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EASE OF DOING BUSINESS

<u>**Guest Articles**</u>

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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.

TABLE OF CONTENTS

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RESOLVING COMMERCIAL DISPUTES IN INDIA: FOCUS ON 'MEDIATION' AS AN EFFECTIVE ALTERNATIVE 'TOWARDS EASE OF DOING BUSINESS'

*Dr. Vijay Kumar Singh**

ABSTRACT

Disputes are inevitable in commercial transactions and this gets further complicated when it comes to cross-boundary commercial transactions. It has frequently been experienced that the parties to a commercial dispute, including international commercial transaction disputes, take a recourse to arbitration. Institutions like I.C.C., L.C.I.A. and I.C.S.I.D. have evolved and are handling the matters relating to international commercial disputes. While one may say that, the international dispute settlement mechanism in commercial matters is invariably 'arbitration', as parties do not prefer to choose litigation due to its inherent lacunae of delay and costs, the new methods or alternate methods of dispute settlement are still evolving. Mediation is one such method and has proven itself to be unique and quite successful settlement process when conducted by a skilled mediator. As regards its utility, mediation is more useful as compared to arbitration because of its principle of parties themselves coming to a settlement and 'without prejudice' process. However, the parties to a commercial dispute or an international commercial transaction dispute have not accepted mediation that readily. This paper explores the reasons behind that by examining the

existing literature and the efforts put in by the countries in promoting mediation as a method of settlement of commercial disputes. It explores if 'mediation' can emerge as an important alternative to the dispute settlement mechanism for settling commercial disputes.

1. INTRODUCTION

Contracts govern the commercial relationships and an efficient enforcement of contract is essential to economic development and sustained growth. This is especially applicable to international commerce and business transactions. Advancements in technology, transportation, and communication have made international business the "most significant, ever-growing, and predominate aspect of the modern world".[1] India is not untouched by these developments and accordingly is concerned about various indices including the one on 'Ease of Doing Business'. Selection of a proper dispute resolution clause in commercial arrangements is an important risk management strategy. Though there cannot be a straightjacket formula, as each transaction has its own risk analysis matrix, which needs to be examined at the contract negotiations stage to project potential disputes. Like every industry, International

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* Professor and Head of Dept., Dept. of Law and Management, School of Law, University of Petroleum and Energy Studies, Dehradun (The first thoughts of this paper were presented by the author as a panelist during the 47th Annual Conference of the ISIL, New Delhi on the theme 'India and International Law: Contemporary Issues and Challenges', May 12-13, 2018.)

[1] Julie Barker, *International Mediation - A Better Alternative for the Resolution of Commercial Disputes: Guidelines for a U.S. Negotiator Involved in an International Commercial Mediation with Mexicans*, 19 LOY. L.A. INT'L & COMP. L. REV. 1 (1996).

Investment has its own peculiarities, and the dispute resolution mechanisms are to be chosen based on such analysis.[2]

2. MEDIATION OF COMMERCIAL DISPUTES

While mediation may not be a right option for all types of commercial cases, for example, the Petroleum Sector disputes,[3] mediation may be suited for resolving commercial disputes in a majority of the matters as the mediators are able to bring parties closer by creating an overall atmosphere conducive to information sharing,[4] confidence building and cooperation.[5] There are many types of dispute resolution mechanisms available to the parties, which may be characterized ranging from 'negotiated settlement to all-out-war (referring to litigation)'.[6] The oldest mode of dispute resolution is litigation, however, is not a preferred mode nowadays. Parties to a commercial transaction prefer Alternative Dispute Resolution ("ADR") modes, which are negotiation, mediation, conciliation, and expert determination other than arbitration, which is the most preferred mode of dispute resolution in international commercial matters.[7]

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[2] MUSTAFA ERKAN, INTERNATIONAL ENERGY INVESTMENT LAW: STABILITY THROUGH CONTRACTUAL CLAUSES 239 (2011).
[3] *Id.*
[4] *See* Moti Ram v. Ashok Kumar, (2011) 1 S.C.C. 466.
[5] CHRISTOPHER MOORE, THE MEDIATION PROCESS 211-94 (3d ed. 2003).
[6] A. Redfern, *Having Confidence in International Arbitration*, 57 DISPUTE RESOLUTION JOURNAL, no. 4, Nov., 2002, at 60.
[7] J.M. Hertzfel, *Applicable Law and Dispute Settlement in Soviet Joint Ventures*, 3 ICSID Rev. Foreign Investment L. J. 249 (1988).

Transnationally, arbitration is still the preferred method of resolving international commercial disputes following the 1958 United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention).[8] However, over a period, the international corporate community has become somewhat disenchanted with International Commercial Arbitration as a mode of dispute settlement because of concerns about rising costs, delays, and procedural formality.[9]

As a result, parties are looking for other means of resolving international commercial disputes.[10] Mediation is one of the popular ones around the world.[11] Mediation introduces effective procedures to generate and evaluate options for settlement.[12]

A study conducted in 1997 by Cornell University of the general counsels of 528 large and medium-sized US corporations revealed a high utilization of ADR in commercial disputes. Mediation was the preferred mode as it provided greater control over the process, especially over potentially risky disputes and ultimately preserved good relationships.[13]

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[8] Ellen E. Deason, *Enforcement of Settlement Agreements in International Commercial Mediation: A New Legal Framework?*, DISPUTE RESOLUTION MAGAZINE, Fall 2015: 32.
[9] *See* WILLIAM PARK, ARBITRATION OF INTERNATIONAL BUSINESS DISPUTES: STUDIES IN LAW AND PRACTICE 3–27 (2d ed. 2012); S.I. Strong, *Increasing Legalism in International Commercial Arbitration: A New Theory of Causes, a New Approach to Cures*, 7 WORLD ARB. & MEDIATION REV. 117, 117–18 (2013) [hereinafter Strong, Increasing Legalism].
[10] S. I. Strong, *Beyond International Commercial Arbitration? The Promise of International Commercial Mediation*, 45 WASH. U. J. L. & POL'Y 11 (2014).
[11] Neil H. Andrews, *Mediation: International Experience and Global Trends*, University of Cambridge Faculty of Law Research Paper No. 42/2018 (June 1, 2018).
[12] CHRISTOPHER MOORE, THE MEDIATION PROCESS 211-94 (3d ed. 2003).
[13] John Weingarth, *ADR as a Risk Management Tool for Business*, 1 THE ADR BULLETIN, no. 9, Mar., 1999.

However, this does not hold good for India where while Mediation has been successful in resolving a number of matrimonial/family and small consumer disputes, it has not been a demonstrated success in managing commercial disputes. Ironically, Indian business scenario is ruled by privately owned companies (even public ones known by its promoter houses, say for e.g. reliance, Mahindra, Infosys, etc.) where preserving relationships becomes very important, yet, mediation has not been preferred. Supreme Court in a number of decisions has emphasized the role of mediation in such cases.[14]

3. MEDIATION: THE TERMINOLOGICAL CONFUSION

Many authors use the terms mediation, conciliation, and good-offices interchangeably. Technically, a mediator is an active participant in the process and informally makes suggestions to the parties, based on the information that the parties supply.[15] A conciliator has more rights to make formal proposals for resolutions, based on independent investigation of the dispute. A good- officer is not an active participant in the dispute and simply encourages the parties to resume negotiations or provides them with an additional channel of communications.[16] In practice, however, these distinctions tend to blur, making it very difficult to draw the line among the three different procedures.

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[14] B.S. Krishna Murthy v. B.S. Nagaraj, (2011) 15 S.C.C. 464.
[15] JAMS International, *Winning at Mediation Getting the Best Outcomes from Mediation*.
[16] *See* R (Cowl) v. Plymouth City Council [2001] E.W.C.A. Civ. 1935; Dunnett v. Railtrack PLC [2002] E.W.C.A. Civ. 303; Hurst v. Leeming [2001] E.W.H.C. 1051 (Ch.).

This confusion was also an important element of debate at the UNCITRAL Working Group discussions, deliberating upon the Model Law on Conciliation.[17]

> *At its sixty-fourth session, the Working Group considered whether the term "mediation" should replace the term "conciliation" throughout the instruments and, if so, the possible implications on existing UNCITRAL texts, which were prepared using the term "conciliation". At that session, a view was expressed that the instruments should refer to "mediation" instead of "conciliation", as it was a more widely used term.*[18]

In India, the term mediation got focused attention in the *Salem Bar Association (I).*[19] Among other things, the newly introduced section 89 in the Code of Civil Procedure was being challenged which provided for 'settlement of disputes outside courts' including 'mediation'.[20] The Supreme Court ruled out a possibility of the provisions being *ultra vires* the Constitution of India; however, it agreed with the suggestion to constitute a Committee "so as to ensure that the amendments made become effective and result in quicker dispensation of justice". Accordingly, a Committee constituted under the Chairmanship of Justice

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[17] U.N. Comm'n on Int'l Trade Law (UNCITRAL), *Model Law on Conciliation*; *see* U.N. Comm'n on Int'l Trade Law (UNCITRAL), *Report of Working Group II (Dispute Settlement) on the work of its sixty-eighth session*, A/CN.9/934 (Feb. 19, 2018).

[18] At its sixty-seventh session, the Working Group reached a shared understanding that the terms "conciliation", "conciliator" and other similar terms should be replaced with the terms "mediation", "mediator" and corresponding terms in the instruments as well as in the UNCITRAL Conciliation Rules (1980).

[19] Salem Bar Ass'n (I) v. Union of India, (2003) 1 S.C.C 49.

[20] Others being arbitration, conciliation, and judicial settlement through lok adalat.

M. Jagannadha Rao, gave a detailed report in three parts.[21] The second report provided for a Model Alternative Dispute Resolution and Mediation Rules. These rules focused in detail on the concept and procedures of mediation including the role of a mediator. These rules got a stamp of approval from Supreme Court in *Salem Bar Association (II)*,[22] resulting in the creation of the Supreme Court Mediation Training Manual,[23] and the establishment of mediation centres in High Courts throughout the Country.

In the landmark decision of *Afcons Infrastructure*,[24] Supreme Court examined the scope of Section 89 in detail and provided the much-needed clarity on the process required to be followed by the courts in referring the disputes to ADR under the modes prescribed in section 89. Applying a purposive construction,[25] this decision also corrected an important draftsman's error by interchanging the definition of "judicial settlement" and "mediation" in Sections 89(2) (c) and (d).

In Para 12 of the *Afcons* decision a reference is drawn to Black's Law Dictionary to say that 'it is (mediation) also a synonym of the term conciliation'; however, it may be noted that the focus of the discussion in that para is not difference between mediation and conciliation. The focus

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[21] The first part dealt with various grievances relating to amendments to the CPC 2002 and the third part dealt with Case Flow Management and Model Rules.
[22] Salem Bar Ass'n (II) v. Union of India, (2005) 6 S.C.C. 344.
[23] https://www.sci.gov.in/pdf/mediation/MT%20MANUAL%20OF%20INDIA.pdf
[24] Afcons Infrastructure Ltd. v. Cherian Varkey Construction Co. (P.) Ltd., (2010) 8 S.C.C. 24.
[25] *See* Tirath Singh v. Bachittar Singh, A.I.R. 1955 S.C. 830; Shamrao Parulekar v. District Magistrate, Thana, A.I.R. 1952 S.C. 324; Molar Mal v. Kay Iron Works, 2004 (4) S.C.C. 285; Mangin v. Inland Revenue Comm'n, 1971 A.C. 739; Salem Bar Ass'n (II) v. Union of India, (2005) 6 S.C.C. 344; Stock v. Frank Jones (Tipton) Ltd., (1978) 1 W.L.R. 231.

is as to the difference between 'judicial settlement' and 'mediation'. Conciliation is separately addressed in para 35 of *Afcons* decision. In fact, according to Justice R.V. Raveendran who wrote *Afcons*, there is a difference between mediation and conciliation in a degree of professional training, i.e.:

> *Where the conciliator is a professional trained in the art of mediation (as contrasted from a layman, friend, relative, well-wisher, or social worker acting as a conciliator), the process of conciliation is referred to as mediation. In cases where the third party assisting the parties to arrive at a settlement is not a trained professional mediator, the process is referred to as conciliation.*[26]

Internationally also, Government of India has maintained the distinction between the concepts of 'mediation' and 'conciliation'.[27]

4. ARBITRATION AND CONCILIATION LAW IN INDIA: SCOPE OF MEDIATION

Under the Arbitration and Conciliation Act, the arbitral tribunal may use mediation, conciliation, or other procedures at any time during the arbitral proceedings to encourage settlement.[28]

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[26] R.V. Raveendran, *Section 89 CPC: Need for an Urgent Relook*, *in* REPORT 238 OF THE LAW COMMISSION OF INDIA ON AMENDMENT OF SECTION 89 OF THE CODE OF CIVIL PROCEDURE, 1908 AND ALLIED PROVISIONS, 2011(2007) 4 S.C.C. J23.

[27] *See* U.N. Comm'n on Int'l Trade Law (UNCITRAL), *Comments by India at the Sixty-third Session on Settlement of Commercial Disputes: Enforcement of Settlement Agreements*, A/CN.9/WG.II/WP.191.

[28] Arbitration and Conciliation Act, 1996, § 30.

> *It is permissible for parties to arrive at a mutual settlement even when the arbitration proceedings are going on. In fact, even the tribunal can make efforts to encourage mutual settlement. If parties settle the dispute by mutual agreement, the arbitration shall be terminated. However, if both parties and the Arbitral Tribunal agree, the settlement can be recorded in the form of an arbitral award on agreed terms, which is called consent award. Such arbitral award shall have the same force as any other arbitral award. Under Section 30 of the Act, even in the absence of any provision in the arbitration agreement, the Arbitral Tribunal can, with the express consent of the parties, mediate or conciliate with the parties, to resolve the disputes referred for arbitration.*[29]

However, experience shows that arbitral tribunal rarely uses these procedures. For that matter, even response from courts is not very encouraging.[30] Internationally, however, the trend is towards adopting hybrid models of dispute resolution like med-arb, co-med-arb, arb-med, etc.[31] It is interesting to note that the Justice B.N. Srikrishna Committee on Arbitration,[32] has recognized this trend by recommending that the Government may examine the feasibility of a standalone legislation for mediation, post-debate, and discussions with the relevant stakeholders.

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[29] Nishith Desai Associates, *International Commercial Arbitration: Law and Recent Developments in India*, Mar., 2018.

[30] VIDHI CENTRE FOR LEGAL POL'Y, STRENGTHENING MEDIATION IN INDIA: A REPORT ON COURT-CONNECTED MEDIATIONS.

[31] *See* Mark Baril & Donald Dickey, *MED-ARB: The Best of Both Worlds or Just A Limited ADR Option?, available at* https://www.mediate.com.

[32] B. N. Srikrishna (Chairman), *Report of the High-Level Committee to Review the Institutionalization of Arbitration Mechanism in India*, Govt. of India, July, 2017.

5. COMPANIES ACT: MEDIATION AND CONCILIATION PANEL - A NON-STARTER

Companies Act, 2013 provides for maintenance of Mediation and Conciliation Panel as per Section 442 of the Act and the rules made thereunder. In fact, the Regional Directors (RDs) have been authorized to maintain the panel and they are doing so. However, the concept has not seen the light of the day in terms of actual commercial disputes being referred to by the National Company Law Tribunal (NCLT). Though legislated with a noble objective, the law leaves the discretion to the parties to move for settling the disputes through a mediation and conciliation panel maintained by the Central Government (Regional Director). The Regional Directors just put up a list of names and addresses of empanelled mediators without any further efforts to sensitize the disputants to try the methods. It should be maintained on an interactive website and there should be some compulsion as per law on the NCLT to at least allow the parties to explore the option before they fully litigate the matter. This would be in line with Section 89 CPC proceedings.

Ministry of Corporate Affairs ("MCA") regulates the corporate affairs in India through various legislations. Majority of commercial disputes involve companies (public and private), LLPs, partnership firms, societies, government companies, and foreign companies. As a regulator, integrator, facilitator, and educator, MCA could be a natural partner in promoting ADR as a mechanism of dispute resolution, which would ultimately improve our ranking in EODB, which is presently being dealt with by Ministry of Law and Justice, as noted above.

6. INSOLVENCY AND BANKRUPTCY CODE, 2016 (IBC) AND MEDIATION

IBC does not formally recognize the concept of mediation, except under the Insolvency and Bankruptcy Board of India (Information Utilities) Regulations, 2017.[33] Internationally, mediation is used in restructuring and insolvency cases by the insolvency professionals. In USA and Europe, mediation is frequently used in insolvency proceedings.[34] However, a ray of hope is that the adjudicating authority under IBC i.e. NCLT may provide some direction to this in future.

7. MEDIATION UNDER THE CONSUMER PROTECTION BILL, 2018

It is proposed in the Consumer Protection Bill 2018 that, the Central Government shall establish a Consumer Mediation Cells attached to the National Commission, State Commission, and District Commissions. These mediation cells would empanel mediators.[35] There would be a compulsory reference to mediation at the first hearing of the complaint after admission, or at any later stage in the opinion of the District Commission.[36] Department of Consumer Affairs has already established The Online Consumer Mediation Centre (OCMC) at NLSIU,

[33] *See* Regulation 12.
[34] BOB WESSELS, MEDIATION IN RESTRUCTURING AND INSOLVENCY (2016).
[35] Consumer Protection Bill, 2018, Chap. V, Cl. 74.
[36] *Id.* cl. 37.

Bengaluru.[37] While mediation has been used successfully to resolve the consumer disputes by the mediation centres,[38] this is another formal introduction of the concept of mediation in a commercial welfare legislation.

8. COMMERCIAL COURTS AND PRE-INSTITUTION MEDIATION (PIM)

India leapt 30 points to reach 100 in the Ease of Doing Business (EODB) 2018 ranking of the World Bank, compared to 130 in the previous year. One of the significant indicators (out of 11 indicators) which restricted India from performing better was raking on the indicator 'Enforcing Contracts' which stood at 164. There was only an improvement of 8 positions on this indicator. One of the major reasons was the delay in settlement of disputes. As per reports, it takes 1445 days to dispose of a commercial case (out of these 1095 days are spent on the trial and judgment phase and 305 days on enforcement of the judgment).

"The enforcing contracts indicator measures the time and cost for resolving a commercial dispute through a local first-instance court, and the quality of judicial processes index, evaluating whether each economy has adopted a series of good practices that promote quality and efficiency in the court system."[39] Availability and effectiveness of 'Alternate Dispute

[37] https://onlinemediationcenter.ac.in/about-online-consumer-mediation-centre/.
[38] *See for e.g.*, The Mediation Center of Delhi Dispute Redressal Society (DDRS), *Samadhan* at Delhi High Court, Bengaluru Mediation Center, etc.
[39] E.O.D.B .REPORT 2018.

Resolution (ADR)' mechanism is also measured as one of the sub-parameters.

In view of the EODB statistics, Government of India constituted a Task Force for Improving India's Ranking in the World Bank Report on Ease of Doing Business for Indicator of 'Enforcing Contracts' under Ministry of Law and Justice.[40] The Task Force has met six times as of 28th March 2018 and as a result, we saw an amendment introduced into the Commercial Courts, Commercial Division and Commercial Division of High Courts Act of 2015 ("Commercial Courts Act") by way of an Ordinance,[41] passed on 3rd May of 2018. The Ordinance introduces the concept of Pre-Institution Mediation (PIM) process:

> *In cases where no urgent, interim relief is contemplated which will provide an opportunity to the parties to resolve the commercial disputes outside the ambit of the courts through the authorities constituted under the Legal Services Authorities Act, 1987 ("LSA"). It is also contemplated to help in reinforcing investor's confidence in the resolution of commercial disputes. A new section 21A is inserted which enables the Central Government to make rules and procedures for PIM.*

The Government has further authorized the State Authority and District Authority constituted under the LSA, for the purposes of pre-institution mediation and settlement under the Commercial Courts Act.[42]

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40 http://doj.gov.in/sites/default/files/Minutes%20of%20Task%20Force%20First%20%20Meeting.pdf.

41 No. 3 of 2018.

42 Notification S.O. 3232 (E) (July 3, 2018).

While this action on part of the Government of India is laudable, the question is whether the authorities so notified under LSA, will be able to do justice to the cause. This concern is not unfounded, as Supreme Court has reiterated in a number of cases that *Lok Adalats* must act only as statutory conciliators having no judicial role.[43] This responsibility seems to be an onerous task on the authorities under LSA, unless there is a special focus on the cause and action is taken accordingly.

9. <u>CHALLENGES AND WAY FORWARD</u>

Hon'ble Justice A.K. Sikri, Judge Supreme Court of India emphasized the virtues of Mediation in commercial disputes in the case of *Vikram Bakshi v. Sonia Khosla*,[44] as follows:

> *Mediation can provide a cost-effective and quick extrajudicial resolution of disputes in civil and commercial matters through processes tailored to the needs of the parties. Agreements resulting from mediation are more likely to be complied with voluntarily and are more likely to preserve an amicable and sustainable relationship between the parties. These benefits become even more pronounced in situations displaying cross-border elements.*

We are witnessing a movement towards utilization of mediation in commercial matters already as may be noticed by insertion of mediation and conciliation panel in the Companies Act, 2013, introduction of the

[43] B.P. Sevamandir v. A.M. Hassan, (2009) 2 S.C.C. 198; United India Insurance Co. Ltd. v. Ajay Sinha, (2008) 7 S.C.C. 4549; State of Punjab v. Jalour Singh, (2008) 2 S.C.C. 660; P.T. Thomas v. Thomas Job, (2005) 6 S.C.C. 478.

[44] Special Leave Petition (Criminal) No. 6873 of 2010 (May 8, 2014).

concept of mediation in the Consumer Protection Bill, and introduction of the concept of Pre-Institution Mediation (PIM) by way of an Ordinance to the Commercial Courts, Commercial Division, and Commercial Division of High Courts Act of 2015. However, one of the major challenges is the advocacy of the concept by natural stakeholders. “Mediation generally is still regarded with considerable suspicion by many lawyers and with profound ignorance by some commercial organizations”.[45]

` The Singapore Report of the GPC Series,[46] gives very important findings, for example, that the ‘parties see lawyers, whether external or in-house, as primarily responsible for advising them about their dispute resolution process options.’ Irrespective of the innovation or reform, education is perceived as a driving force behind the evolution of commercial dispute resolution. In U.K., because of the Court of Appeal judgment in *Halsey v. Milton Keynes*:[47]

> *Legal advisers must ensure that they not only know about mediation but that they are able to and do advise their clients before and during litigation (including arbitration) whether to use mediation and, if so, when to do so. Equally, legal advisers must be able to protect their clients (and themselves!) against an adverse cost order or suit if they decide not to try to resolve the dispute by mediation.*

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[45] Michel Kallipetis, *Mediation in Civil and Commercial Disputes: Top 5 Things Everyone Should Know About Mediation*, A.P.P.G. on ADR (May 25, 2016).
[46] Int’l Mediation Institute, *Global Pound Conference Series 2016-17: Shaping the Future of Dispute Resolution & Improving Access to Justice: The Singapore Report 2016*
[2004] E.W.C.A. (Civ.) 576, 47.

The major role in promoting mediation lies with the lawyers and judges. We need more champions of mediation in the Judiciary.

While mediation is becoming the predominant mechanism for third-party intervention in the settlement of international disputes, one of the challenges is that there are no international instruments that oblige national courts to enforce agreements to mediate and none that guarantee enforceability of mediated settlements.[48] It may be noted that international mediated settlements have not been attractive due to uncertainty around its enforceability by the countries, as UNCITRAL Model law on conciliation does not have a similar treatment as the New York Convention. This is in spite of the fact that several authors have stated that international mediation can make an important contribution to global peace and stability.[49]

On this point, it would not be out of place to reiterate the seven suggestions made by the Committee on Arbitration headed by Justice B.N. Srikrishna.

1. Promote Med-Arb: Every arbitral institution should provide mediation services, through a cell or panel. Such mediation cell or centre should, in turn, enrol trained mediators. This service should be provided by the centre as part of its routine, where parties should be encouraged to strive to settle the dispute without

[48] Bobette Wolski, *Recent Developments in International Commercial Dispute Resolution: Expanding the Options*, 13 BOND L. REV., no. 2, 2001.
[49] Gary Mendoza, *Mediation as an Instrument of International Crisis Management: Cyprus-A Case Study*, 7 YALE J. INT'L L. (1981).

recourse to arbitration. Attempt to settle (through mediation) every dispute referred should be first made, within a limited time frame. If this effort does not succeed, the parties should then revert to the adjudicatory mode in arbitration.

2. Standard Setting: The proposed A.P.C.I.,[50] should indicate standards that institutions can adopt, for enrolling mediators in every institution, in terms of minimum training, experience, etc. The APCI should prescribe the necessary standards or experience which mediators ought to possess.
3. The possibility of parties seeking mediation, as a method of arriving at a settlement, before or during the course of the arbitral proceedings, in respect of one or some points of dispute, should be available. Like in the case of the AMA protocol[51] devised by the SIAC[52] and the SIMC[53], this may be through a limited stay of arbitral proceedings (barring hearings on interim measures) for a specified time, when the parties should make intensive efforts to arrive at a mutually acceptable settlement. This can be a full settlement of all disputes, or partial settlement, that can be embodied in an award; other unresolved issues of the dispute may be a subject matter of the reference to arbitration.

[50] Arbitration Promotion Council of India (proposed).
[51] Arb-Med-Arb protocol.
[52] Singapore International Arbitration Centre.
[53] *Id.*

4. The Government should discuss and debate the feasibility of a standalone mediation law, its scope and ambit, and the way forward for its drafting.
5. The Government should consider separating the mediation and conciliation regimes in the country.
6. ADR culture has to be developed, disseminated and inculcated at the stage of contract formation to parties and counsel. This is often necessary because ADR requires both parties to see the long-term benefits of private dispute resolution; convincing parties or lawyers once the dispute has arisen to give up the perceived advantages of litigation is more difficult.
7. The general focus on legal training in India is on dispute resolution through court proceedings or threat of court proceedings. The professional lawyer is also supposed to be an advisor looking after the best interests of the client but often lacks the training to conduct professional negotiations in a dispassionate manner. Law schools and colleges in India should concentrate on this aspect of legal training, which prevents disputes from escalating into emotional diatribes through notices, and builds capacities and skills to negotiate, mediate and settle disputes. Mediation shall be introduced as a compulsory clinical paper for study/practice in the LL.B. Course.

One of the major stakeholders in a growing number of disputes is the Government Departments. Last but not the least, the Government

Departments must understand the virtues of this form of dispute resolution and promote it in its National Litigation Policy (rather, it should be renamed as National Dispute Resolution Policy).

EASE OF DOING E-COMMERCE BUSINESS IN INDIA: THE FDI POLICY RELATING TO E-COMMERCE AND ITS IMPACT ON THE INDIAN ECONOMY

- *Pankhudi Khandelwal*[*]

ABSTRACT

In recent years, the Indian economy has witnessed significant changes due to an increase in e-commerce. The implications of the surge of e-commerce include various economic, legislative, and social issues. The Department of Industrial Policy and Promotion (DIPP) issued a Press Note in March 2016 to regulate the foreign direct investment (FDI) in the sector. The policy, among other conditions, had put several restrictions on global online retailers in order to maintain a level playing field. The research work seeks to analyse as to whether such restrictions are really necessary in light of the competition issues in e-commerce in the present economic scenario or if they pose as an obstacle in the ease of doing business. Recently, a think tank headed by the Union Minister for Commerce and Industry, Mr. Suresh Prabhu, was set up for the drafting of a national e-commerce policy. The think tank has come up with the first draft of the e-commerce policy which has been shared among the stakeholders for consultations. The draft policy mainly reiterates the provisions relating to competition and FDI issues from the Press Note,

[*] LL.M. (Competition, Innovation & Trade Law) Candidate, London School of Economics and Political Science.

along with some more restrictions placed on e-commerce companies. The research work examines the draft policy with respect to the relevance of the restrictions imposed under the policy and opines on whether the draft policy is the right way forward.

1. INTRODUCTION

In the recent years, the Indian economy has witnessed significant changes due to an increase in e-commerce. Indian Government's Economic Survey of 2018 revealed that India's e-commerce market has reached $33 billion, registering a 19.1% growth during 2016-2017.[1] E-commerce is generally used to denote a method of conducting business through electronic means. There is no statutory definition of e-commerce in India. E-commerce has been defined under the FDI policy 2016 as "buying and selling of goods and services including digital products over digital & electronic network".[2]

The implications of the surge of e-commerce include various economic, legislative, technological, and social issues. There are few inherent distinctions between offline and online retailers. In a country like India, where the technological development is still at a nascent stage, people find it difficult to trust online marketplaces and prefer traditional

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[1] Department of Economic Affairs, Ministry of Finance, Govt. of India, *Economic Survey 2017-18* (Jan., 2018), *available at* http://mofapp.nic.in:8080/economicsurvey.

[2] Department of Indus. Pol'y & Promotion, Ministry of Commerce & Indus., Govt. of India, *Consolidated FDI Policy Circular of 2016*, D/o IPP F. No. 5(1)/2016-FC-1 (June 7, 2016), *available at* http://dipp.gov.in/English/policies/FDI_Circular_2016.pdf [hereinafter FDI Policy].

outlets. In order to deal with this, online retailers have started offering discounts and promoting their platforms through strategies such as 'big billion sales' and 'cash backs'. However, offline retailers have on several occasions made complaints of anti-competitive practices and predatory pricing against the online retailers alleging that such discounts are provided by these companies through funding by global investors.

In order to address these issues, the Department of Industrial Policy and Promotion (DIPP) issued a Press Note in March 2016[3] to regulate the foreign direct investment (FDI) in this sector. The policy, among other conditions, had put several restrictions on global online retailers in order to maintain a level playing field. This research work seeks to analyse whether such restrictions are really necessary in light of the competition issues in e-commerce in the present economic scenario or, if they pose an obstacle in the ease of doing business.

Recently, a think tank headed by the Union minister for Commerce and Industry, Mr. Suresh Prabhu, was set up for the drafting of a national e-commerce policy. The think tank has come up with the first draft of the e-commerce policy[4] which has been shared among the stakeholders for consultations. The draft policy mostly reiterates the provisions relating to competition and FDI issues from Press Note 3, along with some more

[3] Department of Indus. Pol'y & Promotion, *Guidelines for FDI in E-commerce*, Press Note No. 3 (2016 Series), D/o IPP File No.: No. 5/3/2015-FC.I (Mar. 29, 2016) [hereinafter Press Note 3].

[4] *Electronic Commerce in India: Draft National Policy Framework*, *available at* https://www.medianama.com/wp-content/uploads/Draft-National-E-commerce-Policy.pdf [hereinafter Draft Policy].

restrictions placed on e-commerce companies. The research work examines the draft policy with respect to the relevance of the restrictions imposed under the policy and opines on whether the draft policy is the right way forward.

2. CURRENT FDI POLICY ON E-COMMERCE AND ITS IMPLICATIONS

In a writ petition filed in the Delhi High Court, Retailers Association of India and All India Footwear Manufacturers and Retailers Association had argued that e-commerce companies act as retailers because the payment, delivery, returns and refund are all handled by these companies and that the various e-commerce websites have been continuously dodging the question of FDI violations by camouflaging their business as a "marketplace" when in reality a sale through online forum is akin in character to a sale made by a physical retailer.[5] The Ministry of Commerce and Industry requested the Enforcement Directorate (ED) and RBI to investigate and examine if e-commerce companies are indeed engaging in retailing activity. It all finally led to the ruling by the Delhi High Court on November 20, 2015, which in turn, led to the release of Press Note 3 by DIPP. The Press Note 3, 2016 issued by the DIPP has distinguished between two models of e-commerce:

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[5] Priyanka Mittal & Sapna Agarwal, *Govt. Faces More Questions on FDI in E-commerce*, LIVE MINT (Dec. 2, 2015), http://www.livemint.com/Politics/lPrE8sCkWZ0y4d7OrcJMEL/Govt-faces-more-questions-onFDI-in-ecommerce.html.

Inventory-based model of e-commerce – It is an e-commerce activity where an inventory of goods and services is owned by e-commerce entity and is sold to the consumers directly.

Marketplace-based model of e-commerce – It involves providing an information technology platform by an e-commerce entity on a digital & electronic network to act as a facilitator between the buyer and the seller.

As per the FDI policy, FDI up to 100% under automatic route is permitted in Marketplace/ Business to Business (B2B) e-commerce. No FDI is permitted in Inventory/ Business to Consumer (B2C) e-commerce.

The Press Note further places the following restrictions on B2C e-commerce:

(i) A manufacturer is permitted to sell its products manufactured in India through e-commerce retail.

(ii) A single brand retail trading entity operating through brick and mortar stores, is permitted to undertake retail trading through e-commerce.

(iii) E-commerce entity providing a marketplace will not exercise ownership over the inventory i.e. goods purported to be sold. Such an ownership over the inventory will render the business into inventory-based model.

(iv) An e-commerce entity will not permit more than 25% of the sales affected through its marketplace from one vendor or their group companies.

(v) E-commerce entity providing a marketplace will not directly or indirectly influence the sale price of goods or services and shall maintain a level playing field.

It may be noted that the Press Note imposes restrictions on the e-commerce companies relating to influencing of prices of goods and services. Offline retailers have on many occasions accused online retailers of indulging in anti-competitive practices. Allegations have been levelled on companies like Amazon and Flipkart using low prices to boost their revenues and attract customers from the offline market. In light of such allegations, it is pertinent to note various competition issues that have arisen recently in the e-commerce sector.

3. COMPETITION ISSUES IN E-COMMERCE

In the case of *Mohit Manglani v. Flipkart India (P.) Ltd.*,[6] it was alleged that online portals were indulging in anti-competitive practices in the nature of 'exclusive agreements' with sellers of goods/services to sell the selected product exclusively on the selected portal to the exclusion of other e-portals or physical channels. The Competition Commission of India (CCI) held that it seems very unlikely that an exclusive arrangement between a manufacturer and an e-portal will create an entry barrier as most of the products to be sold through exclusive online partners face competitive constraints. It further held that it does not appear that because of these exclusive agreements any of the existing players in the retail

[6] Mohit Manglani v. Flipkart India Private Limited, Case No. 80 of 2014, C.C.I. 8.

market are getting adversely affected, rather with new e-portals entering into the market, competition seems to be growing.

In the case of *Ashish Ahuja v. Snapdeal.com.*,[7] deciding on whether online markets constitute a different distributor or whether they are merely an intermediary, the Commission observed that both offline and online markets differ in terms of discounts and shopping experience and buyers weigh the options available in both markets and decides accordingly. If the prices in the online market increase significantly, then the consumer is likely to shift towards the offline market and vice versa. Therefore, these two markets are different channels of distribution of the same product and are not two different relevant markets.

Under Section 4(2) of the Competition Act, 2002, 'predatory pricing' means "the sale of goods or provision of services, at a price which is below the cost, as may be determined by regulations, of production of goods or provision of services, with a view to reduce competition or eliminate the competitors". The basic assumption about predatory pricing is that the firm exercising predatory pricing must be in a dominant position in the market. Online retailers claim that, in spite of growing demand for e-commerce and online retailing, it accounts for less than 2% of the total retail in India. Therefore, none of the online retailers can be said to have a dominant position in the market since, all of them combined are said to have not more than 2% market share of the total retail market. Hence, the complaints that the online retailers are indulging in predatory- pricing do

[7] Ashish Ahuja v. Snapdeal.com, Case No. 17 of 2014, C.C.I. 9.

not have much weight. It should further be noted that such heavy discount sales are limited in products being offered and are for limited period and stock only. Therefore, such a sale cannot be said to be a predatory pricing sale.[8]

In the case of *Jasper Infotech (P) Ltd. v. Kaff Appliances (India) (P.) Ltd.*,[9] the CCI has observed that any conduct that restricts sales over a distribution channel directly violates competition law. The products sold through online marketplaces must be treated at par with the products sold by authorized distributors through physical stores.

In the case of *Fast Track Call Cab (P) Ltd. v. ANI Technologies (P) Ltd.*,[10] allegations were made against Ola cabs for predatory-pricing, such as offering various unrealistic discounts and rates to lure the customers and unviable incentives to its drivers to establish its monopoly and eliminate otherwise equally efficient competitors. The Commission discarded these allegations and observed that the incentives and discounts are devised as part of competitive strategy to compete with similarly placed aggregators in the market, like Uber. In another order relating to a similar allegation,[11] the Commission observed that there exists stiff competition, at least between Ola and Uber, with regard to the radio taxi service industry. Noting that there are various other players, CCI said that

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[8] Ashish Patel, *Major Competition Law Issues in E-Tail Market*, 2 INT'L MULTIDISCIPLINARY RESEARCH J., no. 6, June, 2015.
[9] Jasper Infotech v. Kaff Appliances (India) Case No. 61/2014.
[10] Fast Track Call Cab v. ANI Tech., Case No. 6 of 2015.
[11] Vilakshan Yadav v. ANI Tech., Case No. 21 of 2016.

the market is competitive and none of the players can be said to be dominant in the relevant market.

On an analysis of the above case laws, it can be seen that most of the competition issues that arose in these cases were decided in favour of the e-commerce companies by C.C.I. under the Competition Act. When the share of the total online market is very less and there are thousands of products offered by online retailers, it is unnecessary to implement the measures that may foreclose the competition in the online market which may have an appreciable adverse effect on competition in India.

While dealing with competition concerns regarding dominant players, the C.C.I. has observed that market power or dominance in itself is not an antitrust concern; it is the conduct of such players that warrants careful competition scrutiny. It is when the evidence shows that the dominant firm uses its market power to stifle innovation and/ or competition, or exploits the market power to the detriment of its consumers, should a competition agency intervene.[12] The restrictions imposed in the F.D.I. policy on global dominant e-commerce firms such as Amazon and Flipkart are unreasonable as there are enough competitors in the market. The prohibition on providing deep discounts not only impacts e-commerce companies but is also detrimental to the consumers.

[12] Matrimony.com v. Google, Case Nos. 7 & 30 of 2012.

4. LOOPHOLES OF THE PRESS NOTE AND ITS IMPLICATIONS

4.1. NO INVENTORY-LED MODEL

Removing restrictions in the inventory model can create a boost in local manufacturing as e-commerce players will be able to procure products in bulk, the risk for the manufacturer will get minimized. This would lead to low costs for both the manufacturer and the consumer by eliminating the middlemen.

4.2. NO DISCOUNTS OR 'BIG BILLION SALES'

According to the press note, e-commerce entities cannot directly or indirectly influence the sale price of goods or services and shall maintain a level playing field. The D.I.P.P. has prohibited discounts, predatory pricing, and 'big-billion sales' that made online marketplaces more attractive for consumers when compared to offline stores. While earlier consumers could compare the prices of online marketplaces with offline stores, this option will no longer be available to the consumer, leading to a reduction in the choices for a consumer. Though the aim of the clause is to prevent big players from providing discounts through unfair practices, such restrictions and price controls may lead to the discouragement of investment in the sector. Increased government intervention in matters relating to the price of goods, instead of focus on economic competition and consumer's choices, might be considered as excessive licensing of the e-commerce market.

4.3. RE-STRUCTURING OF EXISTING E-COMMERCE PLAYERS

D.I.P.P. has clarified that an e-commerce firm will not be permitted to sell more than 25 percent of the sales affected, through its marketplace from one vendor or their group companies. In the marketplace model, any seller can sell his/her goods through the marketplace. This leads to erroneous deliveries and an increase in fraud cases which in turn leads to low quality of service to a consumer. In order to deal with this, Flipkart and Amazon had created a 'primary seller'. For Amazon, Cloudtail India Private Limited is the biggest seller on Amazon India which is a joint venture between Catamaran Ventures and Amazon Inc. Flipkart's largest seller is WS Retail Services, an organization that can be traced back to Flipkart itself. In this manner, Flipkart and Amazon skirted the F.D.I. regulations on inventory-led e-commerce models. With the issuance of the Press Note 3, Amazon and Flipkart will need to stop passing off a quasi-inventory-led model as a marketplace model. Instruments such as Cloudtail and WS Retail Services will slowly have to wind down which might lead to disinvestment in the sector.[13]

5. PROPOSED PROVISIONS UNDER THE DRAFT NATIONAL E-COMMERCE POLICY

The draft national e-commerce policy was tabled in July, 2018 by the e-commerce think tank. The policy states that the overall objective of

[13] Ravikant Bhardwaj, *Competition Issues in E-commerce Sector in India*, http://media.leidenuniv.nl/legacy/ravikant-bhardwaj.pdf.

the national electronic commerce policy is to prepare and enable the stakeholders concerned to fully benefit from the opportunities that would arise from the progressive digitalization of the domestic and global economy. However, it can be seen that the policy imposes certain restrictions for global investor-entities. The draft policy *inter alia*, provides for the following clauses.

5.1. INDIA-FIRST MEASURES

The draft policy initially provided that 49% F.D.I. in inventory model would be allowed for online sale of locally produced goods, as long as 'Made in India' products are sold on the platform, the founder or promoter is a resident Indian, the company is controlled by Indian management, and foreign equity does not exceed 49%. However, recently DIPP secretary Ramesh Abhishek speaking on the draft e-commerce policy, at a roundtable organised by the Swadeshi Jagran Manch, has ruled out the same.[14] This poses as a major hurdle to global companies including Amazon and Walmart, who have made major investments in this market in India. While it is important to help medium and small enterprises (MSMEs) and Indian start-ups to raise funds and create an environment for them to grow, introducing obstacles for global investors could lead to slowing down of the e-commerce sector with politically- motivated and unnecessary regulations. Under the policy, the Government seeks to

[14] *DIPP rules out 49% FDI plan in inventory model*, ECONOMIC TIMES (Aug. 29, 2018), https://economictimes.indiatimes.com/news/economy/policy/dipp-rules-out-49-fdi-plan-in-inventory-model/articleshow/65586549.cms.

promote local companies through preferential treatment for local products created in India. However, it may be noted that many large, local players such as Paytm, Snapdeal, and Ola also have foreign investors. In light of this, such a provision does not entirely ensure the development of locally-backed and locally-managed start-ups.

5.2. DATA LOCALIZATION

The draft policy provides that the data generated by users in India from various sources including e-commerce platforms, social media, search engines etc. would be required to be stored exclusively in India, and suitable framework would be developed for sharing the data within the country. It further provides that Government will have access to data stored in India for national security and public policy subject to privacy and consent rules. Though protection and privacy of data are of extreme significance, the language of the provision has implications on the ease of doing business.

Moreover, the localisation of data does not in any way guarantee protection or privacy. The draft does not mention any framework with regard to protecting the privacy of users or regulating the government's access to user's data. This clause is not only troublesome for foreign investors but also for local start-ups who may go international. As a result of this provision, local companies may not be able to use global cloud services. Many Indian companies use the facilities of cloud-based storages and solutions like Amazon Web Services, mandating them to store locally will affect their operational cost and efficiency. The e-commerce sector will be strained for at least two to three years as they would incur extra costs to set up new data centres in India.[15]

The provision states that it would be guided by ongoing exercises, including the Report of the Justice Srikrishna Committee. The Personal Data Protection Bill, 2018 which was released by the Srikrishna Committee recently, has recommended that a copy of all personal data be stored in India and only critical personal data, as defined by the Central government, will be stored only in India. However, the draft policy states that all the data collected by e-commerce companies needs to be stored within India. Even the Aadhaar (Targeted Delivery of Financial and other Subsidies, Benefits and Services) Act, 2016, which *inter alia* deals with the legal framework in relation to Aadhaar number and protection of information, nowhere states that the Aadhaar information collected by any entity needs to be stored within India except under Regulation 22 and Schedule A of the Aadhaar (Authentication) Regulations, 2016 which states that the entities are required to store the Aadhaar information within the territory of India, if such information is obtained by it for authentication. Hence, it can be stated that the data localisation clauses provided in the draft policy are unnecessarily stringent and pose difficulties for global e-commerce companies. More clarity regarding what data generated by the e-commerce companies constitutes critical personal

[15] Chanakya Yadav, *Draft of E-Commerce Policy: An Analysis*, http://www.youngbhartiya.com/article/draft-of-e-commerce-policy-an-analysis.

data is required to be provided in this regard, in further drafts of the policy.

5.3. RESTRICTION ON DIFFERENTIAL PRICING STRATEGIES

Under the new draft policy, the restriction imposed on e-commerce marketplace, to not directly or indirectly influence the price of sale of goods and services, would be extended to group companies of the e-commerce marketplace. This provision has been reiterated from Press Note 3. It would mean that neither the marketplace nor the group companies of marketplaces such as Amazon and Flipkart can provide big discounts on the goods. In order to strengthen the enforcement of the provisions of Press Note 3, a separate wing would be created in the Directorate of Enforcement to handle grievances related to the implementation of Press Note 3. To further check the price cuts online, the draft policy also prohibits the bulk purchase of branded goods such as electronic products (especially mobile phones), white goods, and branded fashion by related party sellers. The policy may also provide for a 'sunset' clause which will define the maximum duration of differential pricing strategies that are implemented by e-commerce platforms to attract consumers.

As noted above, the restrictions imposed on global companies for attracting consumers through discounts may prove unfavourable to potential global investors. Further, in the long run, even local online retailers might want to secure funding from foreign sources. Deep discounting is a pricing strategy universally followed to gain more customers, especially in online markets which is still a tiny fraction of the total retail. A policy that restricts discounting will not only harm global investors but also future local start-ups. Local start-ups will not flourish if they cannot offer discounts freely. A smarter way of dealing with 'deep-pocket' foreign investors might be to allow online companies to offer price cuts only when their capital is mostly sourced through local entities.[16] This way companies like Amazon or Walmart would be free to offer discounts but they will have to compete with local firms for capital.

6. CONCLUSION

Though the aim of the guidelines formed by D.I.P.P. is to create a level playing field in e-commerce for local entities, too many restrictions may lead to the discouragement of investment in the sector for global investors. Majority of investment in the e-commerce sector in India has been made by foreign entities. Even the major local companies are to some extent, funded through foreign investments. The e-commerce market in India is still at its nascent stage. Excessive licensing and entry restrictions in this scenario may lead to depression in the sector. In these circumstances, it is important that the policy aims to strike a balance

[16] Saubhik Chakrabarti, *View: It's a daft ecommerce policy, will harm future local etailers*, ECONOMIC TIMES (Aug. 2, 2018), https://economictimes.indiatimes.com/news/economy/policy/view-its-a-daft-ecommerce-policy-will-harm-future-local-etailers/articleshow/65238981.cms.

between encouraging local players to invest in e-commerce and providing ease in doing business so that the global investors are not deterred.

Online markets are a necessary competition for offline retailers. An important question that arises is – why the government has restricted foreign investments in this sector when it does not have any appreciable adverse effect on competition? When the online retailers are not allowed to provide deep discounts, in a way, it is an attack on the pricing freedom. Moreover, anti-competitive practices and predatory-pricing should be the concern of the Competition Commission and not of D.I.P.P.

The purpose of the Competition Act, among other things, is to promote and sustain competition in markets, to protect the interests of consumers, and to ensure freedom of trade carried on by all participants in markets. Competition law should not be designed only to incentivise local players but also to encourage them in competing at a global level. Therefore, an approach where the possible competition issues are balanced while ensuring that the local players have the necessary support and infrastructure from the government is required.

What India's e-commerce market needs right now, while keeping global investor community interested, is locally backed and managed competitors to entities backed by foreign capital. Indian start-ups need an economic environment providing ample capital-generating possibilities to make up for the lack of local investment in the sector. The government should refrain from enacting a repressive law. It should also try not to hinder the growth of the e-commerce sector by restricting the investments at its paramount time.

EFFICACY OF I.B.C. IN LIGHT OF ABSENCE OF THE CROSS-BORDER INSOLVENCY REGIME: A CRITICAL COMPARISON OF THE UNITED STATES, THE UNITED KINGDOM AND SINGAPORE APPROACH TO THE MODEL LAW

- *Varendyam Jahnawi Tiwari*[*]

ABSTRACT

The Insolvency and Bankruptcy Code, 2016 (hereinafter "IBC" or the "Code") is the extant law dealing with insolvency in India. While it may seem that by not addressing the issue of cross-border insolvency the Code's efficacy may be questioned because it may not provide an immediate solution in cases of cross-border insolvency which involve the claims of the Indian corporations against the defaulting firms situated globally or the claims of financial persons situated globally having claims against the Indian firms. But, the stance that first, the domestic insolvency regime must prove effective to meet the challenges of time is also the other side which should not be ignored.

The present paper aims to delineate the important provisions of the UNCITRAL Model Law on Cross-Border Insolvency along with a study of a comparative approach of the United States, the United Kingdom, and Singapore which have adopted the Model Law in the year 2005, 2006, and 2017 respectively. The paper also critically analyses the Sections 234 and Section 235 of the IBC. Whether the adoption of the Model Law or

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ratifying an International Convention (yet to develop) is the road ahead for India or, altogether there can be the third approach is the cardinal focal point of the paper.

The central question of the paper is the solution that India may adhere to while addressing the need of incorporating provisions that deal with cross-border insolvency given the need of doing so in the near future due to increased foreign trade and investment and for the ease of doing business in India. The research paper does not focus on questioning the efficacy of the Code in the absence of the Cross-border insolvency, it rather suggests the recommendations that India can be mindful of while incorporating provisions dealing with the cross-border insolvency.

1. INTRODUCTION

The current legislation dealing with insolvency in India is a reflection of the effort of the Bankruptcy Law Reforms Committee which was constituted to study the legal framework of the corporate insolvency in India. The committee undertook the arduous task of not only examining the then existing legal framework for corporate insolvency and to suggest reforms but also to develop a unified legislative Code for both the individual and corporate insolvency in India. The Indian law derives its inspiration primarily from the UK Insolvency Act and from the precedents laid down by the Judges who have contributed to the field by developing and evolving the jurisprudence on questions not envisioned by the lawmakers. The increase in foreign investments in India, the rapid collapse of the corporations, the need of an effective restructuring mechanism for viable entities along with challenges posed by the availability of various adjudicatory forums in India with none being effective enough acted like thrust factor for paving way for the much-needed legislation, in the form of a unified Code. IBC is an assimilated code unifying the different legal regimes dealing with insolvency in India. It covers within its sphere both personal as well as corporate insolvency.

Also, it is pertinent to note the difference between the terms ‘Insolvency’ and ‘Bankruptcy’ as the IBC does not define the term insolvency, so as to know what shall come within the scope of the term but it defines bankruptcy in Section 79(4) as the state of being bankrupt. In other words, being adjudged as an undischarged insolvent. Also, one may look at the literal definition of the two for layman understanding. While insolvency means the stage at which the liabilities of the debtors exceed his assets so as to render him unable to pay his debts, bankruptcy is the judicial determination of the fact of the insolvency of the debtor. In the U.S, insolvency by a corporation is described as bankruptcy while it is so for only individuals in the UK. The insolvency legal regime also differs in the sense that while U.S Bankruptcy Code 1978 is more debtor-oriented as it focuses on effective reorganisation so as to help the viable entity remain as a going concern, the UK Insolvency Act 1986 is more creditor-oriented in the sense that it encourages untimely early liquidation of the corporation so as to satisfy the claims of the creditors.[1] However, the modern approach in the UK insolvency is also one which has developed the rescue-culture for the viable entities. Also, the term 'insolvent' has not been defined in the Code. IBC is an act to consolidate and amend the laws relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximization of the value of assets of such persons.[2] Insolvency law is remedial in nature and is intended to be interpreted in a widest possible manner and it needs to be construed liberally. On one hand, it deals strictly with the debtor in prohibiting him from disposing his property and assets and even goes to the extent of imposing heavy penalties, on the other hand, in case of fraud or non-compliance of the provisions enshrined in the Act it also saves him from disconcertment and his assets from being dismembered for otherwise than in the best interest of the creditors and for the business reorganization.[3]

The IBC also does not address one major issue that is of the 'Cross-Border Insolvency', which primarily involves the claims of the Indian firms in respect to the defaulting firms or corporations which are situated globally or financial persons situated globally having claims against the Indian defaulting companies.

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[1] Julian Franks & Walter Torous, *Lessons From a Comparison of US And UK Insolvency Codes*, 8 OXFORD REV. OF ECON. POL'Y 70 (1992).
[2] *See* Insolvency & Bankruptcy Code, 2016, preamble.
[3] VINOD KOTHARI & SHIKHA BANSAL, LAW RELATING TO INSOLVENCY AND BANKRUPTCY CODE (2016).

2. CROSS-BORDER INSOLVENCY: AN INDIAN PERSPECTIVE

In the BLRC Interim Report, the committee said that while it realizes the importance of addressing the issue of cross-border insolvency given the increase in foreign investments in India, the adoption of UNCITRAL Model Law on Cross-Border Insolvency should ideally take place only after the adoption of the Insolvency Code. The reason forwarded for this was the belief of the committee in the fact that the effectiveness of a cross-border insolvency regime is heavily grounded on the potency of the domestic insolvency regime. It has also mentioned addressing the issue in the final report of the BLRC ("Final Report"). In the Final Report, it was mentioned that the first milepost to be achieved by India is the comprehensive solution to the domestic insolvency issues and to treat the cross-border insolvency to be achieved as the next frontier.

'Cross-border insolvency' includes addressing the claims of the Indian corporations in respect to the defaulting firms or corporations which are situated globally or financial persons situated globally having claims against the Indian defaulting corporations.[4] Although the Final Report dealt with the facet of insolvency in respect to foreign holders of corporate bonds issued in India or borrowing abroad by an Indian firm, it did not address other issues like Indian investors lending to persons situated overseas and the committee proposed to take up the issue in its next deliberation.

[4] B.L.R.C. FINAL REPORT (2015) [hereinafter Final Report].

In 1999, the Eradi Committee recommended the inclusion or incorporation of the UNCITRAL Model Law as a schedule to the Companies Act, 1956, however, this did not lead to any development on the cross-border insolvency front. Therefore, the present status is that, if a foreign firm is undergoing insolvency resolution outside India, its Indian business will be treated as distinct and separate, and will not be affected automatically unless an application is filed before the Adjudicating authority for winding up its branches in India, and hence there would be a need for coordination and cooperation between the courts situated in different jurisdictions to curb this issue of distinct treatment and to provide effective remedy. The adoption of the Model Law without modifications may prove to be a boon for India as it will help India to promote and facilitate international trade, increase in foreign investments, and better access to foreign courts for redressal of cross-border insolvency issues and to meet the challenges posed to the economy due to globalization. Nevertheless, this requires a lot of analysis. A blind and hasty approach at this stage is not appreciated. So far 43 States in a total of 45 jurisdictions have framed their legislations based on the Model Law dealing with the issue. Although there is recognition given to foreign judgments and foreign decrees of some reciprocating jurisdictions, such as the UK and Singapore as enshrined in Section 13 and 44A of the Code of Civil Procedure, 1908, there is none given to foreign insolvency proceedings.

The two pertinent sections of the IBC that show a tinge of the Cross-border insolvency essence are, Sections. 234 and 235. Section 234 talks about the power of the Central Government to enter into agreements with the government of other jurisdictions (with which there are reciprocal arrangements) and also to specify conditions to be applicable in the administration of assets or property of the debtor situated outside India. Section 235 emphasizes on the role of the Adjudicating Authority (*i.e.* the NCLT) in issuing a letter of request to a foreign court or competent authority (situated in a country with which reciprocal arrangements are existing) for proof that the assets of a debtor/corporate debtor are situated outside, if required for any evidence or action relating to such assets in the insolvency resolution, liquidation or bankruptcy proceedings by the insolvency professional, the liquidator and the bankruptcy trustee.

3. CROSS-BORDER INSOLVENCY AND THE UNCITRAL MODEL LAW

3.1. MEANING OF THE TERM 'CROSS-BORDER INSOLVENCY'

According to the Model Law, a 'cross-border insolvency' is one where the insolvent debtor has assets in more than one states or where some of the creditors of the debtor are not from the State where the insolvency proceeding is taking place. The Model Law is designed to foster the enacting States to endow their insolvency regime with a modern legal framework to more effectually deal with the cross-border insolvency proceedings involving debtors undergoing severe financial tribulation or insolvency. It focuses on authorizing and encouraging cooperation and coordination between jurisdictions, rather than attempting the unification or harmonization of various state-specific, substantive insolvency law respecting the procedural differences therein.

3.2. THE OBJECTIVES OF THE UNCITRAL MODEL LAW[5]

The objectives of the Model Law, as enumerated in the Preamble are as follows-

- Cooperation between the courts and other competent authorities and foreign States involved in cases of cross-border insolvency,
- Greater legal certainty for trade and investment,
- Fair and efficient administration of cross-border insolvencies that protects the interests of all creditors and other interested persons, including the debtor,
- Protection and maximization of the value of the debtor's assets and
- Facilitation of the rescue of financially troubled businesses, thereby protecting investment and preserving employment.

3.3. THE MAIN FEATURES OF THE UNCITRAL MODEL LAW

The main features of the Model Law are[6]:

- **Access**: Representatives of foreign insolvency proceedings and creditors have a right of access to the courts to seek assistance and to authorize representatives of local proceedings to seek assistance elsewhere.

[5] U.N. Comm'n on Int'l Trade Law (UNCITRAL), *Model Law*.
[6] *Id.*

- **Recognition:** Simplified procedures for recognition of qualifying foreign proceedings and appointing the foreign representative. A qualifying foreign proceeding is either the main proceeding, taking place where the debtor had its centre of main interests- "COMI", or a non-main proceeding, taking place where the debtor has an establishment. This has an effect on the relief accorded to assist the foreign proceeding.
- **Relief**: Includes an interim relief at the discretion of the court; which may be in the form of an automatic stay upon recognition of main proceedings.
- **Cooperation and coordination**: Cooperation among the courts of States where the debtor's assets are located and coordination of concurrent proceedings concerning that debtor.

3.4. SOME HIGHLIGHTS OF THE UNCITRAL MODEL LAW[7]:

A foreign proceeding should be recognized as either the main proceeding or a non-main proceeding (article 17, paragraph 2). The main proceeding is one taking place where the debtor had its centre of main interests (COMI) at the date of commencement of the foreign proceeding. In principle, the main proceeding is expected to have principal responsibility for managing the insolvency of the debtor regardless of the number of States in which the debtor has assets and creditors, subject to appropriate coordination procedures to accommodate local needs. Centre

[7] *Id.*

of main interests is not defined in the Model Law but is based on a presumption that, it is the registered office or habitual residence of the debtor (article 16, paragraph 3).

A non-main proceeding is one taking place where the debtor has an establishment. This is defined as “any place of operation where the debtor carries out non-transitory economic activity with human means and goods or services” (article 2, subparagraph (f)). Proceedings commenced on a different basis, such as the presence of assets without a centre of main interests or establishment, would not qualify for recognition under the Model Law scheme.

If foreign insolvency proceedings are recognised (in an enacting State) as main proceedings, Article 20 of the Model Law automatically affords the following relief:

- A stay over commencement or continuation of individual proceedings concerning the debtor’s assets, rights, obligations or liabilities in the enacting State in which the foreign insolvency proceedings have been recognised;
- A stay over any type of execution against the debtor’s assets in the enacting State in which the foreign insolvency proceedings have been recognised; and
- A suspension of the debtor’s rights to transfer, encumber or otherwise dispose of any assets.

4. A COMPARATIVE PERSPECTIVE- THE U.K., U.S. AND SINGAPORE

4.1. UNITED KINGDOM:

In Great Britain, the Model Law was adopted in the year 2006. The regulatory framework in the English law comprises of:

- The EC Regulation on Insolvency Proceedings;
- The Cross-Border Insolvency Regulations, 2006; and
- Section 426, Insolvency Act, 1986.

Under Section 426 of the UK Insolvency Act, 1986 the designated countries like Australia etc. can ask the courts in U.K. to seek help in insolvency proceedings through a letter of request. Though the power is discretionary, it has to be applied rationally by the courts and unless there is a strong ground for a departure the Courts, as a general rule must provide the aid requested for.[8] Main proceedings in U.K. are intended to mean a proceeding that has a universal scope and encompasses all of the debtor's assets, wherever situated. If the debtor has an "establishment" in one Member State but its centre of main interests in a different Member State, ancillary insolvency proceedings can be opened in the Member State where the debtor has an establishment. If they are opened after the main proceedings, they are called "secondary proceedings", and if they are opened before the main proceedings, they are called "territorial proceedings".

[8] England v Smith, Ch. 419 (2001); *In Re*, HIH Casualty & Gen. Insurance Ltd., 1 W.L.R. 852 (2008).

4.2. UNITED STATES

The Model Law has been incorporated in Chapter 15 of the U.S. Bankruptcy Code.

The US bankruptcy court had to determine whether a particular foreign proceeding was main or non-main. The court noted the fact that Chapter 15 did not define COMI, the court examined the definition in light of the EU regulations (originator of the COMI concept). The US court stated the proceeding in the country where the debtor had its principal or registered office and primary concentration of its employees was the COMI of the debtor.[9] Similarly, in another case,[10] the US bankruptcy court accepted the finding and judgment of the Irish Supreme Court[11]on COMI and held that the presumption that a debtor's COMI is in the location of its registered office is a rebuttable presumption. A company may not be carrying on business in the jurisdiction in which its registered office is located, for example, as in the case of a 'letterbox' company.

4.3. SINGAPORE

Singapore adopted the model law recently in the year 2017. The Singapore law treats recognition as a mere formality and if the foreign-representative makes an application in the proper format, foreign insolvency proceedings will be mandatorily recognized. Under the Model Law, a foreign representative can apply to the Singapore High Court for

[9] *In re,* Tri-Continental Exchange Ltd., 349 B.R. 627.
[10] *In re,* SPhinX Ltd., 351 B.R. 103.
[11] *In* re, Eurofood IFSC Ltd., 2006 E.C.J. (C-341/04).

recognition of foreign insolvency proceedings. The application must be accompanied by (a) a certified copy of the decision commencing the foreign insolvency proceedings and appointing the foreign representative, and (b) a statement identifying all insolvency proceedings in respect of the debtor that are known to the foreign representative.

The Model Law has been adopted in Singapore with a notion to make Singapore the COMI for the businesses so as to lead to an increase in foreign investments in the country, and because Singapore seeks to become a hub for the insolvency administration and restructuring; thereby intending to reduce the cost incurred in the administration of insolvency proceedings and to increase asset recovery for creditors.

5. SOLUTION FOR INDIA: CROSS-BORDER INSOLVENCY

Now we have the Insolvency and Bankruptcy Code 2016 that is dealing with corporate insolvency resolution process since December 2016, is developing the needed jurisprudence through the recently dealt cases and would continue to do so.[12] It is almost going to be a year to the legislation and it is evident that the Courts have a significant role to play in giving the right interpretation to the provisions of the Code whenever

[12] ICICI v. Innoventive Indus., 82 taxmann.com 190/142 S.C.L. 119 (2017); Nikhil Mehta (HUF) v. AMR Infra. Ltd., C.P. No. (ISB)-03(PB)/2017; Vinod Awasthy v. AMR Infra. Ltd., C.P. No. (IB)-10(PB)/2017; Mukesh Kumar v. AMR Infra. Ltd., C.P. No. (IB)-30(PB)/2017; Sajive Kanwar v. AMR Infra. Ltd., C.P. No. 06/2017; Pawan Dubey v. J.B.K. Developers, C.P. No. (IB)-19(PB)/2017; Satish Mittal v. Ozone Builders & Developers, C.P No. (IB)-66(PB)/2017; Kirusa Software Pvt. Ltd. v. Mobilox Innovations Pvt. Ltd., Company Appeal (AT) (Ins) No. 6 of 2017; JK Jute Mills v. Surendra Trading Co., Company Appeals (AT) (Ins) No. 9 of 2017.

there is a scope for the judicial interpretation. The Code is a commendable effort to develop the right jurisprudence for dealing with the insolvency in India or the domestic issues and would take some time to achieve the landmarks the Code has attempted to achieve.

Nevertheless, when legislators further take a step to incorporate a cross-border insolvency they would need to be mindful of the fact that even the countries that have adopted the Model Law with or without modifications have faced issues of cooperation and coordination and it has not been a been a very serene zone to operate in for the States because of the differences in the regional and national insolvency regimes and that the States have adopted the Model Law only in rudimentary way and not completely.

The question is, whether the solution lies in the form of adopting the Model Law completely or that India should wait for an International Convention to be developed on Insolvency. While mostly Model Laws aimed at the unification of the laws at the national level a convention may provide the necessary mechanism needed for ensuring international judicial and administrative cooperation in cases of cross-border insolvency. Since the Model law does not address concerns about the corporate groups- an international convention seems to be the solution to resolve the issue since in the cases of insolvency many contracting states may be involved. Model Law aims at incorporating a particular law with or without modifications in the domestic insolvency regimes and serves as guidance for the States. An international convention would bridge the difference in the national legal landscape thereby ensuring cooperation and coordination in cross-border judicial and administrative setup.

An international convention may receive polar views due to its non-flexibility, one that favors it because of the binding nature and other that stands against it as many States would be reluctant to adopt the same due to its rigidity, as a convention cannot be adopted with suitable modifications though there may be reservations. On the contrary, the Model Law allows the scope for the same. So, it may seem that a convention may help but it cannot be said with certainty until there is reciprocity element in the Convention and that the States agree to such a move; otherwise it would be nothing more than an effort on paper and the problem of cooperation and coordination would continue to persist.

Also, while it is difficult to incorporate many provisions of the Model Law into the domestic legal systems, owing to cardinal differences between the two, a convention takes care of this issue by leaving very less scope for the States to deviate from the provisions, howsoever distinct it may be from their national insolvency legal regime; except in very exceptional circumstances. Thus, the binding nature of the convention helps in solving many prospective disputes on issues of enforceability and cooperation between nations. The convention may be helpful in determining certain protocols regarding the choice of law, dispute resolution mechanism, and determination of jurisdictional competencies in context to main and non-main insolvency proceedings. A convention may, apart from aiding better access to foreign courts and providing recognition to foreign proceedings, may also help to overcome the trust issues that there shall be any kind of discrimination by the foreign courts in treating different nations.

6. RECOMMENDATIONS

The opinion and views on what is good for India- adoption of the Model Law or to wait for an International Convention on Insolvency Law; is a subjective one. The author believes that it is better to wait for experiences of the nations to be gathered and more jurisprudence to develop on the domestic front for India, given the fact that the legislation (IBC) is a new and developing one. It still needs substantial time for enough jurisprudence to evolve in the area so as to interpret the Code in the right way. An integrated Code striving to achieve insolvency resolution in a time-bound manner is itself a big challenge for the Adjudicating authorities, and for everything to fall in place and function in order time is a crucial factor.

Recently, India witnessed an improvement in its rank from 130thto 100th out of a survey of 190 countries with respect to “Report on Ease of Doing Business_by World Bank Group”. One of the notable steps which led to this significant achievement was the introduction of the ‘IBC, 2016’, which ensures time-bound insolvency resolution while ensuring the maximum return to creditors and easy exit, reorganization, revival, and liquidation for the defaulting business. The Act suggests better recourse to banks as financial creditors and to deal with the Non-Performing Assets

(NPAs) more efficiently. Hence, the Code's efficacy is of paramount importance in respect to "Ease of Doing Business in India" so that there is more security to investors who intend to invest in India or have already invested. Recently the IBBI Chief M.S Sahoo announced that India is now heading towards developing a framework for Cross-Border Insolvency so as to make India an appealable terminus for the foreign creditors. Not only this, but a more predictable cross-border insolvency regime would help the banks as financial creditors to access overseas assets of a corporate undergoing resolution process. As per the Draft Chapter on Cross-Border Insolvency, on which comments and opinions were invited, it has made an endeavor to resolve two main pertinent issues. Firstly, since moratorium does not stop the foreign creditors from filing suits in foreign courts and because the foreign court would not recognize the restructuring plan approved by NCLT i.e. the Adjudicating Authority, there is an urgent need to have a legal regime dealing with such situations where the Central Government can have agreements with other foreign jurisdictions, so as to bring overseas assets of a domestic corporate debtor for IRP in India. Secondly, because even the NCLT in India might face procedural and other issues in implementing or recognizing order or decree of a foreign court, hence the cooperation between the jurisdictions for implementing the law on Cross-Border Insolvency becomes inevitable amongst jurisdictions. The Draft Chapter shall also ensure cooperation with foreign creditors to initiate IRP (Insolvency Resolution Process) against local corporate debtors. This move will instill more confidence in foreign investors hence will ensure enhanced investment and further better ranking in "Ease of Doing Business"; especially if India is aiming to be in top 50 by the next year. This will also ensure more economic growth in the country given its capabilities to enhance boost in trade with India by making it more rhythmic and placid.

Hasty legislation is not needed for India. Hence, it is good that IBC as of now does not deal with the cross-border insolvency and would wait for the domestic front to be strong and effective first. This will also provide sufficient time to the legislators to discuss and deliberate keeping in mind the issues faced by countries adopting the Model Law so that whatever be the next step of India whether adoption of the Model Law or ratifying an International Convention, it is going to be a well thought of step and not a brisk approach. Even if India adopts the Model Law it can adapt it with such modifications which may help India to curb the issues faced by other countries and in a manner so as to best suit its adaptability. So far, India not adopting the Model Law blindly, is, in the author's opinion, the right step for the time being. India is not lagging behind because it has not adopted the Model Law so far but it may have a better vision, a foresightedness to adopt the same or have altogether a new approach depending upon the needs of the country. It will also help to take care of the global panorama more effectively through the international and the domestic jurisprudence evolved over time, addressing in more effectuate manner the issues that other nations have faced in respect to cross-border insolvency. A hasty legislation or a less deliberated approach to deal with an issue is more open to criticism than the good it does.

SELECTIVE LITIGATION: THE TRUE PURPOSE OF I.B.C. MORATORIUM

Srijan Jha[*]

ABSTRACT

Since its entry in the field of insolvency resolution, moratorium has been a hot topic for discussion. The essential requirement is to know and be able to ascertain the right time within which the fiscal health of the concern could be decided and the optimal outcome for all could be achieved.

The paper briefly discusses the considerations that have been there since 1909, when the first Insolvency Act in India came into force. An understanding of how things stood and how they are today is indispensable for scrutiny of all the constructs. This discussion has been further augmented by the English practice of moratorium stays.

This paper at its core enquires into the nature of Section 14 of the Insolvency and Bankruptcy Code, 2016 in the light of recent decisions of the Supreme Court, various High Courts, and the National Company Law Tribunal, owing to the recent decisions of the N.C.L.T., High Courts and Supreme Court. This papers attempts to find the balance between the overriding interpretation of I.B.C. moratorium and a more moderated consideration of other references, such as the Sick Industrial Companies

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(Special Provisions) Act, 1985 and Banking Regulation Act, 1949. This question is more about dispute resolution than about the litigation.

1. INTRODUCTION

A main aim of an insolvency law is to reorganize a legal regime in which creditors' rights and remedies are suspended and to establish a process for the orderly collection and realization of the debtor's assets and the fair use of such assets according to creditor's claims.[1]

Insolvency and Bankruptcy Code, 2016 (hereby, IBC) was enacted to not just consolidate the scattered insolvency procedures, but also to encourage speedy resolution, and to provide the requisite support to the National Company Law Tribunal (NCLT), and create functionaries like Insolvency Professionals (IPs), Information Utilities (IUs), and Insolvency Resolution Professional Agencies (IPAs)[2], to support the functioning of the N.C.L.T. Unlike its predecessors, the central objective of this act is to reorganize the entities in debt and not to recognize the defaulters.

The crux of this written piece is the well-talked point of moratorium provided under the I.B.C. The basic consideration of moratoria earlier in the country was dominated by a distribution of powers to continue litigation in different fora. The I.B.C moratorium, on the other hand, has

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[1] VANESSA FINCH, CORPORATE INSOLVENCY LAW: PERSPECTIVES AND PRINCIPLES 7 (2002).

[2] Shishir Mehta et al., *The Insolvency and Bankruptcy Code, 2016 — New Road and New Challenges*, MONDAQ (May 26, 2016), http://www.mondaq.com/india/x/495202/Insolvency+Bankruptcy/The+Insolvency+And+Bankruptcy+Code+2016+New+Road+And+New+Challenges.

been read to be overriding of all other provisions that can settle the non-payment of credit.

There are also mentions of English moratoriums and pre-IBC moratoriums, so as to further enable us to clearly see the advancement and changes that have been brought. Under the head of 'Pre-IBC Moratoriums' there is an analysis of all the moratoriums and their scope, that were incorporated before I.B.C. came into force.

The object of the paper is to discuss Section 14 of the I.B.C. which provides for moratorium, its scope and procedure. The consideration of what moratorium can override and what it shall not is dealt in detail. These discussions have been the mirrors to the judicial pronouncements we have had in the previous one and a half years, and they provide concisely of all the case laws that have shaped the insolvency resolution in India.

2. ESSENCE OF MORATORIUM IN INSOLVENCY LAW

Moratorium exists to focus on the interests of unsecured creditors and of the company itself rather than those of a specific secured creditor.[3] The Black's Law Dictionary defines moratorium as "an authorized postponement, a lengthy one, in the deadline for paying a debt or performing an obligation".[4]

It was never the purpose of moratorium that a company in an insolvent position should be allowed to continue its operation under the protection

[3] DAVID POLLARD, CORPORATE INSOLVENCY: EMPLOYMENT AND PENSION RIGHTS 17 (2d ed. 2000).
[4] *Moratorium*, BLACK'S LAW DICTIONARY (9th ed. 2009).

of the court, and that those who had dealings with the company should be prevented under the orders of the courts from seeking legal remedies to which they would be otherwise entitled.[5]

The purpose is to ascertain the truth, in any colour: whether there is a chance for revival or the creditors need to get their fair share as liquidation is inevitable. Insolvency mechanisms such as the United Kingdom (henceforth, U.K.) Insolvency regime have been enacted in order to achieve various end results including breathing space to attempt company rescue actions, such as restructuring.[6] This breathing space is defined by various names, such as 'moratorium' or 'stay' or administrative action to halt the other proceedings. The same is a very important aspect of all insolvency proceedings. This breathing space allows the adjudicatory bodies the time to ascertain the truth.

3. INSOLVENCY MORATORIUM IN ENGLAND

The U.K. Insolvency Act came into force in the year 1986, and it changed the contours of individual insolvency applications.[7] This legislation was partly overruled by the Insolvency Act, 2000 in U.K., and the both of these together control the insolvency regime in U.K. Schedule 1 of this Insolvency Act, 2000 provides for 'eligible companies' and only these eligible companies had the power to obtain moratorium, *de jure*

[5] M.L. TANNAN, BANKING LAW & PRACTICE IN INDIA 253 (C.R. Dutta & S.K. Kataria eds., 2015).
[6] *supra* note 4.
[7] JOHN PAGET, PAGET'S LAW OF BANKING 201 (Mark Hapgood ed., 2004).

them being the creditors. There are some other conditions too, to qualify for being ‘eligible companies’, provided in Section 247 of Companies Act, 1985 of England.

The real question is to answer the force this moratorium has. Once the debtor is under the moratorium period, there is a strain on the creditors, and all these creditors can seek various avenues to corner the debtor, for example, winding up petitions, contractual claims, arbitral proceedings, etc. Usually, the courts in England refuse the admission of winding up claims when the moratorium is in force.[8] However, the UK legislation gives the adjudicators power to consider cases individually and in cases where there is a necessity, no legal proceedings may be commenced or continued against the company except with the leave of the court or administrator.[9]

The moratorium cannot be side-lined due to factors such as, administrative orders or the action on the grounds of non-payment of rent, initiated by the landlord[10]; this setting is to make sure that the defaulter or the debtor gets the space to support his business to the greatest extent possible. Such non-payment to institutionalized bodies such as banks hinders the day to day life[11] and credit maintenance system. Yet, the moratorium is given importance for the sole reason of its temporary nature and the rights reinstated if the rescue of the debtor is successful, so that

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[8] *In Re* Piccadily Prop. Mgmt. Ltd. [1999] 2 B.C.L.C. 145.
[9] Insolvency Act, 1986, c. 45, § 11(3) (d) (Eng.).
[10] Insolvency Act, 2000, c. 39, sch. A1 (Eng.).
[11] *supra* note 8, at 203.

nothing is lost[12]. The English law however does provide moratorium to be observed over foreign companies under the domestic company law.[13]

4. INSOLVENCY MORATORIUM IN INDIA (PRE-IBC)

There have been various legislations that provided for stays, come the time for debt realization. The first of such moratoriums were the ones under the Provincial Insolvency Act, 1920 (henceforth PIA) and Presidency Towns Insolvency Act, 1909 (henceforth PTIA). PIA and PTIA have been repealed now.[14] The PIA and PTIA moratoriums were for individual businesses and entities and categorically ousted corporations and banks[15], For these, reliance was directed to be placed on the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 (henceforth SARFAESI)[16].

Under PIA, Section 29 stated that, any court in which a suit or other proceeding is pending against a debtor shall, on proof that an order of adjudication has been made against him under this Act, either stay the proceedings, or allow it to continue on such terms as the Court may impose. There was a distinction in the adjudicating authorities, *i.e.* the Insolvency Court had the power to question the validity or otherwise of security of the secured credit, and the Insolvency Court's order shall be

[12] Philip R. Wood, *Principles of International Insolvency* [Part II], 4 INT'L INSOL. REV. 109 (1995).
[13] *In Re* Int'l Bulk Commodities [1993] Ch. 77; *In Re* Dalhold Estates (U.K.) [1992] B.C.C. 394.
[14] Insolvency and Bankruptcy Code, 2016, No. 31, Acts of Parliament, 2016.
[15] Nagendra Jain v. District Judge, Moradabad, (2001) 44 A.L.R. 243 (All.).
[16] I.O.B. v. Popuri Veriach, A.I.R. 2009 A.P. 170.

binding on him, and shall be final and implicative of *res judicata*.[17] The PIA, however, did not empower the Insolvency Court to stay pending litigation, but the Court can issue injunction if circumstances enumerated in Order 39 Rule 6 of C.P.C. are proved to exist, or it can pass an order in the exercise of its jurisdiction on the analogy of Section 94 of the PTIA.[18] On the other hand, the PTIA was restricted only to the entries that arose in the Presidency Towns. Section 18 of the PTIA provided for the stay of proceedings and Section 18A provides for control over Insolvency Proceedings.

These two are the first such provisions. However, following are the other laws which have provided for moratorium or like provisions:

4.1. SICK INDUSTRIAL COMPANIES (SPECIAL PROVISIONS) ACT, 1985

The prime objective of the Sick Industrial Companies (Special Provisions) Act, 1985 (henceforth SICA) was the timely detection of sick or potentially sick companies owning industrial undertakings, and their speedy revival, wherever possible, or closure thereof.[19]

Section 22 of SICA provided for moratorium, and once this moratorium is in operation no court or authority can proceed by

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[17] S.B. MALIK, S KRISHNAMURTHY AIYAR'S LAW OF INSOLVENCY 49 (7th ed. 2013).
[18] *Id.* at 58.
[19] *Sick Industrial Companies (Special Provisions) Act, 1985 repealed and BIFR/ AIFR dissolved*, PWC INDIA, https://www.pwc.in/assets/pdfs/news-alert-tax/2016/pwc_news_alert_1_december_2016_sick_industrial_companies_act_1985_repealed_and_bifr-aifr_dissolved.pdf.

disregarding the mandates of the provisions.[20] Going by the name of 'Suspension of legal proceedings, contracts, etc.', Section 22 extensively covered legal proceedings, such as enquiries[21], schemes[22], and appeal[23] to be stayed till the time the board resolves the dispute of the survivable characteristic of the sick industrial company, overriding the M.O.A., A.O.A., and the Companies Act itself.

Based on the circumstances of each case under the SICA regime, the courts carved out exceptions to Section 22 of SICA. For example, in *Shree Chamundi Mopeds Ltd. v. Church of South India Trust Association*,[24] the Supreme Court said that Section 22 of SICA does not limit the prosecution of eviction proceedings filed against a sick company, when the sick company is a tenant, making the tenancy distinct from proprietary rights. Similarly, in the case of *BSI Ltd. v. Gift Holdings Pvt. Ltd.*,[25] the Supreme Court held that proceedings under Section 138 of the Negotiable Instrument Act, 1881 had no correlation to Section 22 of SICA and still the moratorium shall be respected. Section 22 of SICA provided immunity from proceedings not under Section 138 of the Negotiable Instruments Act

[20] Madura Coats Ltd. v. Modi Rubber Ltd., (2016) 197 Comp. Cas. 216 (S.C.); Rishabh Agro Indus. v. P.N.B. Capital Services, (2000) 5 S.C.C. 515.
[21] Sick Industrial Companies (Special Provisions) Act, 1985, No. 1, Acts of Parliament, 1986, § 16.
[22] *Id.* § 17 & 18.
[23] *Id.* § 25.
[24] Shree Chamundi Mopeds Ltd. v. Church of South India Trust Ass'n, A.I.R. 1992 S.C. 1439.
[25] BSI Ltd. v. Gift Holdings Pvt. Ltd., (2000) 2 S.C.C. 737.

only but also under all the sections of I.P.C.[26] Further, even the suit for eviction by a landlord of a sick company was not attracted under SICA's moratorium.[27]

The SICA regime gave the secured creditor some security as Section 28(6) of SICA leaves the secured creditor quite independent of the insolvency proceedings and gives freedom to choose his own remedy in realizing or otherwise dealing with his security.[28] Section 33 of SICA in a way, imposed serious restrictions on the rights of third parties against the filing of suits for taking coercive action against the industrial sick company,[29] as the same runs at the risk of criminally inflicting the complainant himself, if the allegation is not proved beyond reasonable doubt.

The general principle of law is that when there are two non-obstante clauses in two different statutes then the later non-obstante clause shall prevail, but since the SICA has a higher mandate to fulfil and Arbitration and Conciliation Act, 1996 is a general statute, the SICA moratorium was read over the Arbitral proceedings and award.[30] This is one of the few forward looking judgments that widened the scope of SICA moratorium.

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[26] VINOD KOTHARI & SHIKHA BANSAL, LAW RELATING TO INSOLVENCY AND BANKRUPTCY CODE, 2016 176 (2016).
[27] Sidramappa Abdulpurkar v. Lakshmi Vishnu Textiles, (2010) 5 Com. Cases 86.
[28] *supra* note 20, at 48.
[29] *supra* note 6, at 2807.
[30] Morgan Securities & Credit Pvt. Ltd. v. Modi Rubber Ltd., (2007) 136 Comp. Cas. 113 (S.C.); Jay Engineering Works v. Indus. Facilitation Council, (2006) 133 Comp. Cas. 670 (S.C.).

SICA has now been repealed. Such repeal was initiated under the Sick Industrial Companies (Special Provisions) Repeal Act, 2003, and the final notification[31] on the repeal came on November 25, 2016; strategically before the implementation of IBC.

4.2. BANKING MORATORIUM

Other kinds of moratorium include the banking moratorium, as has been specified in sections 37 and 45 of the Banking Regulation Act, 1949.

Section 45 provides power to order moratorium or reconstruction of the banking companies in the hands of the Central Government after an application is sent to the R.B.I. Since R.B.I. controls the banking ratios, such as C.R.R., Bank Rate and S.L.R. and plays the role of banker to the banks, it has in its knowledge the fiscal health and debts that the banks may have. Hence the task of determining and evaluating the bank's financial standing can be best done by R.B.I.

Non-payment of a debt of a bank is a bigger issue than that of another person under the I.B.C., and the same can impose a moratorium. Once a moratorium comes in force there are but only two ways forward. The first is, temporary proceedings under Section 37 of the Banking Regulation Act which leads to suspension of business. The other way is permanent, and has been provided under Section 38 (1), which leads to winding up of the

[31] http://www.egazette.nic.in/WriteReadData/2016/172799.pdf.

banking company.[32] Even if a banking company goes into the moratorium period, the question of winding up can still be sought.[33]

Section 35 provides for the suspension of business in the condition where, a "banking company is temporarily unable to meet its obligation".[34] Only High Court can pass any such orders or decisions in its wisdom, which contravenes this moratorium, which however does not extend to the writ jurisdiction of a High Court,[35] as a High Court under a writ can only look if the principles of law, reasonableness, and natural justice have not been followed or not.[36]

5. THE IBC MORATORIUM

IBC is not merely for insolvency proceedings, but it needs to address the restructuring needs at the appropriate time as well. The previous legislation, *i.e.* SICA had a myopic approach to this concept, as its definition of sickness was not in conformity to its preamble, even though both of the legislations' moratorium provisions had the same objective.[37] The SICA definition gives too much time to the adjudicating authorities, and requires at least a five-year prior registration of the debtor to qualify as sick. Because of this construct, there was no timely recognition of sick industries, making the restructuring difficult. There were other problems

[32] *In Re* Chotanagpur Banking Ass'n, (1959) 29 Com. Cases. 487.
[33] Matashri Khodiyarana Makhamakha v. State of Saurashtra, (1956) 26 Com. Cases 262 (Sau.).
[34] *supra* note 6, at 251.
[35] *supra* note 6, at 252.
[36] Maa Mangala Construction v. Indian Oil, (2002) 1 B.C. 390 (Del.).
[37] *supra* note 30, at 175.

with the SICA definitions as well, like they are 'backward' looking, were based on the historical book value of a firm's assets and not future earning potential or current realizable market value. The negative net worth criterion simply implies that the historical value of a company's assets is less than its cumulative liabilities.[38] Hence, the restructuring needs were incorporated under the IBC definition of 'default' under Section 3(12) of the IBC. Now, the purpose is not acknowledging the sick entities, but conducting insolvency "in a time-bound manner for maximization of value of assets of such persons, to promote entrepreneurship, availability of credit, and balance the interests of all the stakeholders".

Section 14 of IBC provides that on the insolvency commencement date, the Adjudicating Authority shall by order declare moratorium for prohibiting all of the following namely the institution of suits or continuation of pending suits or proceedings against the corporate debtor including execution of any judgment, decree or order in any court of law, tribunal, arbitration panel, or other authority.[39]

Section 14 of the IBC provides for moratorium, where the adjudicating authority is given only the facilitating powers, and the creditors decide the fate, if the business goes down the liquidator's path or continues

[38] REPORT OF COMM. ON INDUS. SICKNESS & CORPORATE RESTRUCTURING, *available at* http://reports.mca.gov.in/Reports/31-Goswami%20committee%20of%20the%20industriai%20sickness%20and%20corporate%20restructuring,%201993.pdf.

[39] Sanjeev Shriya v. State Bank of India, MANU/UP/2243/2017, ¶ 11.

operation.[40] The point of s.14 is to suspend all other proceedings and not dismiss[41], either way it is a bar on the creditors to sue the debtor.

S.12 of CPC reads as "Where a plaintiff is precluded by rules from instituting a further suit in respect of any particular cause of action, he shall not be entitled to institute a suit in respect of such cause of action in any Court to which this Code applies". Hence, Section 14 of the IBC is a subject related extension of the principle of 'Bar to initiate further suit' as provided in s.12 of the CPC.

The provision speaks of halting all legal proceedings, unless they do not contravene the following two points:

1. The supply of services be essential to the extent these services are not a direct input to the output produced/supplied by the corporate debtor
2. The mandate under Section 14(2) will come into operation only in respect of the services not terminated before declaration of moratorium under Section 14 of the Code.[42]

The cost of essential goods or services will have to be paid in priority to other costs as a part of solution plan or during distribution of assets, in case of the corporate debtor goes into liquidation.[43] The moratorium will continue to be in effect till the completion of the corporate insolvency

[40] *supra* note 30, at 172.
[41] *supra* note 30, at 184.
[42] 2017 S.C.C. OnLine N.C.L.T. 7180
[43] REPORT OF INSOLVENCY LAW COMM., March, 2018, ¶ 5.14, *available at* http://www.mca.gov.in/Ministry/pdf/ILRReport2603_03042018.pdf).

resolution process on the approval of a resolution plan by the adjudicating authority, or the resolution of the creditor's committee to liquidate the corporate debtor, whichever is earlier.[44]

Any action to disregard the moratorium period is punishable under Section 74 of the IBC. The punishments for debtor and creditor differ.

Now is the need to look into the legal actions that will be halted with the introduction of moratorium under IBC. These are institution and continuation of suits and proceedings, unsuitable action such as transferring and alienating of the assets by the debtor himself, and stay on any action to foreclosure, recover or enforce any security interest created by the corporate debtor in respect of its property including any action under SARFAESI.[45]

The definitions of suit and proceeding are taken in their general sense. Suit is only curial and refers to a non-criminal proceeding[46] and does not include execution proceedings for purposes of stay.[47] Proceedings can't be narrow and are very different from the word 'suit'.[48] The word proceeding is a term of wide amplitude, which includes procedural steps to be taken.[49] The word includes proceedings in a court of law and tribunal.[50]

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[44] *supra* note 30, at 171.
[45] *supra* note 30. at 181.
[46] B.S.I. India Ltd. v. Gift Holding Pvt. Ltd., Criminal Appeal No. 847 of 1999, Supreme Court of India; Kailash Nath Agarwal v. Pradeshiya Indus. & Inv. Cooperation of U.P., (2003) 4 S.C.C. 305.
[47] Madalsa Int'l Ltd v. Cent. Bank of India, (1999) 1 B.C. 333 (Bom.- D.B.).
[48] Maharashtra Tubes, 1993 (2) S.C.C. 144.
[49] Panda Leasing v. Hemant, (2005) 4 B.C. 52 (Ori.).
[50] Barar Indus. Ltd. v. Nagpur Engineering Co. (2008) 1 B.C. 1 227 (Ori.).

Another exception in the regard of essential goods and supply has been left totally in the hands of the Board defined under the IBC,[51] and the same has been defined in Regulation 32 of the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons). The list includes electricity, water, telecom services, and I.T. services.

5.1. THE PROCEDURE

With the admission of insolvency application, a moratorium in terms of Section 14 of IBC is declared by the adjudicating authority, which makes a public announcement about the same. Such announcement contains the last date for submission of claims and the details of the interim resolution professional. Section 17 of IBC vests the management aspects of the corporate debtor in the interim resolution professional, who manages the operations of the corporate debtor as a going concern under the directions of a committee of creditors appointed under Section 21 of IBC, heeding to the conditions which make a person ineligible to be a part of the committee of creditors.[52] Decisions by this committee are to be taken by a vote of not less than 75% of the voting share of the financial creditors, after considering its feasibility and viability according to the recommendations of the Insolvency and Bankruptcy Board of India. Under Section 28, the interim resolution professional is further given the power to carry out the resolution process, is given wide powers to raise finances,

[51] *supra* note 30 at 187.
[52] Insolvency & Bankruptcy Code, 2016, § 29 r/w Insolvency & Bankruptcy (Amendment) Act, 2017.

create security interests, etc., subject to prior approval of the committee of creditors.[53]

6. SCOPE OF THE IBC MORATORIUM

The period of moratorium has been instituted for the sole reason of distribution of the assets in a way equitable to the creditors as well as the debtor, but other provisions, such as breach of contractual obligation, initiation of arbitral claims, seeking of debt recovery by banking institutions, actions already initiated under the SAREFESI Act, and violation of Fundamental Rights provide for remedies which are not exclusively in the context of bankruptcy, and provide remedy for the action of non-payment of debt in a myopic sense.

With the existence of Section 238 of the IBC, the overriding effect of the IBC provisions has carved out an unexpected ease in the entire setting, allowing just two exceptions. The particular heads are dealt as under:

6.1. CONFLICT WITH OTHER MORATORIUM PROVISIONS

Till this point of time, moratorium has been issued in various forms but for the same reason. The reason is to provide a cooling period to the debtor to accumulate all his belongings and assets to dispose of all the loans he has, on an equitable basis.

The Supreme Court in the case of *Innoventive Industries Ltd. v. I.C.I.C.I. Bank*,[54] held that, if there is a direct clash with a state act's

[53] Innoventive Indus. v. I.C.I.C.I. Bank, 2017 S.C.C. OnLine S.C. 1025.

moratorium, then by the virtue of non-obstante clause in IBC, the IBC moratorium shall prevail.

6.2. ACTIONS UNDER THE SARFESI ACT AND CLAIMS IN DRT

The provisions of Section 14, read with Section 13, are almost entirely non-discretionary. The proceedings under SARFAESI ACT will also be put on hold.[55]

As it is clear that for a period of 180 days, as provided in sections above, and a conditional 90-day extension to this 180-day period on the leave from N.C.L.T., under I.B.C., the proceedings under the D.R.T. Act and SARFAESI Act remain suspended, without affecting the limitation period for filing the same, though an order to that effect must be passed by the respective Adjudicating Authority.

Considering the status of a secured creditor under the same, it can be said according to Section 33 of the I.B.C. that:

a) A secured creditor can choose to relinquish his/her security interest and be part of the liquidation process in terms of Section 53, in which case, the dues of the secured creditor will rank higher in preference of distribution; or
b) A secured creditor can choose to stay out of the liquidation process and enforce his/her security interest in accordance with Section 52 of the Code.

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[54] 2017 S.C.C. OnLine S.C. 1025, ¶ 55.
[55] *supra* note 30; Triveni Alloys Ltd. v. B.I.F.R., (2006) 132 Comp. Cas. 190 (Mad.).

In a case where the sale of an asset was challenged by the secured creditor on the ground of SARFESI act covering the said action, and still allowing the moratorium leniency, the N.C.L.T., Mumbai bench held that, the moratorium period was well defined and SARFESI Act could not tamper the same.[56]

I.B.C. shall have the effect notwithstanding anything inconsistent therewith, contained in any other law for the time being in force, including D.R.T. Act, 1993; SARFAESI Act, 2002; money suit, etc.[57]

6.3. ARBITRATION PROCEEDINGS

Staying is not a new construct that is recognized by the I.B.C. Similar provision of stay of legal proceedings can be found in Arbitration cases, such as the *Scott v. Avery Clauses* and Section 9 of U.K. Arbitration Act, 1996, which is taken from Article II of New York Convention,[58] where arbitration proceedings put a stay on the legal proceedings.

The Supreme Court has vehemently stated on the point that if the arbitration proceedings are being initiated after doing a narrow interpretation of the term 'proceedings', to be exclusive of arbitration proceedings, then such a faulty initiation of arbitration mechanism is *non est* in law.[59]

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[56] J.M. Financial Asset Reconstruction Co. v. Indus Finance Ltd., 2017 S.C.C. OnLine N.C.L.T. 11466.
[57] Unigreen Global Pvt. Ltd. v. Punjab Nat'l Bank, MANU/NL/0192/2017.
[58] LORD MUSTIL & STEWARD BOYD, COMMERCIAL ARBITRATION 268 (2d ed. 2001).
[59] Alchemist Asset v. Hotel Gaudavan, 2017 S.C.C. OnLine S.C. 1362.

7. EXCEPTIONS

Even though the definition prima facie suggests that there cannot be any other legal proceeding for the same cause, yet the precedents have carved out the following exceptions:

7.1. PROCEEDINGS IN FAVOUR OF THE DEBTOR

A special situation arose in the case of *Power Grid v. Jyoti Structures*,[60] where an arbitration proceeding was already initiated but the same saw issuance of moratorium period during the pendency of the proceedings of setting aside an arbitral award. Since an award was already passed and further litigation was not touching the aspect of the financial strength and standing of the respondent company, the arbitration proceedings were allowed, stating that Section 14 of the Code would not apply to the proceedings, which are in the benefit of the corporate debtor. This case not being an example of a 'debt recovery action' and its conclusion would not endanger, diminish, dissipate or impact the assets of the corporate debtor in any manner whatsoever, poses no harm to the objective and result of moratorium.

This case is a different discussion under the head of arbitral proceedings. This particular case also saw an initiation of proceedings under Section 34 of the Arbitration and Conciliation Act, 1996, however, the Hon'ble High Court of Delhi relied not on the setting aside proceedings of the impugned award, but the fact that the ongoing

[60] 2017 S.C.C. OnLine Del. 12189.

proceedings were favouring the debtor and that would have become a boost for the restructuring.

7.2. ORIGINAL JURISDICTION CONSTRAINTS

The other exception that has been carved out is in favour of the High Court and the Supreme Court exercising their writ powers or the Supreme Court exercising its special power to grant leave.

The same has been exhibited in the following two decisions:

7.2.1. Paharpur Cooling Towers Ltd. v. Basal Steels and Power Pvt. Ltd.[61]

IBC itself confers jurisdiction on the High Court by virtue of notifications issued under Section 239 and 255 in regard to pending winding up proceedings where notices were already served on the respondent-company prior to December 15, 2016, it cannot be said that by virtue of Section 238, the High Court's jurisdiction gets taken away.

Coming to the Moratorium order announced by the N.C.L.T. invoking Section 14(1) (a), the court considered that the term “any Court of law” cannot be interpreted as inclusive of a High Court and hence such a moratorium order cannot direct a High Court to discontinue a winding up proceeding pending.

[61] MANU/AP/0574/2017, ¶ 11-12.

7.2.2. Canara Bank v. Deccan Chronicle Holdings Limited[62]

Article 131 of the Constitution of India provides for recovery in a money suit, where the dispute is between the Governments at State Level and the Union Government in any prescribed order. The Hon'ble Supreme Court has power under Article 32 of the Constitution of India and Hon'ble High Court under Article 226 of Constitution of India which power cannot be curtailed by any provision of an Act or a Court. This view propounded that moratorium cannot override the aspect of fundamental rights that is protected by the writ jurisdiction. The Court also included Article 136 in the same purview and gave the decision as a moratorium cannot put any restriction on the ongoing Article 136, Article 32 or Article 226 cases.

8. CONCLUSION

Approaching conclusion, one thing must be borrowed from the first paragraph of this piece, and that is the institutionalization provided under the IBC. Till date the insolvency laws in the country were scattered and had a lot of restraints on themselves, such as Contravention of other laws, difficulty in approaching adjudicating authorities and timely intervention from the highest court in the respective state and the country. Now, the charge to determine the existence of loan documents, claims for declaration of insolvency and adjudication of the entire insolvency case has been given to N.C.L.T., and appellate powers vest in N.C.L.A.T.

[62] 2017 S.C.C. OnLine N.C.L.A.T. 255, ¶ 7.

Since there is an amendment made to Section 424(2) of the Companies Act, 2013 by the IBC, the N.C.L.T. (adjudicating authority for insolvency proceedings) has now got the powers of civil court, so the ends of justice can be easily met, if the situation demands so.[63] With additional powers in the competition field also given to N.C.L.A.T., N.C.L.T. has successfully taken over the Company Law Board and has been doing a more commendable and salutary job. Company Law Board was a temporary setting and only a phase before N.C.L.T. and N.C.L.A.T. could spring up, and now with rightful powers in the hands of N.C.L.T. and N.C.L.A.T., the work being done is surely optimistic.

Another important point is the timely arrival of the non-obstante clause. The general practice says that the later legislation's non-obstante clause overrides the prior legislations. This provides far more space for constructive and purposive interpretation of the IBC and in turn moratorium can be implemented as a certainty. With moratorium being a statutory mandate, the prime purpose of IBC shall revolve around restructuring of companies and individuals facing bankruptcy. The part of IBC on the regulation of bankruptcy proceedings for LLPs and individuals has not been notified yet.

Addressing the elephant in the room, we have noticed that IBC moratorium is usually restrictive on all actions except those which attract the original jurisdiction of the High Courts and Supreme Court and the litigation/arbitration that favours the debtor. The explanation to this setting

[63] *supra* note 30, at 190.

is simple. It is not the fact that the purpose of insolvency moratorium is higher than any other legal procedure, but it is certainly a more logical approach to first tend to the need and then to utilize the benefits that can come. IBC has structured and accordingly restored or liquidated 2,100 companies who were facing loan repayments of the quantum of 83,000 Crores rupees.[64]

Even though the measures have been stringent, they have been for the achievement of better results. IBC isn't a commentary on where to litigate and who should hear, but it's more than litigation; it's solving the dispute of value of debtor's estate in a manner which gives the maximized value to creditors, maximum promotion to the entrepreneurial aspect of the debtor. The stay of moratorium is a definitive aspect of the equality that the creditors observe and respect. This stay is the crucial as it makes the entire creditor's body collective in responsibility,[65] and puts them in the driving seat to realize their inputs.

[64] Siddhartha, *Over 2,100 Companies Settle Rs. 83,000 Crores Bank Dues*, TIMES OF INDIA (May 23, 2018), https://timesofindia.indiatimes.com/business/india-business/owners-settle-rs-83k-crore-bank-dues/articleshow/64279946.cms.

[65] SUMANT BATRA, CORPORATE INSOLVENCY: LAW AND PRACTIC*e* 242 (1st ed. 2017).

THE INSOLVENCY AND BANKRUPTCY CODE, 2016: IMPACT OF MORATORIUM ON PRE-EXISTING CONTRACTUAL ARRANGEMENTS AND EXCEPTIONS TO STATUTORY MORATORIUM

Ishaan Chopra[*]

ABSTRACT

The aim of this research paper is to evaluate the implication of statutory moratorium upon pre-existing contractual arrangements. The evaluation of the moratorium's impact involves appreciating the fundamentally distinct rationales which form the basis of insolvency law and contract law. Multifarious views have emerged to resolve this conflict. The Indian insolvency regime, in light of introduction of the Insolvency and Bankruptcy code, 2016, prima facie adheres to the view that bankruptcy law has an overriding effect over the prevailing laws. This helps in achieving the insolvency law's objective of collectivity among creditors in the administration and distribution of assets. However, it blatantly ignores the importance of certainty in mutually beneficial exchanges, which forms the basis of contract law and is essential for expediting commerce. Accordingly, by extinguishing pre-insolvency obligations the moratorium can prejudice the interests of contract vendee. The author, while analysing such alteration in pre-existing contractual relations, tends to focus on the bankruptcy law's objective of maintaining

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the corporate debtor as a going concern. The present code has a single-minded focus upon value maximization of assets, without being cognizant of the highly specialized operations of some corporate debtor. This undermines the new code's objective of effectively reviving stressed assets. The author also puts forth the suggestion of granting exemption from the moratorium to certain category of debts. Mature insolvency law jurisdictions have acknowledged the special nature of certain debts and have accordingly exempted them from the moratorium. The author undertakes a comparative analysis of such exceptions and studies their feasibility in the Indian Context.

1. INTRODUCTION

Investors and creditors seek to maximize the return on investments and attempt to funnel their funds into enterprises which they believe would yield a return greater than the prevailing market rate of interest. But the recovery of principal and anticipated returns on these funds is uncertain due to prevailing macro dynamics of the economy[1]; sector specific return fluctuations, and fundamentals of the business concern which has been the recipient of the inflow. The debtor may make repayments as promised, or he may default and not make the payment. Such a debtor is then classified as insolvent. The insolvency proceedings hence triggered should ideally harmonize two conflicting interest. Firstly,

[1] Roger Backhouse, *Methodology of Macroeconomics*, J. ECON. METHODOLOGY 159, 160 (1999).

facilitating the recovery of creditor's funds and secondly, financial rearrangement to preserve the economic value of the debtor's business.[2]

The Insolvency and Bankruptcy Code, 2016 (IBC) aims to streamline the insolvency proceedings in India and seeks to achieve the aforementioned goals. However, the code being nascent, fails to address certain pertinent business considerations that arise due to effectuation of its provisions. Once a petition under the IBC is admitted against the Corporate Debtor, an absolute moratorium under Section 14 of IBC[3] follows in favour of Corporate Debtor. The moratorium under IBC kicks in following admission of the insolvency petition[4] and is in force till the Corporate Insolvency Resolution Process (CIRP) period and during such period no judicial proceedings for recovery, enforcement of security interest, sale or transfer of assets and beneficial interest, or termination of essential contracts can take place against the Corporate Debtor. Although the statutory moratorium provides immunity to the bankrupt entity, it prejudices the enforcement of pre-existing contractual arrangements, between the corporate debtor and creditor or between the corporate debtor and a third party to CIRP. The benches of National Company Law Tribunal (NCLT), National Company Law Appellate Tribunal (NCLAT), High Courts (HC) and Supreme Court (SC) have not enunciated any relief

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[2] KENNETH CORK, INSOLVENCY LAW AND PRACTICE: REPORT OF THE INSOLVENCY LAW REVIEW COMMITTEE (June 12, 2015), *available at* https://trove.nla.gov.au/version/32035648.

[3] Insolvency and Bankruptcy Code, 2016, No. 31, Acts of Parliament, 2016, § 14 [hereinafter IBC].

[4] IBC, § 7 & § 8.

mechanism for parties to contract prejudiced by such an absolute moratorium. This paper seeks to study whether any relief is available to the parties whose pre-existing contractual arrangements are adversely affected by moratorium. The scope of analysis includes the relevant dictums of competent authorities dealing with situations involving pre-existing contractual arrangement, provisions of IBC, and jurisprudence from mature insolvency jurisdictions.

2. PROBLEMS EMERGING DUE TO IMPOSITION OF MORATORIUM

The jurisprudence examining the relationship between pre-existing contractual arrangements and the statutory moratorium is scarce. The researcher through the following hypotheticals, portrays the conundrum that a moratorium can trigger.

2.1. ILLUSTRATION 1

The purchaser negotiated a favourable purchase price for a commercial property. The seller, a corporate entity, refused to close. The purchaser hired a lawyer who commenced proceedings in court to compel specific performance. Multiple motions for specific performance were made and denied due to infirmities in the purchaser's papers. Nearly five years after the contract was signed, the purchaser's motion for specific performance remained unresolved. Financial Creditors of the seller submitted a petition for insolvency as per Section 7, which was later on accepted and resulted in imposition of moratorium under Section 14. The state court proceedings were stayed and the purchaser lost its right to compel specific performance. The purchaser also does not have a right to institute a suit for damages as Section 14(1)(a) categorically bars initiation of any suits against the corporate debtor. The purchaser owned the adjoining property and had planned to initiate a real estate project and benefit from soaring real estate prices.

2.2. ILLUSTRATION 2

Company X holds 70% and Company Y holds 30% equity in a business concern. The business concern deals with highly specialized technology, requiring long term investments. As per the shareholder agreement, fellow shareholder has a pre-emptive right to purchase the shares at book value if any proceedings analogous to winding-up proceedings are begun in any jurisdiction against a shareholder. The clause analogous to winding up of proceedings can be interpreted to be wide enough to include CIRP. Company Y defaulted and subsequently the CIRP was initiated by its creditors, resulting in imposition of moratorium. Hence, any sale of shares owned by company Y is not possible, in view of the moratorium imposed in respect of transferring or disposing any of its assets or legal right or beneficial interest. Due to CIRP, the shares of company Y may be sold to some third party, in accordance with the approved resolution plan by the committee of creditors, without giving a pre-emptive right to company X. Company X would be adversely affected as the third party acquiring the shares might not have the requisite level of expertise for managing the niche and highly technical operations of the business concern. Such a concern has also been statutorily recognized. Illustration c of Section 12 of the Specific performance Act of 1877[5] provides that "A contracts to sell and B contracts to buy, a certain number of railway shares of a particular description. A refuses to complete the sale. B may compel A specifically to perform this agreement, 'for the shares are limited in number and not always to be had in the market, and their possession carries with it the status of a shareholder, which cannot otherwise be procured'.

Hence, it can be clearly seen in the hypotheticals that nothing except performance of pre-existing contractual arrangement would have restituted the parties, prejudiced due to the imposition of moratorium. The hypotheticals succinctly illustrate the manner in which the bankruptcy code can dramatically alter the rights of a contract vendee.

3. CONFLICTING POLICY CONSIDERATIONS

The nascent Indian insolvency regime has been categorically branded as creditor friendly by the Apex Court in its very first decision pertaining to the insolvency and bankruptcy code,[6] and it gradually seeks to incorporate international best practices. In line with the practice in UK and USA,[7] the policy intent of the moratorium under Section 14 is to keep

[5] Specific Relief Act, 1877, No. 56, Imperial Legislative Council, § 12.
[6] Innoventive Indus. v. ICICI Bank, A.I.R. (2017) S.C. 4084.
[7] *In re* Smith Corset Shops, 696 F.2d 971, 977 (1982).

the corporate debtor's assets intact during the insolvency resolution process and expedite its orderly completion.[8]

IBC, by providing for a moratorium, promotes insolvency law policy's cardinal objective of collectivity among creditors in the administration and distribution of assets.[9] However, such a moratorium prima facie conflicts with the policy considerations of the contract law, which are rooted in high public regard for certainty in mutually beneficial exchanges.[10] Jurisprudence across matured insolvency jurisdictions has reiterated that it is imperative that a balance be struck between the policy objectives of contract law and those of insolvency law.[11] An approach aimed at shielding debtors and using the insolvency law as a redistributive platform will be detrimental to trade and commerce. United Nations Commission on International Trade Law Working Group V has rightly proposed in its draft legislative guide on insolvency law that,[12]

> *Although insolvency law generally forms a distinctive regime, it ought not to produce results that are fundamentally in conflict with the premises upon which the general law is based. Where the insolvency law does seek to achieve a result that defers or fundamentally departs from the general law, it is highly desirable that that result be the product of careful consideration and conscious policy in that direction*.

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[8] AES Barry Ltd. v. TXU Eur. Energy Trading, 2 B.C.L.C. 22, 25(2005).
[9] *In re* BNT Terminals, 125 B.R. 963, 971 (1991).
[10] Goetz & Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261, 1263 (1980).
[11] U.N. Comm'n for Int'l Trade Law (UNCITRAL), *Legislative Guide on Insolvency Law*, 9 (2004).
[12] *Id.*

4. MECHANISM AVAILABLE WITHIN THE EXISTING LEGAL FRAMEWORK TO SEEK REMEDY FOR THE PREJUDICED VENDEE

Following admission of the insolvency application, NCLT appoints IRP within 14 days .The IRP exercises control over the management and assets of the corporate debtor. Accordingly, the powers of the board of directors are suspended. It is pertinent to recognize that the statutory moratorium does not extinguish the substantive law rights of creditors.[13] The mechanism is procedural in nature and merely suspends such rights during the duration of the procedure.[14]

Subsequently, IRP appoints the committee of creditors (CoC) comprising of all financial creditors of the corporate debtors, which will further appoint a resolution professional. Section 25(1)[15] stipulates that the Resolution Professional shall "preserve and protect" the continued business operations of the Corporate Debtor, i.e., run the defaulting corporate entity as a going concern. Also, section 28 explicitly mandates the approval of the CoC, in order for the Resolution Professional to carry out any action that might affect the capital structure, ownership or management of the Corporate Debtor, or the rights of the creditors. In light of the aforementioned statutory limitations, following are the means by

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[13] IAN FLETCHER & JOHN HIGHAM, CORPORATE ADMINISTRATIONS AND RESCUE PROCEDURES 50 (2d ed. 2004).
[14] Jack William, *Application of the Cash Collateral Paradigm to the Preservation of the Right to set off in Bankruptcy*, 7 BANKER DEV. J. 27, 30 (1990).
[15] IBC, § 25(1).

which an affected vendee can seek performance of the pre-existing contract.

4.1. OVERRIDING PROVISIONS OF THE COMPANIES ACT, 2013

Regulation 39(6) of the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016[16] (CIRP Regulations), specifically dispenses with the requirement of shareholders' approval for finalization of a resolution plan. However, Section 30(2)(e),[17] of the IBC clearly stipulates that any resolution plan must be in compliance with the provisions of any law in force. .In absence of any clarification regarding the interpretation of Section 30(2)(e), it cannot be construed narrowly.[18] Consequently, Regulation 39(6) does not in any way eliminate the requirements of shareholder approvals as per the Companies Act, 2013. Accordingly, shareholders' approvals to sell, lease, or otherwise dispose of the whole or substantially the whole of the undertaking of the company, as required under the section 180(1)(a)[19] cannot be dispensed with. Prima facie, IBC has an overriding effect and Regulation 39(6) is an attempt to re-enforce this position. But Section 30(2)(e) is a categorical requirement of the IBC itself, which cannot be

[16] Insolvency & Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016, IBBI/2016-17/GN/REG004, regulation 39(6) [hereinafter CIRP Regulations].
[17] IBC, § 30(2)(e).
[18] U.P. State Elec. Board v. Hari Shanker Jain, A.I.R. 1979 S.C. 65; Rohit Pulp & Paper Mills v. Collector, Cent. Excise, A.I.R. 1991 S.C. 754.
[19] Companies Act, 2013, No. 16, Acts of Parliament, 2013, § 180(1)(a) [hereinafter Companies Act].

overlooked as the National Company Law Tribunal (NCLT) can reject a Resolution Plan, if the same does not comply with provisions of any law in force.

Such a legal ambiguity can be utilized by the party seeking contractual performance during the moratorium. For example, in hypothetical 2, the shareholders of corporate debtor can stop the transfer of shares to 3rd party and instead insist on the shares being acquired by Company X, as it has the requisite technical expertise. The existing jurisprudence purports that the primary burden will to be establish that such a transfer is beneficial for the corporate debtor as it will ensure its continuance as a going concern. This requirement is in line with the Delhi High Court's dictum in *Power Grid Corporation of India Ltd. v. Jyoti Structures Ltd.*,[20] that Section 14 of the Code would be inapplicable to the proceedings which are beneficial for the corporate debtor. Since the word 'proceedings' under section 14(1)(a) is not preceded by the word 'all', the provisions of moratorium would not apply to all the proceedings against the corporate debtor. The aforementioned dictum creates a dichotomy of pre-CIRP proceedings involving the corporate debtor: The proceedings yielding post-CIRP monetary benefit and the post-CIRP proceedings not providing any monetary benefit to the corporate debtor. Hence, an exemption from the moratorium was provided to allow the corporate debtor to extract monetary benefit which entailed to Pre-CIRP affairs. It follows that even the enforcement of pre-existing contractual

[20] Power Grid Corp. of India v. Jyoti Structures Ltd., (2018) 246 D.L.T. 485.

arrangements which would ensure continuance of corporate debtor as a going concern and help in realizing enhanced returns from the stressed assets is exempted from the statutory moratorium. Additionally, it should be noted that Section 20(2)(e) of the IBC,[21] which allows resolution professional to take all necessary steps to keep the corporate debtor a going concern, is broadly framed and execution of such pre-existing contracts should reasonably fall within the terminology "all necessary steps". However, to give a practical effectuation to such an interpretation, it is vital that the resolution professionals appreciate that core strengths, operational synergy and efficient allocation of resources,[22] not solely the monetary realization, are essential for keeping corporate debtor a going concern.

4.2. PREJUDICED PARTY CAN RECLAIM THE AMOUNTS BY ESTABLISHING THAT THE MORATORIUM ADVERSELY AFFECTED ITS INTEREST.

The contract vendor has an option of establishing that amount due to it were prejudicially affected on account of the moratorium imposed under Section 14(1)(d) of IBC. According to Regulation 31(b) of CIRP Regulations,[23] the cost of the insolvency resolution includes the amounts due to the person whose rights are prejudicially affected on account of the

[21] IBC, § 20(2)(e).
[22] Credit Suisse Fides Trust S.A. v. Cuoghi [1997] 3 All E.R. 724, 730; PRINCIPLES OF INTERNATIONAL INSOLVENCY 124 (Sweet & Maxwell, 1996).
[23] CIRP Regulations, regulation 31(b).

moratorium imposed. An application needs to be filed under Section 60(5) of IBC, with a prayer to direct the resolution professional to consider the claim of the applicant as insolvency resolution process cost, as the applicant has been prejudiced due to imposition of statutory moratorium. The jurisprudence on this has been limited with only one order dealing with the Section 31(b).

In *JAS Telecom Private Limited v. Eolane Electronics Bangalore Private Ltd.*,[24] the operational creditor was the landlord of the corporate debtor. The corporate debtor had not been paying rent for five months. A suit was filed by the operational creditor for eviction and recovery of rent. The corporate debtor filed an application under Section 10 of IBC, read with Section 7 to initiate CIRP. Subsequently, the application was admitted and a statutory moratorium was imposed, suspending the proceedings for eviction and recovery. A letter was addressed to the RP stating that rent due to landlord, whose rights are prejudicially affected on account of moratorium imposed should be included in Insolvency Resolution Process cost. The resolution professional argued that rent is a direct cost in manufacturing and does not appear in essential supplies list which is enumerated from Section 31-34 of the CIRP regulations. Moreover, rent had not been paid much prior to the order of the Moratorium. It was submitted that such a default in payment of rent cumulates in operational debt and does not amount to cost of CIRP. NCLT, Bengaluru Bench, upheld that such a cost is not to be included

[24] JAS Telecom Pvt. Ltd. v. Eolane Elec. Bangalore Pvt. Ltd., 65/BB/2017 I.N. L.A. 161/2017, ¶ 19 (NCLT Bangalore 2017).

within the insolvency resolution process cost. Following appeal, NCLAT affirmed the NCLT's order.

In *Jas Telecom*, NCLT provided a criterion to classify the amount claimed as the cost of the insolvency resolution process. It upheld that the amount should become due or prejudiced solely at the commencement of the moratorium period. The tribunal's dictum seeks to convey that an amount whose recovery is prejudiced at the very moment when moratorium is enforced will be covered within the ambit of section 31(b) of CIRP regulations. A party is estopped from claiming an amount which became due prior to the commencement of the moratorium. As Regulation 32 separately defines essential goods, the party affected doesn't necessarily need to be affected solely in relation to essential goods. Contractual damages suffered by the vendee, due to non-performance which has its origin at the point of time of enforcement of the moratorium can be claimed as a part of cost of CIRP. The aforementioned is one of the possible ways for the contract vendee to recover amount paid when the moratorium has been imposed.

Classification of a claim as the cost of CIRP provides it a preference of payment over all other debts and dues. Regulation 38 of CIRP Regulations categorically provides that payment of CIRP Costs takes precedence over any other payments. If an application for recognition of claim as the cost of CIRP is not filed, it would ordinarily be recognized as an operational debt which is lower down the hierarchy of preference, which has been provided in Section 53 of IBC. Consequently, operational creditors, who are generally unsecured in nature, are not able to recover anything from the liquidation proceeds. Hence, the aforementioned methods can be employed to gain preference of payment.

4.3. PRAYING FOR EQUITABLE RELIEFS.

Section 424 of the Companies Act, 2013 stipulates that tribunal shall be guided by the principles of natural justice. Moreover, Rule 11 of the NCLT Rules, 2016,[25] and the NCLAT Rules, 2016,[26] provide 'inherent powers' to the Tribunals to make such orders or give such directions as may be necessary for meeting the ends of justice or to prevent abuse of process of the Tribunal. These provisions affirm the power of NCLT and NCLAT to grant performance of a pre-existing contract as an equitable relief.

4.3.1. Analysis of decisions granting equitable reliefs

The power of NCLT to grant equitable reliefs has been discussed in *Lokhandwala Kataria Construction Pvt. Ltd. v. Nisus Finance & Investment Managers LLP*.[27] The primary issue was, whether a financial creditor can withdraw an application for initiation of CIRP post admission of such an application. It is pertinent to note that Rule 8 of the Insolvency & Bankruptcy (Application to Adjudicating Authority) Rules, 2016 allows

[25] Nat'l Co. Law Trib. Rules, 2016, G.S.R. 716(E), rule 11 [hereinafter NCLT Rules].
[26] Nat'l Co. Law Appellate Trib. Rules, 2016, G.S.R. 717(E), rule 11 [hereinafter NCLAT Rules].
[27] Lokhandwala Kataria Construction Pvt. Ltd. v. Nisus Finance & Inv. Managers L.L.P., (2017) 140 C.L.A. 215.

withdrawal only up to admission. Following declaration of moratorium, parties approached NCLT with a plea to set aside order and to allow withdrawal of application as the parties have reached upon settlement. The plea was denied by the NCLT. Subsequently parties pleaded the NCLAT to allow withdrawal, in light of Rule 11 of NCLAT Rules which bestowed it with equitable power. The NCLAT also upheld that the application cannot be withdrawn once the order for admission is issued and Moratorium is declared. The order was appealed to the SC highlighting that NCLAT could utilize the inherent power recognized by Rule 11 of the NCLAT Rules, 2016 to allow a compromise between the parties after admission of the matter. SC reiterated that the Rule 11 of the NCLAT Rules, 2016 was not notified as on the date of order passed by the NCLAT. However, the Hon'ble Supreme Court utilized its powers under Article 142 of the Constitution of India, which states that Supreme Court in the exercise of its jurisdiction may pass such order or decree as is necessary for doing complete justice. The Hon'ble Supreme Court while exercising its powers allowed the parties to withdraw the application.

The equitable powers of the NCLT and NCLAT were implicitly acknowledged by the Supreme Court. NCLAT did not allow withdrawal simply because the NCLAT Rules, 2016 were not adopted as on the date of adjudication of the matter. Accordingly, if the imposition of the moratorium is prejudicing a party due to non-performance of a pre-existing contract, NCLT or the NCLAT can order performance of obligations under such contract, in order to meet the ends of justice.

Argument may be made that withdrawal of application is a procedural issue whereas equitable remedy of performance despite the imposition of moratorium is a substantive issue. However, the NCLT and NCLAT Rules, 2016 give discretionary power to grant equitable remedy to meet ends of justice. As will be discussed in subsequent sections, equitable remedy of performance has been granted for substantive matters as well.

Interestingly enough, NCLT bench in Kolkata, in one of the orders, permitted execution of a pre-existing contract of sale during the moratorium period. In *State Bank of India v. Gujarat NRE Coke Limited*,[28] the applicant on behalf of the committee of creditors filed an application under Section 60(5) of IBC for approval of sale transaction of windmill assets belonging to the corporate debtor. Section 60(5) provides NCLT with jurisdiction over any application or proceeding by or against the corporate debtor or corporate person. The transaction of sale of windmill assets was contemplated under the Master Restructuring Agreement, which was agreed upon prior to admission of the insolvency petition. Following a bidding process Sun Pharmaceuticals Ltd. and United Technologies Ltd. emerged as successful bidders. Consequently, the prospective buyers made payment of an amount equal to 25% of the total consideration. Subsequently, CIRP was initiated for Gujarat NRE Coke Limited. The maintenance of windmill assets was carried out by Suzlon Global Service Ltd. However, Suzlon has terminated the operation and maintenance contract due to non-payment of their outstanding dues.

[28] State Bank of India v. Gujarat NRE Coke Ltd., C.A. (IB) No. 326.KB/2017 in C.P. (IB) No. 182.KB/2017, ¶ 23 (NCLT Kolkata, 2017).

Subsequently, the value of the windmill asset was depleting due to non-maintenance. The committee of creditors unanimously decided to execute the sale transaction.

Through the sale of non-core windmill assets the debt burden of the corporate debtor was to be reduced. The tribunal took cognizance of the fact that sale of asset would benefit the corporate debtor. However, Section 14 of IBC categorically bars transfer or disposal of assets of the corporate debtor during the duration of CIRP. The tribunal invoked Regulation 29 of CIRP Regulations 2017[29] which empowers the resolution professional to sell unencumbered assets of the corporate debtor, if he believes that such a sale is necessary for a better realization of value under facts and circumstances. The caveat under Regulation 29 is that the book value of assets sold shall not be more than 10% of the total claims admitted. Additionally, consent of committee of creditors is also required. As the sale of asset was compliant with the regulations, it was allowed. The Tribunal noted that:

> *In the interest of justice, keeping the windmills idle without maintenance and without disposing of it for a value which would be procured reasonably it would cause national waste as well as economic loss to the corporate debtor. Denial of approval may cause economic loss to both, corporate debtors and creditors*.[30]

Accordingly, the sale of assets under Regulation 29 of will be permitted by the tribunal if the applicant is able to establish that, in the

[29] CIRP Regulations, regulation 29.
[30] State Bank of India v. Gujarat NRE Coke Ltd., ¶ 29.

given facts and circumstances, such a sale is for the benefit of the corporate debtor. However, the use of phrase, "better realization of value" suggests that Regulation 29 seeks to focus solely on value maximization of the assets. An essential question which arises is whether it is economically sustainable to limit the meaning of the term "for the benefit of corporate debtor" to merely value maximization of the assets. Such a restricted interpretation can substantially prejudice the policy objective of maintaining the firm as a going concern. The existing legal framework is based on the assumption that a corporate person capable of coughing out the highest bid will be efficient in managing a business concern. It ignores the precarious situation of certain sectors where special expertise and operational synergies are vital to ensure maintenance of a business as a going concern.

The aforementioned decision also triggers an interesting debate concerning the power of the CoC to approve execution of a pre-existing contract. NCLAT in its recent decision in *Darshak Enterprises v. Chapparia*,[31] endorsed a laissez faire approach once a resolution plan has been approved by the CoC. It was upheld that adjudicating authority should interfere only in cases of discrimination or perverse decision making. Decision by NCLT Allahabad in *Vivek Vijay Gupta v. Steel Konnect*,[32] reaffirmed the approach stipulated by the appellate tribunal.

[31] Darshak Enter. v. Chapparia, Company Appeal (AT) (Insolvency) No. 328 of 2017, ¶ 6.
[32] Vivek Vijay Gupta v. Steel Konnect, IA No. 9/2017 C.P IB No. 5/7, ¶ 16, NCLT Ahemdabad.

The Bench categorically stated that no provision in the code empowers adjudicating authority to interfere in the rejection of the resolution plan. The dictum of both NCLT and NCLAT portray existence of a presumption that rejection or approval of a plan is contingent on interest of the company and relevant stake holders. Such a presumption can be extended to decisions of CoC which seek to execute a pre-existing contract. This assertion primarily relies on the fact that CoC aims at effectively rehabilitating the corporate debtor. Accordingly, the aforementioned presumption should be deemed to exist unless there exists a conclusive evidence of perverse decision making or discrimination by CoC in approving the execution of contract.

4.3.2. Consideration of operational synergies in the evaluation matrix

At this juncture it is essential to appreciate the concept of Evaluation Matrix.[33] Evaluation matrix means ,parameters to be applied and the manner in which such parameters are to be applied for the purpose of evaluating resolution plans. Such a matrix needs to approved by the CoC and subsequently notified to the Resolution Applicants. The Resolution Plan hence arrived at has to meet the end of achieving a fair-value for the creditors, which refers to market value of assets in an arms-length transaction.[34] Acknowledging the diverse nature of corporate

[33] Insolvency & Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) (Amendment) Regulations, 2018, IBBI/2017-18/GN/REG024, regulation 2(ha).
[34] Jorio Alberto, *An Overview of the Insolvency Procedures and Proposed Reforms, in* CORPORATE RESCUE: AN OVERVIEW OF RECENT DEVELOPMENTS FROM SELECTED COUNTRIES 117 (2004).

debtors, The IBBI does not provide for a standardized evaluation matrix. Committee of creditor exercises the discretionary power of defining a matrix as per the nature of corporate debtor. Moreover, IBC code empowers the resolution applicants to challenge the Evaluation Matrix.[35] Hence, the resolution applicant can challenge the resolution plans which are plagued with the creditor's single mindedness towards value maximization and ignore other essential industrial dynamics.[36]

It is vital to note that while Regulation 29 talks about sales of assets, it is silent on the sale of equity shares. Based on the above analysis it appears that sale of shares can be approved by obtaining a consent of CoC followed by filing an application under Section 60(5) , pleading for the equitable relief of permitting sale of shares.

5. COMPARATIVE REVIEW OF EXCEPTIONS TO MORATORIUM

It is apparent from the legislative debates concerning the IBC that the Bankruptcy Law Report formed an essential *traveux preparatoires* for the current code.[37] The report relies heavily on insolvency law practices prevalent in mature jurisdictions such as UK, USA, and Australia and emphasizes that mechanisms evolved in such jurisdictions have expedited

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[35] IBC, § 60(5).

[36] *Evaluation Matrix: A Discussion*, MINISTRY OF CORPORATE AFFAIRS, GOVT. OF INDIA, http://www.mca.gov.in/ministry/pdf/monthly_newsletter_feb_2018.pdf (last visited June 10, 2018).

[37] *Lok Sabha Debate, Archive from Thursday, May 05, 2016/Vaisakha 15, 1938 (Saka)*, LOK SABHA, http://164.100.47.194/Loksabha/Debates/uncorrecteddebate.aspx (last visited June 13, 2018).

corporate restructuring.[38] Taking such practices into consideration, the Bankruptcy Law Reforms Committee decided to move away from the existing 'debtor in possession' regime to a 'creditor in control' bankruptcy regime, which is prevalent in mature jurisdictions. However, IBC is not a mere legal transposition as it takes cognizance of unique challenges posed by gigantic non-performing asset problem in India[39] and accordingly moulds foreign practices.

This section seeks to evaluate the jurisprudence of mature jurisdictions regarding statutory moratorium and examine its feasibility in context of the Indian insolvency law landscape. Unlike IBC, American and English Bankruptcy regime provide for certain exceptions to the statutory moratorium. Lawmakers have decided that certain debts are very significant and deserve to be granted priority over the policy objectives of the automatic stay. Following is an analysis of such statutorily accepted exceptions to the moratorium and their feasibility in Indian context.

5.1. RETROACTIVE PERFECTION OF INTERESTS.

The American Bankruptcy Code's moratorium does not suspend the right of creditors to perfect an interest in property of the bankruptcy estate. Such a perfection of interest has to be achieved during the

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[38] REPORT OF THE JOINT COMMITTEE ON THE INSOLVENCY AND BANKRUPTCY CODE ¶ 23, Gazette of India, Extraordinary Part-II, ¶ 2 (Dec. 17, 2015).
[39] MINISTRY OF CORPORATE AFFAIRS (GOVT. OF INDIA), BANKRUPTCY LAW COMM. REPORT, *available at* http://www.mca.gov.in/Ministry/pdf/ILRReport2603_03042018.pdf (last visited May 11, 2018).

statutorily prescribed grace period.[40] For example, a lien that arises pre-petition but is not perfected prior to initiation of the moratorium, can be perfected if the applicable non-insolvency law permits a later perfection against any party who has acquired an interest in the property.[41] Hence, such an exception enables retrospective perfection of interest despite the moratorium.

Retrospective perfection of interest can be illustrated through *In Re, 229 Main Street Ltd.*[42] In that case C notified the owner of a property of his intention to file lien against his property under a relevant non-bankruptcy statutory provision. Subsequently, the owner filed for bankruptcy before C could register the lien. The Court held that the bankruptcy code preserved C's statutory right to perfect his interest and allowed C to acquire the complete interest in the property.

The moratorium under the English insolvency regime does not restrain steps taken to create or perfect security and unlike the American code does not require a non-bankruptcy statute granting grace period.[43] Under Indian securitization law, mere creation of security by a company in favour of lender does not validate a charge over secured assets. In order to perfect the charge created, company is required to register the charge by filing Form CHG-1 under Companies Act, 2013 with the concerned

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[40] Bankruptcy Reform Act, 11 U.S.C. §§ 95-598 (1978) [hereinafter Bankruptcy Code]; *In Re*, New England Carpet Co., 26 B.R. 934 (Bankr. D. Vt. 1983).
[41] *Id*.
[42] *In Re*, 229 Main Street Ltd., 262 F.3d 1 (1st Cir. 2001).
[43] Bankruptcy Code, § 43(2).

Registrar of Companies with thirty days of creation of charge.[44] In line with the English insolvency regime, IBC does not envisage a restriction on perfection of interest and as per *lex lata*, the interest in a security can be perfected even during the statutory moratorium. This ensures that the vendee is able to perfect his interest in the insolvency estate. To such an extent, the vendee's right is not prejudiced.

5.2. COMPLEX MARKET CONTRACTS

The English Insolvency Regime exempts market charges from the ambit of statutory moratorium.[45] Similarly several complex market related contracts are exempted from the moratorium imposed under the American bankruptcy code. Contracts with commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency come within the ambit of such.[46] As Derivative contracts are exempted from the statutory moratorium, this permits counterparties to terminate derivatives contracts with a corporate debtor and seize underlying collaterals. Reason for treating derivatives contracts differently arises emanates from the economic theory underlying the automatic stay. The policy objective of the moratorium is to ensure survival of the firm as a going concern. Assets are needed to preserve going-concern status as they add value to the operation of the firm. However, the value adding dimension is absent in derivatives contracts,

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[44] Companies Act, § 77.
[45] Insolvency Act, 1986, c. 45, § 173 [hereinafter English Code].
[46] Bankruptcy Code, § 362(b)(6).

which are mere speculative risk management arrangements. As reported in legislative history, Congress believed this exemption from the automatic stay was necessary to prevent the insolvency of one commodity or security firm to send tremors of instability across the economy.[47] The statutory exemption hence ensures that derivatives counterparties can minimize their losses arising from the insolvency of a debtor.[48]

In Indian Context, section 5(8)(g) provides that financial debt shall include "Any derivative transaction entered into in connection with protection against or benefit from fluctuation in any rate or price". Hence, IBC does not confer any exception from moratorium upon derivative contracts or any other complex market contracts. An evaluation of the Indian markets, it can be seen that following Over the Counter (OTC) Margin Reforms most of the derivatives are traded in OTC rather than stock exchange.[49] A counterparty insolvency can trigger a systemic meltdown in the OTC derivatives market or even the exchange traded derivatives market. This huge derivatives market is dominated by a few large international banks and securities firms. This raises the possibility that a problem (such as insolvency) with a major derivatives-dealer (*i.e.*, a commercial or investment bank) could reverberate throughout the entire

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[47] SALLY MCDONALD HENRY, THE NEW BANKRUPTCY CODE: CASES, DEVELOPMENTS, AND PRACTICE INSIGHTS SINCE BAPCPA 766.

[48] Michael Krimminger, *Insolvency in the Financial Markets: Banks, Hedge Funds, and Other Complications*, 34 BANKING POL. J. 123 (1996).

[49] Shyamala Gopinath, *Over-the-Counter Derivative Markets in India: Issues and Perspectives*, RESERVE BANK OF INDIA, https://www.rbi.org.in/scripts/FS_Speeches.aspx?Id=514&fn=2757 (last visited June 9, 2018).

OTC derivatives market and cause financial distress far beyond derivatives markets.

5.3. RECOUPMENT AND SET-OFF

5.3.1. Doctrine of Set-Off

The doctrine of setoff allows entities to apply their mutual debts against each other, thus "avoiding the absurdity of making A pay B when B owes A".[50] The American insolvency regime does not confer a right but reserves the rights of setoff that is conferred by applicable insolvency law. For exercising such a statutory right creditor is required to file a motion for stay on moratorium.[51] The creditor must demonstrate that both claims arose prior to bankruptcy and that they are unsettled between the parties. Even when a creditor meets the requirements for setoff, the decision to allow setoff is the discretionary power of the court.[52] It is pertinent to note that post-petition debts are not available for set-off as the moratorium effectively results in ceasing of mutuality between the parties.[53]

Moreover, there exists an implicit requirement that the debts be owed between the same parties, giving rise to mutuality.[54] For example, a

[50] Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, 18 (1995).
[51] *In re, Bennett Funding Group, Inc.,* 146 F.3d 136, 140 (2d Cir. 1998).
[52] Local Loan Co. v. Hunt, 292 U.S. 234, 240 (1934).
[53] *In re*, Smart World Techs., 423 F.3d 166, 184 (2d Cir. 2005).
[54] *Id*.

subsidiary's debt may not be set off against the credit of a parent or other subsidiary, due to absence of mutuality.

The position of the American insolvency regime on the set-off eligibility of post-petition debt was clarified in *In re, Lehman Bros. Holdings, Inc.*[55] In *Lehman Bros.* a bank creditor failed to set-off the amount transferred to creditor's account post-bankruptcy. The initial transfer instructions were issued on the business day prior to the bankruptcy petition date and the party that gave the transfer instructions maintained the right to change or reverse the transfer until three hours after the debtor filed for bankruptcy. However, the transfer was not completed and the actual book entry reflected a pre-petition debt that cannot be set-off.

5.3.2. Doctrine of Recoupment

Doctrine of Recoupment allows a creditor to reduce the amount of a debtor's claim by stating a claim against the debtor which arose out of the same transaction to arrive at a balance due to debtor.[56] The key ingredient to exercise the right of recoupment is that the claim and debt should arise from the same transaction. The landmark case of *Ashland Petroleum Co. v. Appel*,[57] succinctly explains the notion of recoupment. In this case, parties entered into an oil division contract that gave Ashland the right to purchase unspecified amounts of crude oil produced by B&L.

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[55] *In re*, Lehman Bros. Holdings, Inc. 404 B.R. 752, 759 (Bankr. S.D.N.Y. 2009).
[56] Rakozy v. Reiman Construction, 42 B.R. 627, 628 (Bankr. D. Idaho 1984).
[57] Ashland Petroleum Co. v Appel, 782 F. 2d 155 (10th Cir. 1986).

Subsequently, Ashland overpaid B&L on two occasions. Within the following 3 months of overpayment, B&L filed for bankruptcy. Ashland sought to balance the amount payable for post-petition deliveries against pre-petition over payments. The US Court of Appeals upheld that Ashland validly withheld the payment and the moratorium doesn't prejudice such equitable interests emanating from pre-existing arrangements.

The doctrine of recoupment is alien to UK insolvency law. Pre-petition claims are subject to set-offs.[58] Insolvency set-off rights in English insolvency law are self-executing[59] and are not subject to the moratorium.[60] The objective of mandatory insolvency set-off is to do substantial justice between contracting parties.[61]

In the Indian Context, Section 173 of IBC deals with mutual credits and set-off. The bankruptcy trustee shall take an account of what is due from each party to the other in respect of the mutual dealings and the sums due from one party shall be set off against the sums due from the other. Only the balance shall be the bankruptcy debt. The IBC also incorporates the dictum from *In re, Lehman Bros.*, whereby, it is necessary to establish that the debt or claim was incurred pre-petition. Section 173(2) stipulates that Sums due from the bankrupt to another party shall not be included for set-off, if that other party had notice at the time they became due that an application for bankruptcy relating to the bankrupt was

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[58] M.S. Fashions Ltd. v. Bank of Credit and Commerce Int'l, (1993) 3 All E.R. 769.
[59] Mersey Steel & Iron Co. v. Naylor, Benzon & Co., (1882) 9 Q.B.D. 648.
[60] IAN FLETCHER, CORPORATE ADMINISTRATIONS AND RESCUE PROCEDURES 57.
[61] Forster v. Wilson, (1843) 12 M&W 191, 204.

pending. Hence, there is a statutory recognition of set-off, provided that, both the debts arose prior to initiation of CIRP.

5.3.3. Governmental Actions taken in public interest.

The Bankruptcy Code exempts government agencies from the ambit of the statutory moratorium when the agencies are carrying out their regulatory functions. In American insolvency regime, the purpose of the § 362(b)(4) exception is aimed at preventing the statutory moratorium from transforming into an asylum for law-breakers. Jurisprudence in this regard has led to the evolution of the 'Public Policy Test'.[62] The public policy test provides that, a court must determine whether the government action will further public interest or merely accomplish the pecuniary interests of government. The moratorium will not bar a governmental action aimed at effectuating public policy. The accepted standard is that, when a governmental unit goes beyond preventing a prohibited or restricted activity and attempts to extract monetary benefit, the stay on moratorium is not available. The primary function of the aforementioned exception is to allow the state to take action against those who seek to abuse the bankruptcy law regime for escaping liability. *U.S.A. v. Nicolet, Inc.*,[63] illustrates an attempt to abuse the statutory moratorium to avoid liability for environmental damage. In *Nicolet*, it was upheld that moratorium did not bar the government's action to recover the clean-up costs and fine from a corporate debtor for causing an oil spill.

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[62] U.S. v. Nicolet, Inc., 857 F.2d 202 (C.A.3 (Pa.) 1988).
[63] *Id.*

There is no similar exception under the UK insolvency law regime. Hence, the English regime does not differentiate between governmental actions taken in pursuit of fulfilling pecuniary interest and those actions initiated to preserve public interest. The Indian position is in line with UK. Although there exists no statutory provision granting a stay on moratorium when proceedings affect the public interest, recent decision by the apex court seeks to incorporate such an exception in the Indian insolvency Regime.

The Supreme Court recently stayed the order of the NCLT which initiated insolvency proceedings against Jaypee Infratech Ltd.[64] Following admission of the insolvency application by the Allahabad Bench of the NCLT, the statutory moratorium came in effect. This adversely affected thousands of home buyers who hadn't been allotted their flats. The moratorium barred the aggrieved home buyers from initiating proceedings under the Real Estate Regulatory Authority Act, 2016 or The National Consumer Dispute Redressal Commission. The stay on CIRP was a relief as it allowed initiation of fresh proceedings by the home buyers. It is pertinent to note that status of home buyers as financial creditors is now settled.[65]

Though this instance does not deal with a governmental action, it affirms that stay on moratorium is contingent on public interest being

[64] Chitra Sharma v. Union of India, (2018)145 S.C.L. 425.

[65] Insolvency and Bankruptcy Code (Ordinance) Amendment, 2018; *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 Aug. 19, 2018).

prejudicially affected. Accordingly, government's actions for preservation of public interests are likely to be exempt from the statutory stay. The domain covered under the notion of public interest, as per the common law tradition, will be limited to exercise and implementation of governmental policies in sectors that are sensitive for the public, such as health, education, immigration and public infrastructure.[66]

6. CONCLUSION

The position of pre-existing contracts during the statutory moratorium remains largely unsettled. The author has attempted to frame out various mechanisms through which the prejudiced party can recover their interest and demand performance during the moratorium. However, the author is cognizant of the discretionary power of the court involved in obtaining some of the suggested reliefs and is of the view the view that legal regime related to the moratorium needs a legislative revamp, with introduction of certain exceptions to the statutory stay. The absolute moratorium implies a conflict between the policy objectives of contract law and those of insolvency law. As noted by UNCTAD, the moratorium should not generate legal implications which are fundamentally in conflict with the premises upon which the general law is based.

The comparative review of statutorily prescribed prescriptions clearly portrays the need to evolve certain exceptions to the moratorium for preservation of certain pre-existing contractual relations and

[66] O'Flynn, *Deliberating About the Public Interest*, 16 RES PUBLICA 299, 313 (2010).

governmental actions. Consider a scenario where National Green Tribunal (NGT) order imposing fine for causing river pollution is imposed during the petition period. There exists no categorical authority which would exempt such a fine from the stay imposed by moratorium. However, the public interest consideration taken by the apex court in *Chitra Sharma,*[67] is capable of emanating judicial decisions and subsequent legislative actions which exempt such NGT fines from the moratorium. Hence the author is hopeful that coming years would witness certain legislative reforms aimed at striking an equilibrium between policy rationale of contract law and insolvency law.

[67] Chitra Sharma v. Union of India, (2018) 145 S.C.L. 425.

CORPORATE LOBBYING: THE MEANS AND ENDS OF CORPORATE BRIBERY

Mallows Priscilla P.[*]

ABSTRACT

Bribing and lobbying are two distinct and separate concepts of influencing the Government or officials of the Government. But in India, lobbying has been equated to bribing and is considered as an illegal act. Lobbying in India is in a nascent stage and there are no laws governing it. It is neither legal nor illegal but is considered to be unlawful in India. Corporations are the best vehicles to do business and their interests matter a lot to the economy. The corporations lobby the Government but it ends up as a crime of corporate bribery as there are no checks on the activity of lobbying. This article will explain how corporate lobbying, when not regulated, paves the way to the crime of corporate bribery which is an impediment to do business in India. The author has attempted to establish the proposition better with a recent example of lobbying activity of the 5/20 rule in the airline industry.

1. INTRODUCTION

The gravity of democracy in a country is based on the participation of the people in the governance of the country. People of a country have a

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say in the governance and can also influence the decisions of the Government. This influence can be labelled as lobbying the Government. Lobbying can be defined as an influential action, motivated by particular interests without any counterpart to it which is notified to the Government official who is capable of influencing the decision of the Government. A lobbyist can only suggest, or propose, without any compensation. However, the reality is that, lobbying is done with the help of money and lobbying of one pressure group becomes repugnant to the other. The corporations are one of the pressure groups in the democracy. Corporate lobbying is prominent in India, though in a nascent stage, and has become the way of doing business in India. It is regarded as corporate bribery, a white-collar crime which needs to be checked in the current political scenario. This article will explain how corporate lobbying has become a way of doing business in India and no letter of law notices it.

2. DISTORTED DEMOCRACY

The dependence of a political system on wealth is based on the nature of the political system. The political system opens the potential of creating inequalities in wealth to become political inequalities. Wealth, power, and influence give rise to prestige and status in the society but this combination of wealth, power, and influence in politics is an unhappy combination for a democracy. Influence of wealth in politics has a corrupting effect. The lobbying of the Government by the wealthy will result in non-egalitarian policies. There will be no equality found in the pure capitalist democracy. The term Capitalist Democracy is an oxymoron in itself. Democracy is egalitarian and Capitalism is in-egalitarian.

The concern about the concept of equality in lobbying is about whether some lobby groups can exert more influence than others by virtue of having more money and political connections. Paying government officials for voting or influencing laws is illegal in India. Some groups might lobby for changes that are detrimental or repugnant to other groups. Both are representing the views of citizens who have the right to petition the government, so it can appear to the less successful group that the other might only have won its case by spending more money. Since individuals can rarely afford to lobby, they often question whether corporations with much deeper pockets have vastly more political power than they should[1]. This kind of lobbying would distort the democracy and make it purely capitalist and the concept of being egalitarian would fail and the concept of welfare cannot be thought of. In this process of securing welfare for the investors, the welfare of the other pressure groups falls low.

India is a mixed economy, as termed by the first Prime Minister, Jawaharlal Nehru. Socialist and capitalist economic principles are combined for the welfare of the people in the democracy. In this capitalist democracy, the welfare of the capitalist must not be the sole concern through lobbying which ends up in corporate bribery. This activity of lobbying helps the wealthy or the corporate, to not get detected under the

[1] Evangeline Marzec, *What Is Corporate Lobbying?*, CHRON (Oct. 26, 2018), https://smallbusiness.chron.com/corporate-lobbying-11729.html.

radar of fraud. In the United States of America, lobbying is regulated and, a study with the help of statistical data has proved that corporate lobbying results in less amount of fraud detection.

A research paper by Frank Yu and Xiaoyun Yu examines the relation between corporate lobbying and fraud detection in the United States. Using data on corporate lobbying expenses between 1998 and 2004, and a sample of large frauds detected during the same period, they have found that the firms' lobbying activities make a significant difference in fraud detection when compared to non-lobbying firms. On an average, firms that lobby have a significantly lower hazard rate of being detected for fraud, evade fraud detection 117 days longer, and are 38% less likely to be detected by regulators. In addition, fraudulent firms on an average spend 77% more on lobbying than non-fraudulent firms, and they spend 29% more on lobbying during their fraudulent periods than during non-fraudulent periods. The delay in detection leads to a greater distortion in resource allocation during fraudulent periods. It also allows managers to sell more of their shares[2]. The authors of the above-stated research conclude by stating that,

> *We also wish to point out that our results should not be interpreted as evidence of the inefficiency of corporate lobbying in general. In fact, lobbying is one of the main means by which various groups promulgate their views to legislators. Just as a corrupt election does not invalidate an entire voting system, our evidence in this study imposes no implication that we should ban*

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[2] Frank Yu & Xiaoyun Yu, *Corporate Lobbying and Fraud Detection*, 46 J. FINANCIAL AND QUANTITATIVE ANALYSIS 1865 (2011).

> *corporate lobbying. Instead, our findings shed light on the recent debate about whether to improve the transparency in corporate political spending. By providing evidence that political spending does affect the welfare of investors, our study suggests a need for more transparency in corporate political spending.*[3]

The author concurs with the views expressed by Frank Yu and Xiaoyun Yu with regards to, not banning the lobbying activity but simply regulating it. The above-mentioned study was based in a country where lobbying is regulated, yet they require more transparency in corporate lobbying. This is because, the political spending by the corporate results in distortion of resources, even if lobbying is regulated in India, it would still be a social problem. Regulating lobbying in India would mean encouraging corporate political spending which includes corporate bribery. This white-collar crime of corporate bribery through lobbying is not governed by the legal systems in the current regulatory framework and corporations continue to distort the democracy.

3. THE PRESSURE GROUP PROBLEM

The government lobbied by the wealthy leads to the destruction of the middle class. Corporate executives who bend the rules and citizens who break the rules; their lobbyists, who work to change the rules; and the politicians who change in their favour are the reason for the destruction. The middle class is the ladder which poor people use to climb out of

[3] *Id.*

poverty. A robust middle class is required to stop the lobby forces in their tracks, take back our democracy and create a middle class that's more vibrant and inclusive than ever.

The interests of the rich men are protected through lobbying. The poor's interests are not protected but are masked by the development programmes that are implemented to cover this vote bank. The middle class has no say in the governance of the nation, they do not participate in the democratic process as they are not rich enough to lobby the Government and not poor enough to avail the subsidies and benefits. They are the neglected group in the governance because of the factor of wealth. There must be equality of influence in an egalitarian society. India is egalitarian by the very spirit of Article 14 of the Constitution of India. Article 14 must be upheld and the inequality that arises from this activity of lobbying must be reduced. The main element of this inequality arises from income inequality and the failure of the Government to recognize everyone's interests. The interest of the corporations when recognized causes social harm. But corporate lobbying has become a part and parcel of doing business in India. Government needs to be cautious in its approach of checking when corporate lobbying results in corporate bribery.

4. THE CHALLENGE

The challenges faced by the corporations, the Government personnel, and the legal system to avoid corporate bribery, will be discussed as follows.

4.1. BY CORPORATIONS

Corporations face the challenge of the need to bribe in the capitalist democracy. Corruption has become the new corporate challenge in the globalized era. The fear of not being able to secure a tende leads to bribery. Every private player pays an unaccountable price for the tender. It has become a custom of business and, is not regarded as a crime in the competitive world.

This custom results in distortion of resource allocation. A competitive market in a democracy like India is not just about making money, it is about resource allocation. Corporate-bribery results in misallocation of these resources, which eventually leads to a loss to the exchequer of the Government. The welfare schemes fail because of these losses which occur more frequently.

One such loss that occurred through lobbying. which resulted in corruption, is the case of the 2G spectrum. Mr Raja, the then Telecom Minister, ignored the recommendations of Telecom Regulatory Authority of India (TRAI) and gave unwarranted benefits to the companies Swan Telecom and Unitech which caused loss to the public exchequer. The company Swan was not supposed to be allotted spectrum by Telecom

Ministry, but it did so under the undue favour of the then Telecom minister. The first come first served basis was a result of corporate bribery. The companies had bribed the government officials, to secure the spectrum. If market mechanisms were adopted like an auction, they would have to compete with the other private players and the expense of bribery will be more than they spend under the non-market mechanism. This was regarded as a case of corruption and not lobbying, which was the main element of bribing the Minister. The corporations have committed the crime of corporate bribery through the process of lobbying.

Nandini Rajagopalan and Yan Zhang in the book 'The Convergence of Corporate Governance', have discussed the major institutional impediments that corporate India faces and how those impediments contribute to the significant gaps between governance on paper and governance in practice. They say that, "some industries were at one stage so strongly permeated by the black money that it was almost impossible to carry on business without using the black money".[4]

Corruption and black money is an institutional impediment in corporate governance, rather than a custom. This impediment is overcome through the process of lobbying.

4.2. CHALLENGE BY THE GOVERNMENT PERSONNEL

Humans respond to incentives, that is where the concept of property rights comes in. Government official who is lobbied with valuable

[4] NANDINI RAJAGOPALAN & YAN ZHANG, CORPORATE GOVERNANCE IN INDIA: THE CONVERGENCE OF CORPORATE GOVERNANCE 106.

resources will act in favour of that wealthy-power, but above all, ethics needs to be practised by the Government officials. The challenge of the officials to say no to the gifts of the wealthy and to govern the country without expecting anything in return from the pressure groups is a natural challenge that every official faces in the current political scenario. This challenge needs to be faced without giving way to corporate bribery. Such challenges need to be met with the democratic spirit. In reality, the challenges are faced with the capitalist spirit and so, the influential actions lead to a loss to the exchequer, which is a major reason for arrested-development in the country despite numerous welfare schemes. Indian Government struggles to face this challenge.

4.3. BY LEGAL SYSTEM

The challenges faced by the legal system with regard to corporate bribery is that it is difficult to prosecute a wealthy corporation. The criminal law approach has a major limitation. It requires proof that an offender meant to commit the illegal act and did so with a guilty mind. The prosecution needs to prove the *mens rea* involved. When the defendant is an organisation instead of an individual, it is frequently difficult to utilize the criminal law against the violator. [5] The criminal liability of a corporation is not well defined in law. This is the major challenge that the judiciary faces in prosecuting a corporation. Legal remedy for corporate bribery should not be limited to the criminal system.

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[5] MICHAEL L. BENSON & SALLY S SIMPSON, WHITE COLLAR CRIME: AN OPPORTUNITY PERSPECTIVE 184-90 (2009).

The regulatory structure should be strengthened. The fragmented regulatory structure is also an institutional impediment identified by Nandini Rajagopalan and Yan Zhang. This current regulatory framework in India gives rise to regulatory overlap and weakens enforcement, often leading to regulatory arbitrage where the regulated take advantage of the differences in jurisdiction and inconsistency across regulators.[6]

5. THE NEW APPROACH

The legal system has to face the challenges that arise from the white-collar crime of corporate bribery through new approaches. The legal remedy for white collar crime can be from the criminal law system, civil law system or the regulatory justice system. The limitations of the criminal law system had been laid down above about the challenges the judiciary faces in prosecuting a corporation. Celia Wells, the author of the book 'Corporations and Criminal Responsibility' observes that: "The language of the law assumes that state coercion is to be exercised against an individual and that the harm which that individual might bring about will injure other specific individuals. Corporate activities do not fit that paradigm."

The civil law enforcement is another legal remedy. This approach is easier to use in comparison to the criminal law system. It requires a lower standard of evidence to prove responsibility rather than proof beyond reasonable doubt. Both individuals and the state can file a suit

[6] *supra* note 4.

against the corporation. The limitation of the civil law approach is with regard to the sanctions and it is difficult to determine the particular victim. Corporate bribery is an offence against society. Civil wrongs are against a particular person. It is difficult to determine the victims in the crime of corporate bribery and so a civil suit faces this limitation to hold a corporation liable.

The third and feasible approach is the regulatory justice system. This is an existing approach in a fragmented and influenced form. This regulatory law when framed gets influenced by the lobbyists. The law ends up protecting the interests of the corporations, which is secured by lobbying. Corporations in India are not scarce of resources. As Sutherland says the rich and the power demand and receives preferential treatment. So does, the corporations get their preferred regulatory laws. This regulatory justice system must be free from lobbying and more importantly free from the political influence. Regulation and politics must not be intertwined as business and politics are. The new approach towards corporate bribery through the regulatory system must provide stronger corporate governance in India.

It must be given a new shape. Regulation is considered the most effective legal remedy as, under regulation when a corporate is detected under the radar of fraud, the regulatory agency can subject the corporate offenders to criminal or civil sanctions, if given the authority. This regulatory system is an effective solution provided that it is free from the political clutches. The investigation officers of the regulatory structure must be independent to act against the corporate offenders. This would control the unregulated lobbying activity and avoid corporate bribery.

6. THE RECENT LOBBY

The author had written this article in 2016 but a news article in 2018 has added scope to this research. The news of 'Air Asia (India) Limited' lobbying the Government to scrap the 5/20 rule has taken place because of the grey area that this article tries to point out. There was a hue and cry about Air Asia influencing the government for a favour. If there were laws on lobbying, the scenario would have been different. Let's imagine.

6.1. THE BACKGROUND

The factual background of the lobbying activity is that Air Asia (India) Limited based in Bangalore owns 18 aircraft and is in operation in India since 2013. The company desperately wanted to go international. But the rule for airlines to go international from India is that they need to own 20 or more aircraft and has to be in operation for a minimum of 5 years in India. Air Asia wanted to start as a premature baby and couldn't wait to grow to meet the expectations of this rule. Rather they wanted to cut the line and so approached the Government officials to relax the 5/20 rule. The rule was relaxed and they started to fly internationally. Air Asia approaching the Government and Government ruling in their favour was not a transparent decision to the public. Charges have been framed against the airline's Company for such an act. So, it is not yet proved that Air Asia lobbied the Government, it is only a news that has brought lobbying into the picture recently.

6.2. THE PRESENCE OF LAW

The author makes an attempt to explain the activity of lobbying, if regulated in India. Disclosure of Lobbying Activities Act in India will make a great difference in case of above-mentioned scenarios. Air Asia (India) Limited, one of the private players in the market approaches the civil aviation ministry, expressing their desire to fly international and explaining how 5/20 rule is a hindrance to their desire. The government will hear their plea and then consult with the expert bodies and consider the market situation with other private and dominant players in the market. If the Ministry deems it fit to encourage competition or to discourage monopoly in the market, or if the economy is going to benefit in a larger way, it will agree to lobby on behalf of Air Asia. This intention of the Ministry has to be written down in the lobby register before the Minister or official of that Ministry represents the interest of the airline company. Through a ministerial declaration or through parliamentary proceedings, the Ministry can ensure that the interest of the lobby group is heard. It can also be put for public voting. After all this procedure, the Government can either give a thumbs-up or a thumbs-down to Air Asia (India) Limited. It becomes a transparent process and, no issue of bribery is involved.

This is how lobbying activity needs to work. It is neither legal nor illegal as there are no laws related to it. But in India, it is considered as illegal when wealthy corporate lobby the Government officials with money. The problem is with the usage of the term ‘lobbying’. If this term does not come into the picture, it will just be ‘bribery’. Corporate lobbying is not bribery and should not be equated with it. It becomes derogatory and is considered illegal to lobby the Government, in the absence of a law governing lobbying. This grey area needs to be coloured soon to prevent the lobbying activity from becoming corporate bribery to speed up the ease of doing business in India.

7. CONCLUSION

Lobbying in India is not recognized by the legal system. Until 2013, the Disclosure of lobbying activities Bill, introduced in the Lok Sabha as a private member’s bill equated lobbying with influencing government’s decision with money and stated that lobbying forms an integral part of democratic functioning. This integral part of the democracy cannot be defined as an influential activity with payment. This would mean bribing the official. The act of payment should not be included in the definition of lobbying. The corporations must approach the Government and convey their interests. The interest must be conveyed not through cash or in kind. The parliamentarians or the Government personnel, who are in a position to influence the decisions of the Government, have the liberty to recognize the interests of the pressure groups. This liberty must not be limited to the wealthy corporate, every interest of different pressure groups must be taken into consideration. The decision taken based on the interests of the pressure groups should be efficient and, welfare of the citizens must not be ignored. In this research paper, the author has tried to establish that lobbying leads to corporate bribery in absence of lobbying being recognised in India. In a country where there is rampant corruption, will making lobbying legal work? Legalising lobbying in a democracy would lead to legalising corruption, which would legalize corporate bribery in India. There is a dire need for regulating the corporate lobbying activity in order to prevent the democracy from becoming distorted by the influence of the corporations as India stands at the global corporate map. A mechanism needs to be introduced to avoid the freedom of lobbying to be converted into the freedom of bribery. A new approach of the regulatory justice system with an independent monitoring mechanism needs to be incorporated into the regulatory system in order to avoid the conversion of corporate lobbying into corporate bribery and to ensure that it is not an impediment to carry out business activities in India.

STARTING A STARTUP: LEGAL ANALYSIS OF A LIMITED LIABILITY PARTNERSHIP AS THE IDEAL BUSINESS STRUCTURE AND AVAILABLE INVESTMENT CHANNELS

Pranjali Sahni[*]

ABSTRACT

Considering the fact that startups are gaining massive popularity these days, it seemed important to understand the legal environment and the legal compliances relating to a startup business. Even the Government of India has a huge focus on the ease of doing business reforms and startup action plans. The reason being that, the Government wishes to simplify the business-related legal environment, in order to give a boost to startups. In this light, this article aims to discuss the structural and financial ease of doing business. Firstly, the article analyses the legal benefits of a Limited Liability Partnership over all other business structures, i.e., a public and a private company by pointing out its less complex and less compliance-seeking nature. Thereafter, the article acknowledges the importance of financial decisions for a business which are the cornerstone for its initial years. It is further understood that most people drift away from the idea of opening a startup because of their concerns over financial hurdles. In this light, the latter half of the article points out multiple funding options

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available with a Limited Liability Partnership, such as Equity and Debt Investment options, Foreign Direct Investment and other unique financing methods, and analyses each method in detail by discussing various legal regulations attached therewith.

1. CHOOSING THE RIGHT BUSINESS STRUCTURE

Choosing an appropriate business structure is one of the most difficult tasks. No business startup can succeed solely on the basis of an idea. Business structure has a very important role to play in its success. And that is why; this decision needs to be taken after a detailed analysis with precision and thought.

A Company is a body corporate having an independent legal identity, with capital divisible into transferable shares carrying limited liability, having a common seal and perpetual succession. A Public Company is one which is owned by the public through freely transferrable shares. The liability of each shareholder, however, stays limited up to the maximum amount of money that remains unpaid on his total number of shares. Another important feature of a public company is the separation of ownership from management. While the ownership lies with the Body of Shareholders, the management power vests in the Board of Directors (BOD). All important decisions are taken by the BOD. Shareholders, too, play a significant role through Annual General Meetings where they cast votes proportional to their number of shares. A Private Company is one which is owned privately by individuals. Therefore, the capital herein remains restricted. Furthermore, shares are not freely transferrable due to the concept of Preemptive Right. The other features that were prevalent in a Public Company, all exist herein as well. Both these business structures are regulated by the Companies Act, 2013.

The process of incorporation is extremely lengthy in case of a Company, beginning with Promoters, to acquiring a Digital Signature Certificate (DSG), to Directors Identification Number (DIN), to preparation of Incorporation Documents (Memorandum of Association MoA, and Articles of Association AoA) to Approval of Name to getting a Certification of Incorporation.

A new form of business structure has gained popularity lately, i.e., One Person Company (OPC). An OPC, treated as a private company[1] is a company which has only one person as a member.[2] While this business structure is suitable for a single entrepreneur wishing to start a business, it is not free from troubles, the biggest hurdles being that membership in an OPC is limited to a maximum of two, so the scope investment expansion even in future stays limited.

A Limited Liability Partnership (LLP) is a business structure that shares characteristics of both a company and an LLP. Herein, the liability of each partner remains limited like a company, the inner flexibilities of management also exist like a partnership. Furthermore, the LLP has a separate legal identity just like a company. But, the ownership and the management are unified and not separate, and exist in the hands of the

[1] Companies Act, 2013, No.18, Acts of Parliament, 2013, § 3(1)(c).
[2] *Id.* § 2(62).

partners. Further, LLP enjoys perpetual succession and transferability of stake as per the LLP Agreement. Also, interestingly, unlike a partnership, the partners in an LLP are the agents of the LLP, but not of each other[3], as pointed out by Sec. 26 of The LLP Act. It, thus, incorporates the advantages of both a partnership as well as a body corporate. Notably, this business structure is regulated by the Limited Liability Partnership Act, 2008. Herein, at least two partners and two designated partners are required for incorporation as per Sec. 6 of the LLP Act, 2008.[4] There is no maximum limit howsoever.

In case of an LLP, the procedure involves obtaining a Digital Signature Certificate (DSC) and a Director Identification Number (DIN) / Designated Partner Identification Number (DPIN) for the proposed Partners, name approval from Ministry of Corporate Affairs (MCA) and, in the end, filing for Incorporation. Notably, as a result of "Companies (Appointment and Qualification of Directors) Rules, 2018, it is mandatory for any person who wishes to incorporate an LLP to have a DIN, without which incorporation procedure would become very difficult (because in cases of incorporation, DIN cannot be applied for using DIR-3).

The document, like a Memorandum of Association (MoA) and Articles of Association (AoA) in case of company, is an LLP Agreement in case of an LLP, which governs it's various relationships, and is a very simplified document.

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[3] Limited Liability Partnership Act, 2008, No. 6, Acts of Parliament, 2009, § 26.
[4] *Id.*, § 6.

It is to be further noted that in an LLP, as indicated by Sec. 42 of The LLP Act, the right of a partner to receive profits and share losses of the LLP in accordance with the LLP Agreement is transferable.[5] This transferability would not lead to disassociation of the partner or a dissolution of the LLP. It also does not confer any management rights on the transferee or the assignee.

With the above stated detailed discussion, it can be figured that an LLP is the most ideal business structure for a business startup. It is a new corporate form that provides an alternative to the traditional partnership, with unlimited personal liability on the one hand, and, the statute-based complex governance structure of a company on the other, in order to enable professional expertise and initiative to combine, organise and operate in flexible, innovative, and efficient manner.[6]

LLP, as a structural concept, emerged out of the Naresh Chandra Committee Report on 'Regulation of Private Companies and Partnership' and the Dr. J. J. Irani Committee Report on 'Company law'. The Limited Liability Partnership Bill, tabled in Rajya Sabha on 15 December, 2006 articulated the need for LLPs in the best possible way. It stated that,

> *With the growth of the Indian economy, the role played by its entrepreneurs as well as its technical and professional manpower has been acknowledged internationally. It is felt appropriate that*

[5] *Id.*
[6] Bhavesh Bhatia & Sukhada Wagle, *Limited Liability Partnership Act,* INDIA L.J., *available at* http://www.indialawjournal.org/archives/volume2/issue_2/article_by_bhavesh_sukhada.html.

> *entrepreneurship, knowledge and risk capital combine to provide a further impetus to India's economic growth. In this background, a need has been felt for a new corporate form that would provide an alternative to the traditional partnership, with unlimited personal liability on the one hand, and, the statute-based governance structure of the limited liability company on the other, in order to enable professional expertise and entrepreneurial initiative to combine, organize and operate in flexible, innovative and efficient manner.*[7]

2. FINANCING OPTIONS AVAILABLE TO A LIMITED LIABILITY PARTNERSHIP START-UP BUSINESS

There are multiple hurdles in the path to success of a business. However, getting finance for one's startup business is not as big a hurdle anymore. In this light, this Chapter aims to point out the financial ease of doing business, by discussing various financing and funding options available for a startup business.

2.1. EQUITY FINANCING

Some innovative and new equity financing options that can be used by an LLP are, Venture Capital and Angel Investors.

Angel Investors are real life 'business angels' because they help a startup at the time when even the business plan is not ready comprehensively. They help the startup business by financing their ventures and investing in them, their deep-pocketed pool of resources,

[7] *Id.*

their high intellect and knowledge of the business world, in return for an ownership-stake in the business. Angel Investors may provide a one-time capital in order to propel the business, or may contribute the same at intervals during the difficult stages faced by the business in its initial years. Thus, an 'angel investor' is any person who proposes to invest in an angel fund and is an individual investor who has net tangible assets of at least two crores rupees excluding value of his principal residence and who has early stage investment experience or experience as a serial entrepreneur or as a senior management professional for at least ten years; or a body corporate with a net worth of at least ten crores rupees or an Alternative Investment Fund registered under these regulations or a Venture Capital Fund registered under the SEBI (Venture Capital Funds) Regulations, 1996.[8]

Venture capitalists, on the other hand, invest in firms that have both high-growth and high-risk potential. Venture-capital investments mostly come in exchange for ownership stake in the company to ensure that the investors have a say in the future. Also, it is not necessary that all venture capital financing occur in the initial stage of the company only. Funding can be provided throughout various stages of the company's progression. The fund comes from venture capital firms, which comprise professional investors who understand the intricacies of financing and building companies. The money invested by them comes from a variety of sources, such as private and public pension funds, endowment funds, foundations,

[8] *Id.*, Reg. 19-A.

corporations, and wealthy individuals. At the end, venture capitalists usually sell their shares in the company back to its owners, or to the public, or to whomsoever they believe to be more profitable.

SEBI released the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 by a notification on 21 May 2012. These Regulations govern various alternative funding investments. It shall be relevant to note that an Investee-Company is a company, special purpose vehicle, or limited liability partnership or body corporate, in which an Alternative Investment Fund makes an investment.[9] This shows that an LLP can receive investment from these financing options.

Notably, the said regulations divide various alternative investments funds into three categories.[10] Category 1 covers angel investors (regulated by Chapter 3-A) and venture capitalists, and includes those investments which invests in start-up, early stage ventures, social ventures, SMEs, infrastructure, or other sectors and areas which the government or regulators consider as socially or economically desirable.

However, any scheme launched by Angel Funds will have to comply with certain conditions.[11] Firstly, the scheme memorandum will have to be filed at least ten working days prior to the launch of the scheme with the Board. Such scheme memorandum shall contain all material information

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[9] Securities & Exchange Board of India (Alternative Investment Funds) Regulations, 2012, regulation 2(o).
[10] *Id.*, regulation 3.
[11] *Id.*., regulation 19-E.

about the investments proposed under such scheme. Apart from this, there are various other restrictions imposed on the investments by Angel Funds which have to be complied with, e.g., angel funds shall invest only in venture capital undertakings which have been incorporated during the preceding three years from the date of such investment or have a turnover of less than twenty five crores rupees; investment shall not be less than fifty lakh rupees and shall not exceed five crores rupees; investment has to be locked-in for a period of three years, investments in associates are not allowed and lastly, more than twenty-five per cent of the total investments cannot be made in one venture capital undertaking.[12]

2.2. DEBT FINANCING

Debt Financing refers to the technique of raising money in the form of loans. In return for lending the money, the individuals, or institutions become creditors and receive a promised principal sum and interest thereon at the pre-decided rate. There are broadly three channels of Debt Financing options available to a business, viz., loans from banks, External Commercial Borrowings (ECBs) and Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) Loans.

Banks and Non-Banking Financing Companies (NBFCs) grant loans on interest to startup businesses. This method is not considered very lucrative, because sometimes, banks in exchange for the loan, trade for an

[12] *Id.*, Regulation 19-F.

important managerial position in the firm until the loan is paid, and this way operates actively in the business functioning.

ECBs are commercial loans raised by eligible resident entities from recognised non-resident entities. They have been dealt with in detail in the External Commercial Borrowing (ECB) Regulations and The Foreign Exchange Management (FEMA) Guidelines.[13] ECB framework enables the raising of money in the form of loans, securitized instruments, buyers' credit, suppliers' credit, Foreign Currency Convertible Bonds (FCCBs), financial Lease; and Foreign Currency Exchangeable Bonds (FCEBs).

However, it is to be noted that the option of raising money through ECBs cannot be availed by LLPs, because as per the regulations, only companies are eligible borrowers.

In this context, it is relevant to note that The Department of Industrial Policy and Planning (DIPP), the policymaking body on foreign investment, discussed the business structure of LLPs in its discussion paper in 2011. In that paper, it was suggested that ECBs should be allowed for LLPs as well. However, the Finance Ministry and The Reserve Bank of India opposed these suggestions. It was said, in the context of LLPs, that, "It is a business structure largely aimed at professionals and small

[13] Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000; Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004; Foreign Exchange Management (Guarantees) Regulations, 2000.

businesses, which do not require overseas debt that comes with its own risks”.[14]

However, in the opinion of the author, the ECB channel should open for the LLPs, for the following two reasons:

I. Since ECBs are a cost-effective means of financing large capital expenditure and projects, they should be allowed for LLPs, otherwise it would adversely hamper their future prospective of growth and their ability to execute large projects on a sustainable basis; and,

II. Such a restrictive angle for the LLPs would obstruct them from indulging in any capital-intensive activity.

A step towards this direction is already in place, as can be seen from the recent RBI Amendment to schedule 9 of the FEMA Regulations 20/2000. By the same, the provision that specifically barred/excluded LLPs from availing ECBs, i.e., para 9(4) has been deleted.

Coming to the option of The Credit Guarantee Trust for Micro and Small Enterprises (CGTMSE) Loans, The Ministry of Micro, Small & Medium Enterprises (MSME), Government of India launched a scheme to encourage small entrepreneurs as it helps them to get loans up to Rs. 1 crore sanctioned without any collateral or surety. All scheduled commercial banks, specified Regional Rural Banks, NSIC, NEDFI, SIDBI, and NBFCs which have signed an agreement with the Credit Guarantee Trust are covered under the said scheme.

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[14] *LLP News*, LLP ONLINE (2010), http://www.llponline.in/news_detail.php?id=38 (last visited May 21, 2018).

Notably, the scheme also provides rehabilitation assistance upto Rs. 200 lakhs in case a unit covered under CGTMSE becomes sick due to factors beyond its control.[15]

2.3. FOREIGN DIRECT INVESTMENT IN LIMITED LIABILITY PARTNERSHIPS

Foreign direct investment (FDI) is an investment made by a company or an individual of one country in another country by either establishing business operations or acquiring business assets.

FDI in India is undertaken in accordance with the FDI Policy which is formulated and announced by the Government of India. DIPP issues a Consolidated FDI Policy Circular on a yearly basis on March 31 of each year explaining the policy. Apart from this, The Foreign Exchange Management Act (FEMA), 1999 and The Foreign Exchange Management (Transfer or Issue of Security by Person Resident outside India) Regulations, 2000 (FEMA 20/2000) govern and regulate FDI in India.

Broadly, there are two routes for the entry of FDI in India; viz, the automatic route and government route. While under the former, the foreign investor or the Indian company does not require any approval from the RBI or the Government; under the latter, prior approval from the Foreign Investment Promotion Board (FIPB), Department of Economic Affairs (DEA) or Ministry of Finance or Department of Industrial Policy & Promotion, as the case may be, is required.

15 *Eligibility Criteria, Credit Guarantee Fund Trust for Micro and Small Enterprises*, UDAAN, https://www.cgtmse.in/Eligibility_criteria.aspx (last visited May 15, 2018).

In the context of LLPs, it is pertinent to note that the Master Circular issued by the RBI[16] on 1 July 2014, clarifies that an LLP formed and registered under The LLP Act, 2008 shall be eligible to accept FDI under Government route only, subject to the conditions given in Annex B.[17] Notably, Annex B deals with the Scheme for Acquisition/ Transfer by a person resident outside India of capital contribution or profit share of Limited Liability Partnerships (LLPs) in detail. It may be further noted that, an LLP operating in sectors where 100% FDI is allowed under the automatic route would be eligible to receive FDI. These sectors are provided under The Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000.[18] However, certain sectors are not eligible to seek FDI, e.g., sectors eligible to accept 100% FDI under automatic route but are subject to FDI-linked performance related conditions; those eligible to accept less than 100% FDI under automatic route; those eligible to accept FDI under Government Approval route; agricultural/plantation activity and print media; lottery businesses, gambling and betting, real estate business, manufacturing of cigars, atomic energy, and railway operations etc.;

[16] Reserve Bank of India, *Master Circular on Foreign Investment in India*, No. 15 /2015-16, RBI/2015-16/96, *available at* https://rbidocs.rbi.org.in/rdocs/notification/PDFs/96MC7984B235BAB249D5ADCD6277CCD68D0D.PDF (last visited May 4, 2018).
[17] Reserve Bank of India, *Master Circular on Foreign Investment in India*, No.15/2014-15, RBI/2014-15/6, ¶ 16(1), *available at* https://rbidocs.rbi.org.in/rdocs/notification/PDFs/06FIC010714FL.PDF.
[18] Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000, annex. B sch. 1.

Downstream Investment has also been regulated by the RBI in its Circular. When an Indian company which has FDI further invests in an Indian company/LLP, it is called an Indirect Foreign Investment or a Downstream Investment. An Indian company, having foreign investment, will be permitted to make downstream investment in an LLP only if both, the company as well as the LLP, are operating in sectors where 100% FDI is allowed under the automatic route and there are no FDI-linked performance related conditions. Responsibility of compliance shall be on the LLP.

Certain other conditions pointed out by the Circular are as follows:

I. If an LLP with FDI has a body corporate as a designated partner or nominates an individual to act as one u/s 7 of the LLP Act, 2008, such a body corporate should only be a company registered in India under the Companies Act. Notably, the word 'body corporate' herein does not include an LLP or a Trust. The individual partner would have to be not only a 'resident' in India',[19] but also, a 'person resident in India'.[20] This means that he must be a person who has stayed in India for more than 182 days in the immediately preceding one year. However, certain exclusions lie to the same.

II. If a company with FDI wishes to convert into an LLP, it will have to meet the provided stipulations and take prior approval of FIPB/Government; and

[19] Limited Liability Partnership Act, 2008, No. 6, Acts of Parliament, 2009, § 6.
[20] Foreign Exchange Management Act, 1999, § 2(v)(i).

III. LLPs shall not be permitted to avail External Commercial Borrowings (ECBs).

Notably, the FDI Policy of 2017 has incorporated many aspects of the RBI Master Circular and has dealt with FDI in LLPs extensively. Most importantly, it recognises foreign investment in startups organised as a partnership firm or an LLP, and says that the same can be made through capital or through any profit-sharing arrangement,[21] while also specifying some conditions[22] with which LLPs have to comply with before undertaking FDI.

The Policy also scrutinizes downstream investments[23] by eligible LLPs and subjects them to the following conditions:

I. Mandatory notification to the RBI within 30 days of any downward investment and the modality of investment in any new or existing ventures;
II. Resolution by the Board of Directors and also a support by the shareholders agreement, if any;
III. Compliance with the SEBI Guidelines and the RBI Guidelines; and
IV. Funds for the downstream investments would have to be brought in from abroad and not leveraged from the domestic market.

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[21] Atul Chaturvedi (Department of Indus. Pol'y & Promotion, Ministry of Commerce & Indus., Govt. of India), *Consolidated FDI Policy Circular of 2017*, D/o IPP F. No. 5(1)/2017-FC-1, 2017, *available at* http://dipp.nic.in/sites/default/files/CFPC_2017_FINAL_RELEASED_28.8.17.pdf.

[22] *Id.*, ¶ 3.2.4.

[23] *Id.*, ¶ 3.8.4.2.

In this context, it shall also be relevant to discuss The FEMA (Transfer or Issue of Security by Persons Resident outside India) Regulations (RBI Second Amendment), 2017.[24] These Regulations prescribe certain conditions for permitting FDI in LLPs, compliance with which is mandatory.[25] Pricing, as provided under the Regulations is the same as that under the RBI Master Circular of 2015. Similarly, the Mode of Payment compliances too are the same, with only one point of difference, i.e., they have to be in accordance with Foreign Exchange Management (Deposit) Regulations, 2016. As far as the reporting of foreign investment in LLPs and disinvestment or transfer of capital contribution or profit shares between a resident and a non-resident is concerned, the same has to be done in a manner prescribed by the RBI. Furthermore, a Report titled 'Annual Return on Foreign Liabilities and Assets' has to be annually submitted by all LLPs which have received FDI in the previous year as well as in the current year.

Importantly, the amendments made by the RBI to Schedule 9 of the FEMA Regulations,[26] led to some key changes,[27] and the same may be summarised as:

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[24] Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) (Second Amendment) Regulations, 2017, RESERVE BANK OF INDIA https://rbi.org.in/Scripts/BS_FemaNotifications.aspx?Id=10876 (last visited May 10, 2018).

[25] *Id.*, ¶ 3 sch. 9.

[26] *Id.*, sch. 9.

[27] *Foreign Direct Investment in Limited Liability Partnership – Revised guidelines*, *Tax Flash News*, KPMG, http://www.in.kpmg.com/taxflashnews/KPMG-Flash-News-FDI-in-LLP-Revised-guidelines-2.pdf (last visited May 13, 2018).

I. Reporting requirements have been simplified as a result of amendments to Para 7(1), (2) and (3).
II. A clarity has been provided for the conversion of a company with FDI into LLP due to an effect of amendment to Para 9(3). Also, now, an FIPB approval for such a conversion would no longer be required.
III. Amendment to Para. 9(4) signals a ray of hope for the ECB channel to be opened soon for LLPs, provided that suitable amendments are made to the ECB regulations as well.
IV. Para. 9(1) was amended to allow foreign companies to be appointed as DP. Apart from that, the residency test criteria under FEMA to be satisfied by individuals appointed as DP is no longer required.

2.4. OTHER METHODS OF FUNDING

Crowd-funding is a method wherein, a business goes to an online crowd-funding portal and mentions all the details of his business, including the objective, products and line of business, capital requirements, expected profits etc. All those who like the idea can invest and pool in their money to help out the business. This money, given under an online pledge, is essentially a payment made by them for the pre-orders of the products sold by the business. Some investments, however, are in the form of donations. One of the benefits of crowd-funding is that it helps in marketing and promotion of the product, apart from being a financing mechanism. Also, if the entrepreneur is apprehensive about the demand of his product, the same can be assessed by the amount of pre-orders received. This method also cuts out professional brokers, as it puts funding in the hands of common people.

Factoring or invoice advancing is another method through which a service provider lends money on the basis of the invoices that have been billed out already. Once the customer pays back the money on the goods taken on credit and settles the bill, the service provider is paid off.

Business incubators and accelerators help in the funding of hundreds of startups every year and are considered to be a very good option for early stage businesses. A fundamental difference between the two is that while incubators help the business in the infant stage and nurture it like a parent, accelerators come into play at the adolescent stage and help the business to progress and grow. An advantage of this method is that the entrepreneurs make good connections with mentors and business professionals.

Rest apart, 'Pradhan Mantri Micro Units Development and Refinance Agency Limited (MUDRA)', is a Government backed scheme that starts with an initial corpus of Rs. 20,000 crores to extend benefits to around 10 lakhs SMEs. All that has to be done is, submitting a business plan, getting it approved, and thereafter, getting the loan sanctioned.

Another program is that of MUDRA Card, which is like a credit card, which you can use to purchase raw materials, meet other expenses etc.

Further, different states have come up with different programs like, Kerala State Self Entrepreneur Development Mission (KSSEDM), Maharashtra Centre for Entrepreneurship Development, Rajasthan Startup Fest, etc. to encourage small businesses.[28]

3. CONCLUSION

It may be safely concluded that, for the ease of doing business, one must choose the business structure of a Limited Liability Partnership. Not only is it much simplified with minimal compliance requirements, there are multiple financing options available for it too, including equity and debt financing methods as well as Foreign Direct Investment. Thus, investment would not be an issue for an LLP, which is the major concern and reason for resorting to and choosing a company structure. However, startups must take the take the decision as to debt and equity wisely, *i.e.*, a balanced proportion of both the funding options.

[28] Harshal Katre, *Funding Options to Raise Startup Capital for Your Business*, PROFIT BOOKS, http://www.profitbooks.net/funding-options-to-raise-startup-capital-for-your-business/ (last visited May 10, 2018).

ACCOMODATING PRE-PACKS IN THE INDIAN INSOLVENCY REGIME

Priyadarsini T.P. & Vishnu Suresh[∗]

ABSTRACT

The Insolvency and Bankruptcy Code, 2016 was enacted to establish a uniform, comprehensive legal framework to govern the matters of Bankruptcy in India. Since its inception, it has been hailed as being creditor-friendly. One of the reasons for the same is that the Code leans in favour of extensive monitoring of the Insolvency Resolution Process by the Courts. Though good in its intentions, this leaves no scope for informal arrangements which may be desirable in certain circumstances. Such an approach is based on the assumption that Indian market is not mature enough for informal Bankruptcy resolution.

It is against this backdrop that this paper seeks to study Pre-Packs, a popular mode of informal/quasi-formal bankruptcy resolution prevalent in many jurisdictions over the world. Such arrangements existing in the US and UK are chosen as the primary subject matter of scrutiny. The paper evaluates the viability of Pre-Packs as an alternative Insolvency Resolution mechanism in terms of both corporate rescue and satisfaction of creditors' claims as against the formal bankruptcy procedure. The criticisms against such arrangements are also discussed. The paper then

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analyses the present Indian Insolvency Regime to determine the feasibility of Pre-Packaging in India. A comparison is made between the legislative intention and judicial trend to show that such pre-packs ought to be given legal recognition. Finally, it illustrates how the Insolvency Code can be amended so as to accommodate such pre-packed arrangements in India.

1. INTRODUCTION

A bankruptcy resolution process ideally aims to enable both the parties, i.e. debtors and creditors to realize maximum value of the insolvent business' assets. Often, this is not possible as both the sides have conflicting aims. Creditors, as soon as they get a whiff of bankruptcy, tend to close their investment and explore other opportunities. To resolve such conflicts, there is a need for a sound regulatory framework, which should ideally bring in 'procedural certainty' and ensure a smooth negotiation process by maximum dissemination of information to both sides. [1]In India, the Insolvency and Bankruptcy Code,[2] is the governing legislation on matters such as Corporate Insolvency, Partnership and LLP Insolvency and Individual Bankruptcy. It was enacted to thoroughly overhaul the erstwhile fragmented framework of Insolvency Resolution which was congested with multiple recovery mechanisms under multiple legislations before multiple Courts. For the same reason, ease of doing business in India was deplorable which is evidenced by a 2014 World Bank Report

[1] REPORT OF THE BANKRUPTCY LAW REFORMS COMMITTEE VOLUME I: RATIONALE AND DESIGN 22 (Nov. 22, 2015).

[2] Insolvency and Bankruptcy Code, 2016, No. 31, Acts of Parliament, 2016.

that stated that the average time to recover from bankruptcy in India is 4 years as opposed to 0.8 years in Singapore and 1 year in London.3 Therefore, the IBC was enacted to bring the Indian Insolvency Regime at par with the well-developed bankruptcy regimes of other countries.

However, the existing framework emphasizes on extensive supervision by Courts. The reason cited for this is, in the former haphazard framework, debtors were often able to get away without paying the creditors' sufficiently. However, analysing the judicial trend for over more than a year after the IBC came into force, one finds that pre-packaging may not be a gruesome addition to the present framework.

The aim of this Paper is to explore the viability of introducing 'Pre-packs', an established mechanism of Insolvency Resolution in many jurisdictions, to India, after perusing the existing models in U.K and U.S. and weighing its pros and cons. Pre-packaged bankruptcy arrangements have come to play an important role in bridging the gap between the formal and informal insolvency regimes in various jurisdictions across the world. Generally, it serves as a mode of contingency or recovery planning, in anticipation of Bankruptcy.[4] U.K and U.S are chosen for the present study as the foundations upon which their insolvency regime rests are sharply contrasting. U.K maintains a pro-creditor approach while the U.S leans towards a pro-debtor approach. In the concluding section, the

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[3] *Time to Resolve Insolvency, Doing Business Project,* THE WORLD BANK, https://data.worldbank.org/indicator/IC.ISV.DURS (last visited Feb. 23, 2017).

4 Vanessa Finch, *Prepackaged Administrations: Bargains in the Shadow of Insolvency or Shadowy bargains* J.B.L. 568, 569 (2006).

authors propose reforms to the existing Indian regime so as to recognize pre-packs which should be a middle ground between Formal and Informal Bankruptcy Procedure (for e.g., out-of-court settlement). This is in consideration of the concern that the existing Indian market is not mature enough to completely do away with Court supervision.

2. PRE-PACKAGED BANKRUPTCY ARRANGEMENTS IN UNITED STATES

The legislation that covers the matters of Bankruptcy in the US is the Bankruptcy Reform Act of 1978[5] in which Chapter 11, specifically deals with reorganization. US bankruptcy regime leans towards corporate rescue in as much as that the important objective of Chapter 11 is to ‘expeditiously and effectively separate the past problems in a business from its future prospects to enable the debtor to continue the business in as many cases as possible after reorganization with protection of the estate and creditors.[6]

Pre-packaged bankruptcy is a combination of private workout and legal bankruptcy.[7] In a conventional bankruptcy case, the debtor files a bankruptcy petition, then negotiates a reorganization plan and solicits votes. An automatic stay of all lawsuits[8] and other proceedings to enforce any pre-petition obligation of the debtor[9] comes into force upon the filing

5 Bankruptcy Reform Act, 11 U.S.C., §§ 1101-1174 (1978).
6 J.S. Moore & V.P. Slusher, *Bankruptcy Code Section 363 Sales: Trends and Opportunities*, NORTON BANKR. L. ADVISER, no. 9, 2007.
7 JEFFREY JAFFE ET AL., CORPORATE FINANCE 841 (10th ed. 2012).
8 11 U.S.C. § 362(a)(1) (2000).
9 11 U.S.C. § 362(a)(3); Section 362(a)(6) ; Sections 362(a)(4)–(5) (2000).

of the petition. The purpose of this stay is to provide the debtor with breathing room during the reorganization negotiations.[10]

In a pre-packaged plan, the applicant negotiates a plan and solicits votes before filing of a Chapter 11 petition.[11]There is simultaneous filing of Chapter 11 petition and plan of reorganization limiting the Court's role to setting a date for approval of disclosure statement and the reorganization plan.[12]

The first major case of pre-packaged bankruptcy was that of Crystal Oil Company. The company filed for bankruptcy on 1stOctober, 1986. Three months later, the total indebtedness of the firm was reduced from $277 million to $129 million. Creditors received combinations of convertible notes, common stock, and convertible preferred stock in exchange for giving up their claims. [13]The company was able to emerge from bankruptcy within such a short period of time because reorganization was finalized by way of private agreement before a petition was filed for bankruptcy under Chapter 11.

Section 1102 (b) (1) of the U.S. Bankruptcy Code permits the official committee to be comprised of members organized by the creditors themselves before the commencement of the case, provided, they are fairly chosen and are representative of different kinds of claims. Section 1121

10 H.R. REP. NO. 95-595, at 340 (1977); S. REP. NO. 95-989, 54–55 (1978).
11 *In Re*, Pioneer Finance Corp., 246 B.R. 626 (Bankr. D. Nev. 2000).
12 LAW AND PRACTICE OF RESTRUCTURING IN THE U.K. AND U.S. 205 (C. Mallon et al. eds., 2011).
13 John McConnell, *The Economics of Prepackaged Bankruptcy* 4 J. APPLIED CORPORATE FINANCE, no. 2, 1991, at 93, 94.

(a) provides that a debtor may file a plan for reorganization simultaneously with its petition for a voluntary bankruptcy case. These provisions are the evidence of Congressional recognition of the fact that negotiations between a debtor and its creditors outside of a bankruptcy court can actually assist in the ultimate goal of bankruptcy law which is to reconcile the interests of debtors and creditors in a mutually satisfactory way.[14]

Before entering into negotiations, creditors typically execute agreements such as waiver or forbearance agreements to modify or waive their rights to collect debts. This is to avoid any creditor from initiating formal bankruptcy proceedings amidst the negotiations. U.S. Courts have upheld such agreements which signalled concerted action, even if they were challenged by a dissenting minority. An illustrative case is *In Re, NRG Energy Inc.*,[15] where, a debtor had begun negotiations with certain creditors for a pre-packaged bankruptcy plan. Certain other creditors, who were not party to the negotiations, filed an involuntary bankruptcy petition against the debtor before a pre-packaged plan could be filed. In response, the debtor sought to have the bankruptcy court abstain from exercising its jurisdiction over it, or in the alternative, to dismiss it. The Court ruled in favour of the debtor and emphasized that the debtor had already entered into substantial negotiations with the creditors which had enabled him to take substantial steps toward filing its own negotiated restructuring.

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14 *supra* note 12, at 206..
15 294 B.R. 71 (Bankr. D. Minn. 2003).

3. PRE-PACKS IN THE UNITED KINGDOM

In the United Kingdom, pre-packaged administration is the mechanism where, an administrator works with the management prior to his formal appointment to work out a resolution plan in confidence. The resolution plan which may provide for sale of all or some of the company's assets is affected immediately after the appointment of the administrator.[16]

Pre-packs are a result of the promotion of rescue culture as opposed to debt collection during insolvency. The reforms introduced by Enterprise Act 2002,[17] such as a system of out-of-court entry into administration, have made way for the higher incidence of pre-packs.[18] Increased costs to be paid to professionals, demands of ransom payments by suppliers who have monopoly, etc. have been observed to be certain flaws of the formal insolvency regime that may have led to this steady growth of pre-packs in the U.K. According to a leading study, there was a considerable amount of increase in pre-pack administrations in the U.K. between 2001 and 2004.[19] A 2009 Report stated that a third of the administrations in the U.K were pre-packs.[20] The 2012 Insolvency Service

16 INSOLVENCY SERVICE, STATEMENT OF INSOLVENCY PRACTICE 16 (2016).
17 Enterprise Act 2002, c.40 (Eng.).
18 GERARD MCCORMACK, CORPORATE RESCUE: AN ANGLO-AMERICAN PERSPECTIVE 72 (2008).
19 SANDRA FRISBY, A PRELIMINARY ANALYSIS OF PRE-PACKAGED ADMINISTRATIONS 15 (2007).
20 INSOLVENCY SERVICE, REPORT ON THE OPERATION OF STATEMENT OF INSOLVENCY PRACTICE 5 (2009).

Report states that the percentage of pre-packs increased from 25 % in 20111 to 29% in 2012.[21]

4. WHY CHOOSE PRE-PACKS?

The U.S. pre-pack is described as a 'hybrid form of reorganization'[22] as it combines the transparency and the need for creditor consent in a Chapter 11 procedure with the flexibility of an out-of-court workout.[23] A study observed that pre-packaged bankruptcies come with the advantages of a formal bankruptcy and are more efficient.[24] Further, empirical studies suggest that, private restructuring is generally the preferred method of dealing with debtor default in the U.S.[25]

4.1. DECREASED COSTS AND INCREASED SPEED

In U.K, a pre-pack is generally observed to offer the best chance to rescue a business, preserve goodwill and employment, maximize realization and generally speed up the insolvency process.[26] Resorting to pre-packs enables the distressed companies to avoid significant expenses

21 INSOLVENCY SERVICE, 2012 ANNUAL REVIEW OF INSOLVENCY PRACTITIONER REGULATION 4 (2013).
22 E. Tashjian et al, *Prepacks, An Empirical Analysis of Prepackaged Bankruptcies*, 40 J. FINANCIAL ECON., no. 1, 1996, at 135, 138-39.
23 J.K. Mateti & R.S. Vasudevan, *Resolution of Financial Distress: A Theory of the Choice Between Chapter 11 and Workouts*, 9 J. FINANCIAL STABILITY 196 (2013).
24 J.J. McConnell et al., *Prepacks as a Mechanism for Resolving Financial Distress: The Evidence*, 8 J. APPLIED CORPORATE FINANCE, no. 4, 1996, at 99,102.
25 G. Kilson et al., *Trouble Debt Restructuring: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FINANCIAL ECON. 315, 335 (1990).
26 INSOLVENCY SERVICE, ENTERPRISE ACT, 2002 – CORPORATE INSOLVENCY PROVISIONS: EVALUATION REPORT 147 (2008).

and relatively complicated formal bankruptcy process.[27] It minimizes the time a company will spend in insolvency and thus increase the chance of rescuing its business as they open up the scope for debt restructuring at a stage when the company's business may still be viable.[28]

Therefore, decreased costs and increased speed in emerging from bankruptcy are, certain factors which prompt the resort to pre-packaged bankruptcy.

4.2. REPRESENTATION OF THE EXISTING MANAGEMENT

In India,[29] and in the U.K, the Corporate Debtor's management is out of the picture once the insolvency proceedings are initiated.[30] It is unreasonable to entirely exclude the Management from the scene in cases where corporate distress was not a result of fault or fraud of the Management. Their non-participation may even result in deterioration of the value as they are the most acquainted with the business and may be in a better position to plan its revival. However, it has to be noted that this may not be the situation at all times as the company's distress might have been brought about by mismanagement itself. In such cases, creditors may be put at greater risk, if the debtor-in-possession model is followed.[31]

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27 BO XIE, COMPARATIVE INSOLVENCY LAW: THE PRE-PACK APPROACH IN CORPORATE RESCUE 323 (2016) .
28 *Id.* at 323.
29 Insolvency & Bankruptcy Code, 2016, § 21.
30 Insolvency Act, 1986, c.45, sch. B1, [59]-[61] (U.K.).
31 John Armour, *The Rise of the 'Pre-Pack': Corporate Restructuring in the UK and Proposals for Reforming*, *in* RESTRUCTURING COMPANIES IN TROUBLED TIMES: DIRECTOR AND CREDITOR PERSPECTIVES 29 (R.P. Austin et al. eds., 2012).

Moreover, increased role of management would decrease the role played by Insolvency Professionals and thereby bring down the Insolvency Resolution Process costs as well.[32]

4.3. LESS DEPRECIATION OF VALUE OF ASSETS AND DISRUPTION IN BUSINESS

Pre-packs can be a good option of informal insolvency resolution in companies whose business is reputation based or Intellectual Property based.[33] The value of such businesses can drastically diminish even at the hint of a formal insolvency.[34] Formal insolvency declaration often drags down the value of the goodwill.[35] Negative publicity as a result of stigma attached to being insolvent, in this way jeopardizes the objective of realization of maximum value of the company's assets.[36] Further, other entities would be reluctant to continue/commence business with the Corporate Debtor and this adversely affects the prospects of the Debtor for a rebirth even more.[37] This problem is aggravated in situations where the

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32 J. Armour et al., *The Costs and Benefits of Secured Creditor Control in Bankruptcy: Evidence from the U.K.*, 10-13, Univ. of Cambridge Centre for Business Research, Working Paper No. 332, 2009, *available at* papers.ssrn.com/sol3/papers.cfm?abstract_id=912302.
33 MCCORMACK, *supra* note 18, at 72.
34 Martin Ellis, *The Thin Line in the Sand – Pre Packs and Phoenixes*, 3 RECOVERY (2006).
35 Tracy Chan, *Schemes of Arrangement as a Corporate Rescue Mechanism: The Singapore Experience*, 18 INT'L INSOLVENCY REV. 42 (2009).
36 P. Walton, *Pre-Packaged Administrations – Trick or Treat,* 19 INSOLVENCY INTEL. 113, 115 (2006).
37 G. Meeks & J.G. Meeks, *Self-Fulfilling Prophecies of Failure: The Endogenous Balance Sheets of Distressed Companies,* 45 ABACUS 22, 25 (2009).

Corporate Debtor has entered into contracts that contain terms to the effect that it will stand terminated on the commencement of formal insolvency proceedings.[38] In such a scenario, pre-packs may be the best option as they are both, beneficial to the creditors and can give the business a second chance.[39] There is no scope for goodwill deterioration because by the time the public comes to know of the insolvency, the plan to save it would already have been conjured.[40] However, it has to be noted that, these costs cannot entirely be avoided and can only be reduced.[41]

Pre-packs cause relatively less disruption to the business and there is a higher degree of certainty of its continuation. In *DKLL Solicitors v. HM Revenue Customs*, the High Court of Justice (Chancery Division) upheld a pre-packed sale of a solicitors' business on the ground that the pre-packaged sale minimized disruption to clients and was the best way to protect jobs.[42]

4.4. BALANCES CREDITORS' INTERESTS WITH CORPORATE RESCUE

Pre-packs aim at selling the distressed business as a going concern and its pre-determined nature offers a high level of certainty to creditors.[43]Further, the secured creditors enjoy a greater degree of control

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38 Armour, *supra* note 31, at 13.
39 A. Bloom & S. Harris, *Prepackaged Administrations –What Should be Done Given the Current Disquiet*, 19 INSOLVENCY INTEL. 122, 122 (2006).
40 *In Re*, DKLL Solicitors [2007] E.W.H.C. (Ch.) 2067 (Eng.).
41 J. Armour & S. Deakin, *Norms in Private Insolvency: The "London Approach" to the Resolution of Financial* Distress, J. Corp. L. Stud. 21, 23 (2001).
42 [2007] E.W.H.C. (Ch.) 2067 (Eng.).
43 Xie, *supra* note 27, at 90.

in such arrangement. For the same reason, they are sometimes considered to be more attractive than a protracted formal insolvency process. [44]

4.5. MINIMIZED CHANCES OF HOLD-OUT

In a pre-packaged bankruptcy, the company enters into an agreement of compromise or sale of the company with the large creditors leaving out the smaller creditors' claims.[45] This minimizes the chances of a holdout by minority creditors. It is further minimized when combined with the protection offered by the formal bankruptcy procedure by way of which dissenting creditors can be bound by the terms of reorganization agreement if it garners the support of the required majority.[46] Therefore, pre-packs can provide a cost-effective and expeditious way for the majority creditors to bind the minority. In U.S, the unsecured and minority creditors are not party to the negotiations as they have no real economic interest in the company. But they are free to use the challenges that are ordinarily brought against conventional bankruptcy cases.

5. INCORPORATING PRE-PACKS IN INDIA

The growing popularity of insolvency resolution, through pre-packs, has led to the recognition of similar procedures in other countries such as Accelerated Financial Safeguard procedure (*Procédure de*

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44 MCCORMACK, *supra* note 18, at 72.
45 T.J. Salerno & C.D. Hansen, *A Prepackaged Bankruptcy Strategy,* 12 J. BUSINESS STRATEGY 36 (1991).
46 K.A. Mayr, *Enforcing Prepackaged Restructurings of Foreign Debtors under the U.S. Bankruptcy Code*, 14 AM. BANKR. INST. L. REV. 469, 497 (2006).

Sauvegar de Financière Accélérée) in France,[47] Protective Shield Proceedings (*Schutzschirmverfahren*) in Germany,[48] Legge Fallimentare of Italy[49] etc. Before analysing the judicial decisions that incline towards party-autonomy, it is pertinent to peruse the preparatory works of IBC to understand whether pre-packs were ever considered at some point.

The Interim Bankruptcy Law Reforms Committee has discussed the prospect of introducing pre-packaged corporate rescue in India.[50] However, it opined that the Indian market is currently not sufficiently developed to allow sales with zero intervention by NCLT. Nevertheless, there is scope for hope as the Report has waved a green flag for encouraging NCLT-supervised schemes of arrangement after consultation with the stakeholders.[51] The Report states that such pre-packs may be approved by NCLT within 30 days of filing after confirming that the scheme satisfies certain requirements. BLRC was of the view that further consultation may be required with the stakeholders before allowing such pre-packed sales as part of Schemes of Arrangement without involving all the requirements relating to creditor meetings, after taking note of the criticism such plans have received for not taking into account the interests of all stakeholders.[52] It was of the opinion that, separate rules be

47 Code De Commerce [C.Com.] [Commercial Code] art. L.628-1 L.628-7 (Fr.).
48 Gesetzzurweiteren Erleichterung der Sanierung von Unternehmen [ESUG] [The Law on the Facilitation of the Restructuring of Enterprise], Dec. 7, 2011, Das Bundesgesetzblatt [BGBI] at 2582 I 2011 (Ger.).
49 Leggefallimentare, 16 marzo1942, n.267, G.U., Apr. 6, 1942, n.81 (It.).
50 INTERIM REPORT OF THE BANKRUPTCY LAW REFORMS COMMITTEE 2 (Feb., 2015).
51 BLRC Report, *supra* note 1, at 79.
52 *Id.*

introduced to provide an impetus to such schemes while also protecting the interests of the stakeholders sufficiently.

Further the makers of IBC have opined that scheme of arrangement have been relatively successful and can be an effective tool for debt-restructuring in India as restructurings can be achieved less formally and less expensively.[53] However, no efforts were made to explore its potential as a full-fledged debt restructuring mechanism under the Insolvency Regime. It is to be noted that scheme of arrangement has the hues of a pre-packaged bankruptcy arrangement. [54]

The BLRC Report has reiterated the nine broad objectives of an insolvency law regime, as stated by UNCITRAL, which includes maximization of value of assets, striking a balance between liquidation, and reorganization etc.[55]Speed has been recognized to be the essence for the working of the Bankruptcy Code. [56]It was also noted that the liquidation value of the assets tends to go down with time and that sale of the company as a going concern would fetch a better realization.[57]The entire scheme of the Code has been summarized by the Hon'ble Supreme

53 *Id.*, at 78.
54 UmakanthVarottil, *The Schemes of Arrangement as a Debt Restructuring Tool in India: Problems and Prospects*, NUS - Centre for Law & Business, Working Paper No: 17/02, 2017, *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2943855.
55 U.N. Comm'n on Int'l Trade Law (UNCITRAL), Legislative Guide to Insolvency Law, Part I, 10 – 14, *available at* www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf (last visited Mar. 3, 2018).
56 BLRC Report, *supra* note 1, at 15.
57 *Id.*

Court in *Innoventive Industries Ltd. v. ICICI Bank Ltd.*,[58] wherein it observed that:

> *The scheme of the Code therefore is to make an attempt, by divesting the erstwhile management of its powers and vesting it in a professional agency, to continue the business of the corporate body as a going concern until a resolution plan is drawn up, in which event the management is handed over under the plan so that the corporate body is able to pay back its debts and get back on its feet.*

From the above observations, it can be concluded that the underlying scheme of IBC and the objectives of Pre-packs are not at polar extremes.

` The IBC is being hailed as being pro-creditor in its nature.[59] This inevitably means that there is little scope for participation of corporate debtors. Once the application is admitted, there is no opportunity for the corporate debtor to make a representation in stages such as, appointment of Insolvency Resolution Professional (IRP), finalizing Resolution Plan etc. Even though the members of the suspended Board of Directors can participate in the meetings of Committee of Creditors,[60] they have no voting rights, thus reducing their role to mere spectators. As the IRP takes over the management and control of the Corporate Debtor entirely, even

58 Civil Appeal No: 8337-8338/2017, ¶ 33, (Aug. 31, 2017).
59 UmakanthVarottil, *Supreme Court reaffirms creditor-friendly nature of Insolvency Law*, INDIA CORP. LAW (Sep. 1, 2017), https://indiacorplaw.in/2017/09/supreme-court-affirms-creditor-friendly-nature-insolvency-law.html.
60 Insolvency & Bankruptcy Code, 2016, § 24(3)(b).

day-to-day activities of the company would require creditors' meeting and approval.

Insolvency Resolution is almost always a costly affair. However, the formal insolvency process in India offers 'little scope for further injection of capital or small-scale sale of assets', during the period of insolvency by reason of the moratorium that is placed.[61] The option to resort to pre-packaged bankruptcy gives the corporate debtor/creditor to start off early so that the company remains sufficiently liquid throughout the entire period of negotiations.

Further, Rule 8 of Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules prohibits withdrawal of an application once it has been admitted, leaving no scope for the parties to settle afterwards. Some recent judicial decisions strike a rather discordant note. The Supreme Court, in its decision in *Lokhandwala Kataria Construction (P) Ltd. v. Nisus Finance and Investment Managers LLP*, allowed a settlement between the parties.[62] However, it is doubtful whether this can be treated as a precedent. as the settlement was allowed in exercise of Supreme Court's powers under Article 142 with respect to the facts of the particular case. [63]In another case, while allowing a settlement between the parties, the Supreme Court observed thus:

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61 *Id.*, § 14.

62 [2017] 140 C.L.A. 215 (N.C.L.A.T.).

63 Goda Raghavan, *No level playing field*, THE HINDU (Aug. 12, 2017), www.thehindu.com/opinion/op-ed/no-level-playing-field/article19476401.ece (last visited Apr. 8, 2018).

> *We are of the view that instead of all such orders coming to the Supreme Court as only the Supreme Court may utilize its powers under Article 142 of the Constitution of India, the relevant Rules be amended by the competent authority so as to include such inherent powers. This will obviate unnecessary appeals being filed before this Court in matters where such agreement has been reached.*[64]

This issue has been discussed by the Report of the Insolvency Law Committee which concluded that such settlements post admission may be allowed if 90% of the Committee of Creditors approves it. [65]Such a high threshold may make it impossible to ever reach a settlement even in the cases where it is the most appropriate recourse. This points at the need for the authority to adjudge the viability and propriety of settlement in the interests of business rescue even when the threshold is not satisfied.

Moreover, if such post-petition settlements can have legal validation, pre-petition settlements such as pre-packs should be considered next.

Apart from the fact that there is no legal recognition of informal insolvency resolution, these are some hindrances which stand in the way of informal insolvency resolution between the management and the creditors indicative of 'extensive intervention of Bankruptcy Laws in the relations between creditors and the Corporate Debtor'. This is not consistent with the modern economic approach by which the relevant

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64 Uttara Foods & Feeds Pvt. Ltd v. Mona Pharmachem, Civil Appeal No. 18520 of 2017.

65 REPORT OF THE INSOLVENCY LAW COMMITTEE 73, ¶2 9.2 (Mar. 28, 2018).

entities should have at least some freedom to contract their way out of insolvency.[66]

Recently, the NCLT-Kolkata Bench suggested an out-of-court settlement in the matter of Binani Cements insolvency.[67] However, the SC refused to allow such a settlement.[68] Such a contradictory approach stems from the lack of legal backing for informal bankruptcy settlements.

These judgments indicate that it is indeed desirable to recognize the autonomy of the parties by allowing settlements with one or some of the many creditors. However, this is also dangerous in the absence of provisions to secure the dissenting creditors' claims. Therefore, there is a need to modify the existing Insolvency Regime so as to accommodate such settlements even before the initiation of Bankruptcy proceedings, in the form of pre-packs, while sufficiently taking care of the interests of other creditors.

6. CONCERNS RELATED TO THE PRE-PACK APPROACH

It has to be noted that the authors' aim is not to suggest that pre-packs must necessarily be preferred to the court-driven insolvency

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66A Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J., 1807, 1851 (1998).

67 *NCLT suggests out-of-court settlement between Binani Cement and Creditors* BLOOMBERG QUINT (Mar. 27, 2018), www.bloombergquint.com/insolvency/2018/03/27/nclt-suggests-out-of-court-settlement-between-binani-cement-and-creditors (last visited Apr. 8, 2018).

68 Arpan Chaturvedi & Vishwanath Nair, *Binani Cement Matter Back in NCLT as Supreme Court Unimpressed by Petition to Terminate Insolvency*, BLOOMBERG QUINT (Apr. 13, 2018), www.bloombergquint.com/business/2018/04/13/binani-industries-withdraws-plea-for-binani-cement-insolvency-settlement-from-supreme-court (last visited Apr. 30, 2018).

process. This is because pre-packs suffer from certain flaws. Moreover, the viability and success rates of pre-packs show that it may even not be the best option at all times.[69] Some scholar's herald pre-packaged administrations as an effective rescue mechanism while others view it with scepticism because they consider it as a means by which the mighty can bypass statutory provisions.[70] Therefore it is relevant to this discussion to examine the major criticisms the existing pre-pack systems in U.S. and U.K have received lest they should not replicate in India.

Firstly, pre-packaged plans have received criticism because it lets the business to be sold off to the corporate insiders.[71] In pre-pack negotiations, the control and management of the company continues to be in the hands of the erstwhile Board and the entire process is also driven by the existing management. This opens up the possibility of connected-party sales to the existing management, promoters, and the like. In U.K, concerns have been raised that pre-packs have given rise to unpleasant practices such as the one where the existing management buys back the business at prices lower than the market value.[72]

Secondly, in pre-packs, there is almost always a possibility of some creditors being left out without asserting their claims or were not

69 Sandra Frisby, *The Second-Chance Culture and Beyond: Some Observations on the Pre-Pack Contribution*, 3 LAW & FIN. MKT. REV. 242 (2009).
70 VANESSA FINCH, CORPORATE INSOLVENCY LAW: PERSPECTIVES AND PRINCIPLES 215 (2d ed. 2009).
71 Walton, *supra* note 36, at 114.
72 J. Moulton, The *Uncomfortable Edge of Propriety – Pre-Packs or Just Stitch-ups?*, 2 RECOVERY (Autumn) (2005).

provided with an opportunity to vote.[73] In the negotiation stage, the creditor's ability to participate is directly related to the ability to gain access to information.[74] Presently, in U.K, secured creditors have access to information by way of terms or warranties in the loan agreements.[75] They may be in an advantageous position because of this and hence a plan which serves their interests best might be the end result.[76] On the other hand, general unsecured creditors may not have the same access to information.[77] This may leave them out of the picture. This problem is particularly acute in U.K, as opposed to U.S. because, the entire process is unsupervised by the Courts while in the U.S, the Court can determine whether sufficient information was disclosed to all the creditors.

Thirdly, lack of objectivity, inclination towards the management, abuse of powers, and lack of accountability to creditors etc. are some of the major criticisms that the administrators have received for their role in pre-pack administrations in the U.K.[78] However, with the development in corporate governance and risk monitoring practices, stakeholders are at a better position to have timely information about the present and possible risks that the company will face.[79] The guidelines issued in U.K, such as, the Statement of Insolvency Practice to regulate the conduct of

73 Mark Plevin et al., *Pre-packaged Asbestos Bankruptcies – A Flawed Solution*, 44 S. Tex. L. Rev. 889, 903 (2003).
74 Vanessa Finch, *The Recasting of Insolvency Law*, 68 MOD. L. REV. 713, 722 (2005).
75 Finch, *supra* note 4, at 517.
76 Xie, *supra* note 36, at 76. .
77 Frisby, *supra* note 19, at 28.
78 S. Davies Q.C., *Pre-pack – He who pays the piper calls the tune*, SUMMER Recovery 19 (2006).
79 Finch, *supra* note 74, at 719.

administrators aim to ensure that the process is transparent and that a fair value is obtained.[80]

Fourthly, some critics have raised apprehensions that, in pre-packaged bankruptcies, the market may not be properly tested[81] in order to choose the best possible rescue mechanism and some interested parties may not be made aware of the sale.[82] As the negotiations happen in secrecy, whether the assets are sold at its maximum attainable value in the absence of market forces is doubtful. Further, in U.K it has been observed that administrators often settle for lower prices just to secure a buyer.[83]

Fifthly, the efficacy of pre-packs as an alternative informal insolvency arrangement, continues to be questioned. There are certain situations where the evidence has convinced a court that only a pre-pack can lead to wealth maximization,[84] but there is no convincing evidence that this is always the case. *Clydesdale Financial Services Ltd. v. Smailes* is an illustration where, the court ordered the replacement of the pre-pack administrator to carry out an independent assessment of the valuation of the business.[85]

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80 L. Conway, *Pre-pack Administration Procedure*, House of Commons-Briefing Paper No: 5035, 3 (Jan., 2017).
81 P. Walton et al., *Pre-Pack Empirical Research Characteristic and Outcome Analysis of Pre-Pack Administration – Final Report to Graham* Review, University of Wolverhampton (May, 2016)
82 VANESSA FINCH, CORPORATE INSOLVENCY LAW: PERSPECTIVES AND PRINCIPLES 81 (2d ed. 2008).
83 Davies Q.C., *supra* note 78, at 4.
84 *In Re*, Kayley Vending Ltd. [2009] E.W.H.C. (Ch.) 904 (Eng.).
85 Peter Walton, *When is pre-packaged administration appropriate? A Theoretical Consideration*, 20 NOTT. L.J. 11, 15 (2011).

Finally, pre-packs may not a viable option when there are a large number of creditors with sharply contrasting interests.[86] In those cases, formal bankruptcy procedure must be resorted to as there is little scope to reach an agreement.[87] Creditors in severely distressed cases, would wish to maximize their recovery and therefore the best option would be formal insolvency proceeding.[88]

7. PROPOSALS FOR REFORM

While countries such as U.K. and Singapore are moving forward to adopt a system that has the hues of the U.S. Chapter 11 Reorganization, India is taking a step back by insisting on extensively creditor-friendly and court-driven process of bankruptcy resolution.[89] This may seem to be inconsistent with one of the main objectives of the new reforms – *i.e.* rescuing the business of the entity as far as possible. This is likely to be detrimental to the emergence of start-ups in the country because the insolvency regime that completely takes away the business out of the control of its management even when the latter is not at fault is not likely to go down well with the new entrants.

In U.K, as pre-packs are not regulated by any legislation, suggestions have been made as to how the existing monitoring regime should regulate the pre-pack negotiations as well. Professional guidance,

86 S. Chatterjee et al., *Resolution of Financial Distress: Debt Restructurings via Chapter 11, Prepackaged Bankruptcies and Workouts*, 25 FINANCIAL MANAGEMENT 5, 7 (1996).
87 Armour, *supra* note 31, at 14.
88 *Id.*, at 13.
89 Varottil, *supra* note 55, at 34.

filing of a report at the end of negotiations to the monitoring body etc., are some of those suggestions.[90] Along these lines, the authors put forth that, the present legal regime governing insolvency and bankruptcy be amended adequately to accommodate pre-packaged bankruptcy settlements between creditors and the Corporate Debtor. How the regime governing pre-packaged bankruptcy should come about is explained below.

The IBC must be amended so as to give powers to the appropriate authority to approve, reject, and even modify a pre-packaged bankruptcy plan arrived at as a result of negotiations between the Corporate Debtor and its creditors, after satisfying itself that the pre-pack complies with certain conditions.

The relevant authority to be vested with the powers of approving or rejecting a pre-packaged bankruptcy should be the Insolvency and Bankruptcy Board of India (IBBI) for two reasons; firstly, the large number of pending IBC cases before the various benches of NCLT and; secondly, because IBBI is the authority which regulates the IRPs and hence can set the standards which the IRP has to comply with during the negotiations.

Unlike how a merger or combination with value above a prescribed threshold requires approval of the CCI, the authors are of the view that, at least at the present stage, every pre-packaged bankruptcy plan must necessarily get the sanction of the IBBI.

90 Finch, *supra* note 4, at 585.

The Corporate Debtor should necessarily appoint an Insolvency Resolution Professional from the pool of professionals regulated by the IBBI, to act as a mediator of the negotiations. This is in consonance with the model called 'integrated co-determination model of control' proposed by Hahn.[91] He has proposed that the negotiations of restructuring should commence without ousting the existing management and, a trustee should be appointed to the Board to oversee the process. Non-appointment of IRP should be a ground for rejection of the proposed plan.

Further, the corporate debtor should be able to bind the creditors under a forbearance agreement during the negotiations without any legal hindrance so that the holdout problem and litigation by dissenting creditors during the negotiations can be avoided.

The IBBI should lay down detailed guidelines regarding the standards to be followed by IRP while discharging duties as an administrator during the pre-pack negotiations. The duties would include ensuring that there is dissemination of information to the negotiating parties, valuation of assets by an independent valuer,[92] professional advice on the viability of continuation of business and on the restructuring plan etc. The IRP should be independent, objective, and impartial. The proposed plan should also necessarily consist of statement of reasons by

91 D Hahn, *Concentrated Ownership and Control of Corporate Reorganisations*, 4 J. CORP. L. STUD. 117, 147 (2004).
92 TERESA GRAHAM, GRAHAM REVIEW INTO PRE-PACK ADMINISTRATION: REPORT TO THE RT HON VINCE CABLE MP 48 (June, 2014).

the IRP for revival of the business.[93] Non-compliance with these standards should be considered sufficient grounds for objection to the proposed plan.

On the conclusion of negotiations, the plan is to be inspected by the IBBI to ensure that the conditions such as disclosure of information to creditors are met with. There should be a period of 30 days for a creditor or any other relevant person to file objections to the proposed plan. This is to ensure that unsecured and other creditors who were not party to the negotiations, can make their representations and have their claims satisfied.

Further, the parties concerned should submit an action plan for the next 12 months on how they intend to revive the business along with the pre-packaged plan.[94] Sales to related parties, existing management, promoters etc. should be permitted subject to the conditions that the terms of the transaction are ordinary and that the assets are valued at a fair market price by an independent valuer.[95] On satisfaction of these conditions, the IBBI may approve the pre-pack. In the event of rejection of the pre-pack by IBBI, CIRP or liquidation should commence. Further, if the business becomes distressed again any time in the next 12 months, there should not be an opportunity to choose pre-packs over CIRP.

What the authors have suggested is that, the system should be modified to recognize pre-packs under such circumstances where they may be successful in rescue of the business. The above proposed model

93 Insolvency Act, 1986, c 45, sch. B1, [49] (U.K.).
94 Graham, *supra* note 93, at 62.
95 Armour, *supra* note 31, at 16.

ensures that there is necessary court supervision to avoid subversion of creditors' interests and seeks to clearly define procedural requirements for a pre-pack thus enabling eligible managements to enter into such arrangements with the necessary legal recognition. Recognition of pre-packs would be a step towards promotion of speedy recovery of small businesses from bankruptcy. However, caution should be exercised so that such reforms do not eventually result in increased costs and delay induced by procedural technicalities.

INSOLVENCY AND BANKRUPTCY CODE, 2016: EMERGING JURISPRUDENCE, AMBIGUITIES AND PREDICAMENTS

Amitanshu Saxena[*]

ABSTRACT

With India's bad loan amount culminating to USD 154 billion and, the moratorium period of 12 major defaulting firms facing resolution proceedings coming to an end, the year 2018 is proving to be a testing one for effectiveness of the Insolvency and Bankruptcy Code, 2016 (Code). The Code was introduced to reorganize and restructure the corporate insolvency process in a time bound manner in India. The fundamental aim of the Code is to revive financial institutions, restructure their debts, and ensure maximisation of the value of their assets. With interpretation of several provisions in question and new amendments introduced, it will be interesting to note how the Adjudicating Authorities have dealt with them. In the past year, various benches of National Company Law Tribunal (NCLT) in the country gave contradicting judgements, and the National Company Law Appellate Tribunal (NCLAT) faced several challenges. This paper, apart from looking into the evolving jurisprudence under the Code, also throws light upon the amendments, highlights the loopholes of the Code, and suggests changes.

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1. EMERGING JURISPRUDENCE UNDER THE CODE

1.1. OVERRIDING EFFECT OF THE CODE

The Code was introduced as an umbrella legislation with the primary motive of restructuring and reorganizing the framework of insolvency resolution laws in the country. It repealed the Sick Industrial Companies Act, 1985 (SICA)[1] and had, as per Section 238 of the Code, immediate overriding effect over any other enactments dealing with insolvency in India. The issue, whether a corporate debtor who is enjoying the benefits of a state enactment,[2] can be subjected to the provisions of the Code, came before the Supreme Court in *Innoventive Industries Ltd. v. ICICI Bank.*[3] Apart from applying the doctrine of repugnancy in the present matter, the apex court highlighted the fact that contours of Section 238 of the Code which is the non-obstante clause are broader than the objective of state legislation.

The NCLAT in the case of *Canara Bank v. Deccan Chronicle Holdings Ltd.,*[4] delved into the issue of whether the moratorium declared under Section 14 of the Code extends to suits and proceedings pending before various High Courts and Supreme Court. The NCLAT set down two broad propositions in answer to this situation. First, the powers of the Supreme Court under Articles 32 and 136 of the Constitution and of High

1 Insolvency and Bankruptcy Code, 2016, No. 31, Acts of Parliament, 2016.
2 Maharashtra Relief Undertaking (Special Provisions) Act, 1958, Bombay Act XCVI of 1958.
3 Innoventive Indus. v. ICICI Bank, Company Appeal (AT) No. 156 of 2017.
4 Canara Bank v. Deccan Chronicle Holdings Ltd., Company Appeal (AT) No. 147 of 2017.

Courts under Article 226 cannot be curtailed by any provision of the Code.[5] Second, any suit or proceedings in relation to recovery of assets under the original jurisdiction of Supreme Court and High Courts should be stayed once the moratorium under the Code initiates. Creating hindrances to the reviving processes of corporate defaulters will end up tarnishing the essence of the code if such suits are allowed.

Recently the Bombay High Court pronounced a landmark judgement in the case of *Jotun India Private Ltd. v. Psl Ltd.*,[6] on the jurisdiction to stay proceedings filed by a corporate debtor. It was held that provisions of the Code have an overriding effect over the Companies Act, 2013 (hereafter, referred to as "Companies Act") and the argument that winding-up petitions were already filed before the High Court does not bar the remedy to file fresh proceedings under the Code. The Court referred to the judgement in *Madura Coats*,[7] which had held SICA's primacy over the Companies Act. Now as the Code has replaced SICA, it will enjoy the same relationship with the Companies Act.

1.2. NOTICE TO THE CORPORATE DEBTOR BEFORE ADMITTING APPLICATION BY CREDITORS

A legislation, which is in its nascent stage, has to inevitably sustain the challenges and develop accordingly. The Adjudicating Authority (*i.e.*

5 Aayush Mitraka, *NCLAT Excludes Proceedings under the Constitution from Moratorium*, INDIACORPLAW (Jan. 25, 2018), https://indiacorplaw.in/2017/09/nclat-excludes-proceedings-constitution-moratorium.html.
6 Jotun India Pvt. Ltd. v. Psl Ltd., Company Appeal (AT) No. 572 of 2017 in Company Petition No. 434 of 2015.
7 Modi Rubber Ltd. v. Madura Coats Ltd., C.A. No. 1475 of 2006.

NCLT), while admitting any application under the Code, has to determine whether principles of natural justice are being followed. In the case of *Innoventive Industries Ltd. v. ICICI Bank*,[8] an important issue before the NCLAT was whether a notice is required to be given to the debtor for initiation of insolvency resolution process under the Code and if so, at what stage and for what purpose.

As of yet, there is no specific provision under the Code to provide hearing to the corporate debtor in petition filed by a financial creditor or by operational creditors under Section 7 or Section 9 of the Code respectively. The Adjudicating Authority, which is NCLT, was constituted under Section 408 of the Companies Act, 2013 and Section 420(1) of it mandates NCLT to provide the parties before it, a reasonable opportunity of being heard before passing orders as it thinks fit. By extending this analogy, we may carve out a requirement for providing a hearing to the corporate debtor at the stage of filing of the petition, but this reasoning needed the approval of the judiciary.

Thus, it was held that, it is mandatory for the Adjudicating Authority to follow the principles of natural justice while passing an order under the Code. The NCLAT also cited the judgement of the Calcutta High Court in the matter of *Sri Metaliks Ltd. v. Union of India*,[9] which dealt with same issue. NCLAT expressed the position of law in the following words:

> *Section 424 of the Companies Act, 2013 requires the NCLT and NCLAT to adhere to the principles of natural justice while adjudicating the matter. It also allows the NCLT and NCLAT the power to regulate their*

8 Innoventive Indus. v. ICICI Bank, Company Appeal (AT) No. 156 of 2017.
9 Sri Metaliks Ltd. v. Union of India, W.P. 7144 (W) of 2017.

> *own procedure. A proceeding for declaration of insolvency of a company has drastic consequences for a company. Such proceeding may end up in its liquidation. A person cannot be condemned unheard. When the NCLT receives an application under Section 7 of the Code of 2016, it must afford a reasonable opportunity of hearing to the corporate debtor as Section 424 of the Companies Act, 2013 mandates it to ascertain the existence of default as claimed by the financial creditor in the application.*[10]

The NCLAT, hence, held that the Adjudicating Authority is bound to issue a limited notice to the corporate debtor before admitting a case of initiating resolution process.

1.3. TIME LIMITS PRESCRIBED UNDER THE CODE

As per Sections 7 and 8 of the Code, whenever a financial creditor or an operational creditor files an application to initiate a corporate insolvency resolution process the Adjudicating Authority is required to admit or reject the application within a period of 14 days from the receipt of such application. Within this period, the Adjudicating Authority is required to decide upon the evidence furnished by the creditors whether such application is worthy of being admitted or not. The authority while deciding has to take a plethora of evidences and information utilities into account (and not only those furnished by the creditors) to satisfy itself and thus the prescribed time limit does not seem to be enough, rather it seems draconian.

10 *Id.*

In the case of *J.K. Jute Mills Company Limited v. Surendra Trading Company*,[11] the issue was whether the time limit prescribed in the Code for admitting or rejecting a petition or initiation of insolvency resolution process is mandatory. The NCLAT held that the time limits prescribed under Sections 7(5), 9(5), and 10(4) are to prevent delay in hearing and disposal of cases. NCLAT said that the Adjudicating Authority cannot ignore these provisions. But in appropriate cases, for the reasons recorded in writing, it can admit or reject the petition after the period prescribed. It opined that these time limits are directory in nature and not mandatory. It held that "time is essence of the Code and there should be no extension granted by the authority except in cases of exceptional circumstances like in the instant case."

The NCLAT also dealt with other time limits present in the Code:

(i) The provision in Section 7(5) and Section 9(5) provides a period of 7 days to the financial and operational creditor respectively to rectify their application according to the relevant provisions is mandatory, on failure of which the application will be rejected. This period of 7 days is not inclusive of the 14 days prescribed to admit or reject the application.[12]

(ii) The time period (moratorium period) specified under Section 12 of 180 days which can be extended by 90 days is also mandatory in nature. After the expiry of this period the resolution plan has to be approved or the company will be liquidated in manner under Section 33.

11 J.K. Jute Mills v. Surendra Trading Co., Company Appeal (AT) No. 9 of 2017.
12 Bank of India v. Tirupati Infraprojects, C.P No. (IB)-104(PB)/2017.

(iii) Section 64 states that if any application is not disposed by the authority in the prescribed time period the reasons for the same should be recorded and in any case an extension of more than 10 days should not be granted. This extension period was also held to be mandatory.

Further in the case of *Speculum Plast Pvt. Ltd. v. PTC Techno Pvt. Ltd*.[13] the question whether Limitation Act, 1963 is applicable to the provisions of the Code was taken into purview.

The following was held by the NCLAT:

> *[t]he Limitation Act, 1963 is not applicable for initiation of Corporate Insolvency Resolution Process but the Doctrine of Limitation and Prescription is necessary to be looked into for determining the question whether the application under Section 7 or Section 9 can be entertained after long delay. The Adjudicating Authority may give opportunity to the Applicant to explain the delay.*[14]

1.4. ‘DISPUTE’ UNDER THE CODE

Under Section 8 of the Code an operational creditor can, on an occurrence of default, deliver a demand notice to the corporate debtor for the payment of the debt. The corporate debtor under sub-section 2 is required to, within a period of 10 days, either repay the debt or bring to the notice of the creditor about an existence of a ‘dispute’. The term ‘dispute’ has been defined under Section 5(6) of the Code as including a suit or arbitration proceedings relating to: (a) the existence of the amount of debt;

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13 Speculum Plast Pvt. Ltd. v. PTC Techno Pvt. Ltd., Company Appeal (AT) No. 47 of 2017.

14 *Id.*

(b) the quality of goods or service; or (c) the breach of a representation or warranty.

The debtor can resist the initiation of a corporate resolution process to start against itself by proving the existence of a dispute. Various benches of NCLT gave diverse opinions on what is a dispute and what all it should entail.

Finally, NCLAT in the case of *Kirusa Software Private Ltd. v. Mobilox Innovations Private Ltd,*[15] deliberated upon the definition of the term dispute. NCLAT held that "the definition of dispute is inclusive and not exhaustive. It was also held that it is necessary for the court to observe the circumstances of such a dispute. A genuine notice of dispute sent, in reply of the demand notice, to the creditor would suffice the successful demonstration of a dispute on the part of the debtor." The judgement also gives instances of what all can constitute a dispute.

A 'dispute' under Sections 8 and 9 of the Code would include any proceeding initiated or pending before a labour court, consumer courts, tribunal, mediation, or conciliation *etc.* This would also include an action taken by the corporate debtor replying to a notice of demand under the CPC, Sales of Goods Act or an action regarding the quality of goods by the creditor. The dispute must be free from any *mala fides* on part of the

15 Kirusa Software Pvt. Ltd. v. Mobilox Innovations, Company Appeal (AT) No. 06 of 2017.

debtor. Also, the necessity of the existence of dispute being prior suit or an arbitration proceeding was done away with.[16]

In a recent judgement of *Ksheeraabd Constructions Pvt. Ltd. v. Vijay Nirman Company Pvt. Ltd.*,[17] the NCLAT held that pending arbitration proceedings under Section 34, Arbitration and Conciliation Act, 1996 do not constitute a dispute under the Code.

It is necessary that the Adjudicating Authority demarcate strict parameters to decide whether a dispute has to be considered for obtaining benefits under the Code as there still remain enough ambiguities and grey areas.

The job to decide subjectively in each case, the bona fides of a dispute, would in the long run may be burdensome and detrimental to the speedy process that the Code promises to deliver. Also, such a stand would result in repercussions such as financial institutions raising formal notices for every possible dispute just to ensure that they do not suffer, if a creditor with *mala fide* intention seeks to initiate a process against them under the Code. The judgement rendered by NCLAT in *Kirusa* case[18] was appealed in the SC which held that the requirement of a dispute to be bona fide for the purposes of the Code does not hold ground. Further the SC

16 *See* VDS Plastic Pvt. Ltd. v. Pal Mohan Elec., C.P.(IB) No.37(ND)/2017.

17 Ksheeraabd Constructions v. Vijay Nirman Co., Company Appeal (AT) No.167 of 2017.

18 Mobilox Innovations v. Kirusa Software Pvt. Ltd., 2017 S.C.C. OnLine S.C. 1154.

also held that the terms "existence of a dispute" and "pendency of a suit or arbitration proceeding" under Section 8(2) are to be read disjunctively.[19]

1.5. STATUS OF PURCHASERS OF RESIDENTIAL PROPERTY

Another crucial issue was the status of residential property buyers under the code. The position of homebuyers under the provisions of the code has now been finally crystallised. It was absolutely necessary that the legislature come up with an amendment or an ordinance determining the same. The resolved situation can be analysed through case laws. In *Pawan Dubey v. J.B.K. Developers Pvt. Ltd.*,[20] the NCLAT held that homebuyers did not fall into the category of financial and operational creditors and therefore, they do not possess the right to initiate corporate insolvency process against the defaulting contract builders. The same was also held by the NCLT Bench in New Delhi in the case of *Mukesh Kumar v. AMR Infrastructure*,[21] when they denied *locus standi* to the Homebuyers' group.

The same view was also upheld by the SC in an order dated 15th September, 2017.[22] However this stance was criticised as there was no reasonable classification in excluding homebuyers from the category of operational creditors. The NCLAT had held this on the basis of the distinction between immovable property and 'goods' and 'services'

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19 R. Jawahar Lal at al., *SC Decodes "Dispute" under the Insolvency and Bankruptcy Code*, INDIACORPLAW, https://indiacorplaw.in/2017/09/supreme-court-deCodes-dispute-insolvency-bankruptcy-Code.html. (last visited Jan. 17, 2018).
20 Pawan Dubey v. J.B.K. Developers, Company Appeal (AT) No.40 of 2017.
21 Mukesh Kumar v. AMR Infra., Company Appeal (AT) No. 50 of 2017.
22 Pawan Dubey v. J.B.K. Developers, Civil Appeal no. 11197 of 2017.

recognized under the Code. In the case of *Nikhil Mehta & Sons v. AMR Infrastructure*,[23] the NCLAT had held that homebuyers with assured returns were financial creditors for filing benefits under the Code but no recognition was given to more common category of homebuyers *i.e.*, those without any agreement of assured returns.

Also, when an insolvency process is initiated against the defaulting builders, the homebuyers will be barred to claim their dues in any other forum as the moratorium period would start. Thus, the homebuyers would be left with no remediless.

All these controversies surfaced again when insolvency proceedings were initiated against the Jaypee Infratech Ltd. where the homebuyers moved the SC for its intervention to stop the proceedings.[24] The SC, in an order dated 10th January 2017, observed that,"they wanted to protect the rights of the homebuyers and they cannot be made to run from forum to forum." Thus, a case law defining the rights of homebuyers is a necessity. A big question, hence, lingered before the legislators about the rights of a third class of creditors under the Code. Earlier, on 16th august the IBBI had introduced the Form F through amendments[25] to the Code for creditors other than financial and operational creditors to file for their claims with the Insolvency Resolution Professionals. The situation was finally resolved with the coming of the Insolvency and Bankruptcy Code

23 Nikhil Mehta & Sons v. AMR Infra., Company Appeal (AT) No. 07 of 2017.
24 Chitra Sharma v. Union of India, Writ Petition (Civil) No.744/2017.
25 Insolvency & Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016; Insolvency & Bankruptcy Board of India (Fast Track Insolvency Resolution Process for Corporate Persons) Regulations, 2017.

(Second Amendment) Act, 2018,[26] which placed homebuyers on a similar footing as financial creditors for the purposes of the code.

1.6. SIMULTANEOUS PROCEEDINGS AGAINST GUARANTORS AND PRINCIPAL DEBTORS

One of the most contentious issues eclipsing the Code is the status of guarantors and principal debtors. In an interesting judgement passed by the Hon'ble Bombay High Court in *Lacchman Joharimal v. Bapu Khandu and Tukaram Khandoji*,[27] the Court had held that "the very object of the guarantee is defeated if the creditor is asked to postpone his remedies against the surety. In the present case, the creditor is a banking company. A guarantee is a collateral security usually taken by a banker. The security will become useless if his rights against the surety can be so easily cut down."[28]

It is a well-established principle that liabilities of the principal debtor and the guarantor are co-extensive in nature[29] and not alternative,[30] unless contracted to the contrary. However, there is a lack of clarity in provisions of the Code regarding this which gave rise to conflicting judgments. In *Sanjeev Shriya v. State Bank of India*,[31] the Allahabad High

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26 Insolvency and Bankruptcy Code (Second Amendment) Act, 2018, No. 26, Acts of Parliament, 2018.
27 Lacchman Joharimal v. Bapu Khandu, (1869) 6 Bom. H.C.R. 241.
28 Rishi Thakur, *Corporate Insolvency Resolution Process under Insolvency and Bankruptcy Code and The Dilemma Surrounding Guarantee*, LIVELAW, http://www.livelaw.in/corporate-insolvency-resolution-process-insolvency-bankruptcy-Code-dilemma-surrounding-guarantee/ (last visited Feb. 7, 2018).
29 Indian Contract Act, 1872, No. 9, Acts of Parliament, 1872, § 128.
30 Indus. Inv. Bank v. Bishwanath Jhunjhunwala, (2009) 9 SCC 478.
31 Sanjeev Shriya v. State Bank of India, Company Appeal (AT) No.30825 of 2017.

Court had held that the liability of the personal guarantor will arise only after crystallisation of the principal debtor's debt, which will only take place when the NCLT approves the resolution plan or passes an order for the liquidation of the corporate debtor. In the case of *Axis Bank Ltd. v. Edu Smart Services Ltd.,*[32] it was held that the invocation of a corporate guarantee when the moratorium period against the debtor has initiated is bad in law. Hence, there was a clear deflection from the recognized concept of a co-extensive relationship between principal debtor and its guarantor.

But in the case of *IDBI Bank Ltd. v. BCC Estate Pvt. Ltd.*[33], the NCLT, Ahmedabad stated that the respondent guarantor in the present case would not escape liability on ground that the insolvency resolution proceedings were already started against the principal debtor and the simultaneous initiation of proceedings against it were inconsistent.

Hence it should be understood that as the focal objective of the Code is not recovery but revival and rejuvenation of the company in distress, and the guarantees provided under it must be treated in accordance with such intent. Especially after the ordinance was introduced in 2017,[34] the stance has gained more clarity. Now all the provisions of the Code apply to guarantors as well. Further Section 60(2) expressly allows simultaneous proceedings against both. This justifies the stance taken by NCLT Ahmedabad.[35]

32 Axis Bank Ltd. v. Edu Smart Services Ltd., IB- 102(PB)/2017.
33 IDBI Bank Ltd. v. BCC Estate Pvt. Ltd., C.P. (I.B) No. 80/7/NCLT/AHM/2017.
34 Insolvency and Bankruptcy Code (Amendment) Ordinance, 2017.
35 *Id.*

On a different note, the NCLAT in *Schweitzer Systemtek India Pvt. Ltd. v. Phoenix ARC Pvt. Ltd.*,[36] held that, only properties of the corporate debtor will come under the purview of Section 14 of the Code and not the properties of promoters or the guarantors. Hence, the proceedings for recovery of amount against the guarantors of the company can be continued despite the pending Insolvency Resolution process against the principal debtor.

After observing the stance of adjudicating authorities on various provisions of the new Code in light of different aspects, let us examine some pertinent issues in the Code.

2. CONTINUING PROBLEMS WITH THE CODE

2.1. PROCEEDINGS UNDER THE SARFAESI AND DRT ACT

Section 14(1)(c) of the Code gives power to NCLT to override any proceedings under SARFAESI Act, 2002,[37] and DRT Act, 1993.[38] In case of transfer of proceedings to the Code, where final order is about to be given or recovery certificates are issued under the DRT Act, 1993, and where banks and financial institutions have already initiated proceedings against the corporate debtor under the SARFAESI Act, 2002, such a transfer would further delay the proceedings as a moratorium period of 270 (180 plus 90) days will start. This will hamper the recovery

36 Schweitzer Systemtek India Pvt. Ltd. v. Phoenix ARC Pvt. Ltd., Company Appeal (AT) No.129 of 2017.

37 Securitisation & Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, No. 54, Acts of Parliament, 2002.

38 Recovery of Debts Due to Banks and Financial Institutions Act, 1993, No. 51, Acts of Parliament, 1993.

proceedings of the bank as they have initiated proceedings under the SARFAESI as there was no chance for the corporate debtor to revive. If it is a case under the DRT Act, the stage of final order or issuing of recovery certificates mean that the company is beyond repair. If at such a moment moratorium period kicks in suspending any existing actions, it will give control to the promoters of the corporate debtor which can cause irreparable loss to its assets eventually causing loss to the claims of the banks and the financial institutions.

Any proceeding under both the statutes usually takes 2 to 3 years to complete. The creditor will only face inconvenience if the moratorium under Section 14 starts at final stages of the existing action. Again, this goes against the very objectives of the Code which is to revive the corporate debtor and if there is no possibility of such a scenario then the rights of the creditors to recover should not be hampered if they have sought relief under other provisions.

2.2. LIQUIDATION VALUE AND FAIR VALUE

The IBBI regulations[39] give a detailed process of the Insolvency resolution process for the corporate persons. Rule 35 of the regulations defines 'liquidation value' as, "the estimated realizable value of the assets of the corporate debtor if the corporate debtor were to be liquidated on the insolvency commencement date." Rule 36 requires the submission of an information memorandum by the resolution professional which should,

39 Insolvency & Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016.

according to sub-clauses (j) and (k) of clause 2, contain the liquidation value.

The problem with the use of liquidation value is that, it prejudices the buyers when the financial institutions' assets are being sold. The prospective buyers would bid at a very small price above the liquidation value accruing losses to the lenders or the creditors. The liquidation value is an imaginary value. It is the total worth of a company's physical assets when it goes out of business.

It is highly disproportionate when compared with the market value of the assets that are held as security by the creditors or the enterprise value. Enterprise Value (EV) is a measure of a company's total value. It can be thought of as the effective cost of buying a company or the theoretical price of a target company.[40]

However, sole dependence on the liquidation value in the Code has consequently influenced the resolution professionals to make it as a basis for the resolution plan. This goes against the very objectives of the Code. When any financial debtor or operational debtor files under Section 7 of the Code for an insolvency resolution process on a default of say rupees one lakh and fifty thousand, the valuation of the financial institution will be on the assumption that, the financial institution is going to liquidate on account of this default, whereas this valuation should be on the market value of the company.

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40 *What is Enterprise Value?*, CORPORATE FINANCE INSTITUTE, https://corporatefinanceinstitute.com/resources/knowledge/valuation/what-is-enterprise-value-ev (last visited Dec. 30, 2017).

The Government has, thus, introduced the concept of *fair value*. Fair value is the estimated realizable value of the assets on the starting date of insolvency proceedings. The amended rules for the insolvency resolution process for corporate persons have made it mandatory for resolution professionals to ascertain "fair value" apart from the liquidation value. This will ensure the banks to estimate the market price of the financial institution facing resolution process.[41]

2.3. STATUS OF PROMOTERS BEFORE AND AFTER THE AMENDMENT, 2017

In general parlance, a promoter is any individual syndicate, association, partnership, or a company which takes all the necessary steps to create and mould a company and set it going. In India, the promoter(s) and principals are usually persons who, in forming the company, secure for themselves the management of the company being formed or are persons who convert their own private business into a limited company, public or private and secure for themselves a more or less controlling interest in the company's management.[42]

41 E.T. Bureau, *Fixing Fair Value of Bankrupt Company under IBC Mandatory Now*, THE ECON. TIMES, https://economictimes.indiatimes.com/news/economy/policy/fixing-fair-value-of-bankrupt-company-under-ibc-mandatory-now/articleshow/62829070.cms (last visited Feb. 2, 2018).
42 *See* A. RAMAIYA, GUIDE TO THE COMPANIES ACT 351 (12th ed.).

The new amendment[43] introduced Section 29A to the Code which debars the following categories of persons from participating in the auction of assets of a company during bankruptcy proceedings:

(i) A wilful defaulter that is a person who is associated with Non-Performing Assets, or is a habitual non-compliant;

(ii) A person who is a promoter, given that, he would be eligible to participate if he repays all the overdue amounts and discharges all his liabilities regarding NPAs before the submission of the resolution plan.

This was done by the Government in order to, address the growing concern that promoters may obtain a backdoor entry to auction proceedings of their own companies and thus have a chance to control their own firms at a steep discount. The amendment, however, is criticised because even honest promoters will be barred from participating. Further, this would also result in reduction of competition in the bidding process as there is already difficulty in finding buyers for distressed assets in India.[44]

The amendment also debars a guarantor of a corporate defaulter, from applying for the resolution plan as well. This also includes a guarantor who has honoured his guarantee, but the resolution proceedings have been initiated due to some other debts of the corporate debtor. However, barring even such guarantors further reduces the market base of the distressed assets of the company.

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43 Insolvency and Bankruptcy Code (Amendment) Act, 2017, No. 8, Acts of Parliament, 2018.

44 Business FP Staff, *Insolvency and Bankruptcy Code Amendment: Promoters of SMEs may get Chance to Bid for Stressed Companies*, FIRSTPOST, http://www.firstpost.com/business/insolvency-and-bankruptcy-Code-amendment-promoters-of-smes-may-get-chance-to-bid-for-stressed-companies-4269823.html (last visited Feb. 2, 2018).

3. CONCLUSION

The expense of hiring the resolution professional has been a growing concern for small corporate houses that are currently facing Insolvency proceedings. Resolution professionals in actual practise need teams of versatile people who can handle different facets of the debtor's business. Hence, an already bankrupt company would further face turmoil investing in such professionals. Also, this would further reduce the amount which the creditors will get at the time of liquidation if the resolution process fails.

The nuances and faults in technicalities of the Code still prevail and are needed to be dealt with. These are still the learning times for an evolving India. The decision to establish Information Utilities is also a big step ahead in resolving these issues. Information Utilities will have a comprehensive database encompassing all significant details about financial and operational creditors which will help the courts in envisaging and analysing the dispute almost immediately. In a welcome step, all creditors were asked by Reserve Bank of India, in December 2017, to share information about their assets and to adhere with the provisions of IBBI (Information Utilities) Regulations, 2017.

Several cases like the PNB bank fraud, and Vijay Mallya's default and subsequent absconding are still lurking and haunting us and are acting as a reminder of how inevitable an efficient framework of insolvency, bankruptcy and recovery laws is for a growing economic giant like India. However, the sense of urgency and awareness in the present government consoles us that measures will be taken to bridge the gaps and plug the loopholes.

WITHDRAWAL OF THE FRDI BILL: BAIL-IN AND OTHER PUBLIC CONCERNS

*Vardaan Bajaj**

ABSTRACT

The Financial Resolution and Deposit Insurance Bill, 2017 (FRDI Bill) was tabled in the Parliament in August 2017, however, it has recently been withdrawn by the Central Government due to enormous pressure from public and other institutions. This article aims to discuss the important aspects of the FRDI Bill and points out to the concerns that were emerging out of this Bill, inter alia, the "bail-in" clause, protection of bank deposits, and the proposed resolution mechanism, conflicts with the existing regulatory body, overlooking disclosures, and inaptness of ownership neutrality model in India. These concerns eventually led to the doom of this Bill.

1. INTRODUCTION

It is worthwhile to note that, the Insolvency and Bankruptcy Code (IBC) was enacted in the year 2016, with an aim to resolve the issues of insolvencies and bankruptcies of corporate persons, partnership firms, and individuals. However, IBC does not cover financial firms and their insolvency resolution was proposed to be governed by the FRDI Bill.

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In the face of distinct laws for resolution of similar financial service providers such as banks, insurance companies, non-banking financial companies, pension fund, or mutual fund run by an asset management company, *etc.*, the FRDI Bill was introduced with an aim to deal with bankruptcy situations and to provide a single legislation for resolution of such institutions.

The bill aimed to establish a framework to carry out the resolution of certain categories of financial service providers in distress, to provide deposit insurance to consumers of certain categories of financial services, and for designation of Systemically Important Financial Institutions by the Central Government for resolution. It sought to protect customers of financial service providers in times of financial distress. It also sought to decrease the time and costs involved in resolving distressed financial entities.[1]

2. EXISTING RESOLUTION FRAMEWORK TO RESOLVE FINANCIAL FIRMS

Currently, there is no specialised law for the resolution of financial firms in India. Provisions to resolve failure of financial firms are found scattered across different laws.[2] Resolution or winding up of financial firms is managed by different regulators for various kinds of financial firms, for example, the Reserve Bank of India (RBI) for banks, the

[1] R. Raghavan, *FRDI Bill 2017 – Key Objectives, Salient Features and Benefits*, ALL BANKING ALERTS, http://allbankingalerts.com/frdi-bill-2017-objectives-sailent-features-benefits/.

[2] DEPARTMENT OF ECON. AFFAIRS, MINISTRY OF FINANCE, REPORT OF COMMITTEE TO DRAFT CODE ON RESOLUTION OF FINANCIAL FIRMS (Sep. 28, 2016).

Insurance Regulatory and Development Authority (IRDA) for insurance companies, and the Securities and Exchange Board of India (SEBI) for stock exchanges.

The procedure of resolution of a banking institution depends upon its type. A banking institution can be a scheduled commercial bank, co-operative bank, or public sector bank. A scheduled commercial bank may either be merged forcibly by Reserve Bank of India (RBI) with another bank which is regulated by the directions of RBI.[3] Winding-up procedure can also be initiated by an order of High Court on the application of RBI. Banks like State Bank of India (SBI), Regional Rural Banks (RRBs), and other nationalised banks, can only be wound up on the order of the Central Government.[4]

Under the current framework, powers of the aforementioned regulators to resolve similar entities also vary. For instance, RBI has powers to wind-up or merge scheduled commercial banks, but not co-operative banks.

3. THE PROPOSED MECHANISM

The FRDI Bill specifies various tools to resolve a failing financial firm which includes transferring its assets and liabilities, merging it with another firm, liquidating it, selling it, or closing it down.

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[3] Banking Regulation Act, 1949, No. 10, Acts of Parliament, 1949, § 44(a).
[4] Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980, No. 40, Acts of Parliament, 1980.

3.1. POWERS OF THE RESOLUTION CORPORATION

The Bill proposed to create a Resolution Corporation[5] to monitor the resolution of financial firms. The Resolution Corporation was to include representatives from the Ministry of Finance, RBI, SEBI, IRDA, and PFRDA among others.[6] The functions of proposed Resolution Corporation included assigning of the risk to viability of a bank (which covered service provider),[7] as namely: low, moderate, material, imminent, and critical; after consultation with RBI. But, only RBI was empowered to classify the bank in low or moderate risk to viability.

Such classification was proposed to be done on the basis of adequacy of capital, assets and liability, asset quality, capability of management, earnings sufficiency, leverage ratio, liquidity of the covered service provider, and sensitivity of the covered service provider to adverse market conditions, and compliance with applicable laws.[8] The Bill provided banks classified under low or moderate risk option to opt for voluntary liquidation under Section 59 of the IBC, subject to any such condition specified by the RBI.[9] Whereas, the bank classified under material or imminent risk to viability were tasked under the Bill to prepare and submit a restoration plan to the RBI and a resolution plan to the Resolution Corporation within ninety days from the date such classification is made. Board of the bank classified as imminent or critical

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[5] Financial Resolution & Deposit Insurance Bill, 2017, § 3.
[6] *Id.*, § 4.
[7] *Id.*, § 13.
[8] *Id.*, § 36.
[9] *Id.*, § 93.

risk to viability could be superseded by the Resolution Corporation for the maximum period of two years, if it was required in public interest.

The Bill gave power to Resolution Corporation to take over the administration of the bank once it was classified as critical risk to viability. Thereafter, the resolution was to take place within the specified time period, during which no legal action could be initiated against the bank. The resolution can be done, *inter alia*, by transferring the assets and liabilities of the covered service provider to another person, creating a bridge service provider,[10] merger, acquisition, liquidation,[11] bail-in,[12] or a combination of all or any of these methods.[13] Dispute or difference of opinion between the Resolution Corporation and the RBI, if any, was provided to be resolved by consultation, however, final power rested with the Resolution Corporation.[14] The Bill also disallowed the Corporation's resolution process from being challenged in courts.

4. ISSUES EMERGING OUT OF THE BILL

4.1. THE "BAIL IN" CONCERN

As per the Bill, one of the major resolution methods for financial firms on the verge of failure is 'bail-in'. As per this method, failing banks are rescued by internally-restructuring their debts. 'bail-in' was introduced

[10] *Id.*, § 50.
[11] *Id.*, Ch. XII.
[12] *Id.*, § 52.
[13] *Id.*, § 48.
[14] *Id.*, § 37.

in the FRDI Bill in order to ensure that the country's economy is not destabilised in the event of big default by a large bank.

Bail-in differs from bail-out. It is pertinent to note that bail-out involves funds being infused by external sources to resolve a firm; however, bail-in involves internally restructuring the Bank's debt.

The Resolution Corporation can internally restructure the firm's debt by: (i) cancelling liabilities that the firm owes to its creditors; or (ii) converting its liabilities into any other instrument (*e.g.*, converting debt into equity); among others.

Bail-in was dealt in Section 52 of the Bill. Section 52(1) of the Bill stated that if the Resolution Corporation was satisfied that it was necessary to bail-in a specified financial service provider (bank) for absorbing the losses incurred, then an action should be taken under that section by a bail-in instrument or a scheme.[15] Section 52(5) provided that a bail-in provision is one cancelling or modifying a liability owed by a specified service provider.[16] As per Section 52(7), the bail-in instrument or scheme was not to affect any liability owed by a specified service provider to the depositors to the extent such deposits were covered by deposit insurance.[17]

Thus, Section 52 instilled depositors with apprehensions that their money will be used by failing financial institutions to save themselves. Furthermore, the Bill did not specify with clarity as to how the depositors'

[15] *Id.*, § 52(1).
[16] *Id.*, §52(5).
[17] *Id.*, § 52(7).

money that was used for bail-in would be paid back and how there will be no financial crises.

4.2. LIMITED DEPOSIT INSURANCE

It is pertinent to note that, currently the Deposit Insurance and Credit Guarantee Corporation (DICGC) provides deposit insurance for bank deposits to depositors. This body was established under the Deposit Insurance Corporation Act. This insurance cover was extended to depositors of all commercial banks and most cooperative banks. So, in a hypothetical scenario where a bank is liquidated, principal and interest up to a particular amount is insured and hence, protected.

The FRDI Bill proposed to subsume the functions of the DICGC under the Resolution Corporation. The Resolution Corporation mandate included provision of deposit insurance to banks up to a certain limit. This implied that, the Corporation could guarantee the repayment of a certain amount to each depositor in case the bank fails. However, the cause of concern is that under the present regime the deposits up to one lakh rupees per depositor are insured and any amounts above one lakh rupees are not insured. Thus, in a situation where deposits are made in a failing bank that is 'bailed-in', the depositors are at a risk of losing their money that is uninsured and above the insured threshold of one lakh.

Furthermore, as per Section 55(2)(b), "only those liabilities may be cancelled the instrument creating which contain a provision to the effect that the parties to the contract agree that the liability is eligible to be the subject of a bail-in." This means that depositors while signing the contract with the bank can agree to a bail-in; however, the problem is that banks will not give consumer that option and it might be forced upon the consumers.

4.3. Concerns Over Conflict With The Existing Regulatory Body

The advent of the FRDI Bill could have led to a clash between regulatory bodies on multiple grounds. RBI had also raised concerns regarding the functioning of the Resolution Corporation and the resultant conflict with the functions of the regulatory body for the financial institutions.[18] RBI, being the regulatory body for the banks, has the power to classify them as material risk to viability. However, the Bill stipulated that, in case of difference of opinion between RBI and Resolution Corporation, the opinion of Resolution Corporation would prevail and it may re-classify the bank in imminent or critical risk to viability.[19]

Whereas, at the stage of material risk to viability, Prompt Corrective Action (PCA) can be used by RBI to address the issue faced by the bank classified. Intervention of Resolution Corporation in material risk to viability category was bound to create conflict between RBI and Resolution Corporation. Further, both RBI and Resolution Corporation had different ways of assessing risks. This, in turn, would have adversely affect recovery or restoration plans of the respective regulatory body.[20] Instead of working in cooperation and coordination, the Resolution

[18] *supra* note 2.
[19] FRDI Bill, *supra* note 5, § 37(4).
[20] *supra* note 2.

Corporation might have ended up questioning the authority of the regulatory body.

4.4. OWNERSHIP NEUTRALITY MODEL NOT APT FOR INDIA

This Bill also adopted an ownership neutrality model with regard to public and private sector banks. The aim of private banks is to provide high-standard facilities to the customers and thereby, increasing profits and spreading business. On the other hand, public sector banks have different aims and they need to serve all the sections of society. If the sovereign guarantee for insulating public sector banks and other public financial institutions from failures is diluted and the powers to resolve them is divested from the government, it will adversely affect the trust and confidence of the depositors in the public sector banks and weaken the entire financial system.

The "ownership-neutral" approach of Resolution Corporation might have turned out to be detrimental to the financial stability of the banking sector.

4.5. OVERLOOKING DISCLOSURES

This Bill also overlooked the disclosures made to the consumers. While there were apt provisions enabling financial institutions sharing information with the regulator or the Resolution Corporation or both, there was nothing in this Bill that said that the information was required to be shared with consumers. One of the reasons could have been that, if consumers came to know about their bank moving to High or moderate risk from low risk, they could have panicked. However, in today's world of instant-information sharing and social media, it is unlikely that the knowledge of risks of banks will not be percolated to the general public. It is far more efficient for banks and regulators to share information than to consciously suppress it.

5. CONCLUSION

It can be said that, at present, there is no comprehensive legal framework for resolution and liquidation of financial firms in India, therefore, the FRDI Bill was a step in the right direction. However, the loopholes in the bill, as pointed out above, eventually led to the withdrawal of this bill.

Another plausible reason for the withdrawal of the Bill was the pressure created on the government, because of the angst amongst the depositors related to their money in banks, especially after the recent scams and loan defaults like Nirav Modi -PNB Scam, Vijay Mallya's default in loan repayment, *etc.*

The Bill has been withdrawn but the issues it sought to address still remain to persist. Bank failure can pose an enormous risk on the overall financial stability. Thus, the need for a specialized framework to cope with large financial corporation on the verge of collapsing cannot be overstated.

One of the major drawbacks in the FRDI Bill was that it was largely based upon the regulatory reform framework of the Financial Stability Board (FSB). This organization has identified some of the banks as "globally-systemically important financial institution"[21] and provides a resolution regime for them. Solutions to insolvency of financial firms provided by FSB, to a large extent, are universal in approach. However, the problem is that India is not on the same level as other advanced countries in terms of economy and regulation machinery and hence without simply emulating a foreign framework, the Indian Government should reappraise the situations of Financial entities in a better way and then come up with a bill which is more suitable for India.

In the end, the author believes that, even though the Bill has been withdrawn, there is still an urgent need persisting to enhance the insurance cover on deposits in banks, which is currently limited to merely Rs one lakh.

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[21] *2017 List of Global Systemically Important Banks (G-SIBS)*, FINANCIAL STABILITY BOARD http://www.fsb.org/wp-content/uploads/P211117-1.pdf (last visited Oct. 25, 2018).

CADY, ROBERTS & CO., 40 SAEC 907 (1961) — CASE ANALYSIS

Debadatta Bose[*]

ABSTRACT

This case analysis is based on the first case that has shaped today's insider-trading law. Through this, the SEC had become the torch-bearer for the world that, insider trading meant much beyond manipulation of markets. Beyond this case, jurisprudence evolved that has had a great impact on the insider trading law as we see it today. This article deals with the *Cady, Roberts & Co.* Case in detail and thereafter deals with how the insider trading jurisprudence evolved in the United States of America along the 'possession' v. 'use' debate. Lastly, it deals with how, if this case was to happen today, Indian law would deal with the same set of facts.

1. FACTS

There are four people at play in the present case, which include Curtiss-Wright Corporation and one of its directors J. Cheever Cowdin referred as 'Cowdin' in the judgment, the broker firm of Cady, Roberts & Co. referred as 'Registrant' in the judgment and Robert M. Gintel, a partner of the firm referred as 'Gintel' in the judgment.

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The incident that led to the case, happened on the 25th of November 1959. Within a few minutes it came to be regarded as one of the first cases of insider trading in the history of the United States of America. It so happened that, Mr. Cowdin was a registered representative of Cady, Roberts & Co. from July 1956 till March 1960, having been elected to the Board of Directors since 1929. On this particular day, a meeting was being held to discuss *inter alia*, a declaration of quarterly dividend which, for the last three quarters, stood at $0.625 per share. It was decided in the Board Meeting that, in this quarter, the dividends would be announced at a reduced rate of $0.375 per share. The information regarding such reduction in payment of dividends was authorised to be sent to the New York Stock Exchange via telegram at 11:00 a.m. However, the transmission could not be done until 12:29 p.m. because of a typing problem. even when the message was delivered to Western Union at 11:12 a.m. The company had a customary obligation to display on the Dow Jones Ticker System, any dividend-related information. This was also delayed due to some technical error, and Wall Street Journal received the news only at 11:45 a.m., and the ticker displayed the information at 11:48 a.m.

While this had all happened, back in time when the dividend decision had just been taken, a recess of the meeting had been scheduled. It was then that Mr. Cowdin called the office of Cady, Roberts & Co. and left a message for Mr. Gintel that the dividend declaration had been reduced to $0.375 per share. Gintel, on receiving the information asked the New York Stock Exchange to execute two orders of selling 2,000 shares in Curtis-Wright and for selling short 5,000 shares for ten and eleven accounts respectively. These instructions were duly executed by the Exchange at 11:15 a.m. and 11:18 a.m., respectively. He then proceeded to sell 2,000 more shares for a mutual fund having a large position in the stock. An investment manager of this fund had expressed concerns to Mr. Gintel regarding the lowering of the dividend and had gone to the Curtis-Wright office at 11:00 a.m., to urge Curtiss-Wright not to lower the dividends.

The Curtiss-Wright dividend announcement appeared on the tickers at 11:48 a.m. and the Exchange had to stop trading operations on the stock due to the large number of sell orders. The trading resumed at 1:59 p.m.

2. PROCEDURAL HISTORY

After the admission of the case before the Securities and Exchange Commission, pursuant to §5(b) of the Administrative Procedure Act and Rule 8 of the Rules of Practice of the Securities and Exchange Commission, an offer of settlement was made by Cady, Roberts & Co. This particular offer of settlement included the proposition that the case could be adjudged on the facts stated by the respondent-authorities if Mr. Gintel's maximum punishment would be his suspension for 20 days from the New York Stock Exchange.

§ 5(b) of the Administrative Procedure Act allows the concerned parties to submit arguments, adjustments, and most importantly offers of settlement in every adjudication proceeding. The erstwhile Rule 8 of the

Rules of Practice of the Securities and Exchange Commission facilitated these offers of settlements, but has been replaced by the current §201.54 and § 201.240 of the Rules of Practice. The former stated that an agreement on a settlement may be done before the case is finally disposed and if in case it is agreed upon before the filing of the application before the Securities and Exchange Commission, then the application has to be filed with the offer of settlement. The latter rule is an elaborate procedural rule on how settlements are done before the Securities and Exchange Commission, who will sign the settlement and how it will be filed. It also mentions that the final acceptance of the offer of settlement will only occur upon an order of the Commission.

3. ISSUES AND HOLDINGS

1. Whether information regarding dividend was non-public price sensitive information?
2. Did Cady, Roberts & Co. have a duty not to trade based on that information or disclose the information?

The Court held that, such information regarding dividend was price-sensitive information and that Cady, Roberts & Co. had a duty not to trade based on that information or disclose that information.

4. RATIO DECIDENDI

The law that was relied upon for this case was, § 17(a) of the Securities Act of 1933, §10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated under the authority of the aforesaid § 10(b). This

§ 10(b) states that, it is “unlawful for any person to use, in connection with the purchase or sale of a security, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for protection of investors.” These sections have their application to “any person” who are traditional ‘insiders’ – ones who have price-sensitive information based on their position that is not ordinarily available to persons they deal with. In this scenario, Cady, Roberts & Co. itself was held liable since the actions of Mr. Gintel was carried out during the course of his employment which was attributable to the firm itself. The section’s use of the term, “any person”, ordinarily includes officers, directors, and controlling stockholders but the list was not exhaustive and included persons who had the same obligations in particular facts and circumstances of a case. Persons who buy stock from an insider have the same protection afforded to them as the persons who sell the stock to them – the defrauded buyer and defrauded seller are thus kept on an equal footing.

The information regarding the decrease in the dividend for the quarter was such information to have an adverse impact on the company stock by affecting investment judgment. This information has a direct impact on the securities market, so much so that, it actually made the exchange stop trading the stock for a period of time.

Even though Mr. Gintel had a fiduciary duty towards the accounts of his clients, it could not justify a violation of the law to keep the accounts in a steady state. There was no manipulation of markets, but acting on such undisclosed information was an act, not valid in the eyes of law. However, the US Securities and Exchange Commission noted that, there was no evidence of a preconceived plan for Mr. Cowdin to inform Mr. Gintel of any decrease in dividends. Both the men acted in good faith – Mr. Cowdin presumed the information had already become public and was unaware of the transmission failure, while Mr. Gintel had acted at the spur of the moment, to protect his customers' interest without reviewing the information. Hence, he was put on a 20 day suspension, thus accepting the offer of settlement, as he had already been fined $3,000 by the New York Stock Exchange.

5. EVALUATION & SYNTHESIS

Pertinent to note that law has not changed and Rule 10b-5 is still in full force to prevent insider trading inside the United States. Rule 10b-5 is called the 'Employment of Manipulative and Deceptive Practices' section, and prohibits fraudulent activities, giving statements that are false, omitting relevant information, and deceit in general in the context of trading of securities. Any use of confidential information or any arrangement that might manipulate price of securities, would be dealt with under this rule.

There are certain general rules that have evolved over time since the *Cady, Roberts & Co.* case and now, there can be said to be three ingredients to constitute a violation of Rule 10b-5:

1. Scienter
2. Materiality of information

3. Use of information

The first condition of scienter requires that, the one alleged of wrongdoing has done it with the intention to do the alleged wrong. As in the cases requiring proof of *mens rea*, it can be inferred from certain facts and circumstances like the previous trading history of the wrongdoer[1] and, the particular circumstances that led to the transaction. Certain points were let-down, which included the following:

- The burden of proof of scienter lies on the party asserting such motive
- Transaction patterns of the wrongdoer
- Dramatic deviation of transaction pattern
    - Magnitude or value of the insider trading
    - Time of the transactions
    - Deviation from ordinary practice

For the second requirement of materiality, it has been laid down that all information cannot be termed as actionable. Only information that is material for price-variation is actionable.[2] Information regarding a company's upcoming projects which have not been made public, for example, information which is of such material nature.

For the third requirement, it is a stark contrast of Rule 14e-3 which emphasises on possession. Rule 14e-3 prohibits any trading in securities, when in possession of material non-public information regarding a tender

[1] *In Re*, Silicon Graphics, Inc., Securities Litigation, 970 F. Supp. 746 (1999).
[2] Securities Exchange Comm'n v. Texas Gulf Sulphur Co., 401 F.2d 833 (1966).

offer or otherwise. The words of focus here are, “in possession”. Rule 10b-5 jurisprudence rather emphasises on ‘use’ of non-public information, and not mere possession[3]. But possession, even though cannot fix liability, is enough to hit the Rule’s trigger of abstaining or disclose-obligation. This obligation has been clarified with the adoption of Rule 10b-5(1) by the Securities and Exchange Commission in August of 2000. The adoption of this rule was necessary to bring clarity to Rule 10b-5. Rule 10b-5(1) states, there is a presumption of ’use' if one is in the possession of information. This is, however, a rebuttable presumption and can be disproved by showing that such information was not used in making the trading decision, vide Rule 10b-5(1)(c)(1). This rule 10b-5(1)(c)(1) allows such presumption not to have effect when there was any action taken to sell the securities before becoming aware of the information or in pursuance of a contract, instruction or plan that was made before the information came into the knowledge of the person. The aforementioned presumption has certain exceptions as provided in Rule 10b-5(2), which are the following:

- The obtainee is a spouse, parent, child, or sibling of the discloser;
- The obtainee is, in habitual discourse, under a position to obtain information and can be said to maintain the information in confidence;
- Or that, the obtainee has agreed to maintain such information in confidence.

[3] U.S. v. Smith, 155 F.3d 1051 (1820); SEC v. Adler, 137 F.3d 1325 (1998).

6. FURTHER JUDICIAL CASES

Judicial pronouncements citing *Cady, Roberts & Co.* are many, since it was at the frontier of an era of insider trading cases from the Securities and Exchange Commission. In the case of *Speed v. Transamerica Corp.*,[4] *Cady, Roberts & Co.* was referred, while discussing the duty of disclosure of material non-public information which requires:

- Information that was meant only for the corporate purpose is accessed by a person, by virtue of his relationship with the insider.
- The inherent unfairness of such disclosure as against those trading without the information that was disclosed.

It further went on to state that a relationship of trust and confidence was in existence between the shareholders and the insiders that gave rise to the liability to disclose any non-public price-sensitive information that they might have. Uninformed minority stockholders are at a great disadvantage without access to information within the doors of the company.

In the case of *Chiarella v. U.S.*,[5] the Court again elaborated on the 'possession' v. 'use' jurisprudence which stated that, mere possession of material non-public information does not create a duty to disclose the information. That duty only arises when that information is sought to be used in making a trading judgment. The case discussed the contrast with Rule 14e-3, which makes even possession of such information actionable

[4] Speed v. Transamerica Corp., 99 F.Supp. 808, 829 (1951).
[5] Chiarella v. U.S., 445 U.S. 227, 228 (1980).

in the sense that it creates a duty to abstain from trading based on that information. Rule 14e-3 prohibits trading in company securities when information regarding the tender offer and commencement of bid on that tender.

The jurisprudential foundations of such insider trading cases are based on the property right to information.[6] There was a regulatory paradigm shift after the aforementioned *Chiarella* case.[7] Insider trading, thus, became illegal because it was unfair.

7. INDIAN LAW

The insider trading regulations in India are governed by the SEBI (Prohibition of Insider Trading) Regulations, 2015. Regulation 2(g) specifies who is an 'insider' and includes 'connected person' as defined in Regulation 2(d) and any person in possession of unpublished price sensitive information. Even in this case, *Cady, Roberts & Co.* would have come under the definition of an insider vide connected person under Regulation 2(d) they have access to unpublished information which they are reasonably expected to allow such access. This is by virtue of the special position they enjoyed with Mr. Cowdin where they were expected to have access to have such information but also had the duty not to act upon it until the information was made publicly available. The law of USA uses the term "any person", whereas the Indian law has specific

[6] Jonathan R. Macey, *Securities Trading: A Contractual Perspective*, 50 CASE W. RES. L. REV. 269, 273-74 (1999), *available at* https://scholarlycommons.law.case.edu/caselrev/vol50/iss2/10.

[7] *Id.* at 284-87.

definitions for who is an insider and connected person and these are the only persons on whom such regulations can be made applicable. Nonetheless, these definitions are extremely wide, and have within their ambit, all possible persons who can get access to and use such unpublished price sensitive information to their unfair advantage. The prohibition in Indian law is for two different actions – communication and/or procurement vide Regulation 3 and; trading with such information vide Regulation 4.

Unpublished price sensitive information as defined in Regulation 2(n) is much clearer in this aspect in comparison to Securities and Exchange Commission Rule 10b-5. Regulation 2(n) is a negative clause and includes every information that is not generally available[8], and might materially affect the price of securities. It further includes an illustrative list of such information which explicitly includes information relating to dividends. Regulation 2(1)(e) defines what is generally available information, and that is such information as is available to the public on a 'non-discriminatory' basis, i.e., anyone can freely access such information irrespective of their connection with the company. In simple terms, generally available information is such information that is available to any stranger as much as available to the top executives of the company. This 'non-discriminatory access' that is spoken about here, is inevitably, access without breaching any law. Thus, even though the general public can get hold of any information that is price sensitive through the use of means prohibited by cyber law, it would not amount to generally available

[8] Hindustan Lever Ltd. v. Securities Exchange Board of India [1998] 18 S.C.L. 311 (S.A.T.).

information. As such, *Cady, Roberts & Co.* would have been a case that would have directly violated the Regulations of S.E.B.I. if such a similar situation was to happen in India in the present day. The U.S. Securities and Exchange Commission Regulation 10b-5 is more ambiguous albeit open to broader interpretation with the use of the words 'artifice to defraud' and 'fraud or deceit upon any person'. It is thus stated that the invoking of the Regulations has the 'scienter' requirement whereas statutorily, the regulations in India are lucid and strict.[9] In India, there is no requirement for *mens rea*, and the decision can rest on a preponderance of probabilities.[10] This enables a penal provision to operate without the strict requirements that such a provision usually entails to satisfy its requirements. The recipient of such information can therefore be held liable for fraud in case there is an "inducement to bring about an inequitable result".[11]

Indian law is somewhat similar to US law, through the case of *Chiarella v. U.S.*,[12] and *Rakesh Agrawal v. S.E.B.I.*,[13] which said that the breach of fiduciary duty was the basis of affixing liability for insider trading. Both cases stated that it has to be read into the Regulations that, there should be the existence of a special relationship which would form the basis of liability. Thus, even though the words, "any person", has been used in the text of US law, it cannot actually, in practice, be applicable on

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[9] Rakesh Agrawal v. Securities Exchange Board of India [2004] 49 S.C.L. 351 (S.A.T.).
[10] Securities Exchange Board of India v. Kanaiyalal Patel, 2017 S.C.C. OnLine S.C. 1148.
[11] *Id.*
[12] *supra* note 5.
[13] *supra* note 9.

any person. Apart from this, the earlier 'possession vs. use' debate is a significant point of difference between Indian law and US law. As stated earlier by citing *Chiarella*,[14] in the USA, mere possession cannot sustain an indictment under insider trading. Indian law, however uses the words "No person shall…while in possession of unpublished price sensitive information" in Regulation 4 and thus, makes trading in securities prohibited even with a mere possession of such information.

However, as in the *Rakesh Agrawal* case,[15] there is a presumption that the person dealing in securities acts for a personal benefit in such cases, which is a rebuttable presumption and can be disproved by appropriate evidence showing facts to the contrary. The decision to deal in securities, if independent of the possession of the unpublished price sensitive information, should be so proved. It will be sufficient if the unpublished price sensitive information was not used and was unconnected in the decision to deal with the securities for avoiding liability.[16] The words "on the basis of" used in the statute signify that the basis of the decision to deal in the securities should be the unpublished price sensitive information, i.e. the unpublished price sensitive information should be the motivating factor and circumstance of the

[14] *supra* note 5.
[15] *supra* note 9.
[16] Chandrakala v. Securities Exchange Board of India, Securities Appellate Tribunal, Jan. 31, 2012, *available at* http://www.sebi.gov.in/cms/sebi_data/attachdocs/1327988739076.pdf (last visited July 3, 2017).

trading. If it is not so, and is proved to be otherwise, the onus stands discharged and the liability under the statute will not be attracted.[17]

In conclusion, *Cady, Roberts & Co.* started the wheels of punishment for insider trading, which had a ripple effect in all common law countries in the world. Further developments of law were suited to domestic needs in these countries, as and when that need arose. As we can see, the US law has been interpreted thoroughly through the various decisions as elaborated above, beginning with *Cady, Roberts & Co.*, but Indian law is a recent creation and therefore, it is a much more precise and elaborate piece of secondary legislation. The Indian law and the US law are almost at parity with each other now, in the particular aspects dealt with in this article, except for a few differences as pointed out above.

[17] Rajiv Gandhi v. Securities Exchange Board of India [2008] 84 S.C.L. 192 (S.A.T.).