very novel innovation of the act has been recognition of voluntary liquidation as a necessary feature that had until now been absent in the Indian financial sector. This provision is probably the most ambitious one, firmly positioning a bill on par with the other legislations around the world. Under voluntary liquidation, any corporate person who intends to liquidate voluntarily may do so, provided that the corporate person follows the requirements laid down by the Board and certain additional requirements in Section 59(3).[70] The Bill provides for an affirmation by the shareholders of the company, and a further affirmation required by two-thirds of the creditors in case the company is indebted to any persons. Within two-days of such affirmation, the Board and the Registrar of Companies must be taken in confidence, and the rest of the process shall happen in the same way as the liquidation process enshrined in Chapter III. The final result must be affirmed by the order from the Adjudicating Authority.

Voluntary Liquidation is an existing phenomenon, which was until now not recognised by Indian law. The 2015 Bill has done well to give recognition to the process and lead the way for more such legislations to follow suit.

Conclusion

While drafting a new consolidated law on bankruptcy, there are two directions that can be taken. One path is laying a heavier emphasis on courts, forums and judicial processes as the go-to redressal system. The other is laying a heavier emphasis on an insolvency framework, which might have a nodal body, and a number of professionals providing personalised service, thereby isolating the resolution process rather than having it centralized. When India was faced with this twin dilemma, the BLRC chose to take a balanced approach of the two, leaning towards

[69] Supra note 66, at 14, made manifest in § 54(1).

[70] Some of the additional requirements are affidavit by the directors of the company declaring non-insolvent status of the company and non-fraudulent intentions and disclosure of assets of the company.

the second option as its choice. While studying the present systems in UK[71] and Singapore[72] they finalised upon the 2015 Bill as favouring the second option, though that has to be ratified by courts, thus providing an amalgam of both options as the solution. Hence instead of initiating large scale judicial reforms, the BLRC has chosen to form a set of institutions to aid a weaker-judiciary, to form an overall robust process.

In line with easing up the burden on the courts, the BLRC recommended forming a creditor's committee, where all creditors have voting rights in proportion to the outstanding debts owed to them, thus making insolvency what is should truly be, a business decision. This has been a positive departure from the previous situation where the laws brought some or other arms of the government into the equation. We can be optimistic in forecasting a future where insolvency professionals[73] will assume a leadership role in dealing with insolvency and bankruptcy in India.

As a departure from the normally conceived view of policy changes requiring a great deal of institutional overhaul, the bankruptcy framework does not require major institutional investments. The insolvency professionals can be nominated from the existing crop of financial consultants in the country, and there are a number of governmental and non-governmental agencies [74]which can serve as information utilities.

---

[71] The UK law has devolved large portion of the responsibilities to the insolvency practitioners thereby minimizing the role of the judiciary, which is now involved primarily in dispute resolution and for setting guidelines for the parties involved.

[72] In Singapore, on the other hand, the court plays a more active role in the judicial management process and the IP is, in a way, subservient to the court system. However, Singapore has also taken considerable effort in significantly improving the capacity and capability of its court system. For further analysis between laws of India, Singapore and UK, see Rajeswari Sengupta & Anjali Sharma, *Corporate Insolvency Resolution In India: Lessons From A Cross-Country Comparison*, IGIDR WORKING PAPER (Dec. 2015).

[73] For the study that was relied upon by the BLRC while formulating the provisions for setting up IPs, see Anirudh Burman and Shubho Roy, *Building the institution of Insolvency Practitioners in India*, IGIDR WORKING PAPER (Dec. 2015).

[74] FSLRC has recommended a statutory database, the Financial Data Management Centre (FDMC), which is a shared data facility for all financial agencies. The proposal here is somewhat different in having an industry of multiple competing information utilities. B. N. Srikrishna, *Report of the*

The BLRC report recognised several aspects of globalisation, namely foreign holders of corporate bonds issued in India, or borrowing abroad by an Indian firm, yet it missed out on many other aspects, like Indian firms which have become multinationals, and Indian financial investors that lend to overseas persons.

Different functions of a company give rise to different stakeholders, and this in-turn gives rise to different set of rights to people. Dealing with all of them in a single consolidated legislation provides the touchstone to balance the rights of all of them, while at the same time minimizing the possibility of conflicts. This Bill is a revolutionary step forward in recognising previously unknown facets of the industry, and improving upon the existing processes at the same time. Commenting on the efficacy of the Bill is not possible at this stage, though a great deal of optimism can be expected of it. To effectively set the pace for the future, the onus is now on the Parliament to pass the Bill, and launch a new age in insolvency and bankruptcy resolution in India.

Financial Sector Legislative Reforms Commission, Volume 1 and 2, COMMISSION REPORT, DEPARTMENT OF ECONOMIC AFFAIRS, MINISTRY OF FINANCE (2013).

BANKING LAW

THE REGULATORY CHALLENGE OF FINANCIAL DISINTERMEDIATION AND MARKET VOLATILITY – ANALYSIS, CRITICISM AND ALTERNATIVES TO THE POST-CRISIS STRATEGIES OF MANAGING SYSTEMIC RISK WITHIN THE SHADOW BANKING SECTOR

MAX BÄRNREUTHER, M.JUR. (OXFORD), MAÎTRE EN DROIT (PANTHÉON-ASSAS)*

Shadow Banking as One of the Yet Unresolved Origins of the Financial Crisis

The failure to fully come to grips with the shadow banking system has rightly been described as one of the most glaring weak spots in financial reform thus far[1]: the run by novation in the OTC derivatives market and the consecutive freezing of the repo and commercial paper market in the case of *Bear Stearns*, the fall of *Lehman Brothers* as a result of defaults on acquired securitized notes, the rescue of *AIG* due to the unknown identities of its CDS counterparties and the necessity to bail out the money market fund industry to prevent bank-like runs have impressively proved that the regulation of the shadow banking sector is far from able to avoid the realization of systemic risk causing negative externalities that harm the global society at large.[2] The Financial Stability Board ("FSB"), The Federal Reserve Bank

* The author is a Ph.D. candidate at the Chair for Civil Law, German and International Business Law at the University of Passau, Germany.

[1] SHanson, A. Kashyap, & J. Stein , *A Macroprudential Approach to Financial Regulation*, 25 JEP, Number 1, 3 (Winter 2011). It should be noted that the neologisms of "shadow banking", "shadow banking sector", "components of the shadow banking sector" are used for mere linguistic convenience rather than the conviction of their adequacy. Concerning their origin, see: *Utzig, S.*: Shadow Banking: Hintergründe und Herausforderungen (1) ("Shadow Banking: Backgrounds and Challenges (1)"), in: Die Bank 10.2012, 80-83.

[2] Concerning the run by novation conceivable in the OTC derivatives market, see *Duffie, D./Li, A./Lubke, T.*: Federal Reserve Bank of New York Staff Reports – Policy Perspectives on OTC Derivatives Market Infrastructure, in: Staff Report no. 424, January 2010, Revised March 2010; concerning the run on repo and commercial paper, see: Darrel, D.*, The Failure Mechanics of Dealer Banks,* 24 JEP Number 1, 51-72 (Winter 2010) ; concerning the default of securitized notes as one of the causes of the financial crisis of 2007/2008, see: Coval, J., Jurek, J. & Stafford, E. *, The Economics of Structured Finance*, 23 JEP, Number 1, 3-26 (Winter 2009) Gorton, G. & Metrick, A., *Securitized banking and the run on repo,* JFE, 104, 425-451 (2012) Acharya, V., Schnabl, P & Suarez, G. *, Securitization without risk transfer*, JFE 107 , 515-536 (2003); concerning the bail out of the Money Market Fund Industry by the U.S. government, see: Gordon, J. & Gandia, C.*: Money*

of New York ("Fed"), the International Organization of Securities Commissions ("IOSCO") and numerous authors have made proposals of how to ameliorate the currently existent weaknesses, some of which have been implemented by national and supranational economic policy makers.[3] While a reaction to the financial crisis is welcome, both the regulation of the individual components of the shadow banking sector as well as the regulation of the shadow banking sector as a whole as designed after the crisis have their weaknesses.

The Regulation of the Individual Shadow Banking Sector Components

Regulation has been put in place for dealer banks (**I.**), wholesale funding (**II.**), structured finance (**III.**), OTC derivatives (**IV.**) and money market funds (**V.**).

i. Dealer Banks

> "*The financial crisis had made clear the need to reconsider the systemic risks posed by the failure of dealer banks and has provided new insights into the mechanics by which they fail. The task of building new institutional mechanisms to address these failure mechanics is timely and urgent*".[4]

Dealer banks are regulated indirectly via the regulation of repos, commercial paper and OTC derivatives. The dealer bank that suffers from a value loss of one of its assets is unlikely to be able to finance itself via equity should the asset depletion be known to potential equity investors. The latter fear that their investment would be little more than the reallocation of wealth from themselves to the creditors who are able to prove ahead of them in the glaring insolvency of the dealer bank. Hence,

---

Market Funds Run Risk: Will Floating Net Asset Value Fix the Problem?, Columbia Law School Publication, Draft 3.0, (Aug 2013).

3 For a comprehensive overview of the reforms undertaken by the FSB, USA and EU, see: Greene, E. & Broomfields, E., *Promoting risk mitigation, not migration: a comparative analysis of the shadow banking reforms by the FSB, USA and EU*, 8 CMLJ, Number. 1, *Rehahn, J.*: Regulierung von "Schattenbanken": Notwenidgkeit und Inhalt ("The regulation of "shadow banks": Necessity and content"), in: Beiträge zum Transnationalen Wirtschaftsrecht, Heft 125, Apr. 2013, *Schaffelhuber, K.*: Regulierung des "Schattenbankensystems" ("Regulation of the "Shadow Banking System""), in: GWR 2011, 488-493. For a reception in the media, see: Masters, B., *Regulators peer into financial shadows*, Financial Times, Nov 18, 2012. More precise references as to the post-crisis reforms will be provided underneath.

4 Duffie, D., *The Failure Mechanics of Dealer Banks*, 24 JEP, Number 1, 51-72, 70 (Winter 2010)

it has to rely on different kinds of financing such as overnight repos or asset-backed commercial paper. What will happen once OTC derivative counterparties are informed about the weakening of the dealer bank's balance sheet asset side is novation: the counterparties will interpose a novating party so as to no longer be exposed to the dealer bank's credit risk which appears to have increased but rather to the credit risk of the new interposed novating party (so-called "run by novation"). 5 Once more and more OTC derivatives counterparties act in this way, potential novating parties will know that something is wrong with the dealer bank's credit worthiness and refuse to novate since it is them who would be exposed to the dealer bank's credit risk as a result of the novation. This refusal to novate will be known to repo and commercial paper buyers who will refuse to roll-over (so-called "repo run" or "run on commercial paper"). The roll-over risk materializes and the dealer bank's house bank will end any pre-existing credit-line. The dealer bank is no longer able to finance itself and will be exposed to a bank-run. The respective regulation does not focus on dealer banks themselves. Rather, it focuses on the creation of rules for the repo, commercial paper and derivatives market.[6] The latter, however, enter the scene of the failure mechanics of dealer banks at a rather late stage.[7] The further the failure mechanics – run by novation, repo run, commercial paper run, ending of the house bank credit line and eventually bank run – have progressed, the harder it appears to be able to stop them from resulting in the ultimate realization of the systemic risk within the shadow banking sector – the freezing of financial resources of the dealer bank – which will ultimately translate into the realization of systemic risk in the banking sector in the form of bank runs. Hence, an alternative regulatory mechanism focusing on dealer banks

---

[5] A thorough description on the failure mechanisms of a dealer bank can be found at Darrel, D., *The Failure Mechanics of Dealer Banks*, 24 JEP, Number 1, 51-72 (Winter 2010), see supra fn. 2.

[6] On the economic mechanics of commercial paper runs, see: Kacperczyk, M. & Schnabl, P., *When Safe Proved Risky: Commercial Paper during the Financial Crisis of 2007-2009*, 24 JEP, Number 1, 29-50 (Winter 2010)

[7] For the regulation of repos, see: *FSB*, Strengthening Oversight and Regulation of Shadow Banking – Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos, Aug 29, 2013; for the regulation of commercial paper, see: *FSB*, Strengthening Oversight and Regulation of Shadow Banking – Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities, Aug 29, 2013; for the regulation of OTC derivatives, see: *FSB*, Consultative Document – Strengthening Oversight and Regulation of Shadow Banking – An Integrated Overview of Policy Recommendations, Nov. 18, 2012.

should intervene at a much earlier stage of the failure process. It should intervene at the very beginning of the process so as to avoid it being triggered. The question that has to be answered is thus: how does the process begin? The answer is this: it begins with the loss of confidence in the balance sheet asset side of the dealer bank by the OTC derivatives counterparties. The beginning is hence of a psychological nature and it is also in the realms of psychology that it should be battled. Thus, the consecutive question must be: how can the confidence in the dealer bank's balance sheet asset side be maintained despite the fact that certain assets have decreased in their value due to the decrease of the credit-worthiness of the dealer bank's debtors? The dealer bank has to refinance itself quickly and efficiently. However, once the market of potential equity investors gets to know of the asset value decrease, hardly anybody will be willing to invest in equity since the investment appears to be little more than a transfer of wealth from the investee to the investee's creditors who will access the invested sums in the anticipated insolvency proceedings. The lack of confidence in the future positive economic development of the dealer bank, more precisely in the future absence of its insolvency allowing creditors to access the invested equity and leaving equity holders with a subsidiary claim, on the side of potential equity investors keeps the dealer bank from successfully refinancing itself so as to maintain OTC derivatives counterparties' confidence and hence to avoid them from initiating novations that will then translate into repo and commercial papers runs. The real question is hence: how can potential equity investors' confidence in the future absence of any loss of their investment due to consecutive insolvency proceedings be maintained so as to incentivize them to invest and thereby allow the dealer bank to refinance itself before the failure mechanics kick in? It appears to be recommendable to create an insolvency rule that allows equity investors to retrieve their investment if they invest in a financially strained dealer bank and the latter enters insolvency. The equity investors would be incentivized to invest despite the fact that the dealer bank's assets have turned bad. This confidence creating insolvency rule specifically tailored for the prevention of the triggering of the dealer bank failure mechanics would allow the dealer bank to refinance itself with equity so as to be able to compensate for the depreciation of its assets and thereby to prevent its derivatives counterparties from novating.

<u>Wholesale Funding: commercial paper and repurchase agreements</u>

> "*Commercial paper played a central role during the financial crisis of 2007-2009. […] Twice during the financial crisis of 2007-2009, the commercial paper market nearly dried up and ceased being perceived as a safe haven*".[8]

The current strategies and proposals of managing risk in the commercial paper and repo market are the following:

- a ban of the re-hypothecation for the purpose of financing the own-account activities of intermediaries purchasing the collateral in the first place;
- a permission to engage into re-hypothecation to entities subject to adequate regulation of liquidity risk;
- having repos that are backed by risky or illiquid collateral not exempt from the automatic stay in insolvency so as to incentivize pre-transaction screening;
- defining numerical floors on haircuts as well as haircut calculation methods.[9]

The permission of re-hypothecation of those entities adhering to certain liquidity requirements should be welcomed. However, both the ending of the exemption of repos from the automatic stay in insolvency and the defining of numerical floors on haircuts by reference to clearly spelt out residual maturity of collateral tables could be viewed critically: the *ending of the exemption of repos from automatic stay* will certainly ensure that repo sellers will screen the repo buyer more closely so as to more clearly anticipate the risk of non-transferal of the transferred collateral at a later stage; however, it will also desincentivize the use of repos since the transaction parties are degraded to normal, non-privileged creditors. A decreased use of repos will decrease the debt funds circulating in financial markets. The

[8] Taken from: Kacperczyk, M. & Schnabl, P., *When Safe Proved Risky: Commercial Paper during the Financial Crisis of 2007-2009*, 24 JEP, Number 1, 29-50, 29 & 48 (Winter 2010) ; for a background into the economics of repos, see: Hördahl, P. & King, M.: *Developments in repo markets during the financial turmoil*, BIS Quarterly Review, Dec 2008.

[9] See *FSB*, Strengthening Oversight and Regulation of Shadow Banking – Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos, Aug 29, 2013.

definition of numerical floors on haircuts by reference to the clearly spelt out residual maturity of collateral tables will incentivize parties to cumulate their transactions at the top of the respective bucket so as to be able to have a maximum length of maturity and a minimum haircut floor. Regulatory arbitrage may result from the schematic system.[10]

As alternative mechanisms may be considered the following: firstly, a sliding scale matching the liquidity matches with the degree to which the repo is privileged within insolvency would be more nuanced and avoid the drastic, intimidating and potentially debt finance draining result of the total negation of the exemption: the greater the liquidity, the more privileged the party should be in the insolvency process. A thorough design of a proposal breathing this idea will be elaborated by the dissertation. Secondly, the numerical floors on haircuts should be complemented by a general rule allowing the respective regulator to reallocate the respective party to a bucket with a higher haircut level if a sufficient amount of repo transactions is located at the top of the respective bucket so as to be able to profit from a maximum maturity of the collateral while only adhering to a minimum haircut floor and hence indicating regulatory arbitrage. The regulatory mechanisms should thus roughly be designed as follows: if the regulator finds a sufficiently large amount of repo transactions at the top of the residual maturity of collateral bucket while a negligible amount is located at the bottom or middle of it, the regulator is justified in assuming that the respective party seeks to profit from regulatory arbitrage and may hence assign the repo transaction to the next bucket demanding a higher haircut level. The clear outline of such a regulatory mechanism will be dealt with in the dissertation.

Structured finance

> "*The 2007-2008 financial crisis was a system wide bank run. What makes this bank run special is that it did not occur in the traditional-banking system, but instead took place in the "securitized-banking" system*".[11]

---

10 See supra fn. 10, p. 27 at the top.

11 Gorton, G. & Metrick, A., *Securitized banking and the run on repo*, JFE 104 (2012), 425-452, 425. For an overview of the economic mechanisms of securitization, see: Acharya, V., Schnabl, P. & Suarez, G.: *Securitization without risk transfer*, JFE 107 (2013), 515-536, Coval, J , Jurek, J & Stafford,

The risk retention or "skin in the game" requirements have already been implemented: in the EU which focuses on investors, CRD prohibits EU credit institutions from investing in ABS unless one originator retains at least 5% of the economic interest in the securitized notes; in the US which focuses on the sponsor, the latter is to retain an economic interest equal to at least 5 % of the credit risk associated with the assets that are collateralized.[12] The idea is to incentivize the originator to thoroughly screen the asset which is transferred by means of an equitable assignment to the SPV or SIV and hence to align the interests of the originator and the eventual noteholders. Furthermore, the enhancement of transparency and standardization of securitization products is proposed as a method seeking to reduce the opaqueness and complexity associated with such products.[13] The risk retention requirement is hence to ensure that the originator does not only transfer an asset hailed as highly income generating which turns out not to be so and should be welcomed. The increased transparency requirements, however, assume that potential noteholders will consume and understand the information which appears unlikely. As an alternative, retail noteholders should be forbidden from investing in the most risky tranche of notes issued by the SPV. The degree of sophistication of the noteholder as well as its degree of systemic importance should correlate to the riskiness of the note tranche that it is allowed to invest in: the less sophisticated or more systemically important the noteholder, the less it should be allowed to invest into high risk tranches. A regulatory rule with a likewise content has to be designed.

<u>OTC derivatives</u>

> "*In the wake of the recent financial crisis, over-the-counter (OTC) derivatives have been blamed for increasing systemic risk. Over-the-counter derivatives markets are said to be*

E., *The Economics of Structured Finance*, 23 JEP, Number 1, 3-26 (Winter 2009); for the basic foundations and new developments in the ABS market, see: *Zeising, M.*: Asset Backed Securities (ABS) – Grundlagen und neuere Entwicklungen ("Asset Backed Securities (ABS) – Foundations and recent developments"), in: BKR 2007, 311-323.

12 See *OICU-IOSCO*, Global Developments in Securitization Regulation, Consultation Report, June 2012

13 *FSB*, Consultative Document – Strengthening Oversight and Regulation of Shadow Banking – An Integrated Overview of Policy Recommendations, Nov 18, 2012.

complex, opaque, and prone to abuse by market participants who would take irresponsibly large amounts of risk".[14]

The current strategies and proposals of managing risks emanating from OTC derivatives in the form of the counterparty credit risk have three directions: *one*, to incentivize uncleared derivatives parties to clear so as to mitigate risk through a well collateralized central counterparty ("CCP"); *two*, to require more robust collateralization of uncleared derivatives contracts[15]; *three*, to repeal the insolvency privileges of OTC counterparties allowing them to jump ahead of the bankruptcy repayment line in front of other creditors so as to incentivize them to thoroughly screen their contractual party so as not to suffer an unexpected liquidity shock if the latter defaults.[16] The entry requirements of CCPs may exclude parties that would suffer a liquidity shock culminating in the realization of systemic risk if their counterparty defaults outside the CCP structure. If this default causes the realization of systemic risk outside the CCP but would not endanger the viability of the CCP if the default took place within the CCP structure, then the entry requirements would prove too rigid. The simple postulation of a requirement of robust collateralization may reduce the likelihood of liquidity shocks. However, it will also drain away liquidity from the market if the collateralization is not risk-adjusted since the collateral could be used by the respective party to refinance itself by means of repos. As far as the proposal to repeal the insolvency privilege of OTC counterparties is concerned, it first of all has to be admitted that it will incentivize OTC counterparties to screen their contractual partners well. If they screen thoroughly, they will not enter into a derivative transaction with a non-credit worthy partner and hence will not see themselves exposed to an unexpected liquidity shock when this party defaults. Alternatively, they will enter into the

14 *Duffie, D., Li, A. & Lubke, T.*, Federal Reserve Bank of New York Staff Reports – Policy Perspectives on OTC Derivatives Market Infrastructure – Staff Report no. 424, Jan. 2010, Revised Mar. 2010; for a general overview over the German and American regulatory status quo, see: *Lehmann, M.*: Reform der Derivatemärkte – transatlantischer Kampf um Wettbewerbsfähigkeit ("Derivative markets – transatlantic struggle for competitiveness"), in: Recht der Finanzinstrumente, 5.2011, 300-309.

15 See supra fn. 19.

16 See Roe, M., *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, Stan. L. Rev. 539.

transaction but take preparations for a potential default so as to be able to cope with an eventual default and not to suffer an unexpected liquidity shock which otherwise might force them to engage in fire-sales that would harm market participants with similar balance sheets and hence spread across the financial market rather swiftly. However, the abolition of the insolvency privileges for OTC counterparties may also result in many market participants seeking a counterparty failing to do so and hence to remain unhedged. Unhedged risk, however, endangers the market, especially so if the party failing to find a counterparty is itself of systemic importance. Three strategies should be pursued: incentivizing uncleared derivative parties to clear (**1.**), requiring the robust collaterlisation of those who refuse to clear (**2.**) and payment priorities (**3.**).

i. Incentivizing uncleared derivatives parties to clear

Both incentivizing uncleared derivative parties to clear and to require robust collateralization of uncleared derivative contracts has its justification: clearing results in the mutualization of realized counterparty credit risk through collateral accumulated in the CCP and hence avoids liquidity shocks suffered by an unpaid counterparty.[17] What is not yet fully appreciated is (i) the question of how to deal with CCPs who become systemically important themselves and (ii) the question of how to calibrate the CCP entry requirement. As far as (i) is concerned, it seems recommendable to establish a size limit to CCPs. Several smaller CCPs appear preferable over few big ones: if a small CCP fails, negative externalities may be restricted. This cannot be said in the case of the failure of a large CCP. Hence, regulation as to the splitting of CCPs is needed. As far as (ii) is concerned, proposals do not yet sufficiently appreciate that too high entry requirements may exclude counterparties that will fail and thereby cause the realization of systemic risk while too low entry requirements may endanger the CCP construct as a whole if the credit risk imported into the structure is sufficiently large. What is needed is a flexible CCP entry gate that allows the entry of counterparties that – in case of the refusal of entry – would be exposed to an eventually failing counterparty and

---

[17] For the alternative resolution approach which appears to operate at a much too late stage and is hence not touched upon, see: Squire, R., *Clearinghouses and the Rapid Resolution of Bankrupt Financial Firms*, forthcoming in: Cornell Law Review.

suffer a liquidity shock that would lead to the realization of systemic risk while not endangering the CCP's financial well-being if it is allowed entry.

a) REQUIRING ROBUST COLLATERALIZATION OF UNCLEARED DERIVATIVES CONTRACTS

The robust collateralization is supposed to ensure that the counterparty in the money does not suffer a liquidity shock if the other party defaults. At the same time, however, the posting of collateral drains liquidity from financial markets since it could be used for repo financing. Hence, only requiring robust collateralization is counter-productive. What is needed is a risk-adjusted requirement of collateral posting.

(1) Designing payment priorities

Leaving the payment priorities as they currently are will only incentivize counterparties not to screen the credit worthiness of their derivative partners and hence being exposed to liquidity shocks, at least to reallocate the economic loss resulting from insufficient screening from themselves to the non-privileged creditors of the defaulting party. This dis-incentivizes creditors to extend credit to a debtor who has entered into numerous and voluminous derivative transactions upon which it is likely to be out of the money. Fully repealing the payment priorities, by contrast, may result in less risk hedging endangering financial stability. A regulatory alternative is the granting of priorities for counterparties that prove that they have screened. What they have to screen, how they have to do it and how they may prove what they did are questions that have to be answered when designing such a regulatory intermediary mechanism that neither leaves the payment priorities as they are, nor fully repeals them but grants them to those who deserve them since they undertook an effort to reduce systemic risk by screening their counterparty.

Money Market Funds

> "*Given the continuing role of MMFs in financial markets, and the inadequacy of the 2010 reforms, additional steps are needed to address the systemic risk posed by MMFs*".[18]

Money market funds are prone to bank-like runs: the investors are equity holders of the fund which invests into certain assets. Should the assets decrease in value, the shares do so as well. Hence, the rumor of decreasing asset values will incentivize money market fund shareholders to run.

The current proposals involve regulating the composition of the fund portfolios so as to avoid assets deteriorating to a degree that incentivizes runs; installing capital buffers signaling to fund equity holders that they will be paid no matter the value of the fund's assets and that they thus have no reason to run; creating gates or redemption fees; mandating floating instead of constant net asset value ("NAV") and requiring a form of minimum balance at risk ("MRB").[19]

A floating NAV, i.e. one that does not adhere to the so-called penny rounding rule, will not be able to avoid bank-like runs: the chief driver of MMF run risk is the response of safety-seeking MMF users in circumstances that threaten full payment of principal, not the desire to capture the small permitted spread between one dollar and 99,5 cent of the actual NAV. Furthermore gates and redemption fees are likely to exacerbate the run risks of MMFs by injecting a new source of uncertainty and instability.[20] The requirement of a floating NAV should only be accompanied with liquidity and capital requirements: MMFs act fully like banks but for the legal difference that the capital they receive is by way of equity rather than a loan and but for the economic difference that their "deposits" may decrease

---

18 Greene, E. & Broomfields, E., *Promoting risk mitigation, not migration: a comparative analysis of the shadow banking reforms by the FSB, USA and EU*, 8 CMLJ, Number 1, 6-53, 49.

19 Summarized at: Greene, E. & Broomfields, E., *Promoting risk mitigation, not migration: a comparative analysis of the shadow banking reforms by the FSB, USA and EU*, 8 CMLJ, Number 1.

20 Both criticisms can be found in Jeffrey Gordon's letter to the SEC of 17 November 2013 as well as the article *Gordon, J./Gandia, C.*: Money Market Funds Run Risk: Will Floating Net Asset Value Fix the Problem?, in: Columbia Law School Draft 3.0, Aug 2013.

in value once the buck is broken. The core question will be whether a system comparable to Basel III can be adopted and if so how it is to be designed.

ii. <u>The regulation of the shadow banking sector as a whole</u>

> "*Shadow banking operations tend to evolve quickly to meet new market conditions, compounding the difficulties of tracking their development through data collection or supervisory monitoring efforts that are based on stable definitions and concepts*".[21]

What appears more disturbing than the technical weaknesses of the regulation of the individual shadow banking sector components, however, is the implicit assumption of the absence of market volatility in most of the concepts presented: OTC derivatives, ABS, MMFs, ABCP and Repos are examined individually and regulatory approaches are presented in respect of each of them. The regulatory answers to the crisis are hence monolithically designed for the existent components and do not anticipate changes, thus leaving the regulator in a defensive position in which it may fail to adapt quickly to new market changes in order to be able to tame new sources of financial risk so as to prevent negative externalities.[22] What is needed is the design of a mechanism capable of coping with the development of new, i.e. yet unregulated shadow banking components that arise from volatile markets and bring about new kinds of risk to financial stability: the monolithic regulatory strategies are confronted with volatile market mechanisms. The case-by-case approach of regulation will leave the regulator in a reactionary and hence defensive position, unable to adapt to new sources of systemic risk in a timely manner so as to avoid its realization in the form of a new financial crisis. [23] At least three regulatory strategies seeking to address the problem

---

[21] *FSB*, Shadow Banking: Scoping the Issues – A Background Note of the Financial Stability Board, April 12, 2011.

[22] For a flavour of the monolithic approach, see some of the component tailored FSB proposals: Strengthening Oversight and Regulation of Shadow Banking – Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos, 29 August 2013; Consultative Document – Strengthening Oversight and Regulation of Shadow Banking – An Integrated Overview of Policy Recommendations, Nov 18 2012; acknowledging the danger of shadow banking system volatility but not drawing any conclusions herefrom: *FSB*, Shadow Banking: Scoping the Issues – A Background Note of the Financial Stability Board, 12 April 2011.

[23] Emphasizing the need for a flexible regulatory approach but not drawing any specific policy conclusions therefrom: supra fn. 23.

of market volatility in the field of shadow banking are conceivable and shall only be briefly sketched so as to provide further gr1ounds for discussion: a numerus clausus (**I.**), a general anti-abuse rule (**II.**) and an abstract-functional rule (**III.**).

a) NUMERUS CLAUSUS

The *modelling* of a numerus clausus of the already existent shadow banking phenomena requires a thorough analysis of the features of the latter given that they will have to be precisely described in order to be able to effectively enforce the ban of new ones so as to relieve the regulator from hastily having to identify and react to them and so as to ensure that there is no unregulated phenomenon. The *discussion* of this strategy should focus on the need of financial markets for adaptability to new financing needs of the real economy on the one side and the social need for the limitation of systemic risk on the other.

b) A GENERAL ANTI-ABUSE RULE

The strategy of the general anti-abuse rule would – as the numerus clausus approach – leave the selective shadow banking legislations unaltered and supplement them by a rule according to which the creation of new financial phenomena which the reasonable man would reasonably understand to have the goal of circumventing the existent rules is forbidden, hence allowing only those new phenomena that result from the legitimate market interest of new financing models and banning the ones that are only inspired by arbitrage interests. The precise *modelling* will have to draw from the making of anti-abuse rules in other fields of the law, most notably the UK GAAR[24], and to debate the extent and modalities of their transferability to shadow banking regulation. Its *discussion* should focus on the potential reproach of new non-arbitrage based phenomena remaining unregulated.

c) AN ABSTRACT-FUNCTIONAL RULE

This strategy seeks to replace the existent selective legislation by a rule that is functional, i.e. focusing on the transformation processes of shadow banks, and

---

24 On the functioning of the UK GAAR: *Lee* Revenue Law, Principles and Practice, 3.75-3.81; *Loutzenhiser*, Revenue Law: Introduction to UK Tax Law, pp. 98, 105-106, 119, 122, 125, 127.

abstract so as to be able to catch new, currently unknown shadow banking forms that exhibit the same risk potential as the currently existent ones. Its *modelling* will seek to distil from the current phenomena a functional lowest common denominator that may be able to catch new ones and it will focus on the adequate risk reducing rules that a caught phenomenon should be subject to. Its *discussion* should seek to answer the question whether the currently existent phenomena are a suitable pool for distilling such a denominator or whether new phenomena may be of such a fundamentally different nature that even this kind of an abstract-functional rule would fail to catch them.

Conclusion

As a response to the latest financial crisis, legislators around the world have implemented rules to address the risks associated with the phenomenon of shadow banking whose largely unregulated status quo ante is perceived to have been at the origin of the crisis.[25] These rules selectively deal with OTC derivatives, ABS, repos, commercial paper and MMFs instead of creating a cohesive regulatory framework capable of dealing with new shadow banking phenomena that may come into existence in the future as a result of new needs of financial markets and that would – once they exist – due to the selective and piece-meal character of the current regulatory approach remain unregulated until the regulator becomes aware of them and implements a further selective response.[26] It is this time between volatile financial markets giving birth to a new shadow banking phenomenon and the implementation of a regulatory response which creates the danger of the realization of – potentially systemic – risk and which the current selective approach is incapable of addressing. A coherent framework could be accomplished by

---

25 An overview of the shadow banking reforms can be found at Greene, E. & Broomfields, E.: *Promoting risk mitigation, not migration: a comparative analysis of the shadow banking reforms by the FSB, USA and EU*, 8 CMLJ, Number 1, pp. 6 et seq.

26 This purely selective approach can best be exemplified by reference to European Union law: Regulation (EU) No 648/2012 on OTC *derivatives*; Regulation 2015/2365 on transparency of securities financing transactions and of reuse (i.e. *repos*); Proposal for a Regulation laying down common rules on securitization and creating a Eureopan framework for simple transparent and standardized securitisation; Proposal for a Regulation on *Money Market Funds*.

supplementing the currently existent selective approach by a numerus clauses, a general anti abuse rule or an abstract-functional rule.

PHASES AND DIMENSIONS OF NON-PERFORMING ASSETS IN INDIAN BANKING SYSTEM: LEGAL RESPONSE

-NEHA SHARMA*

The linchpin of any country's economy is its banking system. For an economic system to sustain, it is of utmost significance that the growth of the banking system is fast and at the same time, stable. The banking system of India, on the other hand, has been rendered to a lot of susceptibilities in the recent years owing to the globalised economic environment. One of the prime issues pertaining to the stability of the Indian banking system is the Non-Performing Assets (NPAs). A loan is characterized as a Non-Performing Asset if the borrower does not repay its principal along with interest payments for 90 days. It tends to block capital, thus reducing the earning capacity of the assets. As a consequence of such reduction, return on assets tends to get affected.

Non-Performing Assets: An Introduction

An asset, including a leased asset, becomes a non-performing asset when it ceases to generate income for the bank[1], i.e. Non-Performing Asset is any asset of a financial institution that does not produce any income. Investopedia defines it as "a debt obligation where the borrower has not paid any previously agreed upon interest and principal repayments to the designated lender for an extended period of time. The non-performing asset is therefore not yielding any income to the lender in the form of principal and interest payments."[2] The loan would be called a Non-Performing Asset if the borrower does not repay its stated principal along with interest payments for 90 days. Section 2(1)(o)(a) of the The Securitisation and

* IV Year, BA.LLB. (Hons), Rajiv Gandhi National University of Law, Punjab.

[1] *Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances*, Circular Number DBOD No. BP.BC/ 20 /21.04.048 /2001-2002 dated August 30, 2001, RESERVE BANK OF INDIA, (Mar. 7, 2016), http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?Id=449&Mode=0 9 (last updated Mar 7, 2016).

[2] *Non-Performing Asset*, INVESTOPEDIA, http://www.investopedia.com/terms/n/nonperformingasset.asp (last updated Feb 14, 2016).

Reconstruction of Financial Assets And Enforcement of Security Interest Act, 2002, describes Non-Performing Asset as:

"an asset or account of a borrower, which has been classified by a bank or financial institution as sub-standard, doubtful or loss asset-

(a) in case such bank or financial institution is administered or regulated by any authority or body established, constituted or appointed by any law for the time being in force, in accordance with the directions or guidelines relating to assets classifications issued by such authority or body;

(b) in any other case, in accordance with the directions or guidelines relating to assets classifications issued by the Reserve Bank"

The earnings of the banks lay in the amount that they earn from the difference between the interest they receive from borrowers and the interest they pay to the savers. The balance sheet of a bank lists loans given to its customers as assets but in fact Non-Performing Assets are a huge liability for the banks as their profit and income remains at risk which worsens even the situation for the payment of interest to the savers and causes the economic value of the loan assets to fall as well.

The loans given to the customers do not turn out to be bad debts at once. A customer in the case of most of the loans is provided a certain duration known as grace period, after which the debts are identified to be delinquent. Further, after a definite number of days, the concerned loan is categorized as a Non-Performing Loan. The number of days may range between 90 days to 180 days. The standard practice by banks is to categorize a commercial loan that is overdue for more than 90 days and a consumer loan which is overdue from more than 180 days as an NPA.[3]

---

[3] *Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances*, Circular Number DBOD.No.BP.BC.9/21.04.048/2012-13, RESERVE BANK OF INDIA, http://rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=7357 (last updated July 2, 2012).

For an agricultural loan to be declared as a non-performing asset, the criterion is that the amount of interest and/or installment or the principal amount should remain overdue for two harvest seasons. But, the stipulated period should not be more than two years and any unpaid loan will be considered as non-performing asset after two years.[4]

Classification of Non-Performing Assets

Till mid of 1980s, management of non-performing assets was the responsibility of the auditors and the banks. The first framework of classification of assets for the Indian banking system was set up on the recommendations of A. Ghosh Committee on Final Accounts in 1985[5]. This system was known as the 'Health Code System' (HCS) and it included classification of bank advances into eight categories ranging from 1 (satisfactory) to 8 (bad and doubtful debt).[6] In 1991, the Narasimhan Committee on the financial system said that the classification of assets according to the HCS was not in accord with global standards and suggested that for the purpose of stipulation, banks should classify their loans into the following four broad groups[7]:

I. Standard Assets: The assets which do not reveal any trouble and do not carry more than normal risk connected to the business are known as Standard Assets. These assets are considered to be performing assets.
II. A sub-standard asset is an asset that has been a non-performing asset for a duration less than or equal to 1 year. Another occasion where an asset class or a loan account of the bank is classified as a sub-standard asset is when the terms and conditions concerning to the loan account are revised

[4] *Ibid.*

[5] Non-Performing Assets of Indian Banks, ACADEMIA.EDU, https://www.academia.edu/4497122/Non_Performing_Assets_ofanks (last updated Feb 15, 2016).

[6] Two decades of Credit Management in Indian Banks: looking back and moving ahead; address by Dr. K. C. Chakraborty, Deputy Governor, RBI at BANCON, (Mar. 1, 2016).

[7] Evolution of Banking in India: First Phase of Reforms, RESERVE BANK OF INDIA, http://rbi.org.in/scripts/publicationsview.aspx?id=10487 (last updated Mar 7, 2016).

or re-negotiated. And counting on the acceptable functioning basis of the reviewed terms, the account has to be assorted within the sub-standard asset class for at least 12 months. Therefore, mere alteration of terms of the account with no proper conformity does not result in the upgradation of the asset category.

III. An asset would fall under the category of doubtful asset if it has continued to remain in the category of sub-standard asset for a period of twelve months. A loan categorized as doubtful has all the inherent disadvantages as were in the assets classified as sub-standard, with an additional feature that the limitations make liquidation or collection in full- on the basis of presently known facts, circumstances and values- highly questionable and implausible.[8]

IV. A non-performing asset is considered to be a loss asset when the loss is recognized by the bank or internal or external auditors or the RBI inspection but the amount in question has not been written off entirely.[9] To put it simply, such an asset is considered uncollectible and of such inconsequential value that its continuance as a bankable asset is not reasonable although there may be some reclaim or recovery value.

However, the Non-Performing Assets, according to a RBI circular[10], requires banks to categorize them into sub-standard asset, doubtful asset and loss asset, on the basis of the duration that has elapsed since the time of such assets being declared as non-performing assets.[11]Following the analogy, prudential norms relating to income acknowledgment, asset categorization and provisioning were

---

[8]*Ibid.*

[9] M/S Holystar Natural Resources Pvt. Ltd. & Anr. v. Union Of India & Anr., AIR 2014 Delhi 60.

[10] *Master Circular- Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances,* Circular Number DBOD.No.BP.BC.9/21.04.048/2014-15 dated July 1, 2014, RESERVE BANK OF INDIA,http://rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=8128#412 (last updated July 1, 2014).

[11] Master Circular- Income Recognition, Asset Classification, Provisioning & Other Related Matters, Circular Number UBD.PCB.MC.No.3/09.14.000/2010-11, RESERVE BANK OF INDIA, http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=5761 (last updated Feb 15,2016).

introduced in 1992 in a phased way. In 1998, the Narasimham Committee on Banking Sector Reforms recommended a further contraction of prudential standards in order to strengthen the current norms and bring them on par with evolving India.[12] With the introduction of 90-days norms for classification of NPAs in 2001, the NPA guidelines were brought as par with international standards.[13]

Importance of the Issue of Non-Performing Assets

The greater the amount of non-performing assets, the weaker will be the bank's revenue system in the economy. Most of the banks are capable to manage an increase in non-performing assets in the short run due to huge reserves or capital in various forms that can be employed to countervail the losses. But after the reserved capital has been exhausted, non-performing loans will begin to jeopardize a bank's growth.[14] Net NPAs (% to Net Advances) which were 1.0% in 2007-08, increased to 1.7% in 2012-13.[15] On examining the percent of Gross NPAs to Gross Advances for the Scheduled Commercial Banks as a whole, NPAs have increased from the level of 2.95% in 2012 to 4.27% in 2015.[16]

It is important to look into the issue of NPA as it results in harmful impacts on the return on assets. The interest income of banks will fall as it is accounted only on receipt basis. The profitability of banks will be adversely affected because of the provision of doubtful debts and consequent write off as bad debts. Further,

---

[12] Pandey, Shruti J. and others, *Non-Performing Assets of Indian Banks– Phases and Dimensions*, 48 Economic and Political Weekly (EPW), No.24, (Mar 5, 2016), http://www.epw.in/system/files/pdf/2013_48/24/NonPerforming_Assets_of_Indian_Banks.pdf.

[13] K.C. Chakrabarty, *Two decades of credit management in banks: Looking back and moving ahead,* BANCON (2013).

[14] Khaoula Hosni, *Early Warning Indicators for Systemic Banking Crises*, 5 JBSQ, Number 4, 2 (2014).

[15] Suresh Kumar, *Non-Performing Assets: An Indian Perspective*, 3 IJ-AREMS, No. 2, (2014).

[16] Standing Committee On Finance (2015-16), Ministry of Finance, http://164.100.47.134/lsscommittee/Finance/16_Finance_27.pdf [Hereinafter as 'standing committee'].

the Return on Investment (ROI) will reduce and the cost of capital or interest on loan will go up.

The non-performing assets affect the economic system so as to make it unstable and thus hamper its growth. A rise in the non-performing assets of the banks will lead to a scarcity of finances in the Indian security markets. Also, if the banks are not assured of the recovery of their lent money, only a few banks will then be willing to lend.

The impact of the non-performing assets will ultimately lead to a huge amount of losses to the shareholders of the banks as banks themselves will find it difficult to last in the market. This will further result in a crisis of confidence and assurance in the market. The value of loans, i.e. the interest rates on the provided loans will increase drastically. A rise in the interest rates will directly affect the investors who wish to take loans for setting up various projects like infrastructural, industrial projects etc.

The common man will equally be affected as now, the retail consumers will have to dispense a larger interest rate for a loan like home loan, car loan etc. All of this will lead to a chain of low take off of funds from the security market which will impair the overall demand in the Indian economy. And, eventually it will result in lower growth rates and higher inflation rate on account of the higher capital cost.

Factors responsible for rising NPAs in the country

In 2012-13 financial year, the worsening quality of asset in the banking sector came out as a key concern, with total NPAs of banks recording a sharp rise. The unrecovered loans were at 4.4 per cent in March 2014 for public sector banks while it stood at 2.09 per cent in 2008-09, i.e. the gross NPA increased by almost four times from March 2010 to March 2014.[17] The Reserve Bank of India, in response

[17] "Economic Survey 2014: Growth of non-performing assets a cause for concern", THE ECONOMIC TIMES, http://articles.economictimes.indiatimes.com/2014-07-09/news/51247902_1_npas-psbs-asset-quality (last updated Feb 14, 2016). [hereinafter 'Economic Survey'].

to an RTI filed by The Indian Express, disclosed that 29 public sector banks wrote off as much as Rs. 1.14 lakh crore of bad debt in the past two years (2013-2015).[18]

Increase in non-performing assets of banks is chiefly accounted for by switching to system-based recognition of NPAs by public sector banks, deceleration of economic growth, and excessive lending of credit by banks in the past, especially during times of economic boom. Thus NPAs or bad loans of the banks, including private sector lenders, increased from 2.36 per cent to 3.90 per cent in March 2014. Increase was sharp in case of infrastructure with NPAs rising from 3.23 per cent to 8.22 per cent.[19]

It is considered that the slowing down of the economic growth shoots up the rate of interest sharply and thus the corporate sector finds it difficult to pay back loans, which leads to the addition to the increasing non-performing assets. However, the rise in the count of the non-performing assets cannot be attributed entirely to the reversal of economic cycles. There are many other reasons for this which can be sub-categorized into external problems and internal problems that are being faced by the banks.

iii. External Factors

d) REASONS ASSOCIATED WITH THE CORPORATE SECTOR

I. The slowdown has not only been observed in the Indian economy but also on the global platform. This has unfavorably struck the corporate sector in India. The continuity of uncertainty in the global markets has resulted in the decline of exports of various products such as engineering goods (exports declined 9.36 per cent to $5.03 billion in

18 *Net bad assets of govt banks a third of their net worth*, THE INDIAN EXPRESS, http://indianexpress.com/article/india/india-news-india/bad-debt-loan-financila-crisis-rbi-net-bad-assets-of-govt-banks-a-third-of-their-net-worth/ (last updated Apr. 12, 2016).

19 *Ibid.*

October 2014[20]), gems (2014 witnessed 3 percent fall[21]), petroleum products (October 2014 witnessed 0.16 percent fall[22]) etc. Hence the adversely affected corporate sector is finding it tough to repay the loans advanced to them by the banks.

II. Various other factors such as the ban on mining undertakings[23] and delay in the permits related to the environment affecting iron and steel sector[24] etc. have had a great impact on the performance of the corporate sector which has further lessened their capability to pay back the loans lent to them.

e) REASONS ASSOCIATED WITH THE PRIORITY SECTOR

The banks in India are extremely regulated. One of the regulations upon the banks is the Priority Sector Lending (PSL) which necessitates the banks to give a fixed percent of their loans to certain sections of the society. These includes farmers, Scheduled Castes (SCs), Scheduled Tribes (STs), IT parks, Micro, Small and Medium Enterprises (MSMEs) etc.[25]

Naturally one would presume that the weaker sections which fall under priority sector lending are the ones to be held responsible for such a situation. However,

---

20 *Engineering exports to China decline by 9.36% in October*, THE HINDU, (Mar. 3, 2016), http://www.thehindu.com/news/national/engineering-exports-decline-by-936-per-cent/article6670953.ece (last updated Mar 3, 2016).

21 Dilip Kumar Jha, *Gems, jewellery export to decline this season, Business Standard*, (Mar 3, 2016), http://www.business-standard.com/article/markets/geery-export-to-decline-this-season-114120900860_1.html (last updated Mar 3, 2016).

22 *After sluggish 2014, India awaits 'promising' 2015 for exports,* INDIAN TRADE PORTAL, http://www.indiantradeportal.in/vs.jsp?lang=0&id=0,10,577 (last updated Mar 4, 2016).

23 Krishna N Das and Jatindra Dash, *Supreme Court orders temporary closure of some Odisha iron ore mines*, REUTERS, New Delhi/Bhubaneswar, http://in.reuters.com/article/2014/05/16/uk-india-iron-mining-idINKBN0DW0HU20140516 (last updated May 16, 2014).

24 Amit Bhandari, Huge, Growing Crisis in Public-Sector Banks, INDIA SPEND, http://www.indiaspend.com/cover-story/huge-growing-crisis-in-public-sector-banks-39870 (last updated Feb 17, 2015).

25 *Priority Sector Lending – Targets and Classification*, Circular Number RPCD.CO.Plan.BC 13/04.09.01/2012-13 RESERVE BANK OF INDIA, http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=7460&Mode=0 (last updated July 20, 2012).

such presupposition is not true. As per the news reports, the Standing Committee on Finance[26] will examine the causes for high non-performing assets in Public Sector Banks (PSBs). The record, shared with the Standing Committee, reflects that non-performing assets in the corporate sector are far higher in number than those in the priority sector. On the other hand, within the priority sector, rise in the non-performing assets were more in respect to micro, small and medium enterprises followed by agriculture. However, the priority lending sector has added considerably to the non-performing assets.

Furthermore, the lethargic legal system in India and lack of efficient and continuous efforts by the banks makes it more difficult to recover these loans from corporate sector as well as non-corporate sector.

iv. <u>Internal Factors</u>

I. There is lack of a system which is rigorous in nature at state-owned banks which weakens the loan appraisal systems and monitoring of warning signals at the required time. This specifically holds true in the case of infrastructural projects, which continue for a time span of 20 to 30 years, out of which many are struggling to pay back the loans. The Gross NPAs and restructured standard advances[27] for the infrastructure sector, together as a percentage of total advances to the sector, has increased considerably from 4.66% as at the end of March 2009 to 17.43% as at the end of March 2013.[28]

II. The poor and inefficient means of recovery used by the banks in recovering loans are also an impediment in the stability of the banking

---

[26] *Banking System in India – Non Performing Assets*, INSIGHTS, http://www.insightsonindia.com/2014/07/05/banking-system-india-non-performing-assets/ (last updated Feb 14, 2016).

[27] When a project loan classified as 'standard asset' is restructured within a period of two years from the original date of commencement of commercial operations, then the loan is known as restructured standard advances.

[28] K.C. Chakrabarty, *Infrastructure Financing By Banks In India: Myths and Realities*, RESERVE BANK OF INDIA, http://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=831 (last updated Mar 8, 2016).

> sector in the country. The wait and watch method used by the banks have often been blamed as the cause for the rising non-performing assets as banks let the deteriorating assets to go from bad to worse in the expectation of revival and sometimes offers restructuring option to the corporates.[29]

A Parliamentary panel on examining the rising incidents of non-performing assets has remarked that the state-owned banks should stop "ever-greening[30]" or repeated restructuring of corporate debt to check the continuous bulging of their non-performing assets. The members of the panel were of the opinion that non-performing assets are the outcome of terrible economic situation, but there are also organizational issues of ever-greening of loans, which could be averted by "not renewing loans, particularly of corporate".

Legal Mechanism

The simplest measure to decrease the count of non-performing assets is to recover the bad loans.Viewing the financial reforms being undertaken by the Government of India on the basis of the Narasimham Committee report I and II, prudential norms were brought in by Reserve Bank of India to address the credit monitoring process being adopted and followed by the banks and financial institutions.[31] To further strengthen the recovery of dues by banks and financial institutions, Government of India promulgated The Recovery of Debts Due to Banks and Financial Institutions Act, 1993 and The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002:

---

[29] *Ibid.*
[30] *Ibid.*
[31] T.R.Radhakrishnan, *Non-Performing Assets or NPA - An Overview*, ALL BANKING SOLUTIONS, http://www.allbankingsolutions.com/Banking-Tutor/NPA-overview.htm (last updated Mar 6, 2016).

The Recovery of Debts Due to Banks and Financial Institutions Act, 1993:

The Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDB Act) came into force more than two decades before. The motivation behind the enactment of the Act is held in the report of the Tiwari Committee: "The civil courts are burdened with diverse types of cases. Recovery of dues due to banks and financial institutions is not given any priority by the civil courts. The banks and financial institutions like any other litigants have to go through a process of pursuing the cases for recovery through civil courts for unduly long periods."[32]

The Tiwari Committee recommended three ways to recover outstanding dues; most important among them was to establish quasi-judicial bodies to address only those issues which involve the recovery procedure of the fiscal sector. The chairman of the financial system Committee, Shri Narasimham supported and advanced in the report submitted to the Ministry of Finance in November 1991, the opinions of the Tiwari Committee for the institution of particular statute law and special tribunals to hasten the recovery process in the concerned domain.[33]

v. Development of the RDB Act

The development of the RDB Act resulted from some of the concerns like under section 537 of the Companies Act, 1956, there was a demand for the leave of the Company court prior to an order of winding up or previous to the appointment of an interim liquidator under section 446 of the stated Act and whether the orders for the stay of proceedings can be passed by the Company court preceding such an order by the Debt Recovery Tribunal constituted under the Act. Further, the stance of the non-obstante clauses within the concerned Act and the Companies Act as well. The jurisdiction of the Recovery and the Tribunal Officer was equally

---

[32] Sabjeet Singh Jabbal, *Recovery of dues by banks*, LEGAL INDIA, http://www.legalindia.in/recovery-of-dues-by-banks/ (last updated Mar 5, 2016).

[33] Meenakshi Rajeev & H P Mahesh, *Banking Sector Reforms and NPA: A study of Indian Commercial Banks,* THE INSTITUTE FOR SOCIAL AND ECONOMIC CHANGE, (Mar 5, 2016), http://www.isec.ac.in/WP%20252%20-%20Meenakshi%20Rajeev%20and%20H%20P%20Mahesh.pdf

a disputable matter. It became imperative to determine the status of the secured creditor who is not involved in the provisions relating to the winding up in the Companies Act and the determination of the constitutional legality of the concerned Act.

vi. <u>Need for the leave of the Company court for shifting of cases</u>

The first case wherein the clauses of the superseding implication of the Act were observed was, *Industrial Credit & Investment Corporation of India Ltd* v. *Srinivasa Agencies*[34]. This case considered the question whether the Company court be allowed to grant leave to carry on legal proceedings in any other civil court.

Section 18 of the RDB Act has debarred the jurisdiction of any other court, with an exception of the writ power that has been accorded to the superior courts, with respect to the subjects mentioned under section 17, which relate to the recovery of due debts to the concerned institutions. The Hon'ble Court opined that the method to be followed up by the Company court need not to be confined by defining its limits. The Company court should be given complete discretion to decide according the varying facts and conditions of individual case. However, when such authority is being exercised by the Company court, it is pertinent that the court observes the underlying principle that resulted in the passage of the Act.

vii. <u>The stance of the non-obstante clauses within the concerned Act and the Companies Act as well</u>

The non obstante clause contained in the RDB Act and the non obstante clauses of the Companies Act, 1956 are conflicting in nature. On one hand, the RDB Act provides Tribunal with the jurisdiction, powers and authority to entertain and decide applications from the banks and financial institutions for recovery of debts due to such banks and financial institutions[35] and bars the jurisdiction of other

[34] Industrial Credit & Investment Corporation of India Ltd v. Srinivasa Agencies (1996) 86 Comp Case 255 (SC)
[35] RDB Act, §17 (1993).

courts except HC and SC[36] while on the other hand, the Companies Act bestows the jurisdiction on the Court which is winding up the company to entertain, or dispose of the matters by or against the company[37].

This conflict was, first, observed in *Industrial Credit and Investment Corporation of India Ltd.* v. *Vanjinad Leathers*[38]. In this case, the court reckoned that section 18 of the Act prevents the other courts and authorities except the High Courts and Supreme Court from exercising jurisdiction. Further the court opined that the concerned Act as well as the Companies Act are special legislations. Nevertheless, as the RDB Act came into force after the Companies Act, 1956 was enacted, it will not be wrong to say that the law makers would have had the provisions of the latter Act into consideration while drafting the former Act. Thus the latter legislation will override the former one due to the fact that the RDB Act reflects, to some extent, the same principles as by the Companies Act.

The various courts have been considering the consequence of a special act ordained following another special or for that matter a general act. The Supreme Court in *Life Insurance Corporation of India* v. *DJ Bahadur & Ors.*[39] adjudged that the

---

[36] Section 18- On and from the appointed day, no court or other authority shall have, or be entitled to exercise, any jurisdiction, powers or authority (except the Supreme Court, and a High Court exercising jurisdiction under articles 226 and 227 of the Constitution) in relation to the matters specified in section 17.

[37] Section 446- The Court which is winding up the company shall, notwithstanding anything contained in any other law for the time being, in force, have jurisdiction to entertain, or dispose of-

(a) any suit or proceeding by or against the company;

(b) any claim made by or against the company (including claims by or against any of its branches in India);

(c) any application made under section 391 by or in respect of the company;

(d) any question of priorities or any other question whatsoever, whether of law or fact, which may relate to or arise in course of the winding up of the company;

whether such suit or proceeding has been instituted or is instituted, or such claim or question has arisen or arises or such application has been made or is made before or after the order for the winding up of the company, or before or after the commencement of the Companies (Amendment) Act, 1960 .]

[38] Industrial Credit and Investment Corporation of India Ltd. v. Vanjinad Leathers AIR 1997 Kerala 273.

[39] Life Insurance Corporation of India v. DJ Bahadur & Ors (1981) 1 SCC 315.

legislators exercise the undisputed authority that they possess to alter a legislation which has already been proclaimed with the help of a succeeding law. In order to modify, abolish or repeal the special law enacted earlier by a general law, an express provision has to be provided in that regard. Furthermore, it was stated that for a general law to supersede a previously enacted special law an express provision in that respect has to be provided, if the two laws are so repugnant to each other that their co-existence cannot be affected. Therefore, a former special law can remain completely untouched by the enactment of a latter law only when no explicit provision is *contra* to the provisions of the earlier act.

In the case of a contradiction between two laws the common rule to be abided by is that the statute which has been passed later abrogates the earlier passed act ('*leges posterior espriores contrarias abrogant*') and the well-established exception that has been observed is that a general statute does not derogate special statutes ('*generalia specialibus non derogant*').

The High Court of Patna in the case of *Bihar Solex (P.) Ltd.*[40], opined in the context of the judgment delivered in *Maharashtra Steel Tubes* case[41]. According to its judgment, the authority and jurisdiction of the DRT to hear the proceedings and adjudge the filed suits is exclusive with the exceptions of the High Courts and Supreme Court under Article 226 and 227 of the Constitution of India.

The SC in *Industrial Credit and Investment Corporation of India Ltd.* v. *Grapco Industries Ltd. & Ors.*[42] opined that for a party to continue with the legal proceedings in the DRT, a leave of the Company court was not required and that the proceedings have to be heard in the specific apparatus provided under the concerned Act.

---

[40] *In re*(1999) 20 Comp Cas 235 (Bihar).

[41] Maharashtra Tubes Ltd. v. State Industrial and Investment Corporation of Maharashtra Ltd., 1993 SCR (1) 340.

[42] Industrial Credit and Investment Corporation of India Ltd.v. Grapco Industries Ltd. & Ors 1999 (3) SCR 759.

Therefore, consequently the conflict and the contradiction between the clauses of two different statutes came to an end.

viii. The disputed jurisdiction of the Recovery and the Tribunal Officer

In the case of *Allahabad* v. *Canara Bank*[43], the Hon'ble Court had deliberated over various issues that it was confronted with. The issues covered, *inter alia*, included jurisdiction of the tribunal and the Recovery Officer under the Act. In this case the jurisdiction of the tribunal related to the judgment of the case was decided to be exclusive. The Court mentioned that the primary duty of the tribunal is to judge the legal responsibility of the defendant in the concerned case and then grant a certificate under section 19(22) of the RDB Act. Likewise, in the case of execution the jurisdiction solely lies with the recovery officer.

ix. Constitutional validity of the Act

After the completion of nine years of its enactment, the Act faced a major challenge with respect to its constitutional validity. The basis for challenging the Act was unreasonableness & its nature which violates Article 14 of the Constitution, which is *ultra vires* and thus outside the legislative authority of the Parliament. Firstly, the validity of the Act was challenged before the High Court of Delhi in *Delhi Bar Association & Ors.* v. *UOI & Anr.*[44] The Delhi High Court opined that the DRT could be instituted by the Parliament despite the fact that it is not within the purview of Articles 323A and 323B of the Constitution of India and that the expression 'administration of justice' as it appears in Entry 11A of List III of the Seventh Schedule to the Constitution includes Tribunals. The impugned Act was, however, declared unconstitutional as it erodes the independence of the judiciary and was irrational, discriminatory, unreasonable, arbitrary and hit by Article 14 of the Constitution. It also quashed the appointment of the Presiding Officer of the Tribunal. The aforesaid conclusions were drawn on the basis that the Act, section 17 in particular, did not have a provision for counter

[43] Allahabad v. Canara Bank [2000] INSC 180 (4 April 2000).
[44] Delhi Bar Association & Ors. v. UOI & Anr AIR 1995 Del 323.

claim as provided in the Civil Procedure Code and was irrational and arbitrary. The Act lowered the authority of the HC on the basis of the pecuniary jurisdiction and eroded the independence of the judiciary since the jurisdiction of the civil courts had been truncated and vested in the Tribunal.

The Hon'ble SC, in appeal[45], dissented with the opinion given by the High Court of Delhi and asserted that the power accorded to Parliament under Articles 323A & 323B to constitute Tribunals does not intervene in the independence of the judiciary.

x. The Securitization Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002**:**

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) has been enacted to provide a prompt and summary remedy for the recovery of thousands of crores which are due to the financial institutions and banks. The Securitisation Act, as known popularly, targets to attain the twin objectives along with providing for an extensive legal framework for asset securitisation and asset restoration. The instant Act lets financial institutions or banks to recover their non-performing assets without the interference of the Court, by the way of gaining and disposing of the secured assets in the non-performing asset accounts with an outstanding amount of one lakh rupees or above. The banks have to follow a specific laid down procedure whereby the issuance of notice is the first action to be performed by the bank and then on the borrower's failure to pay back the loan, they can take the custody of security pledged and/or takes on the organization of the borrowing concern and then appoint a person to handle the concern.

f) INVOCATION OF PROVISIONS OF SARFAESI

The right of the banks or other financial institutions to avail the provisions of the SARFAESI arises only in the event where any borrower, who is under legal responsibility to a secured creditor under a security agreement, makes any default

[45] Appeal (civil) 4679 of 1995.

in payment of a secured debt or any installment thereof and his account in respect of such debt is categorized by the secured creditor as non-performing asset.[46]Hence, classification of account as an NPA is inevitable and, the following eventualities can be harvested for recovery of credit under the provisions of SARFAESI: Existence of a debt by a borrower from a secured creditor under a security agreement; Default made in repayment of secured debt or any installment thereof by the borrower; In the case of default, borrower's account is classified by the secured creditor as 'non-performing asset'; Issuing a notice by the secured creditor to the borrower to discharge in full his liabilities within sixty days from the date of the notice; and as per Section 13(3), the notice shall also give details of the amount payable by the borrower and the secured assets intended to be enforced by the secured creditor.[47]

The borrower is not permitted to approach the Civil Court because of the bar under section 34 of SARFAESI Act, 2002. Though there is a scope for the Civil Court to entertain the SARFAESI related matters in some cases in a restricted sense pursuant to the *Mardia Chemical's case*[48], it is very difficult to convince the Civil Court with regard to its jurisdiction in SARFAEI matters and this can be attributed to the lack of expertise on the part of the Civil Courts with the Securitisation Law.

xi. Lok Adalats:

Section 89 of the Civil Procedure Code, 1908 provides settlement of disputes outside the courts through Alternative Disputes Resolution (ADR) methods such as Conciliation, Arbitration, Mediation and Lok Adalats. The relevant section of the Code states that wherever the court finds that there can be a settlement acceptable to the parties, the court should formulate the terms of settlement and give the same to the concerned parties for their observations and after receiving the observation, it may reformulate the terms of a possible settlement.

---

[46] The Institute of Company Secretaries of India, (Mar 6, 2016), https://www.icsi.edu/docsS%20JUNE22014.pdf.
[47]M/S Signal Apparels Pvt. Ltd v. Canara Bank, 2010 (5) CTC 337.
[48]Mardia Chemicals Ltd. v. Union of India, 2004 136 TAXMAN 360 SC.

The system of Lok Adalats was statutorily recognised under the Legal Services Authorities Act, 1987. Lok Adalats function under the guidance of Central, State and District Legal Services Authority headed by judges from Supreme Court, High Court and District Court respectively, who have powers to settle both pending suit filed cases as well as pre litigation cases.[49] The presiding officers can grant awards, which are treated as decree and can be straight away executed in a court of law.[50] Lok Adalats are one of the most used forms of ADR because, the mechanism of Lok Adalat offers speedy, economical and mutually satisfactory way of resolution of disputes. Lok Adalats is an outcome of court apparatus to settle matters relating to payment of dues, summoned by Debt Recovery Tribunals or Debt Recovery Appellate Tribunals. It is a shared platform for the bank and the borrower to negotiate and reach a mutual settlement. At present, accounts in doubtful and loss category with outstanding above Rs. 20 lakhs can be referred to this forum.[51] Lok Adalats have proved to be an effective and efficient mechanism for rendering quick justice and recovery of small loans. The Hon'ble Supreme Court has observed that loans, personal loans, credit card loans and housing loans with less than ten lakh rupees can be referred to Lok Adalats.[52] The public sector banks have been advised by the Government to make use of this apparatus to its maximum potential for the recovery in non-performing assets cases.[53]

xii. <u>The Insolvency and Bankruptcy Code, 2015:</u>

The Insolvency and Bankruptcy Code, 2015 was passed by the Lok Sabha on May 5, 2016 and by the Rajya Sabha on May 11, 2016, and shall come into force, once, it receives the Presidential assent. It is being considered to be one of the most progressive and innovative legislations in the contemporary times.

---

[49] *Recovery Policy- Financial Year 2012*, RBL BANK, (Mar 8, 2016), http://www.rblbank.com/pdfs/bp/Recovery-%202012.pdf

[50] *Ibid.*

[51] STANDING COMMITTEE, *supra* note 15.

[52] Chandan Karmakar v. UCO Bank & Ors., W.P. 31146 (W) of 2013.

[53] *Master Circular- Loans and Advances – Statutory and Other Restrictions*, Circular No. DBOD.No.Dir.BC.14/13.03.00/2013-14 dated Jul 01, 2013, RESERVE BANK OF INDIA, http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=8135 (last updated Mar 7, 2016).

The Code will provide for a speedy process of winding up for defaulting companies and thus a quick recovery of loans lent by the lenders. The Code provides time-bound process (within 180 days) for insolvency resolution of individuals and companies. Nonetheless, if insolvency could not be resolved, the assets of the borrowers can be sold to make repayment to creditors. The National Company Law Tribunal (NCLT) has been empowered by the Code to adjudicate insolvency resolution for companies whereas for individuals, the Debt Recovery Tribunal (DRT) has been given such jurisdiction. In addition to this, The Insolvency and Bankruptcy Board of India will be constituted to regulate functioning of various other bodies established under the Code.[54]

An analysis of the Code, thus, reveals that it will act as a catalyst in curbing the ever-increasing amount of non-performing assets of the banks.

Efficacy of the laws governing NPA

During 2011-12, total NPAs recovered through these three channels (Lok Adalats, DRTs and SARFAESI) were Rs. 144 billion, and out these Rs. 101 billion were recovered through SARFAESI Act only, i.e. 70%. In 2012-13, the share of SARFAESI Act increased further. In 2012-13, out of the total NPAs recovered of Rs. 232 billion, Rs. 185 billion were recovered through SARFAESI Act alone, i.e. 80% of the NPAs recovered were contributed by this Act. In 2013-14, SARFAESI contributed to the recovery of as much as 25.56% of the total amount recovered whereas DRT and Lok Adalat led to the recovery of 9.83% and 8.31% respectively.[55] It, thus, shows that SARFAESI Act is the most important channel for NPA recovery for Indian banks.[56] Hence, it can be concluded that the laws enacted and measures taken for the purpose of tackling with the issue of NPAs have been working quite effectively. Further, the RBI provisioning law had come into force from April 1, 2015, according to which, all new restructured loans will

[54] The Insolvency and Bankruptcy Code, 2015, PRS LEGISLATIVE RESEARCH, http://www.prsindia.org/billtrack/the-insolvency-and-bankruptcy-bill-2015-4100/ (last updated Mar 7, 2016).

[55] ECONOMIC SURVEY, *supra* note 16.

[56] *Operation and Performance of Commercial Banks*, RESERVE BANK OF INDIA, http://www.rbi.org.in/scripts/PublicationsView.aspx?id=15440 (last updated Mar 8, 2016).

be classified as bad loans and thus, will disincentivize the banks from easily providing for restructured loans.[57]

However, the legal framework governing recovery of secured loans can still be very fair and the Tribunals and Appellate Tribunals can be conferred with well drafted powers so as to give directions to the Bank, when needed.

Conclusion

The holistic performance of the banks is assessed by NPAs. Thus it has always been a cause of concern in the country. Currently Indian banking sector is encountering a critical situation in terms of NPA. A steep rise in the level of NPAs indicates a higher probability of a hefty number of credit defaults that would definitely have an effect on the liquidity and profitability of banks. The amount of NPAs is relatively high in public sectors banks. For an improvement in the efficiency and profitability, the NPAs have to be reasonably planned. The government, from time to time, has taken many steps to reduce NPAs. However it is very unfeasible to have zero percentage NPAs. The management of NPAs is the need of the hour. Every bank has to ensure that an asset does not become NPA and if it does, proper steps should be taken for early recovery, failing to which the profitability of the bank will be eroded. Thus, it is the responsibility of the banks to ensure that they give loans to trustworthy and more importantly creditworthy customers.

Looking at the gigantic size of the banking industry, there can be barely any doubt that the threat of NPAs needs to be cramped. It poses a huge risk to the macro-economic constancy of the Indian economy. An investigation of the current condition brings us to the point that the problem is many-sided and has roots in economic deceleration; worsening business climate in India; shortages in the legal system; and the operational deficiency of the banks. Therefore, it has to be dealt at numerous levels. The government can't be expected to save the state-run banks with tax-payer's money every time they fall into a crisis. But, the kind of attention with which this crisis has been received by policymakers and bankers alike is a big

---

[57] *RBI's new provisioning laws to help banks act at the earliest signs of stress*, ECONOMIC TIMES, http://articles.economictimes.indiatimes.com/2015-04-03/news/60787332_1_indian-banks-bankruptcy-law-restructured-loans (last updated Mar 8, 2016).

ray of hope. Right steps, well-timed and rigorous actions and a revitalization of the Indian economy will put a lid on NPAs. Prevention, however, has to become a priority than mere cure.