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PREFACE

This is the second issue of the fifth edition of RGNUL Financial & Mercantile Law Review. This law review is an endeavor 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. Turning out this issue has been a mammoth challenge but also, a very rewarding one. This issue of RFMLR is concentrated on 'Ease of Doing Business' with papers received from all parts of India with enthusiasm. The review makes for an interesting read and loves to hear your opinions on how to make it better. Please feel free to write in to us.

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FINANCIAL CRIMES IN INDIA

- *Akshi Narula*[*]

ABSTRACT

Amongst the financial crimes recognized worldwide and defined differently by them, the present article would analyse the recently emerged escape-route followed by the High Net Worth Individuals (HNWI) after the commission of financial crimes leading to erosion of wealth of the concerned economy, and absconding across national borders to get away with criminal trial. The term 'financial crime' has been defined by the Australian Criminal Intelligence Commission to "include activities ranging from fraud through active manipulation of the stock market, or laundering the proceeds of crime". A region which is prone to financial crimes in a specific sector of economy would discourage investment and would divert the available resources towards law enforcement and fighting crime. The costs associated with this affects the ease of doing business in the country.

This article analyses the recent Nirav Modi fraud case that subsequently led to the introduction of Fugitive Economic Offenders Ordinance, 2018 (FEO Ordinance) which aims at punishing the persons accused of financial crimes in India who have left India like Vijay Mallya, Nirav Modi, etc. The article initially establishes a base of facts as took place in the case and then explains the role of Letters of Undertaking (LoU) in the whole set up. It further discusses the regulations governing

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such bank guarantees and the gaps which were observed in the present case. It also throws light on the recently emerged SWIFT transactions and auditors' duties with respect to bank guarantees.

Along with the introduction of the FEO Ordinance, the Union Cabinet of India, on March 1, 2018, approved the setting up of an independent regulator of auditors named the National Financial Reporting Authority (NFRA). The powers of this authority have also been described further in the article by comparing the same with the institutions existing prior to such Authority.

1. INTRODUCTION

The INTERPOL defines the term 'financial crime' to cover a wide range of criminal offences which are generally international in nature.[1] The term "includes activities ranging from fraud through the active manipulation of the stock market, or laundering the proceeds of crime."[2] The term 'economic and financial crime' broadly refers to "any non-violent crime that results in a financial loss, even though at times such losses may be hidden or not socially perceived as such. Such crimes thus include a broad range of illegal activities."[3]

The Committee of Ministers of the Council of Europe in 1981, identified 16 offences as economic crimes which

[1] *Financial Crime*, INTERPOL, https://www.interpol.int/Crime-areas/Financial-crime/Financial-crime (last visited June 10, 2018).

[2] *Financial Crimes*, AUSTRALIAN CRIMINAL INTEL. COMM'N, https://www.acic.gov.au/about-crime/crime-types/financial-crimes (last visited June 10, 2018).

[3] U.N. Congress on Crime Prevention and Criminal Justice, *Working paper on Economic and Financial Crimes: Challenges to Sustainable Development*, U.N. Doc. A/CONF.203/7 (Apr. 25, 2005).

> *included cartel offences; fraudulent procurement or abuse of state or international organizations' grants; fraudulent practices and abuse of the economic situation by multinational companies; computer crime; faking of company balance sheets and book-keeping offences; bogus firms; fraud concerning the economic situation and corporate capital of companies; fraud to the detriment of creditors; violation by a company of standards of security and health concerning employees; consumer fraud; unfair competition, including payment of bribes and misleading advertising; fiscal offences and evasion of social costs by enterprises; offences concerning money and currency regulations; customs offences; stock exchange and bank offences; and offences against the environment.*[4]

Financial crimes worldwide are defined in terms of component crimes with different constituent elements as grouped by nations differently. Money laundering, frauds committed while dealing with credit cards, mortgage, insurance fraud, tax evasion, etc. are some types of financial crimes recognised by most of the countries. Keeping into consideration the complex nature of their *modus operandi*, these crimes are covered by different legislations in India. Also, notably, such crimes majorly have an active participation of financial institutions due to the involvement of huge amounts of money. The Reserve Bank of India Act, 1934 is the chief legislation responsible for regulating the working of banks and has made fraud reporting a mandatory process. Furthermore, other laws regulating financial institutions include Securities and Exchange Board of India Act, 1992, Companies Act, 2013, Insurance Regulatory and Development Authority Act, 1999, etc.

[4] *Id.*

The degree of vulnerability of a region to financial crimes depends majorly on the effectiveness of the regulatory frameworks and governmental capacity to tackle with such crimes. Furthermore, the financial crime detection systems face the prominent drawback of determining the actual crime rate within the region because of lower reporting rates of financial crimes. The institutions involved in such crimes are generally financial giants like companies enjoying goodwill in the market. Reporting of financial fraud with such a company would lead to a loss to the company in terms of customers and reputation, and would involve scrutiny by related authorities, and other unascertainable losses. Hence such companies prefer internal resolution of crimes.

Another driving factor which owes to the increasing rate of such crimes is the lower cases of detection, prosecution and punishment. The reward after the commission of such crimes would by any way outweigh the risks associated with it. The technological advancements have further made the commission of these crimes easier and their detection difficult.

Considering the wide base of what constitute financial crimes, this article will focus on the recent case of fraud with the Punjab National Bank (PNB) by the jeweller Nirav Modi who has absconded and is hiding from the jurisdiction of judicial authorities in India.

2. FACTUAL BACKGROUND

Multiple agencies grounded into the work of tracking the PNB scam proceeds have little to say on where the scam money evaporated or is stocked. It was on March 1, 2018 that the Central Bureau of

Investigation (CBI) while carrying on its investigation recovered the documents related to the alleged LoU from a small room of a *chawl* in Wadala, a central Mumbai suburb.[5] Bishnubrata Mishra, the Internal Chief Auditor (Retd.), responsible for concurrent audit for the period 2011-2015 at PNB Brady House branch was arrested in relation to the fraud.[6]

It was on February 5, 2018 when the PNB informed India's stock exchanges of Rs. 280 crore frauds.[7] Again, the bank issued a follow up information on February 14, 2018 to the stock exchanges, bringing into their notice that the fraudulent transactions date back to 2011. The information was an implied notice to the media of the alleged fraud. By January 25, after the devolvement of the first set of LoUs occurred, a liability of $44.2 million was imposed on PNB.[8] Subsequently, more LoUs started devolving on PNB thereby leading to the surfacing of the fraudulent transactions.[9] By February 12, PNB discovered a fraud of Rs. 11,304.02 crores resulting from unauthorized issuances of LoUs and other trade finance instruments to the Modi forms.[10]

[5] Press Trust of India, *Nirav Modi case: CBI recover documents related to LoU from 'chawl'; arrests another executive*, THE ECON. TIMES, https://economictimes.indiatimes.com/industry/banking/finance/banking/nirav-modi-case-cbi-recoverdocuments-related-to-lou-from-chawl/articleshow/63128234.cms (last visited Mar. 10, 2018).
[6] *Id.*
[7] Tamal Bandyopadhyay, *The Anatomy of the PNB Fraud*, LIVE MINT https://www.livemint.com/Opinion/oiMKS98wBunYNviWCVq6hJ/The-anatomy-of-the-PNB-fraud.html (last visited Mar. 3, 2018).
[8] *Id.*
[9] *Id.*
[10] *Id.*

Vide clarification dated February 15, 2018,[11] the bank confirmed following:

> *On January 16, 2018, the partnership firm of Nirav Modi approached their branch at Brady House, Mumbai to present a set of import documents with a request to allow buyers' credit for making payment to the overseas suppliers. Since there was no sanctioned limit in the name of the above firms, the branch officials requested the firms to furnish at least 100% cash margin for issuing LoU for raising buyer's credit. On denial, the firms contested that they have been availing such transactions since past several years.*

It was further mentioned that the issuance of LoUs had been made by the branch officials through the Society for Worldwide Interbank Financial Telecommunication (SWIFT) without taking approval from the competent authority, submitting the requisite documents for import, and making entries in Bank's trade finance module of CBS system.

An FMR-1 (Fraud Report Format of the RBI) was submitted with the Reserve Bank of India (RBI) on January 29 on confirming the first maturity of LoU as a fraudulently credit against the bank. On January 21, criminal complaint for the offences of cheating, criminal conspiracy, and abuse of official position was registered against the accused and the same was entrusted to the Inspector of Police, CBI.

[11] *Clarification/Confirmation on News Item Issued by Punjab National Bank*, TAXGURU, https://taxguru.in/wp-content/uploads/2018/02/Clarification-confirmation-on-news-item.pdf (last visited Mar. 5, 2018).

3. NOT THE FIRST TIME, MANY IN THE ROW

The jeweller-designer Nirav Modi left India on January 1, i.e. much before the bank filed an FIR alleging the company of the fraud.[12] Further, to talk about such offences in India, it was revealed in an RTI[13] filed by Jeetendra Ghadge that Nirav Modi and Vijay Mallya are not the only two fraudsters involved in economic offences who fled India. It was reported by the Economic Offences Wing, Mumbai that since 2015 there have been hundreds of cases of financial scams. RTI revealed that 184 persons accused of such offences are absconding.

Diamond traders Nirav Modi, Mehul Choksi, Jatin Mehta, and Vijay Mallya are amongst the thirty-one businessmen who are fugitives abroad and are facing a CBI investigation.[14] The Ministry of External Affairs had received extradition requests from the CBI in respect of Mallya, Jobanputra, Baid, Sanjay Kalra, Varsha Kalra and Aarti Kalra which were sent to the concerned foreign countries for consideration.[15]

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[12] Press Trust of India, *PNB fraud: Nirav Modi left India with family in first week of January*, THE TIMES OF INDIA, https://tImesofindia.indiatimes.com/business/india-business/pnb-fraud-nirav-modi-left-india-with-family-in-first-week-of-january/articleshow/62930682.cms (last visited Mar. 13, 2018).

[13] Parth M.N., *Nirav Modi, Vijay Mallya aren't only fraudsters to have fled India; RTI shows 184 others on loose: Exclusive Report*, FIRST POST, https://www.firstpost.com/india/nirav-modi-vijay-mallya-arent-the-only-fraudsters-to-have-fled-india-rti-shows-184-others-are-on-the-loose-exclusive-report-4375961.html (last visited Mar. 11, 2018).

[14] Press Trust of India, *Nirav Modi, Vijay Mallya among 31 fugitive business people facing CBI probe*, BUSINESS STANDARD, http://www.business-standard.com/article/current-affairs/nirav-modi-vijay-mallya-among-31-fugitive-business-people-facing-cbi-probe-118031400966_1.html (last visited Mar. 15, 2018).

[15] *Id.*

4. DIVING INTO THE DETAILS

The bank gave the statement in relation to the *modus operandi* of the fraud so committed: "It was found through SWIFT trail that one junior level branch official unauthorisedly and fraudulently issued LoUs on behalf of some companies belonging to Nirav Modi Group for availing buyers' credit from overseas branches of Indian Banks."[16]

The following is an effort to understand the *modus operandi* of the fraud so employed including the controversial credit instrument which had led to the commission of fraud. It is also an introduction to the new electronic system of communication which has been infamous for its efficiency. However, the same later proved to be a means for the commission of the well-arranged continuing plan. Furthermore, apart from the unsuccessful means employed in the commission of the crime, the presence of the regulatory framework in form of an audit to be performed by the auditors also proved to be deficient. The following is a description of the instruments employed and the existing regulatory framework.

4.1. LETTER OF UNDERTAKING

LoU is a type of bank guarantee issued for both overseas import and export payments (in the present case, import payment). To understand the legal framework in relation to issuance of such instruments the following provisions may be referred to: A 'contract of guarantee'

[16] *PNB detects new fraud at Mumbai branch at heart of $2 billion banking scam*, BUSINESS TODAY, https://www.businesstoday.in/sectors/banks/pnb-scam-banking-fraud-mumbai-branch-chandri-paper-nirav-modi/story/272661.html (last visited Mar. 15, 2018).

constitutes of a 'surety', 'principal debtor' and 'creditor'. It is defined as "[a] contract to perform the promise or discharge the liability of a third person in case of his default."[17]

The liability of a guarantor would be limited to the terms of guarantee agreed between the parties in the deed. According to Section 127 of the Indian Contract Act, 1872, anything done, or promise made for the benefit of the principal debtor is considered as an adequate consideration for the guarantor to make the contract valid.

If the above guarantee is rendered by a bank, it is known as a 'bank guarantee'. The banker can also exercise his right of lien on the balance of account of the guarantor in his possession after a default has been made by the principal debtor.

4.1.1. RBI Directions relating to Bank Guarantee

The Reserve Bank of India by issuing various directions regulates the working of banks and its schemes and functions. The following are the directions relating to a bank guarantee in cases where the bank stands as the guarantor:

1. A bank has the authority to issue guarantees on behalf of their customers for various purposes. Furthermore, it is responsible to execute both performance guarantees and financial guarantees.

   A performance guarantee is a contingency arising in the event of failure to perform a non-financial obligation to a third party.[18] Such

[17] Indian Contract Act, 1872, No. 9, Imperial Legislative Council, 1872, § 126.

guarantees are generally issued by an insurance company or bank to a contractor to guarantee the full and due performance of the contract according to the plans and specifications.[19] A financial guarantee on the other hand is a guarantee undertaken for the repayment of a contractual financial obligation. [20] Hence, such a guarantee provides an additional level of comfort that the investment will be repaid in the event of the securities issuer not being able to fulfil the contractual obligation to make timely payments.

2. A bank guarantee shall not have a maturity of more than 10 years. However, RBI has allowed the banks to issue guarantees for period beyond 10 years for various projects taking into account the impact of such long guarantees on their Asset Liability Management.[21]
3. A bank should restrain from issuing guarantees in large amounts for medium and long-term periods avoiding undue concentration of such unsecured guarantee commitments to a particular groups of persons.[22]

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[18] Reserve Bank of India, *New Capital Adequacy Framework – Non-market related Off Balance Sheet Items- Bank Guarantees*, D.B.O.D. No. BP.BC.89.21.04.009/2012-13, *available at* https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=7924&Mode=0 (last visited Mar. 23, 2018).

[19] *Performance Guarantees*, PERFORMANCE & CUSTOMS BOND SERVICES, http://www.pcbs.co.za/performance-guaRAntees-2/ (last visited Mar. 19, 2018).

[20] *Id.*

[21] Reserve Bank of India, *The Asset Liability Management System aims at enforcing the risk management discipline viz. managing business after assessing the risks involved*, D.B.O.D. No. BP.BC. 8/21.04.098/99, *available at* https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=16&Mode=0 (last visited Mar. 29, 2018); Reserve Bank of India, *Master Circular – Guarantees and Co-acceptances*, D.B.R. No. Dir. BC.11/13.03.00/2015-16, *available at* https://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=9879 (last visited Mar. 11, 2018).

[22] *Id.*

4. While issuing a financial guarantee, the bank shall be satisfied that the customer would be able to reimburse the bank in case the guarantee is invoked. On the other hand, in case of a performance guarantee, banks should exercise due caution and have sufficient experience with the customer to satisfy themselves that the customer has the necessary experience, capacity and means to perform the obligations under the contract.[23]
5. In order to ensure the adequacy and effectiveness of the systems and procedures and for preventing frauds and malpractices by the employees and officials of the bank, bank guarantees issued for Rs. 50,000 and above should be signed by two officials jointly.[24]

The RBI has further framed directions for the import of goods and services.[25]

6. AD Category – 1 Banks may particularly adhere to Know Your Customer Guidelines (KYC Guidelines) issued by the RBI (Department of Banking Regulation) in all their dealings.
7. An AD may give a LoU, guarantee or a Letter of Comfort in respect of a debt, obligation or any other liability subjected to by a person resident in India and owed to a person resident outside India for the

[23] *Id.*
[24] *Id.*
[25] Reserve Bank of India, *Master Direction – Import of goods and Services*, FED Master Direction No. 17/2016-17, *available at* https://www.rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=10201#C10 (last visited Mar. 17, 2018).

import of goods subject to such terms and conditions as may be specified by RBI from time to time.[26]

8. An AD may, in the ordinary course of his business, give a guarantee in favour of a non-resident service provider, on behalf of a resident customer who is a service importer, subject to directions issued by the RBI.
9. Further, no guarantee on behalf of a service importer shall be rendered for an amount exceeding USD 500,000 except a Public Sector Company or an Undertaking of the Government. Furthermore, in cases where a Public Sector Company/Undertaking of the Government serves as the importer, the amount for guarantee shall not exceed USD 100,000 or such amount issued by the Ministry of Finance, Government of India.
10. According to the notification issued by the RBI vide Circular No. 75, the arrangement for reporting of data on issuance of guarantees/ LoUs/ LoCs by all AD banks was shifted to a consolidated statement at quarterly intervals, from manual submission to eXtensible Business Reporting Language (XBRL) platform from September 30, 2013.[27]

However, in the present case the right to lien could not be performed for the reason that the properties of the fraudster in form of bank accounts

[26] *Id.*

[27] Reserve Bank of India, *Trade Credit for Imports into India: Online Submission of Data on Issuance of Guarantee/ Letter of Undertaking (LoU)/ Letter of Comfort (LoC) by Ads*, A.P. (DIR Ser.) Cir. No. 75, *available at* https://www.rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=8581 (last visited Mar. 20, 2018).

and others were situated beyond the jurisdiction of the Indian Courts and the Courts hence, did not have the authority to exercise their right to lien.

Hence, it may be noted that the RBI has by itself issued a number of regulatory norms to standardize the issuance of guarantees by the banks. There is, however, no evidence that the same were followed or not in the present scenario.

4.2. SWIFT TRANSACTIONS

4.2.1. SWIFT

Society for Worldwide Interbank Financial Telecommunication (SWIFT) is a member-owned cooperative and the world's leading provider of financial messaging services.[28] It provides with a number of services which set the standards for communicating and to facilitate access, integration, identification, analysis and regulatory compliance. More than 11,000 banking and securities organizations are customers to the services provided by SWIFT with market infrastructures and corporate customers in more than 200 countries and territories.

4.2.2. SWIFT Transactions

With the issuance of a LoU, a message of credit transfer is conveyed to overseas banks through the SWIFT system. This message is an automatic consent of the bank and to guarantee. In order to issue a transaction on SWIFT, an official has to log in to fill information

[28] *Introduction to SWIFT*, SWIFT, https://www.swift.com/about-us/discover-swift (last visited Mar. 22, 2018).

(confidential in nature) in relation to the bank inclusive of the account number and SWIFT Code. It is a system protected by a three layered security – a maker, a checker and a verifier within the core banking system before it is issued.[29]

Even in the presence of multi layered protected system whereby an official is responsible for logging in and filling the information in relation to the bank and the SWIFT code, the same has the potential of being exploited.

4.3. DUTY OF AUDITORS TO CHECK BANK GUARANTEE PROPERLY RECORDED

Another crucial aspect of the bank guarantee is the verification process carried on by auditors by auditing and inspecting the books of record of the banking company. The following are the Bank Audit and Inspection measures in relation to the Bank Guarantee as compiled by Tannan.[30]

Under the Concurrent Audit undertaken for a bank, which is one of the three audits prescribed for a bank, the concurrent auditor should ensure that:

a. the bank guarantees have been issued in the prescribed Performa;
b. recorded in the register of the bank;

[29] Press Trust of India, *Nirav Modi case: What is LoU, CBS, and SWIFT? Know these terms to understand PNB fraud*, BUSINESS TODAY, https://www.businesstoday.in/current/economy-politics/pnb-fraud-what-is-lou-cbs-swift/story/270704.html (last visited Mar. 25, 2018).
[30] M.L. TANNAN, BANKING LAW AND PRACTICE IN INDIA (22d ed. 2008).

c. the counter guarantees/indemnities have been obtained from the constituent before the issue of guarantee;
d. the commission is properly paid by the constituent;
e. the contingent liabilities entries are passed on a daily basis;
f. after the expiry of guarantee period, the branch ensures that the original guarantee is received back and cancelled and the contingent entries are reversed.

5. AFTERMATH

The case is a reverberation of the escape-route followed by HNWI in commission of financial crimes. The following are the recent developments in relation to the regulatory frameworks emerged as a consequence of the commission of such crimes:

5.1. FUGITIVE ECONOMIC OFFENDERS ORDINANCE

The Union Cabinet on March 1, 2018 cleared the FEO Bill after the Nirav Modi Fraud. The President of India then gave his assent to the FEO Ordinance, 2018 on April 21, 2018. The Ordinance is aimed at punishing the accused of financial crimes in India who have left India as in the case of Vijay Mallya and the recent Nirav Modi. It would serve as one comprehensive law to codify the various legislations dealing with the subject.

An essential aspect of the Ordinance is the determination of the offences which are classified as 'economic offences'. Section 2(f) defines "Fugitive Economic Offender" to mean "any individual against whom a

warrant for arrest in relation to a Scheduled Offence has been issued by any Court in India." Further, such a person has left India so as to avoid criminal prosecution or if being abroad refuses to return to India to face criminal prosecution. The Schedule to the Ordinance names specifically the legislations and the provisions therein which would constitute an 'economic offence' and hence be covered under the Ordinance. Furthermore, the "Scheduled Offence" defined under Section 2(m) means an offence specified in the Schedule if the total value involved in such offence or offences is Rs. 100 crore or more.

The Ordinance includes offences such as criminal conspiracy, counterfeiting government stamp, cheating, forgery of valuable security or will, etc. under the Indian Penal Code, 1860; dishonour of cheque under Section 138 of the Negotiable Instruments Act, 1881; penalties listed under Section 58B of the Reserve Bank of India Act, 1934; offences and penalties listed under Section 9 of the Central Excise Act, 1944; evasion of duty or prohibitions under Section 135 of the Customs Act, 1962; prohibition of Benami Transactions under Section 3 of the Prohibition of Benami Property Transactions Act, 1988; offences covered by Section 7, 8, 9, 10 and 13 of the Prevention of Corruption Act, 1988; insider trading as prohibited by Section 12A read with Section 24 of the Securities and Exchange Board of India Act, 1992; money laundering as covered by Sections 3 and 4 of the Prevention of Money Laundering Act, 2002; offence of carrying on business with intent to defraud creditors of the Limited Liability Partnership or for any other fraudulent purpose listed in Section 30(2) of the Limited Liability Partnership Act, 2008; penalty for

article or currency or security obtained in contravention of Section 10 listed under Sections 34 and 35 of the Foreign Contribution (Regulation) Act, 2010; offences under the Companies Act, 2013; offences under Section 51 of the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015; offences under Section 69 of the Insolvency and Bankruptcy Code, 2016; and under Section 132(5) of the Central Goods and Services Tax Act, 2017.

The Ordinance further describes the meaning of "proceeds of crime" to mean "any property derived or obtained, directly or indirectly, by any person from any criminal activity relating to a scheduled offence or the value of such property or where such property is outside of the country, then the property equivalent in value held within the country." Also, the director has been conferred with similar powers as in the case of Prevention of Money Laundering Act whereby he may file an application with the Special Court (designated under PMLA) to declare a person as a FEO.

The Ordinance promulgated to cover the specific economic crimes was put into action when a Special Court was formed for the Nirav Modi case. Furthermore, the Enforcement Directorate (ED) moved to the Special Court in Mumbai to pray for "immediate confiscation" of the Rs. 7,000 crore assets of the fraudster.[31] The ED hence filed its first charge

[31] Press Trust of India, *PNB fraud: ED to seek immediate confiscation of Nirav Modi's assets under fugitive ordinance*, THE INDIAN EXPRESS, http://indianexpress.com/article/india/pnb-fraud-ed-to-seek-immediate-confiscation-of-nirav-modis-assets-under-fugitive-ordinance-5193199/ (last visited June 12, 2018).

sheet before the Special Court under the Prevention of Money Laundering Act (PMLA) where a total of 24 accused were listed.

5.2. SETTING UP OF NFRA TO REGULATE THE AFFAIRS OF AUDITORS

The Union Cabinet of India, on March 1, 2018 approved the setting up of an independent regulator of auditors called the NFRA.[32] The establishment of such a body has been called "requirement of the day" by the 2016 Report of Companies Law Committee.[33] Broadly speaking of the purpose of establishment of the NFRA, it shall provide for "matters relating to accounting and auditing standards under the Act".[34] It is established "for enforcement of auditing standards and ensuring the quality of audits to strengthen the independence of audit firms, quality of audits and, therefore, enhance investor and public confidence in financial disclosures of companies".

5.2.1. The NACAS and the NFRA

Establishment and Powers

National Advisory Committee on Accounting and Auditing Standards (NACAS) was introduced by the Companies (Amendment) Act, 1999 and was formed under the Companies Act, 1956 to advise the central

[32] *Cabinet approves Establishment of National Financial Reporting Authority*, PRESS INFO. BUREAU, http://pib.nic.in/newsite/PrintRelease.aspx?relid=176918 (last visited June 12, 2018).
[33] REPORT OF THE COMPANIES LAW COMMITTEE 41 (Feb., 2016), *available at* http://www.mca.gov.in/Ministry/pdf/Report_Companies_Law_Committee_01022016.pdf (last visited May 12, 2018).
[34] Companies Act, 2013, No. 18, Acts of Parliament, 2013, § 132(1).

government on the formulation and laying down of accounting policies for adoption by companies.[35] The Amendment Act made it mandatory for companies to abide by the accounting standards prescribed by the central government in consultation with the NACAS.

NFRA, on the other hand, is an authority deriving its powers from the Companies Act, 2013. The NFRA is an independent quasi-judicial body for monitoring corporate financial management. NFRA would not only continue with the advisory functions of the NACAS but will further recommend the central government on the formulation of accounting and auditing policies for adoption by companies or class of companies or their auditors;[36] monitor and enforce the compliance with such standards; oversee the quality of service of the professionals and suggest measures required for improvement in quality of service; and to perform such other functions relating to the above stated matters as may be prescribed.

5.2.2. The ICAI and the NFRA

Establishment

The Institute of Chartered Accountants was established under the Chartered Accountants Act of 1949 (C.A. Act). The Act was enacted to make provision for the regulation of the profession of Chartered Accountants. It provides for the establishment of a Disciplinary

[35] Companies Act, 1956, No. 1, Acts of Parliament, 1956, § 210A.
[36] Companies Act, 2013, § 132(2) (a).

Directorate, Board of Discipline and Disciplinary Committee for the investigation of matters pertaining to specified misconducts.[37]

Application

The NFRA has been conferred with the power to investigate Chartered Accountants and their firms of listed companies, large unlisted public companies, and such other entities where public interest would be involved. However, the ICAI would continue to exercise its inherent regulatory role in respect to members of the Institute, private limited companies, and public unlisted companies. Hence, in the presence of clearly demarked spheres of jurisdictions of both the institutions, the problem of overlapping does not arise. According to Arun Jaitley, "NFRA will certainly be an oversight body. It is not intended to replace the disciplinary jurisdiction of the CA Institute."[38]

Power to Investigate

Further, the NFRA shall have the power to investigate Chartered Accountants and their firms of listed companies, large unlisted public companies, and such other entities where public interest would be involved,[39] either *suo moto* or on a reference made to it by the central government. Besides this, where the NFRA has already initiated an

[37] Chartered Accountants Act, 1949, No. 38, Acts of Parliament, 1949, §§ 21, 21A & 21B.
[38] K.R. Srivats, *Cabinet nod for National Financial Reporting Authority*, THE HINDU: BUSINESS LINE, https://www.thehindubusinessline.com/economy/cabinet-nod-for-national-financial-reporting-authority/article22894653.ee (last visited May 17, 2018).
[39] *Cabinet approves Establishment of National Financial Reporting Authority*, PRESS INFO. BUREAU, http://pib.nic.in/newsite/PrintRelease.aspx?relid=176918.

investigation, no other institute or body shall initiate or continue any proceedings in such matters of misconduct.[40]

The C.A. Act provides for a Disciplinary Directorate for making investigations in respect of any information or complaint received by it. There are two Schedules under the C.A. Act. The misconducts listed under the Second Schedule are of a graver nature than the acts listed under the First Schedule. If the Director of the Directorate is of the opinion that a member is guilty of any professional or other misconduct mentioned in the First Schedule, the matter shall be placed before the Board of Discipline and if he is of the opinion that the matter falls within the Second Schedule, he shall place the matter before the Disciplinary Committee.[41]

The ICAI would continue to exercise its inherent regulatory role in respect of members of the Institute, private limited companies and public unlisted companies.

Power to Punish

If professional or other misconduct is proved, NFRA has the power to make an order imposing a penalty (which varies in cases of individuals and firms) and debarring the member or the firm from engaging himself or itself in practice as a member of the ICAI.[42] On the other hand, the Committee or Board have the powers listed under the Schedules to the C.A. Act.

[40] Companies Act, 2013, § 132(4) (a).
[41] Chartered Accountants Act, 1949, § 21(3).
[42] Companies Act, 2013, § 132(4) (c).

Similarity: Powers of a "Civil Court"

Furthermore, both the authorities have been conferred the same powers as a civil court while trying a suit for matters including: (i) discovery and production of books of account and other documents; (ii) summoning and enforcing the attendance of persons and examining them on oath; (iii) inspection of any books, registers and other documents of such person; and (iv) issuing of commissions for examination of witnesses or documents.[43]

5.3. LETTER OF UNDERTAKING FOR IMPORTS DISCONTINUE

The RBI decided to discontinue the issuance of LoU and Letters of Comfort for the purpose of extending trade credit for importing in India.[44] It shows that the RBI accepted the trade instruments to be flawed and therefore discontinued the same.

6. CONCLUSION

The benchmarks for determining the ease of doing business rankings are:[45] starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts and

[43] *Id.* § 132(4) (b); Chartered Accountants Act, 1949, § 21C.
[44] Vishwanath Nair, *RBI Discontinues Letters of Undertaking for Trade Credit for Imports*, BLOOMBERG, https://www.bloombergquint.com/business/2018/03/13/rbi-discontinues-letters-of-undertaking-and-letters-of-comfort-for-trade-credit (last visited Mar. 16, 2018).
[45] *Measuring Business Regulations: Ease of Doing Business in India*, THE WORLD BANK, http://www.doingbusiness.org/data/exploreeconomies/india (last visited June 13, 2018).

resolving insolvency. A region which is prone to financial crimes in a specific sector of business would lead to discouragement of investment and would divert the available resources towards law enforcement and fighting crime. A stricter check over the crimes would attract complex crime detection systems to be loaded by the public and private institutions. Further, the quantification of costs associated with financial crimes in form of direct losses and fines for non-compliance and reputational damage has been called to be a significant issue by Deloitte.[46] The costs associated would hence affect the ease of doing business in the country, where it would be difficult to attract foreign investment if the regulations are proven to be inadequate and prone to frauds.

The financial institutions comprising the major lenders are the most prone to financial crimes since it is expected that high value transactions would float from financial institutions or would in any way have a link with such institutions. Financial institutions can be involved in financial crime in three ways: as victim, as perpetrator, or as an instrumentality.[47] However, in the present case, the complainant-victim bank PNB has also been accused[48] time and again of not maintaining

[46] *Insight on Financial Crime: Challenges facing Financial Institutions*, DELLOITE, https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Risk/gx-cm-insight_on_financial_crime.pdf (last visited June 9, 2018).

[47] *Background Paper on Financial System Abuse, Financial Crime and Money Laundering*, IMF, https://www.imf.org/external/np/ml/2001/eng/021201.pdf (last visited June 9, 2018).

[48] Manas Chakravarty, *Who's responsible for the PNB fraud?*, LIVEMINT, https://www.livemint.com/Opinion/XmchEVqQ2LsLjv4V1sQSeJ/Whos-responsible-for-the-PNB-fraud.html (last visited June 14, 2018); Sudipto Dey, *PNB fraud: Who's liable and why multiple audits failed to raise an alarm?*, BUSINESS STANDARD, https://www.business-standard.com/article/opinion/pnb-fraud-who-s-liable-and-why-

proper compliance with the regulations that facilitate protection from such crimes. It was pointed out that amongst the CIBIL's overall list of wilful defaulters against whom lawsuits has been filed as on December 31, 2017, PNB has the highest number of wilful defaulters and the largest amount outstanding from these accounts amongst the nationalized banks.[49] In order to combat the same, the steps, as discussed before have been taken by the government.

Finally, it can be concluded that this move of the government to bring within the ambit of the FEO Ordinance the economic offences specifically where the wrong-doer is a fugitive is a welcome move since the same would help in combating offences involving HNWI. Also, it is worth mentioning that the RBI has prescribed sufficient framework of regulations to govern the working of financial institutions and the instruments issued by such institutions. Also, in order to strengthen and plug in the gaps of offences involving auditors, the new NFRA will have the power to investigate Chartered Accountants and their firms of listed companies, large unlisted public companies, and such other entities where public interest is involved. Therefore, the setting up of NFRA is an additional safeguard to prevent such economic offences.

The FEO Ordinance has solved the difficulty of unavailability of a universal definition of 'economic offences'. It was iterated during the 11th U.N. Congress on Crime Prevention and Criminal Justice, held in Bangkok from April 18-25, 2005, that the conceptualization of economic

multiple-audits-failed-to-raise-an-alarm-118021800662_1.html (last visited June 14, 2018).

[49] *Id.*

and financial crimes has been a major problem due to rapid advancements in technology. Furthermore, on the international level, the systems for recording economic and financial crime vary greatly from country to country, and hence it serves as a drawback for recognition of financial crimes globally. This problem has been catered to by introduction of the FEO Ordinance as it clearly defines the ambit of financial crimes as would mean within the national law.

ANALYSIS OF COMPANY LAW AMENDMENTS: AS A PROGRESSIVE STEP TOWARDS BETTER CORPORATE GOVERNANCE

- *Ishita Chaudhary & Vanshika Taneja*[*]

ABSTRACT

This paper seeks to critically analyse the role of various amendments to the Companies Act, 2013 (hereinafter referred to as "the Act"), namely the Companies (Amendment) Act, 2015 and the Companies (Amendment) Act, 2017, and allied laws in promoting ease in doing business. In view of increasing emphasis on adherence to norms of good corporate governance, Companies Law assumes an added importance in the corporate legislative milieu, as it deals with structure, management, administration and conduct of affairs of Companies.[1] The enactment of the Companies Act, 2013, was the most significant reform which introduced various changes in the company law in India. However, the implementation of the same was met with various difficulties. In order to overcome them, various amendments were made in the Act. These amendments thus focus upon the flaws and faults which were observed in the bare text of the Act and were aimed at widening and enlarging the scope of the provisions of the Act, to make company law free from ambiguities. Thus, the authors have attempted to explain the present position of the amended provisions in this paper. This

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paper is thus an analysis of the amendments that are aiding the businesses by adopting a liberal and progressive corporate governance mechanism.

1. INTRODUCTION

The Companies Act, 1956 underwent a huge change with the introduction of the Companies Act, 2013, whereby the latter instead of repealing all the provisions of the 1956 Act, added new concepts like One Person Company (OPC), women directors, Corporate Social Responsibility (CSR), class action etc. The establishment of National Company Law Tribunal (NCLT) and National Company Law Appellate Tribunal (NCLAT) were two other additional features. This Act was a step forward by the Indian legislature to bring company law of India in consonance with the global standards. Greater emphasis was placed on disclosures, accountability, investor protection, and corporate governance.

Yet, there were a number of discrepancies in the application of the new Act and the Parliament of India was constrained to bring two new amendments in the Act within a short span of four years. These were the amendments of 2015 and 2017. Both these amendments have tried to cater to various subjects which were quite ambiguous and needed strict interpretation for the application of the company law jurisprudence. The Act consists of 470 sections, of which 283 sections and 22 sets of rules corresponding to such sections have so far been brought into force in two phases – one on 12th September, 2013 and the other on 1st April, 2014.

Due to such hurried implementation of the Act, many loopholes and ambiguous provisions remained unattended, which created massive

difficulties and interpretational issues for the corporate world. The Rules that were introduced to supplement the Act were an attempt to rewrite the Act itself and did a poor job in stitching together the gaps left in the Act. The Rules created various inconsistencies with the provisions of the Act, and this left the business environment baffled at the thought of how to cope up with the new piece of poor legislation. The changes which were brought to the Companies Act, 2013 by the 2015 and 2017 Amendments are discussed below in detail.

2. THE COMPANIES (AMENDMENT) ACT, 2015

The Ministry of Corporate Affairs (MCA) came up with a clarification spree and accidentely assumed the role of the lawmaker instead of a subsidiary body responsible for the practical implementation of the existing law. The period was a saga of circulars and notifications passed by the MCA to clear the mess created by the earlier notifications and circulars. Thus, the Act instead of facilitating the ease of doing business created an atmosphere of ambiguity and chaos. The same was also evident by India's fall in position from 140 to 142 out of 189 counties assessed under the World Bank's report called 'Doing Business 2015'.[1] In order to address the issues in regard to practical applicability of the Act and in accordance with the suggestions made by various stakeholders, the government decided to amend certain provisions of the Act with an objective of facilitating the ease in doing business. It thereby introduced

[1] THE WORLD BANK, http://www.doingbusiness.org/reports/global-reports/~/media/WBG/DoingBusiness/Documents/Annual-Reports/English/DB15-Chapters/DB15-Report-Overview.pdf.

the Companies (Amendment) Bill, 2014 which received the approval of both Houses of the Parliament, and then the assent of President of India on May 25, 2015.

The various amendments which facilitated the ease in doing business and their impact on the corporate governance in India are as follows:

1) Removal of minimum paid up share capital: The definition of "private company" and "public company" stipulated under Section 2(68) and 2(71) respectively, were correspondingly amended to omit the words "of one lakh rupees or such higher paid-up share capital" and the words "of five lakh rupees or such higher paid-up capital". However, the Sections 2(68) and 2(71) retained the words "minimum paid-up share capital as may be prescribed". Thus, the amendment removed the previously stipulated paid-up share capital without taking away the right of the central government to prescribe a minimum capital requirement in the future and at the same time it gave a boost to the new business ventures.
2) Removal of compulsion of common seal: The Act by various sections made it mandatory for the company to have a common seal. However, the Companies (Amendment) Act, 2015 removed the requirement of common seal by amending various sections in the principal act. For instance, in Section 9 (which prescribed the effect of registration) the words "and a common seal" were omitted; and Section 12(3)(b) was substituted by "(b) have its name engraved in legible characters on its seal, if any". Further, Section 22(2) (which deals with execution of

bill of exchange) and Section 46(1) (which deals with certificate of shares) of the Act were amended to prescribe that the authorization in regard to the companies not having a common seal for the above mentioned two sections shall be made by two directors or by a director and the company secretary (where appointed). This removal of a procedural requirement may go a long way in ensuring the smooth functioning of business.

Thereafter, the proviso to Rule 5(3) of the Companies (Incorporation) Rules, 2014 (which dealt with shares that are not in dematerialized form) was also amended to provide that in case of a company not having a common seal, the share certificate shall be signed by two directors, or by a director and company secretary (where appointed). In case of a one-person company not having a common seal, the share certificate shall be signed by the person in whose presence the seal is required to be fixed.[2]

3) Removal of requirement of declaration of commencement of business: Section 11 of the Act was omitted. It prescribed that in order to commence the business or exercise borrowing power, the director of the company having a share capital, was required to file a verified declaration with the ROC (Registrar of Companies). The declaration provided that the requisite value of shares required to be paid by the subscriber and the criteria of minimum paid-up share capital (also removed by virtue of this amendment) has been satisfied along with verification of its registered office. By the virtue of this omission, the

[2] Companies (Incorporation) Rules, 2014, G.S.R 250(E).

restriction on the commencement of business by the registered companies has been eliminated. However, despite the complete omission of Section 11, its effect has not been eliminated as no amendment has been made to Section 248 which prescribes that the name of the company shall be removed, if the members do not subscribe to the shares within stipulated time and "a declaration under sub-section (1) of Section 11 to this effect has not been filed".[3]

Thus, while interpreting the Section 248, reference to Section 11 is required to be ignored. Post-amendment, this reference has reduced the effect of omission of Section 11 to the business, by prescribing that the companies can commence operation after receipt of certificate of incorporation, however, they still have to ensure that agreed subscription amount is paid by the subscribers, within 182 days of incorporation.

4) Prohibition of public inspection of certain board resolutions: Section 117(3)(g) has been amended to remove the requirement of making available by the companies, the board resolutions on the matters mentioned in the Section 179(3). This includes matters related to buying back, issuance of securities, borrowing or investing money, approving financial statements, granting loans, acquisition of controls etc. However, the companies are still required to carry out the fillings in respect of these matters. The amendment has facilitated doing of business for companies by not only providing them the liberty to not expose its regular business operations to general public, but also by

[3] Companies Act, 2013, No. 18, Acts of Parliament, 2013.

reducing the formalities and saving time which can be invested in the principal business activities.

5) Regulation of the transfer of unclaimed dividend and shares to investor education and protection fund: Section 124 of the Act stipulates that where dividend is declared, but has not been paid or claimed within 30 days to or by any shareholder entitled to the payment, the company shall within seven days from the date of expiry of such period transfer the unpaid dividend to the Unpaid Dividend Account.[4] The 2015 Amendment amended Section 124(6) to state that where the dividend has not been claimed or paid for seven consecutive years or more, the same shall be transferred in the name of Investor Education and Protection Fund. Further, an explanation was added to the proviso of the amended sub-section providing that if the dividend is claimed or paid for any year during the said period of seven consecutive years, then such shares shall not be transferred to the Investor Education and Protection Fund. Overall, the provision ensures the use of the dividend in just, equitable, and transparent manner.

6) Reporting by Auditor in case of Fraud: By the Company Law (Amendment) Act, 2015, the auditors of the company are made responsible to inform the central government about the frauds which have taken place in the company or in its name, or if the auditors have a reason to believe that there are any fraudulent activities taking place in the company. The enabling provision of Section 143(12) prescribes

[4] *Id.*

a threshold limit, above which, the fraud is to be disclosed to the central government. The auditors who have reported frauds to the Board or to the audit committee, but have not disclosed the same to the central government are also required to disclose the details in the Board's report.[5]

The Amendment ensures that there must be a threshold limit above which the fraud must be brought to the notice of the central government, and the auditors are assigned this responsibility. This provides for a quicker relief, whether the fraud has been committed or not.

7) Audit Committee empowered to give omnibus approvals in case of related party transactions: With the 2015 Amendment, the audit committee may, subject to prescribed conditions, give omnibus approvals for related party transactions as provided under Section 177(4). With such approvals, the decisions can be taken faster, implemented at the earliest, and the results follow accordingly, where the audit committee is satisfied, after the fulfilment of certain conditions.

8) Loan to Directors: According to Section 185, a company can give loans, guarantees, and securities to the directors or the person(s) in whom the interest of the director lies. The 2015 Amendment has added certain additional exceptions, according to which, nothing contained in Section 185 shall apply to loans and guarantees given by the holding company to its subsidiary company. Same applies to any

[5] U.S. SECURITIES AND EXCHANGE COMM'N, https://www.sec.gov/news/pressrelease/20.

guarantee or security by a holding company to a bank or any financial institution, provided that the loan so taken in the name of the subsidiary company is for the principal business of such company.

By excluding the loans, guarantees or securities given or taken for the subsidiary company, the holding company is relieved from the tedious processes. This ensures ease of doing business for both companies.

9) Related party transactions: Earlier, when a company entered into an agreement with a related party, it had to fulfil certain conditions and the Board of Directors had to pass a special resolution at the board meeting to that effect in accordance with Section 188.

However, with the 2015 Amendment, two changes were brought in this section. Firstly, now the Board of Directors may pass a simple resolution instead of a special resolution. Secondly, where there is a related party transaction between a holding company and a fully-owned subsidiary company, their accounts can be placed before the shareholders in the general meeting for approval in a consolidated manner.

By virtue of these changes, where a company is regularly performing its business with a certain related party, both the parties are allowed to carry out day-to-day tasks with much ease. The word 'may' is directory in nature, i.e., where the company feels to discuss the matter before entering into any agreement, it is free to do so.

10) Special Courts: The Amendment Act of 2015 has restricted the power of special courts, established by the central government by virtue of

Section 435, to the trying of cases where the punishment of offence is two years or more. For the offences punishable with imprisonment of two years or less, the Metropolitan Magistrate or a Judicial Magistrate of First Class is empowered to try cases, as under the present company law or any other previous company law.

By limiting the power of the special court, it can focus on heinous and grave offenses, rather than wasting its expertise and valuable time on petty cases.

Section 436 lays down the jurisdiction for the special courts, which derives its powers and limitations from the provisions of Section 435.

3. THE COMPANIES (AMENDMENT) ACT, 2017

The Companies (Amendment) Act, 2015 enabled India to take a step ahead in the "Ease of Doing Business" rankings where after 2015 India's position improved by four places. However, the Indian Government continued to receive recommendations that the principal act needed further amendments. The Hon'ble Minister of Corporate Affairs, at the time of consideration of the amendments in the Rajya Sabha in May 2015, underscored some of these concerns. It was decided to constitute a committee in which the representatives of the Company Secretary institute, the CA institute, and the Department were to find place. A broad-based Committee, was decided to be constituted to go into this whole question for the next few months and to figure out as to where the 'shoe pinches'. In view thereof, the Ministry of Corporate Affairs (the "MCA") constituted the Companies Law Committee (the "CLC" or the

"Committee") under the chairmanship of the Secretary, Ministry of Corporate Affairs vide an office order dated 4th June 2015.[6]

Thereafter, based on the recommendations received from various stakeholders the CLC prepared a report which was made available to the general public to comment on. Based on the final report, the Companies (Amendment) Bill, 2017 was passed by Lok Sabha and Rajya Sabha on July 27, 2017 and December 19, 2017 respectively. It was published in the official gazette on January 3, 2018. The various changes, brought by this amendment, which facilitated the ease in doing business and their impact on the corporate governance in India are as follows:

1) Definition of small company: Section 2(85), which denies small companies, was amended to increase the threshold limit of maximum paid-up share capital from five crore rupees to ten crore rupees, and the prescribed turnover amount has been increased from twenty crore rupees to one hundred crore rupees. Thus, by increasing the threshold limit, the legislature has made it easy for more companies to avail the benefits that are given to small companies.
2) Key Managerial Personnel: The definition of key managerial personnel given in Section 2(51) was amended to include any officer at a post up to one level below the director.[7] Thus, it removed hindrance in working of business in absence of directors.

[6] MINISTRY OF CORPORATE AFFAIRS, REPORT OF THE COMPANIES LAW COMMITTEE (2016).
[7] Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014, G.S.R 249(E).

3) Increase in the time period for declaration of registered office**:** The time frame for giving notice of situation or change in registered office has been increased from 15 days of incorporation or such change to 30 days under Section 12 of the Act.

4) Authentication of Documents: Section 21 of the Act before the amendment prescribed authentication of a document or proceeding by any key managerial personnel or an officer of the company duly authorized by the Board in this behalf. However, post 2017 Amendment, all employees of the company have been empowered to sign documents and contracts on behalf of the company. The same is a progressive step towards business liberalization and it waters down the accountability provided in the existing provision.

5) Private Placement of Shares: Section 42 of the principal act dealt with a private placement of shares and was completely substituted. The new section has brought the following changes: a) the requirement of a letter of private placement has been substituted by the issue of private placement offer and application in the prescribed form to identified persons without the right of renunciation; and, b) there is no need of filling private placement of offer letter. The new section thereby ensures ease in arrangement of capital by simplifying the procedure of private placement of shares.

6) Issuance of shares at discount: Section 53(1) of the Act prohibited the issue of shares at a discount except in case of sweat equity shares. The Amendment Act of 2017 provides that company may issue shares at a discount to its creditors when its debt is converted into shares in

pursuance of any statutory resolution plan, or debt restructuring by the RBI under the RBI Act, 1934 or the Banking (Regulation) Act, 1949. The addition of another exception to the general prohibition will aid the company as it will enable the company to reduce its liability and at the same time, increase its capital subject to the consent of creditor on the same.

7) Sweat equity shares: Section 54(1)(c) has been omitted which elucidated that companies could issue sweat equity shares only after one year of commencement of business; thus, post-amendment, newly incorporated companies are also eligible to issue sweat equity shares of a class of shares already issued. This is a welcoming change which will facilitate the startups in arranging investment.

8) Diversified modes of dispatch of notice of the issue of shares: Section 62(2) of the Act prescribed that the notice for the issue of shares can only be circulated through electronic mode, registered post or speed post. However, the amendment has relaxed this provision to include courier or any other mode of dispatch which is capable of ensuring a proof of delivery.

9) Provisions pertaining to deposit: Section 73(2)(d) has been amended to abolish the requirement of deposit insurance, and to relax the lifetime ban on a company defaulting repayment of deposit accepted or interest thereon. Instead, a cooling period of five years commencing from the date of clearance of default was provided for. This has increased the chances of revival of a company, which had defaulted for the first time.

10) Punishment for contravention of Section 73 or 76: According to Section 76A of the Act, the threshold limit of punishment has been reduced to twice the amount of deposit accepted by the company or one crore rupees, whichever is less in comparison to the earlier stipulated fixed sum of one crore rupees. Now, offences punishable with fine can also be compounded with offences punishable with fine and/or imprisonment. Earlier, only offences punishable with fines were compounded.

11) Registration of charge: Before the 2013 Act, the 1956 Act prescribed a list of charges which were required to be registered; the same was done away with by the 2013 Act. In the absence of a list, all the transactions covered by the wide definition of charge, which included pledges and liens, were required to be registered.

The Amendment Act of 2017 inserted a proviso to Section 77(1) providing a negative list of charges which shall be decided in consultation with RBI to which this section will not apply. This amendment is likely to cure the lacuna of 2013 Act and might once again exclude the registration of charges for pledge etc.

12) Satisfaction of Charge: The Amendment of 2017 inserted a proviso to Section 82(1), which deals with the registration of modification and satisfaction with the registrar. The proviso erroneously omitted the power of Registrar to grant an extension time of up to 300 days after the expiry of the earlier prescribed period of 30 days from the date of payment or satisfaction in full of any registered charge by straight

away prescribing the same to be made within 300 days by sending an application to the registrar in that regard.

13) Annual Return: The Amendment of 2017 has reduced the paperwork formalities for the companies by bringing various amendments to Section 92. The amendments are:

- The requirement of filling MGT-9 i.e. an extract of final returns to form a part of boards report has been omitted and instead the company is now required to upload the copy of the same on its website if any and attach its link in the Board's Report.
- An abridged form of report may be filled for one person company, small company, or such other class or classes as may be prescribed by the Central Government.
- It has omitted the requirement of disclosing indebtedness and details with respect to name, address, country of incorporation etc. of FII in the annual return of the company.
- The time limit of 270 days within which additional return can be filed on payment of additional fees has been removed and the company has been empowered to file ROC at any time.[8]

14) Omission of filing of returns for change in stake: The Amendment has omitted Section 93 whereafter, the requirement of filing a return with the ROC in respect of change in promoter's stake & submission of an advance copy of the special resolution for place of keeping register etc. has been done away with.

[8] Companies (Amendment) Act, 2017, No. 1, Act of Parliament, 2018.

15) Place of holding Annual General Meetings: The Amendment Act of 2017 has amended Section 96 to authorize the unlisted companies to hold Annual General Meeting (AGM) at any place in India (which as per the earlier regulations were required to be held at the registered office of the company) provided that all the members of such company are required to give their consent in advance either in electronic mode or in writing.[9] Thus, reducing physical constraints while conducting an AGM.

16) Extra Ordinary General Meetings: Section 100 of the Act has been amended to authorize the fully owned subsidiaries of the company which are incorporated outside India to hold the EGM anywhere in the world. This has cleared the mist in regard to the EGM in India created due to the lack of any provision in this regard in the Act or the erstwhile Act. Further the same has been mistakably reiterated in the Rules by way of an Explanation to Rule 8(3)(ix) of Companies (Management and Administration) Rules, 2014 and in the Secretarial Standard.[10]

17) Relaxation in the items restricted to be transacted through only Postal Ballot: Section 110 of the Act has been amended by 2017 amendment to allow items of business which earlier could only be passed in the general meetings of the company to be passed by postal ballet provided that an e-voting facility shall be provided by the company.

[9] *Id.*

[10] Companies (Management and Administration) Amendment Rules, 2015, G.S.R. 669(E).

The said amendment is likely to increase the shareholder's participation in meetings, discussions and casting of vote further will also save the cost of conducting the general meetings.

18) Resolutions and agreements to be filed: Section 117 has been amended to provide an exemption to banking companies from fillings resolutions and agreements in relation to passing of loans, giving of guarantee or providing security in respect of loans in the ordinary course of business. Further, the minimum fine for non filling by the company and officer has been reduced from rupees five lack to one lakh rupees and from rupees one lakh to fifty thousand and the time limit of 270 days within which resolutions and agreement could be filled has also been done away with.

19) Interim dividend: The Amendment of 2017 added clarification to the Section 123(3) where after the companies have been authorized to declare their interim dividend, after the closing of the financial year and till conduct of the AGM. However, cannot be out of surplus in profit & Loss account or out of the profit of that financial year or out of the profit generated until the quarter before the declaration.

20) Books of Account: Under Section 130(3), books of accounts can be reopened for a period of eight financial years, unless a longer period of keeping the books is directed.

21) Web Address: According to the amendment to Section 134(3)(a), web address, if any, where the annual returns of the company are displayed, shall now be a part of the Director's Report instead of Extract of Annual Returns.

22) Abridged Board's Report: As per Section 134(3A), central government may specify the format of Abridged Board's Report for One Person Companies (OPCs) and Small Companies.

23) Amendments related to CSR: As per Section 135, the tenure of threshold limit has been reduced to the end of immediately preceding financial year; whereas, earlier it was any financial year, thereby covering the lacunae of 2013 Act. It further provides that where the appointment of an independent director is not required, in such class of companies, any two directors can constitute the CSR committee.

24) Receipt of financial report along with auditor's report: According to Section 136, if agreed by 95% majority or more, when the copy of financial reports along with auditor's report is sent to the members of the company in less than 21 days, then it must be deemed to be received by all.

25) Disclosure of indebtedness: The disclosure of liabilities of the companies in its annual returns has been removed by the 2017 Amendment, thereby ensuring stability in the internal working of the company.

26) Statutory auditor: The amendment to Section 139 of the Act has removed the earlier statutory requirement of obtaining the ratification of members in regard to the appointment of auditors in every general meeting during the tenure of the auditor. The said amendment restricts the rights of shareholders to appoint or reject the appointment of auditors in every meeting. However, it would bring predictability and stability in the internal working of the company.

27) Resident Director: Section 149(3) has been amended to stipulate that for a newly incorporated company the requirement under the above-mentioned sub-section shall apply proportionately till the end of the financial year. The section earlier imposed an unconditional applicability of the requirement of having at least one director who shall be a resident of India i.e. stayed in India for a total period of not less than 182 days in the previous calendar year.

28) Deposit of amount on the appointment of directors: Section 160 of the Act was amended to exclude the independent directors and directors appointed by Nomination and Remuneration Committee from the requirement of making a directorship election deposit.

29) Disqualifications from appointment of directors: Section 164 has been amended to provide that in situations wherein the director appointed by the company has defaulted in fillings; in financial statements; in payment of interest; in repayment of deposits; in payment of interest on debentures; or in redemption of debentures etc. then such a director shall not be disqualified before the expiry of the period of six months from the date of appointment. It has further clarified that the disqualification arising due to conviction by court or order passed by a court or tribunal or conviction related to Section 188, will continue to exist irrespective of whether an appeal or petition has been filed against the conviction or disqualification.

30) Number of directorships: Section 165(1) has been amended to exclude the directorship in a dormant company from the statutory limit that

prescribes that no director can hold directorship in more than 20 companies at a time.

31) Filing requirement for DIR-11: The requirement of filing the DIR-11 form by the resigning director has been done away with by the 2017 Amendment to the Companies Act, 2013. According to Section 168(1), now it has become optional. This is a positive change as it allows a director to resign where it is out of mutual consent and not because of management issues. Hence, it also facilitates the ease of doing business.

32) Participation of director through video conferencing: A second proviso has been added to Section 173(2) to enable any director, in case where the quorum of the directors is present physically, to attend the meeting through video conferencing or any other audio visual means on any specified matter as stated under the first proviso to this sub-section. This proviso gives relief to the non-resident director to attend a meeting and discuss important issues without actually travelling to that place to attend the meeting.

33) Audit and Nomination Committee: Under Sections 177 and 178, the 2017 Amendment has amended the words “every listed company” to “every listed public company” providing relief to private companies from the provisions of Audit Committee and Nomination and Remuneration Committee. This amendment is also in tune with SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.

34) Loan to Director: Section 185 of the Act has been completely substituted by a new provision which allows extending a loan to a

director or for his guarantee or security on the basis of fulfilment of certain conditions given in sub-section 2 of the newly instituted section. It also provides for a detailed explanation, in order to remove any ambiguities and includes a penalty clause to heftily penalize the defaulting company.

35) Loan and Investment by the Company: The 2017 Amendment to Section 186 excludes employees from the ambit of this section and has done away with the requirement of shareholder's approval when a company wants to give a loan, guarantee, or security for its wholly owned subsidiary. Therefore, it provides a speedy decision making process and ensures separation of control of the company from its ownership.

36) Related Party Transactions: The 2017 Amendment has also introduced two changes in this regard. The first one being that where 90% or more of the members of a company are relatives or related persons to the promoters of that company, the company cannot restraint such members from voting in a general meeting; and the second one prescribes that non-ratification of a transaction shall be voidable at the instance of the board as well as the shareholders. Earlier, this right was only available to the board.

37) Insider Trading: Section 194 and 195 of the principal act were omitted. They dealt with forwarding dealings in securities by key managerial personnel, and insider trading respectively.

38) Remuneration to Managerial Personnel: A number of amendments were made to Section 197. They are:

- The requirement of approval from central government for paying managing director or manager of a company when the total pay exceeds 11% of the profits was removed.
- Now, approval of central government will only be necessary in case of variance under Schedule V Part 1 for the appointment of personnel.
- While payment of remuneration or for waiver of recovery of excess remuneration, prior approval of banks or financial institutions, etc., is required in case the company has defaulted in the payment of the dues.
- Directors have to repay the excess remuneration, if any, within a stipulated period of two years.
- It is the duty of the auditor to report payment of remuneration in conformity with the provisions of the Act, and disclose excess remuneration, if any.

39) Conversion into a company: Any form of business which has two or more members can now be converted into a private company under the provisions of the Section 366 of the Act, which has made the process of business transfer easier.

40) Fee for filing: Section 403 and its provisos have been amended in order to lessen the strict ties of the previously existing penalties under this section. Now, delayed filing of fees will vary depending upon the number of defaults, the nature of forms to be filled and the class and category under which a company falls.

4. CONCLUSION

The rationale behind corporate governance in India as also envisaged by the Companies Act, 2013, is to empower independent directors with proper checks and balances so that such extensive powers are not exercised in an unauthorized manner but in a rational and accountable way. However, within a short span of its incorporation various stakeholders started noticing the lacunae in the hastily drafted and implemented legislation. The same is also evident by the fact that the same attracted two amendments within a span of five years. Some of those changes are a mere attempt to reduce or clarify certain existing formalities, whereas most so far appears to be a step forward in the direction of aiding smooth running of the management and affairs of the companies in the interest of stakeholders. As analysed above, most of these changes are welcome changes in the globalized corporate world of today and are an endeavour to strengthen the core corporate machinery by instilling strong corporate governance norms in a company leading to economic efficiency and higher ethical standards which will always inspire the company's management to uphold its goals of maximization of wealth of stakeholders and building good corporate repute.

The 2015 Amendment to the Act focused on enhancing ease in doing business by providing various procedural relaxations and bringing the law in tune with the global standards for corporate laws. The Amendment of 2015 also provided for stricter penalties in case of frauds to make the Act more investor or business-friendly. The amendment enabled the existing companies to function efficiently by reducing formalities and red-tapism,

but most importantly, by way of substantial amendments such as the elimination of minimum share capital requirements and common seal etc., India has taken a leap ahead in terms of encouraging aspiring businessman to set up new ventures.

The 2017 Amendment to the Act targeted the difficulties which were faced during the implementation of the Act because of stringent compliance requirements. This Amendment also focused upon the aspect of ease in doing business and promoted growth and employment. The 2017 Amendment has done the necessary task of harmonizing the Act with the accounting standards; SEBI Act, 1992 and the regulations made there under; and, the RBI Act, 1934 along with its regulations made thereunder. The Amendment of 2017 has further contributed towards rectifying the existing lacunae and inconsistencies of the principal act. The said change has improved India's business regulations in absolute terms which is envisaged by the fact that India for the first time moved into the top 100 in the World Bank's Ease of Doing Business global rankings on the back of sustained business reforms over the past several years. This was announced by the World Bank Group's latest 'Doing Business 2018: Reforming to Create Jobs' report. Last year the report had ranked India at 130.[11]

The Act already had various provisions which supported the aim of providing ease in doing business, but this was further supported and substantiated by the following two amendments. The authors are of the firm view that, these amendments are quite unambiguous and mainly

[11] World Bank, *India Jumps Doing Business Rankings with Sustained Reform Focus*, Press Release (Oct. 31, 2017).

cover the large grey areas which were not discovered earlier, but were identified only after the implementation of the Act. However, there may still be many more areas where judicial decisions and reasoned orders will fill in the gaps. However, the job of the government never comes to an end in the dynamic field of law. Whether it is to maintain global standards or to introduce amendments to the existing laws, it is all for the government to look into it and amend according to the needs of the changing time.

REVIEW OF R.B.I.'S RECENT EFFORTS IN THE I.B.C. ERA TO MINIMIZE N.P.A.

Divya Gautam[*]

ABSTRACT

The Indian economy is facing a major challenge with a rise in the number of non-performing assets (NPAs) and defaulters. The accumulation of NPAs with creditors has a deleterious effect on the economy, thereby discouraging the positive flow of credit in the economy. The government and the Reserve Bank of India (RBI), time and again, keep formulating different policy-measures and regulations to curb this prevalent problem. Keeping in line with the same, in 2016, the NDA government came up with the Insolvency and Bankruptcy Code (IBC). The IBC has several peculiar features that make it stand apart from other legislations aimed at solving the menace of NPAs and defaulters before it. The objective of IBC is to boost the overall economic health of the country. The RBI was given power through the Banking Regulations (Amendment) Ordinance, 2017 to direct the banks for initiating insolvency resolution. From there on, the RBI, through its regulations and policies, began to meticulously implement the IBC. Within a month, RBI recognized twelve accounts for insolvency resolution and instructed public sector banks to frame a plan for the potential defaulters. Thereafter, in a crucial step, the RBI discarded other resolution- mechanisms to rely solely

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and completely on the IBC for the same. This was heralded as a much-needed step in the direction of creditor-protection. Likewise, the judiciary has also supported the IBC through its various pronouncements and decisions, giving the widest possible interpretation to the Code for its effective implementation. As a result of this, India took a massive leap by moving from 130th to 100th rank in the "Ease of Doing Business" index of the World Bank in 2017. Specifically under the head of 'insolvency resolution', the country took a leap of 33 points. Thus, the commendable step taken by the government and RBI on this front is showing a positive effect and will certainly show a positive result on the balance sheet of the country as well.

1. INTRODUCTION

India's banking industry is in the midst of a crisis due to the rising problem of non- performing assets (hereinafter "NPAs"). The insolvency laws in India may be categorized under two heads: 1. personal insolvency laws dealing with individuals and partnership firms; and 2. corporate insolvency laws dealing with companies and business houses. There were, in fact, several laws which dealt with insolvency for companies, such as the Sick Industrial Companies (Special Provisions) Act,1985 (hereinafter "SICA"), the Recovery of Debt Due to Banks and Financial Institutions Act,1993, and Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (hereinafter "SARFAESI"), etc. Till 1985, the Companies Act, 1956 was the sole legislation to deal with corporate insolvency and bankruptcy. However, due to non-inclusion

of insolvency cost in any of the provisions of said legislation, it proved to be insufficient. There were a couple of laws dating back to the time of the British era, dealing with individual debtors, such as, the Presidency Towns Insolvency Act, 1909 and the Provisional Insolvency Act, 1920. The former was related to individuals residing in the erstwhile presidency towns of Calcutta, Bombay and Madras; whereas, the latter covers all other individuals. However, these multiple laws failed to recover the money for the banks.

By 1985, the Indian industries were in major crisis and the economy was in shambles. So, SICA was passed. This was the first legislation for addressing the problem of insolvency and bankruptcy in the country. This legislation primarily focused on the revival of sick industries. However, there were several lacunae in the provisions of the said act. For instance, under Section 22, any corporate debtor could avoid recovery proceedings or liquidation indefinitely by referring the sick industry to the Board for Industrial and Financial Reconstruction. Therefore, owing to its inefficiency, the said act was repealed in the year 2016.

The Insolvency and Bankruptcy Code, 2016 (hereinafter "the Code") is a pioneering framework, which replaced India's archaic bankruptcy laws. It aims to provide a far speedier resolution of insolvency proceedings and debt restructuring for the benefit of operational creditors[1] and financial creditors[2]. The Bankruptcy Law Reforms Committee (hereinafter "BLRC") headed by Dr. T.K. Viswanathan, on November 4,

[1] Insolvency & Bankruptcy Code, 2016, § 5(20).
[2] *Id.*

2015, submitted its report to the Union Ministry of Finance. This paved the way for a comprehensive draft of Insolvency and Bankruptcy Bill covering all entities. The BLRC proposed shift of the Indian insolvency law from a "debtor-in-possession" model to a "creditor-in-control" model. The Code seeks to consolidate the scattered and unstructured jurisprudence on insolvency and bankruptcy law present in various legislations like SICA, 1985 and SARFEASI, 2002, among others.

According to its statement of objects and reasons, the Code seeks to provide an effective legal framework for timely insolvency-resolution, in order to the support development of credit markets and encourage entrepreneurship. It would also improve the ease of doing business, and facilitate more investments leading to higher economic growth and development.[3]

To quote Finance Minister, Mr. Arun Jaitley, "[a] systemic vacuum exists with regard to bankruptcy situations in financial firms. This code will provide a specialized resolution mechanism to deal with bankruptcy situations in banks, insurance firms and financial sector entities."[4]

2. IBC – THE CODE TO DECODE INSOLVENCY REGIME

The Code embodies peculiar rules and regulations which transformed the course of action to deal with insolvency and bankruptcy in

[3] MINISTRY OF CORPORATE AFFAIRS, REPORT OF THE INSOLVENCY LAW COMMITTEE, *available at* http://www.mca.gov.in/Ministry/pdf/ILRReport2603_03042018.pdf (last visited Nov. 26, 2018).

[4] *Economics for Everyone: The Insolvency and Bankruptcy Code in India and the National Company Law Tribunal*, IIFL, https://goo.gl/wevjB9 (last visited May 29, 2018).

the economy. The Insolvency Act of 1986 of the United Kingdom has served as a model for the Code.[5] Broadly speaking, the Code has four pillars which make the process work effectively:

i) The regulator: The Insolvency and Bankruptcy Board of India[6] (hereinafter "IBBI") is the key pillar of the ecosystem responsible for implementation of the Code. It consolidates and amends the laws relating to reorganization and insolvency resolution of corporate persons, partnership firms, and individuals in a time bound manner. This maximizes the value of assets of such persons, promotes entrepreneurship, and ensures availability of credit and balance in the interests of all the stakeholders.[7]

ii) The adjudicator: The National Company Law Tribunal (hereinafter "NCLT") is the adjudicator for insolvency resolution and liquidation for corporate persons including corporate debtors and personal guarantors.[8] Appeals from here lie to the National Company Law Appellate Tribunal (hereinafter "NCLAT").[9] The Debt Recovery Tribunal is the adjudicator for individuals and partnership firms.[10] The Supreme Court is the final court of appeal to be approached within a period of 45 days from the date of the order.[11]

[5] Innoventive Indus. v. ICICI Bank, (2018) 1 S.C.C. 407.
[6] *supra* note 1.
[7] *About IBBI*, INSOLVENCY & BANKRUPTCY BOARD OF INDIA, http://www.ibbi.gov.in/about-ibbi.html (last visited May 29, 2018).
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] *Id.*

iii) Information Utilities (hereinafter "IUs"):[12] It is a depositary of financial information. It receives, authenticates, maintains, and delivers financial information pertaining to a debtor, with a view of facilitating the insolvency resolution process in a time bound manner.

iv) The Insolvency Professionals (hereinafter "IPs"):[13] They are monitored by Insolvency Professionals Agencies (hereinafter "IPAs").[14] These IPAs are further regulated by the regulations laid down by the Board.

The Code enshrines strict time bound insolvency resolution. 180-day period is the specified for corporate insolvency resolution process (hereinafter "CIRP") of a company after case has been filed in the NCLT.[15] This deadline may be extended for a period of 90 days. The assets of the company will be liquidated after 270 days.[16] The CIRP of sick companies in a time bound manner makes the legislation distinct from its predecessors.

The priority of payment mechanism[17] prescribed in the Code does equity to all the parties involved. Moreover, the cross-border insolvency[18] process mentioned in the Code does not discriminate between the national and foreign creditors. Both are allowed to commence and initiate proceedings under the Code. However, it does not specify the same for the

[12] *Id.*
[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] *Id.*
[17] *Id.*
[18] *Id.*

debtors. These are some other intriguing aspects of the Code which makes it stand apart.

Additionally, the Code has a provision of non-obstante clause.[19] Subsequent jurisprudence on the same, developed by the Supreme Court, says that the Code has an over-riding effect over all other laws on the subject matter.[20] In the same case,[21] the Supreme Court affirmed that non-obstante clause of the Parliamentary enactment i.e. the Code will prevail over the limited non-obstante clause mentioned in the State Act.

3. BEGINNING OF A NEW ERA

The Code has created a new wave of significant changes in the entire mechanism of the CIRP. Over 1812 Insolvency Professionals are registered under three IPAs, namely, the Indian Institute of Insolvency Professionals of ICAI, ICSI Institute of Insolvency Professionals, and Insolvency Professional Agency of Institute of Cost Accountants of India. As per the Economic Survey 2017-18, at the end of March, 2018 a total of 525 cases of CIRP has been admitted under the Code in NCLT. The corporate person is entitled to initiate voluntary liquidation under Section 59 of the Code, and till now at least three corporate persons have initiated the same.[22] On May 19, 2018, Tata Steel acquired debt laden Bhushan Steel, thereby wrapping up the first case of resolution under the Code.

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[19] *Id.*
[20] *supra* note 5.
[21] *Id.*
[22] *The Quarterly Newsletter of the Insolvency and Bankruptcy Board of India*, INSOLVENCY & BANKRUPTCY BOARD OF INDIA,

An important factor behind the effectiveness of the Code has been the adjudication by the judiciary. The Code prescribes strict time limit for various procedures under it. In spite of the large inflow of cases to NCLT benches across India, these benches have been able to admit or reject applications for CIRP admissions with very little delays. In addition, appellate courts, including the NCLAT, High Courts and the Supreme Court have also disposed-off appeals quickly and decisively. In this process, a rich body of case-laws has developed, thereby reducing future legal uncertainty.[23] This is a paradigm shift in insolvency resolution mechanism in the country, as the adjudicators understand their responsibility and acknowledge the same in judgments delivered by them on this subject matter. A landmark judgment on the Code, *Innoventive Industries Limited v. ICICI Bank Limited*,[24] boosted confidence of the creditors in the Code as the judgment explained various provisions of the Code by giving way to the widest possible interpretation of the legislation. The judgment clarified position of the financial creditor and the operational creditor in initiation of the insolvency proceedings, emphasized on the deadlines prescribed, and overriding effect of the Code. Similarly, in the case of *Surendra Trading Company*,[25] the Supreme Court settled the dispute whether time period prescribed in the legislation is

http://www.ibbi.gov.in/IBBI_News_letter_2018_06_11_18_12_27.pdf. (last visited May, 29, 2018).

[23] *Monetary Management and Financial Intermediation*, INSOLVENCY & BANKRUPTCY BOARD OF INDIA, http://www.ibbi.gov.in/044_055_Chapter_03_Economic_Survey_2017_18.pdf. (last visited May 29, 2018).

[24] (2018) 1 S.C.C. 407.

[25] Surendra Trading Co. v. Juggilal Kamlapat Jute Mills, (2017) 16 S.C.C. 143.

directory or mandatory in nature, the Supreme Court held that the time prescribed to operational creditor under Section 9(5) is mandatory, whereas the time limit prescribed to appellate authority under same provision is directory in nature. The Supreme Court through its pronouncements gave the widest possible interpretation to the various provisions under the legislation, for instance, the Court said that under Section 8(2) the term 'dispute' is not confined to pending suits and arbitration.[26] There are several other cases along the same lines where the Supreme Court, High Courts, NCLT, and NCLAT have pronounced judgments backing the Code affirmatively, thus widening scope of application of the legislation. In a historic judgment on the Code, Hon'ble Supreme Court quoted:

> *The Banking sector is one of the largest and most crucial sectors in India. It involves heavy financial and economic stakes of not only the banks themselves but also industry and commerce in India as a whole apart from the public. Any interference with this process formulated by RBI will prejudice the very significant economic reform formulated by Parliament and the Government of India which was to bring value back in the system.*[27]

4. RBI – PAVING WAY FOR IBC

This is the first time that the Government and the Reserve Bank of India (hereinafter "RBI") are on the same front for effective resolution of the problem of bad debt. The stressed assets and increasing NPAs with the

[26] Mobilox Innovations (P) Ltd. v. Kirusa Software (P) Ltd., (2018) 1 S.C.C. 353.
[27] Essar Steel India Ltd. v. Reserve Bank of India, 2017 S.C.C. OnLine Guj. 995.

major banks had been a concern for the RBI for many decades. Several measures were taken by the RBI to tackle the same.

4.1. GOVERNMENT COUNTS ON THE RBI

The Banking Regulation (Amendment) Ordinance, 2017 issued in May 2017 empowered the RBI to issue directions to any banking company or banking companies to initiate insolvency resolution process in respect of a default under of the Code. The RBI may specify authorities or committees to advise banks on resolution of stressed assets. The members on such committees would be appointed or approved by the RBI. The RBI can, from time to time, issue directions to banks for resolution of stressed assets.

4.2. THE OPENING MOVE

Thereafter, through a Press Release on May 22, 2017, the Apex Bank outlined its action-plan to implement the legislation. It issued the following directives to the Banks to deal with the stressed assets which include gross bad loans, advances whose terms have been restructured, and written-off accounts:

i) A corrective action plan for the stressed assets could include flexible restructuring, SDR and S4A.
ii) It slashed the minimum votes required in a Joint Lenders' Forum (hereinafter "JLF") to reach a decision. Now, decisions agreed to by 60% of creditors by value and 50% by number is the basis for corrective action plans as compared with assent of 75% creditors by

value and 60% by number to achieve resolution earlier. Conscious steps were taken by the Apex Bank to curb the prevalent difficulties in insolvency initiation and rules regulating it.

iii) Banks which are in the minority on proposal approved by the JLF are required to either exit by complying with the substitution rules within the stipulated time or adhere to the decision of the JLF.[28]

The RBI further mentioned that it is working on a framework to facilitate the objective and consistent decision-making process with regard to cases that may be determined on reference for resolution under the Code.[29]

4.3. APEX BANK IDENTIFIED MAJOR NPA ACCOUNTS: A METTLESOME MOVE

In June 2017, RBI came up with a master stroke by identifying the twelve accounts totalling about 25 per cent of the current gross NPAs of the banking system. However, the names of these bankrupt accounts were not disclosed in the report. An Internal Advisory Committee (hereinafter "IAC") was constituted to focus primarily on the large stressed assets. It classified the accounts as partly or wholly NPAs from amongst the top 500 exposures in the banking system. These twelve accounts fulfilled the criteria set up by the IAC of fund and non-fund based outstanding amount

[28] *Reserve Bank of India Outlines the action plan to implement the Banking Regulation (Amendment) Ordinance, 2017*, RESERVE BANK OF INDIA, https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=40518. (last visited May 29, 2018).
[29] *Id.*

greater than ₹5000 crore, with 60% or more being classified as non-performing by banks as on March 31, 2016. These accounts were referred for the insolvency proceedings under the Code forthwith. Moreover, the IAC recommended that the banks should finalize a resolution plan within six months for those NPAs which do not satisfy the above criteria. In cases where a viable resolution plan is not agreed upon within six months, the banks were required to file insolvency proceedings under the Code. In its first meeting, the panel discussed the top 500 stressed accounts in the banking system that should be referred for resolution under the Code.[30]

Big names came in the scenario. Among the twelve bankrupt accounts, Bhushan Steels Ltd., Essar Steels Ltd., Monnets Ispat and Energy Limited, etc. were the major names referred by the RBI.[31]

4.4. CAUSE *CÉLÈBRE*

During this pursuit of the RBI, a controversy popped up, Essar Steels challenged this particular directive issued by the RBI in the Gujarat High Court. It contended that the twelve entities mentioned in the RBI directive had been chosen arbitrarily. Moreover, it was in discussions with its lenders for restructuring of its debts, but the discussions had come to a standstill as a result of the RBI directive. The RBI counter argued that the

[30] *RBI identifies Accounts for Reference by Banks under the Insolvency and Bankruptcy Code (IBC)*, RESERVE BANK OF INDIA, https://www.rbi.org.in/scripts/bs_pressreleasedisplay.aspx?prid=40743# (last visited May 29, 2018).

[31] *Monetary Management and Financial Intermediation, Table 4: First Twelve Defaulters as Notified by RBI*, INSOLVENCY & BANKRUPTCY CODE OF INDIA, http://www.ibbi.gov.in/044_055_Chapter_03_Economic_Survey_2017_18.pdf (last visited May 29, 2018).

list was not prepared arbitrarily as these twelve accounts are the largest and longest standing NPAs. The Gujarat High Court refused to interfere with the RBI directive and held that the said RBI directive was not arbitrary.[32] This eventually paved the way for initiation of insolvency resolutions against other large companies.

4.5. 40 MORE ACCOUNTS DISCERNED – NEED OF THE HOUR

Thereafter, in August, RBI identified 40 large loan defaulter accounts for clean-up to banks,[33] as the next lot of firms for early resolution. This was followed by another 26 defaulters to banks being asked to first resolve through any of its schemes before 13 December, failing which they shall be referred to NCLT under the Code before 31 December. However, this report was submitted in anonymity.[34] These acute measures taken by the RBI clearly show that it was adamant on eliminating up to the maximum the NPAs from the banking sector by taking advantage of the Code and power conferred on it by the new banking legislation amendments.

[32] Essar Steel India Ltd. v. Reserve Bank of India, 2017 S.C.C. OnLine Guj. 995.

[33] *RBI identifies 40 larger loan defaulter accounts for clean-up*, LIVEMINT, http://www.livemint.com/Industry/TECdaxHBGkvi0FRnQuorFL/RBI-identifies-40-more-large-loan-defaulter-accounts-for-cle.html. (last visited May 29, 2018).

[34] *RBI sends second list of 26 defaulters to banks*, LIVEMINT, http://www.livemint.com/Industry/OXbCxiTnEIX1QV6hEGIykK/RBI-sends-second-list-of-26-defaulters-to-banks.html. (last visited May 30, 2018).

4.6. IUs – Technology Making It Easy

The IBBI registered National E-Governance Services Limited (hereinafter "NeSL")[35] as the first IU under the IBBI (IUs) Regulations, 2017.[36] IUs store financial information to help establish defaults and verify claims expeditiously in order to complete transactions under the Code in a time-bound manner. On 19th December, 2017, the Apex Bank took a step further to make IUs a success and issued direction to all banking and the non-banking companies to share financial information and information relating to the assets in relation to which any security interest has been created with information utilities in the manner specified in the regulations. This step was taken to ensure the adherence to the provisions of the Code. The letter was addressed to all scheduled commercial, small finance, local area and cooperative banks as well as non-banking financial institutions and all-India financial institutions.[37]

4.7. The Growing NPAs: An increasing concern

Meanwhile, RBI's Financial Stability Report released on 21st December 2017 cautioned that in the upcoming time, Gross Non-Performing Assets (GNPA) of the banking sector may rise from 10.2 per cent of gross advances in September 2017 to 10.8 per cent in March 2018,

[35] *Information Utilities (IUs)*, INSOLVENCY & BANKRUPTCY BOARD OF INDIA, http://www.ibbi.gov.in/information-utilities.html. (last visited May 30, 2018, 5:03 PM).
[36] Insolvency & Bankruptcy Board of India (Information Utilities) Regulations, 2017, *available at* http://ibbi.gov.in/IU%20Regulations%2031032017%20Final.pdf. (last visited May 30, 2018).
[37] *Submission of Financial Information to Information Utilities*, RESERVE BANK OF INDIA, https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11189&Mode=0 (last visited June 1, 2018).

and to 11.1 per cent by September 2018.[38] The RBI in its publication named 'Perspectives on the Indian Banking Sector' [39] clarified that banks can take advantage of the Code to clean up their balance sheets and improve performance on a sustained basis to remain competitive. Instead of waiting for regulatory directions, banks can file insolvency proceedings on their own to realise promptly the best value of their assets. The banks need to strengthen their due diligence, credit appraisal, and post-sanction loan monitoring to minimise the risks of such occurrence in future[40].

The Apex Bank considered the IBC due to two factors. They are the rising GNPA of banks and slower resolution of NPAs through various other channels.

4.8. PONDERING UPON THE FRAMEWORK: LEFT NO STONE UNTURNED

Taking a big leap ahead the RBI took a major decision by revising its stressed asset framework to ensure speedy resolution of bad loans in the future. The RBI relied completely on the Code to resolve stressed assets and scrapped all debt restructuring schemes prior to it.

4.9. A RENEWED STRESSED ASSET FRAMEWORK

On 12th February, 2018, RBI released the revised framework of resolution of stressed assets. According to the revised framework, lenders

[38] *RBI releases December 2017 Financial Stability Report*, RESERVE BANK OF INDIA, https://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=42642 (last visited June 1, 2018).

[39] *Perspectives on the Indian Banking Sector*, RESERVE BANK OF INDIA, https://rbi.org.in/scripts/PublicationsView.aspx?Id=18057 (last visited June 1, 2018).

[40] *Id.*

were required to identify the stressed loan account in the initial stage and classify those accounts as Special Mention Account (hereinafter "SMA") as per the categories provided by the framework and entitle it as 'defaulter' forthwith. The SMA contained three sub-categories, and the basis for the classification is principal or interest payment or any other amount wholly or partly overdue between (i) 1- 30 days; (ii) 31-60 days; (iii) 61-90 days. After such classification, lender must report credit information, including classification of an account as SMA to Central Repository of Information on Large Credits (hereinafter "CRILC") on all borrower entities having aggregate exposure of ₹50 million and above with them. Additionally, CRILC report must be submitted on monthly basis. Further to facilitate the resolution plan, the RBI directed the banks to have their Board approved policies for the resolution of stressed assets.

The Code seeks strict time-bound initiation of corrective action at the stage of first default either to the bank or to the business counter parties. The same framework prescribed strict timeline within which insolvency proceedings must be initiated. The accounts which have aggregate exposure of the lenders at ₹20 billion and above including accounts where resolution may have been initiated under any of the existing schemes, as well as the accounts classified as restructured standard assets (large accounts), the resolution plan must be implemented as per two time liners i.e., if in default as on the reference date, then 180 days from the reference date and if in default after the reference date, then 180 days from the date of first such default. The reference date for the same purpose mentioned was on or after March 1, 2018. However, if the

resolution plan was not implemented within the given timeline then the lender shall file insolvency proceeding under the Code within the 15 days of expiry of such timeline. This can be concluded that the RBI was resolute to eliminate the issue of stressed assets from the economy by largely stressing on the large accounts and potential defaulters.

4.10. THE RBI MANEUVERING WITH THE CODE

Moreover, the RBI substituted the existing guidelines with the harmonised and simplified generic framework of the Code for the resolution of stressed assets. Therefore, Framework for Revitalising Distressed Assets, Corporate Debt Restructuring Scheme, Flexible Structuring of Existing Long Term Project Loans, Strategic Debt Restructuring Scheme (SDR), Change in Ownership Outside SDR, and Scheme for Sustainable Structuring of Stressed Assets (S4A) were withdrawn with immediate effect. Accordingly, the Joint Lenders' Forum (JLF) as an institutional mechanism for resolution of stressed accounts was also discontinued.[41] This path-breaking step signifies the complete reliance on the Code as a resolution mechanism, subsequently this boosted confidence of the stakeholders and showed positive outcome.

4.11. IBBI AND RBI – THE ALLIANCE AGENDA

Moreover, for the effective implementation of the Code, the IBBI and the RBI signed a Memorandum of Understanding (MoU) to assist and

[41] *Resolution of Stressed Assets – Revised Framework*, RESERVE BANK OF INDIA, https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11218&Mode=0 (last visited June 2, 2018).

co-operate with each other for the effective implementation of the Code, subject to limitations imposed by the applicable laws. The objectives were sharing of information and resources available to each other to the extent legally permissible, and making joint efforts to enhance the level of awareness among creditors, among others.[42] This can be concluded that both the statutory bodies are determined to make the Code a success and are interested in the effective implementation of the Code and its allied rules and regulations through a quick and efficient resolution process.

5. CONCLUSION

Since, the last five year NPAs are rising steadily in the country deteriorating the health of the economy, there was an urgent need for a defined and comprehensive legal framework to deal with this stressful state of affairs. The performance of the banking sector, PSBs in particular, continued to be subdued in the current financial year. The GNPA ratio of Scheduled Commercial Banks has increased from 9.6 per cent to 10.2 per cent between March 2017 and September 2017.[43] The hopeful and buoyant legislation, the Insolvency and Bankruptcy Code, gave hope to the RBI, the controller of credit in the country and the government to relieve this rising stressful situation by addressing the problem of the

[42] *Insolvency and Bankruptcy Board of India signs a Memorandum of Understanding with the Reserve Bank of India*, INSOLVENCY & BANKRUPTCY BOARD OF INDIA, http://ibbi.gov.in/webadmin/pdf/press/2018/Mar/RBI-IBBI%20MoU%20Press%20Release.pdf (last visited June 2, 2018).

[43] *Monetary Management and Financial Intermediation, Banking Sector*, INSOLVENCY & BANKRUPTCY BOARD OF INDIA, http://www.ibbi.gov.in/044_055_Chapter_03_Economic_Survey_2017_18.pdf (last visited June 2, 2018).

NPAs. The RBI was optimistic and took complete advantage of the Code by formulating policies and regulations for the PSBs under the Code. The success of the Code rests on the alacrity with which the government, courts, tribunals and IBBI respond to early-stage issues arising in their domain. The World Bank recognised the sustained efforts and commitment of the government when the country became one of the top ten 'improvers' in the ranking. India is ranked in top 100 for the first time in World Bank's "Ease of doing business". India's ranking jumped from 130th to 100th position in 2018; and taking note of the head of insolvency resolution, the country stands at 103th rank.[44] There is no doubt that this sharp improvement owed to the implementation of a well-defined legal framework and sincere steps taken by the RBI to keep up with the pace of development of the Code, and this eventuated in efficient channelization of debt recovery in our developing economy. The World Bank and International Monetary Fund have acknowledged and praised the efforts for the same purpose. This will prove to be a game changer in the interest and long-term growth of the economy, and would subsequently improve financial discipline in the country.

[44] *Economy Rankings*, THE WORLD BANK, http://www.doingbusiness.org/rankings (last visited June 3, 2018).

FINANCIAL CRIMES: DISTURBING THE EASE OF DOING BUSINESS IN INDIA

- *Shree Shishya Mishra*[*] *& Aishwarya Surana*[**]

ABSTRACT

This paper tries to highlight the effect of different financial crimes on the ease of doing business in India with the help of statistics provided by recognized databases. The paper also delves deeper into the impediments faced by businesses in functioning smoothly which arise due to incidents of financial crimes in India such as the Satyam scam and the Punjab National Bank fraud case. These cases along with a few others have been discussed at length to bring to the light the lacunae in the present system and to show that the aftermath of the regulation introduced due to an upsurge in the financial crimes further restricts the ease of doing business in India. The paper also tries to extract evidences from instances occurring abroad so as to prove the generality of the offences and the consequences which remain the same across the globe. Attempts have been made to provide suggestions to deter the incidents of financial crimes and to strengthen the regulations. The primary aim of the paper is to provide for affirmative action to the businesses against such crimes, thereby bridging the gap between the regulations brought and the ease of doing business.

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1. INTRODUCTION

Businesses act as tools of empowerment for any developing economy. Today, they play a significant role in determining not only whether an economy is developed or not, but also whether it is worth investing in. To make these decision-making processes easier for the investors the World Bank comes up with an 'Ease of Doing Business' report which ranks countries on their ability to ease the process of setting up and pushing businesses. The rank is based on several criteria which are affected by the level of white collar crimes a sector of a State is subject to. With an increase in white collar crimes, people become more cautious to venture or invest into businesses, and this, through a chain reaction, ends up affecting the consumers. The impact on the consumers then cyclically affects the market performance, digging a hole in the economy.

2. IMPACT OF VARIOUS CRIMES ON THE EASE OF DOING BUSINESS

With India ranking 100th in the World Bank's Ease of Doing Business Index, the question pertinent to note is the impact which financial crimes can have on such index. To study the impact, it becomes essential to trace the history of incidents of financial crimes in India. Typically, financial crime in India is not a new phenomenon. It has been plaguing the society for a long time now with one of the first reported post-independence scam taking place in 1951 known as the 'Mundhra scam', in which the Life Insurance Corporation (LIC) was defrauded into investing the shares of six troubled companies. Since then, the number of incidents such as these has only continued to rise.

Some famous scams may be named. In the year 1992, the Harshad Mehta scam highlighted the loopholes existing in the Indian financial system such as the then restrictions on banks to directly invest in the Equity Markets and their reliance on the brokers to purchase securities and forward bonds from other banks (known as the Ready Forward Deal). The imprint of the scam could be seen in the Ketan Parekh scandal (2001) wherein Parekh conned banks by buying shares in fictitious names to manipulate the share prices of the companies. Furthermore, the Saradha scam in 2009 exposed the loopholes in SEBI regulations. The running of ponzi scheme by the Saradha Group (a consortium of over 200 private companies) caused financial loss to its 1.7 million investors. Another mega-scam that shook Indian markets was the Sahara scam, wherein Sahara had illegally raised over Rs. 20,000 crores from over 4000 investors and had managed to remain out of the grasp of SEBI for a very long time. The upsurge in these types of scams eventually affected the potential investment opportunities and prompted people to investigate other spheres and tactics through which corporate crimes can be committed. Some of the common types of corporate crimes are expounded below.

2.1. BRIBERY

A crime like bribery has always posed a hurdle for India. As per the Transparency International Corruption Perceptions and Bribe Payers Indices (2012), India ranks 94 out of 176 countries and 19 out of 28 countries in the offences of corruption and bribery respectively. This not

only indicates the gravity of the matter but also points at the necessity to rectify them.[1] Table 1 shows us that Bribery is common amongst those sectors where it is not only difficult to start a business but also the ones that require a substantially higher amount of investment.

Following sectors are the ones known to be the most sensitive to bribery related crimes:[2]

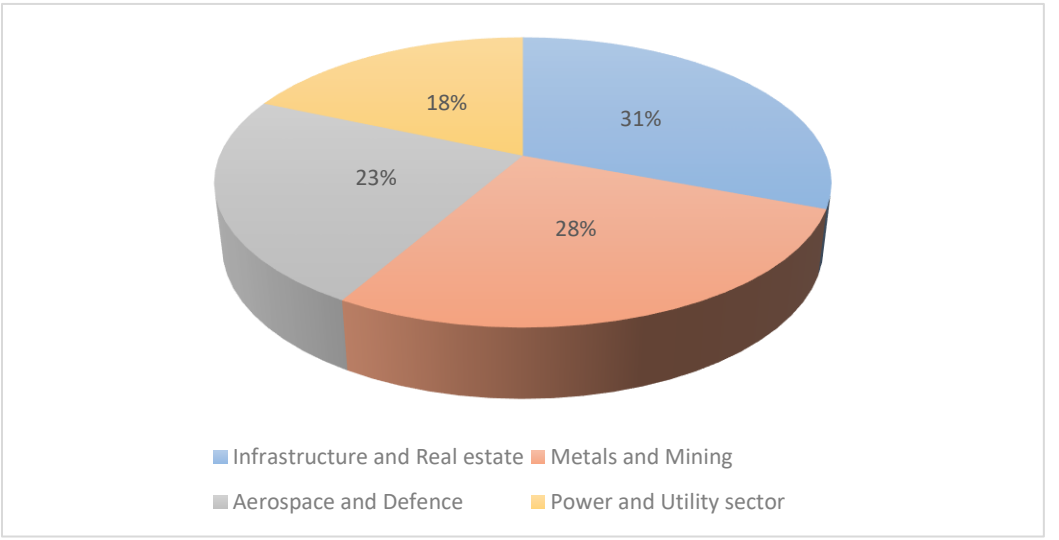

Table 1

Therefore, if these sectors are affected, not only will it discourage investment but will also discourage entrepreneurs from ever venturing into that field, resulting in the stagnation of that sector. Bribery has also a

[1] *Bribery & Corruption: Ground Reality in India*, EY, https://www.ey.com/in/en/services/assurance/fraud-investigation---dispute-services/bribery-and-corruption-ground-reality-in-india (last visited June 28, 2018).
[2] *Id.*

direct impact on the tools required to facilitate business as explained hereafter.

Empirically, bribery perpetually:[3]

- Increases transaction costs
- Increases uncertainty in the economy
- Lowers efficiency
- Inhibits the development of a healthy marketplace
- Distorts economic and social development

With reference to the above, it would be safe to assume that bribery indeed directly co-relates to the difficulty of business growth[4] as can be seen from the plague of corporate bribery cases that hit India starting from the *Diageo* bribery case (2003), where Indian subsidiaries of the U.K based alcoholic beverages company employed agents to make unlawful payments to state-owned liquor shops, followed by the *Wabtec scam* (2005), *Control Components* (2003-07), and the latest *Oracle Corporation Scam* (2012), which not only dissuaded foreign companies from investing and opening subsidiaries in India but also subjected Indian-subsidiaries of foreign based companies to more scrupulous and unwarranted checks.[5]

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[3] *Effects of Corruption on Business*, YOUR BUSINESS, https://yourbusiness.azcentral.com/effects-corruption-business-15261.html (last visited June 28, 2018).

[4] *Id.* at 2.

[5] *Indian Bribery and Corruption Exposed*, INT'L FINANCIAL REV., http://www.iflr.com/Article/3196287/Indian-bribery-and-corruption-exposed.html (last visited Apr. 24, 2013).

2.1.1. Final impact of Bribery on the market

Through several reports, it is concluded that around 83% of the respondents feel a string of these scams can definitely hit the FDI inflow negatively. Furthermore, around 73% of investors feel that they might have to go through a more austere bargaining process before entering into any transaction due to the fear of corruption. Subsequently 50% of the respondents have also been known to say that one of the prime reasons their companies lost business was their competitor's unethical conduct. Finally, according to 73% of the respondents from various PE firms, companies that are perceived as highly corrupt and are operating in such sectors may not be able to stand strong upon fair valuation of its business and without them the sector would continue to fester.[6]

2.2. FRAUD

After the fraudulent actions of Modi and Choksi, who were involved in defrauding the Punjab National Bank of a potential amount of Rs. 11, 400 crores by obtaining fake Letter of Undertaking for procuring funds and diverting the same to overseas entities, the market sentiments were hurt affecting investments in the jewellery sector as a whole.[7] According to Dhanajay Singh, Head, Research, Emkay Global financial services, banks are going to become more vary of the jewellery sector

[6] *Id.* at 2.

[7] Sameer Bharadwaj, *Nirav Modi case: PNB fraud affects stocks of Union Bank, Allahabad Bank, SBI, Axis Bank*, BUSINESS TODAY, https://www.businesstoday.in/markets/stocks/nirav-modi-case-pnb-fraud-affects-stocks-of-union-bank-allahabad-bank-sbi-axis-bank/story/270786.html (last visited July 2, 2018).

which will not only hit the flow of credit to that sector but may also cause huge short-term impacts. He also explained that jewellers usually focus less on the revenue derived from domestic market and they rely heavily on the bank credit which means almost all jewellery companies will now suffer a tightening in the credit system.[8] Though the impact will be less on domestic players, it will continue to affect them. Investors in these situations are also usually advised to avoid small players and stick to the big companies. "When financing for the industry becomes tough, smaller players usually suffer more," says Abneesh Roy, Senior VP, Edelweiss Securities.[9] Another scam that sent ripples across the world was the Enron Corporation scandal, popularly known as the Enron scam. To cope up with the aggressive competition prevailing in the market, Enron sought to adopt dubious method such as "mark to market accounting" which involved hiding losses by projecting unrealized future gain from trading contracts as higher current profits in their current income statement. This gave an impression to the investors that the company was in a continuous process of earning profit despite rigorous competition.[10]

Enron's downfall drained the investment savings of investors who had put their pension and other investments into mutual funds, pension

[8] *Want your customers to commit? Build a foundation of trust and honesty*, SCROLL, https://scroll.in/bulletins/148/want-your-customers-to-commit-build-a-foundation-of-trust-and-honesty (last visited June 18, 2018).

[9] Narendra Nathan, *Should Stock Market Investors Avoid Jewellery Sector Totally Due to PNB Fraud Impact?*, THE ECON. TIMES, https://economictimes.indiatimes.com/wealth/invest/should-stock-market-investors-avoid-jewellery-sector-totally-due-to-pnb-fraud-impact/articleshow/63055995.cms (last visited Feb. 16, 2018).

[10] Troy Segal, *Enron Scandal: The Fall of a Wall Street Darling*, INVESTOPEDIA, https://www.investopedia.com/updates/enron-scandal-summary/ (last visited Jan. 3, 2018).

funds, and other vehicles that invested in Enron, thereby affecting the financial position of thousands of people across the country connected to the company directly or indirectly.

2.2.1. Impact of the Enron scam on India

On 20th June 1992, the Dabhol Power Plant project was set up by the Enron International through a Memorandum of Understanding (MOU) signed between the Government of Maharashtra and Dabhol Power Corporation. This power project was to be the single largest foreign direct investment in India. But the project could not achieve complete production due to the downfall of Enron, and caused widespread financial loss coupled with subsequent environmental degradation and human rights violation.[11]

2.3. INSURANCE FRAUD

As per the Ease of Doing Business Report given by the World Bank, in almost 6 out of the 10 criteria insurance plays a huge role in ensuring their success. Insurance brings about stability which may also result in an improvement in the ranking if properly incorporated. If insurance can improve the ease of doing business, it can bring about its downfall as well.[12] 54% of the insurers believe that insurance fraud is the biggest

[11] Sandip Roy, *Enron in India: The Giant's First Fall*, ALTERNET, https://www.alternet.org/story/12375/enron_in_india%3A_the_giant%27s_first_fall (last visited Feb. 7, 2002).

[12] Kapil Mehta, *How Insurance Can Improve the Ease of Doing Business*, LIVE MINT (Nov. 16, 2016), https://www.livemint.com/Money/3tZg2NSgzQX3WIgSN2sgJL/How-insurance-can-improve-the-ease-of-doing-business.html.

threat to businesses and their development. They believe that not only does it affect insurance companies per se but also every other class of business. It compels customers to bear the brunt of its subsequent impact especially with respect to the outlays suffered while also damaging the image and repute of the insurers.[13] The severity of fraud can range from misconceived hyperboles to causing calculated damages to the assets of the insured.[14] A study showed that in India, its insurance sector incurs a loss of more than 8% of its total revenue collection in a fiscal year.[15] In 2010, the CBI registered a case against the Divisional Manager of United India Insurance Co. Ltd. for having collected money from various customers and then for issuing cover notes to all those customers. However, neither the money nor the cover notes were deposited with the insurance company. This scam raised a lot of hue and cry amongst the companies to re-check their insurance policies.[16] These scams impact small time businesses and businesses in general. All small-time entrepreneurs or big companies purchase various insurance covers to shelter their investments and reserves that is why when they are hard hit by these scams, they not only tend to become vulnerable to market instabilities, but they are also subsequently deterred from taking liberal ventures which are necessary for market growth.

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[13] *Insurance Fraud Detection and Cost to Industry*, ATLAS MAG (2010), https://www.atlas-mag.net/en/article/insurance-fraud-detection-and-cost-to-industry.

[14] *Fraud in insurance on Rise- Survey 2010-11*, ERNST & YOUNG (2011), https://www.ey.com/Publication/vwLUAssets/Fraud_in_insurance_on_rise/$FILE/Fraud_in_insurance.pdf.

[15] *Id.*

[16] *Id.* at 15.

2.4. MONEY LAUNDERING

As per the Base Anti Money Laundering Index, India has a score of 5.58. In 2013 itself, the Financial Action Task Force had recorded at least 1,561 cases of money laundering in India.[17] Facts like these deter companies from investing in India as can be seen in the Kingfisher Airlines case (KFA) wherein the vendors such as the Airports Authority of India and international aircraft leasing companies have shown reluctance to do business with other Indian airline companies.[18]

Airlines sector is one of the most difficult sectors to venture into for entrepreneurs and because of the KFA scam it has become all the more difficult. It has also been pointed out by many that "the challenges faced by lessors to repossess Kingfisher's aircraft continue to hurt the domestic industry and that they will continue to see serious market risks in India."[19]

Another incident which shook the facets of a stable market is the 2G scam. The scam not only hit the telecom sector hard and bad but also hit companies, banks, and IT vendors around the country. After Supreme Court's verdict on the scam was announced, investors were displeased with the cancellation of licenses. Some of the foreign investors such as Telenor from Norway and Sistema from Russia even decided that they will quit the Indian market altogether and may not even wait for a new

[17] *India Registers 1,704 Cases against Money Laundering, Sees Few Convictions*, FIRST POST (Dec. 20, 2014), https://www.firstpost.com/business/economy/india-registers-1704-cases-against-black-money-sees-few-convictions-907349.html.

[18] *Indian Aviation Market: Impact Of Kingfisher-Air Deccan Deal on LCCS*, CASE CENTRE (2008), https://www.thecasecentre.org/main/products/view?id=77710.

[19] Ashwini Phadnis & K. Giriprakash, *Kingfisher Fallout: Leasing Firms Wary of Doing Biz with India*, FIRST POST (Aug.17, 2017), https://www.firstpost.com/business/2g-scam-verdict-how-it-hits-companies-banks-it-vendors-and-you-202463.html.

market. They were given four months to shut their operations and this not only resulted in huge write-offs of the investments they made but also affected their banking sponsors.[20] This deterred not only investors' confidence but also the confidence of the smaller companies which were probably looking forward to tagging such investment opportunities. Loans provided to the telecom industry account for 3% of the entire loan funds issued which will now be termed as bad assets, and this will further discourage banks from investing in that sector altogether.[21] Without loans and investments, not only will the sector go downhill but will also affect the consumers.

2.5. PYRAMID SCHEMES

Pyramid schemes work under a disguise to manipulate fair instruments of investments by luring investors with high returns in a short duration. One such instance was exposed after the arrest of William Scott Pinckney, Amway India Managing Director and CEO, and other two Indian executives for defrauding members of its own direct selling network. It displayed the confusion amongst Indian consumers surrounding marketing concepts such as direct selling, multi-level marketing and other pyramid marketing schemes.[22] These scams increase distrust on all other selling schemes, and have a negative impact on the

[20] *2G Scam Verdict: Thumbs-down for FDI, Telenor warns it may quit India*, FIRST POST, https://www.firstpost.com/business/2g-scam-verdict-thumbs-down-for-fdi-telenor-warns-it-may-quit-india-202084.html.
[21] *Id.*
[22] *Amway India CEO, MD arrested in Kerala for financial fraud*, FIRST POST (Dec. 20, 2014), https://www.firstpost.com/business/amway-india-chief-william-scott-pinckney-2-directors-arrested-in-kerala-819359.html.

entire industry. This is one of the prime reasons why businesses have welcomed a ban on companies using pyramid schemes.

3. FINANCIAL CRIMES BRING BUSINESSES TO A HALT

3.1. IMPACT OF THE SATYAM SCAM

In an environment raided with financial crimes as described before, it not only becomes difficult for the businesses to prosper but also for any sector to grow individually. The bigger the scam, the greater is the number of investors that withdraw their support. One such example is the Satyam Fraud.

Satyam, one of the pioneers in the Information Technology (IT) sector in India, hit the rock bottom on 7th January 2009, when its chairman Byrraju Ramalinga Raju confessed the manipulation of accounts to the tune of Rs. 14,162 crores.[23] With the scam surfacing, in addition to the conviction of the chairman and 10 others, liability was also imposed on Price water house Coopers (PwC) whose auditors served as independent auditors of Satyam Computer Services for non-compliance with auditing standards and practices.[24] Hours after the scam unfolded, shares of Infosys gained 1.67% to close at Rs. 1,187.10 on the Bombay Stock Exchange (BSE) and those of Wipro gained 0.23% to end at Rs. 243.30. It was

[23] Richa Bhattacharya, *Lesson from Satyam: Corporate Governance Evolves, Not Execution*, THE ECON. TIMES (June 14, 2017), https://economictimes.indiatimes.com/news/company/corporate-trends/lesson-from-satyam-corporate-governance-evolves-not-execution/articleshow/50476372.cms.

[24] Shelly Singh & Shailesh Dohal, *Satyam Scam: Credibility of Brand India IT under Cloud*, SCRIBD (Jan. 8, 2009), https://www.scribd.com/document/38155508/Satyam-Scam-Impact.

foretold by many analysts that customers who had dealings with Satyam would have no other option but to resume their dealings with any other firm because of a deficiency in comparable cost structures. The shares had fallen from a decent 77.7% to the lowest ever in a decade at Rs 29.95. This led to the obvious chain reaction and suspicions about the Indian corporate governance standards, dragging the value of other stocks and the sensex down. The equity benchmark index of India closed down really low at 7.3% (9,586.88).[25] For anyone who was new to Indian markets and had not invested in the country before, India had become a complete no-no.[26]

The aftermath of this corporate fraud introduced certain regulations and amendments which include:

1. In April 2014, SEBI brought changes to Listing Agreement wherein amendments were made to the provisions relating to the role of vigil mechanism, auditing committee in cases of suspected fraud or irregularity, and the powers of the Chief Executive Officer and the Chief Financial Officer pertaining to financial reporting and disclosure to the Audit Committee. In 2015, SEBI framed the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("LODR"), applicable to all listed companies, and provided "for

[25] Ravi Krishnan, *Satyam Scandal May Scare Away New Equity Investors from India*, LIVE MINT (Jan. 7, 2009), https://www.livemint.com/Companies/eEOtDzYJu86kl3BrEedDTI/Satyam-scandal-may-scare-away-new-equity-investors-from-Indi.html.
[26] *Id.*

stringent guidelines relating to reporting/disclosure of material events and actual and suspected fraud."[27]

2. The Companies Act of 2013 laid down stringent regulations pertaining to corporate governance. For instance, it defined corporate fraud as a criminal offence; laid down the responsibilities and accountability of independent directors and auditors; made rotation of auditors compulsory; and introduced better checks and balances to detect discrepancies.[28]
3. 'Serious Fraud Investigation Office (SFIO) was accorded statutory status by virtue of the Companies Act, 2013 with an additional power to arrest.'

The objective behind the above amendments was to ensure a smooth flow of investment which would help boost businesses whenever the market is down because even if other pre-requisites fail, a controlled investment will keep the businesses alive.

3.1.1. The effect of the Regulations

"Such incidents led to the strengthening of the regulatory framework which not only placed stringent rules on auditors but also on everyone else involved in corporate governance". This, in turn, does not allow the

[27] Susmit Pushkar & Susanah Naushad, *What Changed in the Legal Landscape Post Satyam Scam*, MONEY CONTROL (Jan. 11, 2018), https://www.moneycontrol.com/news/business/companies/what-changed-in-the-legal-landscape-post-satyam-scam-2480623.html.
[28] *Id.*

flexibility that is usually required of a business to grow without unnecessary legal hurdles.[29]

3.2. IMPACT OF THE PUNJAB NATIONAL BANK FRAUD CASE

In the past few months, diamonds which are considered a rare commodity have become the talk of the town for reasons not so obvious. Nirav Modi, a diamantaire, who is the epicentre of this talk, was accused of defrauding Punjab National Bank (PNB) of astonishing amount to the tune of Rs. 11,400 crores.[30] The diamantaire, who hails from a family of diamond merchants, rose to fame for his exquisite collection of diamond jewellery, so much so as being famous amongst celebrities both within and outside India.

3.2.1. Facts and charges levied under various statutes

The controversy arose in February 2018 when an investigation was carried out by Central Bureau of Investigation (CBI) on a complaint filed by PNB. The charge sheet filed against him and 23 other accused persons and entities by the Enforcement Directorate (ED) included:

- Involvement of three companies of the businessman, namely, Solar Exports, Stellar Diamonds, and Diamonds R Us, in fraudulently obtaining a total of 1,213 Letters of Undertaking (LoUs) between March 2011 and May 2017 i.e., over 16 fake LoUs a month over the

[29] *Bank Run*, INVESTOPEDIA, https://www.investopedia.com/terms/b/bankrun.asp.
[30] *Nirav Modi Case: How PNB was defrauded of Rs 11,400 crore*, BUSINESS TODAY, https://www.businesstoday.in/sectors/banks/nirav-modi-case-pnb-fraud-11400-crore-scam-ed-cbi-raid/story/270708.html (last visited Mar. 15, 2018).

course of six years, to the tune of approximately ₹6,498 crores with the aid of a junior level branch official of Bank's Mid Corporate Branch in Mumbai's Brady House. Moreover, the charge sheet stipulated that "[t]he funds so obtained by the said three entities were partly used for payments to various overseas companies and, also for offsetting earlier Letter of Undertakings. Payments were made to 17 overseas entities in Hong Kong, Dubai and the United States since 2011 in the guise of export or import."[31] During investigation, it was found that all the overseas entities were "dummy" or "fictitious" firms of Nirav Modi.

- The investigation also directed the involvement of Firestar Group of Companies whose current/former employees assumed the role of directors and shareholders in the aforesaid overseas entities on the direction of Nirav Modi.
- Funds were diverted to these companies and as per an official, the "modus operandi was fraudulent import or export, wherein there were no actual manufacturing activities undertaken in any of the dummy overseas companies. The invoices of export/import were overvalued to a huge extent to inflate the balance sheets and procure high credit facilities from banks."[32]
- The diamonds and pearls used in jewellery exported from India were removed, and the gold/silver was sent for melting. The latter was re-

[31] Devesh Pandey, *PNB fraud: ED files charge sheet against Nirav Modi & associates*, THE HINDU, https://www.thehindu.com/news/national/pnb-fraud-ed-files-charge-sheet-against-nirav-modi-associates/article23977536.ece (last visited May 24, 2018).
[32] *Id.*

exported to Dubai and the former were re-exported to India. The sole purpose of doing so was to inflate the turnover of Indian companies without any substantial value addition. Such re-exporting was merely a disguise to get loans in foreign currencies without offering any security.

Consequently, Mr. Nirav Modi was charged under various laws including the Prevention of Money Laundering Act, the Indian Penal Code, and the Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015, under which the Income Tax Department imposed liability after it detected that a bank account in Singapore was allegedly held by him, and the same was not disclosed to the tax authorities. Also, the Enforcement Directorate had filed a 12,000 page charge sheet against Nirav Modi before a special court in Mumbai under Section 276 C (1) (wilful attempt to evade tax), Section 277 A (false statement in verification), Section 278 B (offences by companies), and Section 278 E (presumption of culpable mental state) of the Income Tax Act, 1961.

3.2.2. Lacunae exposed in the present system due to the scam

The exposé has raised doubt regarding the viability of Society for Worldwide Interbank Financial Telecommunication (SWIFT). SWIFT enables the financial institutions worldwide to receive and share information about financial transactions in a safe, secure, regularized and reliable platform. It is a messaging system for financial institutions to communicate and a medium which is highly trusted by institutions

worldwide as the instructions emanating from such a medium requires the prior sanction and endorsement of the supervisors.

In the present case, it is alleged that SWIFT was used by the "junior level branch official" of PNB as a medium to send instructions to foreign banks. The instruction explained that the LoUs had been issued by them on behalf of the company, and on that basis, granted credit to Nirav Modi assuring the foreign banks of payment for the same.

Thus, it not only raises questions as to how far SWIFT can be trusted but also questions the stringency of the regulations set by PNB in transmitting of instruction through such a platform.

The present scenario raises certain doubts such as:

1. The possibility of the instruction passing unnoticed through PNB's Core Banking Solution (CBS) system without any clearance issue.
2. The failure of PNB to tally the instruction sent through SWIFT with its CBS, which uses Infosys's Finacle software.
3. The failure of PNB's internal audit system to detect the discrepancies or anomalies in the transactions, and thereby allowing such instructions to be transmitted unnoticed.

3.2.3. Regulations introduced after the expose´

The scam has led to Reserve Bank of India (RBI) providing certain regulations especially with regard to SWIFT. It has issued directions to banks to link their respective CBS with SWIFT within a stipulated time i.e. 30th April, 2018 so as to avoid the consequence suffered previously. It is pertinent to note that "on November 25, 2016 also, the RBI [had] sent

letter to banks stating that it had found several common deficiencies in the way banks were using SWIFT."[33] The letter criticized the banks for not having a robust system for regulating instructions transmitted through SWIFT and condemned the access being given to junior officials.

Post the scam, the RBI decided to disallow the practice of issuance of Letter of Undertakings (LoUs) and Letter of Comfort (LoCs) for obtaining trade credits for import into India with immediate effect, but in case of trade financing, banks may issue Letter of Credit and bank guarantee subject to fulfilment of RBI guidelines.

It has also directed nostro reconciliation on a real-time basis to detect disparity, if any, and reconciliation of payment messages in every one or two hours to strengthen the rules pertaining to the usage of SWIFT.

3.2.4. Ineffectiveness of the regulations introduced paves way for another rip-off: The Rotomac scam

If financial crimes such as PNB fraud in India are considered, the regulations brought about did not deter the commission of other corporate crimes as is evident from the Rotomac case, wherein Kanpur based Rotomac Global Private Limited promoter Vikram Kothari defrauded a consortium of seven banks to the tune of Rs. 3,695 crore including interest thereon by diverting the loan which was sanctioned by the bank to the

[33] Reuters, *PNB Fraud: Loopholes in Indian Banks' Systems Were Flagged, But Not Fixed*, The Hindustan Times, https://www.hindustantimes.com/business-news/loopholes-in-indian-banks-systems-were-flagged-but-not-fixed/story-XlluPf2xlZzH4m3vR94k2J.html (last visited Mar. 5, 2018).

company for the procurement of wheat and other goods for export. The loan procured was diverted to an offshore company and was remitted back to Rotomac without undertaking any export order. When this scam surfaced, the sensex fell by over 400 points on 19th February 2018. The news had started its impact and had already crashed several indices. The Rs. 800-crore scam deepened the wounds of the banking sector with the Bank's nifty falling down to 150 points. The nifty PSU bank index suffered the most after the news of the fraud broke out as it dropped by over 100 points in a single day after the release of the news. The consortium of lending banks and their share prices were also drastically affected. Not only were the banks affected but so were the sentiments of the public.[34] The Allahabad Bank's share price fell by 10%, going down to as low as Rs. 48.8 in the a day from Rs. 54.75 the day before. Even the Bank of Baroda's shares were hit drastically and took a tanking plunge at 10%, they had opened at Rs. 152. and then stood at a new low at Rs. 138.25. This has not stopped there and the recent market volatility arising out of the two back to back bank frauds is again having the market witness that the banking sectors stocks and indices in general are heading towards a massive wipe off of the market capitalisation which not only plays a crucial role for the financing of businesses in India but also for the development of the economy, both of which had then come to a standstill.[35]

Incidents such as these question the extent to which regulations help in overcoming impediments in ease of doing business. Such instances make

[34] *Id.*
[35] *Id.*

one think as to what can be done differently to put an end or at least reduce these crimes so that the businesses can be conducted easily and conveniently.

3.2.5. Possible effect of the scam on ease of doing business

In pursuance to the Rs. 11.4 thousand crore fraud that sent waves of shock across the banking sector, Finance Minister Arun Jaitley said that "Indian companies need a new way of doing business where ethics is at the core"[36] and that "ease of doing business should be replaced with ease of doing ethical business".[37] He reiterated the issue by questioning the credibility of those employees in the banking sector who fail to raise a red flag when fraud is committed in multiple areas of banking system. He expressed a sorry state of affair of such a system where instances such as these go unnoticed or undetected despite various regulations.

So far as the effect of such an incident is concerned on the ease of doing business in India, it proves to be an impediment. Incidents such as these bring about regulations which are more stringent and procedures which are less flexible, thereby making it difficult for businesses to raise capital by taking loans from the bank. This was reiterated by President, PHD Chamber, Anil Khaitan, who said that "the current situation is worrying for Indian industry since it may lead to unnecessary tightening of

[36] Bodhisatva Ganguli, *Bank Frauds Killing Entire Ease of Doing Business Efforts*, THE ECON. TIMES, https://economictimes.indiatimes.com/markets/expert-view/banks-frauds-killing-entire-ease-of-doing-business-efforts-says-arun-jaitley/articleshow/63055931.cms (last visited Feb. 24, 2018).
[37] *Id.*

norms and procedures in raising capital from banks. This will in turn hurt the positive sentiment generated in ease of doing business."[38]

Thus, the hurdles which can be expected are the explained below:

- In the present scenario wherein, directions by the RBI have been issued to banks for strict compliance in linking SWIFT with CBS so as to tally the transactions of the bank with SWIFT to detect discrepancies, a major setback of such direction is the cumbersome process involved which would be time consuming and at the same time tedious. As per reports, a senior banker with a public sector bank said that "[g]iving access to CBS, and writing code, is not enough. You have to run it a thousand times to find bugs in the system. For a public-sector bank, it often is a cumbersome exercise and therefore, most of the third-party systems are outside the CBS. Interestingly, any of these third-party applications such as SWIFT can leak sensitive information, and banks are wholly dependent on the service providers for the integrity of the products."[39] Such linkage or integration would turn out to be a hurdle for businesses carrying out financial transactions or attempting to obtain credit from the banks due to various checks and procedures involved for obtaining clearance of it

[38] Press Trust of India, *PNB Fraud Might Impact Ease of Doing Business: PHD Chamber*, MONEY CONTROL, https://www.moneycontrol.com/news/business/economy/pnb-fraud-might-impact-ease-of-doing-business-phd-chamber-2512417.html (last visited Feb. 21, 2018).

[39] Anup Roy, *PNB Fraud: Not All Banks Have SWIFT Integrated with CBS*, SMART INVESTOR, http://smartinvestor.business-standard.com/pf/savings-513959-savingsdet-PNB_fraud_Not_all_banks_have_SWIFT_integrated_with_CBS_say_bankers.htm (last visited Feb. 21, 2018).

being a "legitimate transaction". At the same time, this would cause delay to businesses on various levels.

- The fraud of this kind affects economy, and with India ranking third amongst major economies for bad loans as per World Bank data, it questions the extent to which businesses in India can be conducted with ease considering that a major portion of the bad loan has been found to be originating from fraud of such kind. This leads to less money being recoverable from the borrower (as per Goldman Sachs, the banks may have to write off up to 65% of the bad loans) than what is projected, and consequently affecting the ability of the banks to raise fresh loans.[40]
- As far as the discontinuance of LoUs and LoCs is concerned, to raise trade credit for import into India, this step is likely to raise the cost of financing for import dependent businesses. As per an expert:

> *the loans raised from Indian banks will have to be converted to foreign currency so as to affect payment overseas and the conversion cost would increase so as to factor in forex risk which could be avoided previously. Such measure would further prove to be a hurdle in ease of doing business imposing a higher business risk on importers due to need for higher finance limit for banks. Alternatively, it will also prove to be a challenge*

[40] Sriram Iyer, *Nine Ways in Which the PNB Scam Will Affect India's Economy*, GOLDMAN SACHS, https://qz.com/1233666/goldman-sach-says-the-pnb-fraud-will-make-indias-economy-sputter/ (last visited Mar. 21, 2018).

for the gems and jewellery sector which contributed to 13% of the country's exports in the fiscal year of 2017.[41]

- In addition to the above, there is also a possibility of foreign companies especially those interested in investing or starting a business in India showing distrust towards the banking sector and thereby, restricting or limiting their ties with India financially to avoid such consequences. The image of India as a global investment destination is likely to be affected.

After the Rs. 11, 4000 crore scam in Punjab National Bank, the shares dropped by almost 30% in four trading sessions. Until the fraud, the bank had never witnessed such a negative impact on its share price; its shares continued to spiral downwards. Furthermore, the news of the fraud not only had a direct impact on the integrity of the bank but it also caused its figure of market capitalization drop by a great margin of ₹10,781 crores.[42] This therefore would mean that any business relying on this bank can count its chickens.

4. SUGGESTIONS

There are a few changes or amendments which should be brought about to better regulate businesses to facilitate ease in doing business in India, and to restrain them from indulging in corporate crimes. These may include:

[41] *Why RBI Has Banned LoUs but Not Letter of Credit*, BUSINESS TODAY, https://www.businesstoday.in/sectors/banks/rbi-ban-lous-but-not-the-letters-of-credit-lc-lou/story/272617.html (last visited Mar. 14, 2018).
[42] *Id.*

1. The banking sector is a major component in determining the ease with which businesses can be conducted and India is subjected to a large number of bank frauds (approximately 17,504 bank fraud cases were reported in 2013-2017).[43] What becomes important is to not just to introduce regulations but also making them infallible to prevent further fraud. For instance, in the case of PNB fraud case, the regulation directing tallying of SWIFT system with CBS system though a robust method was not enough as the same is susceptible to fraudsters and even malware which can delete transaction details from the system after committing the fraud. In order to prevent these fraudsters from deleting transaction log, it requires financial institutions to have reconciliation tools like a real time flow monitoring system which would allow them to confirm the transactions by extracting data from SWIFT servers. Moreover, SWIFT's newly introduced service, that is a GPI tracking system, can be introduced in our system which enables lenders to track the payment instruction at all times through the network, giving them an opportunity to be aware of the payment activity taking place. It enables the banks to check if any intermediary lender is unlawfully gaining any fee from the transaction. In the words of Lars Sjögren, Global Head of Transaction Banking, Danske Bank, the GPI tracking

[43] *17,504 Cases of Bank Fraud*, THE QUINT, https://www.thequint.com/news/india/17504-cases-of-bank-fraud-reported-between-2013-2017-rbi-data (last visited Feb. 18, 2018).

system is a game changer: "Enabling end-to-end tracking of all payment instructions till the end destination is a game-changer".[44]

2. On a more cellular level, the vulnerability of the businesses to such crimes can be avoided by bringing about an amendment in the Indian Penal code (IPC) and in the Code of Criminal Procedure (CrPC) by categorising "financial crimes" or "white-collar crimes" as a separate head of offence instead of dealing with such crimes under "fraud" or "criminal misappropriation". Therefore, a well-structured definition and equivalent punishment for "financial crime" is required for this purpose.

   By doing so, it will not only provide clarity about the exact nature of such crime but will also aid in achieving justice faster. The 137th Law Commission Report also recommended, in the context of fraudulent sales of flats by some unscrupulous builders to innocent buyers, that such offences per se should be brought within the purview of the IPC without the need to prove any criminal intent, which is normally required under the criminal law.[45]

3. At present, the Enforcement Directorate (ED) has the exclusive jurisdiction to investigate money-laundering cases under Prevention of Money Laundering Act, 2002 in India. It is recommended that all

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[44] *SWIFT Introduces Universal Real Time Payment Tracking*, SWIFT, https://www.swift.com/news-events/news/swift-introduces-universal-real-time-payment-tracking (last visited Mar. 23, 2018).

45 O.N.Ravi, What Modi government should do to stop Niravs and Mallyas, Econimic Times, https://economictimes.indiatimes.com/news/economy/policy/What-Modi-governement-should-do-to-stop-Niaravs-and-Mallays/articleshow/631-92-464.cms. (last visited Mar.7, 2018, 09:12 am).

enforcement agencies should be given power to investigate money-laundering cases as is the case in U.S.A. By adopting the aforesaid recommendation, the redressal mechanism would become faster and would provide support to the main authority in bringing defaulters to justice.

4. As a measure to restrain economic offenders from fleeing the country to avoid the trial of his or her offences, the government has introduced the Fugitive Economic Offenders Bill, 2018 which has indeed been a step forward in combating fraud of such kind. The Bill allows for a person to be declared as a fugitive economic offender (FEO) if: (i) an arrest warrant has been issued against him for any of the specified offences where the value involved is over Rs 100 crore; and (ii) he has left the country and refuses to return to face prosecution. The properties of those declared as fugitive economic offender may be confiscated.

However, the major challenge with regard to the Bill would be to bridge the gap which prevails in the Bill and other existing laws such as:

(i) The Bill does not require the authorities to obtain a search warrant or ensure the presence of witnesses before a search whereas existing law such as the Code of Criminal Procedure (CrPC), 1973, mandates such requirements to safeguard the rights of the accused against harassment and planting of evidence.

(ii) Also, the Bill provides for confiscation of property upon a person being declared an FEO. This differs from other laws, such as the CrPC, 1973, where confiscation is final (two years after proclamation as absconder).

5. CONCLUSION

In the light of the above discussion, it is clear that the financial crimes do prove to be an impediment in ease of doing business in any part of the world. Financial crimes occur in various forms but the consequences which it brings about remains the same.

To sum up, financial crimes are a reminder to the authorities of the gaps existing in the system and if not curbed, more scams such as those seen in the case of Vijay Mallya, PNB fraud case, Rotomac etc. will continue to haunt businesses and the economy as a whole. Thus, efforts should be made to put up in place a robust system which would not only deter such crimes and criminals but also smoothen out the process of ease of doing business.

WILL THE RESOLUTION CORPORATION RESOLVE COMPLICATIONS?

- *Vrinda Jule*[*]

ABSTRACT

The Financial Resolution and Deposit Insurance Bill, 2017, or FRDI Bill was aimed at providing a mechanism and framework for resolution of certain categories of financial service providers that might be in distress, and for resolving bankruptcy in banks, insurance companies and other financial establishments.[1] Since, there is no comprehensive and integrated legal framework for resolution and liquidation of financial firms in India presently, in order to have a systematic resolution of all financial firms — banks, insurance companies and other financial intermediaries— this Bill had been introduced.

It was introduced in the Lok Sabha on August 10, 2017, and was under the consideration of the Joint Committee of the Parliament which had been asked to submit its Report to the Parliament by the last day of the Budget Session, 2018, during which it was withdrawn by the government. But, now, that the Bill has been withdrawn by the government, it is imperative to understand the nature and characteristics of the said Bill in order to

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[1] *The FRDI Bill and Concerns of The Depositor*, THE HINDU, http://www.thehindu.com/business/Industry/the-frdi-bill-and-concerns-of-the-depositor/article21081902.ece (last visited Dec. 1, 2017); *FRDI Bill 2017*, BUSINESS TODAY, https://www.businesstoday.in/current/economy-politics/frdi-bill-2017-govt-protect-public-deposits-banks-arun-jaitley/story/265792.html (last visited Dec. 12, 2017).

determine the reasons behind such withdrawal and the present scenario. Although, the drafters of the Bill suggested that the Bill will promote ease of doing business in the country, improve financial inclusion, increase access to credit, and encourage discipline among the financial service providers by putting a limit on the use of public money to bail-out distressed entities, there are many questions that have arisen regarding its functioning. The key issues in the Bill were the establishment of the uniform body called Resolution Corporation, its powers, the Deposit Insurance Coverage Limit, the provision of bail-in, and the lack of autonomy of the Systematically Important Financial Institutions (SIFI). All these issues oblige us towards answering the question as to whether the Resolution Corporation will resolve complications or not.

1. INTRODUCTION

The Financial Resolution and Deposit Insurance Bill, 2017, or FRDI Bill, was under the consideration of the Joint Committee of the Parliament when it was withdrawn by the Government. It was aimed at promoting ease of doing business in the country, improving financial inclusion, and increasing access to credit. This ultimately may have also reduced the cost of obtaining credit. The Bill was to encourage discipline among the financial service providers by putting a limit on the use of public money to bail-out distressed entities.[2] The Bill had come together with the

[2] *What Is FRDI Bill? Here Is All You Need to Know in 10 Points*, THE FINANCIAL EXPRESS, https://www.financialexpress.com/economy/what-is-frdi-bill-all-you-need-to-know-about-financial-resolution-and-deposit-insurance-bill-2017-in-just-10-points/964461/ (last visited Dec. 7, 2017).

Insolvency and Bankruptcy Code to spell out the procedure for the winding up or revival of an ailing company.[3]

As pointed out by the Ministry of Finance, there was no comprehensive and integrated legal framework for resolution, including liquidation, of financial firms in India and therefore, this Bill was introduced.[4] It was introduced in the Lok Sabha on August 10, 2017, and was under the consideration of the Joint Committee of the Parliament which had been asked to submit its Report to the Parliament by the last day of the Budget Session, 2018.

2. SALIENT FEATURES OF THE BILL

1. Establishment of a Resolution Corporation (RC): The Bill provides for the establishment of an RC to monitor financial firms, anticipate their risk of failure, help them in their resolution, and take corrective measures. The Corporation is supposed to replace the already existing Deposit Insurance and Credit Guarantee Corporation (DICGC) that takes care of the deposit insurance which at present is Rs. 1 lakh rupees.
2. Deposit Insurance: The DICGC will be nullified and replaced by the RC. The DICGC insures deposits and guarantees credit facilities. Under the proposed FRDI Bill, the RC has the right to fix the threshold for deposit insurance which is not yet decided.

[3] T.C.A. Sharad Raghavan, *What does the FRDI Bill do for you?*, THE HINDU, http://www.thehindu.com/business/Economy/what-does-the-frdi-bill-do-for-you/article21386264.ece (last visited Dec. 10, 2017).

[4] THE HINDU, http://www.thehindu.com/business/Economy/what-does-the-frdi-bill-do-for-you/article21386264.ece.

3. Risk based classification: Based on their risk of failure, the RC or the appropriate financial sector regulator may classify financial firms under five categories. These categories in the order of increasing risk are: (i) low, (ii) moderate, (iii) material, (iv) imminent, and (v) critical. The RC shall also take over the financial firm as soon as it is classified as "critical" and shall resolve the same within a resolution period of two years which can be extended.
4. If the Board of the RC, in its opinion, is of the view that the risk to viability is at critical level, it will have sweeping powers and various methods of resolution can be undertaken by the RC, including: i) merger or acquisition; (ii) transfer of the assets, liabilities, and management to a temporary firm; and (iii) liquidation.

3. KEY ISSUES

3.1. ESTABLISHMENT OF RC

Chapter 2 of the Bill seeks to establish a corporation called the 'RC' which will replace the 'Deposit Insurance and Credit Guarantee Corporation' (DICGC) as the principal agency to monitor financial firms; provide for the resolution of specified service providers (SSP), which under FRDI covers the entire gamut of financial service providers and their holding companies, if any; act as an administrator for the SSPs classified as 'critical'; provide deposit insurance; classify banks based on risk to viability; anticipate risk of failure; take corrective action; and

resolve them in case of such failure.[5] The corporation will be more powerful than any other corporations and institutions in the field.[6] The unfettered powers to merge or acquire shares and assets of a company raise few competition concerns as to whether the decision taken by the RC would supersede the decision taken by the Competition Commission, in cases of finding that there is an effect on the relevant market.

While analysing the effectiveness of creating a single authority, i.e., the RC, it is imperative to look at both the sides of the issue. On one side, it has been proposed by many authors and writers that the creation of RC for the purpose of resolution of the financial sector can create common regulatory standards and make the resolution process speedier and more efficient. While on the other hand, the critical analysis of the corporation can be witnessed like vast possibility of conflicts between the regulators such as the RBI and the RC over the classification of risk to viability of a financial firm as well as over its restoration or resolution plans.[7]

The Bill provides for risk to viability determination of 'Covered Service Providers' (CSPs) differently for different stages. It specifies the determination by RBI up to the first two stages of moderate risk to viability, and by the RC for the last two stages of imminent risk to

[5] *Wrong Diagnosis, Harmful Prescription: A Critique of Financial Resolution and Deposit Insurance (FRDI) Bill, 2017*, CENTRE FOR FINANCIAL ACCOUNTABILITY, http://www.cenfa.org/publications/a-critique-of-frdi-bill-2017/; *The Financial Resolution and Deposit Insurance Bill, 2017*, PRS LEGISLATIVE RESEARCH http://www.prsindia.org/billtrack/the-financial-resolution-and-deposit-insurance-bill-2017-4871.

[6] *Id.*

[7] *Id.*

viability and critical risk to viability.[8] The RBI in the report of the Committee to Draft Code on Resolution of Financial Firms,[9] has expressed that the RC should add value to the financial sector stability rather than acting as an additional watchdog. The RBI is of the view that the RC should intervene only when classification done by the regulators is 'imminent risk to viability' as it would allow the Corporation sufficient time to prepare for the resolution.[10] The RBI justifies its stand by specifying that the Corporation's intervention at 'material risk to viability' stage may not be necessary as the resolution would start only in the 'critical risk to viability' stage.[11] Further, there is a certain amount of trust among the people with regard to the public sector banks as they are in the hands of the government. If the government, through this Bill, begins to handover its responsibility and that of the RBI to an RC, it would be breaking this trust.[12]

3.2. DEPOSIT INSURANCE COVERAGE LIMIT

The Bill envisages that there will be an RC which will replace the existing Deposit Insurance and Credit Guarantee Corporation for the purpose of monitoring the financial companies, classifying them in accordance with their risk profiles, and determining the steps to be taken for resolution in case of their failure. The DICGC is an RBI subsidiary,

[8] MINISTRY OF FINANCE: DEPARTMENT OF ECON. AFFAIRS, REPORT OF COMM. TO DRAFT CODE ON RESOLUTION OF FINANCIAL FIRMS (2016).
[9] *Id.*
[10] *Id.*; Prasenjit Bose, *FRDI Bill, 2017: Inducing Financial Instability*, EPW ENGAGE, https://www.epw.in/engage/article/frdi-bill-2017-issues-and-concerns.
[11] *Id.*
[12] *Id.*

established on July 15, 1978, and presently offers an insurance coverage of up to Rs. 1 lakh to all kinds of bank deposits.[13] In case of winding up or liquidation of an insured bank, such deposits up to Rs. 1 lakh is to be provided to the depositors, and within 3 months a list of all the deposits have to be submitted by the liquidator to the DICGC. After receiving such list, the DICGC is obligated to pay such amounts within two months from receiving the list. In other cases like amalgamation, the DICGC pays the difference between the amount due to the depositors and the amount actually received under the scheme, or Rs. one lakh, whichever is less.[14] However, the Bill seeks to replace this subsidiary with the RC.[15]

3.3. BAIL-IN

The Bill mentions in Section 48(1) (c) that the RC is empowered to resolve an SSP classified as a critical risk to viability through bail-in.[16]

> *…48. (1) The Corporation may resolve a specified service provider classified in the category of critical risk to viability under section 45 through a scheme or a bail-in instrument, in such form and manner as may be specified by regulations made by it, by—*

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[13] *The FRDI Bill And Concerns Of The Depositor*, THE HINDU, http://www.thehindu.com/business/Industry/the-frdi-bill-and-concerns-of-the-depositor/article21081902.ece (last visited Dec. 1, 2017); Tamal Bandyopadhyay, *Much Ado About 'Bail-In' And FRDI Bill*, Livemint, https://www.livemint.com/Opinion/4AYBWrd3m9RukcEGik53mL/Much-ado-about-bailin-and-FRDI-Bill.html (last visited Dec. 18, 2017).

[14] *supra* note 8.

[15] *Bail-In Doubts — On Financial Resolution Legislation*, THE HINDU (Dec. 5, 2017); *supra* note 8.

[16] *supra* note 5; Financial Resolution & Deposit Insurance Bill, 2017, *available at* http://164.100.47.4/BillsTexts/LSBillTexts/Asintroduced/165_2017_LS_Eng.pdf.

(c) bail-in in accordance with the provisions of section 52…

The said Bill contains a bail-in clause which has been highly debated upon. It is one of the resolution tools in case of insolvency in a bank or in the event a financial firm is sought to be sustained by resolution. The depositors, in such cases, will have to bear a part of the cost by a corresponding reduction. A bail-in clause is different from a bail-out clause where the public funds are used to inject capital into an ailing company.[17] A bail-in clause gives the bank the authority to refuse repayment of a customer's money or to issue securities such as preference shares to a customer instead of giving money. These funds are then used for recapitalization of the bank.[18] The amount covered by the deposit insurance is the only money owed that cannot be used for bail-in. Presently, the DICGC insures 1 lakh rupees but the Bill empowers the RC to decide such amount. This clause has been opposed by many including trade unions, terming it as anti-people.[19] The Ministry of Finance by a press release[20] attempted to clarify its stand. The excerpt from the press release is reproduced below:

[17] *supra* note 3.

[18] Meera Nangia, *Banking On Legislation*, THE HINDU, http://www.thehindu.com/opinion/op-ed/banking-on-legislation/article20005363.ece (last visited Nov. 9, 2017); Shohini Sengupta, *FRDI Bill: Dispelling Some Myths About Bail-In And Other Issues To Allay Depositors' Concerns*, FIRST POST, https://www.firstpost.com/business/frdi-bill-dispelling-some-myths-about-bail-in-and-other-issues-to-allay-depositors-concerns-4258241.html (last visited Dec. 14, 2017).

[19] *Bail-In Clause in FRDI Bill: Depositors Need Not Have Any Apprehensions, Says Government*, THE INDIAN EXPRESS, https://indianexpress.com/article/business/banking-and-finance/bail-in-clause-in-frdi-bill-depositors-need-not-have-any-apprehensions-says-government-5010647/ (last visited Jan. 4, 2018).

[20] *supra* note 4.

> *…The Government always stands ready to take care of the capital needs of the public sector banks. Bail-in amounts to liabilities' holders bearing a part of the cost of resolution by reduction in their claims. Bail in provision may not be required to be used in case of any specific resolution. Most certainly, it will not be used in case of a public sector bank as such a contingency is not likely to arise…*

Prior to the press release, there had been immense confusion and fear among the citizens regarding the bail-in clause. The need of a bail-in clause had been questioned time and again. With the Press release of January 2, 2018, the Ministry of Finance attempted to clarify the reasons for the same and the safeguards provided under the Bill. It stated that only the RC shall have the option to design an appropriate bail-in instrument, which will be subject to government scrutiny and oversight of the Parliament. It also compared the present scenario where in case of forced mergers of banks under the Banking Regulation Act, 1949, without the consent of depositors, the right of depositors of a merging bank can be reduced, with the proposed bail-in clause, where the cancellation of the depositor's liability beyond the insured amount will be possible only with his or her prior consent. Another safeguard mentioned was the judicious and reasonable use of the bail-in clause by the RC, and where the use is injudicious and unreasonable, the depositors will have the right to get compensation from the RC on an order of the National Company Law

Tribunal.[21] Furthermore, it has stated that the bail-in clause will not be used for public sector banks (PSBs).[22]

There are both positive and negative aspects of this provision. Various columnists have expressed their views regarding the same. Some say that the provision will not be beneficial at all. They compared it to the case of Cyprus, where the depositors lost almost 50 per cent of their savings when a "bail-in", similar to the one proposed in the Bill, was implemented by the RC.[23] Others are of the view that the provision will provide a necessary safeguard and enable quick restoration of solvency. Some took the example of the Lehman Brothers' case and explained how a bail-in could have changed the outcome for them. They are of the view that a bail-in during the course of crisis could have allowed Lehman to continue operating and would have forestalled much of the investor panic that froze markets and deepened recession.[24] It can only be used in respect of specific liabilities, which are specified in the regulations framed through a consultative process. These liabilities would be known upfront

[21] *supra* note 4; *Fears Over FRDI Bill Misplaced, Says Government*, THE HINDU, http://www.thehindu.com/news/national/fears-over-frdi-bill-misplaced-says-government/article22354147.ece (last visited Jan. 2, 2018).

[22] *supra* note 3; *supra* note 4.

[23] Purnima Tripathi, *Dangers in a Bill*, FRONTLINE, https://www.frontline.in/the-nation/dangers-in-a-bill/article9896821.ece (last visited Oct. 27, 2017); *Wrong Diagnosis, Harmful Prescription: A Critique of Financial Resolution and Deposit Insurance (FRDI) Bill, 2017*, CENTRE FOR FINANCIAL ACCOUNTABILITY, http://www.cenfa.org/publications/a-critique-of-frdi-bill-2017/; *The FRDI Bill And Concerns Of The Depositor*, THE HINDU, http://www.thehindu.com/business/Industry/the-frdi-bill-and-concerns-of-the-depositor/article21081902.ece (last visited Dec. 1, 2017).

[24] *From bail-out to bail-in*, THE ECONOMIST (Jan. 28, 2010), https://www.economist.com/node/15392186/all-comments.

and well before the bail-in tool is exercised.[25] Some are also of the view that this tool of bail-in will be most advantageous in cases where the authorities would fail to find a willing buyer for a failed financial institution, and effecting a full or partial transfer of the firm is difficult.[26]

3.4. SIFI

SIFI stands for Systematically Important Financial Institutions. The central government in consultation with the appropriate regulator has been given the ability to characterize a SIFI. A financial service provider that meets the criteria mentioned by the government will be designated as a SIFI.[27] The proviso to Section 25(1) states as follows:

> *...Provided further that any person designated as Domestic Systemically Important Bank by the Reserve Bank of India shall be deemed to be a systemically important financial institution for the purposes of this Act, for a period of six months with effect from such date as the Central Government may, by notification, specify…*

Prior to the FRDI Bill, RBI had already identified certain banks as DSIBs i.e., Domestic Systemically Important Banks. These were: State

[25] Smita Aggarwal, *FRDI Bill: An ICU to Take Care of Critically Ill Patients*, LIVE MINT, https://www.livemint.com/Opinion/rqQXkzRnKQm7sL3lUfY2bI/FRDI-Bill-An-ICU-to-take-care-of-critically-ill-patients.html (last visited Dec. 20, 2017).

[26] Shohini Sengupta, *FRDI Bill: Dispelling Some Myths About Bail-in And Other Issues to Allay Depositors' Concerns*, FIRSTPOST, https://www.firstpost.com/business/frdi-bill-dispelling-some-myths-about-bail-in-and-other-issues-to-allay-depositors-concerns-4258241.html (last visited Dec. 14, 2017).

[27] Financial Resolution & Deposit Insurance Bill, 2017, § 25(1), *available at* http://164.100.47.4/BillsTexts/LSBillTexts/Asintroduced/165_2017_LS_Eng.pdf; *Financial Resolution and Deposit Insurance Bill, 2017: Key highlights*, PWC, https://www.pwc.in/assets/pdfs/publications/2018/financial-resolution-and-deposit-insurance-bill-2017-key-highlights.pdf.

Bank of India, ICICI Bank, and HDFC Bank.[28] The new provisions in the FRDI Bill give the Corporation the ability to control all the financial institutions and this might lead to delay in decision making and response time. The lack of autonomy of SIFI can also serve as a limitation to the growth of the sector.

4. CONCLUSION

The answer to the question as to whether the RC is efficient in resolving the complications or increasing them has to be seen only when those rules on paper start to apply in the world. On the face of it, it is good as people's money is now better protected because of the institutions being classified into categories that are monitored by a single authority which will deal with them for their benefit, subsuming the factor that there is an additional constant monitor that will be on the rear to watch the already heavily scrutinized industry. The scope of extent of RC interfering and determining itself the powers and in certain cases the obligations to pay, though is always under judicial review, there is a need to have guidelines to check it before the judiciary actually draws the border line. A higher accountability for the decisions taken would decrease the load on the ever-stressed judiciary as well. Overall, the law resolves complications by re-assessing corporate status.

Although, the Bill has been withdrawn, understanding its salient features and the consequent issues that led to the withdrawal of the same, was necessary in order to understand the government's actions and the

[28] *supra* note 7.

present scenario. The Joint Parliamentary Committee was informed by the Union minister that a "resolution of these issues would require a comprehensive examination and reconsideration", and that it is "appropriate" to withdraw the Bill.[29] The very undoing of the Bill can be blamed on to the bail-in clause of the Bill which was highly criticised by many including the opposition parties who termed this clause as anti-people and anti-poor.[30] This withdrawal has come as a relief to the citizens who were afraid of the chances of losing their money through this Bill.

[29] *A Welcome Retreat: Withdrawing The FRDI Bill*, THE HINDU, https://www.thehindu.com/opinion/editorial/a-welcome-retreat-withdrawing-the-frdi-bill/article24646860.ece (last visited Aug. 10, 2018).

[30] *Govt. Withdraws FRDI Bill In Lok Sabha: Framework For Resolution Of Distressed Financial Firms Fails To Go Through*, FIRST POST, https://www.firstpost.com/business/govt-withdraws-frdi-bill-in-lok-sabha-framework-for-resolution-of-distressed-financial-firms-fails-to-go-through-4908821.html (last visited Aug. 7, 2018); *Govt. Withdraws FRDI Bill In Parliament Following Backlash*, LIVE MINT, https://www.livemint.com/Industry/Ff29jhSKgcOxZkjkipHY5K/Govt-withdraws-FRDI-Bill-from-Lok-Sabha.html (last visited Aug. 7, 2018).

CHALLENGES IN THE IMPLEMENTATION OF INSOLVENCY CODE AND THE INSOLVENCY AMENDMENT ORDINANCE

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ABSTRACT

The advent of the Insolvency and Bankruptcy Code, 2016 ("Code") was much awaited and has been highly appreciated by the investors. It has proved to be fruitful in facilitating the ease of doing business in India by empowering creditors and making certain essential changes in the priority list.

However, the implementation of the Code has not been entirely smooth and requires amends in order to make the structure work with its entire efficiency. The article deals with these points and lays down the issues regarding the same. While doing so, the article also mentions the changes brought about by the recent bankruptcy code amendment ordinance.

The first issue that the article talks about is the lack of adequate manpower and infrastructure. With only 11 benches of the National Company Law Tribunal and combined strength of 26 judges, handling more than 2500 cases under the Code is a difficult task.

The article proceeds to look into the issue under section 29A which provides for disqualification of certain persons from becoming resolution

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applicants but fails to define the term 'person acting jointly or in concert' mentioned therein which has led to fierce litigation in this short span.

Another issue is the role of the guarantors under the Code and whether a creditor can proceed against a guarantor of corporate debtor after institution of corporate insolvency resolution process while under the moratorium.

The article further analyses the status of homebuyers as financial creditors under the Code and the recently released draft intending to introduce a chapter on cross-border Insolvency in the Code.

The article concludes with the authors summarising the abovementioned issues and laying down the current status of the effectiveness of the Code.

1. INTRODUCTION

One of the landmark changes of the present government includes a robust and codified Insolvency and Bankruptcy Code, 2016. The bankruptcy code was introduced in the backdrop of ever rising Non-Performing-Assets of banks which were sky-rocketing with bad-loans forming 8.4% of India's GDP,[1] and there was no effective law to deal with the situation except for piece-meal approach adopted by the Reserve Bank of India in form of various notifications which was largely unfruitful. The process of corporate bad loan recoveries in India has been very long and

[1] *NPA Problem: India Ranked 5th in Bad loans in the World, EUs 4 Tumbling Economies top list*, BUSINESS TODAY, https://www.businesstoday.in/current/policy/npa-problem-india-ranking-bad-loans-economies-with-huge-npa-bank-recapitalisation/story/266898.html (last visited Dec. 28, 2017).

often extending up to 15 years, as historical data suggests. According to World Bank, India takes over 4 years to declare a promoter or a company insolvent which is more than twice the time taken in China and USA. Consequently, Indian banks have been observed to recover only 25 cents to a dollar compared to 36 cents in China and as much as up to 80 cents in USA. In this scenario banks had become extremely conservative in their lending wisdom and were ever more reluctant to lend anything which had created problems for Indian corporates.[2]

Ever since it's coming into force, the Bankruptcy Code has caught the imagination of the creditors and the investors alike as it fills up a long existing void present in the Indian Law in providing a mechanism for recovery from a debt ridden corporate. This can be demonstrated from the fact that cases are being filed under the Bankruptcy Code at a breakneck speed. In one year, Bankruptcy Code has come a long way with 2,434 fresh cases being referred to NCLT. These numbers clearly show that IBC has become the preferred route to resolution for the creditors. Also, the rate at which NCLT is either accepting or rejecting applications is commendable as it encourages more and more creditors to take this route for efficient NPA resolution. As on 30th November, 2017, 830 NCLT orders disposed of insolvency petitions of which about 87 percent of the petitions were filed by creditors.[3]

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[2] Sankar Chakraborti, *Insolvency and Bankruptcy: Will the Recovery Game Change in India?*, FICCI'S FINANCIAL FORESIGHTS, http://blog.ficci.com/insolvency-bankruptcy-recovery-india/7970/ (last visited Mar. 28, 2018).

[3] Sreyan Chatterjee et al., *Watching India's Insolvency Reforms: A New Dataset of Insolvency Cases,* BLOOMBERG QUINT,

Early positives have been seen in World Bank's ranking where India's position in ability to handle insolvency cases improved by 33 places to 103rd position.[4] This jump contributed significantly in India's ease of doing business ranking by 30 places to join the top 100 countries club. This demonstrates that through its short existence the code has been able to instil confidence in itself however, numerous bottlenecks have appeared in the implementation of the bankruptcy code which relates to the very fundamentals on which the Bankruptcy Code is based. The present article attempts to bring into light some of the recent issues that have emerged with respect to the implementation of code. The article also attempts to discuss the effect of the recent amendments.

2. LACK OF ADEQUATE MANPOWER AND INFRASTRUCTURE

Currently there are only 11 benches of National Company Law Tribunals with a combined strength of 26 judges handling more than 2500 bankruptcy related cases. This strength is grossly inadequate to handle the number of cases that are being currently filed for the resolution process. In addition to the cases under the Bankruptcy Code these tribunals are also required to deal with cases and proceedings filed under the various

https://www.bloombergquint.com/insolvency/2018/05/16/insolvency-and-bankruptcy-code-one-year-report-card#gs.55sgDLs (last visited May 16, 2018).

[4] Ministry of Finance: Govt. of India, *Coordinated Action between Government and Judiciary to Boost Economic Activity- Ease of Doing Business*, PRESS BUREAU OF INDIA, http://pib.nic.in/newsite/PrintRelease.aspx?relid=175975 (last visited Jan. 29, 2018).

provisions of the Companies Act, 2013. This has put NCLT under tremendous pressure.[5]

Similarly, there is a marked shortage of resolution professionals who form one of the bedrocks of the Insolvency Resolution Process. Resolution professionals are entrusted with two important duties under the code, firstly, to run the company as a going concern to ensure least value erosion and secondly, to facilitate a resolution by coordinating with a committee of creditors. In this regard it should be noticed that there is a big question on the expertise of the resolution professional in being able to discharge any of the responsibilities entrusted under the bankruptcy code since the resolution professionals are mainly company secretaries, lawyers, chartered accountants etc. with exorbitant fees and little experience of running a business.

3. SECTION 29A: RIGHTS OF PROMOTERS

There has been a lot of controversy since the induction of this provision in November 2017.[6] Further, the issues surrounding this provision are multi-faceted and has seen some fierce litigation in the short history of the Bankruptcy Code.

Section 29A of the Code provides for such disqualifications which render certain persons and any other 'person acting jointly or in concert' with such persons from becoming resolution applicant. The term 'person

[5] *2018 crucial for insolvency code, says AZB's Bahram Vakil*, LIVEMINT, https://www.livemint.com/Companies/zadNomW4LNxkRKKn4KLSJO/2018-crucial-for-insolvency-code-says-AZBs-Bahram-Vakil.html (last visited June 12, 2018).
[6] *See* No. 8, Acts of Parliament, 2018, § 5.

acting jointly or in concert' has not been defined. However, Bankruptcy Code provides that words/expressions not defined under the Bankruptcy Code shall have the meaning assigned to them under other acts identified under the Bankruptcy Code[7] and if reliance is placed on such definition as provided in SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011[8] then it would include wide range of persons within its ambit which cannot be the real intention of this provision. If this definition is relied on the inclusion of "persons acting in concert" will have a far wider net than what may be required for the purposes of Bankruptcy Code. In this regard Insolvency Amendment Ordinance 2018 has brought in two changes with the intention of providing clarity on this aspect wherein it has excluded purely financial entities, like asset reconstruction companies and scheduled commercial banks, from the ambit of the disqualifications which is a major respite in the sense that under previous 'corporate debt restructuring' regime which was headed by the RBI, upon a default by a debtor banks were given the option to convert loans into equity of the corporate-debtor. This was a handicap under the unamended provision as these financial entities would be debarred from being a resolution applicant since it could be in 'control' or be classified as promoters of a corporate debtor classified as an NPA account.

Section 29A (c) further disqualifies a person or a person acting jointly or in concert with such person who-

- has an account classified as NPA;

[7] Insolvency and Bankruptcy Code, 2016, § 3(37).
[8] RBL Bank Ltd. v. MBL Infra. Ltd., CA (IB) No. 543/KB/2017.

- is a promoter of a corporate debtor the account of which has been classified as NPA;
- is in the management of a corporate debtor the account of which has been classified as NPA;
- is in control of a corporate debtor the account of which has been classified as NPA.

At least a period of 1 (One) year should have elapsed from the date of classification till the insolvency commencement date.

It should be noted that the provision is stringent as it disqualifies the promoter group for bidding for the corporate debtor in *toto*. This has been a subject of fierce litigation. Promoters worldwide are allowed to bid for the asset based on the principle of value maximisation. Though under the working of Insolvency Code the same has been rejected in spite of being the largest bid. For example, in the case of Essar Steel, The eligibility of bidders – Arcelor Mittal and Numetal Mauritius - is the contentious issue as one of the promoters of the special purpose vehicle is Rewant Ruia, the son of one of the original promoters of Essar Steel.[9] Similarly, the Binani Cement case also involves the promoter-disability angle and Dalmia Bharat NSE has written to the lenders and the resolution professional of Binani Cement, alleging that UltraTech 'seemingly' is ineligible to bid for the stressed asset for acting "in concert" with the promoters Binani Industries. As loan defaulters, the Binani promoters are themselves barred

[9] *Lenders reject bids by Numetal, ArcelorMittal for Essar Steel*, THE TIMES OF INDIA, https://timesofindia.indiatimes.com/business/india-business/lenders-reject-bids-by-numetal-arcelormittal-for-essar-steel/articleshow/63398532.cms (last visited Mar 21, 2018.

from bidding under the clause.[10] However, with regard to Micro, Small and Medium Enterprises ("MSMEs"), since usually only promoters of an MSME are likely to be interested in acquiring it, applicability of section 29A has been restricted only to disqualify promoters who were wilful defaulters from bidding for them.

This provision has been termed as a game changer in terms of bench-marking new corporate governance standards by the bankruptcy code. This provision might prove to be the impetus for a wider promoter-shareholding which has been a constant sore in Indian corporate governance standards. Further, Indian corporate governance has historically suffered from the promoter-manager collusion. It has also been observed that when the insolvency is imminent the promoter-managers indulge in desperate tactics like asset stripping, creation of fresh encumbrances where external creditors like banks have little to no control.[11] In this regard it is necessary to quote observation made in *RBL Bank Ltd. v. MBL Infrastructures Ltd.*,[12] by the NCLT, considering the objective of the Ordinance, 2017, it opined that section 29A is not to disqualify the promoters as a class for submitting a resolution plan. The intent is to exclude such class of persons from offering a resolution plan,

[10] Vatsala Gaur, *Dalmia Bharat alleges Ultratech acting 'in concert' with promoters of Binani*, THE ECON. TIMES, https://economictimes.indiatimes.com/news/company/corporate-trends/dalmia-bharat-alleges-ultratech-acting-in-concert-with-promoters-of-binani/articleshow/64103754.cms (last visited May 10, 2018).

[11] Suharsh Sinha, *A Wake-Up Call for Promoters*, BUSINESS STANDARD, https://www.business-standard.com/article/opinion/a-wake-up-call-for-promoters-118060900745_1.html (last visited Nov. 25, 2018).

[12] *Id.*

who on account of their antecedents, may adversely impact the credibility of the processes under the Code.

Viewed from this background the imposition of ban under section 29A is not unfounded. This reason alone has been cited by experts as providing the necessary "moral thrust" for tightening the noose around promoters.[13] As far as the recent litigation on this provision and principle of value-maximisation is concerned the same should be achieved within the ambit of the provisions of Bankruptcy Code so as to preserve the spirit and sanctity of the process.

4. ACTION AGAINST GUARANTORS

Over the short existence of the Bankruptcy Code various questions have cropped up in relation to role of guarantors. One of the hot topic being whether a creditor can proceed against a guarantor of corporate debtor after institution of corporate insolvency resolution process while under the moratorium. This question cropped up before the Supreme Court in *State Bank of India v. V. Ramakrishnan*,[14] where the Court cleared the air on the fact that Section 14 of the Act is not to apply to a personal guarantor of the corporate debtor. In this case, while the proceedings against the corporate debtor were pending, the personal guarantor took the plea that section 14 shall apply to him as well and thus, the proceedings

[13] Sandeep Parekh, *Insolvency process: How punishing promoters will ensure stemming the rot early*, THE FINANCIAL EXPRESS, https://www.financialexpress.com/opinion/insolvency-process-how-punishing-promoters-will-ensure-stemming-the-rot-early/950201/ (last visited Nov. 28, 2017).

[14] State of Bank of India v. V. Ramakrishnan, Civil Appeal No. 3595 of 2018, *available at* http://ibbi.gov.in/webadmin/pdf/whatsnew/2018/Aug/SBI-v.-V-Ramakrishnan_2018-08-14%2021:59:42.pdf.

against him and his property would have to be stayed. With regard to section 31, the Court observed:

> *Section 31(1), in fact, makes it clear that the guarantor cannot escape payment as the Resolution Plan, which has been approved, may well include provisions as to payments to be made by such guarantor. This is perhaps the reason that Annexure VI(e) to Form 6 contained in the Rules and Regulation 36(2) referred to above, require information as to personal guarantees that have been given in relation to the debts of the corporate 23 debtor. Far from supporting the stand of the Respondents, it is clear that on point of fact, Section 31 is one more factor in favour of a personal guarantor having to pay for debts due without any moratorium applying to save him.*

Further, the Court ruled that the amendment to the Code, which states that the provisions of section 14(1) shall not apply to a surety in a contract of guarantee for corporate debtor, is retrospective and that the objective of the amendment was to clarify the interpretation of the section and such clarificatory amendment is retrospective.

It is worth noting here that the guarantor's liability is co-extensive with that of the principal debtor.

The choice is left entirely with the decree-holder. The Hon'ble Supreme Court of India in its judgement dated 18th August, 2009 *in Re: Industrial Investment Bank of India v. Biswanath Jhunjhunwala*, also analysed the term ‘co-extensive’ and referred to the celebrated book of Pollock and Mulla on Indian Contract and Specific Relief Act which read as under:

> *“Co-extensive" – Surety's liability is co-extensive with that of the principal debtor.*

> *A surety's liability to pay the debt is not removed by reason of the creditor's omission to sue the principal debtor. The creditor is not bound to exhaust his remedy against the principal before suing the surety, and a suit may be maintained against the surety though the principal has not been sued.*

In this context, it is pertinent to refer to the judgement dated 10th July, 2017 passed by the National Company Law Tribunal, Mumbai Bench, in *Alpha and Omega Diagnostics (India) Ltd. v.. Asset Reconstruction Company of India Ltd*.,[15] wherein the NCLT Mumbai declined to order moratorium in respect of the security held by the lender bank since it was the personal property of the guarantor and it was not the property of the corporate debtor. The NCLT Mumbai held that the word 'its' used in the opening line of Section 14 of the Code indicates that it refers to the properties owned by the corporate debtor and that moratorium shall be declared prohibiting any action to recover or enforce any security interest created by the corporate debtor in respect of 'its' property and that the property not owned by the corporate debtor, therefore, does not fall within the ambit of moratorium. On an appeal filed by the corporate debtor against the said decision of NCLT Mumbai, the National Company Law Appellate Tribunal ('NCLAT') vide its judgement dated 31st July, 2017,[16] upheld the order of NCLT Mumbai on its interpretation of the provisions of section 14 of the Code with regard to the coverage of the

[15] Alpha & Omega Diagnostics (India) v. Asset Reconstruction Co. of India, C.A. (A.T.) (Insol.) No. 116 of 2017.
[16] *Id.*

protection under moratorium in respect of the assets/properties of the corporate debtor.

The Insolvency Amendment Ordinance, 2018 and the recent Supreme Court judgment have brought in a much-needed clarity in this respect in as much as it has inserted a definition of "corporate guarantor"[17] in the definition clause to mean a "corporate person who is the surety in a contract of guarantee to a corporate debtor." Under Section 14 it has inserted a sub-clause 3[18] by virtue of which a surety in a contract of guarantee to a corporate debtor has been excluded from the effect of moratorium. Thus, the right to action against a surety remains even after imposition of moratorium.

5. HOMEBUYERS AS FINANCIAL CREDITORS

The status of flat-buyers or homebuyers was a contentious one since the introduction of the Code. The Code classifies creditors into two kinds: financial creditors and operational creditors. Financial creditors are the ones who are said to have forwarded cash to the corporate debtor as consideration for the time value of money or what is most popularly known as "interest payment". On the other hand, operational creditors are those who have rendered any kind of goods or services to the corporate debtor. At the time of enactment of the Code home-buyers were not included under any of its provisions. Apart from the ensuing litigation in this regard, steps were taken to address the issue through other modes, for example, Insolvency and Bankruptcy Board of India (IBBI) created a third

[17] Insolvency and Bankruptcy Code (Amendment) Ordinance, 2018, § 3(i).
[18] *Id.*, § 10.

category of creditors and introduced a new Form 'F', which was perceived to be meant for home or flat buyers but the same was without any such indication in the regulations or otherwise. Thus, amendment in this regard is the most significant and anticipated change that has been brought about in the form of elevation of the home-buyers to the status of "financial creditors." This has been done by introduction of a legal fiction through an explanation[19] to Section 5, which defines "financial debt", so as to deem the amount paid by the allottees to have the effect of commercial borrowing.

The logic behind this change is simple in as much as homebuyers give an advance to the developers and fund the cost of the project in return for a house and thus play a role equivalent to a financial creditor. It is not infrequent that amounts raised from homebuyers are used as primary capital to finance a real-estate project, and similarly, in some cases the amounts advanced by homebuyers could be more than the debt availed from the banks. This reasoning has been criticised on the ground that it pays overt emphasis on the utilisation of fund for financing the real-estate project in as much as utility of the funds is by itself insufficient to define the relationship between the parties.[20] Looked from this angle the amendment seems to be equitable. However, from a commercial point of view, this may result in the escalation of the cost of real-estate projects whose ultimate costs may be passed on to the homebuyers. The said the escalation of the cost may be owing to the fact that due to change in status

[19] *Id.* § 3(ii).

[20] Umakanth Varottil, *Homebuyers As Financial Creditors: An Inelegant Solution?*, BLOOMBERG QUINT, https://www.bloombergquint.com/insolvency/2018/06/07/homebuyers-as-financial-creditors-an-inelegant-solution (last visited June 7, 2018).

of the homebuyers the real-estate market players are reluctant to finance their projects from homebuyers' money, and an increased dependency on other creditors increased the cost of credit. Further a dilution of rights of the Committee of Creditors may lead to reprising of the credit yield by the creditors which is likely to result in such upward trends in costs.[21]

Apart from the business constraint that might follow this amendment, it has also not been very well received in terms of procedural outcomes of this elevation.[22] Firstly, it is not clear that how will the homebuyers, who are financial creditors now, be represented in the CoC, since in a given case their numbers will be large and this may prevent the whole CoC from engaging in any meaningful and informed decision-making. In this respect, the IBBI is expected to come out with a mechanism for homebuyers' representation in the Committee of Creditors. Secondly, the amendment has left a big lacuna in not clarifying whether the homebuyers are "secured" or "unsecured" financial creditors. This bifurcation is important as it affects the order of priority in the "waterfall list" in case of a final liquidation of the company. In view of the government, the same is a conscious omission as it will provide the

[21] Andy Mukherjee, *Bankruptcy Code Amendment: The Problem with Treating Homebuyers as Financial Creditors*, THE ECON. TIMES, https://economictimes.indiatimes.com/news/economy/policy/bankruptcy-code-the-problem-with-treating-homebuyers-as-financial-creditors/articleshow/64536958.cms (last visited June 11, 2018).

[22] *Will homebuyers really benefit if they are financial creditors?*, LIVEMINT, https://www.livemint.com/Money/FpxvRx0JZiZkiBwa9D17lL/Will-homebuyers-really-benefit-if-they-are-financial-credito.html (last visited May 28, 2018); *Treating homebuyers as financial creditors could impact real estate lenders negatively: Ind-Ra*, MONEY CONTROL, https://www.moneycontrol.com/news/business/real-estate/treating-homebuyers-as-financial-creditors-could-impact-real-estate-lenders-negatively-ind-ra-2574487.html (last visited May 23, 2018).

flexibility to the corporate debtor and the homebuyer to decide the same in their agreement to purchase or any other similar instrument.[23]

The amendments have been touted as providing major relief to home-buyers which is, to say the least, preposterous. Apart from speculation surrounding their status as a secured or as an unsecured creditor with its consequences, another aspect which needs a look is whether the changes are effective enough in affording the remedy sought by the home-buyers. On triggering of bankruptcy proceeding under IBC, the IRP along with the CoC take over the assets of the corporate debtor and ensure that the same are preserved till the time of liquidation. In real-estate projects, more often than not, the land on which the project is being developed might not belong to the developer or corporate debtor. The same is made available to him in form of a lease or with development rights under a 'joint development agreement' or a 'memorandum of understanding' with the owner of land. In such a scenario, such a land might not qualify as an 'asset' of the corporate debtor and thus the CoC will not be in a position to take over the same for recovering the outstanding debts payable to the home-buyer. In this regard, reference can be made to a recent decision by NCLT[24] wherein an application was filed

[23] K.R. Srivats, *Why the Centre has not classified home buyers as 'secured' or 'unsecured' creditors under IBC*, THE HINDU: BUSINESS LINE, https://www.thehindubusinessline.com/economy/why-the-centre-has-kept-away-from-classifying-home-buyers-as-secured-and-unsecured-creditors-under-ibc/article24138323.ece (last visited June 11, 2018); *Not all homebuyers to get first claim on liquidation proceeds*, LIVEMINT, https://www.livemint.com/Companies/DqWRsIMBkyRf3nEBoB6A5H/Not-all-homebuyers-to-get-first-claim-on-liquidation-proceed.html (last visited June 14, 2018).

[24] Rajendra Bhutia v. Maharashtra Housing & Area Dev. Authority [2018] 92 taxmann.com 376 (NCLT - Mum.).

by the Resolution Professional (RP) through corporate debtor to ascertain his entitlement to the exclusive possession of the property. The documents disclosed that a license was granted to the corporate debtor for joint development and not for exclusive development by the corporate debtor. The NCLT held that where corporate debtor had possession of a land as developer under Joint Development Agreement (JDA) and subsequent to initiation of insolvency resolution process against corporate debtor, the owner of land sought for cancellation of said agreement and claimed the possession of the land, RP of corporate debtor could not claim any right upon said land under Section 14(1)(d) as possession of land under JDA could not be called as ownership. Thus, in the factual matrix where the home-buyer initiates a bankruptcy proceeding against developer who merely holds the land under a license, the picture will be bleaker for as far as question of the buyer being able to recover the amounts paid is concerned. It should also be noted that, by their very nature real-estate projects are thinly-capitalised, which should be another consideration the home-buyer willing to take upon the developer must have in mind, as it can directly affect his chances of recovering the amounts due.

6. CROSS-BORDER INSOLVENCY

The current legal framework fails to provide any extensive solution to the problem which arises in certain cases with relation to use of overseas assets of the defaulters in the proceedings. The provisions existing are as follows:

- The IBC provides for Sections 234 and 235 pertaining to cross border insolvency. Section 234 provides for entering into bilateral agreements with other countries and Section 235 provides for issue of a letter of request by the Adjudicating Authority to a court in the country with which the bilateral agreement has been entered into to deal with the required assets. These agreements are applicable in cases where proceedings in India would require recognition abroad as well as where foreign proceedings require recognition or assistance in India.
- For foreign proceedings to be recognised and enforced in India, the Civil Procedure Code, 1908 has to be applied along with the principles developed in English Common Law.
- For Indian proceedings to be recognized abroad, the law of that country will apply or if the country has adopted the Model Law, the Model law shall apply, irrespective of whether India has adopted the same or not.

This need for entering in bilateral treaties with the foreign governments is aimed to be removed by Government as it has released a draft of a chapter on cross-border insolvency in the Code, based on the UNCITRAL Model. The idea behind this is to allow access of overseas assets of the stressed companies to the lenders. Implementation of this will ensure cooperation of the respective foreign country to bring those assets under consideration for the insolvency proceedings. The Ministry of Corporate Affairs has invited suggestions and comments from the

stakeholders on the released draft by the end of June which might be included in the final proposal to be placed before the Cabinet.

Enactment of effective cross-border insolvency regime will make India an attractive investment destination for foreign creditors given the increased predictability and certainty of the insolvency framework for the foreigners. This will result in reduction in time for exchanging necessary information between countries and will increase the credit recovery efficiency.[25]

The draft chapter provides that a resolution professional or a liquidator shall be provided similar authority to act in the foreign state as well, or such person shall assist a foreign representative, subjected to the Indian law and the applicable foreign law. Sections 7 and 8 provide rights to a foreign representative to exercise his power and function, and to commence a proceeding if the conditions under the provisions of the Code are satisfied. However, the Adjudicating Authority may refuse to take an action if it would be "manifestly contrary to the public policy of India".

Further, an application can be made to the Adjudicating Authority to recognise a foreign proceeding but it has to be accompanied by certain documents related to that proceeding. Section 18 provides for reliefs that may be granted upon recognition of a foreign proceeding. Chapter IV of the draft talks about cooperation and communication with foreign courts and representatives.

[25] Ministry of Corporate Affairs: Govt. of India, *Insolvency Section File No. 30/27/2018: Public Notice* (June 20, 2018), *available at* http://www.mca.gov.in/Ministry/pdf/PublicNoiceCrossBorder_20062018.pdf.

7. CONCLUSION

It is undeniable that the implementation of the Insolvency and Bankruptcy Code, 2016 has brought some relief to the creditors and has eased the process of insolvency with the introduction of a single law and adjudicating authority. The 'Ease of Doing Business' rankings issued by the World Bank have also shown an 8% improvement by India with respect to the 'resolving insolvency' factor.

However, as the article lays down, certain lacunae can be seen in the statute which the legislature is trying to fill. The article has discussed such rectifications in the form of the bankruptcy code amendment ordinance and the draft chapter on cross-border insolvency. Further, the issue of immunity to a guarantor during the moratorium has also been dealt with by the Ordinance which provided the definition of the term 'corporate guarantor' and introduced a clause wherein a guarantor has been excluded from the effect of moratorium.

There is still a requirement of better implementation of the Code by increasing the number of National Company Law Tribunals available in order to divide the burden and achieve the aim of speedy justice.

THE INSOLVENCY AND BANKRUPTCY CODE: CHALLENGES AND REFORMS

Wajahat Monaf Jilani[*]

ABSTRACT

The Insolvency and Bankruptcy Code, 2016 heralded a new and fresh approach towards insolvency resolution in the country. Justice A.K Sikri has identified two conflicting interests that face an insolvency regime. On the one hand, there is the interest of the creditors, while on the other there is the issue of restructuring or reviving of the insolvent company. Further, in balancing these two conflicting interests, lies the paramount economic interest of the nation, which can only be achieved if the interest of all the parties is safeguarded.[1]

Ever since it was introduced, being a completely new system, the Insolvency and Bankruptcy Code has faced its fair share of challenges. As a result, a fresh jurisprudence has emerged. This paper seeks to examine the legal issues faced, identify the possible solutions, and discuss the reforms made. It takes into account the report of the Insolvency Law Committee, the Insolvency & Bankruptcy (Amendment) Ordinance, 2018 and the Insolvency & Bankruptcy (Second Amendment) Act, 2018 from the perspective of efficient working of the Code as well as the suitability of the reforms in creating an atmosphere of ease in doing business and achieving the purposes of the Code. While many red flags were raised

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[1] V.S WAHI, TREATISE ON INSOLVENCY & BANKRUPTCY CODE 9 (1st ed. 2018).

with regards to the functioning of the code, the author has focussed on the more pertinent issues. In doing so and for the sake of understanding, the author has chosen to trace the history of the problem, various legislative and judicial interventions up to its present status.

1. INTRODUCTION

The New Insolvency process in India essentially embraces facets of rehabilitation, revival, recovery, and winding up. Therefore, the procedure is to be viewed in a holistic mode keeping all these features in mind.[2]

Prior to 2016, the insolvency laws were extremely fragmented in India among the Provincial Insolvency Act, 1920, the Companies Act, and the Sick Industrial Companies Act. The need for a comprehensive law encapsulating the entire insolvency regime was deeply felt; hence the enactment of a unified insolvency code was a welcomed step. The landmark Insolvency & Bankruptcy Code (IBC or Code) was a unique piece of law and new to the Indian legal system. It is thus not surprising that major issues have arisen during its journey in the last couple of years. This paper seeks to examine some of the major challenges facing the insolvency regime in India through an analysis starting from the root of the issues, tracing the step by step progress made to resolve them up till now.

This paper has discussed the Insolvency & Bankruptcy (Second amendment) Act, 2018 ("Amendment Act") which received the assent of

[2] *Id.*

the President of India on 17th August, 2018. The Amendment Act provides that it shall be deemed to have come into force from 6th June, 2018. As a result, the Insolvency & Bankruptcy (Amendment) Ordinance, 2018 ("Ordinance") was repealed and replaced by the Amendment Act having the same provisions as the ordinance.

2. WITHDRAWAL OF CIRP PROCEEDING PURSUANT TO SETTLEMENT

Rule 8 of the Insolvency & Bankruptcy (Application to Adjudicating Authority) Rules, 2016 provides that the National Company Law Tribunal (NCLT), constituted under section 408 of the Companies Act, 2013 may permit withdrawal of the insolvency application on a request of the applicant before its admission. However, the Code and the rules are silent on the question of legality of withdrawal of the application after its admission by the NCLT.

This issue first came before the NCLT, Kolkata in the matter of *Parker Hannifin India Pvt. Ltd. v. Prowess International Pvt. Ltd.*,[3] wherein after analysing the code the tribunal observed that post-admission of the insolvency petition, its nature changes to a representative suit and the dispute does not remain between the operational debtor and corporate debtor alone, as through publication in newspapers etc. applications were invited from other creditors to file their claim before the Insolvency Resolution Professional (IRP).

[3] Parker Hannifin India Pvt. Ltd. v. Prowess Int'l Pvt. Ltd., 2017 S.C.C. OnLine N.C.L.T. 1724.

Similar issues were also raised in *Lokhandwala Kataria Construction Pvt. Ltd. v. Nisus Finance and Investment Manager*,[4] and *Mothers Pride Dairy India Pvt. Ltd. v. Portrait Advertising and Marketing Pvt. Ltd.*,[5] wherein the National Company Law Appellate tribunal (NCLAT) was called upon to answer whether, in view of Rule 8 of the 2016 CIRP Rules, the NCLAT could utilize the inherent powers recognized by Rule 11 of the National Company Law Appellate Tribunal Rules, 2016 in order to allow for a compromise or settlement between the parties after the admission. In both cases, the tribunal took the view that permitting such a compromise was beyond its powers; therefore, it could not do so. On Appeal, the Hon'ble Supreme Court *prima facie* agreed with the view taken by the NCLAT. However, it opined that under Art. 142 of the Constitution of India, it had the requisite inherent power to record the settlement entered after admission.[6] Thereafter in *Uttara Foods and Feeds Private Limited v. Mona Pharmachem*,[7] the Supreme Court referred to its decision in *Lokhandwala* and observed that in view of the influx of post admission settlement cases coming before the Court, since only it could utilize its special powers to allow such settlements, relevant rules may be amended so as to give such inherent powers to the NCLT and NCLAT.

With regard to the present dispute, opinions are sharply divided.

[4] Lokhandwala Kataria Construction v. Nisus Finance & Inv. Manager, 2017 S.C.C. OnLine N.C.L.A.T. 406.
[5] Mothers Pride Dairy India v. Portrait Advertising & Marketing, 2017 S.C.C. OnLine N.C.L.A.T. 411.
[6] Civil Appeal No. 9286/2017, Supreme Court of India.
[7] Uttara Foods & Feeds v. Mona Pharmachem, 2017 S.C.C. OnLine S.C. 1404.

2.1. PROPONENTS

The proponents of recording settlements after initiation of the corporate insolvency resolution process point out that through such compromises the concerned parties can retain the ball in their own court. In other words, the management and control would continue to vest in the company itself allowing the existing board of directors, who have better knowledge of the affairs and dealings of the company to navigate the troubled period as opposed to a resolution profession, thus giving the company a better chance of survival. Moreover, once a company enters the Corporate Insolvency Resolution Process (CIRP), the investors' confidence plunges and vice versa. For example, the withdrawal of the insolvency application by Andhra Bank against HDIL, albeit before admission of the petition, saw the stock rally a healthy five per cent the same day.[8] Thus, settlement option enables the promoters to realize the value of the withdrawal of the application.

2.2. OPPONENTS

On the other hand, the opponents argue that although the insolvency application may be filed by one or more creditors the insolvency resolution process is a collective process. It must be borne in mind that all the financial creditors are part of the Committee of Creditors (CoC). The Committee of Creditors play a significant role in the insolvency resolution

[8] Shaleen Tiwari, *Settlement under the Insolvency and Bankruptcy Code, 2016: A Contrarian Perspective*, INDIA CORP LAW, https://indiacorplaw.in/2017/11/settlement-insolvency-bankruptcy-code-2016-contrarian-perspective.html (last visited Apr. 20, 2018).

process. For instance, Section 28 lists the kinds of actions which the resolution professional cannot take without the prior approval of the CoC, such as creating any security interest over the assets of the corporate debtor, change the capital structure of the corporate debtor etc. Most importantly, any resolution plan under Section 30(4) needs the requisite approval of the CoC.

Thus, if such a practice is allowed the applicant creditor could disregard the other creditors and reach a settlement best suited to him. Moreover, in such an eventuality the avenues available to the other creditors remain unclear. This practice could be misused by first filing an insolvency application so as to gain leverage and a strong bargaining position in the subsequent settlement talks. The aim of the Code in providing the CIRP was to simplify the process, allowing for such a settlement would complicate the process.

2.3. MIDDLE PATH – RECOMMENDATION OF THE INSOLVENCY LAW COMMITTEE AND THE AMENDMENT

The objective of the code as encapsulated in the Banking Law Reform Committee (BLRC) Report,[9] is that the design of the Code is based on ensuring that:

> *…all key stake holders will participate to collectively assess viability. The law must ensure that all creditors who have the capability and the willingness to restructure the liabilities must be part of the negotiation process. The liabilities of all*

[9] T.K. Vishwanathan, *The Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design*, THE INSOLVENCY AND BANKRUPTCY BOARD OF INDIA, http://ibbi.gov.in/BLRCReportVol1_04112015.pdf (last visited June 20, 2018).

> *creditors who are not part of the negotiation process must also be met in any negotiated solution.*

In view of the same, the Insolvency Law Committee ("the Committee") noted in its report[10] that once:

> *…the CIRP is initiated it is no longer a proceeding only between the applicant creditor and the corporate debtor but is envisaged to be a proceeding involving all creditors of the debtor. The intent of the Code is to discourage individual actions for enforcement and settlement to the exclusion of the general benefit of all creditors.*

The Committee was thus of the opinion that the rules be amended to provide for withdrawal post admission if the Committee of Creditors (CoC) approves of such an action by a voting share of ninety per cent and the need to adopt Rule 11 of the NCLT Rules, 2016 was not considered necessary as Rule 8 of the CIRP Rules were considered adequate to address the issue.

Acting upon these recommendations, on 9th June 2018, the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2018 was promulgated. This ordinance inserted Section 12A titled 'withdrawal of application admitted under Sections 7, 9 or 10.' The section provides that withdrawal of the insolvency application under sections 7, 9 or 10 will be allowed only if approved by 90% of the voting share of the CoC. Moreover, after Expressions of Interest (EoI) are invited and commencement of the

[10] Injeti Srinivas, *The Report of the Insolvency Law Committee*, MINISTRY OF CORPORATE AFFAIRS, http://www.mca.gov.in/Ministry/pdf/ILRReport2603_03042018.pdf (last visited June 21, 2018).

bidding process takes place, no withdrawal will be allowed.[11] The Amendment Act also contains the same provision.

3. APPLICABILITY OF THE LIMITATION ACT TO THE INSOLVENCY CODE

The debate on the applicability of the Limitation Act, 1963 on the proceedings under the IBC Code is perhaps as old as the Code itself. The question has been a recurring one, arising out of the silence of the Code itself on the issue; therefore the judiciary has been called upon to answer the question. It has been dealt with by the tribunals as well as the Supreme Court.

In *SBI, Colombo v. Western Refrigeration*,[12] and *Deem Roll-Tech Ltd. v. R.L Steel & Energy Ltd.*,[13] it was held that, despite no provision of the Code specifically makes the Limitation Act applicable to it, Section 433 of the Companies Act, 2013 makes the Limitation Act applicable upon the proceedings before the NCLT, since it is also the adjudicating authority under the Code, the tribunal would apply the Limitation Act in insolvency matters as well. In *Speculum Plast Pvt. Ltd. v. PTC Techno Pvt. Ltd*.,[14] despite arguments to the effect that Section 424,425, 433,434 and 430 of the Companies Act make the Limitation Act applicable on the corporate insolvency resolution process, NCLAT relied on the rule of interpretation

[11] *President Approves Promulgation of the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2018*, PRESS INFO. BUREAU, http://pib.nic.in/newsite/PrintRelease.aspx?relid=179805 (last visited July 6, 2018).
[12] SBI, Colombo v. Western Refrigeration, 2017 S.C.C. OnLine N.C.L.T. 1766.
[13] Deem Roll-Tech Ltd. v. R.L. Steel & Energy, 2017 S.C.C. OnLine N.C.L.T. 465.
[14] Speculum Plast Pvt. Ltd. v. PTC Techno Pvt. Ltd., 2017 S.C.C. OnLine N.C.L.A.T. 319.

in holding that the IBC being a 'Code in itself', it should be read as it is. This rule has been approved by the Supreme Court as well; it was observed that if a law is a complete code, then an express and necessary exclusion of the Limitation Act should be respected.[15]

In *Neelkanth Township and Construction Pvt. Ltd. v. Urban Infrastructure Trustees Ltd.*,[16] the NCLAT through its order dated 11.08.2017 took the view that absence of a specific provision making the Limitation Act applicable to the Code indicates the intent of the drafters. On Appeal to the Supreme Court, while the appeal itself was dismissed, the Court through its order dated 23.08.2017 left the question of applicability of Limitation Act open.[17] In January of 2018, the Apex Court stayed the decision and took up the mantle of resolving the conundrum.[18] As of July 2018 the decision in the case is still awaited.[19]

3.1. INSOLVENCY LAW COMMITTEE

While the decision of the Supreme Court is awaited, the Insolvency Law Committee has observed that the non-application of the Limitation Act would result in the reopening of the right of financial and operational creditors holding time-barred debts under the Limitation Act to file for CIRP. It would also reopen the right of claimants to file time-barred

[15] Ravula Saubba Rao v. Comm'r of Income Tax, Madras, (1956) S.C.R. 577.
[16] Neelkanth Township and Construction Pvt. Ltd. v. Urban Infrastructure Trustees Limited, Company Appeal (AT) (Insolvency) No. 44 of 2017.
[17] Civil Appeal No. 10711/2017, Supreme Court of India.
[18] Akanksha Jain, *SC Stays NCLAT Order That Said Limitation Act Doesn't Apply To Proceedings Under IBC*, LIVE LAW, http://www.livelaw.in/sc-stays-nclat-order-said-limitation-act-doesnt-apply-proceedings-ibc-read-petition/ (last visited April 21, 2018).
[19] B.K. Edu. Services v. Parag Gupta & Associates, Civil Appeal No. 23988/2017, Supreme Court of India.

claims with the resolution professional, which may be part of the resolution plan. The committee observes that the intent of the Code was not to give a fresh opportunity to creditors and claimants to recover their capital. Thus, it recommended the insertion of a specific section making the Limitation Act applicable to the Code.[20]

3.2. THE AMENDMENT ACT

Pursuant to the recommendations, Section 34 of the Amendment Act has inserted Section 238A which unequivocally lays down that the provisions of the Limitation Act, 1963 shall apply to the proceeding or appeals under the Code.

4. VOTING SHARE THRESHOLD FOR DECISIONS OF THE COMMITTEE OF CREDITORS (COC)

Section 21(8) of the Code lays down that the decisions taken by the CoC, including the key decision of approving the resolution plan, shall be by a vote of not less than 75 per cent of the voting share of the financial creditors. Regulation 25(5) read with Regulation 26 of the CIRP Regulations provides that if all the members of the CoC are not present, they must be provided an option to vote electronically.

The high threshold of 75 per cent for decisions of the CoC poses potential problems for a number of reasons, for one, the creditors' committee does not give the right to vote to operational creditors or other creditors such as home buyers and public depositors, even if they are

[20] *supra* note 10.

above the prescribed threshold. Only financial creditors can vote in the CoC. Furthermore, the 75 per cent majority vote is a high threshold to reach practically. Different creditors have different interests and it may not be easy to bring about an agreement among all of them. Attempting to achieve this kind of a majority would significantly slow down the CIRP process. It could even be misused as a pressure tactic by big creditors, who may impose upon the debtor and other creditors such a resolution plan as serves their own interests. Unlike the Joint Lenders Forum (JLF) process, it is unclear whether the dissenting creditors have an 'exit option' under the CIRP.

Internationally, voting thresholds are below the 75 per cent. In USA, the resolution plan is required to be approved by at least 66 per cent voting share in value and 50 per cent or more voting share in number, for each class of creditors.[21] In the UK, the resolution plan requires the approval by simple majority in value of the creditors present and voting. The requirement in Singapore is that there should be approval by 75 per cent or more of voting share by value and more than 50 per cent voting share in number of creditors present and voting.[22]

This issue was considered by the Insolvency Law Committee. After considering the empirical evidence of liquidation orders passed by NCLT benches, the Committee was of the opinion that there is little substance in the fear that minority creditors are forcing the companies into liquidation. Nevertheless, to promote resolution, at no. 5 among its key recommendations, the Committee says, "in order to fulfil the stated

[21] 11 U.S. Code § 1126(c).
[22] Singapore Companies Act, 2006, § 268(3)(b).

objective of the Code i.e. to promote resolution, it has been recommended to re-calibrate voting threshold for various decisions of the committee of creditors"[23]

It recommended that the voting share for approval of resolution and other critical decisions such as extension of CIRP beyond the statutory period of 180 days under Section 12(2), replacement or appointment of resolution professional (RP) under Sections 22(2) and 27(2), and passing a resolution for liquidation under Section 33(2), be reduced from 75 per cent to 66 per cent or more of the voting share of financial creditors. The Committee recognized that it is the responsibility of the interim resolution professional/resolution professional to manage the operations of the corporate debtor as a going concern. Hence for routine decisions, it was recommended that the voting threshold be reduced to 51 per cent or more of voting share of the financial creditors.[24]

The Amendment Act has brought the recommendation of the Committee into effect by making suitable amendments to the Code.

5. INCLUSION OF HOME BUYERS AND PUBLIC DEPOSITORS AS 'FINANCIAL CREDITORS

Since the initiation of the Code, the question of protection of the interest of home buyers has been raised and confusion prevailed as to whether home buyers could initiate CIRP against their defaulting developer or builder.

[23] *supra* note 10.
[24] *Id.*

As recently as in May 2018, the NCLT Hyderabad Bench in *Col. Giridhar v. Name Construction Pvt. Ltd.*,[25] observed that "[u]nder Chapter II of the Code, only a financial creditor, an operational creditor or the corporate debtor can initiate Corporate Insolvency Resolution Process...it remains unclear under the Statute as also in the light of various pronouncements whether home buyers or plot buyers would come under any of the above categories." In *Nikhil Mehta v. AMR Infrastructure*,[26] the NCLAT held the flat buyers concerned to be "financial creditors" due to the inclusion of an assured return scheme in the contract, whereby it was agreed that the seller i.e. developer would pay assured returns to the buyer until delivery of the possession. Therefore, this was a fact specific decision and is not a general rule.

Earlier, in November 2016, responding to the demand of home buyers, an amendment was made to the Insolvency and Bankruptcy Board of India (Insolvency Resolution for Corporate Persons) Regulations, 2016,[27] ("CIRP Regulations") whereby a 'form F' was provided for creditors other than financial and operational creditors to enable them to file their claims with the Insolvency Resolution Professional (IRP). The intention of the IBBI seems to hint that home buyers were neither financial nor operational creditors.

[25] Col. Giridhar v. Name Construction, 2018 S.C.C. OnLine N.C.L.T. 2377.
[26] Nikhil Mehta v. AMR Infra., 2017 S.C.C. OnLine N.C.L.A.T. 219.
[27] Insolvency and Bankruptcy Board of India (Insolvency Resolution for Corporate Persons) Regulations, 2016, *available at* http://ibbi.gov.in/webadmin/pdf/legalframwork/2017/Oct/CIRP%20Regulations%20-%20after%202nd%20Amendment_2017-10-24%2017:32:27.pdf.

As a result of non-inclusion of home buyers as financial or operational creditors under the IBC, the home buyers were deprived of the right to initiate the CIRP, the right to be on the committee of creditors as well as the right to at least receive the liquidation amount under the resolution plan.

5.1. INSOLVENCY LAW COMMITTEE

The Insolvency Law Committee took note of this confusion and analysed the peculiarity of the Indian real estate sector. It noted the following[28]:

1. The agreement between home buyers and developers are for disbursement of money by the home buyer for delivery of a building to be constructed in the future, therefore disbursement of money is for a future asset.
2. The money raised from home buyers is in effect financing the project, and thus it is a tool for raising finance.
3. Not all forward sale or purchase are financial transactions, but if they are structured as a tool or means for raising finance, there is no doubt that the amount raised may be classified as financial debt under Section 5(8)(f). Therefore amount raised under a real estate project from home buyers falls within Section 5(8)(f) [Note: pre- amendment Section 5(8)(f)]
4. Usually the collective amount given by home buyers as advance for their purchase is very high and often higher than the debt owed to

[28] *supra* note 10.

banks, such as in the *Chitra Sharma v. Union of India*.[29] Despite that, banks enjoy greater protection than home buyers as they are financial creditors.

The Committee noted that the current definition of financial debt is sufficient to include the amount raised from home buyers or allottees. However to avoid confusion it recommended insertion of an explanation clarifying that such creditors fall within the definition of financial creditors.[30]

5.2. THE AMENDMENT ACT

The Statement of Object of the Insolvency & Bankruptcy (Amendment) Ordinance, 2018 as well as the Insolvency & Bankruptcy (Second Amendment) Bill, 2018 as introduced in the Lok Sabha recognizes the need to balance the interest of various stakeholders, especially home buyers etc. The Bill having received the parliamentary approval and presidential assent has now become an Act.

Section 5(8)(f) of the IBC, 2016 provides that financial debt includes "any amount raised under any other transaction, including any forward sale or purchase agreement, having the commercial effect of a borrowing". In order to bring the home buyers within the domain of financial creditors, the definition of financial debt has been expanded by the Amendment Act. Section 3 of the Amendment Act adds an explanation after Section 5(8)(f). Explanation (i) provides that "any amount raised from an allottee under a

[29] Chitra Sharma v. Union of India, Writ Petition(s) (Civil) No.744 of 2017, Supreme Court of India.
[30] *supra* note 10.

real estate project shall be deemed to be an amount having the commercial effect of borrowing." Explanation (ii) provides that the definition of "allottee" and "real estate project" are to be taken from the Real Estate (Regulation and Development) Act, 2016 ("RERA"). "Allottee" is defined under RERA in relation to a real estate project as "a person to whom a plot, apartment or building has been allotted, sold (whether as freehold or leasehold) or otherwise transferred by the promoter and includes a subsequent acquirer of such property."

The Amendment Act also introduced Section 21(6A), which provides that in case where a class of creditors to which a financial debt is owed exceeds a specified number (except where a trustee or agent is appointed under the terms of the financial debt), the interim resolution professional will make an application to the Adjudicating Authority with the name of an insolvency resolution professional, other than the interim resolution professional, to act as the authorised representative of such class of creditors. Such authorised representative will be appointed by the Adjudicating Authority prior to the first meeting of the CoC.

5.3. POTENTIAL PROBLEMS

Although the protection provided to home buyers comes as a relief to thousands of affected persons, their classification particularly as 'financial creditors' has thrown open some fresh concerns.

Firstly, the real estate sector has recently seen the enactment of Real Estate (Regulation and Development) Act, 2016 ("RERA"). There are concerns regarding conflicts arising between RERA and IBC. As per IBC

procedure, once an application is admitted and the moratorium on any other proceeding is declared. So, any on-going or fresh application before RERA would be suspended for the duration of the CIRP. The law provides that this process is to be completed within 180 days, extendable by further 90 days. Therefore, if the home buyer is unable to settle the matter with the developer or promoter and his application under IBC is admitted, the moratorium may defeat the purpose of his inclusion in the IBC.

Secondly, under Section 7 of the IBC, a financial creditor can initiate the CIRP only when a 'default' in relation to his financial debt occurs. Section 3(12) defines default as "non-payment of debt when whole or any part or instalment of the amount of debt has become due and payable and is not [paid] by the debtor or the corporate debtor, as the case may be." However, the Amendment Act is silent on when a default arise in case of home buyers.

6. OTHER ISSUES DEALT WITH BY THE COMMITTEE AND AMENDMENT

A number of other issues have been also considered by the Insolvency Law Committee, some of which have been accepted by the government and included in the recent amendment to the Insolvency & Bankruptcy Code, 2016.

6.1. PREFERENTIAL AND UNDERVALUED TRANSACTIONS

The IBC, like insolvency laws of most jurisdictions, includes avoidance provisions intended to avoid certain transactions which may

have a negative effect on the finances of the corporate debtor and for maximising the value of the company's assets. Sections 43 to 48 of the Code deal with undervalued and preferential transactions. Such transactions can be set aside on an application by resolution professional or liquidator.

A corporate debtor is deemed to have given preference at a relevant time when there is transfer of a property or an interest of the corporate debtor in respect of an existing debt or liability, and such transfer has the effect of putting such creditor in a beneficial position than it would have been in the event of a distribution of assets under Section 53 of the Code. However, transfer made in the ordinary course of the business or financial affairs of the corporate debtor or any transfer creating a security interest in property acquired by the corporate debtor does not constitute a preferential transaction. Such preferential transactions must be made 'at a relevant time'. As per Section 43(4), the relevant time in case of a related party, is the period of two years preceding the insolvency commencement date. In case of other persons, it is one year preceding the commencement of insolvency.

Section 45(2) provides that a transaction shall be considered to be an undervalued transaction, if during the relevant period the corporate debtor makes a gift or transfers one or more assets for a consideration lower than the actual value, provided that such transaction has not taken place in the ordinary course of business of the corporate debtor. Like, preferential transactions, for an undervalued transaction to fall within the provision of the Code, it must be made within the 'relevant period' i.e., within one year

preceding the insolvency commencement date in case of any person other than related party and within two years preceding the insolvency commencement date where the transaction was made with a related party. In the case of undervalued transactions, in addition to resolution professional and liquidator, the creditor, member or partner of a corporate debtor are permitted to make an application to Adjudicating Authority if the liquidator or the resolution professional has not reported the same.

In both cases, on an application being made to the Adjudicating Authority, an order may be made reverse the transaction in the manner described under Sections 44 and 48 for preferential and undervalued transactions respectively.

In *IDBI Bank Limited v. Jaypee Infratech Limited*,[31] the NCLT has observed that Sections 43 and 45 are made retrospectively applicable. The tribunal has noted "that the code itself has provided a retrospective effect to the provision of section 43(4)(a) wherein it is stated that it is given to a related party, during two years preceding the insolvency commencement date." The above provision indicates that the retrospective effect is laid down in the legislation itself. Thus, the look-back period for the transactions is made dependent on the insolvency commencement date, and not on the date when the Insolvency & Bankruptcy Code came into effect.

[31] C.A. No. 26/2018 in Company Petition No. (1B) 77/ALD/2017.

6.2. BAR UNDER SECTION 29A (G)

Section 29A was inserted in the IBC through an amendment[32] made in 2017 to provide a list of 'persons not eligible to be resolution applicants'. Clause (g) of it provided that a person who has been a promoter or in the management or in control of a corporate debtor in which preferential or undervalued transaction has taken place and in respect of which an order has been made by the Adjudicating Authority shall not be eligible to submit a resolution plan.

With regard to this provision, the Committee noted that a person should not be punished for acts of another person, such as a predecessor if he or she did not have a nexus with past actions that led to preferential or undervalued transactions. It recommended that clause (g) must be amended to carve out from its ambit persons who acquired a corporate debtor pursuant to the CIRP process under the Code or a scheme or plan approved by a financial sector regulator or a court of law and preferential, undervalued, fraudulent or extortionate credit transactions had taken place in the corporate debtor prior to such acquisition.[33] The Committee also emphasized on the importance of ensuring that the resolution applicant has not contributed to such transactions in anyway.

These suggestions have been duly incorporated in the recent amendment made to the IBC. A proviso has been inserted after section 29A(g) providing that clause (g):

[32] Insolvency and Bankruptcy Code (Amendment) Act, 2018.
[33] *Id.*

> *…shall not apply if a preferential transaction, undervalued transaction, extortionate credit transaction or fraudulent transaction has taken place prior to the acquisition of the corporate debtor by the resolution applicant pursuant to a resolution plan approved under this Code or pursuant to a scheme or plan approved by a financial sector regulator or a court, and such resolution applicant has not otherwise contributed to the preferential transaction, undervalued transaction, extortionate credit transaction or fraudulent transaction.*

Another suggestion which has been included in the Amendment Act is the deletion of the reference to Section 43 (related to preferential transaction) in Section 45(1) which deals with undervalued transactions, as the insolvency law committee had noted it as a drafting error.

In a case decided after the insertion of the proviso to clause (g) of Section 29A by the ordinance, in *Chitra Sharma v. Union of India*,[34] the Hon'ble Supreme Court held that Jayprakash Associates Ltd. (JAL) and Jaypee Infratech Ltd. (JIL) and their promoters shall be ineligible to participate in the CIRP by virtue of the provisions of Section 29A. The Court observed that:

> *…under Clause (g), a person who has been a promoter or in the management or control of a corporate debtor in which a preferential transaction, undervalued transaction…has taken place and in respect of which an order has been made by the adjudicating authority under the IBC is prohibited from participating. The Court must bear in mind that Section 29 A has been enacted in the larger public interest and to facilitate effective corporate governance.*

[34] Chitra Sharma and Ors v. Union of India and Ors., 2018 SCC OnLine SC 874.

6.3. ELIGIBILITY OF RESOLUTION APPLICANTS

Initially the IBC allowed any person to be a resolution applicant and submit a resolution plan. In *Sree Metaliks Ltd. v. SREI Equipment Finance Ltd.*,[35] the NCLT has held that the Code provides no restriction on who can be a resolution applicant, and this may include a promoter of a corporate debtor. Similar observation has been made in *Sanjeev Shriya v. State Bank of India*.[36]

However, as discussed above, this position changed pursuant to the insertion of section 29A by an ordinance and subsequently the Insolvency and Bankruptcy Code (Amendment) Act, 2018. The need for this legislative intervention arose due to concerns that persons who through their misconduct had contributed to the default of companies may use this lacuna in the law to participate in the resolution or liquidation process and ultimately gain or regain control of the corporate debtor. The statement and object of the Bill as introduced in Lok Sabha notes that, "[t]his may undermine the processes laid down in the Code as the unscrupulous person would be seen to be rewarded at the expense of creditors."[37]

However, the insertion of Section 29A led to a new set of problems. Due to its 'wide' nature, the disqualifications had the potential to prevent innocent applicants from participating on technical grounds, thereby making the possibility of liquidation rather than resolution more likely.

[35] Sree Metaliks Ltd. v. SREI Equipment Finance Ltd., 2017 S.C.C. OnLine N.C.L.T. 6812.
[36] Sanjeev Shriya v. State Bank of India, (2018) 2 All L.J. 769.
[37] Insolvency & Bankruptcy Code (Amendment) Bill, 2017, *available at* http://www.prsindia.org/uploads/media/Bankruptcy/Insolvency%20and%20Bankruptcy%20Code%20Amendment%20Bill%202017.pdf.

This section laid down a complex and multi layered range of disqualifications for resolution applicants.

In *RBL Bank Ltd. v. MBL Infrastructure Ltd.*,[38] the NCLT observed that it cannot be the intention of the legislature to disqualify the promoters as a class but to rather exclude those classes of persons who may affect the credibility of the resolution process given their antecedents. The tribunal noted that "merely because there is default by a borrower in repayment of borrowed amount to a creditor does not render the borrower or its guarantor, dishonest. Every act of default cannot be equated with malfeasance."

Dealing with this issue, the Committee recognized the need to streamline the process so as to ensure that only those parties who directly contributed to the default of the company are prevented. This provision was depriving genuine persons who could aid the revival of the company from doing so. In view of the NPA situation in the country, it recommended that financial entities be allowed to participate in the resolution process.

The Amendment Act has taken this recommendation into account and fine-tuned section 29A accordingly. Moreover resolution application holding an NPA by virtue of acquiring it in the past under the IBC, 2016, has been provided with a three-year cooling-off period, from the date of such acquisition.[39] Furthermore, through an amendment in Section 30 the

[38] C.A. (I.B) No. 543/KB/2017 arising out of C.P (IB)/170/KB/2017.

[39] *President Approves Promulgation of the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2018*, PRESS INFO. BUREAU, http://pib.nic.in/newsite/PrintRelease.aspx?relid=179805 (last visited July 6, 2018).

onus has been placed on the applicant to prove that he is eligible to submit a resolution plan by submitting an affidavit to that effect. It also grants a one year grace period to the resolution applicant to gain all necessary statutory requirements. The Committee had recommended the deletion of the words "if such person, or any other person acting jointly or in concert with such person" in the first line of section 29A to clarify that the disqualification applied only to resolution applicant and 'connected persons'. However, this recommendation has not been incorporated in the Ordinance or the Amendment Act.

In *Insolvency & Bankruptcy Board of India v. Wig Associates Pvt. Ltd.*,[40] The NCLAT observed that the view of NCLT Mumbai bench *in Re: Wig Associates (P.) Ltd.*,[41] in holding that that the ineligibility in Section 29A does not apply to on-going insolvency proceedings 'may not be proper, but the IBBI having no *locus standi* cannot challenge the finding aforesaid.' However, the appellate tribunal left the door open for the resolution professional to file an appeal.

6.4. MICRO, SMALL & MEDIUM ENTERPRISES (MSME)

The Amendment Act has inserted Section 240 to the principal act to support the MSME sector. Section 37 of the Amendment Act lays down that clause (c) and (h) of Section 29A shall not apply to a resolution applicant in case of CIRP of a MSME. Moreover, the central government has been empowered to issue notification directing that provisions of the

[40] Company Appeal (AT) (Insolvency) No. 415 of 2018.
[41] MA No. 435 of 2018 in CP No. 1214/I & BC/NCLT/MB/MAH/2017.

Act will not apply to the sector. This amendment follows the recommendations of the Insolvency Law Committee to the same effect.

7. CONCLUSION

In a short span of two years, the Insolvency & Bankruptcy Code, 2016 has thrown open a host of legal issues. As a result, businesses, lawyers, judges, and specialized professionals have faced unique challenges. It was therefore unsurprising to witness frequent amendments being made to the Code. A large number of issues have even been dealt with by the Hon'ble Supreme Court. In the context of early resolution being one of the objectives of the new law, this was not ideal.

However, the recent report of the Insolvency Law Committee has painstakingly delved into most of the existing problems and suggested adequate reforms. While debate continues on some of them as well as their adequacy, the recent Ordinance and subsequent Amendment Act which incorporated some of the changes came at a crucial time and is sure to aid India's ease of doing business rankings. The learning curve in the field of insolvency law is not over yet, and it will take another few years for the mechanism of the Insolvency & Bankruptcy Code to fully assimilate with Indian law, until then, novel concerns will keep arising, the onus will be on NCLT, NCLAT, IBBI and the Supreme Court to resolve these as early as possible, given what is at stake for the country and the economy.

ANALYSIS OF THE FINANCIAL RESOLUTION AND DEPOSIT INSURANCE BILL

- *Pranav Bafna*[*]

ABSTRACT

Although the 2007-08 financial crises wreaked havoc across the board, it also served as a catalyst for change. Overwhelmed by the financial ramifications of their impudent behaviour, many financial institutions found themselves on the verge of going bust. Their lack of preparedness in dealing with such a financial catastrophe put billions of dollars' worth of bank deposits at risk. Although the financial institutions were bailed out by the taxpayers' money, it exposed the hollowness in their incumbent insolvency mechanisms.

To prevent such a situation from recurring, several economies have revamped their insolvency mechanisms for financial institutions. Taking cognizance of its hypersensitive financial sector, the Indian government has also tabled the Financial Resolution and Deposit Insurance Bill before the Parliament.

Although certain provisions of the Bill have received a hostile response from the media, this article seeks to separate the facts from fiction. This article seeks to highlight certain significant provisions of the Bill which merit the readers' attention. Further, this article would also mention the criticisms and recommendations forwarded to the drafting committee by other regulatory stakeholders. While the Bill adopts a two-

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pronged approach to protect the interests of financial institutions and their associated depositories, its success hinges on how well it reconciles the interests of all the affected stakeholders.

1. INTRODUCTION

The financial industry is the 'heart and soul' of any thriving economy. Just like the famed 'Titanic', it was often regarded as 'too big to fail'. Just like the mighty ship - devoid of emergency preparedness - the financial sector lacked adequate resolution mechanisms to deal with such a situation. Consequently, on being hit by the 2007-08 'iceberg', it wreaked havoc across the globe.

2. BACKGROUND

It was in response to this unfortunate event that countries got exposed to the hollowness in their insolvency resolution mechanisms. A glaring instance of this apparent lacuna could be identified in the United States of America's inability to deal with the simultaneous failure of its non-banking financial institutions and the catastrophic failure of its systemically significant banking institutions. The federal government of the United States of America found themselves in a catch twenty-two situation, wherein, they had to choose between letting the financial firms go into regular corporate bankruptcy (in the case of Lehman Brothers) or bail them out (in the case of American International Group, AIG). The lack of clarity in dealing with such a situation resulted in an unprecedented

nervousness, which rubbed salt in the wounds of an already hyper-sensitive financial market.

Consequently, several economies have acted against its resolution-making incapacity by strengthening the existing mechanisms and expanding their resolution making capabilities. The Financial Stability Board, established in 2009, succeeded the erstwhile Financial Stability Forum with a broader mandate to promote financial stability. One of the integral features of its Mandate is to assess vulnerabilities affecting the global financial system as well as to identify and review, on a timely and on-going basis within a macroprudential perspective, the regulatory, supervisory, and related actions needed to address these vulnerabilities, and their outcomes.[1] Thus, most of the policies developed in pursuit of this agenda form the backbone of the legislation, which intends to promote a financially stable economic environment.

While Indian lenders withstood the meltdown of 2007-08 fairly well, they embarked on an ill-advised lending spree, backing many infrastructure projects that were snarled in bureaucracy.[2] Bad loans started to pile up. State-owned lenders, which account for around two-thirds of the banking sector, now had "stressed" loans of 10.5 trillion rupees, about a fifth of their cumulative loan book.[3] Due to its structural incapacity of dealing with a financial meltdown of this magnitude, the Indian economy

[1] *Our Mandate*, FINANCIAL STABILITY BOARD, http://www.fsb.org/about (last visited June 29, 2018).
[2] *The round-trip rupee trick-India recapitalises its state-owned banks*, THE ECONOMIST, https://www.economist.com/finance-and-economics/2017/10/28/india-recapitalises-its-state-owned-banks (last visited June 14, 2018).
[3] *Id.*

started to fear the worst.

3. INTRODUCTION OF THE BILL IN THE PARLIAMENT

The Finance Minister of India, in his 2016-17 budget speech announced his intention of creating India's first holistic bankruptcy resolution code – dedicated solely to financial firms. In his words:

> *A systemic vacuum exists with regard to bankruptcy situations in financial firms. A comprehensive Code on Resolution of Financial Firms will be introduced as a Bill in the Parliament during 2016-17. This Code will provide a specialised resolution mechanism to deal with bankruptcy situations in banks, insurance companies, and financial sector entities. This Code, together with the Insolvency and Bankruptcy Code 2015, when enacted, will provide a comprehensive resolution mechanism for our economy.*[4]

Pursuantly, a committee to draft a bill on the resolution of financial firms was constituted on March 15, 2016. On the basis of the findings from the reports of the Financial Sector Legislative Reforms Commission (2013), the High Level Working Group on Resolution Regime for Financial Institutions (2014), and various publications of the Financial Stability Board, the committee successfully drafted the Financial Resolution and Deposit Insurance Bill, 2017 (the 'FRDI Bill').

4. BAIL-IN PROVISION

Before we analyse any finer aspects of this proposed legislation, it would be ideal to address the most controversial issue. Section 48(1) of

[4] Arun Jaitley, Minutes of Budget Speech, 17-19 (Feb. 29, 2016).

the FRDI Bill proposes debt resolution through a variety of resolution mechanisms. Among them, sub-clause (b) enables banks to be 'bailed in' by depositors' funds rather than being 'bailed out' by taxpayers (or potential buyers).[5] The Bail-In provision has been further explained in Section 52 as follows:

> *A bail-in provision means any or a combination of the following:*
> *(a) A provision cancelling a liability owed by a covered service provider;*
> *(b) A provision modifying or changing the form of a liability owed by a covered service provider*
> *(c) A provision that a contract or agreement under which a covered service provider has a liability is to have effect as if a specified right had been exercised under it.*

In other words, the 'bail-in provision' provides capital – through restructuring or conversion of depositors' funds - to an ailing bank in order to absorb its losses and subsequently ensure its survival. Survival in this context refers to the restoration of the capital of the bank, not the safety of depositors' money. It empowers the concerned resolution making institution to unilaterally cancel a liability owed by the bank to its depositors or change the form of an existing liability to another security. Simply said, the financial institution refuses the repayment of its customer's deposits, or converts these deposits into another

[5] *Bail-In Doubts – On Financial Resolution Legislation*, THE HINDU, http://www.thehindu.com/opinion/editorial/bail-in-doubts/article21261606.ece (June 13, 2018).

financial instrument in lieu of their deposits being utilised for recapitalising the said bank.

5. *RAISON D'ÊTRE* FOR CRITICIZING THE BAIL IN PROVISION

Undoubtedly, having one's hard-earned money being forcefully taken away by its – bona fide appointed - custodian is a scary thought for any person. In a literary context, this banking saga has all the ingredients of a full-fledged Shakespearean tragedy. Out of the three protagonists, the government and the corporate borrower are projecting their victimhood as a badge of honour, while the customer - the real victim- is projected as the unsung hero in spite of him being compelled to part with his hard-earned money.[6]

This section has serious ramifications on the dynamics shared between the customer and its bank. It turns a safekeeping or deposit into a 'mortgage-able' commodity in the hands of the financial institution. Further, putting away money in a bank for safe custody would be akin to buying shares of a company. While the government has nudged citizens towards joining the formal banking system through initiatives such as the Jan Dhan Yojana and drastic measures like demonetisation, forcefully injecting depositors' hard-earned money to cure a fragile banking system, prima facie, appears to be self-contradictory.

In an attempt to allay fears against the alleged misgivings about the aforementioned provision, the Ministry of Finance vide a Press Release

[6] Meera Nangia, *Banking on Legislation*, THE HINDU, http://www.thehindu.com/opinion/op-ed/banking-on-legislation/article20005363.ece (last visited June 13, 2018).

dated 7th December, 2017, sought to clarify the intention of introducing the bail-in clause. According to the Press Release:

> *The provisions contained in the FRDI Bill, as introduced in the Parliament, do not modify present protections to the depositors adversely at all. They provide rather additional protections to the depositors in a more transparent manner.*
>
> *The FRDI Bill is far more depositor friendly than many other jurisdictions, which provide for statutory bail-in, where the consent of creditors/depositors is not required for bail-in.*[7]

6. THE BAIL-IN PROVISION VIS-À-VIS THE EXISTING POSITION OF DEPOSITORS

In light of the aforementioned press release, it becomes imperative to understand the current position of depositors. Presently, the Deposit Insurance and Credit Guarantee Corporation (DICGC) provides an insurance cover of up to Rupees one lakh to protect depositors against cancellation of license or issuance of an order for winding up or declaration of insolvency. Further, this insurance cover is available only to commercial banks and eligible cooperative banks as defined under the Deposit Insurance and Credit Guarantee Corporation Act. It is pertinent to note that the DICGC does not insure deposits of governments, inter-bank deposits, and deposits of State Land Development Banks with state cooperative banks. Hence, it is quite evident that the DICGC fails to secure a large quantum of depositories. To eliminate this lacuna, the FRDI Bill proposes to replace the DICGC with the Financial Resolution and

[7] Ministry of Finance, *Provisions of the Financial Resolution and Deposit Insurance Bill, 2017 meant to protect interests of depositors*, PRESS INFO. BUREAU (Dec. 7, 2017).

Deposit Insurance Corporation ('the Corporation').

7. ARGUMENTS IN FAVOUR OF THE BAIL-IN PROVISION

As highlighted in the earlier paragraphs, the bail-in provision has been subjected to significant hostility from the general public, thus, it is essential to separate the facts from fiction. In the proposed mechanism, the Corporation will collect premium and fees from the insured service providers and covered service providers, respectively. The money collected shall be used to constitute a corporation insurance fund and a resolution fund which shall be used exclusively for its designated purpose. Unlike its predecessor, the proposed fund shall protect a plethora of financial firms, giving greater security to depositors' interests in case of a firm facing a financial clout. Further, in Section 55(2), it is explicitly provided that the bail-in provision shall be used only as a last resort. It stipulates that the tool of bail-in should be resorted to only after attempts of recovery has been made and had not been successful.

To provide greater consistency in the resolution making process, the resolution corporation is obliged to follow a prescribed hierarchy while distributing the assets of the insolvent institutions. It is important to note that uninsured depositors are placed at a higher pedestal than unsecured creditors. This order of distribution has been stipulated in Section 79 of the FRDI Bill.

Section 55 of the Bill also guarantees that the use of the bail-in clause does not deprive a depositor of a higher quantum of claim which he would have received had another resolution mechanism been adopted.

Thus, the aforementioned safeguarding provisions ensure that the bail-in clause is not exercised in a prejudiced manner.

Most importantly, before terming this as a draconian law, it should be noted that the law provides for an *ex-ante* consent for certain liabilities to be bailed in.[8] As mentioned in the Ministry of Finance Press Release, some of the most developed resolution regimes in the world have a much more stringent and mandatory regime in place. For instance, the EU Bank Recovery and Resolution Directive (BRRD) and Single Resolution Mechanism empower authorities to unilaterally impose a mandatory restructuring of shareholders' and creditors' claims.[9] This is not the case in the incumbent Bill.

To conclude our analysis, the introduction of the 'bail-in' provision is an attempt to prevent the aftermath of the 2007-08 like financial apocalypse in future. In the build-up to the crisis, several large financial institutions made numerous unprecedented and irresponsible decisions. When the crisis hit and the fear of bankruptcy loomed, the de facto risk takers were not penalised for their imprudent behaviour. Instead, governments resorted to recapitalisation of the affected banks by bailing them out using public funds. The concept of 'bail-in' seeks to break this cycle of moral hazard and distributional inequity associated with ad hoc government handouts.[10]

Pursuant to a detailed critique on the 'bail-in' clause, one can

[8] Sohini Sengupta, *Another Tool of Resolution*, THE HINDU, http://www.thehindu.com/opinion/op-ed/another-tool-of-resolution/article22086691.ece (last visited June 14, 2018).
[9] *Id.*
[10] *Id.*

safely conclude that the stigma surrounding it is unfounded. With only a select few countries inducting this provision in its resolution mechanisms, the literature available on it is largely academic. Indeed, the Government of India will be taking a bold step forward in its crusade for insolvency resolution.

8. NEED FOR CREATING THE FRDIC

While the bail-in clause has stolen all the limelight, the creation of the Financial Resolution and Deposit Insurance Corporation (FRDIC) is another significant milestone. The proposed institution endeavours to ensure stability and resilience in the financial system, protect the financial interests of depositories, and ensure responsible usage of public funds. It is expected that most of the regulated financial service providers are expected to fall within its purview, and hence its analysis is imperative.

A major drawback in the current insolvency mechanism is it functions on a reactive and not on a proactive basis. Further, due to the growing complexity of financial firms, it has become imperative for regulatory institutions to identify the early warnings of failure. To ensure that the financial ecosystem is braced for the impact of potential insolvency, the Corporation should assess the probability of failure of a financial organization timely. The FRDIC in tandem with the respective regulatory institution shall classify firms on the basis of a five-stage 'risk to viability' framework. When a firm reaches a 'critical risk to viability' threshold, the FRDIC would become its liquidator after making an application in this regard to the National Company Law Tribunal. By

appointing FRDIC as the liquidator, it can be ensured that the resolution and liquidation tools are utilised in an unbiased manner, thereby benefitting all stakeholders.

9. CONSTITUTION OF FRDIC

The proposed FRDIC will have representation from the Ministry of Finance, Reserve Bank of India, Securities and Exchange Board of India, Insurance and Regulatory Development Authority of India, and the Provident Fund Regulatory Development Authority. By securing representation from all the concerned regulatory institutions, one can feel assured that the Corporation will not operate arbitrarily.

The Committee set up to Draft the Bill deserves credit for taking into account the significance of cross-border bankruptcy resolution in today's globalized economy. Many financial firms operate on a global level. The lack of coordination between the domestic authorities and its foreign counterpart could make the resolution proceedings cumbersome and could potentially undermine the financial interests of its domestic customers. To prevent this communication vacuum, Chapter 16 of the Bill grants FRDIC the authority to enter into a cooperation agreement with its foreign counterparts. Needless to say, the aforementioned initiatives would play an integral role in securing financial stability and resilience in the economy.

10. SHORTCOMINGS IN THE EXISTING INSOLVENCY FRAMEWORK

In order to appreciate the potential benefits of this institution, it is

imperative to understand the shortcomings in the existing insolvency framework. Regulation of financial institutions has been plagued by saturation and lack of standardization. For instance, while the Banking Regulation Act, 1949 generally deals with banks, the State Bank of India and its subsidiaries are regulated by an additional legislation which is the State Bank of India Act, 1955. Further, the resolution mechanism for commercial banks is different from that of cooperative banks. In addition to this lacuna, regulatory institutions have often found themselves in a dichotomy of whether they must ensure a smooth and speedy resolution or delay the resolution proceedings in the hope of revival in fortunes. This lack of decisiveness has often caused significant damage to India's economic climate and has burnt a significant hole in the pockets of the public exchequer.

Another chronic problem that the Indian economy faces is the lack of competitive neutrality among financial institutions. While public sector financial firms are backed by an implicit or explicit financial guarantee from the government, there is no such financial backing available to private institutions. Further, the drafting committee in its report expressed its concern with regards to the rose tainted mirror through which public sector firms are viewed by the general public. The report remark that "[the] exemptions from the mainstream resolution systems, may be creating a perception of safety in the minds of the consumers, and an expectation that they will be insulated from the failure of such firms."[11]

Due to a lack of instruments available for insolvency resolution,

[11] DEPARTMENT OF ECON. AFFAIRS, MINISTRY OF FINANCE, REPORT OF COMMITTEE TO DRAFT CODE ON RESOLUTION OF FINANCIAL FIRMS 13-15 (Sep. 21, 2016).

institutional incapacity, and legislative lacunae to effect a smooth and timely resolution, there is an urgent need for a statute which serves as a parachute for a nose-diving financial institution. On a lighter note, it is quite ironical that a country which is promoting incubators at one end needs to start revamping its ventilators at the other end.

11. MISCELLANEOUS BENEFITS OF THE FRDI BILL

On the basis of the aforementioned analysis, it can be said that the FRDI Bill has tactfully resolved a large number of shortcomings in the incumbent resolution mechanism. Additionally, a few other benefits of the proposed legislation are listed below. Section 52 endeavours to complete the entire insolvency proceedings within an ambitious deadline of two years and the provisions of the Bill apply pari materia to all its participants. In this context, Schedule 2 of the Bill provides a comprehensive list of 'covered service providers' that will fall within the ambit of the proposed legislation.

In addition to the previously mentioned financial entities, Chapter 5 of the FRDI Bill extends its applicability to a very important set of financial institutions. Section 26 of the Bill provides that the provisions of the Bill shall apply pari materia to Systemically Important Financial Institutions (SIFI) as well. Section 25 of the Bill vests power with the Central Government to identify any financial service provider on the basis of its size, complexity, nature, volume of transactions, and interconnectedness with other financial service providers. Recognizing the theory of 'too big to fail', the bill grants the Corporation some additional

powers in respect of SIFIs when it comes to their resolution or bankruptcy. All such institutions are expected to provide the requisite information in such frequency and manner as may be prescribed by the FRDI Regulations.

By bringing such institutions within the ambit of the FRDI Bill, it ensures that legislation is watertight and covers all the necessary service providers. Further, through periodic reporting, the Resolution Corporation is ensuring that the financial health of an entity is constantly being tracked for any signs of leakage. Although this additional institution increases the fear of additional compliance burden, timely information sharing between the existing regulatory institutions and the FRDIC could significantly reduce the reporting that needs to be done by an organization.

12. FEEDBACK FROM THE RBI

In response to the proposed draft bill, regulatory institutions have also provided some constructive feedback which merits attention. The Reserve Bank of India (RBI) had remarked that the Resolution Corporation should add value to the financial sector by ensuring efficient resolution of the financial firms in the most cost-effective manner rather than acting as an additional watchdog. The RBI has also recommended that the Corporation should intervene only after an institution reaches 'critical risk to viability' stage. Any intervention from the Resolution Corporation prior to that will become an unnecessary burden for the financial firms and dilute the existing powers vested with the regulatory bodies.

13. FEEDBACK FROM THE IRDA

The Insurance Regulatory and Development Authority (IRDA) has also highlighted a significant void in the proposed legislation. The IRDA has suggested that in order to protect the interests of Indian consumers of foreign financial entities, the FRDIC in tandem with the regulator concerned must have the power to take control of its Indian operation if the ailing institution attains a "critical risk to viability" threshold. Such power to initiate action must exist, irrespective of a Memorandum of Understanding existing with the country of the troubled financial organisation, vis-à-vis, the IRDA has suggested that a suitable provision be incorporated for plugging the aforesaid loophole.

14. OPINION OF THE AUTHOR

In my opinion, the proposed legislation is an honourable attempt at providing a secure macroeconomic environment within which financial institutions could operate. Further, with the Indian economy being predicted to enjoy an exceptional growth trajectory, the likelihood of irresponsible and unwarranted lending increases significantly. The recent default by the Infrastructure Leasing and Financial Services and its group companies is a glaring instance of the non-performing assets mess extending beyond the banking space and affecting the aggregate financial services sector. Therefore, the author argues that the FRDI Bill is a *sine qua non* for securing the interests of all the stakeholders operating in a highly volatile financial environment.

15. CONCLUSION

To conclude, with the FRDI Bill being pitched on the plank of greater protection of financial interests, the Bill has a moral as well as legal responsibility to ensure that depository interests are placed at a pedestal higher than those of its monetary custodians. At an academic level, the proposed Bill does tick in the boxes while acknowledging the need to protect depository interests as well. While consistency, transparency, and accountability are the bed rock of a "high flying" business environment, a sound parachute will always be reassuring in case of turbulence. The FRDI Bill will serve as this parachute to India's economic growth story.

THE REGULATORY FRAMEWORK OF INTERNATIONAL FINANCIAL SERVICES CENTERS IN INDIA: AN ODE TO COMMERCIAL JOY

Akshay Douglas Gudinho[*]

ABSTRACT

The concept of International Financial Services Centres (IFSC) was introduced in India in 2007 by the High Power Expert Committee's report on making Mumbai an International Financial Centre (MIFC report).[1] Historically speaking, the MIFC report provides that London originated as the first IFSC augmented *inter alia* by the rapid growth in technology and the free flow of capital across borders; this ushered in the age of universal capital convertibility. Disrupted by the two World wars, New York rose to the pedestal as the dominant IFSC. The historical account in the MIFC report provides a market oriented explanation of an IFSC over IFSCs developing as strategic infrastructural projects that serve as investment hubs primarily for the derivative market of foreign securities.

The first legal enactment for IFSCs in India was announced in the 2016-17 budget speech where the Honourable Finance Minister, Mr. Arun

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[1] Ministry of Finance, Govt. of India, *The High Powered Expert Committee (HPEC) on Making Mumbai an International Financial Centre*, *available at* https://dea.gov.in/sites/default/files/mifcreport.pdf (last visited Sep. 20, 2018).

Jaitley, provided tax concessions to units operating in IFSCs.[2] The said concessions have been included in the Finance Act, 2018. IFSCs are initiatives to incentivize the exchange of foreign securities in India where the financial services sector accounts for 5% of the GDP.[3] Gujarat International Finance Tech (GIFT) in Gandhinagar, Gujarat holds the title of the first IFSC to be set up in India. Apart from tax incentives and regulatory exemptions, an IFSC can be best described as a commercial haven catering essentially to non-residents in commodities of foreign currencies.

It is thus an exemplification of Ease of Doing Business policy for those who intend to operate in the form of an IFSC. The paper shall be restricted to the regulatory framework and the benefits of setting up businesses in an IFSC. The paper shall not deal with the potential success or failure of the GIFT initiative.

1. DEFINING INTERNATIONAL FINANCIAL SERVICES CENTRES

The International Monetary Fund (IMF) summarizes the definition of an IFSC or an Offshore Financial Centre (OFC) as having a; (i) primary business orientation towards non-residents; (ii) favourable regulatory requirement; and (iii) low or zero taxation schemes.[4] Asserting the limitations embedded in the aforementioned definition, the IMF has

[2] Ministry of Finance, Govt. of India, *Budget 2016-17, Speech of Arun Jaitley, Minister of Finance*, India Budget 41, *available at* https://www.indiabudget.gov.in/ub2016-17/bs/bs.pdf (last visited June 10, 2018).

[3] *Genesis, about GIFT*, GUJARAT INT'L FINANCE TECH-CITY, http://www.giftgujarat.in/genesis (last visited June 14, 2018).

[4] Ahmed Zorome (IMF Working Paper), *Concept of Offshore Financial Centers: In Search of an Operational Definition*, 4 (2007).

proposed a macro economical definition: "An OFC is a country or jurisdiction that provides financial service to non-residents on a scale that is incommensurate with the size and the financing of its domestic economy."[5]

This proposed definition provides for the OFC status of a country as a ratio of the net exports of financial services to the Gross Domestic Product of the country. As majority of the IFSCs do not provide balance of payments statistics, the IMF has proposed a proxy indicator based on the stock options: "OFCs are characterized by a proportionally high level of portfolio investment assets because they are home (legal domicile) to a large number of primarily custodian entities, which hold and manage securities on behalf of clients residing outside the OFC."[6]

In case of IFSCs in India, the Special Economic Zone Act, 2005, does not provide a comprehensive definition. It merely holds that an IFSC is one that has been approved by the Central Government.[7] Nevertheless, the Securities and Exchange Board of India (SEBI), the Reserve Bank of India (RBI) and the Insurance Regulatory and Development Authority of India (IRDA) have provided regulations, circulars and notifications which more or less encapsulate the features of an IFSC.

2. THE FRAMEWORK OF INTERNATIONAL FINANCIAL SERVICES CENTRES IN INDIA

[5] Special Economic Zone Act, 2005, 31 Gazette of India, § 2(q) & § 18(1).
[6] Dipesh Shah, *How can India become a Global Financial Centre?*, https://www.weforum.org/agenda/2016/02/how-can-india-become-a-global-financial-centre/ (last visited July 24, 2018).
[7] Special Economic Zone Act, 2005, § 2(q) & § 18(1).

The regulatory framework for IFSCs in India is designed: (i) to capture the capital from foreign securities market in the country itself; and (ii) to incentivize companies to set up operations within an IFSC. With regards to the first point, due to Indian investment in foreign IFSCs and an absence of an IFSC in India, India stands to lose $50 billion annually which will grow to $120 billion in 2025.[8] With regards to the latter one, companies set up in IFSCs do project a higher growth rate of capital as compared to those which function outside. For example, the first two IBU's set up in GIFT, reported transaction of more than $100 million within a span of 50 days.[9]

There are primarily five regulatory guidelines governing the framework of an IFSC in India. They are:

I. The SEBI (International Financial Services Centres) Guidelines, 2015, (2015 Guidelines);
II. The Ministry of Corporate Affairs notification providing exemptions to Specified Public Companies operating within an IFSC;
III. The RBI notification on International Banking Units (IBUs) operating in an IFSC;
IV. The Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017 (FEMA 20); and
V. The Insurance Regulatory and Development Authority of India {Registration and Operations of (International Financial Services

[8] Dipesh Shah, *International Financial Services Centre: Here's why late-starter India must make it a success*, FINANCIAL EXPRESS, https://www.financialexpress.com/opinion/international-financial-services-centre-heres-why-late-starter-india-must-make-it-a-success/365884/ (last visited July. 24, 2018).
[9] *supra* note 6.

Centres) Insurance Offices (IIO)} Guidelines, 2017 (2017 Guidelines).

2.1. SEBI (INTERNATIONAL FINANCIAL SERVICES CENTERS) GUIDELINES, 2015

The 2015 guidelines[10] apply to financial institutions[11] desirous of organizing a stock exchange, a clearing corporation or a depository.[12]

However, a stock exchange, clearing corporation or depository operating in an IFSC must function through a subsidiary of a stock exchange, clearing corporation or depository, in India or foreign jurisdiction, where at least 51% of the paid up share capital is held by the parent stock exchange, clearing corporation or depository subject to the minimum net worth requirement.[13]

2.1.1. Exemptions in case of Stock Exchanges and Clearing Corporations

Unlike other stock exchanges, every recognized stock exchange operating in an IFSC is not required to credit 25% of its profits every year to the fund of the recognized clearing corporation which clears and settles trades executed on that stock exchange. Similarly, every depository operating in an IFSC is not required to credit 25% of profits every year to

[10] S.E.B.I. (International Financial Services Centers) Guidelines, 2015, *available at* https://www.sebi.gov.in/legal/guidelines/mar-2015/sebi-international-financial-services-centres-guidelines-2015_29457.html.
[11] *Id.*, ¶ 2(d).
[12] *Id.*, ¶ 3(1).
[13] *Id.*, ¶ 4 (1) (2) & (3); ¶ 5 (1) (2) & (3).

the investor protection fund.[14] This proves cheaper for an investor as the fees aligned to trading (like transaction fees, listing Fess, registration fees, etc.) on a stock exchange operating in an IFSC are likely to reduce in comparison to stock exchanges outside India.

Previously, the clearing corporations were permitted to invest their own funds as well as funds in the Core Settlement Guarantee Fund only in fixed deposits or central government securities and liquid schemes of debt mutual funds. Such funding has been extended to triple-A rated Foreign Sovereign Securities. This provides a wider range of securities for investors to invest in. This however cannot exceed 10% of the total investible resources, excluding funds lying in the Core Settlement Guarantee Fund.[15]

2.1.2. Issue of Capital

Companies, domestic or of foreign jurisdiction, can list and trade their securities in a Stock exchange of an IFSC.[16] All categories of exchange-traded products identified in the stock exchanges of Financial Action Task Force (FATF)/International Organization of Securities Commissions (IOSCO) compliant jurisdictions are eligible for trading in a Stock exchange of an IFSC. This includes Masala bonds provided that they are listed in a stock exchange of a FATF/IOSCO compliant

[14] *Id.*, ¶ 6 (1) & (2).
[15] S.E.B.I. Circular No. SEBI/HO/MRD/DRMNP/CIR/P/2018/82 (May 21, 2018), *available at* https://www.sebi.gov.in/legal/circulars/may-2018/investment-of-own-funds-excluding-funds-lying-in-core-settlement-guarantee-fund-by-clearing-corporations-in-international-financial-services-centre-ifsc-_39009.html.
[16] S.E.B.I. (International Financial Services Centers) Guidelines, 2015, ¶ 11.

jurisdiction. However, a person resident in India is not permitted to invest in rupee denominated bonds except to the extent permitted by the RBI.[17]

SEBI may even provide certain relaxations with listing agreement obligations where the issuer is already in compliance with the listing agreement for securities apart from debt securities listed on the Stock exchange in an IFSC.[18] Thus, an investor in a stock exchange operating in an IFSC need not undergo the arduous task of ensuring listing agreement compliances. However, guidelines or clarifications with regards to relaxations with listing agreement obligations need to be provided by the Government.

2.1.3. Exemptions to the Formation of Companies

According to the 2015 guidelines, an intermediary had to form a company to provide financial services relating to the securities market in an IFSC. However, the formation of a company for an intermediary and its international associates trading in an IFSC is no longer required.[19] Similarly, an IFSC Banking Unit set up in an IFSC is permitted to act as a trading member of an exchange or a professional clearing member of a clearing corporation in an IFSC without forming a separate company.[20]

[17] S.E.B.I. Circular No. IMD/HO/FPIC/CIR/P/2017/003 (Aug. 31, 2017), *available at* https://www.sebi.gov.in/legal/circulars/aug-2017/securities-and-exchange-board-of-india-international-financial-services-centres-guidelines-2015-amendments_35776.html.
[18] S.E.B.I. (International Financial Services Centers) Guidelines, 2015, ¶ 20.
[19] SEBI Circular No. SEBI/HO/CIR/P/2017/85 (July 27, 2017), *available at* https://www.sebi.gov.in/legal/circulars/jul-2017/securities-and-exchange-board-of-india-international-financial-services-centres-guidelines-2015-amendments_35452.html.
[20] SEBI Circular No. SEBI/HO/MRD/DSA/CIR/P/2017/34 (Apr. 27, 2017), *available at*

This proves feasible for intermediaries providing financial services within an IFSC as they no longer need to bear the additional cost of forming a company only to operate in an IFSC. However, an entity of Indian or foreign jurisdiction in order to act as a trading member of a stock exchange or a clearing member of clearing corporations in an IFSC, has to form a separate company in an IFSC.[21]

2.2. RELAXATIONS FOR PUBLIC COMPANIES OPERATING IN IFSCS

The Ministry of Corporate Affairs has provided for certain exceptions, modifications and adaptations for Specified Public Companies (SPCs) operating within an IFSC.[22] The SPCs are provided with extensions for regulatory compliances, exemptions in issuing securities and are not needed to fulfil mandatory norms which apply to non-SPCs.

2.2.1. Relaxation in Capital Instruments

The issuance of capital instruments by an SPC and voting rights accruing therefrom are not subject to the Companies Act, 2013 (2013 Act) unless the Articles of the Company provide for the same.[23] This permits SPCs managing capital instruments to function to an extent far beyond the compliance norms maintained under the 2013 Act. To illustrate, even if a

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https://www.sebi.gov.in/legal/circulars/apr-2017/securities-and-exchange-board-of-india-international-financial-services-centres-guidelines-2015-ifsc-banking-units-ibus-acting-as-trading-member-or-professional-clearing-member-on-stock-exchang-_34767.html.

[21] SEBI Circular No. SEBI/HO/MRD/DSA/CIR/P/2017/117 (Oct. 17, 2017), *available at* https://www.sebi.gov.in/legal/circulars/oct-2017/securities-and-exchange-board-of-india-international-financial-services-centres-guidelines-2015-amendments_36289.html.

[22] Ministry of Corporate Affairs Notification No. F. No. 3/1/2015-CL.I (Jan. 4 2017), *available at* http://www.mca.gov.in/Ministry/pdf/IFSC_Public_04012017.pdf.

[23] *Id.*, ¶ 13 & 14; Companies Act, 2013, § 43 & § 47.

company consists of more than 1000 security holders, it does not need to set up a Stake Holders Relationship Committee.[24]

Private Placement

Section 23 of the 2013 Act[25] maintains private placements as a means for private and public companies to issue their securities. The 2013 Act provides that private placement is an issuance of securities to a number of persons that cannot exceed fifty at a time.[26] Further, the 2013 Act prohibits fresh offers to subscription to securities by private placement even if allotments to previous offers have not been completed, withdrawn or abandoned.[27] However, SPCs can make fresh offers for subscription to securities by private placement even if allotments to previous offers have not been completed, withdrawn or abandoned.[28]

This proves beneficial to SPCs as they can offer their securities to a wider number of persons than the mandate of fifty persons. By implication, a private placement for SPCs has a similar end that a public offer through prospectus seeks to achieve. Given that SPCs are public companies, they can avoid the issue of a prospectus to make a public offer and can make multiple fresh offers for subscription to their securities by private placement itself. SPCs do not face liability in this regard as they are not required to maintain a record of the names of the persons who they

[24] *Id.*, ¶ 49; Companies Act, 2013, § 178.
[25] Companies Act, 2013.
[26] *Id.*, § 42 (2).
[27] *Id.*, § 42 (3).
[28] *supra* note 22, ¶ 11; Companies Act, 2013, § 42 (3).

invite to subscribe to their securities.[29] However, the SPCs will have to allot the securities within sixty days of each fresh offer to subscribe to securities by private placement.[30]

Loan, Guarantee or Security

The 2013 Act mandates that a company cannot give a loan, guarantee or security with a loan, and acquire by way of subscription, purchase or otherwise, to an extent exceeding 60% of its paid-up share capital, free reserves and securities premium account, or 100% of its free reserves and securities premium account, whichever is more. An SPC however by an ordinary resolution can even give a loan, guarantee or security in connection with a loan, and acquire by way of subscription, purchase or otherwise, exceeding the aforementioned limits.[31] However, this is subject to the following conditions: (i) no body corporate has invested money in the share capital of the SPC; (ii) its borrowing are less than twice of its paid up share capital or 50 crores, whichever is lesser; and (iii) there is no default in repayment on such borrowing.[32]

This provides an alternative to SPCs which are in debt to approach other SPCs for loans instead of banking units that operate within an IFSC. This can prove fruitful as IFSC banking units are not eligible for RBI bail outs as the lender of the last resort.

[29] *supra* note 22, ¶ 11; Companies Act, 2013, § 42 (7).
[30] Companies Act, 2013, § 42 (6).
[31] *supra* note 22, ¶ 55; Companies Act, § 186 (2) & § 186 (3).
[32] *supra* note 22, ¶ 19; Companies Act, § 67.

Furthermore, the 2013 Act mandates that a company cannot invest through more than two layers of investment except in the two following cases: (i) a company acquiring any other company incorporated outside India if the latter company has investment subsidiaries beyond two layers as per the laws of the foreign country; (ii) a subsidiary company has any investment subsidiary for the purposes of complying with any law, rule, or regulation.[33] However, an SPC is even permitted to make an investment with more than two layers of investment.[34] Thus, SPCs are not prohibited from enhancing their commercial footprint to more than two layers of investment through a number of subsidiaries or subsidiaries of subsidiaries.

Equity Options

Sweat equity are equity shares issued by a company to its directors or employees at a discount for their technical know-how or any other kind of value additions to the company. The 2013 Act mandates that at least one year has to pass since the company has commenced business in case it intends to issue sweat equity shares.[35] However, to issue sweat equity options to its directors and employees, SPCs are not required to complete one year from the date of commencement of business before issuing the same.[36] Thus, even start-ups that have gone public and operate in an IFSC are eligible to issue sweat equity options.

[33] Companies Act, § 186 (1).
[34] *Id.*; *supra* note 22, ¶ 54.
[35] Companies Act, § 2(88).
[36] *Id.* § 54(1)(c); *supra* note 22, ¶ 15.

Further, SPCs can issue further capital to its equity shareholders (rights shares) and provide a time period lesser than the 15-30 day period after which the offer is deemed to be rejected subject to a special resolution.[37]

An Employee Stock Option (ESOPs) is an option given to directors, officers and employees of a company to purchase shares of the company at future date at a pre-determined price.[38] The 2013 Act mandates that a special resolution needs to be passed in case a company wants to provide ESOPs.[39] However, in case of SPCs providing ESOPs, only an ordinary resolution is required.[40] This enables an SPC to retain its directors, officers or employees of key importance with greater ease as compared to non-SPCs which must pass a special resolution to provide such a stock option.

Public Deposits

The only conditions imposed on SPCs for accepting public deposits is that it should not exceed 100% of its aggregate paid-up shared capital and free reserves, and the details of such monies are submitted to the Registrar.[41] This provides SPCs, in comparison to non-SPCS, with a procedurally easier mechanism to ensure a larger capital reserve to meet fund requirements.

[37] *supra* note 22, ¶ 17; Companies Act, § 62 (1) (a).
[38] Companies Act, § 2 (37).
[39] *Id.* § 62 (1) (b).
[40] *supra* note 22, ¶ 18; *Id.* § 62 (1) (b).
[41] ¶ 20; § 73 (2) (a) to (e).

2.2.2. Relaxations Provided to Auditors

Notice for appointment of an auditor of an SPC can be sent to the Registrar within 30 days unlike within 15 days for non-SPCs.[42] Unlike non-SPCs, an individual auditor who has completed one term of five consecutive years and an audit firm which completed two terms of five consecutive years can be re-appointed as auditors without a gap of five years from the completion of the tenure. Further, even if the audit firm whose tenure has expired has common partners in another audit firm, the latter audit firm can be appointed without a gap of 5 years from the completion of the former audit firm's tenure.[43]

In case of removal of an auditor of an SPC or a non-SPC, prior Central Government approval is required. However, in case of SPCs, if the Central Government fails to reply within 60 days of the submission of the application for removal, the approval is deemed to have been given and the SPC can appoint a new auditor in a general meeting.[44] In case of non-SPCs, there is no period prescribed for the Central Government to provide its reply on the said application. Furthermore, an SPC does not need to form an Audit Committee.[45] Also, an SPC is at liberty of conducting an internal audit. In the absence of a mention in the Articles, the internal audit is not mandatory for it.[46]

2.2.3. Relaxations Provided to Directors

[42] ¶ 33; § 139 (1).
[43] ¶ 34; § 139 (2).
[44] ¶ 35; § 140 (1).
[45] ¶ 48; § 177.
[46] ¶ 32; § 138.

The SPCs are required to hold the first Board of Directors (BOD) meeting within 60 days from the date of incorporation and the meetings are to be held at least once on a half yearly basis. Whereas, non-SPCs have to hold first BOD meeting within 30 days and they have to hold four meetings in a year without a gap of more than 120 days.[47]

There are no restrictions on the numbers of directors that can be appointed in the BOD of an SPC.[48] The only condition is that there must be one director who has stayed in India for a period of not less than 182 days in the previous calendar year. However, this is applicable to the financial years succeeding the financial year in which the SPC is incorporated.[49] Furthermore, an SPC need not appoint an independent director on its BOD.[50] A director of an SPC is not mandated to retire by rotation at the general meeting.[51]

2.2.4. Extended Powers of the Board of Directors

Resolutions passed by BOD in exercise of its powers are not needed to be submitted to the Registrar.[52] In case of resignation of a director, the BODs have the option of not intimating the Registrar and of not including a mention of such resignation in the report of directors laid

[47] ¶ 46; § 173 (1).
[48] ¶ 36; § 149 (1).
[49] ¶ 37; § 149 (3).
[50] ¶ 38; § 149 (4) to § 149 (11), § 149 (12) (i) & 149 (13).
[51] ¶ 40; § 152 (6) & (7).
[52] ¶ 27; § 117 (3) (g) & §179 (3).

in the general meeting of the company.[53] Further, The BOD of an SPC can convene an extra-ordinary general meeting within or outside India.[54]

2.2.5. Remuneration to the Managing Directors

Restrictions imposed on remuneration payable to the managing director are not applicable to the managing director of an SPC. For example, the 2013 Act maintains that a managing director shall not be paid remuneration in case of absence or inadequacy of profits. However, whether or not a resolution has been passed to the contrary effect, the managing director can be paid remuneration even in time of losses. However, the BODs do retain the power to restrict such payment if a resolution is passed to that effect.[55]

2.2.6. Liberty of the Articles of Association

The Articles of an SPC have wide powers of exemption as certain provisions of the 2013 Act apply unless the Articles mention otherwise.

a) Conducting meetings

In providing notice for a general meeting, the company is mandated to give at least a 21 days' notice, and any notice prescribing less than 21 days' notice would require the 95% of the vote of the members entitled to vote at the meeting. In case of SPCs, the Articles can provide that no consent from the members entitled to vote is necessary. Similarly, the quorum, chairman, and proxies can also be altered by the Articles from

[53] ¶ 44; § 168 (1).
[54] ¶ 24; § 100 (1).
[55] ¶ 59; § 197.

what is required by the 2013 Act. The restrictions on the voting rights and the extent of such restriction can also be altered by the Articles beyond what is prescribed in the 2013 Act.[56]

b) Exempting special resolutions

The BOD need not get the consent of the company by a special resolution to sell, lease, or dispose of an undertaking of the company's undertakings; to invest in trust securities; to borrow money in excess of its aggregate paid-up share capital and free reserves; and to remit or give time for repayment of debt due from a director.[57]

2.2.7. Other Relaxations

Corporate Exemptions

An SPC does not need to follow secretarial standards specified by the Indian Institute of Company Secretaries in India.[58] An SPC does not need to undertake Corporate Social Responsibility activities for a period of five years from the commencement of its business.[59]

Permissible Extent of Transactions

The extent of transactions a subsidiary or an associate company of an SPC in an IFSC is wider as compared to that of non-SPCs as no Board Resolution is required for such companies to enter into related party

[56] ¶ 25; § 101 to §107 & §109.
[57] ¶ 51; § 180.
[58] ¶ 29; § 118 (10).
[59] ¶ 31; § 135.

transactions.[60] Members can even vote by a special resolution to give effect to a contract or arrangement entered by the company with such a subsidiary or associate company in an IFSC.[61]

2.3. RBI NOTIFICATION ON INTERNATIONAL BANKING UNITS

RBI has issued regulations for International Banking Units ("IBUs") in an IFSC.[62] The regulations are divided into two parts: (i) setting up of IFSC IBUs by Indian Banks; and, (ii) setting up of IFSC IBUs by foreign banks. The notification applies to public and private sector banks eligible to deal in foreign exchange which intend to form an IBU in an IFSC, and foreign banks which already have a presence in India.[63]

The Regulations mandate that the parent bank must have a minimum capital of 20 million USD whether it is an Indian or foreign bank.[64] In case of a parent Indian bank, the branch it sets up in an IFSC is treated as a foreign branch of that bank.[65] The IFSC IBUs are not permitted to deal in domestic payment systems and onshore markets.[66]

The incentive in setting up an IBU in an IFSC is that it is not bound by the Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio

[60] ¶ 2; § 2 (76) (8).
[61] ¶ 57; § 188 (1) Second Proviso.
[62] R.B.I. Notification No. RBI/2014-15/533DBR.IBD.BC.14570/23.13.004/2014-15 (May 17, 2018) *available at* https://rbidocs.rbi.org.in/rdocs/notification/PDFs/FNIBU010415CIRN.PDF.
[63] *Id.* annex I, 2.1 & annex II, 2.1.
[64] *Id.* annex I, 2.3 & annex II, 2.3.
[65] *Id.* annex I, 2.2.
[66] *Id.*

(SLR) requirements issued by the RBI.[67] Further, priority sector lending obligations on the parent company of Indian or foreign jurisdiction are not applicable to an IFSC IBU as the loans and advances of an IBU are not considered as the net bank credit of the parent company.[68]

However, there are certain restrictions placed on IFSC IBUs which do not apply to other banks. Firstly, IFSC IBUs are not eligible for deposit insurance[69] and liquidity support is not available to IFSC IBUs from the RBI.[70] Secondly, IFSC IBUs are not permitted to open current or savings account except foreign currency current accounts of units operating in IFSCs and of non-resident institutional investors.[71] Such account holders are not provided a cheque facility so all transactions in the said accounts have to be done by bank transfers.[72] This could prove cumbersome for the retail banking sectors of banks that open branches in an IFSC. It may not prove feasible for a customer as banks operating outside IFSCs do offer retail services that are not as restrictive as that mandated for IFSC IBUs. Lastly, IFSC IBUs are not permitted to raise any liabilities from retail customers including High Net Worth Individuals.[73]

[67] *Id.* annex I, 2.4 & annex II, 2.4.
[68] *Id.* annex I, 2.12 & annex II, 2.12.
[69] *Id.* annex I, 2.13 & annex II, 2.13.
[70] *Id.* annex I, 2.14 & annex II, 2.14.
[71] *Id.* annex I, 2.6 (v) & annex II, 2.6 (v).
[72] *Id.*
[73] *Id.*

2.4. THE FOREIGN EXCHANGE MANAGEMENT (TRANSFER OR ISSUE OF SECURITY BY A PERSON RESIDENT OUTSIDE INDIA) REGULATIONS, 2017 (FEMA 20).

FEMA 20,[74] consolidates the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 and Foreign Exchange Management (Investments in Firms or Proprietary Concern in India) Regulations, 2000. It regulates the entry routes (automatic or Government), the sectorial caps, and the conditions governing transactions between Foreign Portfolio Investors (FPIs), Non-Resident Indians (NRIs), Overseas Citizens of India (OCIs), Persons Resident Outside India (PROI), and venture capitalists. RBI has deemed a financial institution or a branch of a financial institution operating in an IFSC as a PRIO.[75]

The benefits of extending FEMA to IFSCs are fivefold. Firstly, a FPI is no longer an intermediary under the 2017 guidelines. This means that FPI's are not required to attain further approval for trading in an IFSC provided that they already have been registered by SEBI.[76] Secondly, SEBI has permitted Segregated Nominee Account Structures (SNAS) for foreign investors investing in IFSCs where their investments shall be

[74] Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2017, Notification No. FEMA 20(R)/ 2017-RB (Nov. 7, 2017), *available at* https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11161&Mode=0.

[75] R.B.I. Notification No. FEMA. 339/2015-RB (Mar. 2, 2015), *available at* https://rbi.org.in/scripts/FS_Notification.aspx?Id=9636&fn=2&Mode=0.

[76] S.E.B.I. Circular No. IMD/HO/FPIC/CIR/P/2017/003 (Jan. 4, 2017), *available at* https://www.sebi.gov.in/legal/circulars/jan-2017/guidelines-for-participation-functioning-of-eligible-foreign-investors-efis-and-fpis-in-international-financial-services-centre-ifsc-_33955.html.

routed through Segregated Nominee Account Providers (providers).[77] The Providers are required to be registered in a stock exchange or a clearing corporation for providing SNAS services. The Providers are required to conduct due diligence of their end users as well as KYC (Know Your Customer) compliance. This ensures a vetting system for FPIs investing in a stock exchange of an IFSC.

Thirdly, the onus of ensuring regulatory reporting compliances no longer falls on the resident. FEMA 20 maintains that reporting compliances falls on the PROI.[78] However, this does not prove cumbersome as the RBI has subsumed eight of the reporting requirements in one single master form to be filled online with effect from August 1, 2018.[79] RBI has even permitted late reporting compliance subject to a late payment fee.[80]

Fourthly, FEMA 20 necessitates an expedited process for the issuance of shares of an Indian company upon purchase. In case of a branch of a financial institution operating in an IFSC purchasing shares of an Indian company, the said shares need to be issued within 60 days instead of 180 days from the date of receipt of payment or is refunded within 15 days from the same date in case of failure of issuance.[81] Lastly, FEMA 20 has also permitted transfers from PROI to another PROI even in

[77] S.E.B.I. Circular No. SEBI/HO/MRD/DRMNP/CIR/P/2018/83 (May 24, 2018), *available at* https://www.sebi.gov.in/legal/circulars/may-2018/segregated-nominee-account-structure-in-international-financial-service-centre-ifsc-_39042.html.
[78] Regulation 13 (4) (a) 2, n. 65.
[79] R.B.I. Notification No. RBI/2017-18/194A.P (DIR Series) Circular No.30 (June 7, 2018), *available at* https://rbi.org.in/Scripts/NotificationUser.aspx?Id=11297&Mode=0.
[80] Regulation 13.2., n. 65.
[81] *Id.* sch. I, 2. (2).

cases of liquidation, merger, demerger, and liquidation of foreign companies which was not permitted in the 2000 Regulations.[82]

2.5. THE INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY OF INDIA (REGISTRATION AND OPERATIONS OF INTERNATIONAL FINANCIAL SERVICES CENTERS INSURANCE OFFICES (IIO)) GUIDELINES, 2017

The 2017 Guidelines[83] permit foreign and Indian insurance offices to conduct their business within an IFSC. The said guidelines apply to the branch office of an Indian or foreign insurer or reinsurer transacting in direct insurance and reinsurance business operating in an IFSC known as International Financial Services Centre Insurance Office (IIO).[84] The IIOs are not permitted to carry on other business apart from insurance and reinsurance.[85] The IIOs, Indian or foreign, conducting insurance and reinsurance businesses can transact within the IFSC, from others SEZs and outside India.[86] The IIOs can also conduct insurance business in the Domestic Tariff Area of the SEZ.[87]

[82] *Id.* regulation 10 (1) Explanation.
[83] Insurance Regulatory and Development Authority of India {Registration and Operations of International Financial Services Centers Insurance Offices (IIO)} Guidelines, 2017, *available at* http://www.dhc.co.in/uploadedfile/1/2/-1/IRDAI%20-%20Registration%20and%20Operations%20of%20International%20Financial%20Service%20Centre%20Insurance%20Offices%20%20IIO%20Guidelines,%202017.pdf.
[84] *Id.* Guideline 4 (b) r/w 5(b) & (c).
[85] *Id.* Guideline 6 (b).
[86] *Id.* Guidelines 6 (c) & 6 (e) (i).
[87] *Id.* Guideline 4 (e).

The Indian IIOs in comparison to the foreign IIOs are benefitted from setting up branches in an IFSC as the minimum capital requirement is INR. 10 crores.[88] However, for foreign IIOs, the minimum capital requirement is INR. 100 crores in case of life or general insurance business, and INR. 200 crores in case of reinsurance business.[89]

3. TAX BENEFITS IN INTERNATIONAL FINANCIAL SERVICE CENTRES

Apart from regulatory relaxations, the cost of investment in an IFSC is relatively cheaper as tax exemptions are galore, thus incentivizing commerce in an IFSC. The Income Tax Act, 1961, maintains that a unit[90] located in an IFSC which derives its income solely in convertible foreign exchange is chargeable at 9% of Minimum Alternate Tax instead of 18.5% chargeable otherwise.[91]

A transaction in a stock exchange in an IFSC where the consideration is in foreign currency is subject to Short Term Capital Gains Tax but is not subject to Securities Transaction Tax (STT).[92] Similarly, Long Term Capital Gains Tax is applicable to IFSCs but STT is exempt.[93] However, Global Depositories, rupee denominated bond of an India company, or a derivative made by a non-resident in a stock exchange of an IFSC has now

[88] *Id.*. Guideline 8 (a) (i).
[89] *Id.* Guideline 8(a) (i) First proviso r/w Insurance Act, 1938, 4 The Gazette of India, § 6(1).
[90] *See* §2 (zc), n. 6.
[91] Income Tax Act, 43 The Gazette of India, § 115 JC (4), (1961). Inserted by the Finance Act, 13The Gazette of India, §38, (2018).
[92] *Id.* § 111-A
[93] *Id.* § 112-A (3).

been exempted from capital gains tax itself.[94] Further, no tax is chargeable on distributed profits on the total income of a company which is a unit of an IFSC.[95]

The gross total income accruing from a unit in an IFSC or an IBU in an IFSC is deductible up to 100% for five consecutive years beginning with the assessment year relevant to the previous year the banking company intending to operate in an IFSC attains the prior approval of the RBI and 50% for five consecutive years thereafter.[96] Thus, units set up in IFSCs offer tax deductions for up to ten years.

Lastly, NRIs now possess a tax benefit in having deposits in an IFSC IBU as no Tax Deductible at Source (TDS) needs to be deducted by an IFSC IBU for interest paid on deposit made by and borrowing from an NRI.[97]

4. CONCLUDING REMARKS

Regulatory compliances are going to be simplified even further for units operating in an IFSC. The 2018-19 budget speech suggests the need for a unified regulator to make IFSCs in India more

[94] *Id.* § 115-JC (4).
[95] *Id.* § 115-O (8).
[96] Income Tax Act, 43 The Gazette of India, § 80-LA (a) & (b), (1961). Inserted by the Finance Act, 28The Gazette of India, (2016) r/w Banking Regulation Act, 10 The Gazette of India, § 23 (1), (1949).
[97] Income Tax Act, 43 The Gazette of India, § 197-A (1D) (a) & (b), (1961).

competitive with offshore IFSCs.[98] To summarize, units in an IFSC are to benefit *inter alia* on primarily 4 commercial points:

4.1. COST CUTTING

Following exemptions and deduction reduces the cost of investment in an IFSC in comparison to units operating outside an IFSC: reduced fees for trading on a stock Exchange in an IFSC; exemptions to intermediaries to form companies within an IFSC; exemptions from corporate social responsibilities; and lowered tax rates.

4.2. CAPITAL AVAILABILITY

The wider range of securities offered to an investor investing in an IFSC stock exchange; offering fresh subscription to securities through private placement even though allotments to previous offers have not been completed, withdrawn or abandoned; procedural relaxations in terms of providing inter-corporate loans; regulatory relaxations in accepting public deposits; exemptions to IFSC IBUs from CRR, SLR requirements, and priority sector lending obligations; and a lower minimum capital requirements for India IIOs as compared to foreign IIOs, provides for a larger corpus of capital for investors, SPCs, IFSC IBUs, and Indian IIOs to utilize for funding and investment requirements.

4.3. RETAINING KEY PERSONNEL

[98] Arun Jaitely, Budget 2018-19, Speech of Arun Jaitley, Minister of Finance, India Budget 20 (July 2, 2018), https://www.indiabudget.gov.in/ub2018-19/bs/bs.pdf.

Relaxations in providing sweat equity options and ESOPs, retaining auditors or an audit firm even after the completion of the term, and payment of remuneration to managerial directors even in case of inadequacy or absence of profit; and the fact that directors need not retire by rotation at the general meeting or independent directors need not be appointed enables SPCs to retain key personnel in the company.

4.4. REGULATORY RELAXATIONS

Regulatory relaxations expedite execution of transactions, reduce compliance obligations and increase the powers of the SPCs and their directors. In case of IFSCs, these relaxations *inter alia* extend to listing agreements; internal audits; compliances with respect to the Registrar; compliances with respect to FEMA; company meetings; powers of the BODs to sell, lease, or dispose of the undertakings of the company; and powers of SPCs to enter into related party transactions.

5. CRITICISMS

There are certain points of contention that still need to be addressed in light of the exemptions provided to units operating in an IFSC. Firstly, exemptions provided to auditors operating in an IFSC vitiate the guidelines enumerated in the Corporate Governance Voluntary Guidelines, 2009, which calls for rotation of auditors to maintain independency from the firm. Secondly, exemption of a special resolution required for the BOD to sell, lease, or dispose of an SPC undertaking can lead to collusion in pursuance of private gain. This is especially in light of

the exemption of a Board resolution provided to a subsidiary or an associate company of an SPC in an IFSC to enter into related party transactions. Lastly, exempting IFSC IBUs from SLR and CRR requirements may be risky to individuals having deposits in IFSC IBUs in case of unforeseen circumstances. If the reserves of an IFSC IBU fall, the same cannot be replenished by the RBI as a lender of the last resort.