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1. **RECENT IMPROVEMENTS IN CORPORATE GOVERNANCE IN BRAZIL**[*]

Abstract

Despite the economic crisis and political turmoil of recent years, Brazil has undergone major positive changes in its macroeconomic environment in the past decades. In addition to economic growth, the country managed to pass important pieces of legislation, saw some significant development in its capital markets, and positioned itself as one of the world's leading emerging economies. More recently, Brazil has also drawn attention for its determination to halt corruption practices, and to set better and more transparent ways of doing business in the country. In this context, consistent improvements in the corporate governance practices in Brazil have been an irreversible trend. This article shows that corporate governance practices (and particularly those at listed corporations) improved significantly in Brazil since the early 2000s. This evolution results not only to the entry of new, sophisticated players in the Brazilian market, but also from the efforts of more skilled lawmakers and regulators. In addition, this article provides an overview of the corporate governance regime in Brazil, addressing subjects such as the operation of decision-making bodies, disclosure obligations, corporate responsibility, and shareholders activism.

I OVERVIEW OF GOVERNANCE REGIME

The corporate governance regime applicable to Brazilian listed companies is basically established by the Brazilian Corporation Law (Federal Law No. 6,404, of 15 December 1976, as amended), the rulings issued by the Brazilian Securities Commission (CVM), and the listing rules issued by the São Paulo Stock Exchange (B3)

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[1] to each of its listing segments.

Among the Law and rules mentioned above, it is important to highlight that CVM enacted in June 2017 a new ruling (i.e., Ruling No. 586) establishing the obligation for the listed companies to disclose, on an annual basis,[2] the 'Brazilian Corporate Governance Code: Listed Companies Information', whereby the companies shall indicate, in relation to each recommendation of the Brazilian Corporate Governance Code, whether the company was compliant, and if not, would provide an explanation for the non-compliance (i.e., 'comply or explain' approach). The Brazilian Corporate Governance Code for listed companies was elaborated by GT Interagents (the Interagents Working Group, which comprises 11 of the most important agencies concerned with the Brazilian capital markets), and issued on 16 November 2016.

Out of the B3 listing segments, the Novo Mercado sets the highest standards of corporate governance rules, followed by Level 2 and Level 1. There is also the BOVESPA MAIS, an organised over-the-counter market managed by B3 and created as a way for small and medium-sized companies to access the capital markets. It falls under the authority of CVM, a federal independent agency reporting to the Ministry of Finance that supervises and enforces listed companies' compliance with the Brazilian Corporation Law and the rules issued by CVM. This enforcement can result in the imposition of fines and restrictions on companies and their administrators.

B3 is responsible for supervising compliance with its listing rules and has the authority to impose on companies and their administrators, contractual fines and other sanctions, such as suspension and exclusion from trading in shares in the B3 environment.

Most Brazilian listed companies do not have widely held stock, but in recent years there has been a trend for CVM to stimulate the participation of minority shareholders in the governance of companies, through the creation of a mechanism that enables all the shareholders to send their votes electronically prior to any shareholders' meeting. In 2017,

[1] B3 SA – Brasil, Bolsa, Balcão is the current corporate denomination of the São Paulo Stock Exchange, whichwas formerly denominated BM&FBOVESPA SA – Bolsa de Valores, Mercadorias e Futuros until 10 May 2017.

[2] The Brazilian Corporate Governance Code: Listed Companies Information must be disclosed within seven months of the end of each fiscal year.

implementation of this mechanism was only mandatory for the main companies listed on B3; however, as from 2018 it has become mandatory for all companies.

In recent years, CVM has also enacted rules to improve the quality and amount of information that a listed company must disclose to its investors, including Ruling No. 480, published at the end of 2009, which created the 'reference form', a document containing very detailed information about the company that must be updated at least once a year; and Ruling No. 481 (published simultaneously with Ruling No. 480), which sets forth the mandatory information that must be disclosed by listed companies on an ordinary basis and prior to each shareholders' meeting. Both these rulings have been adjusted and amended on a continuous basis to incorporate improvements that CVM considered necessary.

Furthermore, in September 2015, B3 launched the State-Owned Enterprise Governance Programme in response to the recent corruption scandals and political use of state-owned companies by the government. The Programme aims at restoring investors' confidence in state-owned enterprises (which are significant elements of the Brazilian capital markets) by enhancing the corporate governance rules of these companies in the following ways: (1) through more clear disclosure of the company's objectives; (2) through the creation of mechanisms to remove administrators who divert company activities from the stated objective; (3) through the establishment of detailed nomination criteria encompassing the qualifications and expertise of the administrators; and (4) through the commitment of the public controlling shareholder to comply with corporate governance best practice.

2018 was an unique year for corporate governance in Brazil, since in this year we had: (1) the publication of the first Brazilian Corporate Governance Code: Listed Companies Information, which became required from the companies whose shares are part of the IBOVESPA index or the IBrX-100 index; (2) the application of some of the changes in the Novo Mercado Listing Rules that became effective as from 2 January 2018 (other changes will become effective in 2021), such as the disclosure of material facts and earnings releases in Portuguese and English, disclosure of the resignation or removal of board members and officers through material fact or announcement to the market within the business day following the resignation or removal and the mandatory statement of the board of directors

regarding the tender offers; and (3) implementation of the proxy voting system for all the listed companies on B3.

II CORPORATE LEADERSHIP

Brazilian listed companies are managed by a board of directors[3] and by an executive board or office. Brazilian companies may also install a fiscal board, which does not have the nature of a managerial body but rather of a supervisory body.

BOARD OF DIRECTORS

The board of directors is a decision-making body with authority to establish the company's business policy in general; to elect and dismiss officers; to set the duties and monitor the day-to-day managerial actions of the officers; to express an opinion on any matters to be submitted to the shareholders; and to approve the implementation by the executive office of specific matters prescribed by law or under the company by-laws. The authority of the board of directors established by the Brazilian Corporation Law cannot be delegated to other bodies.

The Brazilian Corporation Law sets for that the board of directors shall be composed of at least three members, who are not required to be Brazilian residents.

In the case of the companies currently listed on the Novo Mercado, considering the changes approved in its Listing Rules in 2017, they must observe the following rules: (1) until the ordinary shareholders' meeting that shall approve the financial statements related to the fiscal year of 2020 - the board must be composed of at least five members and at least 20 per cent of the members must be considered to be 'independent'; and (2) as from the ordinary shareholders' meeting that shall approve the financial statements related to the fiscal year of 2020 – the board must be composed of at least three members and at least two or 20 per cent of the members, whichever is greater, must be considered to be 'independent'. For the

[3] Closely held companies are not required to have a board of directors.

companies that became listed on the Novo Mercado as from 2 January 2018, it shall apply the rule provided in item (2) above, as from its listing.

In the case of the companies currently listed in the Level 2 segment, the board must be composed of at least five members and at least 20 per cent of the members must be considered to be 'independent'.

The requirements for the appointment to occupy a position on the board of directors are established in the Brazilian Corporation Law. In broad terms, the director must be someone with an unblemished reputation who has not been convicted in an administrative or judicial procedure in relation to corporate crimes or irregularities.

The board of directors can create specific committees (e.g., compensation, related-party transactions, and audit) to assist it in the management of the company. For the companies currently listed in the Novo Mercado segment, it will be mandatory to install an audit committee, statutory or not, as from the ordinary shareholders' meeting that shall approve the financial statements related to the fiscal year of 2020.

Listed companies must rotate their independent auditor every five years and must wait at least three years before rehiring the same auditor. However, if the listed company has installed a statutory audit committee, rotation can occur every 10 years instead of five.

In the event of a tender offer for the acquisition of the control of a listed company (Takeover TO), in principle, the board of directors of the listed companies is not under an obligation to make a statement as to whether or not it agrees with the terms and conditions of the Takeover TO.

If, however, the board of directors decides to make a statement on the Takeover TO, the statement must be disclosed to the market and must address such issues as: provision of information on all aspects necessary to allow an informed decision by the investor, especially with regard to the price being offered; and any material changes in the company's financial condition since the date of the most recent financial statements or quarterly reports disclosed to the market.

In the case of companies listed on the Novo Mercado and Level 2 listing segments, the board of directors is required to prepare and disclose a reasoned opinion on the Takeover TO

– in favour or against it – and to address the following topics: (1) the suitability of and opportunities presented by the Takeover TO; (2) the impact of the Takeover TO on the interests of the company; (3) the offeror's stated strategic plans for the company; and (4) any other point of consideration the board may deem relevant.

The board of directors is a decision-making body of the company, but the daily routine of administration of the company shall fall to the executive board. All the members of the board of directors, including the outside or independent members, must receive in advance of the meetings of the board of directors, information about the matters that will be discussed and put to the vote.

Brazilian law fails to expressly state that the directors have the right to visit the company's facilities and its subsidiaries, or that the directors should have free access to the lower management of the company. However, considering that among the duties provided for the board of directors in the Brazilian Corporation Law it is established that the board of directors shall 'supervise the performance of the officers, examine the books and records of the company at any time, request information on contracts signed or about to be signed, and take all other necessary action', it is expected that the directors shall have free access to the company, its subsidiaries and its lower management.

Pursuant to the Brazilian Corporation Law, the directors have the following duties and obligations: (1) a duty of diligence, employing the same care and diligence that every diligent and honest person employs in its own business; (2) to act within the scope of their duties without misuse of power, refraining from the performance of gratuitous or non-authorised acts and from the receipt of personal advantage by reason of the performance of their duties; (3) even if elected by a certain group or class of shareholders, they have the same duty to the company as everyone else, and must not, even in the defence of the interests of those who elected them, fail to fulfil these duties; (4) a duty of loyalty; (5) to act without conflict of interest, not intervening in any transaction where they have an interest conflicting with that of the company; and (6) a duty of information.

As regards the liability of the directors, the directors shall not be held personally liable for the obligations assumed on behalf of the company as a result of a regular act of

management. However, the directors shall be held liable in civil lawsuits for the losses that they cause owing to acts of negligence or fraudulent intent and in violation of the law or the company's by-laws.

Note that the directors shall not be liable for unlawful acts performed by other directors, unless they are involved with these directors, or they neglect to perceive them or if, having knowledge of them, fail to act to prevent their performance. However, directors are held jointly liable in the case of decisions taken by the board of directors.

In this particular, we note that each of its members is personally liable for any act of omission or negligence of the board of directors, and a dissident director shall express his or her disagreement regarding the resolutions taken through the clear and written register in the minutes of the meeting of the competent administration body, to release him or herself from any eventual civil liability. The director who agrees with the performance of acts that violate the law or the company's by-laws shall be held jointly liable for the losses resulting from said act.

The members of the board of directors are elected by the shareholders, who can dismiss them at any time. The shareholders representing at least one-tenth of the voting capital may request that a multiple voting procedure be adopted to entitle each share to as many votes as there are board members and to give each shareholder the right to vote cumulatively for only one candidate or to distribute his or her votes among several candidates.

The term of office of the directors must be defined in the by-laws, but it cannot exceed three years, although re-election is permitted. In the case of companies listed in the Novo Mercado, Level 2, Level 1 and BOVESPA MAIS listing segments, the term of office cannot exceed two years, although again re-election is permitted.

The requirements for the appointment to occupy a position on the board of directors are established in the Brazilian Corporation Law. Generally speaking, the director must be someone with unblemished reputation, who has not been convicted in an administrative or judicial procedure in relation to corporate crimes or irregularities. Furthermore, unless waived in a shareholders' meeting, individuals who hold positions in companies that may be regarded as market competitors of the company, or who have any interests that conflict with those of

the company, cannot be elected as board member.

As regards conflicts of interest, a director shall not take part in any corporate transaction in which he or she has an interest that conflicts with an interest of the company, nor take part in the decisions made by the other directors on the matter. He or she shall disclose his or her disqualification to the other directors and shall cause the nature and extent of his or her interest to be recorded in the minutes of the meeting of the board of directors.

Notwithstanding compliance with the conflict of interest provision, the director may only contract with the company at arm's length. Any business contracted other than on an arm's-length basis is voidable, and the director concerned shall be compelled to transfer to the company all benefits that he or she obtains through such business.

EXECUTIVE BOARD

The executive board shall be composed of at least two officers. The officers of Brazilian listed companies can be elected and removed at any time by the board of directors.

Up to one-third of the board members may be elected for executive board positions held concurrently. Pursuant to the rules of the Novo Mercado, Level 2 and Level 1 listing segments, the offices of chairman of the board of directors and CEO cannot be held by the same individual.

However, the holding of these positions concurrently is allowed, on an exceptional basis: (1) in the case of the companies listed in Level 2 and Level 1 listing segments a maximum period of three years from the date that the company's shares start to be traded on the special listing segment; and (2) in the case of the companies listed in the Novo Mercado listing segment, in the case of vacancy for a maximum period of one year, within such period the company shall disclose the accumulation of positions owing to vacancy not later than the business day following its occurrence and disclose within 60 days of the vacancy the measures taken to end the accumulation of positions.

Among other duties, the executive board represents the company in dealings with third parties. The by-laws may establish that certain managerial decisions should be taken in

executive board meetings only.

The by-laws will establish the number of officers permitted, the manner of their replacement, their term of office, and the assignments and powers of each officer. Officers will perform their duties separately, according to their assignments and powers, but in keeping with the other officers, and will not be held liable for any obligations assumed on behalf of the company as regards routine acts necessary for the company's management.

If the by-laws are silent or there is no resolution adopted by the board of directors prescribing the officers' duties, any officer may represent the company and take the actions necessary for its routine operations.

COMPENSATION OF THE MEMBERS OF THE BOARD OF DIRECTORS AND EXECUTIVE BOARD

The shareholders' meeting shall prescribe the aggregate or individual compensation of the members of the board of directors and executive board, including benefits of any kind and representation allowances, taking into consideration their responsibilities, the time devoted to their duties, their skills and professional standing, and the market value of their services. If the shareholders' meeting approves the aggregate compensation to be paid to the company's directors and officers, it will fall under the authority of the board of directors to approve the allocation of the compensation between the company's directors and officers.

If the company's by-laws set forth a compulsory dividend equal to or above 25 per cent of the net profits, it may establish a share in the company's profits to the benefit of the company's directors and officers, provided that the total amount thereof does not exceed the annual compensation of the directors and officers, nor one-tenth of the profits, whichever is the lower. Nevertheless, directors and officers shall only be entitled to a share in the profits in a financial year for which the compulsory dividend is paid to the shareholders.

Detailed information on the compensation paid to the company's directors and officers, including, but not limited to, the breakdown of the compensation (e.g., fixed and variable compensation), the minimum, lowest and average compensation paid, must be disclosed in the company's reference form. In addition, the companies listed in the Novo

Mercado segment must have and disclose their compensation policies.

FISCAL BOARD

The fiscal board is a supervisory body responsible for supervising the company's directors and officers and providing information in this respect to the shareholders.

The fiscal board is a compulsory body, but need not operate on a standing basis. A non-permanent fiscal board must be instated upon the request of shareholders representing at least 10 per cent of the voting stock or 5 per cent of the non-voting stock.

The fiscal board is composed of three to five members and a like number of alternates. The conditions for election and impairment of fiscal board members (who must be Brazilian residents) are prescribed by law.

The fiscal board has the authority to, among other things: (1) monitor the actions of the company's officers and directors and verify their compliance with their legal and statutory duties; (2) review and give an opinion on the board of directors' annual report; (3) review and give an opinion on proposals of the management to the shareholders' meeting relating to changes in capital, issuance of debentures or warrants, investment plans or capital budgets, dividend distribution and certain corporate reorganisations; (4) report any error, fraud or criminal act and suggest measures useful to the company to any officer or member of another administrative body and, if these fail to take any necessary steps, to act to protect the corporation's interest and report to the shareholders' meeting; (5) review the balance sheet and other financial statements periodically prepared by the company; and (6) examine the financial statements for the fiscal year and give an opinion about them. The fiscal board's authorities can be neither delegated nor attributed to any other body of the company.

III DISCLOSURE

The Brazilian Corporation Law has adopted the principle of full disclosure when it comes to acts or facts related to the company that may be considered relevant. The disclosure

of material events is a duty of the company's investor relations officer, who may be held personally liable for damages arising as a result of non-disclosure.

CVM Ruling No. 358/2002, which sets forth the general disclosure rules for listed companies, defines 'material event' broadly, as any decision arising from a controlling shareholder, a general shareholders' meeting or a management body of a publicly held corporation, or any other act or event of a policy, management, technical, business, economic or financial nature in connection with its business that could considerably influence the trading price of the securities issued by or related to the company; the decision by investors to buy, sell or keep those securities; and the decision by investors to exercise any rights they have as holders of securities issued by or related to the company. The companies listed in the Novo Mercado segment are required to disclose their material facts in Portuguese and English, concurrently.

At the end of 2009, CVM enacted CVM Rulings Nos. 480/2009 and 481/2009, modifying, respectively, the rules regarding the disclosure of information by publicly held companies and the presentation of documents and information before meetings are held. The main change in disclosure issues was the introduction of the reference form, which basically compiles corporate, contractual, financial or economic, governance, and human resources information about the company. The reference form must be updated at least once a year, or in a shorter period upon the occurrence of certain events that demand an update of the information provided in the reference form.

As to financial reporting, listed companies must disclose their financial statements, together with the management report, the independent auditors' report and the opinion of the fiscal board, if installed, at least one month in advance of the ordinary shareholders' meeting.[4]

Listed companies must also disclose the standard form of financial statements (DFP), within the first three months of the end of each fiscal year. The DFP is an electronic form created in CVM's electronic system that must be completed using information obtained from the annual financial statement.

Listed companies shall also disclose, on a quarterly basis, the quarterly information

[4] The ordinary shareholders' meeting must be held within the first four months of the end of each fiscal year.

form, which is also an electronic form, and which must be completed using the company's quarterly financial information; it must contain the report of the special review issued by the independent auditor.

In addition to disclosing their financial statements in Portuguese, companies listed in the Level 2 listing segment must also disclose them in English.

Regarding one-on-one meetings, companies listed in the Novo Mercado must hold a public presentation on the information disclosed in their quarterly earnings results or financial statements within five business days of their release. Such public presentation may be conducted face-to-face or via teleconference, videoconference or any other means that enables stakeholders to participate remotely. On the other hand, the companies listed in the Level 2 and Level 1 listing segments are required to hold, at least once a year, a public meeting with analysts and other third parties, to disclose information about their financial and economic situation, projects and expectations.

IV CORPORATE RESPONSIBILITY

Pursuant to the Brazilian Corporation Law, all publicly held companies must prepare on an annual basis, within their financial statement, a value-added statement, which could be considered as the balance statement of the company's 'social account'. This statement provides information on the overall wealth produced by the company, on the allocation of resources to those areas of the company that contributed to the generation of that wealth (such as employees, financiers, shareholders, the government and others) and on the unallocated portion of that wealth. In addition, some companies seek certification from institutes such as the Ethos Institute, the Brazilian Institute of Social and Economic Analysis and the Global Reporting Initiative, but such certification is not mandatory for listed companies.

Another aspect of this 'social accounting' is evidenced in the code published by the Brazilian Financial and Capital Markets Association (ANBIMA) regarding public offerings, which sets forth that companies must include in their reference form information on social responsibility and cultural incentives, and on any projects in those areas implemented by the

company. Thus, although the ANBIMA code does not require their existence, if the company has any social responsibility policies in place, these should be disclosed in the reference form.

Furthermore, a new anti-corruption law has been in place since 29 January 2014, and this introduced administrative and civil liability of legal entities for illicit acts committed in relation to local and foreign public officials. However, there is as yet no whistle-blowing legislation in force in Brazil.

V SHAREHOLDERS

SHAREHOLDER RIGHTS AND POWERS

Each common share shall have the right to one vote in shareholders' meetings, and it is not possible to have shares with multiple voting rights. Brazilian companies can, however, issue preferred shares, which can be issued without voting rights (although companies listed in the Novo Mercado are required to issue only common shares).

In addition, the Brazilian Corporation Law sets forth that it is possible to include in the company's by-laws a provision restricting the number of votes by each shareholder. Nevertheless, the companies listed in the Novo Mercado and Level 2 listing segments are not permitted to include in their by-laws any provision restricting the number of votes of shareholders to a percentage below 5 per cent of the stock capital, except in a few cases provided in the listing rules.

In theory, shareholders should not have the ability to influence the directors' decision-making. In this regard, a specific article of the Brazilian Corporation Law sets forth that a director shall use his or her powers to achieve the company objectives and to support its best interests, even if these interests are contrary to those of the shareholder, or group of shareholders, who have elected or indicated him or her.

Nevertheless, the Brazilian Corporation Law also contain a provision stating that the votes of directors can be bound by a shareholders' agreement. Therefore, the Brazilian Corporation Law recognises that the directors can receive instructions from the shareholders

on how to vote in board meetings.

The shareholders' meeting has exclusive authority to (1) amend the by-laws; (2) elect or discharge the company's senior management and fiscal board members; (3) receive the annual accounts of the senior management and resolve on the financial statements presented by them; (4) suspend the exercise of rights by a shareholder; (5) resolve on the appraisal of assets contributed by any shareholder to the company's capital; (6) authorise the issuance of participation certificates; (7) resolve on the transformation, merger, consolidation, spin-off, winding-up and liquidation of the company; elect and dismiss liquidators; and examine the liquidators' accounts; and (8) authorise the senior managers to admit bankruptcy of the company and to file for debt rehabilitation.

As for the rights of dissenting shareholders, certain fundamental changes in the company entitle the shareholders who have not voted in favour of the resolution to withdraw, by refund of their shares, under the circumstances below:

a in the case of the creation of preferred shares or increase of an existing class without maintaining its ratio in relation to the other classes, and change of a preference, a privilege or a condition of redemption or amortisation conferred upon one or more classes of preferred shares, or creation of a new and more favoured class;

b the spin-off of the company only triggers the right to withdraw if it results in a change in the corporate purposes – except when the spun-off company is transferred to a corporation with a main line of business that coincides with the line of business of the spun-off company – a reduction in the mandatory dividend or participation in a group of corporations;

c the reduction of the compulsory dividend in any specific fiscal year, change of corporate purpose and insertion of an arbitration clause in the by-laws;

d the approval of the 'merger of shares' entitles shareholders of both companies involved to withdraw; and

e a shareholder who has not voted in favour of the acquisition by the listed company of which he or she is a shareholder of the control of a business corporation is entitled to withdraw if the purchase price exceeds 1.5 times the greatest of: the average quotation

of the shares on the stock exchange during the 90 days prior to the contracting date; the net value of each share or quota, the assets and liabilities having been valued at market prices (liquidation value); and the net profit of each share or quota, which may not exceed 15 times the annual net profit per share during the past two fiscal years, monetarily adjusted.

Shareholders' duties and responsibilities

The controlling shareholder has the duty to use its controlling power to make the company accomplish its purpose and perform its social role, and shall have duties and responsibilities towards the other shareholders of the company, those who work for the company and the community in which it operates, the rights and interests of which the controlling shareholder must loyally respect and heed.

The controlling shareholder shall be liable for any damage caused by acts performed in abuse of its power. The Brazilian Corporation Law list some examples of what would be considered an abuse of power, which include, among others, the following:

a to guide a company towards an objective other than in accordance with its stated objects, or harmful to national interests, or to induce it to favour another Brazilian or foreign concern to the detriment of the minority shareholders' interests in the profits or assets of the company or of the Brazilian economy; and

b to arrange for liquidation of a viable company or for the transformation, merger or division of a company to obtain, for itself or for a third party, any undue advantage to the detriment of the other shareholders, of those working for the company or of investors in the company.

There are no specific duties provided in Brazilian legislation for institutional investors, and there is no code of best practice for shareholders.

SHAREHOLDER ACTIVISM

Shareholder activism is not well developed in Brazil. Recent years, however, have seen a growing amount of shareholder activism, especially by some fund managers, but shareholder activism is still not part of the culture of the Brazilian capital markets.

The Brazilian companies most exposed to shareholder activism are those that have issued American depository receipts in the US market. A good example would be Petrobras, the Brazilian oil and gas company, which faced securities class actions filed with the New York courts by US investors, owing to losses stemming from the money-laundering and corruption schemes that have become public in the past years; Petrobras announced in January 2018 that it has signed an agreement to settle such class action in the amount of US$2.95 billion. Owing to this settlement, some minority shareholders have filed lawsuits in Brazil asking for a similar indemnification in Brazil, but it is unlikely that they will receive an indemnification from Petrobras in such amount, since the Brazilian legislation and judicial environment do not provide minority shareholders the ability to receive indemnifications in such proportion.

TAKEOVER DEFENCES

Brazilian Corporation Law and CVM Ruling No. 361 requires as a condition for effectiveness of the direct or indirect disposal of a controlling interest in a listed company that the acquirer make a mandatory public tender offer (tag-along TO) for the acquisition of all the voting shares that are not part of the controlling block.

The tag-along TO must ensure minority shareholders the receipt of at least 80 per cent of the value paid per voting share included in the controlling block. For companies listed on the Novo Mercado listing segment, the amount to be paid in the tag-along TO shall correspond to 100 per cent of the value paid per voting share included in the controlling block.

Another defence to be considered is the use of ‘poison pills’, which Brazilian legislation does not prevent companies from putting in place, and they are used in some listed companies. The typical Brazilian poison pill requires the acquirer of an equity interest above a given

threshold to make a tender offer to all shareholders for a punitive price. The use of poison pills must, however, be established in the by-laws of the company. As a consequence, only the shareholders' meeting, which has exclusive authority to amend the by-laws, is empowered to put poison pills in place.

CVM has already pronounced against provisions that penalise or prevent shareholders from voting against the exclusion of poison pills on a case-by-case basis in a definitive manner. Furthermore, the rules of the Novo Mercado listing do not allow companies that want to trade their shares on the Novo Mercado to have poison pills in their by-laws.

CONTACT WITH SHAREHOLDERS

The company must disclose to all of its shareholders, through its website, as well as on the CVM and B3 websites, certain ordinary and extraordinary reports or information, such as the reference form, financial statements, minutes of the shareholders' meetings and documents necessary for review by shareholders to be able to exercise their voting right in shareholders' meetings.

It is a common practice in listed companies to hold a conference call with investors right after the release of the annual or quarterly financial statement to discuss the company's results. It is also usual for the companies to hold meetings or calls with analysts to discuss the company, to enable the analysts to issue their reports on the company. In the case of the companies listed in the Novo Mercado segment, as already mentioned above, they must hold a public presentation on the information disclosed in their quarterly earnings results or financial statements within five business days of their release.

Whenever the company holds a meeting with a specific shareholder to discuss a material fact that has not been disclosed, it is usual to have this shareholder sign a non-disclosure agreement and the shareholder would be subject to a blackout period, during which it would be unable to trade in the company's shares, until the material information is disclosed to the market.

The call notices for the shareholders' meetings of publicly held companies must be published

at least three times, with the first call notice being published, as a general rule, at least 15 days in advance.[5]

Publicly held companies are required to disclose on the same day as the first publication of the call notice the manual of the shareholders' meeting, which contains detailed information about the matters to be discussed and the management proposal for each of the matters that will be voted on.

The supporting documentation for the ordinary shareholders' meeting (e.g., financial statements, management report, independent auditors report and opinion of the fiscal board) must be disclosed to the shareholders 30 days in advance of the date of the meeting.

In 2015, CVM enacted a ruling on attendance and distance voting at shareholders' meetings of publicly held companies, whereby shareholders would be able to present proposals of deliberations to be voted on, and to vote on the deliberations of the shareholders' meeting, subject to certain requirements. Implementation of this proxy voting system was mandatory for the major companies listed on B3 as from 2017 and will be mandatory for all listed companies as from 2018.

VI OUTLOOK

We expect that the biggest trends in the next few years in Brazil will be the escalation of proxy voting and the battle over the implementation by listed companies of the practices provided in the Brazilian Corporate Governance Code. Besides, considering the increase on the number of IPOs and follow-ons in the pipeline we expect that it will be important for companies to pursue the highest level in terms of corporate governance rules in order to be evaluated well by the investors and, consequently, be successful in their offerings.

[5] For some specific matters, the call notice must be published 30 days in advance.

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2. CORPORATE GOVERNANCE: TIRELESS STANDARDIZATION*

Abstract

Corporations since their inception have catered multiple needs of mankind like management of wealth, social justice, employment, development, choices to consumers, taxation etc. However, it is sad to mention that right from Solomon's case we have seen innumerable abuses of corporate personality and scams of the Himalayan size committed by corporate personalities. Corporate Governance wants to secure democratic values of 'transparency' and 'accountability' in corporate affairs. The scams, scandals, abuses have always been directly proportional to stringent and ever-changing laws. However, we find that remedy has been worse than malady. Scammers and fraudsters commit scams and legal system tightens the loose nuts and bolts which results in hardships for new entrepreneurs and entrants to market. Mammoth size of scams has dented the image of India as the Indian Corporate legal structure has often failed to execute the economic offenders who have abused corporate personalities. Introduction of institution of independent directors, woman director, internal and external auditing, corporate social responsibility, self-disclosure norms, strict vetting and compliance requirements by MCA, SEBI, RBI, SFIO, ED and Finmin, introduction of Indian Accounting Standards (Ind AS) in the line of IFRS, whistleblower's protection etc. have tremendously attempted to secure good corporate governance but insider trading, poor vetting, due diligence and compliance, poor accounting standards, indifference of board, feudal outlook of directors, the real independence of independent directors, related party transactions, poor and shabby disclosures, dilatory judicial process, abuse of ESOP, unfair trade practices, fugitive economic offenders have raised multiple challenges before Indian legal system. In this paper the author tries to investigate the pros and cons of corporate governance in India and changes suggested by Uday

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Kotak Committee and their implementation by SEBI in LODR regulations and challenges which lie ahead and suggest for betterment of corporate governance in India.

Corporate Governance

Corporate personality has been one of the most important concepts evolved in the history of mankind. Companies and corporation have served the mankind with vigour and zeal however the men have often abused it for their private ends and means. The corporate Governance alike democratic governance aspires for people's representation and participation and accountability of its representatives towards people. Openness and transparency ensure corruption free, value based, judicious and impeccable decision-making process. Corporation had always a unique feature of separation of management from ownership. However, in any given society family owned business has been dominant players which have not let the family members to appreciate the fact that corporations are to be run on 'trusteeship formula' rather they have always run it on 'ownership formula'. The promoters and their allies have always treated companies as their own baby and have ignored the interests of shareholders and stakeholders who have resulted in corruption and poor corporate governance.

Defining the corporate governance has been a difficult task. Milton Friedman, Noble Laureate defines it, "Corporate Governance is to conduct the business in accordance with the owner's or shareholder's desires, which generally will be make as much money as possible while conforming to the basic rules of the society embodied in law and local customs."[6]

Palmer says that, "Corporate governance rules are concerned with the manner in which a company conducts its internal business, mainly focusing at this level on the inter-action of the various organs of the complex corporate entities which issue securities on such regulated markets and their debt and equity investors."[7]

Shardul S. Shroff writes that, "The central feature of corporate governance is the recognition of the fact that the shareholders are true owners of the company and hence while the board

[6] Indian Institute of Corporate Affairs, Corporate Governance, Taxmann Publications (P.) Ltd. , New Delhi, p. 1.5.

[7] Palmer's Company Law, Sweet and Maxwell, May, 2013, p. 5155

of directors/managers should have freedom to take operational decisions, they remain accountable at all times and are in fact trustees of shareholders[8]." Corporate Governance is all about transparency and accountability. It is about maintaining credibility and discharging obligation to shareholders, creditors, employees, consumers, government and society.

OECD says that, "Good corporate governance is not an end in itself. It is a means to create market confidence and business integrity, which in turn is essential for companies that need access to equity capital for long term investment. Access to equity capital is particularly important for future oriented growth companies and to balance any increase in leveraging."[9]

To sum up all above definitions it can be said that corporate governance through transparency and accountability maintain credibility to fetch investment for profit maximization for fulfilling aspirations and desires of promoters, shareholders, stakeholders and above all society.

To find out traces of Corporate Governance it is sad to say that we have to find out big scams like in U.K. Robert Maxwell scam resulted in appointment of a committee known as Cadbury Committee headed by Sir Adrian Cadbury. The committee created the 'Code of Best Practices' in 1992. In 1995 dealing with the issue of remuneration of directors Sir Richard Greenbury Committee submitted a report which again created a 'Code of Best Practices'. Cadbury till date one of the best reports submitted so far makes a wonderful submission about good corporate governance as it says that 'Marginal Social Cost' (MSC) represents the value of natural resources of society and value addition by company is 'Marginal Social Benefit'. When MSC exceeds MSB then regulation of business by law is required. The committee also submitted on role of board, liability of auditors, standards of financial reporting. In 2000 Financial Services and Markets Act was passed and in 2005 Transparency Obligations Directives were issued and Companies Act 2006 boosted the system of Corporate Governance in United Kingdom.

Likewise, in USA in 1998 the Blue Ribbon Committee recommended for best financial reporting standards, role of audit committee, and gave guiding principles for best practices. The corporate scams of Enron[10] and WorldCom resulted in passing of Sarbanes Oxley Act,

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[8] Shardul S. Shroff, Corporate Governance, CCH India, Wolters Kluwer (India) Pvt. Ltd. in the foreword.

[9] G20/OECD Principles of Corporate Governance, available at **https://www.oecd.org/daf/ca/Corporate-Governance-Principles-ENG.pdf accessed** on 3rd January 2019 at 7:49AM.

[10] In Enron Scandal a lady executive blew the whistle that accounts are not in accordance with accounting standards. Arthur Andersen as an accounting firm was on board which was paid 51 million USD and its presence on board was

2002[11]. The Act established a Public Company Accounting Oversight Board for good corporate governance. OECD in 1999 gave the Guidelines on Corporate Governance which was revised in 2004 and 2015. The concerns in corporate governance have been mainly related to corruption, fudging of accounts, poor financial reporting standards, collusive role of external and internal auditors, no regulation or less regulation by law, remuneration of directors, ignoring interests of shareholders and stakeholders.

In 1978 Sachar Committee took up the issue of corporate governance and suggested that every company must report relating to social responsibility aspects. Rahul Bajaj under the aegis of CII submitted the Desirable Code of Corporate Governance. In the line SEBI 1999 constituted the Kumar Mangalam Birla Committee and its submission led to creation of clause 49 of Listing Agreement. J. Bhagwati Committee Report created SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.

Malegam Committee report led to creation of SEBI (Disclosure & Investor Protection Guidelines), 2000. Naresh Chandra Committee report in 2003, Narayan Murthy Committee Report 2003 amended clause 49. J.J. Irani Committee Report in 2005 insisted on self-regulation instead of regulating from outside[12]. MCA's Corporate Governance Voluntary Guidelines (2009) and Uday Kotak Committee Report was submitted in 2017. This committee also suggested many recommendations which have been duly incorporated in SEBI LODR Regulations 2015. In 2018 National Guidelines on the Economic, Social and Environmental Responsibilities of Business is being drafted by MCA.

Corporate ownership in India has been of four types, family owned companies, PSUs, MNCs, Professionally Managed Companies, Society and Trusts. Family owned companies have been of three types; listed, private equity company, unlisted company. Listed companies mostly comply with corporate governance norms. Entities with private equity investor have an investment by Private Equity companies only after due and periodic certified compliance of corporate governance norms[13]. This shows that corporate governance in India has been

itself a guarantee of due diligence. SEC asked for restatement of account and Andersen hided the information and stocks had a free fall.

[11] Public Company Accounting Reform and Investor Protection Act, 2002.

[12] Shardul S. Shroff, Corporate Governance, CCH India, Wolters Kluwer (India) Pvt. Ltd. p. 18.

[13] Ibid p. 44.

limited to public listed companies. Anglo-Saxon model of corporate governance has been 'shareholder model' while Europe and Asia have adopted 'stakeholder model.' Value addition to interests of shareholder is changing to accountability of company to stakeholders especially of society[14]. Both these models have been adopted and best practices have been introduced in corporate structure of country.

After liberalization of economy the core issues in corporate governance has been accountability, transparency, accounting & auditing, role of auditors, corruption, fudging of accounts, watering of stocks, oppression and mismanagement, communications & disclosures, poor and loose compliance and regulatory regime, independence of independent directors, victimization of whistle blowers, no separation of ownership and management of companies, poor accounting standards, insider trading, unfair trade practices, abuse of ESOPs, unregulated remuneration of Board, indifference and inefficiency of board, public shareholding in companies.

Clause 49 of Listing Agreement introduced truly corporate governance in India. The right mix of 'fearless', impartial and independent directors depending upon executive or non-executive director being the Chairman of board. If chairman of Board is an executive director (Insider) then ½ shall be Independent and if he is non-executive then 1/3rd shall be Independent Directors. The idea of independent director introduced the value of 'dissent' in corporate governance which is based on 'majority rule[15].' He could muster the courage to oppose the decisions of unscrupulous board members. However his independence was and shall always be questionable.

Corporate Governance Paradigm Shift

After LPG effect and establishment of SEBI in 1992, the demand of corporate Governance came in the light and OECD in 1999 identified certain Principles of Corporate Governance amongst which rights of shareholders, equitable treatment of shareholders, role of stakeholders in corporate governance, disclosure and transparency and responsibility of Board

[14] Roberto Garcia, et.al, "Shareholder vs. Stakeholder: Two Approached to Corporate Governance," Business Ethics, A European Review, vol. 13 p. 3 (June)

[15] Ibid.

was fixed.[16] In same year Kumar Mangalam Birla Committee almost highlighting the same values made submissions which were notified by SEBI on 21st February, 2000 incorporating all those changes in Clause 49. The committee recommended constitution of audit and remuneration committee including at least one independent director, recognition of leadership role of chairman, enforcement of accounting standards, more disclosure in annual financial reports, effective role of institutional investors etc. It also made some non-mandatory recommendation.

One must be mindful that clause 49 was a clause of listing agreement which any company intending to get listed its on recognized stock exchange had to execute listing agreement as mandated by Companies Act and Securities Contract Regulation Act, 1956. Clause 49 was binding only on listed companies and it had binding and non-binding clauses as whistleblower's protection clause then was non-binding.

MCA's Voluntary Guidelines in 2009, MCA's refined National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business in 2011 and are again being revised in 2018[17]. These guidelines are meant for all kinds of business enterprises including MSMEs. These guidelines highlight the issues of transparency, accountability, safety, sustainability, welfare of employees and persons in value chain, protection of interests of stakeholders, human rights, environment, responsible public policy, inclusive growth, equitable development, protection of interests of consumers etc.

MCA in 2003 started initiative of replacing the Companies Act, 1956 with a new sleek Act to contemporize the provisions confirming the best international practices and demand was further accelerated by Satyam fiasco. In 2005 JJ Irani Committee was constituted and its submission also suggested for new Act and Companies Act, 2013 was passed which institutionalized the independent director and its role in corporate governance got a statutory recognition.

Companies Act, 2013 and Corporate Governance

[16] OECD Principles on Corporate Governance (1999) available at https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=C/MIN(99)6&docLanguage=En

[17] http://www.mca.gov.in/Ministry/pdf/DraftNationalGuidelines2018_20062018.pdf

The Companies Act, 2013 to promote good corporate governance provide certain provisions in following way; Section 110 provides passing of resolutions through postal ballot for wider participations of shareholders, section 130 (3) provides for re-opening of financial accounts[18], section 134(5) provides for director's report including responsibility statement[19], Section 135 provides for corporate social responsibility[20], section 138 provides for statutory audit and appointment of internal auditor for certain companies, section 139 provides for rotation of internal auditors in case of individual after 5 years and institutional after 10 years, section 144 prohibits statutory auditor of company to perform certain services, section 149 provides for IDs and code of conduct, section 177 provides for appointment of audit committee, section 177(9) provides for a vigil mechanism to raise genuine concerns of directors and employees, section 184 provides for disclosure of interest by director, section 188 provides for related party transaction with board's and members' resolution, section 194 prohibits for forward dealing by director and KMP and Section 195 prohibits insider trading by director and KMP on the issue of non-public price sensitive information, section 204 provides for secretarial audit, section 245 provides for class action. Creation of SFIO[21], NFRA[22] and NCLT[23] also have paved the way for better regulation of corporate world.

SEBI LODR Regulations &Uday Kotak Committee

SEBI on 2nd June 2017 in the chairmanship Mr. Uday Kotak[24] formed a 'Committee on Corporate Governance' for improving the standards of corporate governance with a TOR of independence of IDs, safeguards and disclosures in related party transactions, improving effectiveness of board's evaluation practice, shareholders voting and participation, disclosure and transparency issues. The committee submitted its report and many of its

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18 Inserted by Companies (Amendment) Act 2017.

19 Section 134 & 136 are thoroughly revised by Companies (Amendment) Act 2017.

20 For interconnection of CSR with CG see Suzanne Young and Vijaya Thyil, "Corporate Social Responsibility and Corporate Governance: Role of Context in International Settings" Journal of Business Ethics, Vol. 122, No. 1 (June 2014), pp. 1-24

21 Till date 312 cases have been investigated by SFIO available at **https://sfio.nic.in/archives.aspx** accessed on 9th January, 2013.

22 Its an establishment for enforcement of accounting & auditing standards and oversight of work of auditors.

23 Madras Bar Association v. Union of India (2015) 8 SCC 583 in this case the constitutional validity of NCLT was upheld by Apex Court.

24 Executive Vice Chairman and Managing Director, Kotak Mahindra Bank Limited

recommendations have been executed[25] by amendments in SEBI LODR Regulations 2015. The committee has made submissions with deadlines like 2018, 2019, 2020, 2021 and 2022. Submissions and regulations are being analysed together for lucidity. Prior to LODR corporate governance was regulated by Clause 49 of Listing Agreement and to maintain uniformity 'The Securities Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015' were made and it has also been amended several times. About Clause 49 one author observes that, "In particular, a large group of firms was exempted from the reforms, and the complex rules for the application of the reforms created considerable overlap in the characteristics of affected and unaffected firms."[26]

The tighter we are making the noose the slippery neck of offenders is becoming. Clause 17 to 27 of LODR Regulations provides regulations regarding corporate governance.

The LODR regulations provide for proper combination of executive and non-executive directors and ratio depending on whether Chairman is executive or non-executive including at least one-woman director. Board must meet at least four times a year with a maximum gap of 120 days. Board must provide for code of conduct including duties of independent directors (IDs). Board needs to maintain due diligence and proper compliance of regulatory regimes. Some of key submissions made by Uday Kotak Committee were that board must comprise at least six directors. However, committee fails to submit any justification for the same. It does not differentiate between the public and private company in which board size does matter due to scope of companies and business model. The size of board must be strategic, and it should not ornamental like celebrity director is not needed on board[27]. The size of board must be optimum having less insiders and more outsiders and diversity of board in terms of locality, race, culture, language, gender, expertise must be maintained. American Corporate Boards fired 92 CEO and 103 CEO in 2005 for scandals, lack luster results and insider trading issues[28].

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[25] Bhumesh Verma & Soumya Shekhar, "Strengthening Corporate Governance in India" (2018) Practical Lawyer (CL) June p 93.

[26] Dhammika Dharmapala and Vikramaditya Khanna, "Corporate Governance, Enforcement, and Firm Value: Evidence from India" Journal of Law, Economics, & Organization, Vol. 29, No. 5 (October 2013), pp. 1056-1084 Oxford University Press p. 1082

[27] Recommended by J.J. Irani Committee;
Available at **http://www.mca.gov.in/MinistryV2/management+and+board+governance.html** accessed on 9th January at 5:34 AM.

[28] A.C. Fernando, Corporate Governance, Principles, Policies and Practices, Pearson, New Delhi, 2012 p. 204

LODR provides that top 1000 listed companies w.e.f. 1st April 2019 and top 2000 listed companies w.e.f. 1st April 2020 shall have a minimum six members' board[29]. The report makes submission about one woman director[30] must be on the board as non-executive director but it must have been to include one woman as executive and non-executive director on the board to maintain gender perspective and diversity on board. LODR as amended now provides that on board of top 500 listed entities from 1st April 2019 and top1000 listed entities from 1st April 2010 there shall be one woman independent director[31]. In Scandinavian countries woman are in sumptuous number on board. Keeping woman on board will enhance the corporate governance as 70-80% decisions of buying are done by woman, post-sale services, pricing of products, packaging can be better handled by them. However, in India even now many appointees are family members and it will take some time for their role play[32]. In 26th January 2018 out of 1723 NSE listed companies only 1667 had one woman director on board. This shows a good sign.[33]

The report does not make any submission about racial diversity and there should have been a submission that at least one director from recognized minority race in India should be on board to maintain the true democratic values. Committee recommended that director must attend minimum half of board's meeting otherwise his continuance on board will need ratification at AGM. This is laudable recommendation however his attendance should be mandatory for at least in one meeting in each quarter. NED after 75 years of age must be appointed only after confirmation of shareholders[34] and this recommendation has been implemented[35].

A diverse and wholesome board having a proper matrix and blend of technology, global

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[29] Regulation 17(1)(c) of LODR Inserted by the SEBI LODR Amendment) Regulations, 2018, w.e.f. 1.4.2019.

[30] In UK Lord Davies Submitted a report in 2011 "Women on Boards available **https://www.gov.uk/government/publications/women-on-boards-5-year-summary-davies-review** accessed on 10th January, 2019 at 6:56 AM

[31] Proviso of Regulation 17(1)(a) of LODR Inserted by the SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019

[32] The Economic Times, 19th February 2018 available at **https://economictimes.indiatimes.com/news/company/corporate-trends/gender-diversity-on-boards-improves-but-more-ground-needs-to-be-covered-experts/articleshow/62988324.cms** accessed on 8th January 2019 at 6:30 AM.

[33] Ibid.

[34] W.e.f. 1 October 2019.

[35] Regulation 17(1A) of LODR Inserted by the SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019.

business, manufacturing, risk management, operations and general management is need of modern era so the committee recommended for skills/expertise/competence of board director via a chart matrix must be shown and it must confirm all such directors have such skills/expertise/competence however skills/expertise/competence is vague it must be mentioned from 12th grade onwards.

The report also submits the mandate to board to meet at least 5 times a year with a maximum gap of 120 days to discuss the strategy, board evaluation, risk management, Environment, Sustainability and Governance issues and succession planning. However, such functions are often delegated by Board. The regulation has not been changed board is required to meet 4 times a year[36].

The committee recommended for a formal meeting between IDs/NED and senior management once in every year for better understanding of company's business and their managerial capacity and capability of company. The consequence of such meeting like minutes must be released to shareholders about evaluation of board but committee did not recommend on those lines.

The quorum for board's meeting shall be 1/3 of board or three directors whichever is higher including one ID even by video conferencing[37]. Committee has proposed that in listed companies having 40% public shareholding w.e.f. 1st April 2020 shall appoint NED as chairperson of board[38] and w.e.f. April 1, 2022 all listed companies will appoint NED as their chairperson of board. The committee proposed a cap of maximum number of listed entity's directorship to eight including seven as IDs[39] and if he is WTD/MD then he can serve three listed entities as IDs[40] and the deadline is to be met between April 1, 2019 and to seven by April 1, 2020. Committee recommended that directors' report must be submitted as part of corporate governance report by the board about responsibility of business and overall affairs of company[41]. At least ½ of the size of board of W.e.f. 1April 2019 in top 500 listed companies

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[36] Regulation 17(2) of LODR, 2015

[37] W.e.f. 1st October, 2018

[38] Implemented by Regulation 17(1B) of LODR Inserted by the SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2020.

[39] Implemented by Regulation 17A Inserted by the SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019.

[40] Ibid.

[41] W.e.f. 31st March 2019

depending on market capitalization and from 1 April 2020 of all listed companies shall be NED/IDs. The chairperson of board and CEO must be separate as there are different roles required to play by both of them and this will avoid the conflict of interests.

For maintaining the 'independence' of IDs and removing 'board-interlocks' the ID must not be a member of a promoter group. Committee also recommended that If Mr. A is an executive director on Co. A (being a listed entity) and is also an independent director on Co. B, then no non-independent director of Co. B can be an independent director on the board of Co. A[42]. The committee recommended that performance and independence evaluation of IDs shall be made by subjective and objective assessment process by board[43]. ID will submit a declaration about situation or circumstances which might affect his independence at first meeting[44]. The committee recommended for good payment to IDs for risk reward balance. Rs 5 Lakhs for top 500 listed companies shall pay as remuneration to IDs to attract good people to work as IDs. The committee recommended for detailed reasons for resignation of IDs[45]. This recommendation lacks rationale as nobody will try to bell the cat as bitter truth is seldom spoken.

The committee also recommend for D&O insurance for IDs in top 500 listed companies which may be extended to all listed companies in future to attract best IDs[46]. The committee recommended a formal induction and training programme for IDs. IDs need to get familiarize themselves about nature of industry, business model, organization structure, their role & responsibilities. They need to be trained formally once in every five year. Five years seems a quite long time. Rather for updating the knowledge of IDs once in a year a formal updation programme need to be conducted to understand regulatory and compliance changes, and it should have been for all kinds of directors. The onus of training and content must be on companies as need based. A certification examination with the help of IICA may be evolved for IDs. The committee also recommended that IDs must not appointed as alternate director

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[42] Uday Kotak Committee Report P. 33

[43] Implemented by Regulation 17(10) of LODR inserted by SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019

[44] Implemented by Regulation 25(8) of LODR inserted by SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019.

[45] Implemented by amendment in Schedule V of LODR Inserted by the SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019.

[46] Implemented by Regulation 25(10) of LODR amended by SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019.

because their acumen and objectivity is not replaceable. The committee for better co-ordination amongst IDs mooted the idea of appointing the lead ID[47]. Any casual vacancy of IDs must be filled by a new ID in next board's meeting or within three months whichever is later subject to confirmation by shareholders in next AGM.

Board needs to manage risk and secure performance evaluation. Auditing has been a major issue since Satyam Fiasco for which PWC is still facing a prohibition by SEBI[48]. LODR provides that an independent audit committee of minimum three directors of which 2/3rd shall be IDs. The chairperson shall be ID and CS will be secretary to audit committee. It will also meet four times a year. The audit committee has been given power to investigate any activity within its TOR. The audit committee may invite internal auditor, statutory auditor in committee's meetings. A person can be a member director only in ten committees and a chairperson of five committees of listed companies. They will confirm the code of conduct of board. KMP and senior management will disclose material, financial and commercial transaction involving personal interests to board.

The Uday Kotak Committee recommended that audit committee must meet five times in a year and nomination and remuneration[49], risk management committee[50], Stakeholders relationship committee must meet once in a year[51]. The committee recommended that audit committee of listed company should review the investment of 100 crores or 10% of asset size made in unlisted subsidiary company including foreign company. The committee recommended that like audit committee in Nomination and remuneration committee 2/3rd of its members should be IDs. The committee gave a clarification about senior management as it now includes CEO/MD/WTD/Manager/CS and CFO. The NRC shall also recommend to board about remuneration of senior management.

LODR provides that Nomination and Remuneration committee are obliged to maintain

[47] W.e.f. 1 October 2018.

[48] SEBI banned PWC for two years by SEBI Order No. WTM/GM/DRA 1/ 83 /2017-18 dated 10th January, 2018.

[49] Implemented by Regulation 19(3A) of LODR inserted by the SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019.

[50] Implemented by Regulation 21(3A) of LODR Inserted by the SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019.

[51] Implemented by Regulation 20(3A) of LODR inserted by the SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019.

quality and independence of board, KMP and IDs. Stakeholders' Relationship Committee has to look in to personal rights of stakeholders and redress the grievances. Role of Risk Management Committee is for making and executing risk management plan.

The Uday Kotak Committee recommended that Stakeholders Relationship Committee shall have at least three directors and one of them shall be ID[52]. The Chairperson of SRC will respond the queries of stakeholders in AGM[53]. SRC will redress grievances regarding transfer, transmission of shares, dividends, duplicate certificate, meet once in year with all stakeholders along with KMPs/Board, ensure effective exercise of voting of stakeholders, ensure standards be followed by Registrar and Share Transfer Agent and timely payment of dividend and reduction in unclaimed dividend. The quorum for SRC and NRC shall be two members or 1/3 of committee whichever is greater including at least one ID[54].

The committee recommended that Risk Management Committee should deal with the issue of cyber security[55] in top 500 listed companies. In modern world IoT, DoS, Big Data, Hacking, Data Protection is a real concern hence data protection must be real concern for Risk Management Committee. The committee also recommended that listed companies *may* constitute Information Technology Committee to confirm digital & technology developments[56]. The committee also recommended that for counting the limit of director as member or chairperson of committee, NRC shall be counted. The committee taking inference of subsidiary defined material subsidiary the income of which exceeds 10% of consolidated income of subsidiaries of listed entity. The ID of listed company shall be on board of material subsidiary whether incorporate in India or not but for this requirement income requirement is 20%. Now the recommendation includes foreign subsidiaries also. The committee also recommended in non-binding manner for group governance of group entities. The committee

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[52] Implemented by Regulation 20(2A) of LODR inserted by the SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019.

[53] Implemented by Regulation 20(3) of LODR substituted by the SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019.

[54] Implemented by Regulation 19(2A) of LODR Inserted by the SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019.

[55] Implemented by Regulation 21(4) of LODR Inserted by the SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019.

[56] Data leak and compromise have been reported from big companies like Google and Facebook for which J. B.N. Shrikrishna Committee recommended for The Personal Data Protection Bill, 2018 which is underway and a demand of data localization has surfaced. See The Economic Times, 5th December, 2018.

mandated for compulsory secretarial audit for all listed companies[57].

On the issue of Related Party Transaction, insider trading, unpublished price sensitive information (UPSI) committee found huge gap between legal regulation and practical realities. Insider trading issue has left a huge impact and conviction of Rajat Gupta in USA for insider trading of 13.5 million USD with the help of Raja Rajaratnam has been an eye opener. Recently T.K. Vishwanathan Committee in 2018[58] recommended for empowering SEBI for tapping the phone calls for curbing the problems of market frauds, insider trading, surveillance and investigation etc. Access to UPSI must be for legitimated purpose and according to agreement for which committee recommended to insert a new chapter and an amendment in SEBI PIT Regulation 2015. Promoters and PACs have created havoc in corporate governance therefore where no identifiable promoters are found then person holding 10% paid up equity shall be promoter. The committee recommended the disclosure by Promoter of their shareholding pattern[59]. Reclassification of promoters may be needed on account of professional management or opt out or shar transfer and such reclassification may be allowed on request but subject to ratification by Board and Shareholder in an AGM in which promoters and PAC will not vote[60]. The disclosure requirement in six monthly and annual financial reports about related party transaction (RPT)[61] and with Promoters and PAC holding 10% of paid up equity was recommended by committee[62]. The definition of related party was recommended to include any party who belongs to a promoter group holding 20% of paid up equity. In RPT related party shall not vote. Royalty payment shall also be considered as material transaction[63]. Promoters often throw weight in board's meeting rather they must afford complete autonomy to board and only vote in AGMs. The board manages the business of company with the help

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[57] Implemented by Regulation 24A of LODR Inserted by the SEBI LODR (Amendment) Regulations, 2018, w.e.f. 31st March 2019.

[58] Committee on Fair Market Conduct, 2018

[59] Implemented by amendment in Regulation 31(4) inserted by SEBI LODR (Sixth Amendment) Regulations, 2018, w.e.f. 16.11.2018.

[60] Implemented by substitution of Regulation 31A of LODR inserted by SEBI LODR (Sixth Amendment) Regulations, 2018, w.e.f. 16.11.2018.

[61] See Ami Galani and Nathan Rehn, "Related Party Transactions: Empowering Boards and Minority Shareholders to Prevent Abuses" National Law School of India Review, Vol. 22, No. 2 (2010), pp. 29-57

[62] Implemented by amendment in Regulation 23 inserted by the SEBI LODR (Amendment) Regulations, 2018, w.e.f the half year ending March 31, 2019.

[63] Implemented by Regulation 23(1A) of LODR inserted by the SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019.

of executive officers. 85% of business in India have been family held the same promoter is director, managing director, CEO etc. now companies have started appointing executive in companies for better and effective management.

The committee also recommended for maximum cap for executive promoter director which is 5 crore or 2.5% of net profit whichever is higher for one and 5% of net profit for all[64]. The committee also recommended that if a NED is paid 50% of designated for NEDs of pool then confirmation of shareholders shall be required[65]. The committee recommended for adoption of materiality policy for RTP which must be reviewed once in three years.

Disclosure brings transparency. Annual Report indicates the performance, so committee recommended that it must be published on website[66] and sent to members along with the notice of AGM and if any change suggested by shareholder then it must be revised and sent back to members within 48 hrs after the AGM. The disclosure of GDR if 1% shareholding is mandatory and listed entities will seek information from overseas depositories of such holders. List of Credit Rating and revision of it must be disclosed. Disclosures must be in XBRL or any searchable format[67]. Disclosure of schedule of analyst and institutional investor meet was discarded. Disclosure of key changes in financial indicators including, Debtors Turnover, Inventory Turnover, Interest Coverage Ratio, Current Ratio, Debt Equity Ratio, Operating Profit Margin (%), Net Profit Margin (%), return or net worth compared to previous Financial Year was recommended[68]. Disclosure regarding utilization of funds through preferential placement and QIP was recommended[69].

The committee recommended that details of directorship of a director in listed entities and a certificate from CS that directors are not disqualified must be disclosed in corporate governance section of annual report of company. The information regarding directors must

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[64] Implemented by Regulation 17(6)(e) of LODR inserted by SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019

[65] Implemented by Regulation 17(6)(ca) of LODR inserted by SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019.

[66] Implemented by Regulation 34 of LODR amended & inserted by the SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019.

[67] Implemented by Regulation 36 of LODR amended & Inserted by the SEBI (LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019.

[68] Implemented by amendment in Schedule V of LODR Inserted by the SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019.

[69] Implemented by Regulation 32(7A) of LODR Inserted by the SEBI LODR (Amendment) Regulations, 2018, w.e.f. 1.4.2019.

be disclosed on website under a separate section. Public listed companies are required to have audited financial statements for the relevant financial year of each of its subsidiaries available on its website at least 21 days before the date of the annual general meeting. The public listed entities *may* disclose its long term and medium term strategy in its annual report. The committee recommended that due to price sensitive nature of bonus issue prior intimation by board to stock exchanges should be required. Board has to disclose the non-acceptance of recommendation of committee which is mandatorily required in Corporate Governance report.

Accounts and audits are very important as maximum scams are done via cooking up accounts. The committee recommended that disclosures are requiring quantification of audit qualifications to be mandatory[70], with the exception being only for matters like going concern or sub-judice matters. In case auditors not satisfied with expert opinion, he shall have right to obtain independent external opinion. For group audit recommendation was made to SEBI that it should recommend to ICAI to introduce the group audit of holding and subsidiary in the line of International Standards 600 in place of SA 600. For better financial disclosure the committee recommended for consolidated financial results[71], publishing half yearly cash flow statement, all listed entities, for every quarter, financial information of the group, accounting for at least 80% of each of the consolidated revenue, assets and profits, respectively, should have undergone limited review/audit, any material adjustments made in the results of the last quarter which pertain to earlier periods should be disclosed by the listed entity as a note in the financial results[72]. Auditors are 'gatekeepers' so their resignation matters a lot. Detailed reasons must be given by auditor of his resignation. Fees paid to auditors must be disclosed in Annual Report in CG section[73]. Committee said that SEBI should recommend to ICAI about disclosure of audit quality indicators. In the appointment of auditors in AGM the notice to shareholders must contain the proposed fees payable to auditors, any material change in fees,

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[70] Implemented by amendment in Regulation 33 of LODR inserted by the SEBI LODR(Amendment) Regulations, 2018, w.e.f. 1.4.2019.

[71] Implemented by amendment in section 129(3) of Companies Act, 2013 by Companies(Amendment) Act 2017.

[72] Ibid.

[73] Implemented by amendment in Schedule III of LODR Inserted by the SEBI LODR(Amendment) Regulations, 2018, w.e.f. 1.4.2019.

basis of recommendation for appointment, credentials of statutory auditors. The committee recommended for full implementation of IND-AS as per timeline prescribed by MCA and SEBI. The committee recommended for revival of qualified audit report review committee. The committee also recommended for power of SEBI regarding auditors and statutory third-party fiduciary as the same was contested in PWC case before Bombay HC but ICAI rejected the recommendation on jurisdictional conflict issue. The committee also recommended for enhanced penal power of ICAI and a separate cell to monitor disciplinary action against public listed entities, the idea was rejected by ICAI as it has already been done and outside the scope of TOR of committee. Quality Review Board(QRB) is a system of independent oversight of auditors. QRB must meet the criteria of International Forum of Independent Audit Regulators (IFIAR). QRB must be given financial resources and requisite operational independence to carry out the mandate.

Committee identified that e-voting has secured greater shareholders' participation in meetings. However, it recommended that in line of global practice the top 100 listed entities by market capitalization may be required to hold AGMs by August 31, 2018, i.e. within five months from the end of the next financial year to avoid participation in AGMs of companies in September/October mostly[74]. The committee recommended for live one way webcast of proceedings of meeting in top 100 listed entities by market capitalization and opening of e-voting till midnight of AGM. Identifying the stewardship responsibilities of institutional investors the committee recommended that common stewardship code may be introduced in market.

On treasury stock[75] (holding shares of own company via trusts) SEBI in SEBI (Share Based Employee Benefits) Regulations, 2014 prohibited with an exception of three years sunset clause and Committee recommended that w.e.f. 1st April 2021 no voting rights attached to treasury stock shall be exercised. The committee recommended that certain resolutions shall be sent to shareholders on board's recommendation and in exception situations without

[74] Implemented by amendment in Regulation 44 of LODR inserted by SEBI LODR(Amendment) Regulations, 2018, w.e.f. 1.4.2019.

[75] See Pratiek Sparsh Samantara & Kemi Gupta, "A Critical Analysis of Relationship Between Corporate Ownership and Governance" 2017 NLS Bus L Rev 55

boards' recommendation but with an explanatory note resolution may be sent to shareholders. The committee generally recommended for enhancing corporate governance in PSEs. It recommended for evaluation of government stake, avoidance of conflicts and autonomy of PSEs. For protection of whistleblower the committee recommended for leniency mechanism wherein by rules and regulations and amendment in SEBI and SCRA the SEBI may grant lesser penalty or reduction in liability of whistleblowers. CBI observed that at least 40 persons lost their lives due to whistleblowing. Whistleblowers' Protection Act, 2014 is limited to Government offices and bodies and this must be extended to public listed entities.

On capacity building of SEBI on Corporate Governance committee comparatively analyzed the structure of US Security Exchange Commission with SEBI and recommended for staff strength of SEBI, their skill and expertise, introduction of revolving door policy to induct people from private sectors or alike, forming a data science department within SEBI and setting up a sub-unit for reviewing quality of audit (including forensic audit) to investigate any potential red flags in a timely manner. Companies (Amendment) Act 2017 has in confirmation to Uday Kotak Committee report has made useful amendments stringent compliance requirement, improving ease of doing business and co-ordination in SEBI and RBI for better and effective accounting standards.

Insolvency & Corporate Governance

Insolvency of companies has always been a core issue related to corporate governance. Recovery of loan has been tedious job due to judicial intervention and DRT Act, SARFAESI were found to be ineffective. NPAs are big problems for India and Banking Law Reforms Committee headed by T.K. Vishwanathan in 2015 recommended for Insolvency and Bankruptcy Code which was enacted in 2016. The implementation of IBC is facing severe challenges for which Srinivasan Committee has suggested certain submissions for smooth functioning of IBC. In India again, we see scams and regulation go hand in hand. Harshad Mehta Scam, Enron Scandal, Satyam fiasco, Sahara Scam, PNB Scam, IL& FS, Dirty Dozen scam show the credibility of Indian Capital market and economy. Baking sectors frauds and NPA is an alarm indicator wherein according to a report of IIM Banglore, "In the last three years, public sector banks (PSBs) in India have lost a total of Rs. 22,743 crore, on account of

various banking frauds."[76] Bharat Vasani submitted in National Conference on Corporate Governance at National Law University Jodhpur[77] that we do not need such number of public sector banks which are run on political alliances and increase NPAs. The pressure on banking sector resulted in resignation of Urjit Patel as the opposition of writing off loans by public money. Demand of more money from RBI reserve to fund the fiscal deficit is one of the reasons.[78]

There have been two amendments in Code within two years. The amendment of 2018 was made to give allottees of real estate the status of secured financial creditor in the Code due to Amrapali Issue. Amendments to IBC barred Promoters from submitting a resolution plan before repayment of dues and also allowed them for the withdrawal of an asset from the process seems unfair as the promoters only shall be interested to save the concern and retrospective and prospective operation also makes in unfair. Essar Group CEO Prashant Ruia says that even a genuine business decision may go wrong for which promoters must not be punished and there must be a distinction between failure of genuine business decision and willful wrongdoing of promoters in IBC[79]. Some judgments have shaped the IBC.[80] After notification the issue of voluntary winding up has been handed over to IBBI[81]. Training, induction and behavior of Insolvency professional is a big issue however in 2018 the recovery of Rs 36,400 corers by sale of Bhushan Steels to Tata Steels was huge achievement under Code.[82] The recent PNB Scam and IL& FS Collapse again gave a big blow which resulted in

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[76] Working Paper NO: 505, "Frauds in the Indian Banking Industry", Charan Singh RBI Chair Professor Economics & Social Science Indian Institute of Management Bangalore p. 3 available at https://www.iimb.ac.in/sites/default/files/2018-07/WP_No._505.pdf

[77] 15th -17th September 2018 available at www.nlujodhpur.ac.in.

[78] The Economic Times, 11th December, 2018 available at **https://economictimes.indiatimes.com/news/economy/policy/heres-what-could-have-led-to-rbi-governor-urjit-patels-exit/articleshow/67026855.cms** accessed on 8th January, 2019 at 7:11 AM.

[79] The Economic Times, 9th January, 2019 p. 1 "Can't Have a One Size Fits All Policy for Insolvency, Says Ruia".

[80] Alchemist Asset Reconstruction Co. Ltd/ v. M/s Hotel Gaudavan Pvt. Ltd. 2017 SCC OnLine 1362,Mobilox Innovations Pvt. Ltd. v. Kirusa Software Pvt. Ltd. (2018) 1 SCC 311, Innoventive Industries Ltd v. ICICI Bank (2018) 1 SCC 356,Macquarie Bank Ltd. v. Shilpi Cable Technologies Ltd. (2018) 2 SCC 706, Surendra Trading Co. v. Juggilal Kamlapat Jute Mills Co. Ltd. (2018)2 SCC 730, Chitra Sharma v. U.O.I. 2018 SCC OnLine 874.

[81] **The MCA Notification No. F.O. 3453(E) Dated 15th November, 2016, enforcing the related sections of Insolvency and Bankruptcy Code, 2016**

[82] The Economic Times, 10th June 2018 available at **https://economictimes.indiatimes.com/news/economy/policy/ibbi-keeps-a-vigilant-eye-on-conduct-of-insolvency-professionals-m-s-sahoo/articleshow/64528365.cms** accessed on 8th January 2019 at 7:28 AM.

extradition of Vijaya Mallya[83] and passing of The Fugitive Economic Offenders Act, 2018[84] which again is a good sign.

Conclusion

Over the years the corporate governance in India has moved from 'relationship based' to 'rule based.' There is 'trust deficit' amongst companies against regulators. Now there is role of cognitive corporate governance. The cultural amongst the enterprises must be promoted for transparency and accountability and cultural issues in companies must be handled in proper way. Proxy Advisory Firm, Business Media and Activist Judiciary can play a crucial role. Many times, people recommend twin board formula of Germany which is not feasible in India and we need to Indianize the Corporate Governance. Dilatory judicial process has been a cause of concern and there must be constructive role of Judiciary in Corporate Governance and courts must respect the award of arbitral tribunals. We are placing too much reliance on IDs[85] for better and effective corporate governance, but he is not a panacea for all problems. We need to train[86] them to strengthen our corporate governance. Now if companies must attract the investors then due diligence and due compliance of all norms of corporate governance is *sine quo non*. There has been a good jump in Ease of Doing Business rank of India and now in 2018 it is placed on 77th rank.[87] This shows that people are regaining faith in business environment of India. Auditing and accounting in the line of IND AS will result in better and effective due diligence. The amendments in LODR and Companies Act has further boosted the confidence of investor and IBC is at the same time working for better insolvency regime for better and effective recovery of NPA and Insolvency resolution plan. The level of corporate governance depends upon the corporate culture and corporate democracy. 'The core philosophy of corporate governance relies on quality of corporate democracy[88].' Private equity investment

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[83] Government of India v. Vijay Mallya decided on 10th December, 2018

[84] http://legislative.gov.in/sites/default/files/A2018-17.pdf

[85] Vikramaditya Khanna and Shaun J. Mathew, "The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidences", National Law School of India Review, Vol. 22, No. 1 (2010), pp. 35-66

[86] Finding an ID is difficult and task and director's database is underway by IICA and in place by NSE & BSE like **http://www.indianboards.com/pages/index.aspx**, **http://www.primedirectors.com/** accessed on 9th January, 2019 at 7:11 AM

[87] http://pib.nic.in/newsite/PrintRelease.aspx?relid=184513

[88] N.L. Mitra, "Corporate Governance: A Sojourn to Find a Yardstick" 56 JILI (2014) 437-462 p. 445

shall also lead to better corporate governance.[89] But in this tireless sojourn of standardizing corporate governance the entrepreneurship must not become impossible as Nietzsche states ***"Whoever fights monsters should see to it that in the process he does not become a monster."***

[89]Afra Afsharipour, "Corporate Governance And The Indian Private Equity Model" National Law School of India Review, Vol. 27, No. 1 (2015), pp. 17-48 p. 47

3. CHANGING DYNAMICS OF CORPORATE LAW AND GOVERNANCE IN INDIA: HOW TO HAVE EFFECTIVE IMPLEMENTATION OF THE INSOLVENCY AND BANKRUPTCY CODE*

Abstract

This paper reviews the implementation of the Insolvency and Bankruptcy Code, 2016 (IBC) since it came into force. It shows that the IBC has certainly achieved a noteworthy presence in the business environment and has also done well in bringing the issue of insolvency and bankruptcy in the limelight, which, prior to the IBC, was not paid due attention. However, it has been less effective in sticking to the statutory timelines. There has been progress in creating institutions like Insolvency and Bankruptcy Board of India (IBBI), and empowering National Company Law Tribunal (NCLT) to handle the insolvency resolution proceedings but the headway has been much less than anticipated. The role of the insolvency resolution professionals (IRPs) is very critical. A large number of them have qualified and registered within a short period of time but a lot more needs to be done to create proper and effective entry barriers. Due to large number of cases are being filed; delay is becoming the norm. There are other reasons for delay also which may defeat the very purpose of enactment of IBC. The paper recognises some of the serious problems in the implementation of IBC and gives suggestions for effective insolvency resolution. The paper concludes by identifying the most important issues which need to be tackled head-on.

Keywords

Bankruptcy, Insolvency, NCLT, IBBI, Insolvency and Bankruptcy Code, IRP

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Introduction

The Insolvency and Bankruptcy Code, 2016 (IBC) is a step in the right direction and consolidates the economic reforms initiated in India in 1991. These were the first major structural reforms tackling the core issues with a holistic view. Though conservative and cautious in approach – as compared to sudden, half-baked, and knee-jerk – the reforms of 1991 were well thought out and laid the foundation of a growing economy with some important immediate results like lesser dependence on International Monetary Fund (IMF), and later percolation of benefits in the entire society.[90] Exactly a quarter of a century later, in 2016, one of the most meaningful legislative reforms has been made in the shape of the IBC. Economists, legal experts and business consultants, among other professionals concerned with the business environment in India, had long been advocating a simpler and effective legal framework for insolvency and bankruptcy. The policymakers in India had usually agreed in principle for the need of such a law. However, sufficient steps were not taken to make it a reality for a long time. It saw the light of the day in 2016, marking a new era in ease of doing business in India.

Background

In India resolution of commercial insolvency has been quite cumbersome for a fairly long time and the previous company law – the Companies Act, 1956 – despite having provisions for winding up of a company was not effective enough due to procedural rigmarole and inordinate delay in proceedings. It is commonly believed that slow court proceedings do have a negative effect on the economic activity in the society.[91] To expedite the process the Sick Industrial Companies Act (SICA), 1985 was enacted and a board for this purpose called the Board for Industrial Finance and Reconstruction (BIFR) was established. However, it was experienced

[90] Ahluwalia, M.S. (2016). The 1991 reforms: How home-grown were they? Economic and Political Weekly, 51 (29), 38–46.
[91] Chemin, Matthieu (2010). "Does Court Speed Shape Economic Activity? Evidence from a Court Reform in India," The Journal of Law, Economics and Organization 28.3. pp. 460-485.

that the existing legal framework was not adequate to effectively resolve insolvency cases. Banks were under the tremendous pressure of non-performing assets (NPAs) and the Reserve Bank of India (RBI) prepared a list of some of the worst performing companies which were the primary burden on the banking sector. The RBI also came up with a list of the "dirty dozen", with an obvious intention of cleaning the filth as soon as possible following the legal mechanism. These 12 companies were responsible for about 25% of the country's total NPAs. The lending banks knew the magnitude of the problem and could have easily identified the particular borrowing companies, but the then existing legal framework did not give them enough confidence to pursue recovery proceedings doggedly. Every now and then there were obstacles in the legal journey for recovery, frustrating the lenders and then making them follow religiously the oft-repeated statement, "let the law take its own course." All this changed with the new law – IBC – coming into effect, which surely made it easier for lenders to start legal proceedings for recovery with greater conviction and higher probability of success.[92]

The IBC did not happen on its own but for a growing economy like India, it had to happen as insolvency and bankruptcy proceedings had become absolutely irrelevant, inconclusive, and hence a big joke. The world was laughing at India and insincere debtors were enjoying the borrowed money like parasites. Globally, there are varying legal and regulatory mechanisms in different jurisdictions to take care of insolvency and bankruptcy, with varying effectiveness.[93] However, the shamelessness shown by the borrowers in India can be said to be unmatched as they had no intention to pay back and their conduct made it quite obvious to the lenders and the world at large. At times, bankers colluded with them, as is being investigated in several bank cases[94], and made their life easier by not pursuing the recovery proceedings in the right

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[92] Bankruptcy Law Reforms Committee (2015). The report of the Bankruptcy Law Reforms Committee, Volume I: Rationale and Design. Tech. rep. Department of Economic Affairs, Ministry of Finance, Government of India, Nov. 2015.

[93] Djankov, Simeon et al. (2008). "Debt Enforcement around the World", Journal of Political Economy 116.6., pp. 1105-1149.

[94] How PNB fraud happened: A 162-page report lays bare the lapses; LiveMint, June 21, 2018, https://www.livemint.com/Companies/QVrxBXaZBX2t82KkFBSAOL/How-PNB-fraud-happened-A-162page-report-lays-bare-the-laps.html ; Bank frauds grip not just PNB but Canara Bank, Axis Bank too; Here are 5 latest cases under probe, Financial Express, March 19, 2018, https://www.financialexpress.com/industry/banking-finance/bank-frauds-grip-not-just-pnb-but-canara-bank-axis-bank-too-here-are-5-latest-cases-under-probe/1104074/; ICICI Bank tops list of most employees

earnest. BIFR had lost relevance due to totally ineffective handling of matters and most of the sick units either continued to function in one way or the other, or simply became conduits for laundering money, or siphoning off lenders money to unscrupulous promoters and directors of sick units. BIFR was creating more problems than solving them. Loans worth billions of dollars were not recovered. For a large number of sick units, debts had been repeatedly recast, which made a mockery of the deadline to move into the next stage of shutting down the units and liquidating everything. Non-implementation of restructured package had become the norm rather than the exception. Lenders were often left with no option but to approve restructuring of loan payment packages but that option was the only legal choice. Truly speaking, there was no choice at all but to rue the day when they had agreed to lend money. Borrowers were having a field day.

It was therefore urgently needed to have a proper law for resolution of commercial insolvency so as to have the economy back on track and bring back some sense in lending and borrowing business.[95] In August 2014, the Government of India had set up the Bankruptcy Law Reform Committee (BLRC) which recommended enacting a new law for insolvency and bankruptcy. The BLRC, before making the recommendation, had studied minutely the legal framework on the subject and taking the shortcomings into account had prepared a draft for a new insolvency law in the country for individual and business financial failure. The intention of the Government was very clear that there should be a speedy mechanism in place for insolvency proceedings and shutting down a business should not itself be a lengthy and circuitous exercise. The bill for this purpose was introduced in the Parliament in May 2016 with the aim that it should become the single law in the country to deal with the issues of insolvency and bankruptcy in India, both for corporates as well as the individuals. The most important feature

caught in fraud, Financial Express, December 14, 2018, **https://www.financialexpress.com/industry/banking-finance/icici-bank-tops-list-of-most-employees-caught-in-fraud/1413287/** ; Bank of Maharashtra CEO, executive director booked for role in Rs 3,000 crore DSK Group default case, Economic Times, June 21, 2018, **https://economictimes.indiatimes.com/industry/banking/finance/banking/bank-of-maharashtra-ceo-executive-director-held-for-role-in-rs-3000-crore-dsk-group-default-case/articleshow/64662531.cms**; and many others

[95] Ravi, Aparna (2015). "The Indian insolvency regime in practice: an analysis of insolvency and debt recovery proceedings". The Economic and Political Weekly. Vol. 50, Issue No. 51, 19 Dec, 2015; **https://www.epw.in/journal/2015/51/special-articles/indian-insolvency-regime-practice.html**

of the proposed law was time bound stages for the proceedings. Conspicuous touch of professionalism was imparted to the insolvency law with emphasis on professionals trained in the subject of insolvency rather than generalists working ad-hoc on insolvency issues. The matter was thought through to identify the significance of an independent regulator – Insolvency and Bankruptcy Board of India (IBBI) – to have proper check on the activities of professionals dealing with the subject.

IBC: Salient Features

The most salient feature of the IBC is its strictness about timely proceedings ensuring the envisaged outcome within a certain time and not letting the legal proceedings linger on forever, as unfortunately sometimes the case is with procedural rigmarole. The usual time period specified is 180 days with the possibility of an extension of 90 days in cases of matters involving complexity. The IBC provides for an institutional framework in the form of the IBBI, Insolvency Professionals (IP), Insolvency Professional Agencies (IPA), and Information Utilities (IU). These four shall be responsible for speedy and effective commercial insolvency resolution. As the success of any institution depends on the individuals who man it, the role of the IPs are crucial. They are the persons who shall take the insolvency process forward by managing the liquidation process and the company in the interim period. They will also collect the relevant information from the reliable sources. The IPAs have been mandated with the task of examining and certifying the insolvency professionals. The information utilities, as the name suggests, will collect financial information about the borrowers and this information will be supposed to be good enough to be relied upon. Thus, the IBC is what the institutions and individual professionals will make it. Professionalism, which in other words can be said to be competence and objective delivery, shall be the differentiating feature in the entire scheme of the IBC. The IPs have to be well trained in insolvency proceedings as well as in managing business, as they have to prepare a lender-approved insolvency resolution plan. Finding such IPs is not going to be easy.

The procedure and forum for insolvency proceedings are different for companies and individuals. In the case of a loan default by a company or a limited liability partnership (LLP), proceedings shall start at the NCLT with its appellate authority being the National Company Law Appellate Tribunal (NCLAT) and in case of individuals and partnership firms the proceedings shall start at the Debt Recovery Tribunal (DRT) with its appellate authority being the Debt Recovery Appellate Tribunal (DRAT). Insolvency proceedings can be initiated in the appropriate forum by either the borrower or the lender. Insolvency proceedings obviously can either lead to the insolvency resolution process; if there is a possibility of continuing the operations financially or outright liquidation. The primary purpose of insolvency proceedings is not to jump onto liquidation as the sole and obvious option but to explore the possibility of letting the organisation continue its operations for some time if it is financially viable. This is very different from the earlier insolvency regime which was marked with the controversies such as inefficient handling and delay in proceedings.[96] Now, this is a call the IPs have to take in consultation with the stakeholders and with the approval of the adjudicatory authority. Interim measures have to be taken at the initial stage with the appointment of an IP to take stock of the situation in the light of the reliable information provided by the IUs. Not to give too much power to an individual and therefore take care of individual whims, fancies and biases; a committee of creditors is constituted to take note of and approve the future plan of action. All the important decisions of the committee are to be made with a majority of 75% of the members of the committee.

The committee's decision – for a revised repayment plan or liquidation – has to be finally approved by the tribunal. Therefore, the role of the committee is to apply its mind in a professional manner to the problem at hand and suggest the most suitable plan of action taking into consideration the cold facts of the situation without mixing emotions. Very often, the promoters of a company have an emotional connect with the business and therefore the decision making gets coloured due to inclusion of non-objective and not fully relevant factors

[96] Ravi, Aparna (2015). "The Indian insolvency regime in practice: an analysis of insolvency and debt recovery proceedings", The Economic and Political Weekly, Vol. 50, Issue No. 51, 19 Dec, 2015, https://www.epw.in/journal/2015/51/special-articles/indian-insolvency-regime-practice.html

in the exercise. If the tribunal approves the resolution plan of the committee, it has to be implemented at the earliest. Faster proceedings are envisaged so that everything can be completed within 180 days. In exceptional cases an extension of 90 days can be granted. The sense of urgency can be gauged from the fact that bankruptcy proceedings have to be filed within a period of 90 days from the date of initiation of insolvency proceedings. There is a definite human touch to the entire proceedings as the IBC ensures that the interests of workers are safeguarded and the money due to them is paid before entering into the final stage of liquidation. Even the secured creditors have to wait to be paid as the IBC provides that the workers have to be paid 24 months' salary first. Any public office will be out of bound for anyone declared bankrupt. The IBC also makes provisions for cross-border insolvency with the help of bilateral agreements.

The IBBI

The IBC created the insolvency regulator IBBI, which was established on October 1, 2016. Within a short period of its establishment, the IBBI got be known and taken seriously in the business and legal fraternity. It is powered statutorily to oversee the insolvency proceedings. It regulates the working of IPAs, IPs, and IUs besides making the effort to create a better environment for insolvency proceedings along with working on myths and stigma associated with insolvency in the country. The role of IBBI is to regulate both the professionals and the processes which is bit unique; as in most of the other cases – for instance, lawyers, doctors, chartered accountants, etc. – the professionals are regulated by their own concerned professional body using a set of rules either made by them or by a competent legislative body. In the case of IBBI, the challenge shall be immense to regulate the processes as the present insolvency law of 2016 is in its nascent stage with hardly any strongly applicable precedents. Borrowing and applying precedents from other jurisdictions – typically the United States and the European Union – may not be apt and helpful as the business environment in those jurisdictions is very different from that in India to a large extent. It would, therefore, be unfair to the stakeholders if IBBI gets itself fully aligned with similar regulators in the other parts of

the world. However, taking guidance and thereafter adapting the foreign processes to the Indian ecosystem is always welcome – there is evidence from the developed and developing countries, for instance Brazil's experience in this field can be quite helpful for India[97] – though with the caveat that borrowing and adapting should neither suppress nor supplant inherent ingenuity of individuals involved in the insolvency proceedings in India.

The powers and functions of IBBI are enumerated in section 196 of IBC. A large number of functions are listed which make the job of IBBI, at the first sight, appear to be next to impossible. But, with the passage of time, it is expected that the things will be in place and with experiential learning, the IBBI will be able to do justice to most of the critical ones, if not all. The critical functions are indubitably the regulation of IPs, IPAs, and IUs. This regulation entails registering and updating information about each of these essential pillars of insolvency code. Besides the ministerial work of collecting forms, levying fees, etc., the IBBI has to truly apply its mind in setting the standards expected from individuals and institutions along with conducting examinations for screening and selecting the best persons for the desired purpose. Strict compliance – in letter and in spirit – with the IBC has to be ensured, which is not an easy task. Difficult and hard decisions have to be made by the IBBI to penalise, and if necessary de-register, the erring individuals. Another extremely important function is to make the bye-laws for the working of IPAs, etc. This is a one-time exercise but requires heavy lifting and deep understanding of several inter-related disciplines impacting business. To enable the IBBI perform several quasi-judicial functions, it has been vested with the powers of a civil court under the Code of Civil Procedure, 1908. Broadly, these powers are for discovery, production and inspection of necessary documents, summoning persons and issuing commissions. These are very wide powers which make IBBI truly a power-packed body.

The IBBI is expected to work with transparency and accountability. In today's digital world, IBBI is working with all the necessary information uploaded in almost real time on its website,

[97] Ponticelli, Jacopo and Leonardo Alencar (2016). "Court Enforcement, Bank Loans, and Firm Investment: Evidence from a Bankruptcy Reform in Brazil," Quarterly Journal of Economics 131.3, pp. 1365-1413.

https://ibbi.gov.in/ which is commendable. It is important in the current initial phase of its establishment that it remains open to suggestions, and at times criticism. With immense power, there is often a tendency to misuse and abuse it and the IBBI has to exercise restraint and be doubly cautious to steer clear of legal issues about its working. It has also been designated as the authority for the regulation of the profession of valuers, who usually rely on their gut feeling, work intuitively and exercise wide discretion. Judicial discretion and discretion exercised by professionals has very often been linked to the final decisions of insolvency proceedings.[98] Bringing the very necessary objectivity in their working and training their minds to select unprejudiced criteria while making decisions is going to be tough, and that's the most important task in valuation, which has the unavoidable and unmistakable effect on insolvency and bankruptcy proceedings. There has to be a conscious segregation of the functions of valuation and insolvency – their regulation, advocacy and training included – so as not to tilt the entire exercise against the debtor. The role of valuation gained due recognition and importance after the company law of 2013 was enacted and rules were framed for the purpose of valuation in 2017.

The NCLT and NCLAT

It was after Companies Act, 2013 came into effect, a need was felt for a brand-new tribunal to deal with matters related to the new company law particularly insolvency and bankruptcy. It was also recommended by Justice Eradi committee on insolvency law. It was experienced that there was inordinate delay in the winding up of companies under the earlier law or 1956 which very often frustrated the parties involved. To handle these matters effectively and speedily, the National Company Law Tribunal (NCLT) was constituted under the Companies Act, 2013 on June 1, 2016. It is a quasi-judicial body. Its primary function is to adjudicate matters pertaining to the company law and its decisions can be appealed in the National Company Law Appellate Tribunal (NCLAT), which is also the appellate tribunal for hearing

[98] Giammarino, Ronald and Ed Nosal (1994). "The Efficiency of Judicial Discretion in Bankruptcy Law", **https://pdfs.semanticscholar.org/9526/cf4193efd9eeee4a0d9bc59180231c8f1055.pdf**

appeals against orders passed under the IBC by the IBBI, and by the Competition Commission of India (CCI) under the Competition Act, 2002. Decisions of NCLAT can be challenged in the Supreme Court of India. NCLT deals with all proceedings under the Companies Act, 2013 and insolvency proceedings under the IBC. Civil courts do not have any jurisdiction to entertain any matters which fall under the jurisdiction of NCLT and NCLAT. Thus, the black-letter law clearly demarcates the boundary of the civil courts as far as matters related to various aspects of companies, including insolvency, are concerned. The NCLT has been transferred the authority from the Company Law Board (CLB) and Board for Industrial and Financial Reconstruction (BIFR).

Eleven benches of the NCLT have been constituted, with two in New Delhi and the other nine in major cities in different parts of India. These benches are manned by judicial and technical members. The NCLT's jurisdiction includes class action taken by shareholders and depositors, as a large group with common grievance or complaint, against fraud committed by promoters, directors, and management of the concerned company. Matters related to dissatisfaction in transfer of shares, or registering transfer, are also dealt by NCLT. Matters pertaining to mismanagement of a company or when a company is managed in a way which is not in public interest, an application for appropriate legal proceedings can be filed in the NCLT. The tribunal also checks collusion between the companies' accountants and auditors by allowing them to revise financial statements only in exceptional circumstance, which had unfortunately become a routine phenomenon under the earlier law of 1956. In several cases, the balance sheet used to show profits whereas in reality the company was heading towards insolvency. Falsification of accounts had become very common, which did not give the correct information about the health of the company to the investors and the market. NCLT can deregister companies if illegal means had been used to get them registered, which also includes procedural errors. Money deposited with the company as loan or in any other form is strictly dealt with under the new company law, and NCLT is empowered to adjudicate matters filed by depositors aggrieved by the concerned company's commissions or omissions. Class action can also be initiated for this purpose.

NCLT has the power to investigate a company in case of substantial complaints to this effect and can freeze company's assets and take other necessary action. It has a role in conversion of a public company to a private company. At times, companies are not able to call the Annual General Meetings (AGM) or Extraordinary General Meetings (EOGM) due to a variety of reasons. In such cases, a general meeting is convened by the NCLT. It can change the financial year of companies to match the uniformly followed April 1st to March 31st financial year, if they have been following some other year.

The processes followed by NCLT and NCLAT are evolving and will take some time to get into the right shape. There are several grey areas, which have to be tackled either through legislative action or judicial interpretation. It can be an iterative exercise which hopefully would finally result in a completely fine-tuned mechanism. As there are many regulatory authorities having a say in insolvency cases, the interplay between these authorities in a positive manner, eliminating sources of avoidable friction, shall be the key factor in making NCLT and NCLAT effective. Markets have reacted in a mixed manner and left with no other option but to approach the NCLT for all company matters, the business persons, lawyers, company secretaries, chartered accountants, insolvency professionals, and others involved in the proceedings of these tribunals are cautious and observant of the developments.

The IRPs

Section 5(27) of the IBC defines "resolution professional" as an insolvency professional appointed to conduct the corporate insolvency resolution process and includes an interim resolution professional. In short, we will call the insolvency resolution professional as the IRP, which takes into its ambit all resolution professionals, and does not stand only for interim resolution professional. This individual is the lynchpin of the entire insolvency process. Once the corporate insolvency resolution process begins, the existing management of a company has to handover the management of the company to the IRP, who takes the charge and

manages the routine working of the organisation, as well as works towards the finalisation of insolvency proceedings. It is important for the IRP to prepare a resolution plan and with the consent of the creditors get it approved by the NCLT. Workers must be paid first so that the normal and daily work continues without disruption, and the payment to creditors takes place a little later. The IRP is entitled to a reasonable amount of remuneration for the services rendered. The main reason for handing over the management and control of the company undergoing insolvency process to IRPs is to have a neutral third-party manage the affairs of the company instead of the debtors who, quite obviously, keep delaying the proceedings and always grumble that there are no resources to keep the entity functioning and thereby do not continue paying the workers. This may not be the real picture as unscrupulous debtors either siphon off the company's funds to their personal accounts at the cost of workers' survival. IRPs ensure transparency and objectivity.

The role of IRP, in a sense, is somewhat similar to the earlier roles of liquidator, operative agency, or interim administrator as have been in practise for a long time, however, there is a marked difference as the legislature under the IBC has vested IRP with many more responsibilities, which were never imagined under the earlier legal framework for insolvency and bankruptcy proceedings. The IRP is expected to maximise the valuation of the company, keep the company going, ensure that workers get paid, and overall management of the company. He has to raise interim finances and enter into contracts, if required. The IRP has a much wider scope as compared to the liquidator, operative agency or interim administrator. Earlier, these roles were performed by banks, financial institutions, or government agencies. As the entire process has to be completed in a time-bound manner – within 270 days, which is the maximum time limit – the job of the IRP becomes even tougher. Thus, the IRP must possess qualifications which make it possible for him to perform the envisaged role. He must know the company law, basic tenets of jurisprudence, principles and functions of management, accounts, basics of costing, and should be confident enough to make even senior managers in the organisation to work according to his plan. This is a tall order, and practically, it is very difficult to find such qualified and competent persons.

Usually, qualified persons with managerial experience would already be managing companies and not find the role of IRP attractive enough. And, those lacking in substantial managerial experience are not expected to be able to handle the situation of a company in trouble and facing insolvency. In case they are able to do so, despite the lack of experience, that may be due to serendipity, or their courage of conviction, or any other reason, but surely not due to the professional training. So, the role of IRP poses serious challenges in the manner it has been envisioned. Though the IRPs can take help of expert professionals, whose role shall be of providing expert opinion on the basis of facts shared with them, the final decisions are to be made by the IRPs themselves. They cannot abdicate this responsibility. There have been suggestions by practitioners that instead of an individual, the role of IRP can be assigned to an institution, which can take the services of experts in different fields in managing the company in distress. The previous management persons may be given a chance to handle some of the affairs, or at least make suggestions for the smooth functioning of the company. These necessary changes can be made by the legislature to expedite the proceedings rather than wait for the courts to interpret the provisions and expand the scope of the language of the statute and rules. It all applies to the Interim Resolution Professional also whose appointment is for not more than 30 days, forcing him to work in a pressure cooker situation. Emotional stability and integrity are truly at test under these conditions.

Effective Implementation of IBC: Problems and Suggestions

Sticking to the Timeframe Strictly

The time period for insolvency resolution is statutorily stipulated as 180 days which can be extended by 90 days subject to agreement by majority creditors. This strict timeframe has been quite effective and pushed defaulting companies, as well as lenders, not to get into the vicious cycle of extension of time *ad infinitum*. Legal proceedings in India have typically been a victim of inordinate delay and even in cases where strict time limits have been specified as in

arbitration matters and the general law of limitation, there are usually escape routes available in the form of delay condonation allowed by exercise of discretion by the presiding officers. This must not be allowed to happen to insolvency resolution. The legislature should tread with caution to approve of any such amendment to the law, and the judiciary also should refrain from interpreting the black-letter law liberally to relax the specified timeframe for all practical purposes. The statute book and the real situation should not be at variance.

Exercise of judicial discretion

Before the IBC, most of the bankruptcy proceedings were monitored by courts through administrators, liquidators, etc., and judicial discretion was widely exercised. It could have resulted in biases and heavy tilts in favour of creditors and thus made the direction in which the proceedings would have taken place predictable and thus, a foregone conclusion.[99] Bringing professionalism to the entire process will hopefully help in maintaining objectivity. The professionals need to work with strong sense of purpose and adherence to the ethical values.

Empirical Research to Bolster Practise

It is necessary to have empirical research conducted to understand the real problem and thereafter suggest proper and rational alternatives. At policy formulation stage, empirical research helps to draft realistic agenda with action points. Though use of empirical research has not been too high, yet there is hope that use of numbers and empirical research in times to come will go up.[100] It is not easy to get access to data related to insolvency, especially due to stigma associated with insolvency and bankruptcy in India. There are also issues of

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99 Gennaioli, Nicola and Stefano Rossi (2010). "Judicial Discretion in Corporate Bankruptcy". The Review of Financial Studies, Volume 23, Issue 11, 1 November 2010, Pages 4078–4114, **https://academic.oup.com/rfs/article/23/11/4078/1605995**

100 Sullivan, T, E Warren, and J Westbrook (1987). "The Use of Empirical Data in Formulating Bankruptcy Policy". Law and Contemporary Problems 50.2., pp. 195-235. **https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=3899&context=lcp**

confidentiality and data protection. Most of the successful businesspersons at one time, who are seeing bad days later in their business and professional career, are not willing to share the stories of their failure and usually try to make all efforts so that information pertinent to individuals concerned does not become accessible in public domain. Lack of reliable data will not help in policy formulation and taking necessary steps for implementation. It is necessary that the regulators like IBBI and adjudicators like NCLT release most of the information available with them, after camouflaging or redacting, if necessary. Numbers will help in research and providing right answers to the problems cropping up now and then in the insolvency proceedings.

Banks and Bankers

The IBC has brought out the relationship between defaulting businesses, banks and bankers in the open. Several debt-ridden companies, which hitherto had the patronage of banks and bankers, are facing trouble and the banks are finding no option left but to go through the statutory insolvency procedure taking large haircuts in their stride.[101] No longer are the debts untold stories. There are discussions, legal actions, failing companies, red-faced bankers, banks in the red, and a sense that the banks will not be able to continue to support the loss-making businesses. Hard decisions have to be made and erring businesspersons and bankers, both, have to face the music. The power balance between bankers and lenders seems to have been changed forever by IBC, and it should not let the litigation kill the spirit of IBC.[102] The bankers, undoubtedly, will not take unnecessary risk and their relationship with the corporate sector may take a beating. The thin line of distinction between being prudent and being passive has the possibility of getting blurred. Bankers' role is going through a major transformation.

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[101] Ahluwalia, M.S. (2019). "India's Economic Reforms: Achievements and Next Steps", Asian Economic Policy Review (2019) 14, 46–62

[102] FE Best Banks Awards: Don't allow litigation to kill IBC's spirit, Narayanan Vaghul to bankers; Financial Express, January 11, 2019; **https://www.financialexpress.com/industry/fe-best-banks-awards-2019-dont-allow-litigation-to-kill-ibcs-spirit-narayanan-vaghul-former-icici-bank-chairman/1440283/**

Shifting Focus

One of the most commonly observed problems in insolvency and bankruptcy proceedings is that of shifting the focus from the core objective of the entire exercise to something which was never ever the main goal. It usually happens in the form of various new goals being set rather than trying to unlock available funds and assets, and make the distressed business entity continue to function, if financially viable in a realistic period of time, thereby causing no damage or the least damage to the economy. Creeping of vested interests of promoters, directors, and other influential interested parties tend to get the goals of insolvency proceedings shifted to something else, which usually is continuation of the position of these individuals in the society and market, without causing any damage to their reputation and goodwill. The IBC has been the game-changer in making promoters take lenders seriously and not continue living the life as it used to be without honouring the commitment made to lenders. They are not allowed by law to control the business without clearing the dues.[103] It all depends on continuously focusing on the primary goal and not letting promoters' interests get in the way of legal proceedings.

Unintended Consequences

As different actors in the insolvency resolution are guided by their own interests – obviously, they are not out there for philanthropy – and they will act in consonance with others only, and only if, their interests are affected by the actions of others, there are high chances that due to the insolvency exercise being pulled in different directions, there may be unintended consequences, contrary to the originally envisaged goal. It has been experienced that insolvency applications have been filed by suppliers and vendors to recover operational unpaid dues also, rather than only money lent by financial creditors. There is, thus, a clear difference between operational creditors and financial creditors, which has been almost made

[103] Bajpai, G. N. (2019). "Time to sort out IBC's teething troubles", The Hindu BusinessLine, January 7, 2019; https://www.thehindubusinessline.com/opinion/time-to-sort-out-ibcs-teething-troubles/article25933329.ece

indistinguishable for insolvency proceedings. Litigation is rife due to actions by operational creditors, who find insolvency proceedings effective enough to recover the dues, or at least bring the other party to the negotiating table.[104] There are, therefore, some cases where viable businesses are also going through insolvency proceedings.[105] Among others, value destruction and wealth transfer problems due to insolvency proceedings have been argued by Datta.[106]

Conclusion

Backlog in NCLT benches may force the tribunals to slow down the process. Infrastructure at the insolvency courts, which presently is not in good shape at most of the benches, has to match the requirement, which is growing at a very fast pace. [107] The RBI's dirty dozen list is also facing delay in insolvency resolution.[108] So many other cases are facing the same fate, and there is a possibility with very high probability that the reasons which have been cited for delay in these cases will get rooted in the system and become the norm. It is a big challenge for the insolvency professionals that they do not succumb to the wishes of defaulters. Ethical and legal norms of the insolvency professionals demand timely action and not resorting to delaying manoeuvres. This is a tall order given the high stakes usually involved the proceedings. IBBI must act tough and promptly. Only then IBC will be a new light bringing speedy insolvency resolution, otherwise, it will become a toothless law.

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[104] Bigger role for operational creditors in resolution process worries bankers; The Hindu BusinessLine, January 13, 2019, **https://www.thehindubusinessline.com/money-and-banking/bigger-role-for-operational-creditors-in-resolution-process-worries-bankers/article25986702.ece**

[105] The IBC has an incentive problem, LiveMint, January 2, 2019; **https://www.livemint.com/Industry/nYs7QsAfNqtgGoQHZw2zBJ/The-IBC-has-an-incentive-problem.html**

[106] Datta, Pratik (2018)., Value destruction and wealth transfer under the Insolvency and Bankruptcy Code, IGIDR-IBBI Conference, **http://www.ifrogs.org/EVENTS/IBC_Confference/papers_for_conf/Datta_2018.pdf**

[107] How to prevent IBC from becoming a victim of its own success, The Economic Times, September 23, 2018, **https://economictimes.indiatimes.com/news/economy/policy/how-can-we-prevent-ibc-from-becoming-a-victim-of-its-own-success/articleshow/65916543.cms**.

[108] Watching The IBC: Lessons From The RBI-12 Cases; BloombergQuint, September 24, 2018, **https://www.bloombergquint.com/insolvency/watching-the-ibc-lessons-from-the-rbi-12-cases#gs.Lwu6C50O**

4. EFFECT OF INSOLVENCY & BANKRUPTCY CODE: ENSLAVEMENT OF THE OPERATIONAL CREDITORS*

Abstract

The insolvency and Bankruptcy Code, 2016 was brought to consolidate the scattered and unstructured insolvency laws in India. The Code classified the creditors into two categories, the financial and the operational. However, there has been an exponential disparity between the position and the rights of both the creditors. While financial creditors are given right to become members of the Committee of Creditors (CoC) and have voting rights to approve or reject the resolution plan for the revival of the company, operational creditors are mere bystanders. Likewise the plights of operational creditors are countless and the same continues. The liquidation waterfall envisaged in the Code gives more preference to financial creditors for the payment of debts over the operational creditors. Such an arrangement brings us to a very important question that, if upon liquidation, the debt of financial creditors are paid off first, then what is the significance on the part of the operational creditor initiating the case at the first place? Why does the classification of creditors prescribed in the foremost and basic part of the Code suddenly disappears by the time the resolution plan is approved. Operational creditors are neither being benefitted from the resolution process nor the liquidation process. Later in 2018, an amendment was brought to the IBBI Regulations, 2016 which uplifted the position of the operational creditors and prioritized their payment over financial creditor. This amendment was not helpful in supporting the situation as the claims of operational creditors were still subject to approval of the CoC which essentially consisted of financial creditors.

Keywords: financial creditors, operational creditor, corporate insolvency resolution process, liquidation waterfall, prioritisation.

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INTRODUCTION

The legal framework for insolvency and bankruptcy in India was unclear and hazy until the new path breaking legislation 'The Insolvency and Bankruptcy Code' of 2016 (herein after referred as **"the Code"**) came into force. The Code was enacted to consolidate the various provisions from the Presidency Towns Insolvency Act, 1909[109], the Sick Industrial Companies (Special Provisions) Act, 1985 (**SICA**)[110], Limited Liability Partnership Act, 2008[111], the Companies Act, 1956 (**Companies Act**)[112], the Recovery of Debts due to Banks and Financial Institutions Act, 1993 (**RDDB Act**)[113], the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (**SARFAESI Act**)[114] which dealt with various aspects of insolvency and bankruptcy separately. The jurisprudence on insolvency and bankruptcy was absolutely scattered, unstructured, failed to improve the position of the Gross Non-Performing assets (NPA) of the country and that is when the Insolvency and Bankruptcy Code, 2016 (hereinafter referred to as "the Code") was brought in to the framework.

The Code prescribes a time limit of 180 days[115], which can be extended further up to 90 days[116] in certain cases for resolution of the sick companies. Within the said 180 days, application can be filed by operational creditors or financial creditors or corporate debtors to the Adjudication authority[117], who then would appoint an interim resolution professional[118] (herein after referred as "**IRP**") to constitute the Committee of Creditors[119] (herein after referred as "**CoC**"). The CoC then appoints a resolution professional[120] (herein after referred as "**RP**") who prepares a resolution plan for the company's revival and submits it to the CoC for

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[109]The Presidency- Towns Insolvency Act, Act No. 3 of 1909, INDIA CODE (1909).

[110]The Sick Industrial Companies (Special Provisions) Act, INDIA CODE (1985) repealed by The Sick Industrial Companies (Special Provisions) Repeal Act 1 of 1986 INDIA CODE (2003).

[111]Limited Liability Partnership Act, Act No.6 of 2009, INDIA CODE (2008).

[112]Companies Act, Act No. 1 OF 1956, INDIA CODE(1956).

[113]Recovery of Debts Due to Banks and Financial Institutions Act, Act No. 51 of 1993, INDIA CODE (1993).

[114]The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 Act No. 54 of 2002, INDIA CODE (2002)

[115]S.12, The Insolvency and Bankruptcy Code, 2016 Act No. 31 of 2016.

[116]Ibid at S. 12(3).

[117]Ibid at S. 6.

[118]Ibid at S. 16.

[119]Ibid at S. 21.

[120]Ibid at S. 22.

approval. If the resolution plan is approved with 75% majority by the CoC[121], it is submitted to the Adjudicating authority for its acceptance[122]. If the resolution plan is rejected by the Adjudicating authority, it may pass liquidation orders for the sick company.[123]

The objective of the Code and the prescribed procedure is to avoid undue delays in resolution. It essentially aims at the recognition, recapitalisation and reformation of the company which is a paradigm shift from the "**debtor-in-possession**" model to "**creditor-in-control**" model.[124]

The authors in the paper have delved into contemporary laws, precedents to endeavour the tenability of the Code. The First Part of the paper deals with the classification of creditors encompassed by the Code which is one of the most vital and unbeaten provisions in Bankruptcy laws. The Second Part further delves into the distinction between the classes of creditors i.e., financial creditors and financial creditors. The Third Part puts out the 'Waterfall' which seems to be the most lucrative yet debatable part of the Code. The prioritisation in the Code comes into play when the company gets liquidated and the same is followed in asset distribution. The authors have tried to reflect upon the biasness in the Code towards certain creditors. The Fourth Part deals with the issues and plight of operational creditors who are of the opinion that the framework of the Code is entirely favourable to the financial creditors. The Fifth Part revolves around the judicial precedents and jurisprudence of bankruptcy and insolvency law in India. The Sixth Part apportions the Indian Legislation and compares the same with global legislations of certain countries like UK, Singapore etc. The Seventh Part attempts to put forth plausible solutions to the oppressions of the operational creditors and strike a balance.

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[121]Ibid at S. 28.

[122]Ibid at S. 31.

[123]Ibid at S. 33.

[124]IBC Mechanism Used Actively to Resolve NPA Problem: Survey, The Economic Times, Jan 29 (2018), availabk at:**https://economictimes.indiatimes.com/news/economy/policy/ibc-mechanism-used-actively-to-resolve-npa-problem-survey/articleshow/62693550.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst .**

CLASSIFICATION OF CREDITORS

The Code in India unfolded a huge amount of complexity just about an applicant's eligibility to commence Corporate Insolvency Resolution Process[125](hereinafter referred as **"CIRP"**). The Code defines a creditor under Section 3(10) as-

"any person to whom a debt is owned and includes a financial creditor, an operational creditor, a secured creditor, an unsecured creditor and a decree holder".

It mostly depends on the condition of an applicant to be categorized into either an "operational creditor" or a "financial creditor" under the Code. It is significant to note that there was no such classification under the Companies Act, 2013 and merely the term 'creditor' was used. This classification under the Code aims to put the creditors on different platforms at different stages of the proceeding, be it regarding maintainability of applications,[126] or pertaining to sanctioning of resolution plan or distribution of assets (only in case of liquidation)[127] etc.

The Code defines a "financial creditor" under Section 5(7) as

> *"a person to whom a "financial debt" is owed and includes a person to whom such debt has been legally assigned or transferred".*

Thus, any lender who extends any kind of loan, guarantee or financial credit falling under the ambit of financial debt[128] (as under Section 5(8) of the Code) will stand as a financial creditor.

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[125]Supra Note 7, the Code at Chapter II.
[126]Ibid the Code at S. 6,7 &8.
[127]Ibid the Code at S.53
[128]Ibid the Code at S.5(8): financial debt– "a debt along with interest, if any, which is disbursed against the consideration for time value of money and includes:
1. Money borrowed against payment of interest;
2. Any amount raised by acceptance under any acceptance credit facility or its de-materialized equivalent;
3. Any amount raised pursuant to any note purchase facility or the issue of bonds, notes, debentures, loan stock or any similar instrument;
4. The amount of any liability in respect of any lease or hire purchase contract which is deemed as a finance or capital lease under the Indian Accounting Standards or such other accounting standards as may be prescribed;
5. Receivable sold or discounted other than any receivable sold on non-recourse basis;
6. Any amount raised under any other transaction, including, any forward sale or purchase agreement, having the commercial effect of borrowing;
7. Any counter-indemnity obligation in respect of a guarantee, indemnity, bond, documentary letter of credit or any other instrument issued by a bank or financial institution;
8. The amount of any liability in respect of any of the guarantee or indemnity for any of the items referred to in sub-clauses (a) to (h) of this clause."

Similarly Section 5(20) of the Code defines an "operational creditor" as-

> *"any person to whom an operational debt is owed and includes any person to whom such debt has been legally assigned or transferred."*

Further Section 5(21) of the Code defines "operational debt" as –

> "*a claim in respect of the provisions of goods or services including employment or a debt in respect of the repayment of dues arising under any law for the time being in force and payable to the Central Government, any State Government or any local authority"*.

Thus, operational creditor demotes to any person who has provided goods or services and the payment for same is due from the corporate debtor. The Bankruptcy Law Report Committee (hereinafter referred as "BLRC") in ¶ 5.2.1 of the Final Report[129]has observed that-

> *"Operational Creditors are those whose liability from the entity comes from a transaction on operations. Thus, the wholesale vendor of spare parts whose spark plugs are kept in inventory by car mechanic and who gets paid only after the spark plugs are sold is an operational creditor. Similarly, the lessor that the entity rents out space from is an operational creditor to whom the entity owes monthly rent on a three-year lease."*

Vide Order dated 20th February 2017, the Principle Bench of Hon'ble National Company Law Tribunal (hereinafter referred to as **"NCLT"**), New Delhi in *Col. Vinod Awasthy v. AMR Infrastructure Limited*[130] interpreted the definition of '*operational creditor'* under the Code to determine the maintainability of a flat purchaser as operational creditor. The Hon'ble Tribunal

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[129]Bankruptcy Law Reforms Committee Report, Insolvency and Bankruptcy Board of India, Nov. 15 (2015), ¶5.2.1, available at:**https://ibbi.gov.in/BLRCReportVol1_04112015.pdf**

[130]Col. Vinod Awasthy v. AMR Infrastructure Ltd., NCLT, Principal Bench, Delhi, [2017] 141 SCL 70, CP No. (IB)-10(PB)/2017; Also Mukesh Kumar v. AMR Infrastructure Limited , NCLT, Principle Bench, Delhi,[2017] 139 CLA 166, C.P. No. (IB)-30 (PB)/2017); Pawan Dubey and Another v. J.B.K. Developers Private Limited, MANU / NC / 0444 / 2017 (C.P. No. (IB)-19 (PB)/2017).

dismissed the Petition under Section 9 of the Code, at the admission stage itself and decided that a flat purchaser is not an operational creditor as under Section 5(20)[131] of the Code. It observed that the maker of the Code did not propose to include within the definition of 'operation debts' a debt other than a financial debt. The Tribunal held that the debt owed to the Petitioner (a flat purchaser in this case) did not generate from any goods, services, employment or dues which were payable under any statute to the Centre / State Government or local bodies.

It is impossible to interpret Section 9 r/w Section 5(20) and Section 5(21) of the Code so widely to include within its scope more substance than already prescribed. It is evident that the farmers have carved out unique definitions of operational creditor' and 'financial creditor' and they shall not be interpreted as inclusive or exclusive of each other.[132]

Numerous transactions are entered into only on credit basis which is customarily followed in different sectors during the course of business. Thus, the Code generates the distinction between an operational creditor and financial creditor termed on the nature of the transaction i.e transaction on daily operations or only the financial transactions. It is pertinent for the creditors to be entirely conscious of the variety of rights available to them, in order to safeguard their interests.

DISTINCTION BETWEEN OPERATIONAL CREDITORS AND FINANCIAL CREDITORS

The Code, inimitably inscribes the distinction between operational and financial creditors. The BLRC in its report[133], suggested at ¶5.2.1 that–

[131]Supra Note 7, the Code at S. 5(20):"operational creditor is any person to whom an operational debt is owed and includes any person to whom such debt has been legally assigned or transferred."

[132] Arohee Gursale, Financial Creditor And Operational Creditor Under The Insolvency And Bankruptcy Code, 2016, Dhaval Vussonji & Associates (2017), (accessed at 10th January, 2018 at 15:16), available at: **http://www.mondaq.com/india/x/607738/Insolvency+Bankruptcy/Financial+Creditor+And+Operational+Creditor+Under+The+Insolvency+And+Bankruptcy+Code+2016.**

[133]Supra Note 21 at ¶5.2.1.

"Here, the Code differentiates between financial creditors and operational creditors. Financial creditors are those whose relationship with the entity is a pure financial contract, such as a loan or debt security. Operational creditors are those whose liabilities from the entity come from a transaction on operations... The Code also provides for cases where a creditor has both a solely financial transaction as well as an operational transaction with the entity. In such a case, the creditor can be considered a financial creditor to the extent of the financial debt and an operational creditor to the extent of the operational debt"

As per Section 7 of the Code, only on satisfying the default in payment of a due debt, a financial debtor can directly approach the Adjudicating Authority.[134] However, for an operational creditor to succeed in initiating the CIRP under Section 9[135] of the Code, its *sine qua non* for it to satisfy the Adjudicating Authority and fulfil the ingredients of Section 8 of the Code.[136] It is to be noted that financial creditors can initiate CIRP even for disputed debts but operational creditors cannot.

The admission of insolvency petition to the Adjudicating Authority is followed by a 'moratorium'[137] order which is imposed against corporate debtor until the allowance of the

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[134]Supra Note 7, the Code at S.7(5): Where the Adjudicating Authority is satisfied that—
(a) a default has occurred and the application under sub-section (2) is complete, and there is no disciplinary proceedings pending against the proposed resolution professional, it may, by order, admit such application; or
(b) default has not occurred or the application under sub-section (2) is incomplete or any disciplinary proceeding is pending against the proposed resolution professional, it may, by order, reject such application:
Provided that the Adjudicating Authority shall, before rejecting the application under clause (b) of sub-section (5), give a notice to the applicant to rectify the defect in his application within seven days of receipt of such notice from the Adjudicating Authority.

[135]Ibid the Code at S.9(1): After the expiry of the period of ten days from the date of delivery of the notice or invoice demanding payment under sub-section (1) of section 8, if the operational creditor does not receive payment from the corporate debtor or notice of the dispute under sub-section (2) of section 8, the operational creditor may file an application before the Adjudicating Authority for initiating a corporate insolvency resolution process.

[136]Ibid the Code at S. 8(2): The corporate debtor shall, within a period of ten days of the receipt of the demand notice or copy of the invoice mentioned in sub-section (1) bring to the notice of the operational creditor
(a) existence of a dispute, if any, and record of the pendency of the suit or arbitration proceedings filed before the receipt of such notice or invoice in relation to such dispute;
(b) the repayment of unpaid operational debt—
(i) by sending an attested copy of the record of electronic transfer of the unpaid amount from the bank account of the corporate debtor; or
(ii) by sending an attested copy of record that the operational creditor has encashed a cheque issued by the corporate debtor.

[137]Ibid the Code at S. 14(1): Subject to provisions of sub-sections (2) and (3), on the insolvency commencement date, the Adjudicating Authority shall by order declare moratorium for prohibiting all of the following, namely:—
(a) 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;
(b) transferring, encumbering, alienating or disposing of by the corporate debtor any of its assets or any legal right or beneficial interest therein;

resolution plan. The financial creditors can and *shall* propose name of the resolution professional (hereinafter referred to as "**RP**") intended to act as an interim resolution professional (hereinafter referred to as "**IRP**").[138]Erstwhile an operational creditor *may* propose a resolution professional to act as an interim resolution professional.[139]

The RP has to comprise the CoC which is commissioned for the framing of a resolution plan.[140]The CoC is one of the most important elements of CIRP as it frames the resolution plan as well as approves it, which ultimately applies on all the creditors equally. Financial creditors solely constitute the CoC[141], whereas the operational creditors do not form a part of it. The Operational creditors thus, do not have a say regarding the allowance or refusal of the resolution plan. As observed by the BLRC, in its report[142] –

> *"The Committee deliberated on who should be on the creditors committee, given the power of the creditors committee to ultimately keep the entity as a going concern or liquidate it. The Committee reasoned that members of the creditors committee have to be creditors both with the capability to assess viability, as well as to be willing to modify terms of existing liabilities in negotiations. Typically, operational creditors are neither able to decide on matters regarding the insolvency of the entity, nor willing to take the risk of postponing payments for better future prospects for the entity. The Committee concluded that, for the process to be rapid and efficient, the Code will provide that the creditors committee should be restricted to only the financial creditors."*

It is pertinent to note that the division culled out in the above report, is regardless of the fact that a creditor is secured or unsecured.[143] And that mostly, operational creditors are unsecured

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(c) any action to foreclose, recover or enforce any security interest created by the corporate debtor in respect of its property including any action under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;
(d) the recovery of any property by an owner or lessor where such property is occupied by or in the possession of the corporate debtor.

[138]Ibid the Code at S.7(3).
[139]Ibid the Code at S. 9(4).
[140]Ibid the Code at S. 21(1).
[141]Ibid the Code at S. 21(2).
[142]Supra Note 21 at ¶4.
[143] Anumeha Agrawal, Position of Operational Creditor under IBC, Manupatra (2018), (accessed on 10th January, 2019 at 17:18) available at:**http://docs.manupatra.in/newsline/articles/Upload/413C6DEB-C214-4500-A17C-A558BFCB8481.pdf**

and according to Section 53 of the Code are ranked quite below other creditors (discussed later).

The approval of CoC shall be obtained by a vote of not less than 75% of the voting shares.[144]Voting share of financial creditor is determined in proportion with the financial debt owed to them.[145] On the other hand voting share of operational creditor is nil. Further only those operational creditors whose aggregate debts amounts to not less than 10% of the total debt, are allowed to be a part of the meetings of the CoC.[146] But they still do not qualify as members and cannot vote.

A financial creditor can either qualify as a secured or unsecured creditor, however an operational creditor always come under the category of unsecured creditors. Therefore, at the time of liquidation and asset distribution, financial creditors are given prominence over operational creditors. However,few operational creditors like workmen and employees are specified to be given priority and treated at par with secured financial creditors.[147] When the distinction between the operational creditors and financial creditors was challenged, the same was upheld in the Calcutta High Court.[148] However the Supreme Court has directed the High Courts from refraining from forming any opinion in such matters.[149]

WATERFALL

Prioritisation is one the major grounds why operational creditors are given a cold shoulder during the payment of dues. Section 53[150] of the Code envisages the 'liquidation waterfall' which determines who shall be paid first and who shall be given priority over another. According to the provisions of the Code the secured and the unsecured financial creditors are given priority over the operational creditors. Such an arrangement brings us to a very

[144]Ibid the Code at S. 22(1).
[145]Ibid the Code at S. 5(28).
[146]Ibid the Code at S. 24.
[147]Supra Note 35.
[148]Akshay Jhunjhunwala & Anr. v. Union of India through the Ministry of Corporate Affairs & Ors., AIR 2018 Cal 139 (W.P. No. 672 of 2017).
[149]Shivam Water Treaters Private Limited v. Union of India & Ors., SLP (C) No.1740/2018
[150]Supra Note 7, the Code at S.53.

important question that, if upon liquidation, the debts of financial creditors are paid off first, then what is the significance on the part of the operational creditor for filing and initiating the case at the first place? Initiating a case at the Adjudicating Authority against the corporate debtor by an operational creditor renders no value if they are not entitled to any advantage or benefits by the end of the process.

In insolvency liquidation, there shall be shortfall of assets against the claims made.[151] The prioritisation in payments as per Section 53 of the Code answers the key questions like who shall be paid first , whom shall it be shared among or shall it be done so proportionally. At home, if there is shortage of food on the dinner table, then the food may be shared equally among the members of the family but sometimes children and elders are given priority over others.[152] But that is not the case in liquidation waterfall enshrined in the Code. The Code says, if the one ahead in the priority status hasn't eaten belly full, the subsequent person in the queue won't even get a crumb. So the prioritisation not only determines *how much* amount to be paid but also *if at all* they will be paid considering their position in the priority status.[153] This shows that the recovery rate is directly proportional to the position of the stakeholder in the priority status.

Section 53 lists down the ranks allotted to the distinguished stakeholders in the liquidation waterfall. Interim resolution professionals (hereinafter referred to as "IRP) and the liquidation costs are given the utmost position in the waterfall followed by the workmen's dues[154] and secured dues in the second position[155]. Employee's dues[156], unsecured financial creditors[157] and government dues[158] along with unpaid dues to secured creditor are given third, fourth and fifth position respectively. There is no specific mention of the operational creditors in the priority status and they are left in the residual category of "*any remaining debts and dues*"[159] which

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[151]Vinod K. and Sikha B., Subordination of Operational Creditors under IBC: Whether Equitable, July 26 (2018), available at: **http://vinodkothari.com/2018/07/subordination-of-operational-creditors-under-ibc-whether-equitable/.**

[152]Ibid.

[153]Ibid.

[154]Ibid the Code at S. 53 (b)(i).

[155]Ibid the Code at S.53 (b) (ii).

[156]Ibid the Code at S.53 (c).

[157]Ibid the Code at S.53 (d).

[158]Ibid the Code at S.53 (e) (i).

[159]Ibid the Code at S.53 (f).

is given the sixth position in the waterfall. So the operational creditors are placed four levels below the secured financial creditors and two levels below the unsecured financial creditors. Is such subordination or discrimination of unsecured operational creditors justified? Is it justified to make such a discrimination against the supplier of goods and services, who supplied on credit, to have the claim to their money levelled so below the working capital financiers or other unsecured creditors?

The BLRC's recommendation on differentiating the operational and financial creditor is envisaged in the provisions of the Code.[160] Thus, the reason why BLRC prioritised financial creditors over operational creditors was the "*capability to assess viability, and willingness to modify terms of existing liabilities in negotiations*". So the financial creditors were presumed to be willing to take the risk of postponing the payments while operational creditors were not envisioned to fetch the burden of postponing the payments.[161] However, this reasoning can be considered relevant for determining the eligibility to be on the CoC. But should the same distinction be considered relevant to determine the position of the creditors in the priority status?[162] Further BLRC in its report suggests-

> *"The Committee has recommended to keep the right of the Central and State Government in the distribution waterfall in liquidation at a priority below the unsecured financial creditors in addition to all kinds of secured creditors for promoting the availability of credit and developing a market for unsecured financing (including the development of bond markets). In the long run, this would increase the availability of finance, reduce the cost of capital, promote entrepreneurship and lead to faster economic growth."*

BLRC report backs a proper justification for preferential ranking of unsecured financial creditors over Government debts but does not justify for *not* placing unsecured financial creditors above operational creditors.[163] Ironically, until and unless the financial creditors have filled up their bellies, the operational creditors positioned so low in the liquidation waterfall would not even get a *soupcon* (even no payment at all).[164]This leads to the misuse of the

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[160]Supra Note 21.
[161]Supra Note 43.
[162]Ibid.
[163]Ibid.
[164]Ibid.

machinery by the debtors and their related creditors at the cost of unsecured operational creditors.[165]

PLIGHT OF OPERATIONAL CREDITOR

On the basis of whether the creditor is an operational or financial, the Code prescribes procedure with respect to the admissibility of insolvency petition for initiation of the resolution process. In case of a financial creditor, he has to show the existence of a default in payment of a due debt and can directly approach the Adjudicating Authority.[166] However, it is not the same in case of an operation creditor to succeed in initiating the CIRP under Section 9 of the Code. In order for an operation creditor to succeed in initiating the CIRP under Section 9 of the Code, its *sine qua non* for the operational creditor to demonstrate the Adjudicating Authority to *firstly* serve a demand notice to the corporate debtor stating the default debt and *secondly* that there exists no dispute between the parties in respect with the payment of debt. The Hon'ble Supreme Court in the case of *Mobilox Innovations Pvt. Ltd. Vs. Kirusa Software Pvt. Ltd*[167]interpreted the expression 'dispute' as defined under Section 8 (2) of the Code and held that,

> *"The adjudicating authority shall only take into consideration if there exists a bona fide dispute and shall not examine the merits such dispute. This applies even if the notice of dispute has been served after the corporate debtor accepted the demand notice".*

As a result of the above mentioned observation, if the debt is not admitted by corporate debtor and the same is disputed within the purview of Section 8(2), it turns into a plausible ground for rejecting the insolvency application of an operational creditor.[168]Irrespective of there being any dispute or not between the parties, the insolvency proceedings can be scuttled by the

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[165]Ibid.
[166]Supra Note 7, the Code at S. 7.
[167]Mobilox Innovations Pvt. Ltd. v. Kirusa Software Pvt. Ltd, AIR 2017 SC 4532
[168]Supra Note 35.

corporate debtor. In contrast, a financial creditor can proceed for CIRP under Section 7 of the Code even if the corporate debtor disputes the debt.

A resolution plan can be intimated by any group of creditors but it has to be approved by the CoC which consists of the financial creditors only. Consequently, the plight of operational creditors is that, the rights vested on the operational creditors are subject to few predicaments, which mainly gives value to the distresses of financial creditors because unlike operational creditors, they enjoy full monopoly over the CIRP.[169] The CoC being a linchpin to CIRP poses as a major drawback for the concerns of operational creditors. CoC which implements the resolution plan does not constitute of operational creditors and *vis-a-vis* the Code[170], the operational creditors have to satisfy the aggregate limit of 10% of the total debt, to merely get the notice of the meeting. Following the same, operational creditor are permitted to remit one representative in the meeting who represents them without even having the right to vote. Despite the size of the claim and receiving the notice of the meeting, the operational creditors do *not* qualify as members of the CoC. On the other hand, a financial creditor is allowed a right to participate in the meeting of CoC[171] as well as right to vote, regardless of the debt owed (even if it is less than 1% of the total debt). Hence the Code restricts an operational creditor to the said threshold of just attending the meeting of CoC.

Every financial creditor is a commercial entity and thus aims at maximum recovery of dues via their debts and consigns the concerns and dues of operational creditor to be of secondary nature (almost extinguished).[172] Section 30 (2) of the Code r/w Regulation 35 &38 (1) of the IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 ensures that at least the *liquidation value*[173] due to operational creditors is received. As referred in *Mourant&*

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[169] Swaroop George, Corporate Insolvency Resolution Process: Are Operational Creditors being given the cold shoulder?, Bar and Bench (2018), available at: **https://barandbench.com/corporate-insolvency-resolution-operational-creditors-cold-shoulder/**

[170] Supra Note 7, the Code at S. 24(3).

[171] Ibid the Code S. 24(7): As per Regulation 24 (7) of the Insolvency Resolution Process for Corporate Persons Regulations, 2016, even the minutes of meetings of the Committee of Creditors need only be sent to the participants of the meeting of the Committee of Creditors.

[172] Supra Note 61.

[173] Regulation 35, Regulation on Insolvency Resolution Process for Corporate Persons Regulations, 2016; It defines liquidation value as the estimated realisable value of the assets of the corporate debtor if the corporate debtor were to

Co Trustees Ltd v. Sixty UK Ltd[174], "*liquidation value is the irreducible minimum below which the revival arrangement cannot go*". It's an irony because though the operational creditors are receiving their share in priority to the financial creditors, the liquidation value is the worst possible value (could be zero or extremely low) and the liquidation is the worst possible case.[175]

Operational creditors are simply bound by the decisions taken by the COC and the plan approved by the National Company Law Tribunal (NCLT), irrespective of their exposure in the company.[176] Once the adjudicating authority approves the resolution plan, then according to section 31 (1) of the Code, the resolution plan shall be binding on the corporate debtor and its employees, members, creditors, guarantors and other stakeholders involved in the resolution plan.

Further Section 31(1) of the Code lays down the binding nature of the resolution plan on members, employees, creditors, corporate debtor and other stakeholders related to the resolution plan. The representative of the operational creditor cannot vote for approval of a resolution plan to even possibly provide the operational creditors a greater amount than the liquidation value. The maximum attempt can be to persuade the financial creditors to vote in favour of the said resolution plan. So the resolution process concludes on an underprivileged, ignored and unheard class of creditors bound by the resolution plan without being paid off their debts. The operational creditors do not have an opportunity to impart their case which further handicaps them, compounded with the fact of their dues being entirely extinguished and rendering them a status that of a third party.

Also the plight of operational creditor is subject to the provision under Section 32 of the Code[177]which grants for an appeal against the approval of resolution plan, but the basis on which appeal can be preferred is limited. The Chennai Bench of Hon'ble NCLT Tribunal in *Forward Shoes India Pvt. Ltd*[178] recently refused the objection of the operational creditor,

be liquidated on the insolvency commencement date.

[174]Mourant& Co Trustees Ltd v. Sixty UK Ltd. (In Administration) [2010] EW HC 1890 (Ch),

[175]Supra Note 35.

[176] Anubhav Pandey, Financial Creditors v. Operational Creditors – Who is better off and Why?, Ipleader (2017), available at: **https://blog.ipleaders.in/financial-creditors-vs-operational-creditors-better-off/**

[177]Supra Note 7, the Code at S. 32: Any appeal from an order approving the resolution plan shall be in the manner and on the grounds lay down in sub-section (3) of section 61.

[178]Brasher Boot Company Ltd v. Forward Shoes India Pvt Ltd, NCLT, Chennai, MANU/NC/0390/2018, [2018] 147 CLA 55.

reasoning it with lack of provision in the Code of any notice to the operational creditors. This might result in very incongruous situations. Hypothetically stating, if the financial creditors owe a recurring debt of 4 crores and the operational creditors owe a debt amounting to 8 crores, the control would still rest in the hands of financial creditors. Despite the majority of debt being owed to the operational creditor, they are bystander at best with no exposure. The resolution plan will be tempted to suit the financial creditors and reduce the repayment of debts owed to operational creditors to the liquidation value.

JURISPRUDENCE

- Constitutional Validity of Insolvency and Bankruptcy Code, 2016

Many have considered the Code to be a path breaking and a necessary piece of law but at the same time it has also been considered as a *draconian legislation*. With such varied opinions regarding the legislation, legal and constitutional challenges were inevitable. The constitutional validity of the Sections 7, 8 and 9 of the Code were challenged at the Calcutta High Court in November, 2017.[179] The petitioners argued that the objective the Code had no nexus with the classification of the creditors. It was contended that placing the financial creditors at a higher pedestal than the operational creditors in the CIRP is violating the constitution as it is unjust and has no underlying intelligible basis for such discrimination.[180] The access of financial creditors in the CoC and their voting rights in the approval of resolution plan were contended to be irrational and discriminatory since the operational creditor have no say in the COC or the resolution plan regardless of their claim.

There's an exponential disparity between the scrutinization of the validity of the claims of the financial creditor and claims of the operational creditor. The former is examined intensely than the latter, while it was prayed that both the classes shall be subject to the same standards of scrutinization. The Hon'ble High Court rejected the contentions of the petitioner and held that the classification of the creditors into financial and operational is done on the basis of

[179]Supra Note 40.

[180]**Gyanendra Kumar**, Constitutionality of the IBC Upheld, March 06 (2018), available at: **https://corporate.cyrilamarchandblogs.com/2018/03/constitutionality-ibc-upheld/.**

reasonable differentia. The principle of equality is not offended if the classification is done on the basis of reasonable differentia. The Court referred to the paragraph no ¶5 of the BLRC report[181]and justified the underlying reasonable differentia in the distinction of the financial and operational creditors. The Court while dismissing the appeal said that the operational creditors are not entirely ousted from the CoC as they have right to appoint their representative in the CoC. It was observed by the Court that the difference in the treatment of the operational and the financial creditors is made to make way for expeditious resolution of an insolvency issue of a company.

- Reforms: Bringing operational creditors at with financial creditors.

On 5th October, 2018 the IBBI (Insolvency Resolution Process for Corporate Persons) (Fourth Amendment) Regulations, 2016 (Amendment Regulations)[182] came into effect. This amendment brought in some hope for the operational creditors to get their rights that were neglected under the Code. The Regulation 38 (1)of the Amended regulations states-

> "*The amount due to the operational creditors under a resolution plan shall be given priority in payment over financial creditors.*"

Before the amendment, the regulation stated that the liquidation value shall be paid to the operational creditors prior to the financial creditors and the corporate debtor has to do so within 30 days from the day the Adjudicating Authority approves the resolution plan.[183] According to it, the liquidation value was given to the operational creditor which is equivalent to maximum reducible value. It did no justice to the debt they were supposed to get back.[184] It further provided that any other payment could be made to the operational creditors but they were neither mandatory nor a priority. The new amendment has removed all the above stated discrepancies. It has brought room for the operational creditors to get their due amount from

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[181]Supra Note 21, ¶ 2.

[182]Insolvency Resolution Process for Corporate Persons, IBBI, 4th Amendment (Regulations), (2016).

[183] **Abhijeet K**. and **Manisha P**., Effect Of The IBBI (Insolvency Resolution Process For Corporate Persons) (Fourth Amendment) Regulations, 2018 On Operational Creditors, October 10, (2018), available at:**http://www.mondaq.com/india/x/744132/Insolvency+Bankruptcy/Effect+Of+The+IBBI+Insolvency+Resolution+Process+For+Corporate+Persons+Fourth+Amendment+Regulations+2018+On+Operational+Creditors.**

[184]Ibid.

the resolution plan, that too before the financial creditors are paid.[185] The interests of the operational creditors are safeguarded by Section 30(2)(b)[186]of the Code which prescribes that the operational creditors shall not be paid any amount below the liquidation value and their interests to the extent of liquidation value are safeguarded.

The amended regulations still puts the operational creditors into a dilemmatic position. Irrespective of the priority allotted to operational creditors *vide* the Regulation, the CoC is consisted of financial creditors only. The amount of debt the operational creditors will be paid from the resolution plan, still remains subject to approval of the financial creditor. The regulation has definitely brought a parity in position of the operational creditor with that of the financial creditor but the CoC has no fiduciary duty to consider and protect all the claims of the operational creditor while approving the resolution plan. There are no specific provision either in the Code or in the Regulation providing for the obligation on the part of the Adjudicating Authorities, to accept or reject the resolution plan if due importance has not been given to the claims of the operational creditors.

- The Binani Cement Saga

In February, 2018, started the Binani Cement saga[187] which brought the discrimination made against the operational creditors into the limelight. Many resolution plans for the Binani Cement were submitted which included the resolution plans of Rajputana Properties Private Limited (herein after referred as 'Rajputana') and UltraTech Cement Limited (herein after referred as 'Ultratech').[188]Rajputana was considered to be the highest bidder and thereafter UltraTech came up with a revised and an improved offer. The CoC refused to consider the offer of UltraTech and accepted the resolution plan of the Rajputana. As a result there were many challenges put forth by various stakeholders at the NCLT that the resolution plan

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[185]Ibid.

[186]Supra Note 7, the Code at S. 32(2)(b): provides for the repayment of the debts of operational creditors in such manner as may be specified by the Board which shall not be less than the amount to be paid to the operational creditors in the event of a liquidation of the corporate debtor under section 53.

[187]Rajputana Properties Private Limited v. Ultratech Cement Limited & Ors., MANU/NL/0284/2018 [2018]147 CLA 320, Civil Appeal Nos. 5789-5790 of 2018.

[188]Pooja S. Mahajan, Implications Of Binani Ruling For IBC, 22 November (2018), available at:**https://www.livelaw.in/implications-of-binani-ruling-for-ibc/**.

discriminated the operational creditors and there was no transparency in the entire process.[189] Consequently, the NCLT rejected the resolution plan of Rajputana and ordered the CoC to consider the revised offer of UltraTech. The matter went before the Hon'ble Appellate Tribunal of NLAT (NCLAT) and further to the Hon'ble Supreme Court, where in the Apex Court directed the NCLAT to resolve the matter expeditiously.[190]

Meanwhile, the revised offer of Ultratech was considered by the CoC and was approved with 100% voting shares. It was submitted to the Adjudicating authority for the approval and the NCLAT observed that the objective of the Code is resolution, maximisation of value of assets, availability of credit and promotion of entrepreneurship.[191] While considering a resolution plan the interests of all the stakeholders and value maximisation should be considered and a balance should be brought. Undue benefit to one stakeholder at the cost of another should be avoided in the strictest way possible. NCLAT held the resolution plan to be discriminatory and opined that the similarly situated operational and financial creditors can't be treated differently.[192] The liquidation waterfall prescribed in Section 53 shouldn't be relied upon while approving the resolution plan. Misreading of the Section 30(2) (b)[193] of the Code can end up the operational creditors merely with the liquidation value and this would discourage them to supply good and services on credit. NCLAT approved the plan of UltraTech as it took care of the balance between the operational and financial creditors and focused on maximization of assets of the corporate debtor.[194]

This judgement shall definitely become a benchmark for operational creditors to secure their interests in upcoming cases of insolvency resolution. Following the trend set by the *Binani Cement* case[195], the interests of the operational creditors are given importance and priority in the case of *SBI v. Bhushan Steel*[196]. Tata steel had offered a 100% recovery of the debts of the operational creditors which was approved by the Adjudicating Authority.[197]

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[189]Ibid.
[190]Ibid.
[191]Ibid.
[192]Ibid.
[193]Supra Note 78.
[194]Supra Note 80.
[195]Supra Note 79.
[196]SBI v. Bhushan Steel, C.P. NP. (IB) 201 (PB)/2017.
[197]Supra Note 35.

COMPARISION OF INDIAN LAW WITH THAT OF UK AND SINGAPORE

India follows a hierarchy when it comes to repayment of debts in an insolvency case and liquidation. In Section 53the hierarchy has been envisaged in which secured creditors are given priority over the unsecured creditors. However in the liquidation waterfall of India secured and unsecured financial creditors are ranked above the unsecured operational creditors. The parity in position of operational creditors and financial creditors has been brought to safeguard the interests of the former and the same has been discussed earlier. The law relating to insolvency and bankruptcy in United Kingdom prescribes a similar arrangement for liquidation waterfall as the Code in India. A major part of the Indian Insolvency and Bankruptcy Code is borrowed from the United Kingdom. An essential dissimilarity between the Indian and the English law is that all the creditors including the operational creditors have the right to become the members of the CoC and have right to vote for the approval of the resolution plan whereas in India only the financial creditors (both secured and unsecured) have the right to become members of the CoC and vote for the approval of the resolution plan.[198]

The insolvency and bankruptcy law in Singapore[199] has provisions for the waterfall which decides the priority of repayment of debts. The arrangement prescribes that the unsecured creditors should be given preference above the secured creditors for repayment of debts. Thus, according to it, the unsecured operational and unsecured financial creditors shall get priority over the secured financial creditors. This arrangement is entirely different from the Indian Legislation; however such a scheme in India might end up with more challenges against it. The uniformity in position is an essential aspect however it has not been entirely achieved in India.

SUGGETIONS

The grievances of the operational creditors are genuine. The Hon'ble NCLT of Kolkata Bench has rightfully observed that dominance of financial creditor is overshadowing the operational

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[198] Interpreting the Code, Corporate Insolvency in India, January (2017), available at: **https://www.ey.com/Publication/vwLUAssets/ey-interpreting-the-insolvency-and-bankruptcy-code/$FILE/ey-interpreting-the-insolvency-and-bankruptcy-code.pdf**

[199] δ. 56(I),BANKRUPTCY ACT,2009, Act No. 15 of 1995 SINGAPORIAN CODE;δ. 56(I): Priority of debts and interest on debts.

creditors whose claims are being overlooked and abandoned. The operational creditors need to gain not only access but access backed with appropriate voting rights in the insolvency process. It is practically not viable to get consensus and accord of all the operational creditors (may be numerous). Thus, it is suggested that representatives are appointed by the operational creditors. The representative shall *firstly* represent operational creditor having a particular percentage of the entire operational debt and *secondly* hold voting rights in proportion with the entire debt (total financial and operational debt). Hypothetically stating, according to the first part of the suggestion, if 15% of the operational debt is owed to operational creditor 'A', 'B' & 'C', then there can be one representative for them. Coupled with other such representatives there can be 5 representatives in total representing the operational creditors of the whole operational debt. According to the second part of the suggestion, the single representative of 'A', 'B' & 'C' shall hold voting rights equivalent to the percentage of the entire financial and operational debt. In case of disagreement on the terms of having a mutual/joint representative, the same can be governed and regulated by Insolvency and Bankruptcy Board of India (hereinafter referred to as **"IBBI")**. IBBI may appoint a person (according to the suggestion stated above) to represent such aggrieved operational creditor and protect their interest. This resolves the problem of operational creditors to the extent that they will get exposure to the insolvency process. Not only will they be able to be aware of the proceedings but also represent, vote and have value. *Arguendo* the voting shares of only the operational creditors shall not be calibrated according to the total debt, both financial and operational. Hence it is further suggested for standardization purposes that the voting rights of the financial creditors too shall be attuned according to the total debt. There is a likelihood that the receiving of the liquidation value as against the fair value will continue to cause severe damages to operational creditors. Immediate steps should to be taken to ensure proper representation and participation of operational creditors to safeguard their interest in CIRP.

It is recommended that Section 53 of the Code which assigns the waterfall neglects to consider few important aspects. The supply of goods and service on exchange of a certain sum is a vital segment of the economy. It is the foundation of the economy of any country. Financial sector is crucial but not at the cost of supply of goods and services, the base sector. Supplier of goods

and services and MSMEs (micro, small and medium enterprises)forms the very *grundnorm* of the base sector.The MSME cannot be made subject to the consequences of a customer's default. The suppliers providing on credit cannot be subject to the fact that in case of a customer's default, the repayment to the suppliers becomes the most uncertain one. MSMEs cannot be told that the entire surplus will goto the banker first, while if a penny remains, the suppliers will be paid off and yet be expected to make the supply. The economy of any country does not run solely on the financial system but on the chain of supply of goods and services. Such supply of goods and services on credit give rise to operational creditors. As a result, working capital is generated for the entity. This is parallel to how financial creditors function. The distribution according to the waterfall is not backed with economic rationale. Among the diversified classes of creditors, a residual entry of the operational creditor is discriminatory. Further on prioritisation and nature of claims, the UNCITRAL Legislative Guide on Law of Insolvency[200] states-

> *"While many creditors will be similarly situated with respect to the kinds of claims they hold based on similar legal or contractual rights, others will have superior claims or hold superior rights. For these reasons, insolvency laws generally rank creditors for the purposes of distribution of the proceeds of the estate in liquidation by reference to their claims, an approach not inconsistent with the objective of equitable treatment."*

There lies a thin line of difference between equal and equitable. Equitability forms the base norm for reparation of any distribution priority.[201]

The resolution plan under the Code has a reflection on being *imposed.* The Code ultimately binds the unheard operational creditors whose rights are unfairly prejudiced due to the resolution plan. The authors suggest prior to the submission and approval of the resolution plan, the same *shall* be notified to all the stakeholders. It would be fair to seek objections, if any. In the case of *Innoventive Industries Ltd. v. ICICI Bank& Anr.*[202]and *Sree Metaliks Limited &*

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[200] UNCITRAL Legislative Guide on Insolvency Law, United Nations Commission on International Trade Law (2004), Official Records of the General Assembly, Fifty-fifth Session, Supplement No. 17 (A/55/17), ¶ 400-409.

[201]Vinod Kothari and Sikha Bansal, Subordination of Operational Creditors under IBC: Whether Equitable?, Vinod Kothari Consultants, July (2018), available at:**http://vinodkothari.com/2018/07/subordination-of-operational-creditors-under-ibc-whether-equitable/**

[202]AIR 2017 SC 4084, Company Appeal (AT) (Insolvency) No. 1 & 2 of 2017.

Anr. v. Union of India[203] NCLAT and High Court of Calcutta have respectively held that,-

> *"proceedings before NCLT are adversarial in nature and such proceedings have drastic consequences, hence, person(s) cannot be condemned unheard.."*

Further, the opposing creditors could also be given a reasonable opportunity[204] to set out their reasons to object. Also the creditors being adversely affected from the resolution plan *shall* be heard.

CONCLUSION

The Code is a docket explosion and the same is here to stay. But its only a matter of time when the legislation will be attacked with complicated questions regarding the plight of the operational creditors. Bhushan case is just the beginning. However Sanjay Singal, the promoter in the Bhushan Power and Steel Co. has correctly said in his petition that, "The Code is an imbalanced economic provision that is metamorphosing into a takeover or liquidation code instead of its objective of being a financial resolution code." Clearly a generality presides over the BLRC report that the operational creditors are not interested in restoration of the company but favour liquidation. Does the Code foster resolution over liquidation? Even if the framework of the Code is still a mystery, why are only the operational creditors being oppressed? They are neither being benefitted from the resolution process nor the liquidation process. The classification of creditors prescribed in the foremost and basic part of the Code, suddenly disappears by the time the resolution plan is approved. A resolution plan endorsed by a certain class when sanctioned binds all (regardless of class). The financial creditors cannot be the deciding force in the CIRP, the interest of other stakeholder cannot be sacrificed and the equals cannot be treated unequally.

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[203] (2017) 4 CompLJ 193 (SC), W.P. 7144 (W) of 2017.

[204] Supra Note 7, the Code at S. 424(1): "The Tribunal and the Appellate Tribunal shall not, while disposing of any proceeding before it or, as the case may be, an appeal before it, be bound by the procedure laid down in the Code of Civil Procedure, 1908, but shall be guided by the principles of natural justice, and, subject to the other provisions of this Act and of any rules made thereunder, the Tribunal and the Appellate Tribunal shall have power to regulate their own procedure."

5. IS SARFAESI ACT BOWLED OVER BY I&B CODE, 2016?- A CRITICAL ANALYSIS OF THE IMPACT OF INSOLVENCY AND BANKRUPTCY CODE, 2016 ON THE PROCEEDINGS UNDER SARFAESI ACT, 2002*

Abstract

The Insolvency and Bankruptcy Code is a remarkable piece of legislation which was much awaited and needed. However, the Code has caused a lot of stir not only in the existing laws but also on the rights of various persons. The rights of secured creditors which were granted to them under the SARFAESI Act, 2002 are now overshadowed by the Code. The non-obstante clause in the Code grants supremacy to the Code in case of any conflict with any existing laws. The author, vide this research paper, attempts to understand and analyse the effect of the Code on SARFAESI Act. The beginning of the paper, deals with the supremacy of the Code over SARFAESI Act which is supported by the Judgements of the Hon'ble Supreme Court. Thereafter, the second chapter highlights the effects of moratorium period and various stages of the corporate insolvency resolution process on the proceedings under the SARFAESI Act. The author then analyses whether the moratorium period is applicable to the personal guarantors of the corporate debtor. The fourth chapter deals with the effect of moratorium period on the sale decree under the SARFAESI proceedings. While the fifth chapter highlights the effects of the Code over the proceedings initiated against individuals and firms under the SARFAESI Act, the sixth chapter deals with the impacts of the Code on the other aspects of the SARFAES Act. The author concludes by stating that the Code is a welcome step even when there are such repercussions on the rights of the secured creditors under the SARFAESI Act.

Keywords: Corporate Debtor, Secured Creditor, security interest, moratorium, Corporate Insolvency Resolution Process

INTRODUCTION

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest ("SARFAESI") Act, 2002 came as a ray of hope in the year 2002 for the banks and the financial institutions who were deeply buried under the stress of non-performing assets

and bad debts. The Non-Performing assets ("NPAs") and the bad debts were on a rise and the burden of the same was on the economy. SARFAESI came as a relief as it permitted the banks and the financial institutions of India to enforce the security mortgaged with them without the intervention of court so as to ensure speedy recovery of the loan amount. The SARFAESI Act, 2002 was introduced with the purpose of allowing the financial institutions and banks to assess the asset quality in different ways. In other words, the Act facilitated multiple mechanisms to identify the NPAs and rectify the problem of NPAs.[205] The Act was introduced when the problem of the non-performing assets was at its peak and the banking and financial institutions had to face the heat of the same.

The SARFAESI Act envisages, in great detail, the formation and other aspects of Asset Securitization Companies and Reconstruction Companies.[206] Although it is the Reserve Bank of India ("RBI") that regulates these institutions, the SARFAESI Act lays down the rules with respect to capital requirements, funding and other activities of the Reconstruction Companies.

As per the several provisions under the Act, the financial institutions and banks possess rights and powers to handle different categories of bad asset in different manner. The prime objectives of the SARFAESI Act are as follows[207]:

- The Act lays down the process for NPAs transfer to the asset reconstruction companies.
- The Act confers powers to the financial institutions and banks to take possession/ custody of the immovable properties, which are charged or mortgaged as security for the purpose of recovery of loan.
- The Act envisages provisions for enforcement of security interest without any intervention from the court.

[205]Tojo Jose, What is SARFAESI Act 2002? INDIAN ECONOMY.NET, Jul 14, 2017, available at https://www.indianeconomy.net/splclassroom/what-is-sarfaesi-act-2002/.

[206]What is SARFAESI Act, TAXMAN, available at **https://www.taxmann.com/blogpost/2000000381/what-is-sarfaesi-act.aspx** (last updated on May 04, 2018).

[207]Padmanabhan Iyer, India: The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002-An Overview of the Provisions, MONDAQ, available at **http://www.mondaq.com/india/x/22031/securitization+structured+finance/The+Securitisation+and+Reconstruction+of+Financial+Assets+and+Enforcement+of+Security+Interest+Act+2002+An+Overview+of+the+Provisions**. (last updated on July 23, 2003).

SARFAESI Act which was passed in the year 2002 was one of the Acts under the Insolvency Laws at that time. In the year 2002 when the SARFAESI Act was passed, there was no separate Act/ Code for Insolvency Proceedings in the country.

There were several acts under the insolvency laws[208]. Some of them are:

- The Presidency Towns Insolvency Act, 1909
- The Provincial Insolvency Act, 1920
- The Sick Industrial Companies (Special Provisions) Act, 1985
- Recovery of Debts and Bankruptcy Act 1993
- The Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002
- The Payment and Settlement Systems Act, 2007
- The Companies Act, 2013

All these acts had provisions pertaining to the Insolvency and bankruptcy under various circumstances and were applicable to companies, corporates, individuals, partnership firms etc. Multiple Acts not only caused inconvenience to the parties involved but often led to multiplicity of proceedings and caused lot of unwarranted grievance to the parties and sometimes even assisted the parties in evading the proceedings. On account of all these, it became imperative to bring all the insolvency laws under one umbrella and the need for a unified legislation was felt by the government[209].

As time passed, a need for a unified code of insolvency and bankruptcy proceedings was felt and in pursuance of the same, the Insolvency and Bankruptcy Code 2016 was introduced. The Insolvency and Bankruptcy Code, 2016 ("Code") is conceived as a ground breaking legislation which consolidates several laws dealing with insolvency of corporate persons, partnership firms and individuals, in a time bound manner.[210] The primary objective of the Code is also to ensure the that maximum value of the assets is realised, to encourage

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[208] Kunal Tandon, Effect of Insolvency And Bankruptcy Code, 2016 On SARFAESI ACT, DRT ACT, LEGAL ERA, June 07,2017 available at http://www.legaleraonline.com/articles/effect-of-insolvency-and-bankruptcy-code-2016-on-sarfaesi-act-drt-act.

[209] Gayatri Athare Mohapatra, Summarising the Insolvency and Bankruptcy Code, 2016, INDIA LAW, Aug 02, 2016 available at http://www.indialaw.in/blog/blog/commercialcorporate/summarising-insolvency-bankruptcy-code-2016/.

[210] Archan Shah, Objective of insolvency law: Resolution over liquidation? BUSINESS TODAY, available at https://www.businesstoday.in/opinion/objective-of-insolvency-and-bankruptcy-law-ibc-resolution-liquidation/story/266337.html (last updated on Dec 19,2017).

entrepreneurship, to attempt revival of company and balance the interest of all the stakeholders.[211] The Legislative intent was to better the process of conducting business and to facilitate and attempt to bring in more investments and funds, leading to a advanced economic growth and development.[212] The Code is based on the Bankruptcy Reforms Act, 1978[213], adopted by the US and the Insolvency Act of 1986[214] applicable in the United Kingdom. The Code is a one stop destination for resolving insolvencies by initiating insolvency resolution process in a time bound manner which earlier was a lengthy and tedious process and does not propose an economically viable and feasible arrangement[215]. A resilient insolvency framework where the expenses and the time incurred is minimalised in attaining liquidation has been long needed in India. The code is in a position to safeguard the interests of small investors thereby making the process of doing business less cumbersome for the small investors and businessmen.

However, the Code has caused repugnancy with several existing laws. Proceedings under various acts are stayed and rendered fruitless after the introduction of the Insolvency and Bankruptcy Code and this has caused tremendous amount of grievance to the persons who have filed suits under such other insolvency laws[216]. Vide the present research paper, the author attempts to analyse the effects of the Insolvency and Bankruptcy Code on the SARFAESI Act and the proceedings filed under the SARFAESI Act.

LEGAL ANALYSIS

CHAPTER I:

OVERIDING EFFECT OF IBC ON SARFAESI

At the time of drafting of the Insolvency and Bankruptcy Bill, the makers were well aware that the Insolvency and Bankruptcy Code would cause repugnancy with several existing Acts which were also dealing with Insolvency. In order to reduce the complications arising out of

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[211] S.S. Rana & Co. Advocates, India: Effective Enforcement of The Insolvency and Bankruptcy Code, 2016, MONDAQ, available at http://www.mondaq.com/india/x/634914/Insolvency+Bankruptcy/Effective+Enforcement+Of+The+Insolvency+And+Bankruptcy+Code+2016 (last updated on Oct 5, 2017).

[212] Anupam Lal Das, The Insolvency and Bankruptcy Code: Some Fundamentals and Issues, LIVE LAW, Mar 26, 2018, available at https://www.livelaw.in/insolvency-bankruptcy-code-fundamentals-issues/.

[213] The Bankruptcy Reform Act of 1978 (Pub.L. 95–598, 92 Stat. 2549, November 6, 1978) is a United States Act of Congress regulating bankruptcy.

[214] The Insolvency Act 1986 is an Act of the Parliament of the United Kingdom that provides the legal platform for all matters relating to personal and corporate insolvency in the UK.

[215] Supra note 6.

[216] Supra note 4.

the inconsistencies among various insolvency laws, the legislators have already incorporated the overriding clause in the Code[217]. Section 238 of the Code, expressly and unequivocally envisages that the provisions of this code will be applicable notwithstanding anything inconsistent contained in any other law[218]". This section alone establishes the supremacy of the Code over all the existing and prevailing laws pertaining to insolvency and bankruptcy[219].

For the purpose of granting further clarity, the Code through the sections 243 to 255 envisages the amendments that would be caused to all the other insolvency Acts so as to reduce the complications and maintain uniformity. Particularly section 251 read with Schedule 7 lays down the amendments that the Insolvency and Bankruptcy Code will bring about in the SARFAESI Act[220]. The Schedule 7 lays down that "*in sec. 13 (9), for the words 'In the case of', the words and figures 'Subject to the provisions of the Insolvency and Bankruptcy Code, 2016, in the case of' shall be substituted"*.

Any doubts with regards to the supremacy of the Code over other legislations were cleared by various judgements by which the Supreme Court and the National Company Law Tribunal held that in case of any discrepancies or inconsistencies, it is the provision of Code that would have the final say[221]. One of the earliest and landmark cases in deciding the supremacy of the code is the case of **M/s. Innoventive Industries Limited v. ICICI Bank & Anr**[222]**.** This case has laid the foundation of supremacy and the ratio held by the SC in this case has been a guiding path for NCLT to decide various cases[223]. The facts of the said case are as follows:

> *The Appellant (Innoventive Industries Limited), a multi-product company began to suffer losses, and was unable to repay financial assistance availed by it from 19 banks. Therefore, corporate debt restructuring was proposed by the Appellant and a Master Restructuring Agreement (MRA) was executed. Under the MRA, funds were to be injected by the creditors (banks), and certain obligations were cast on the Appellant. As things stood thus, the Respondent (ICICI Bank) made an application for initiating CIRP before NCLT, Mumbai. The Appellant heavily relied on the Maharashtra Relief Undertakings (Special Provisions Act),*

[217]Supplementary: Impact of Insolvency and Bankruptcy Code 2016 On the Companies Act, 2013 available at http://icmai.in/upload/Students/Supplementary/Impact-IBC.pdf.

[218]Divesh Goyal, Overriding Effect of IBC Code on other Acts, TAX GURU, Jun 26, 2017, available at https://taxguru.in/corporate-law/riding-effect-ibc-code-acts.html.

[219]Shivi Gupta, Overriding effect of IBC, 2016, MYADVO, July 25, 2018, available at https://www.myadvo.in/blog/overriding-effect-of-ibc-2016/.

[220]Dhir & Dhir Associates Advocates & Solicitors, "Insolvency and Bankruptcy Code (IBC) and other Corporate Laws, available at https://www.icsi.edu/media/portals/2/ppt/Varsha-IBC-230317.pdf.

[221]Supra note 10.

[222](2018) 1 SCC 407.

[223]Supra note 15.

1958 (Maharashtra Act), which was enacted to provide financial assistance by the State Government, for certain industrial undertakings to prevent unemployment. It was contented by the Appellant that there was no debt legally due since as per the Maharashtra Act, for 2 years, all liabilities of the Appellant and remedies for enforcement thereof, were temporarily suspended, via declaration of moratorium, as a result of which, all proceedings relating thereto, pending before any Court, Tribunal, Officers or Authorities against the Appellant shall be stayed. The Appellant also contended that the non-obstante clause provided under the Maharashtra Act is to prevent unemployment in the industry, which prevails over the provisions of IBC, while the non-obstante clause mentioned in Section 238 of IBC is to realise credit facilities availed by debtors, making it clear that the former is more of a worthy cause, which shall therefore not be affected by the invocation of Section 238 of IBC. On the other hand, the Respondent contended that the Appellant had defaulted in making payments to it, there was an enforceable 'debt' owed by the Appellant which the MRA did not 'suspend'. Therefore, CIRP under IBC must be initiated against the Appellant. The Respondent also contended that under Section 7 of IBC, the adjudicating authority is required to determine whether 'default' has occurred or not, and accordingly admit an application under the said provision of IBC.

After two hearings before the NCLT, the Appellant moved an application and took a different plea to the effect that, since funds were not released as per the MRA, the Appellant was unable to satisfy payment of its debts, thereby no 'default' had actually been committed by it (earlier the Appellant had taken a plea that the Maharashtra Act overrides IBC)[224].

NCLT admitted the corporate insolvency petition against the Appellant concluding that the Appellant had indeed defaulted in making requisite payments to its creditors, consequently declaring a moratorium under Section 14 of IBC. NCLT also held that IBC shall prevail over the Maharashtra Act, since (i) the former is a parliamentary statute and (ii) the non-obstante clause mentioned in Section 238 of the IBC stipulates that IBC shall continue to operate even if its provisions are inconsistent with any other law in existence. NCLT also dismissed the subsequent application filed by the Appellant since it was filed belatedly and after completion of two hearings, wherein the Appellant had already been given an opportunity to be heard[225].

The Appellant then challenged the said order, before the NCLAT, which affirmed the NCLT order. However, it was held by NCLAT that although the Maharashtra Act is not repugnant to IBC, since the Maharashtra Act and the IBC operate in two completely dissimilar fields, the

[224](2018) 1 SCC 407.

[225]Pooja Mahajan, Finally, Supreme Court on IBC – Innoventive v. ICICI, BAR & BENCH, Sep 02, 2017 available at https://barandbench.com/supreme-court-ibc-innoventive-vs-icici/.

Appellant is not entitled to derive any advantage under the Maharashtra Act in order to delay insolvency proceedings under IBC. Furthermore, in relation to the MRA, it was held that the Appellant had 'defaulted' in paying its debts due to the financial creditor, therefore, the MRA could not be used to stave off initiation of CIRP[226].

Dissatisfied with the NCLAT order, the Appellant moved the Hon'ble Supreme Court. After heating both the sides, the Hon'ble Supreme Court while dismissing the appeal, inter alia observed that, the view taken by the NCLT was correct, whereas the NCLAT failed to appreciate the existence of repugnancy between the provisions of the Code and the MRU Act. SC further held that the non-obstante clause under the Code would prevail over the non-obstante clause provided under the MRU Act, as the MRU Act is proven to be repugnant to the Code by virtue of article 254(1) of the Constitution of India (Constitution).[227] *In addition to the above, the SC also delivered a detailed judgment for all the courts and tribunals to take notice of the paradigm shift in law, by analysing relevant provisions of the Code dealing with CIRP.*

The ratio of **M/s. Innoventive Industries Limited (supra)** was the basis and the ground stone for several other cases to come[228]. In the case of **Canara Bank v. M/s. Sri Chandramoulishvar Spinning Mills Pvt. Ltd. & Anr.**, the National Company Law Tribunal, Delhi relying upon the judgement of the Hon'ble SC in **Innoventive Industries Ltd. (supra)** held that although the appellant is aggrieved because it has already initiated action under SARFAESI Act, 2002, such action would not continue as the I&B Code will prevail over SARFAESI Act[229]. When the said order of NCLT was challenged in NCLAT, NCLAT once again referred to Supreme Court's verdict in **Innoventive Industries Ltd. (supra)** and ruled that when two proceedings are initiated, one under the Code and the other under the SARFAESI Act, 2002, then the proceeding under the I&B code shall prevail.

Thus, the Supreme Court, NCLAT and NCLT, while interpreting the intent of the legislators and complying with the mandate of sec 238 of the Code, upheld the supremacy of the Code.

CHAPTER II:

EFFECTS OF MORATORIUM PERIOD ON PROCEEDINGS UNDER THE SARFAESI ACT, 2002.

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[226]Supra note 20.

[227]L. Viswanathan & Indranil Deshmukh, Innoventive Industries Limited v. ICICI Bank Limited: Paradigm Shift in Insolvency Law in India, INDIA CORPORATE LAW, Sept 1 2017, available at https://corporate.cyrilamarchandblogs.com/2017/09/innoventive-industries-limited-v-icici-bank-limited-paradigm-shift-insolvency-law-india/.

[228]Raghav Pandey, Innoventive v. ICICI Bank: Supreme Court settles the law; Centre's Insolvency Code will hold sway over all conflicting Acts, FIRSTPOST, Sep 05, 2017, available at https://www.firstpost.com/business/innoventive-vs-icici-bank-supreme-court-settles-the-law-centres-insolvency-code-will-hold-sway-over-all-conflicting-acts-4009427.html.

[229]Company Appeal (AT) (Insolvency) No. 429 of 2018.

SARFAESI Act allows the banks and financial institutes to take possession of the property of the NPA that has been secured with them. The said power has been granted to the financial institutions u/s. 13 of the Act.[230] The financial Institutions do not have to go through the whole ordeal of the trial. After issuance of Demand Notice under this Act and upon the expiry of the notice period of 60 days, the financial institutions can obtain the symbolic possession of the property u/s. 13 (4) [231]and thereafter, the banks and the financial institutions can approach the Magistrate and seek an order from the magistrate to take possession of the mortgaged property u/s. 14 of this Act, takeover the management of the business of the borrower u/s. 15 of the Act, the banks and the financial institutions can even procure an order for auctioning the security interest. Apart from these reliefs, there are various other reliefs that are provided to the banks and the financial institutions under the Act.

It is pertinent note that where the SARFAESI Act was introduced with a purpose of providing relief to the bankers and financial institutions, the Code was introduced with a different intent altogether. Therefore, the provisions of the code though provide relief to the creditors, there are several safeguards in the act for providing breathing space for the companies and the small enterprises. There are several provisions which tilt towards the corporate debtors. The biggest example of the same is the introduction of moratorium period which was not existent in the earlier acts. Moratorium period under the Code means a period during which no judicial proceedings for recovery of any kind, foreclosure or enforcement of any security interest, sale, transfer, encumbrance, alienation or conveyance of any asset, or termination of material and essential contracts can be instituted or continued against the corporate debtor including arbitration proceedings or proceedings before any other authority or tribunal[232]. In other words, all the proceedings against the corporate debtor are stayed. This of course is not applicable to the criminal proceedings. In fact, the corporate debtor is also not allowed to sell or alienate any of his property[233].

The purpose of moratorium period is to give some calm period to the corporate debtor so that it can have a chance to revive the company from the losses and reconstruct the company. Revival of the company would be in the best interest of all the stakeholders and that is the essentially why moratorium is a necessary must. The Hon'ble SC in **Innoventive Industries**

[230]Section 13 of SARFARESI Act, 2002.
[231]Section 13 (4) of SARFARESI Act, 2002.
[232]Sharad Tyagi and Saloni Sharma, India: IBC Diluting the Rights of The Secured Creditors, MONDAQ, available at http://www.mondaq.com/india/x/589098/Insolvency+Bankruptcy/IBC+Diluting+The+Rights+Of+The+Secured+Creditors (last updated on Apr 26, 2017).
[233]Supra note 10.

Ltd. (supra)[234] had observed that the intention behind the levying moratorium was that the debtors would have some breathing spell in which they could reorganize their business.

Section 14 of the Code deals with the moratorium period. As per IBC, a petition for Insolvency against the Corporate Debtor can be triggered by any Creditor, Operational or financial (in cases where the default amount is more than Rs. 1 lakh) or by Corporate Debtor itself. Once the petition under the Code is admitted by NCLT, moratorium period commences. The moratorium period under the code on the Insolvency Commencement date and shall remain in force during the whole Corporate Insolvency Resolution Process ("CIRP") period and for such period no proceedings, judicial or otherwise, for recovery, enforcement of security mortgaged, sale or transfer or conveyance of assets, or termination of material or essential contracts can take place against the Corporate Debtor[235]. The maximum period for moratorium is 180 days and it can be extended to 270 days after obtaining approval from the adjudicating authority.

After the introduction of the act there was some debate whether the moratorium period was mandatory or discretionary. This debate was finally concluded when the Supreme Court, while interpreting the language of Section 14 of the Code, held that the word "shall" in the section implies that the moratorium period is mandatory and that it will commence from the time the petition is admitted.

Section 14 (1) (c) of the IBC lays down prohibition on any action to foreclose, attach, sell, recover or enforce any security interest, created by the corporate debtor in respect of its property including any action under the SARFAESI Act during the moratorium period[236]. The Code specifically and expressly lays down that all the proceedings under the SARFAESI Act would be stayed once the petition is admitted and the moratorium period commences.

The moratorium period ends either when the CIRP process is approved by the committee of creditors or when the period of 180 days or 270 days (as the case may be) ends and then the dissolution proceedings are initiated against the corporate debtor. In other words, once the moratorium process ends, the entity shall either be under the resolution process or the entity shall be wound up[237]. In case of the CIRP process is approved then the eligibility of the lender to exercise SARFAESI powers would depend on what agreement/ arrangement has been

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[234] Supra note 19.

[235] Supra note 28.

[236] MR Umarji, How bankruptcy code treats secured creditors, THE ECONOMIC TIMES BLOGS, July 13, 2016, available at https://economictimes.indiatimes.com/blogs/et-commentary/how-bankruptcy-code-treats-secured-creditors/.

[237] Kunal Tandon, Effect of Insolvency and Bankruptcy Code, 2016 On SARFAESI ACT, DRT ACT, LEGAL ERA, June 07,2017 available at http://www.legaleraonline.com/articles/effect-of-insolvency-and-bankruptcy-code-2016-on-sarfaesi-act-drt-act.

entered into vide the resolution plan. Upon a liquidation order being passed, the moratorium will be deemed to be lifted but all the assets of the corporate debtor would be transferred into the possession and custody of the insolvency resolution professional and the winding up process would be initiated which would render the proceedings under SARFAESI useless[238]. The stages of filing insolvency resolution process and its impact on the proceedings under SARFAESI are enumerated below[239]:

1.**Application/ Petition for insolvency resolution process is filed but not admitted:** Application for commencement of resolution process can be filed by any Creditor (financial or operational) where claim value is more than Rs. 1 Lakh, or by Corporate Debtor ("CD"). There will be no stay on SARFAESI proceedings at the time of application.

2.**Admission of resolution application:** Within 14 days of filing an application, Adjudicating Authority (NCLT) will decide on the admission of the application. On admission of application, the NCLT will pass an order appointing the proposed IP as IRP, declare a moratorium (Section 14)- all suits, decrees, arbitration matters covered, stay on transferring, alienating, encumbering assets and make public announcement for commencement of resolution process and submission of claims. There will be stay on SARFAESI proceedings as soon as the suit is admitted.

3. **If Adjudicating Authority approves the resolution plan:** Where the resolution plan is approved by more than 66% (earlier it was 75%) votes by Committee of Creditors ("CoC") and the same is in accordance with the provisions of law, the NCLT, vide its order would approve the plan which will be binding on all the stakeholders including the corporate debtor, Guarantors, employees, creditors, shareholders, etc. Pursuant to NCLT passing the order approving the resolution plan, the parties need to act as per the resolution plan and terms and conditions specified therein and the proceedings under the SARFAESI Act would be rendered useless.

4.**Commencement of liquidation proceedings:** The NCLT will pass a liquidation order in the following circumstances:

a. In case no resolution plan is received within the stipulated time of 180/270[240] days.

b. NCLT rejects the Resolution Plan which is approved by the CoC vide 66% or more votes.

c. If Resolution Professional intimates NCLT that CoC with a vote of more than 66% has decided to liquidate the corporate debtor.

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[238]RP Vats & Yashika Sarvaria, Moratorium Under the Insolvency and Bankruptcy Code, VGC LAW FIRM, available at http://vgclawfirm.com/Image/PDF/636541321780909380.pdf.

[239]Supra note 33.

[240]Time specified under the code is 180 days but extension of 90 days is granted by the adjudicating authority.

d. When the Resolution Plan approved by the NCLT has been contravened by corporate debtor or any person other than the corporate debtor (i.e. scheme has failed).

Implication of liquidation order[241]:

- the Resolution Professional would act as the liquidator.

- No suit or other legal proceedings will be initiated by or against the CD, provided that liquidator can, with prior permission of NCLT, institute a suit or legal proceeding.

Options available to Secured creditor in liquidation proceedings

The secured creditor has the following options at his disposal once the liquidation proceedings commences[242]:

- [section 52(1)(a)] to relinquish its security interest to the liquidation estate and receive proceeds from the sale of assets as per section 53
- Realize its security interest in the following manner:

a. Intimate the liquidator of its right over the mortgaged asset/ security interest and identify assets subject to such security interest.

b. Liquidator would then verify the security interest and after being satisfied with the legitimacy of the same, allow and permit the secured creditor to realize such security interest, which would be duly recorded in the information utility or such other means as specified by the board.

c. Secured creditor can, in accordance with law, enforce, settle, compromise or deal with secured assets (including SARFAESI or execution proceedings in DRT etc.). In case secured creditor faces restraint from CD or any person connected therewith at the time of taking possession of the asset, selling or disposing off assets, the creditor can approach NCLT for directions to facilitate the enforcement/sale etc.

d. Amount of Insolvency Resolution cost due from the secured creditor to be deduced from sale proceeds generated from sale of secured assets.

e. Where money recovered in excess of dues, the secured creditor shall give a detailed account of the same to liquidator and tender to liquidator the excess funds.

f. Where money received is less than the outstanding liability towards the secured creditor, the secured creditor to approach liquidator for balance amount and in that case, he would stand last in to receive the funds from the liquidation estate.

All these clearly establish that after the initiation of the liquidation process, the proceedings

[241] Supra note 34.

[242] Uday Khare, Liquidation under the IBC – Order of priority signals shift in economic rationale, MY LAW BLOG, available at http://blog.mylaw.net/liquidation-ibc-order-priority-signals-shift-economic-rationale/.

under the SARFAESI Act become absolutely pointless[243]. In light of the above, it can be safely construed that once the petition is admitted, the proceedings under the SARFAESI Act against the corporate debtor become moot and it has been observed that this is misused a lot. [244]

CHAPTER III:

APPLICABILITY OF MORATORIUM PERIOD TO SUITS FILED UNDER SARFAESI ACT AGAINST PERSONAL GUARANTORS.

Guarantee Agreements are a commercial practice that is prevalent in the society since ages. Guarantee means that the creditor/lender can claim the dues/liability from the guarantor in case the debtor/borrower defaults in making the payment[245]. A Guarantee Agreement is a separate agreement entered into between the guarantor and the lender/creditor. The lender can invoke the guarantee given by the personal guarantor and claim the dues from the guarantor. The underlying understanding is that the lender would have independent legal remedies against the guarantor meaning that the lender can sue the guarantor without suing the debtor/borrower.

The general practice is that the promoters or the directors of the entities usually give personal guarantees for the entities with a view to avail any credit or financial assistance for the working of the company. The personal guarantee provided by the promoters and/or the directors may or may not be secured by their personal assets. In case when the company defaults then in that case, suits can be filed against the promoters/ the directors for realisation of their assets or for payment of the accrued liability[246].

It is pertinent to note that under the Companies Act, there was no scope of any moratorium period. As soon as there was a default committed by the company, the creditor/ lender was free to initiate legal action against the personal guarantor and simultaneously file proceedings against the debtor company under SARFAESI or even winding up proceedings[247]. However,

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[243] Supra note 33.

[244] Saloni Shukla, Borrowers hit by SARFAESI may hide behind IBC laws, ECONOMIC TIMES MARKETS, Jun 28, 2017, available at https://economictimes.indiatimes.com/markets/stocks/news/borrowers-hit-by-sarfaesi-may-hide-behind-ibc-laws/articleshow/59346674.cms.

[245] Aishwariya Mishra and Rahul Pandey, India: Applicability of Moratorium To Personal Guarantors Of The Corporate Debtor Under Section 14 Of Insolvency And Bankruptcy Code, 2016, MONDAQ, available at http://www.mondaq.com/india/x/702166/Insolvency+Bankruptcy/Applicability+Of+Moratorium+To+Personal+Guarantors+Of+The+Corporate+Debtor+Under+Section+14+Of+Insolvency+And+Bankruptcy+Code+2016 (last updated on May 17, 2018).

[246] Rajendra Beniwal, Creditors Can Move Against Personal Guarantor of Corporate Debtor Under IBC-NCLAT, INDIA LAW, Apr. 23, 2018, available at http://www.indialaw.in/blog/blog/no-moratorium-initiation-resolution-process-personal-guarantor/.

[247] Samanwaya Rautray, No moratorium for personal guarantors: Supreme Court, THE ECONOMIC TIMES, available at https://economictimes.indiatimes.com/news/politics-and-nation/no-moratorium-for-personal-guarantors-supreme-court/articleshow/65408751.cms (last updated on Aug 15, 2018).

with the introduction of the Code, the scheme of moratorium was also introduced. The moratorium period was a sigh of relief for the corporate debtors.

However, the personal guarantors thought of it as their own victory. They were under the impression that they also would get protection under the Code. Therefore, they tried to take the advantage of the same. Whenever, there was multiplicity of proceedings against the personal guarantor on account defaults by the corporate debtor and any of the creditors had filed a petition under IBC against the corporate debtor, they would file application with the NCLT thereby praying that NCLT should pass an order stating that the moratorium period would be applicable to the personal guarantors as well. Whereas on the other hand, the creditors claimed that the moratorium period was only against the corporate debtor and not against the personal guarantors. This stirred up a debate. This controversy was brought up in NCLT, NCLAT and various High Courts of the country. It is interesting to see that different High Courts had contradicting views. In the case of **Sicom Investments and Finance Ltd. v. Rajesh Kumar Drolia**[248]**,** the Hon'ble Bombay High Court resorted to strict interpretation of Section 14 and held that the suit against the personal guarantor cannot be stayed merely on account of a moratorium order,[249].

However, in the case of **Sanjeev Shriya v. State Bank of India,** the Hon'ble Allahabad High Court acted in a very liberal manner and chose to take a broad and wide view of Section 14 and held that the moratorium order once passed would also be applicable against the personal guarantors[250].

In light of the above contradicting views, the said issue of applicability of moratorium period on personal guarantors went before the Hon'ble Supreme Court in the case of **State Bank of India v. V Ramakrishnan**[251]**.**

> In this case, *V. Ramakrishnan (Respondent No. 1) was the Managing Director of the corporate debtor (Respondent No.2) and also the personal guarantor for credit facilities that had been availed from the State Bank of India (Appellant) vide the Guarantee Agreement entered into between the State Bank of India and the v. Ramakrishnan. As the Respondent No.2 Company did not pay its debts in time, the account of Respondent No.2 was classified as a non-performing asset on 26.07.2015. Consequent thereto, the Appellant issued a notice dated 04.08.2015 under Section 13(2) of the SARFAESI Act thereby demanding an*

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[248](2017) SCC Online Bom 9725.

[249]Deepak Joshi, Moratorium, Personal Guarantees and the attempted Flight of the Phoenix - Section 14, IBC, BAR & BENCH, Aug. 23, 2018, available at https://barandbench.com/moratorium-personal-guarantees-and-the-attempted-flight-of-phoenix-section-14-ibc/.

[250]2017 (9) ADJ 723 and (2018) 2 All LJ 769.

[251]AIR 2018 SC 3876.

outstanding amount of Rs.61,13,28,785.48 from the Respondents within the statutory period of 60 days. As no payment was forthcoming, a possession notice under Section 13(4) of the SARFAESI Act was issued on 18.11.2016.

Thereafter, an application was filed by Respondent No.2, the corporate debtor, under Section 10 of the Code on 20.05.2017 to initiate the corporate insolvency resolution process against itself. On 19.06.2017, the petition filed under Section 10 was admitted, followed by the moratorium that is imposed statutorily by Section 14 of the Code. While the said proceedings were pending, an interim application was filed by Respondent No.1 as personal guarantor to the corporate debtor, in which Respondent No.1 took up the plea that Section 14 of the Code would apply to the personal guarantor as well, as a result of which proceedings against the personal guarantor and his property would have to be stayed.

The National Company Law Tribunal held that since under Section 31 of the Code, a Resolution Plan made thereunder would bind the personal guarantor as well, and since, after the creditor is proceeded against, the guarantor stands in the shoes of the creditor, Section 14 would apply in favour of the personal guarantor as well. The interim application filed by Respondent No.1 was thus allowed, and the Appellant was restrained from moving against Respondent No.1.

The Appellant then filed an appeal with the NCLAT. The Appellate Tribunal relied upon Section 60(2) and (3) of the Code as well as Section 31 of the Code to find that the moratorium imposed under Section 14 would apply also to the personal guarantor. The reasoning was that since the personal guarantor can also be proceeded against, and forms part of a Resolution Plan which is binding on him, he is very much part of the insolvency process against the corporate debtor, and that, therefore, the moratorium imposed under Section 14 should apply to the personal guarantor as well.

Thereafter, the matter went before the Hon'ble Supreme Court. The question before the court was that whether Section 14 of IBC which lays down the provisions of moratorium, apply to a personal guarantor of a corporate debtor.

Supreme Court vide its well-reasoned order held that "under sections 96 and 101 protection is granted to Individuals and partnership firms and the personal guarantors of the individuals and firms by way of moratorium. This protection is specifically and expressly provided under the Code. Whereas, under section 14 which deals with insolvency of corporate debtors, no specific and express provision has been made to include the personal guarantors. There is a reason for the difference in language between Sections 14 and 101. Section 14 refers only to debts due by corporate debtors, who are limited liability companies. In majority of these cases,

personal guarantees are given by Directors or promoters who are in control of the management of the companies. The object of the Code is not to allow such guarantors to escape from an independent and coextensive liability to pay off the entire outstanding debt, which is why Section 14 is not applied to them. However, in case of individuals and firms, the scenario is different as often the guarantors could be a personal friend or a stranger. Therefore, the moratorium laid down in Section 101 is applicable to personal guarantors whereas the one under section 14 is not applicable to personal guarantors".

Vide a very well-reasoned judgement the Hon'ble Supreme Court finally ended the debate and held that the moratorium period would only be applicable to the corporate debtors and not to the personal guarantors[252].

In the matter of **Alpha & Omega Diagnostics (India) Ltd. v. Asset Reconstruction Company of India Ltd. & Ors.**[253], the question before NCLT, Mumbai was that whether the personal property of the promoters which are given as a security to the banks come under the purview of the moratorium as the same were not held in the name of the corporate debtor. NCLAT while upholding the decision of NCLT held that the protection of moratorium would not be granted to any assets, movable or immoveable, which does not belong to the Corporate Debtor. Similarly, in the case of **Schweitzer Systemtek India Pvt. Ltd. v. Pheonix ARC Pvt. Ltd. & Ors.4**[254] the question was whether personal property of the promoters that was mortgaged to the creditor-banks would fall under the gambit of the moratorium under the Code. The NCLAT while referring to earlier judgments of the Tribunal and held that the moratorium under the Code is only applicable to the property of the Corporate Debtor.

CHAPTER IV:

EFFECT OF MORATORIUM ON THE SALE INITIATED UNDER SARFAESI ACT, 2002

The NCLT, Mumbai recently was faced with the issue of whether moratorium would be applicable on sale initiated under the SARFAESI Act[255]. In the matter of **Indus Finance Limited v. Quantum Limited, J.M Financial Asset Reconstruction Company**[256] (applicant) preferred an application, to seek directions as to whether a sale initiated under the

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[252]Moratorium is applicable to the properties of the personal guarantors too: NCLAT, ECONOMIC LAW PRACTICE, Mar. 2018, available at https://elplaw.in/leadership/ibc-case-law-alert-moratorium-is-applicable-to-the-properties-of-the-personal-guarantors-too-nclat/.

[253]Company Appeal (AT) (Insol.) No. 116 of 2017.

[254]Company Appeal (AT) (Insolvency) No. 129 of 2017.

[255]Manisha Paranjape, Calm Period Under Section 14 Of IBC: Causing Storm for Secured Creditors? MONDAQ, Dec. 6, 2017, available at http://www.mondaq.com/india/x/653402/Corporate+Commercial+Law/Calm+Period+under+Section+14+of+IBC+Causing+Storm+for+Secured+Creditors.

[256][2017] 139 CLA 236 (NCLT).

SARFAESI Act can be proceeded with, when moratorium is declared under the Code[257].

In this matter, Corporation Bank had assigned to the Applicant, an asset reconstruction company, a debt availed by Quantum Limited, the corporate debtor. The corporate debtor had defaulted in repaying the loan facility. Proceedings were filed under the SARFAESI Act before the Debt Recovery Tribunal, Pune Bench which, vide order dated 05 May 2014, directed the corporate debtor to pay a certain sum along with interest. The Applicant had also issued a sale notice under the SARFESI Act and had obtained an order from the District Magistrate, for getting the necessary assistance in taking physical possession of the immovable property. The corporate debtor challenged the measures taken by the Applicant before Debt Recovery Tribunal, Mumbai Bench (DRT, Mumbai) which refused to grant interim relief to the corporate debtor. The Applicant then proceeded with the auction of the assets mortgaged by the corporate debtor and confirmed the offer from Omni for a sale price of INR 19,26,00,000 (~ USD 2,963,076) on payment of 25% on the same day and balance sale price payable on or before 14 March 2017.

Accordingly, the payment of 25% was made by Omni to the Applicant. The corporate debtor once again filed a stay application with the DRT, Mumbai. Subsequently, the DRT, Mumbai stayed the proceedings on the corporate debtor on certain conditions. The corporate debtor was unable to fulfil the conditions as prescribed by the DRT, Mumbai and sought an extension for making the payment.

Indus Finance Limited, the financial creditor, then, vide an intervening application before the DRT, Mumbai, offered to fulfil the condition. However, when the financial creditor too was unable to fulfil the condition, the Applicant moved DRT, Mumbai to vacate the stay in order to enable it to hand over the possession of the property to Omni. However, the financial creditor prayed before DRT, Mumbai to stay the securitisation application as Moratorium had already been initiated against the corporate debtor.

NCLT, in view of rule 9 of the Security Interest (Enforcement) Rules, 2002, held that failure to make balance 75% payment results in forfeiture of 25% deposit and annulment of the sale, thus allowing the property to be resold to someone else. This is pari materia to Order 21 of the Civil Procedure Code, 1908. Further, the NCLT held that until the full consideration has not been discharged and it has not been confirmed by the secured creditor, it can't be considered that the sale is complete[258]. In other words, until the sale is not complete and made

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[257]Varun Marwah, Sale Initiated under SARFAESI hit by Moratorium under IBC? BAR & BENCH, Oct. 9, 2017, available at https://barandbench.com/sale-sarfaesi-ibc-moratorium/.

[258]Supra note 51.

absolute, no interest can be considered as transferred to the purchaser. Since, in the present case, only 25% deposit had been paid by Omni, it could not have been said that the sale had been confirmed. In view of the above, NCLT dismissed the application[259].

Thus, NCLT, Mumbai held that sale initiated under SARFAESI Act would also be stayed upon the commencement of the moratorium period.

CHAPTER V:

EFFECT OF MORATORIUM ON THE SUITS FILED UNDER SARFAESI AGAINST INDIVIDUALS

'The Presidency Towns Insolvency Act, 1909' and 'The Provincial Insolvency Act, 1920' are the acts which provide for insolvency of individuals[260]. The code brought all the types of insolvency under one roof including the ones pertaining to individuals. Part III of the Code deals with Insolvency and bankruptcy of Individuals and partnership firms.

However, Section 243 of the Code which provides for repeal of 'The Presidency Towns Insolvency Act, 1909' and 'The Provincial Insolvency Act, 1920', has not been notified till date. Besides, provisions pertaining to insolvency resolution and bankruptcy for individuals and partnerships as contained in Part III of the Code are yet to be notified[261].

As the part III of the code is yet to be notified, as of now there is no scope of any moratorium taking place which would stay the matters that are filed under SARFAESI Act[262]. However, once the notification for part III of IBC is done, the moratorium period would put a stay on all the proceedings including the ones under SARFAESI.

CHAPTER VI:

EFFECTS OF THE IBC CODE ON SECURITIZATION AND ASSET RECOUNSTRUCTION COMPANIES UNDER SARFESI ACT, 2002.

Apart from the enforcement of security without the intervention of the court, SARFAESI Act has other two principal functions which are as follows:

(i) Securitization;

Securitization is the process under which financial assets are pooled together and rearranged into marketable securities which can be sold to investors.[263] In respect to management of bad assets, securitization means the activity of converting the existing assets (loans) which have

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[259]Supra note 52.

[260]FE Bureau, Old individual insolvency norms still valid, FINANCIAL EXPRESS, Aug. 30, 2017, available at https://www.financialexpress.com/india-news/old-individual-insolvency-norms-still-valid/831937/.

[261]Individual Bankruptcy Provision Under IBC Yet to Be Notified, BLOOMBERG, Aug. 29, 2017, available at https://www.bloombergquint.com/law-and-policy/individual-bankruptcy-provision-under-ibc-insolvency-and-bankruptcy-code-yet-to-be-notified.

[262]Supra note 56.

[263]Supra note 1.

low liquidity into marketable securities. It includes issuance of security receipts.[264]

(ii) Asset reconstruction:

Asset reconstruction is an activity by which bad or non-performing assets are converted into performing assets. The whole procedure of reconstruction of an asset involves manifold steps such as an asset reconstruction company (ARC) purchasing bad asset including the underlying hypothecated asset, then financing of the bad asset to be converted into good asset by way of bonds, debentures, securities and cash, realization of returns from the hypothecated assets etc.[265] Reconstruction, is to be done as per the RBI regulations.

IBC is no way concerned with these 2 aspects of the SARFAESI Act of looking after the compliance of the asset reconstruction companies and issuance of security receipts and process of securitisation and these provisions are solely the prerogative of the SARFAESI Act.

CONCLUSION

Once an application for CIRP filed with the Adjudicating Authority is admitted, the others cases/suits filed under the SARFAESI Act go for an absolute toss. Post the admission of the application, there is a mandatory moratorium period of 180 days which stays all the other existing/pending suits and puts a bar on filing of the new suits. This means that the proceedings under the SARFAESI Act are also stayed. The outcome post the moratorium period is that either resolution plan is approved or that the company goes for liquidation. If the resolution plan is approved than in that case as well, the rights of the secured creditors would depend on the arrangement scheme and the proceedings under SARFAESI would be ineffective and if the company goes for liquidation, then in that case, the rights of the secured creditors would be as per section 52 of IBC and once again the suits filed under SARFAESI would be rendered useless.

The introduction of IBC has caused a stir to the SARFAESI Act. It has caused grievances to several banks and financial institutions who have already filed their suits under SARFAESI and lead to a drain on the resources of these institutions as well. However, if we see the larger equity then, in case of SARFAESI there would only a handful of secured creditors who would get some relief whereas in case of IBC, there would be an equitable distribution of assets and it would benefit larger group. Also, the SARAFESI Act has the objective to secure the money of the financial institutions and they are not concerned with the status of the company or the

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[264] Tojo Jose, What is SARFAESI Act 2002? INDIAN ECONOMY.NET, Jul 14, 2017 available at https://www.indianeconomy.net/splclassroom/what-is-sarfaesi-act-2002/.

[265] Supra note 1.

impact on stakeholders whereas IBC aims at attempting to restructure the company and come up with a probable solution by which the company would be saved and tries to protect the rights of stakeholders.

IBC provisions are beneficial in terms of larger equity. However, it has been observed that several persons are misusing the provisions of IBC for their personal good and causing undue loss and hardships to others. That is something that needs to be prevented.

6. TRANSCENDING INTERNATIONAL BOUNDARIES: CROSS BORDER MERGERS IN THE LIGHT OF FEMA REGULATIONS*

Abstract

Cross Border Mergers have become important economic players in this era of extreme globalisation. They have an important role in determining company structures which in turn determine several transnational relations, including but not limited to, privatisation, labour growth, transportation and communication development. Hence, there is an urgent requirement to understand and analyse this phenomenon, especially in the background of the latest FEMA Cross Border Regulations of 2018.

Part I of this article is a study on the regulatory framework of cross border mergers in India before the Merger Regulations (2018) came to being. Following this, Part II discusses the outlines of the Merger regulations (2018). Part III examines the inbound and outbound merger provisions of the above-mentioned Regulation by evaluating its substantive and procedural efficiency. Part IV discusses the various other laws that actualise a cross border merger and an analysis on how these legal provisions can be customised to suit the present-day structure of a cross border merger. In Part V, the authors give an overview on the legal systems that govern cross border mergers in other countries, and how their provisions set examples of powerful legal precedents that India can aim to achieve. Finally, under Part VI, the authors have suggested how the current legal system that regulates cross border Mergers can be revamped to facilitate the economic growth India aims to achieve.

I. Introduction

"Diversification and globalisation are the keys to the future" - Fujio Mitarai.

Cross border mergers are an increasing phenomenon in the light of the abovementioned concepts; i.e., diversification and globalisation. Markets have integrated on a worldwide scale due to decrease in trade barriers, surge in technology, transportation and communication and standardisation of economic norms and practices.[266] While global market integration intensifies, there arises a need to evaluate and assess the players that facilitate this, i.e., the

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[266] Siah Hwee Ang and Snejina Michailova, Institutional Explanations of Cross-border Alliance Modes: The Case of Emerging Economies Firms, 48 MIR 551, (2008).

legal backbone that deals with the intricacies of actualising this global competition. This article deals with the cross border mergers wave that hit India post our liberalisation years, with special emphasis on analysing the Foreign Exchange Management (Cross Border Merger) Regulations, 2018 (hereafter referred to as the Merger Regulations).

As companies started facing tough competition and an inbuilt desire for growth, size and competence became the two hallmarks that could spearhead this development.[267] A cross border merger (or amalgamation; terms which are interchangeably used in this article) is one such tool that aids development from a global perspective. In simple terms, a cross border merger means "any transaction in assets of two firms belonging to two different economies".[268] While business considerations do fuel this inorganic growth of companies in different countries, local legislations play an important role in determining the extent of this growth.[269] This growth has passed through several stages in India; the evolution of which is detailed below.

Revamp of the Companies Act in 2013 brought about the much-awaited change in the structure of mergers and amalgamations as it had previously existed. The precursor, i.e., the Companies Act of 1956 had given that a foreign company could merge with an Indian company, provided it obtains prior sanction of the court.[270] This was not explicitly given but inferred from the explanation provided to "transferee" and "transferor" companies.[271] The former included only Indian companies, whereas the latter could include "anybody corporate". Since the transferee had to be an Indian entity, they could not merge with a company in a foreign jurisdiction.[272] This was coupled with the Income Tax Act, 1961, which had explicit provisions for a foreign company to amalgamate with an Indian company (the latter being the resultant company) and was at the same time provided with tax benefits.[273] Hence, a reverse process, where an Indian company merges with a foreign company was not allowed by either of the Acts. The abovementioned concepts are known as inbound merger and outbound merger. To elucidate, an "inbound merger" is one where the resultant company, i.e., the entity to survive post-merger is an Indian company. In contrast, when the

267 Pramod Mantravadi and A.Vidyadhar Reddy, Type of Merger and Impact on Operating Performance: The Indian Experience, 43 Economic and Political Weekly 66, (2008), URL: http://www.jstor.org/stable/40278002

268 Pacific Economic Cooperation Council (PECC), A Review of Cross-border Mergers & Acquisitions in APEC, (2002).

269 Mr Himanshu Srivastava and Mr Nitin Arora, Cross Border Merger & Acquisition, Corporate Catalyst India, file:///C:/Users/hp/Downloads/Cross-Border-Merger-Acquisition%20(5).pdf.

270 Companies Act 1956, Sections 391 and 394. See further, Raghav Sharma , Rajeev Vidani, Law relating to Cross Border Mergers under Companies Act, 1956, ResearchGate, October 2008.

271 Companies Act 1956, Section 394(4)(b).

272 Sharma, Raghav & Vidhani, Rajeev, Law relating to Cross Border Mergers under Companies Act, 1956, (2008). **https://www.researchgate.net/publication/228240813_Law_relating_to_Cross_Border_Mergers_under_Companies_Act_1956.**

273 Income Tax Act 1961, Sections 47 (vi) and 47 (vii).

resultant company is a foreign entity, the same is termed as "outbound merger". Both these concepts would be dealt in detail in the later part of this article.

Unfortunately, the shift in industrial policy that defined globalisation, took place in an era that was still under the regime of the 1956 Act. There were indeed immediate changes seen in the law framework that facilitated the wave of industrial expansion. The Monopolies and Restrictive Trade Act (MRTP), 1970 was tweaked to remove its restrictive policies relating to expansion of enterprises, amalgamations, takeovers and acquisitions with respect to foreign technology and investment.[274] Following this, emerged the amendment to the Foreign Exchange Regulation Act (FERA) in 1993 that relaxed its restrictive trade and investment policies, thereby opening up the economy for global demand of investment.[275] In 1995, overseas development was transferred from the purview of Ministry of Commerce to the Reserve Bank of India (hereafter referred to as the RBI) so as to provide for a single transaction window, and further policies were set up to fast track India's expansion.[276] Introduction of Foreign Exchange Management Act (FEMA) in 2000, that repealed FERA, was perhaps the most important step that expanded the concepts of cross border Joint Ventures (JVs) and Wholly Owned Subsidiaries (WOS) as we know today.[277] With an upper limit of 100% proceeds from American Depository Receipts or Global Depository Receipts (ADR/GDR) issues which could be used to acquire foreign companies and foreign investment in JVs and WOSs, Indian companies could expand its domestic ties and venture into foreign markets.[278] While the above mentioned facilitated cross border acquisitions, the scenario of cross border mergers, outbound mergers in specificity, was still in the dark and yet to be actualised.

Earlier cross mergers took place by the Indian companies by setting up branches in the foreign territory of the desired company with whom a merger was proposed. There was no direct system of cross border merger.[279]

The 2013 Act could finally bring in the provisions that paved way for explicit cross border mergers.[280] On 13th of April, 2017, the Ministry of Corporate Affairs notified Section 234[281]

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[274] P. L. Beena, Trends and Perspectives on Corporate Mergers in Contemporary India, 43 Economic and Political Weekly 48, (2008).

[275] Id.

[276] Id.

[277] Id.

[278] Shyamala Gopinath, Overseas Investments by Indian Companies - Evolution of Policy and Trends, 61 RBI Bulletin (February 2007), https://www.bis.org/review/r070122c.pdf.

[279] Geeta Rani Duppati & Narendra V. Rao, Cross-border mergers and acquisitions: Mature markets vs. emerging markets—with special reference to the USA and India, 2 Cogent Business & Management (2015), https://www.tandfonline.com/doi/full/10.1080/23311975.2015.1088817.

[280] Companies Act 2013, Section 234.

[281] Id. Reads as follows:

of the 2013 Act and inserted Rule 25A in the Companies (Compromises, Arrangements and Amalgamations) Rules, 2016 (hereafter referred to as the Compromises Rules) that facilitated mergers and amalgamations between India and foreign companies without any restriction on the term "transferee". Both forms of mergers as explained above are permitted now through the 2013 Act as well as the associated Rules. Under Rule 25A, there arises a requirement for prior approval from the RBI for cross border mergers to take place. Therefore, other procedural provisions are required to actualise such mergers post the above mentioned notification.

II. FEMA (Cross Border) Regulations: Analysis

The Indian corporate laws permitted a foreign company to merge with an Indian company whereas the opposite was not possible, as explained in the introductory pages. This was a major limitation under the scope of the existing legal framework

An attempt to overcome this was finally made on the 26th April, 2017 when the RBI issued draft regulations on Cross Border Mergers between Indian and Foreign companies. This was with an intention to establish a substantive and regulatory framework for governing cross border mergers. The RBI thereon invited comments and views on the proposed regulations from stakeholders and experts in the area[282]. Almost a year later, on 20th March 2018, the RBI notified the Merger Regulations (2018).This was done in exercise of powers conferred upon them,[283] to issue regulations so as to carry out the provisions of the Foreign Exchange Management Act (1999).

The Merger Regulations are the last leg of legal provisions along with the corresponding procedural aspects which will finally allow both inbound and outbound mergers in India.[284] It is also to be noted that the implementation of provisions on cross-border merger will fulfil

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"(1) The provisions of this Chapter unless otherwise provided under any other law for the time being in force, shall apply mutatis mutandis to schemes of mergers and amalgamations between companies registered under this Act and companies incorporated in the jurisdictions of such countries as may be notified from time to time by the Central Government:

Provided that the Central Government may make rules, in consultation with the Reserve Bank of India, in connection with mergers and amalgamations provided under this section.

(2) Subject to the provisions of any other law for the time being in force, a foreign company, may with the prior approval of the Reserve Bank of India, merge into a company registered under this Act or vice versa and the terms and conditions of the scheme of merger may provide, among other things, for the payment of consideration to the shareholders of the merging company in cash, or in Depository Receipts, or partly in cash and partly in Depository Receipts, as the case may be, as per the scheme to be drawn up for the purpose.

Explanation.—For the purposes of sub-section (2), the expression "foreign company" means any company or body corporate incorporated outside India whether having a place of business in India or not."

[282] Press Release, RBI proposes fresh Regulations under Foreign Exchange Management 1999 from Cross Border Mergers: Invitescomments from stakeholders, (April 26, 2017),https://rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=40288.

[283]Foreign Exchange Management Act 1999, Section 47(3) & 47(6).

[284] Ruchika Chitravanshi, RBI Rolls out Regulations for Cross Border Merger , Economic Times (March 28, 2018, 11:57PM),**https://economictimes.indiatimes.com/news/economy/policy/rbi-rolls-out-regulations-for-cross-border-mergers/articleshow/63523129.cms-m.**

the recommendations of the JJ Irani Committee report on corporate law reforms in India.[285] Whether these provisions are in themselves sufficient in actualising the Committee views on cross border mergers is a question that is answered in the further chapters of this article.
Foremostly, the authors seek to understand the meaning and the purpose of the Merger Regulations through the differences identified in a comparative analysis with the Draft Regulations.[286]

Crucial Definitions

In dealing with the most crucial definition, Section 2(iii) of the Merger Regulations defines cross border mergers to mean any "merger, amalgamation or arrangement" in accordance with the Compromises Rules and the Companies Act, 2013. The Draft Regulations expressly included the word demerger, which is also implied from the above definition.[287] At the same time, there seems to be a conflict between this provision and Rule 25A of the Compromises Rules coupled with section 234 of the Act, since the latter only provide for "mergers and amalgamations" without any mention of "arrangement".
Primacy is given to the Companies Act as it is the governing legislation with respect to arrangements, mergers and amalgamation[288]. It can thus only be assumed that any form of arrangement including cross border demergers is not permitted even though it is contemplated in the Merger Regulations. This dichotomy of views has to be rectified through an amendment of the Companies Act so as to permit all forms of arrangement.

Valuation

There have been changes with regards to the provision in relation to evaluation of the cost of the transaction. The Draft Regulations authorised the valuation to be conducted in either jurisdictions. The Merger Regulations on the other hand shift the onus of obtaining the valuation onto the transferee company. The Regulations also place the burden on the transferee company to ensure that it is conducted by a recognised professional and in accordance with internationally accepted principles of accountancy and valuation.[289]
It should also be noted that while the Compromises Rules are silent on the valuation requirement of inbound mergers, the Merger Regulations prescribe the same requirement to

[285] Dr. Jamshed J. Irani, Expert Committee Report on Company Law (May 31, 2005), http://www.primedirectors.com/pdf/JJ%20Irani%20Report-MCA.pdf
[286] Cross Border Merger Draft Regulations, 2017.
[287] Cross Border Merger Draft Regulations, 2017. Regulation 2(iv), "Cross border merger means any merger, demerger, amalgamation or arrangement between Indian companies and foreign companies in accordance with the Co. Rules. "
[288] M.Nirmala, Corporate Restructuring And Companies Act 2013- An Impact Analysis, 1 IJMSRR 26, (November 2014), http://ijmsrr.com/downloads/30112014IJMSRR%204.pdf.
[289] Companies (Compromises, Arrangement or Amalgamation) Rules 2016, Rule 25A.

be applicable both for inbound and outbound mergers.[290]

Compensation

The Merger Regulations attempts to cater to the rights of the stockholders of the transferor company. Even though it is diluted, it provides for the resultant company to pay compensation to the stockholder as approved by the National Company Law Tribunal.[291]

At the same time, it is to be noted that the provision is worded as "may be paid", which does not make it obligatory for the resultant company. Moreover, the Regulations do not contain any explicit provisions to cater to the appraisal rights of the minority shareholders.[292]

In contrast, foreign cross-border regulations provide a rather broad and unqualified right for the minority shareholders of the transferor company.[293] For instance, as per EU Merger Directives, the decision to proceed with the merger itself can be de- facto over ruled if a significant majority of the minority exercise their appraisal rights. This is applicable especially in the case of an outbound merger as foreign laws may not provide for the protection of minority interest. [294]

Reporting Requirements

The Draft Regulations required for all transactions to be reported to the RBI. The specific formats of these reports were expected to be provided for in the final regulation.[295] On the contrary, the Merger Regulations seem to have relaxed the reporting requirements of the companies involved with respect to any transaction that may arise.[296] They also require the RBI to consult with the Government of India when prescribing reports that are to be furnished to them. This could be so as to bring about regulatory certainty and compliance.[297]

Deemed Approval

One of the most important features of the Merger Regulations is that they provide for deemed approval. This means that any transaction on account of cross border merger undertaken in accordance with these regulations will be deemed to have the prior approval as required under

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[290] Foreign Exchange Management (Cross Border Merger) Regulations 2018, Regulation 6.

[291] Foreign Exchange Management (Cross Border Merger) Regulations 2018, Regulation 7(1).

[292] Jinesh Shah,A welcome move by RBI on Cross Border Mergers, Financial Express (May 11, 2018, 3:07 AM), https://www.financialexpress.com/opinion/a-welcome-move-by-rbi-on-cross-border-mergers/1163100/

[293]Article 4 EU Merger Directives, Article 4 (Implemented in Netherlands in 2008)

[294] Commission v Portugal [2002] ECR I-4731

[295]RBI issues Draft Regulations in relation to Cross Border Mergers, (May 02, 2017) https://www.pwc.in/assets/pdfs/news-alerttax/2017/pwc_news_alert_2_may_2017_rbi_issues_draft_regulations_in_relation_to_cross_border_mergers.pdf

[296] Deloitte, RBI notifies provisions relating to cross border mergers, amalgamations and arrangements, (26 March, 2018)https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/Regulatory%20Alert/in-tax-regulatory-alert-fem-cross-border-merger-regulations-noexp.pdf.

[297] Foreign Exchange Management (Cross Border Merger) Regulations, Regulation 8(1).

Rule 25 A of the Compromises Rule.[298] This provision was set up with a two-fold purpose, i.e., to expedite the transaction to speed up the entire timeline of the merger and to ease the burden on the regulatory authority.[299] Hence it acts as an express provision that relaxes the reporting requirements during such mergers.

At the same time, under such a system, there is the possibility of negative impacts on cross border transactions. Hence to mitigate the downside to such an approval system, regulatory and prior approval act as protective mechanisms.[300] The Merger Regulations do indeed reflect these safeguards. For example, the Regulation has provided an indirect -approval requirement in certain cases. This two-step process involves a) reporting of non-compliance prior to the merger[301] and b) furnishing of a compliance certificate by the managing/whole time director and Company Secretary to the National Company Law Tribunal (NCLT) along with the application that is required to be filed by them as under Rule 25A (e) of the Compromises Rules. This reporting requirement has imbibed the concept of secretarial audit as under the Companies Act of 2013 which will act as an internal mechanism to monitor the compliance with the requirements of the law. [302]

III. A Critical Overview ontheInbound and Outbound Merger Provisions in the Regulation.

The Merger Regulations contain substantive provisions for both inbound and outbound mergers. These enabling provisions are beneficial in a two-fold manner. Firstly, it pushes India in a step towards globalization. Secondly, it facilitates ease of doing business for a foreign entity in India and vice versa.[303] The provisions as stipulated include the following:

Definitions

Primary definition of the provisions better explain the concepts especially in the context of the Merger Regulations.

An outbound merger is defined as a cross border merger wherein the resultant company is a foreign company.[304] The definition is fairly simple and consists of two stakeholders, i.e., an Indian company and a foreign company. In contrast, an inbound merger is one that takes place between an Indian and a foreign company, where the resultant company, or the

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[298] Both Inbound and Outbound merger were subject to the approval of the RBI before the execution of the merger

[299] Shivani Saxena, Cross Border Mergers: The Five-Year Wait Is Over...Maybe, The Quint (April 03 2018, 2:39 PM)

[300] Regulatory Consultation, A Mena-Oecd Practitioners' Guide For Engaging Stakeholders In The Rule-Making Process, (2011).

[301] Foreign Exchange Management (Cross Border Merger) Regulations, Regulation 7(2)

[302] Id.

[303] Ketan Dalal, Cross Border Merger- The Outbound Stitch, Law Street India, http://lawstreetindia.com/experts/column?sid=250

[304] Foreign Exchange Management (Cross Border Merger) Regulations, Regulations 2(viii).

company to emerge after the merger, is the Indian entity.[305] While the outbound merger is a relatively new phenomena, inbound mergers were allowed since the 1956 Act. They provided a basic route for foreign companies to invest in India.[306]

As explained above, inbound mergers are not a new concept to Indian law and have been well established. Hence it is more imperative to describe an outbound merger as envisaged under the Merger Regulations. In an outbound merger, foremostly, the Indian company will completely cease to be in existence. It will become a branch of the resulting foreign company and its shareholders will be issued shares in the resultant company.[307] Secondly, the foreign company is required to be incorporated in a jurisdiction specifically provided for in Compromises Rules.[308] It can be understood that this is to ensure that the foreign company is not indulging in any fraudulent practices and is strictly monitored by efficient regulatory bodies that will certify the same.

It also requires the jurisdiction's Central Bank to be a member of the Bank of International Settlements (BIS). This is to foster international monetary and financial cooperation.[309]

Deemed Branch Office

Pursuant to the sanction of the scheme of Outbound Merger by the NCLT, the Indian company becomes the branch office of the resultant foreign company[310] as per the Branch Office Regulations, 2016[311] . On the other hand, for an inbound merger, the provisions under Foreign Currency Accounts Regulations[312], 2015 are to be complied with, while operating a branch office of the resultant company outside India. In the case of an inbound merger, this would mean having a place of business in the foreign jurisdiction, but such an establishment would inevitably incur tax liabilities as per the foreign laws.

In the case of an outbound merger, it is to be noted that the Branch Office Regulations usually require the foreign entity to follow certain procedures so as to obtain prior approval before setting up branch offices in India. The Merger Regulations have relaxed these requirements as it stipulates that this approval is already deemed to be given on the sanction of the scheme

[305] Foreign Exchange Management (Cross Border Merger) Regulations, Regulation 2(v).

[306] PWC, Mergers and acquisitions: The evolving Indian landscape, (February 2017), https://www.pwc.in/assets/pdfs/trs/mergers-and-acquisitions-tax/mergers-and-acquisitions-the-evolving-indian-landscape.pdf

[307] Shruthi Shenoy, Cross Border Merger- Key Regulatory Aspects to consider, Mondaq (April 25, 2018) http://www.mondaq.com/india/x/695282/M+A+Private+equity/Cross+Border+Mergers+Key+Regulatory+Aspects+To+Consider.

[308] Companies (Compromises, Arrangement or Amalgamation) Rules, Annexure B.

[309] Reem Haekal, What Is the Bank for International Settlements? Investopedia (May 18, 2018, 8:58 AM), https://www.investopedia.com/articles/03/120903.asp.

[310] Foreign Exchange Management (Cross Border Merger) Regulations, Regulation 5(iii).

[311] Foreign Exchange Management (Establishment in India of a branch office or a liaison office or a project office or any other place of business) Regulations, 2016.

[312] Foreign Exchange Management (Foreign Currency Accounts by a person resident in India) Regulations, 2015.

subject to the foreign entity conforming to the compliances under the Branch Office Regulations.[313] Further, the resultant company is now permitted to open an SNRR Account for a two-year period as prescribed under FEMA (Deposit) Regulations, 2016.[314] The balance amount in such an account is allowed to be repatriated outside India, which is indeed an incentivising step for investors to cross borders.

At the same time, the Branch Office Regulations seem to be placing a few restrictions on the execution of the outbound merger.

Firstly, the Branch Office Regulations[315] prescribe eligibility criteria which the foreign company must conform in order to set up a branch office in India. Such as, a specific profit-making track record and a net worth of not less than USD 100,000.

Secondly, the Branch Office Regulations permit the branch office to undertake only certain activities that are listed out specifically in schedule I or II. Any other activity outside the scope of the schedule requires the prior permission of the RBI.[316] This restriction could pose to be a significant limitation on outbound mergers as the permitted activities are rather restricted in nature.

For example, manufacturing activities are not included in the list. It can thus only be assumed that the Merger Regulations do not allow a foreign company to undertake any manufacturing activities in India as the resulting branch office that comes into existence post-merger will not be permitted to do the same.[317]

Another potential limitation is that a branch office is specifically included as a Permanent establishment (PE) of a foreign company.[318]Hence, they run the risk of falling within this category and being subject to much higher tax rates on the profits attributed to the Indian operations of the branch office.

Acquisition of assets

The Merger Regulations provide for the resultant company to acquire and hold any and all assets to the extent permitted under the FEMA Act, rules or regulations thereunder [319] , in

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[313] Anandaday Misshra, Mr. Rohit Lalwani and Ms. Kamya Shah , Foreign Exchange Management (Cross Border Merger) Regulations, 2018 - A Boost to Foreign Investment in India,Lexology, https://www.lexology.com/library/detail.aspx?g=87b6c6ff-9d75-45f2-b316-3ab961dbde52.

[314]Foreign Exchange Management (Cross Border Merger) Regulations, Regulation 5(vii).

[315] Foreign Exchange Management (Establishment in India of a branch office or a liaison office or a project office or any other place of business) Regulations 2016, Regulation 4(a).

[316]Id. At 4(b)

[317]Atul Pandey, Abhishek Sanyal, Indruj Rai and Hirak Mukhopadhyay ,FEMA Cross Border Merger Regulations Issued By RBI, Mondaq (April 05, 2018) http://www.mondaq.com/india/x/689316/Corporate+Commercial+Law/FEMA+Cross+Border+Merger+Regulations+Issued+By+RBI.

[318] Income Tax Act 1961, Section 5(2).

[319] Foreign Exchange Management (Acquisition and Transfer of Immovable Property outside India) Regulations, 2015.

both forms of mergers.

As per the provisions, if the resultant company is not permitted to acquire or hold any asset under Indian rules and laws, the Merger Regulations provides for a two-year transition or adjustment period beginning from the date of sanction of scheme by the NCLT. The merged entity is expected to sell any such asset or security within this time. In other words, this period is for the resultant company to regularise compliance with the existing foreign exchange laws in India.

A similar provision was present in the Draft Regulations but the transition period was only that of 180 days.[320] This was heavily criticised as it was found to be rather inadequate. Moreover, the failure to sell the assets within the period would result in heavy penalties, increased stamp duty and tax burden[321]. It was thus imperative that this period be extended. The extended two year period does indeed provides the merged entity with the flexibility to structure its transactions in accordance with the business and to take into account other commercial considerations as well.[322] However, it remains to be tested whether such increased timeframe would be sufficient for sale of foreign assets in light of compliance under foreign laws, pricing, tax concerns, foreign market conditions and other factors.[323]

The proceeds from this sale can either be repatriated outside India through normal banking channels immediately or it may be used to pay off any liabilities in India within the transition period.[324] This could avert fraudulent siphoning of proceeds from such sales.

Guarantees and outstanding borrowings of the Indian Company

In the case of an inbound erger, the Merger Regulation prescribe that all external borrowings of the foreign company from an oversea lender which are transferred to the resultant company in the natural course of a merger, has to be compliant with India's foreign exchange regulations on guarantees and external commercial borrowings, within two years from the merger being effective.[325] The resultant company is also barred from remitting any money for its outstanding borrowings or guarantees for two years.[326] This indeed puts a heavy burden on the resulting companies as they would have to negotiate and sometimes even renegotiate the existing credit facilities with the foreign lenders as there are high strung requirements on

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320 Draft Regulations (2017), Regulation 5(d).

321 Puneet Shah, MCA and RBI gears up for cross border mergers and restructuring, Bar & Bench (May 5, 2017) Bench. https://barandbench.com/mca-rbi-gears-cross-border-mergers-restructuring/.

322 Supra, Note 19.

323 Hiten Kotak & Lakshmisha.S, Cross-border mergers – Creating new frontiers and challenges, Law Street India (June 8, 2018), http://lawstreetindia.com/experts/column?sid=229

324 Foreign Exchange Management (Cross Border Merger) Regulations, Regulation 5(6).

325 Foreign Exchange Management (Cross Border Merger) Regulations, Regulation 4(3).

326 Id.

security, maturity period and all-in-cost ceiling in the said Regulations.[327] Further, the immediate prohibition of payments that is imposed on the resultant company on its existing borrowings and guarantees could be factored as another drawback in the system, when infact a two year period for compliance is given to all the resultant companies. Such a restriction lacks reasoning. In addition to this, due to limitation of types of guarantees under India's Foreign Exchange Regulations on Guarantees, many existing oversea guarantees would have to be cancelled. [328]

While, the Merger Regulations do provide more clarity to the procedures of a cross border merger, it is less clear as to whether it can have a substantive effect on the merger scenario by ironing out the creases that are present today in the process of these mergers. The following chapters tackle the inefficiency of our laws through study of our legal framework that supplements the existing cross border system and drawing a parallel to other foreign laws that deal with the same.**IV. Cross Border Mergers in The Light of Other Existing Legal Provisions**

Foreign direct investment in India seems to be hitting a five-year low of 3% at $44.85 billion in the year 2017-2018. Experts believe that the reason for this is because there isn't an ease of doing business in the country.[329] As already stated the Merger Regulations is a step towards improving this situation. Despite this, the other laws that regulate cross border mergers in the country are rather uncertain and complex, defeating the entire purpose of the Merger Regulations.

Under this chapter, the authors seek to point out a few such provisions and recommend amendments that can be made to Indian laws in order to ensure ease of doing business.

Firstly, The Competition Act, 2002 provides that any sort of combination (including mergers) whose (A) total assets and turnover value of the combined entity is above the threshold as prescribed under the Act[330] and has (B) a territorial nexus with India will come under the scrutiny of the Competition Commission of India (CCI)[331].

Moreover, there is a waiting period of either a two hundred and ten days post-filing review[332]

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[327]Majumdar & Partners, A Year On, The Reserve Bank Of India Notifies Regulations On Cross Border Mergers, (April 21, 2018 11:16 AM), http://www.majmudarindia.com/insights/a-year-on-the-reserve-bank-of-india-notifies-regulations-on-cross-border-mergers/

[328]Id.

[329]Press Trust of India, FDI growth hits 5 year low, The Hindu (July 2, 2018), https://www.thehindu.com/todays-paper/tp-business/fdi-growth-hits-5-year-low/article24307196.ece.

[330] Competition Act (2002), Section 5.

[331]Ganesh Chandra Prasad & Suchetha Ray, CCI blessing to be must for M&As (June 08, 2009), //economictimes.indiatimes.com/articleshow/4629250.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst.

[332] Competition Act (2002), Section 6.

or till the CCI passes orders to approve/reject or modify the scheme,[333] whichever is earlier. Within this period the merger cannot be consummated.

This provision defeats the purpose of deemed approval under the Merger Regulations which is to speed up the timeline of the entire cross border merger. Although similar provisions are found in foreign legislations, the length and the scope of the process is much longer in India. It is found that many a times even though the asset and turnover value might exceed the threshold, there is no appreciable effect on the competition in India[334]. Taking for instance, mergers under certain capital-intensive industrial sectors will contain parties big enough to cross the prescribed threshold, but may not really have an effect on the competition in India.[335] It therefore seems rather restrictive to subject the transacting parties to the long review period and to incur substantial costs in the process.

It is recommended that the Board first does a preliminary review within a period of thirty days. This can be conducted in a summary fashion. (The option of parallel review system will be discussed in the final chapter).

At the end of the review, if there is no prima facie adverse effect on the competition, then the parties may avoid the complex process of filing and the post review period. If the authority is of the opinion that there may be an adverse effect, they may issue directives to the company and give them a time period to comply with the same. On the completion of this, the authority may have another review which is also shorter in scope and length than the 210 days.

Secondly, the Merger Regulations are expected to have a benefit on the Insolvency and Bankruptcy Code, 2016 since the foreign investors will now be able to take part in insolvency proceedings. This is because it is expected to allow better pricing decision with regards to the assets to be sold. Although, in order to achieve this, the timeline prescribed under the code must be strictly adhered to.[336]

There exists a concept of pre-packaged insolvency in foreign laws[337]. This is a bankruptcy procedure where a restructuring plan is agreed in advance before the company declares insolvency[338]. If this concept is introduced into the Code it will reduce the timeline and the

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[333] Competition Act (2002), Section 31.

[334] Rav Pratap Singh, Implications of Cross Border Mergers Under Indian Competition Law – A Comparative Analysis With US & EC Jurisdictions, Competition Commission Of India (15 March, 2010), URLhttp://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.604.7012&rep=rep1&type=pdf.

[335] S, Ramanujan, Mergers Et Al: Issues, Implications, and Case Laws in Corporate Restructuring, (3rd ed. Lexis Nexis Butterworths, 2006).

[336] Shivani Saxena, IBC: Will India's Foreign Exchange Regulations Discourage Foreign Bidders Of Insolvent Assets?, The Quint (8 March 2018, 2:39 PM), https://www.bloombergquint.com/law-and-policy/2018/03/08/ibc-will-indias-foreign-exchange-regulations-discourage-foreign-bidders-of-insolvent-assets.

[337] Catherine Maguire, Pre-packaged Insolvency, Mishcon de Reya (October 6, 2017), https://www.mishcon.com/news/publications/inside-disputes/pre-packaged-insolvency.

[338] United States Bankruptcy Code, Chapter 11, Title 11

complexities in the entire process. Thus attracting foreign companies and resulting in an increase in cross border merger activity under the code.

Thirdly, issues pertaining taxation exist in the current business scheme of cross border mergers. A market is considered viable for business expansion if it factors a high internal rate of return (IRR), among various other reasons.[339] The tax regime influences this factor to a high degree. It is in this light the Authors examine the tax provisions of the country.

As explained in the introductory paragraphs, the Income Tax Act only recognises an Indian entity to be a "transferee" company. Thereby, only inbound mergers received tax incentives. Such mergers would have the benefit of tax neutrality, which in turn means that the shareholders and merging company transferring their shares and assets respectively would be exempted from being taxed.[340] The most glaring issue today is that outbound mergers would not have this sort of tax exemptions which can incentivise oversea transactions.

Further, the operations of the resultant foreign company in India through a "permanent establishment" might incur a 40% tax rate on their income.[341] Hence, there is a requirement for amending such a structure in order to encourage outbound mergers.

There may also arise problems with cross border mergers and the General Anti-Avoidance Rules (GAAR), 2017. These rules are anti- tax abuse provisions that give tax authorities wide powers to deny tax benefits, including ones received by way of tax treaties.[342] Under such provisions, tax authorities may bring up an arbitrarily large number of objections against sanctions given to cross mergers with respect to tax benefits due to the wide discretion of powers vested in them.[343] Hence there is a need to reduce this arbitrariness by reducing the scope of applicability of such rules to cross border mergers. In addition to issues generated through tax provisions mentioned above, The SNRR's balance being subjected to tax liability

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[339] Richie Sancheti & Hanisha Amesur, Taxation of Cross border M&A- A paradigm shift? 3 International Taxation 152(October2010). **http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Taxation_of_Cross_Border_M-A_-_A_paradigm_shift-.pdf**.

[340] Hiten Kotak & Lakshmisha S, Cross-border mergers – Creating new frontiers and challenges, LawSteetIndia (June 08, 2018), http://lawstreetindia.com/experts/column?sid=229.

[341] Atul Pandey, Abhishek Sanyal, Indruj Rai and Hirak Mukhopadhyay, FEMA Cross Border Merger Regulations Issued By RBI, Mondaq (5 April, 2018), http://www.mondaq.com/india/x/689316/Corporate+Commercial+Law/FEMA+Cross+Border+Merger+Regulations+Issued+By+RBI.

[342] Shashwat Sharma & Ashish Sodhani, India's Tax Regulator Issues Clarifications Regarding the Implementation Of The GaarProvisions, Nishith Desai Associates (February 01, 2017), http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/indias-tax-regulator-issues-clarifications-regarding-the-implementation-of-the-gaar-provisions.html?no_cache=1&cHash=4ef51b860372ec0707ac3af0ad4bf508.

[343] The Central Board of Direct Taxes released Circular No 7 of 2017 on January 27, 2017 which, among other things, clarified that where any court or authority such as the NCLT "explicitly and adequately" considers the tax implication of an arrangement, while giving its sanction, GAAR will not apply to such an arrangement. The wording of this clarification gives room to the tax authorities to invoke the GAAR provisions even in the case of mergers which receive sanction of the NCLT.

is also a notable disincentive that is place within the Regulation itself.

The next chapter gives a brief overview on a few foreign legal systems and their cross border merger scenario, so as to draw a holistic picture on the lacunae India faces in its legal mechanisms that support cross border mergers.

V. INTERNATIONAL PERSPECTIVE ON CROSS BORDER MERGERS

The Merger Regulations seek to bring about corporate clarity with regard to cross border mergers. In spite of this, there still exists ambiguity on various aspects in relation to the same. The Expert Committee on Company Law suggested that the lawmakers adopt International Best Practices and a co-ordinated approach while dealing with the law on Cross Border Merger.[344] In this section, the authors seek to bring out and analyse such provisions that they believe could also be applied to the Indian scenario.

The European Parliament and Council of the European Union passed a set of directives on cross border mergers in the year 2006.[345] These directives oblige all the member states to adopt and implement them into their national laws before December 2007. The directives cover crucial issues under cross border merger. For example, it lays down a standard procedure to execute the merger which includes a "common draft of terms" for the merger. This brings about uniformity and ensures that all the cross border transactions amongst the member states have this element of fairness to them.[346]

Another example to be noted is their provision for co-determination of employees. This provides for the interest of the employees by requiring them to form a "negotiation committee". They will be a part of the discussions and will play a role in deciding the terms and scope of employee co-determination that will apply post- merger.[347]

The UK implemented the EU Cross-Border Merger Directives by enacting a comprehensive set of Regulations.[348] As a result of Brexit, a unique mode of corporate restructuring was executed under the British Regulations. This was Reverse Cross Border Merger. This happened for the first time in the year 2017 when the High Court approved a reverse cross border merger between A UK Company (Formernta Ltd) and its Italian Subsidiary (Newco Immobiliare S.R.L).[349]

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344 Supra, Note 20.

345 Directive 2005/56/Ec Of The European Parliament And Of The Council on Cross Border Mergers of limited Liability Companies, (2006) https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32005L0056.

346 Id, At Preamble, sub-clause (4).

347 German Transformation Act 2007, Merger Directives Sub Clause 13.

348 The Companies (Cross Border Merger) Regulations 2018, Regulation 2(1).

349 First EU Cross Border Merger; First of many, available at: https://uk.practicallaw.thomsonreuters.com/7-639-2692?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1.

This was executed through the mode of merger by absorption[350] which is prescribed for in the UK Regulations. It provides that the transferor company dissolves and becomes a subsidiary of the transferee company (similar to the mode of cross border mergers prescribed in India). In the case of a reverse cross border merger, the parent company will merge into the subsidiary company and the members of the parent will become that of the subsidiary company. This can be done by a number of ways, ie, cancellation of shares, buy- back of shares or a waiver.[351] It is predicted that an increasing number of mergers will now be executed through reverse cross border merger as there aren't too many procedural complexities.

The French law[352] with regards to cross border merger regulates the various forms of corporate restructuring, one of them being restructuring by way of a "split-off". This enables the parent company to split its business activities into smaller units and transfer the same to an existing or a new company.[353]

The legal consequences of this form of restructuring are almost similar to that of merger by absorption. That is the transfer of all the assets and liabilities to the resulting company and the dissolution of the absorbed or split-off company. Analysts have described split-off to set the stage for the next wave of cross border mergers. [354]

In China, The State Administration of Foreign Exchange Regulations (SAFE) have a tight control on foreign exchange transactions including that of cross border mergers. There exists a concept of Foreign Exchange certificate Cards (FOREX cards) which are crucial for every transaction that involves the transfer of foreign currency into or out of the country. These cards contain all the necessary information about the target company which may include the shareholding structure, foreign exchange amount approved for the merger transaction and the details of the target company's bank which is required for the transaction.[355] The SAFE may deny to issue or amend these cards if either company fail to comply with the requirements as prescribed by them when purchasing shares in the target company. Although this is a rather strict practice it also acts as a sanction to the companies that fail to comply with the mandatory

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[350] The Companies (Cross-Border Mergers) Regulations 2007, Regulation 2(1).

[351] http://www.mondaq.com/uk/x/697292/M+A+Private+equity/Issues+to+consider+when+structuring+a+crossborder+merger+under+the+CrossBorder+Merger+Regulations.

[352] French Commercial Code, Article L-236-25.

[353] Robert Heym, Constantin Conrads, Reed Smith, EU Cross-Border Merger Directive and "SEVIC" – Implications for Corporate Restructurings in Europe, Lexicology (August 2008), https://www.lexology.com/library/detail.aspx?g=2ccc73b4-9556-42d4-9c3c-65dd6e6f53c2.

[354] Manuel Baigorri and Tara Lachapelle, Spinoffs Could Set Stage for Next Merger Wave: Real M&A, Bloomberg (October 15, 2014, 3:57 AM), **https://www.bloomberg.com/news/articles/2014-10-14/spinoffs-could-set-stage-for-next-merger-wave-real-m-a**.

[355] Rocky T. Lee, China: SAFE Regulations Affecting Inbound And Outbound Payments In Cross-Border M&A Transactions Within The People's Republic Of China, Mondaq (26 September, 2011) http://www.mondaq.com/china/x/146588/Mergers+Acquisitions/SAFE+Regulations+Affecting+Inbound+And+Outbound+Payments+In+CrossBorder+MA+Transactions+Within+The+Peoples+Republic+Of+China.

regulations.

Surprisingly, the United States do not have any additional legal or regulatory framework to govern cross border mergers. At the same time, they do have a comprehensive set of anti-trust laws which provide for a system that review the competition aspect of such mergers review.[356] It has a parallel review system wherein two agencies, namely, the Department of Justice and the Federal Trade Commission[357] are empowered with co-extensive powers of pre-merger review. The agencies divide the responsibility amongst themselves and specialise in different sectors in the country. The post filing review period within which the merger cannot be consummated is 30 days (as opposed to 210 days period in India). This parallel system not only ensures a thorough and specialized review but also divides the burden with regards to anti-trust concerns. [358]

Cross border mergers have seen an increased rate of efficiency in these countries due to their regulatory framework that governs the same. In the next chapter, the authors recommend changes that can be brought into the Indian legal structure in order to develop our system of cross border mergers.

VI. Recommendations

In addition to the several recommendations that were placed in the previous chapters in light of analysis of various provisions in India as well as foreign jurisdictions, the authors further propose for changes in several sphere of laws as well as policies that could better the current system. The recommendations propose for laws in areas which have not been discussed previously in the paper and such a proposal is with keeping in mind the need for an all rounded mechanism that could smoothen out the creases of the impediments cross border mergers face in India.

A SINGLE COMPREHENSIVE LEGISLATION

The authors recommend for the formation of an expert committee specifically to regulate and deal with all the legal and administrative aspects of all cross border mergers:

[356] The Sherman Act covers the restraint or monopolization of "commerce…. with foreign nations". The Clayton Act defines commerce with similar inclusiveness although its substantive provisions limit their foreign applications. Clayton Act δ2(a) as amended by the Robinson-Patman Act applies only to sales for "use, consumption or resale within the United States". Clayton Act δ3 is similarly limited, and δ7 concerns only those mergers whose anti-competitive effects may be felt within the 'section of a country'.

[357] The Clayton act, Section 7 & Section 7(A).

[358] Kevin.B. Goldstein, Reviewing Cross-Border Mergers and Acquisitions for Competition and National Security: A Comparative Look at How the United States, Europe, and China Separate Security Concerns from Competition Concerns in Reviewing Acquisitions by Foreign Entities, 3 Tsinghua China Law Review 215(2011), http://www.tsinghuachinalawreview.org/articles/0302_Goldstein.htm.

- They will form recommendations, inclusive of best practices from around the world into a compilation. This would be followed by the enactment of a new Act based on the same.
- The abovementioned Act would be an all-inclusive legislation which would detect and rectify any inconsistency between the laws and would be a compilation of all the laws dealing with cross border merger into one comprehensive Act. This Act shall be of comprehensive and exhaustive nature and will deal with all the aspects including the current FEMA Regulations.
- The Committee would set up a single platform to specifically administer the process of cross border mergers. It would calibrate the timelines and implementations of all the laws dealing with cross border mergers. Since different Acts can create different standards of compliances, the expert committee should also proceed along with a notion to standardise the compliance and reporting requirements so as to minimise the costs incurred in for compliance of different statutory requirement under the various laws and so as to avoid confusion and ambiguity.
- It is further recommended by the authors that the expert committee should also further recommend provisions to be added to the act so as to improve the overall ease of doing business in India.

REMOVAL OF EXIT BARRIERS

Exit and demerging of companies is a consequence that should be fully considered by the legislative scheme of the act that proceeds with the idea of facilitation of Cross border mergers under the realm of increasing ease of doing business in India. The authors recommend that the Act should provide for adequate regulatory apparatus to deal with demerging and exit of companies and a practical system to execute such demerging and exit of the companies quickly. This includes-

- Ensuring that there are provisions which protect creditor's rights, against erosion of the asset value, management of the company. A court appointed administrator to take control of the assets and the management of the firm to either ensure revival or speedy winding up.

- Increase the use of technology so as to bring down human discretion or political involvement and also to reduce the number of intermediaries in the entire process and speed it up.

Further, the Act should also include explicit provision on restricting the use of lock-in clauses. Thus, if a foreign entity wants to merge with an Indian company, there would not be an arbitrary imposition of lock in period by the approving authority.

SETTING UP OF A DISPUTE RESOLUTION TRIBUNAL

The Dispute Redressal Tribunals in India are over-burdened. Referring a dispute to these tribunals is not only time-consuming but also results in an inefficient judgement. The authors thus recommend for a separate Dispute Resolution Tribunal to deal with matters that might arise out of cross border mergers quickly and expeditiously. The judges in these tribunals will be well versed with the laws in relation to the same and the procedure will also be prescribed taking into consideration the specific nature of the dispute. It will thus provide for a specialized review of any dispute that may arise guaranteeing the foreign company of a speedy and effective solution to any problem that may arise.

CORPORATE GOVERNANCE MECHANISMS

The authors recommend that the Act includes provisions that provide for appraisal rights of the minority shareholders and the employees, especially in the case of an outbound merger. The Act should also provide for convergence in different systems of corporate governance. That is, the resultant company and the merging company should adopt the best practices from the corporate governance systems and laws of either or both countries.

REVISION IN EXISTING LAWS

- The Indian labour laws are currently considered to be "archaic" and "regressive" and act as an impediment to cross border mergers. Many a time, the laws are not conducive to the labour requirements of the foreign companies.
- It is recommended that the all the labour laws be dealt with under a single comprehensive code. This code should include provisions which are specifically drafted for the companies resulting out of a cross border merger. They should maintain a balance between the requirements of the company and the interest of the labourers.
- The possibility of the expropriation of property by the government is also a reason for foreign investors to hesitate in doing business in India.
- In India, this was initially governed by the Land Acquisition Act of 1984, which in 2013 has been revamped to form the Right to Fair Compensation and Transparency in Land Acquisition, Rehabilitation and Resettlement Act 2013. Government uses terms like "public policy" as well as "urgency" in its plan and act of land acquisition, which has been loosely defined in the said Acts and is filled with loopholes. Such

uncertainty would not be favourable to a business man who proposes business in India. Hence, there is a must need to amend and better define the provisions with regards to appropriation along with a restriction in arbitrary appropriation of land.

VII. CONCLUSION

Cross border mergers pave way to three principles enshrined in our economy post 1991, ie, liberalisation, privatisation and globalisation. The article in whole has been a testimony to the growing trend of cross border mergers. Though such mergers present vast opportunity to the expansion of Indian business abroad as well as in the domestic arena, this growth is impeded by a weak regulatory structure that is weaved with ambiguities and uncertainties. Through the recommendations, the authors have tried to establish a strong legal mechanism that can support such mergers in line with international standards as well as remove the maladies present in the current system. Through a system consisting of properly regulated authorities that can monitor and direct cross border mergers, it is certainly believed that India can indeed ease its economy to attract investors and actualise the current paper provisions on cross border mergers. Further, the mere introduction of the current Merger Regulations with its well demarcated provisions itself is a welcoming step for India. Hence cautious optimism in the future of an efficient cross border merger system is indeed well placed. There has to be a well-placed study by the Indian Government on the impact of such cross border mergers in India and amend the existing legal provisions to provide clarity to its current position along with ensuring effective implementation of such mergers.

7. ENSUING CONUNDRUMS IN MERGER AND ACQUISITION BEYOND BORDERS WITH FUTURE DIRECTIONS*

Abstract

Corporate restructuring is a global phenomenon adopted by the corporate entities to elevate their market position. Merger and Acquisition (M&A) is a form of restructuring which is not devoid of global influences. The recent trend in M&A is cross-border transactions in which two different entities are involved having headquarters at different geographical locations. The trans-border M&A is not an easy method of integration and it involves lot of knottiness. The researcher in the present paper endeavour to examine the intricacies involved in the cross-border M&A. For this purpose, the paper has ramified the phases of M&A process into three stages i.e., Pre phase, Integration and Post M&A phase. Each broad segment covers the challenges encountered by the parties involved in the deal and the researcher attempts to put forth measures to mitigate such involutions. The paper exhibits the Indian scenario with respect to international corporate restructuring deals. Lastly, the researcher gazes into contemporary tenets emerging in cross-border M&A.

Keywords: Cross-Border M&A, Challenges, Recommendations, Contemporary Issues.

INTRODUCTION

Economic growth is the main buttress for national prosperity and development. The advent of globalization, privatization and liberalization paved the way for financial and economic achievements through trans-national transactions. Corporate restructuring is not devoid of the cross-border influences. International Merger and Acquisition (M&A) occurs between acquirer and target company when both entities are headquartered at different countries. Banking, insurances, telecommunications, chemicals and pharmaceuticals companies generally observed continent-wide M&A. While the majority of merger and acquisitions involve two firms within the same country, over 40% of the merger and acquisitions that were completed between 2000 and 2007 involved firms headquartered in two

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different countries.[359] The primary reason for an M&A is to achieve synergy by integrating two or more business units in a combination with an increased competitive advantage.[360] For instance, the Carrefour merged with Promodies in order to compete Walmart as the company got expanded on a large-scale.

The trans-border mergers and acquisitions are filled with intricacies if compared to national mergers. However, trans-mergers are unavoidable in the present era where corporate entities aspire for expansion of their business at a global level despite having glitches. The difference in the geographical locations poses encounters at different stages of M&A. In the preliminary stage regulatory, taxes, legal issues, management conflicts, cultural differences, financial constraints and valuation difficulties are some enumerated and recognized stones in the path of M&A deal which generally every party involved in the transaction beyond borders has to confront. The difficulties do not end here, the integration and post-merger and acquisition are other milestones to be conquered. Integration of new business, assessing the market opportunity, advent of new legislation, political ventures, retention of talent, bridging the gap through communication are other challenges faced in the later part of the deal. Re-engineering a corporate structure is not a task to play and it proffers mutual benefit for which the entities enter into the complex procedure of M&A, especially the trans-national transactions which requires a step ahead of general endeavour. Incentives are the drivers for the bidder and the target company to restructure their capital.

In case of cross-border M&A challenges are likely to emerge due to variation in the structure, management and other soft and hard elements of the corporations. Although, viewing to the economic viability and significance of trans-national transactions, the discontinuance of it does not seem to be economical and therefore, measures should be taken to avoid maximum risks involved in global deals.

INDIA'S VENTURE TO TRANS-BORDER MERGER AND ACQUISITION

The 1990s were a golden era when the Asia Pacific region witnessed a double hike in the volume of trans-border M&A. India remained in dilemma to put its reliance on foreign direct investment or not, this favoured other countries like Africa and Latin America which had become favourite destination for investors around the world. In the year 1999 the Foreign Exchange Regulation Act (FERA) was reformed to Foreign Exchange Management Act (FEMA) which governed the foreign exchange and the new regulation facilitated the Indian

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[359] Gladys Millicent Njambi Muchae, Challenges of Cross Border Mergers and Acquisition: A Case Study of Tiger Brands Limited (Haco Industries Limited), 2.

[360] 9, Advances in Mergers and Acquisitions, 8 (1st ed., Sydney Finkelstein and Cary L. Cooper, 2010).

corporations to grab international opportunities. The new legislation relaxed the overseas investment and considerably raised the investment limits. With the view of removing the stringent provisions of Monopolies and Restrictive Trade Practices Act, 1969 which restricted expansion of the corporation and other restructuring procedures, the legislators replaced the Act with a more comprehensive statute named Competition Act, 2002.

Earlier India was a fascinating destination for foreign investment and Indian companies were acquired by the foreign stakeholders. The trend has been shifted and now the Indian companies are the bidder after the amendment in laws in April 2017. The recent growth in cross border M&A has been a boon for small businesses as they receive opportunities to expand themselves as an international corporate player and this, in turn, boost the Indian Economy. The 2005 World Investment Report by United Nation Conference on Trade and Development recognized India as a leading nation in the Information Technology and an attractive hub for research and development. Uncountable transactions have been entered between Indian and global entities notably the acquiring of a telecommunication corporation Zain of Africa by the Bharti Airtel, Jacquar and Land Rover was acquired by Tata company, the purchase of Daewoo Electronics by Videocon, etc.

Driving force for the Indian entity to indulge in foreign acquisition: to grab the alien market, expansion in assets and ability, growth of services or product and intense domestic competition. The bidder and the target company of distinct nations come together to create newfangled legitimate corporation through integration of industrial assets and processes. This trans-national the integration facilitates global networking via goods, services, technology, etc. As the operational efficacy increases by a reduction in cost as a consequence of integration, this provides operational synergy which is one of the driving force for the M&A. The Financial synergy which reflects the effect of M&A on the cost of capital and owning to this restructuring the cost of the capital is diminished. Other motives for which the companies attract towards integration are managerial motives, diversification, to boost market power, expanding the size of the business, cross-selling, economies of scale, to reduce tax liability, etc.

Broadly, the cross border M&A is categorized into inward and outward wherein the former deals in selling of a domestic firm which results in inward capital flow, however, the latter signifies acquiring of a foreign entity which entails with the outward capital flow. Unlike joint ventures, M&A is long term integration where the capital of the companies is gathered. The ultimate objective of expanding the horizon of their businesses is achieved through investment intangible as well as in intangible assets. Through these investments, there is

capital growth and the activities of the company experience enlargement. The other perk is employment creation for the long term. For instance, the world's largest e-commerce acquisition was made between Walmart, Inc., a U.S. based company with Flipkart, India's largest online retailer, for $16 billion.[361] This evidences the emerging market opportunity for India.

CHALLENGES AT DIFFERENT PHASES OF MERGER AND ACQUISITION

The figure shown below illustrates that each decision made in the deal at any stage affects whole of the procedure of transaction. The process is in cyclic form and each segment contributes to a successful M&A. In the pre-phase, if any differences arise it is to be negotiated and only by reaching to the compatibility height, a deal is completed. Each compartment, in the figure shown, requires diligent approach from the parties involved to mitigate the challenges encountered at each stage of the deal.

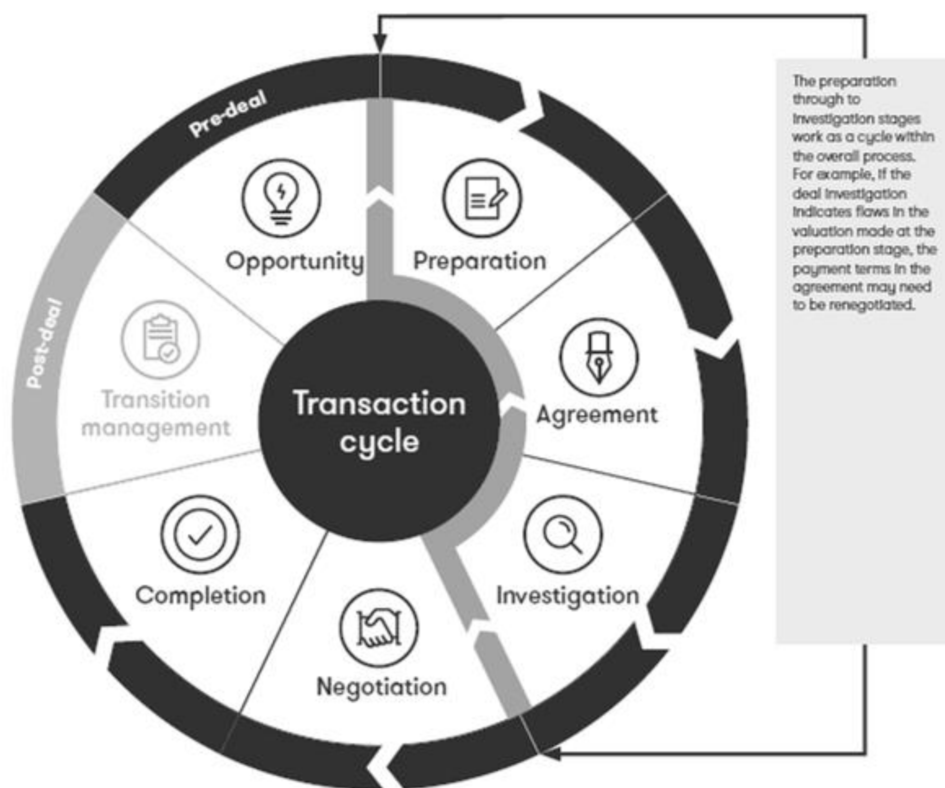

Figure 1[362]

The challenges in trans-border M&A is broadly ramified into three major stages at which

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361 ET Bureau, Walmart acquires Flipkart for $16 billion in world's largest ecommerce deal, Economic times (10 May 2018), **https://economictimes.indiatimes.com/small-biz/startups/newsbuzz/walmart-acquires-flipkart-for-16-bn-worlds-largest-ecommerce-deal/articleshow/64095145.cms** accessed 2 July 2018.

362 Reducing Risk in Cross-Border Transaction [2017] Grant Thomton, 3, http://www.grant-thornton.ch/globalassets/1.-member-firms/switzerland/insights/pdf/201711/crossborder_transactions_1117.pdf accessed 02 July 2018.

the acquirer and the target company has to take all precautions and measures to puzzle out the emerging issues. It is pertinent to mention that there is no water-tight compartment division of factors offering challenges at different stages as they inter-play at different stages and the consideration is needed to be given to each factor influencing M&A at every stage. In the following segments of this paper, the researcher attempt to broadly divide M&A phases: (1) Pre-M&A phase, (2) Integration phase and (3) Post M&A phase.

a) Pre-Merger and Acquisition Phase

Willingness paves the way for any success or failure. The thought of engaging in M&A is the seed which germinates when the entity makes an offer to the targeted organization. Pre-merger stage is a crucial one which can save the finance availability and shield the entity from any unprofitable agreement. The cautiousness level is needed to be peak in this phase. Before the integration process begins the seekers of M&A goes through challenges such as resistance by the employees, negotiation by the executive, approval by shareholders and regulators, analysis of the target firm, development of process plan for re-integration including business administration and tax laws.

b) Due Diligence

Due diligence provides a scenario of market opportunity which is to be initially examined or else causes post -deal issues. Due diligence should undertake the scrutiny of target's business along with legal, political and social issues which could anyway affect the deal. Due diligence is a spearhead to kill the possibility of failures in M&A. Asia- Pacific region and North America attach a lot of importance to due diligence for a successful M&A. It involves a step-wise procedure to examine the possible risks and the ways to mitigate the same. Due diligence process involves accounting and tax due diligence, operational and commercial due diligence and regulatory and legal due diligence. Non-adherence to due diligence might give pessimistic results even in the case where the transaction comes to an end.

c) Identification and Valuation

Identification and valuation is the primary conduct of the parties dreaming for M&A. In the stage of identification, the bidder company has to spot a target entity which could prove to be beneficial to the business of the acquirer if merged. For the purpose of identification, there are acquisition specialists who can assist in finding out the right firm. In the past, the business person had confined choices and could not dream beyond boundaries. However, with the development in technology and globalization in fuel, the domestic corporate has a plethora of options to go for trans-border merger by identifying best for it. After identification, the stage of valuation comes. Valuation methods are industry -specific and a

variety of sword is used by the parties to evaluate the target company. Valuation aids to gather economic viability and point towards the use of intellectual property which can facilitate the acquirer for developing their future plans with the vision of victory. For valuation, one has to foresee the profitability, market power, cash flows, assets, etc. of the targeted entity. The price is fixed on this valuation prior to the finalization of the deal. In Tsingtao Brewery in China, "*the cost per tonne of brewing capacity of the business is an industry-specific valuation method frequently employed*"[363]. Due to the low availability of information in cross-border M&A, the target's business is not evaluated pre-merger. The information is sometimes very sensitive and earthed deeply which makes the task of the acquirer to evaluate the acquiree a difficult game to play. Valuation of intangible assets can be a good way to avoid any contingencies. Especially in cases of M&A deals, audit, valuation and due diligence are the ways for reaching successful integration.

d) Stage of Settlement

Settlement is the next platform for valuation and identification. This stage involves the consent of the management, regulatory authorities and compensation assessment, etc. An acquisition can be friendly or hostile, in the former there is support and consent of the target company for the deal however, in the latter faces certain resistance by the takeover company.[364] It is the bidder company who makes the offer and approach to the target company in order to vividly express their logistics for acquisition. There are possibilities of having descending members in the target company and often resent on the premise that the management of the company is not holding their shareholders value. Tender offer is another tool used by the acquirer to gain control over the company even if the shareholders rejects the deal.

Before venturing to sign and confirm the purchase agreement, the acquirer should find all possible means to resolve the intricacies involved or which might encounter at a latter stage of integration. One needs to consider restrictions and deal with protection methods as per the legal framework of the nation.

e) Regulatory Challenges

Regulatory Challenges are of such nature which is to be mitigated in the first place and most of the industries believe that regulatory issues lead to failure in understanding the

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[363] Web Chapter: Cross-Border Mergers, Acquisitions, and Valuation, **http://wps.aw.com/wps/media/objects/5315/5443332/Chapter_WEB.pdf** accessed 02 July 2018.

[364] Isabel Feito-Ruiz and Susana Menéndez-Requejo, Cross-Border Mergers & Acquistion in Different Legal Environment, EFMA Annual Meeting MILAN 5, (2009), **http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.502.6304&rep=rep1&type=pdf** accessed on 01 July 2018.

domestic requirements of the target company. An estimation of such issues should be done at the opportunity stage. The government policies of a nation largely effect and influence investment, privatization, liberalization and in turn is decisive for trans-border M&A. It is required that the specialist hired must have knowledge of the domestic regulations and should have a good professional network in the area. To maintain public welfare, there are stringent regulations to deal with international transactions, for instance, the American government poses two-level safeguard, i.e., the approval of the deal by the Federal Trade Commission and the Department of Justice.[365] It is likely in international M&A that the involved countries' legal requirements would vary. The competition and corporate laws are distinct in different nations and these laws play a vital role in the restructuring process. The compatibility in compliance with these laws is determinative in deciding whether to go ahead with the integration.

In inbound mergers, the resultant domestic entity has to adhere to all the requirements regarding loans and other provisions of the foreign jurisdiction. However, in outbound mergers, the company has to comply with the regulations of Reserve Bank of India (RBI) if the merger takes place with an Indian company. The present legislation sets a minimum amount for investment which has resulted in depreciation of outbound M&A.[366]The acquiring of MTN Ltd., a South African corporation, by Bharti enterprises pointed out deficiencies in Indian Legislation. Uniformity in the regulations would reduce the creeping problems. At the investigation stage the legal problems in the deal is to be mitigated in order to understand the viability of the agreement. An alien has to take support of a good legal advisor to understand the domestic compliances.

f) Avoidance of Tax Default

It is significant to have a clear outlay of the tax when it comes to integration and restructuring the assets and stocks of a company. Also, the accounting considerations are to be observed by the bidder company to score substantial growth. The parties engaged need to be fully aware about the financial and accounting policies in the transaction to avoid any perplexity. Tax regulations determine whether the deal is going to be smooth or it has to pass through thorny bushes. In international M&A, tax issues of two nations are to be resolved and advisors who are industry specific are preferred. Tax compliance is needed to be met at

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365 Dr. Vijay Kumar Sharma and Rakesh Kumar Sharma, Cross-Border merger and acquisition with special reference to India, **http://www.indianmba.com/faculty_column/fc720/fc720.html** accessed 11 July 2018.

366 Rishabh Shroff and Manu Varghese, A New Dawn for India's Cross Border Merger Regime, India Corporate Law: A Cyril AmarchandMangaldas Blog, (24 May 2017), **https://corporate.cyrilamarchandblogs.com/2017/05/new-dawn-indias-cross-border-merger-regime/** accessed 11 July 2018.

the pre and post phase of M&A for the newly formed entity.

g) Technology Barriers

Technology is one of the accelerating factors for M&A. Where there are high technological reforms, entities feel compulsory to go for integration as it would share the cost of innovation and also it is necessary for multiplying their innovatory capability, the transportation cost is reduced to technological development and creates a platform for more and more cross-border M&A. Due to technology improvement, the interaction gap between the target and acquiring entity is reduced and it further simplifies the cross-border transaction. An example is CleanTech Biofuels, Inc.'s acquisition of the sophisticated technology of Biomass North America Licensing, Inc. through a strategic merger to convert municipal solid waste into cellulosic biomass and generate electricity.[367] Technological reforms revamp the competitive environment. In recent years, the increasing dependence on technology is offering not only benefits but cyber threats too. These cyber-crimes hinder national and international transactions. Cyber wrongs are big stones in M&A deals and parties involved must opt for safeguard measures to shield the deal from any cyber threats. Generally, the parties in the initial phase underestimate the probable impacts posed by the Information Technology (IT) and the latter suffer from the uneasiness in the deal. It is suggested that a pre-plan regarding IT would serve the purpose of a smooth deal. IT sector is in itself intricate and needs long term investment for substantial return. These intricacies further aggrandize when any such corporation involved in M&A and integration poses risks too. In the words of Shant Peter Yeremian, "*the best mitigation post-deal IT integration failure is early assessment, planning and engagement well before the deal is closed*."[368]

h) Financial Constraints

Finance is the backbone of the business. Assessment of the availability of finance is must and the parties need to be specific about it. However, the significance of finance is attached to the nation's economy. The initial phase of the deal experience struggles in establishing terms among the parties regarding finances. The bidder at the outset has to analyse its financial capabilities to fulfil the requirements of the deal, also analysis of target company's finance is to be done to forecast the post-merger position.

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[367] Mandavi Singh, Intellectual Property: The Dominant Force in Future Commercial Transactions Comprising Mergers and Acquisition, Indian J. Intell. Prop. L. 180, 182.

[368] Managing IT challenges pre- and post-M&A, Financier Worldwide, (July 2018), **https://www.financierworldwide.com/managing-it-challenges-pre-and-post-ma/#.W0XfitJLjIV** accessed 01 July, 2018.

❖ Integration Phase of Merger and Acquisition

Once the agreement stage has arrived, the practical problems begin to pop-up. Till the agreement is made, the difficulties encountered is on paper but the real world issues are yet to arrive for the parties involved in the deal. At this stage, the management of the companies involved has to go through a lot of hurdles in order to combine two distinct corporate entities.

a) Inevitable Human Factors

In pre-merger phase the bidder company generally avoids social and human factors while expanding its operations, however, in the integration phase this proves to be a significant problem. The Human factor is important for running a successful business which is resultant of two different entities. It includes the psychological and organizational environment of the employees of both units. Irrespective of the hierarchy there is a psychological connection between the corporation and the individual. The challenge encountered by the employees is the adoption of the working with new methods, adaptation to the new culture in the management process, etc. The challenge is more in cross-border mergers wherein the human culture of the engaged organizations is at two different poles. In *Hindustan Lever Employees Union v. Hindustan Lever Ltd.*[369]the Supreme Court upheld the interest of the employees in M&A however, it ruled that the scheme which was opposed safeguarded the interest of the employees as the staff post M & A enjoys the same conditions of service as before. The co-relation is required to be maintained for a successful growth in international transactions as well as regular functioning. After an acquisition operation, the employees either support the organization, working more (loyalty) or continue working like before the change (complacency), or they try to change certain aspects by expressing their opposition (opposition), or they reduce the effort at work (slovenly).[370] The employees are generally apprehended of losing their jobs and working under a different leadership of the new organization. The social capital theory determines the rate and the extent to which the employees make social contacts in or outside the organization. These factors are of more importance at post acquisition in contrast to other external factors.

b) Culture differences

Culture as a factor more or less marks a difference in the integration process. Where few scholars consider culture as a prime field player while others give dim focus on cultural elements in effecting the merger. The importance of this factor is eroded by hard factors

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369 Hindustan Lever Employees Union v. Hindustan Lever Ltd., AIR 1995 SC 470.

370 13(1), Mariana Vancea, Challenges and Stakes of the Post-Acquisition Integration Process, AnnalesUniversitatisApulensis Series O economica, 167, 177 (2011).

which opine that in the globalized world homogeneity prevails and cultural differences do not create a substantial difference. Language is another barrier in reducing the distance of corporate situated in different parts of the world. Language resists the feasibility of communication which hinders the emotional and psychological connection to be built up within the parties of the deal. Tiger Brands Limited is one of the leading food and healthcare company in South Africa. Presently there are lots of issues in Tiger Brands (Haco) due to cultural instability, delay in decision making owing to layered structure for making decisions since the entity was merged with Tiger brands. Bancel F. and Duval-Hamel J. are of the view that a stronger corporate culture will more thwart the integration process and the association of employees with their corporate culture resists assimilation in the new culture.[371]In case of trans-border merger, the distance aggrandized the cultural differences and hence, finding a mid-way for integration is quite difficult. This concept looks at how social interactions such as public relations can facilitate mutually beneficial cooperation and coordination (Putnam, 1993) and how social capital can enhance network and industry growth.[372]In case of resolving the cultural repugnancy amidst the bidder and target company, the ideologies of both should be taken into consideration and a mixed culture attitude should be adopted. A two sword approach needs to be applied in mitigating cultural conflict, i.e., 'formal' culture and 'operational' culture integration.[373]

c) Management Integration

In processes of restructuring, there occurs a number of overlapping jobs and posts. The integration of the entities into a single unit poses a challenge to restructure the employees post. A diligent mapping is needed and the competency of the employees should be the criteria to decide the post seekers. Sometimes there is even reshuffling of the departments of the employees and it demands a very flexible attitude on the side of the managers and staffs. Behemoth Bertelsmann acquired Napster which in turn charged the acquirer to pay for its audio service.[374] In parlance to this, the acquiring of Yahoo by the Microsoft was basically an acquisition for its intellectual property. It involves a lot of negotiation skills on the part of the offerer to provide compatibility to the target company in adapting the environment. The human resource management is here a path maker for the deal and has a series of role to play.

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[371] Id. At 173.

[372] Rudolf R Sinkovics, MohdHaniffJedin and Noemi Sinkovics, Marketing Integration in Cross-Border Mergers and Acquisitions: Conceptual Framework and Research Propositions, European Journal of International Management 1, 8 (2013).

[373] Vancea, supra, 176.

[374] Drew Cullen, Bertelsmann saves Napster, the Register, (17 May 2002), **https://www.theregister.co.uk/2002/05/17/bertelsmann_saves_napster/** accessed 01 July 2018.

Communication strategy can reduce the differences if it flows from the top management. Communication requires in the same time the broadcasting of insertions, the psychological approach of employees in order to adapt them to the new context and also an influence strategy to mobilize and co-interest the employees in order to achieve the objectives.[375]

d) Other Challenges

The political structure of the nation determines the feasibility and flexibility in terms of foreign investment especially industries related to defence and security. Prior approval from the trade unions or labour unions is sometimes a pre-requisite of in certain countries. Therefore, an investor before venturing into an alien environment for investment, need to avoid every probability of political risk.

The acquirer company often seeks to take over the intellectual property assets of the target company. Acquiring intellectual property rights is one of lucrative motive for indulging in the restructuring process. In trans-border M&A when the intellectual property asset is transferred the regulations of the bidder company differ from the target company regulation and hence, if any issues arise it is subject to multiple jurisdictions. To restrict such issues, it is admirable to record intellectual property right timely and to safeguard its enforcement.

The payment of the shareholder of the target company is to be done by the acquirer. Either there is an exchange of share or else, the shareholder is paid in cash. The regulatory delay is a major challenge at this foot which affects the share prices of the parties involved. At this segment, negotiation curbs any future hurdles and it is a strong means to peacefully settle the terms between the parties. The phase of the merger is based on industry genre and mostly phase wise merger is apt for successful integration. Any ambiguity at the primary stages of the deal need to be vividly expressed in the agreement or the acquirer ought to specify the occurrences, future happenings and consequences to the management of the target company.

❖ **Post-Merger and Acquisition Phase**

In post-acquisition integration there is restructuring of enterprise and both the acquirer and the target company's employees struggle to achieve compatibility for a successful integration, for instance, in the case of Sanofi-Synthelabo. Post-acquisition management is next mountain to be crossed over by the M&A seekers. Those reasons, such as more effective management, synergies arising from the new combination, or the injection of capital at a cost and availability previously out of the reach of the acquisition target, must be effectively implemented after the transaction.[376] As a function of the total number of studies examined,

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[375] Vancea, supra, 174.
[376] Web Chapter: Cross-Border Mergers, Acquisitions, and Valuation, 8,

14 of 17 (82.4%) cited business combination failures related to post-merger and post-acquisition integration.[377] Past research has raised their concerns regarding trans-border M&A as two-thirds of the integration. desert to make purposeful shareholder value. The Association of South-East Asian Nations investment department owing to the financial issues in 1998 provided various incentives for trans-border M&A. Reasons for subsequent failures in M&A are human risks, retention of talent, job risks, employees diminishing commitment and fall in productivity.

a) Employees Dilemmas

It is often found that the employees of the target company are forced to adjust and survive in the corporate environment of the bidder company. The cultural differences weaken the performances of the entities after merger and acquisition operations. Cultural conflicts mean a clash of values, morals, ideologies, visions, missions, etc. of the distinct bodies. Lack of trust building by acquirer company's management creates a distrust in the employees of target companies. They apprehend that their concerns and grievances would be left unheard. This generally happens due to poor communications regarding notifying the staff about the process of M&A. Another, dilemma which pops up at managerial level is a clash of leadership and losing key personnel. The management must be fully acknowledged about the demands of the staffs and should adopt strategies to train the employees with such skills and knowledge which can assist them to leap from the current position to a new desired structure of the business. In terms of employees care and training post-merger, the acquiring of Ash Stevens Inc. by Piramal Enterprises sets an example for other future deals.[378] Piramal Enterprises looking up to the requirement of the target company provided the key personnel's specific guidance and opened opportunities in order to retain their talent and to prove their deal to be successful. Educating staffs and enhancing social interactions would prove beneficial. Accountability of involved organizations is a must factor. Introduction to the change management prior M&A process would strengthen the target company's workforce to work in the right direction and also this gives a time period to the employees for psychological adjustment to suit the coming changes. In no way, the merger and acquisition, either domestic or international, should be prejudicial to the interest of the employees and therefore, it is recommended that the entities

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<**http://wps.aw.com/wps/media/objects/5315/5443332/Chapter_WEB.pdf** accessed 02 July 2018.

377 Avinash Kumar Singh, Challenges in Retaining Talent Post Merger & Acquisition in India: A Literature Review, Degree of Master of Business Administration, (2016), https://www.sims.edu/placementapi/storage/app/phpGfVRic.pdf accessed on 03 July 2018.

378 **Nandini Piramal**, Manage employees during a merger, Livemint, IndiaMBA.com, (09 July 2018), **https://www.livemint.com/Leisure/9nfANbboS5er4aXCMjHaMO/Manage-employees-during-a-merger.html** accessed 10 July 2018.

must vividly express the beneficial terms in the agreement for their employees.

b) Centralization versus Decentralization

In transnational M&A, the integration of two companies with different visions which provides vagueness in the direction in which the new business has to move. It is a long process to figure out what vision exactly the new company holds. To weave the thread of the same vision in the new company there is a need to set a common goal, mission, vision, values, etc. to avoid any kind of confusion among the employees of the acquirer and the target company. Post-merger, the company having branches at different geographical locations, it complicates the management of the organization. The top level management many a time fails to release the considerations of different branches and this might raise dissentient in the shareholders and employees. It is advisable to adhere to the decentralization mechanism for a smooth working of the management as the desires, aspirations and requirements of the branches connects with the domestic environment where the entity operates. For the sake of control if the parent company opts for the centralization of the management, this might lose the threads of authority following from the top to the ramified branches.

c) Size Concerns

M&A encounters hurdles due to the difference in the size of the corporates involved which includes assets and capacity of the company in terms of employees. Owing to the variation in the size of the companies, there arises an apprehension in the minds of the shareholders and the employees of the target company if it is too smaller in proportion to the acquirer company, as their right is at stake. These differences sprout due to the target company's irresponsibility or less sensitiveness towards communication or proper guidance which could have been made to facilitate a better impact about their competencies to acknowledge the needs of the acquiree. The acquirer often commits mistakes of devaluing the importance of future investment and ignoring the same advances haphazard results. Differences can hamper the growth and defeat the purpose of the merger. For instance, the merger of Daimler and Chrysler ended to form a third largest automobile corporation with increased market capitalization and revenue.

Although other prerequisite continues to be favourable for the integration, transaction often fails in the course of running the integrated business. The vision of the acquirer's management struggles to sustain its practical implementation but due to failure in managing to fulfill all the hopes of the targeted business the deal ends. This further hampers invested finance, workforce, time, and efforts which could have been attributed for other strategies. Hence, in the initial phases, a strong due diligence and mapping is needed to shield the

company from futile and unprofitable task. A post-closing M&A plan should be ready and the plan should be drafted well to counter the hurdles in ending the transaction.

INDIAN LEGAL FRAMEWORK REGULATING TRANS-BORDER MERGER AND ACQUISITION

In the developing nations, the pace of M&A accelerated at a later stage and in Indian M&A picked up with the advent of liberation in 1991. The remarkable amendments of the companies act in 2013 fuel the growth rate of cross-border transactions by easing and liberalizing the norms regulating such transactions. In recent times the Indian legislature is venturing to amend the Indian statutes in tune with the contemporary demands for leaping to cross-border integrations. In India, Cross border is majorly regulated under (i) the Companies Act 2013; (ii) SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 2011; (iii) Competition Act 2002; (iv) Insolvency and Bankruptcy Code 2016; (v) Income Tax Act 1961; (vi) The Department of Industrial Policy and Promotion (DIPP); (vii) Transfer of Property Act 1882; (viii) Indian Stamp Act 1899 (ix) Foreign Exchange Management Act 1999 (FEMA) and other allied laws as may applicable based on the merger structure.[379] For governing the inbound and outbound mergers there are rules which provide elaborative mechanism like Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 (the FDI Regulations) and Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004 (the ODI Regulations).[380] In Companies Act 1956, there was no provision for merger of the Indian company with a foreign company incorporated outside India (Outbound Merger) but it was possible for a foreign company to merge with an Indian company (Inbound Merger). Section 234 of Companies Act, 2013 provides for M&A among domestic(s) and foreign companies which are in force from 13 April 2017. Reserve Bank of India (RBI) with the view to give effect to trans-border amalgamation, engraved the new section which level the field for international transactions. In providing an extension to the procedure provided in Section 234 the Ministry of Corporate affairs by its notification added Rule 25-A in the Companies (Compromises, Arrangements and Amalgamations) Rules 2016. The section further widens the scope of rule formation in consonance with international amalgamation on consultation

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[379] Cross Border Mergers – Key Regulatory Aspects to Consider, NOVOJURIS, **https://novojuris.com/2018/04/19/cross-border-mergers-key-regulatory-aspects-to-consider/** accessed on August 22, 2018.

[380] Id.

of central government with RBI.

Foreign Exchange Management (Cross Border Merger) Regulations, 2018 is one of such contemporary move by the RBI to resolve the emerging conundrums in the cross-border M&A. FEMA regulations creates a legal fiction regarding the approval by the RBI for any transaction in the trans-border deal about the approval from the RBI. Also, the key personnel of the companies are required to give an undertaking enumerating their compliance to the FEMA regulations. Chapter XV of the Companies Act regulates compromises, arrangements and amalgamations; however, Section 234 enumerates provisions only on merger and amalgamation. This poses a dilemma regarding the scope of other arrangements like de-merger in Section 234. Prima facie it appears that other trans-border arrangements are not facilitated by the Section but the FEMA Rules provides insights on such international deals.

Foreign M&A are at greater risk as there are stringent restrictions in respect to political, economic, financial and legal arena. It is also a fact that Indian institutional laws, mechanism and governance are weak compared to advanced countries and of course, other emerging markets like China and Brazil.[381] In fact, one would argue that India has become less favored or riskiest locations for investment due to information problems, imperfect contract enforcement, inability to enforce property rights, and flawed regulatory structures.[382] In addition, there is a lack of coordination among various regulatory authorities and the failing corporate governance and control exaggerates the troubles of foreign investors. It is pertinent to understand, for the entities involved, the legal necessities which are core or ancillary to the deal. Rules and regulation of a nation can become a facilitator or a deterrent in international transactions especially M&A as each phase is touched by the regulations prevailing in the states of target as well as the bidder company.

CONTEMPORARY SETTING OF GLOBAL MERGER AND ACQUISITION

Viewing the recent figures, there is a sharp decline in the volume of M&A in 2008, while the year 2007 experienced a good growth of cross-border transactions. This sudden fall was the direct effect of the crisis. Till 2009 the depletion continues and it reached $123 billion. At the same time, the cost of debt financing for cross-border M&A's has risen, as bank lending conditions have deteriorated rapidly following tightening credit conditions and rising interest

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381 K. Srinivasa Reddy, Institutional Laws, and Mergers and Acquisitions in India: A Review/Recommendation, MPRA Paper No. 63410, 4-5, (2015, https://mpra.ub.uni-muenchen.de/63410/1/MPRA_paper_63410.pdf.
382 Id.

rate premiums for the corporate sector.[383] Even in 2012, also saw a decline in the volume of global merger and acquisition. More or less the cross-border deals as per the figure are running corollary to the volume of the deals.

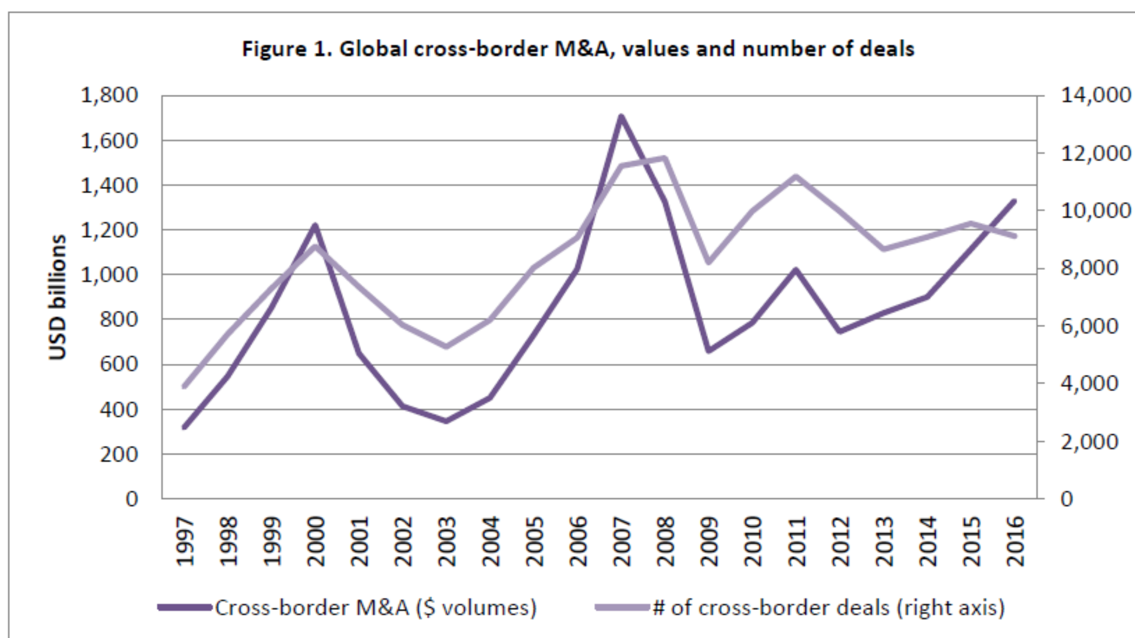

Figure 2[384]

The nations are running for gaining economic and political autonomy, to build a strong foundation and impact in the world in order to compete in the race of trade excellence. Every nation by hook or crook attempts to attain superiority and this drives to impose tariffs on imports and trans-national deals due to which a sudden fall is witnessed in global transaction in recent time. There were 2,834 cross-border deals in the first half of 2018, compared to 3,346 in the same period in 2017.[385] Nations want to build a shield through political intervention to improve its domestic financial position and gain self-sufficiency rather than initiating global trade. Expressing her concerns, the managing director of DBRS, Elisabeth Rudman, recently opined that "*we've seen big cross-border mergers and acquisitions in the banking sector in the past and a lot of them did not turn out very well at all … (It's) difficult to see that as a solution to everything*"[386]. One of the political moves by American President Donald Trump in pursuance

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383 World Investment Report 2009, United Nations Conference on Trade and Development, **http://unctad.org/en/Docs/wir2009pt1_en.pdf** accessed on 03 July 2018.

384 Michael Gestrin, Cross-Border M&A on the Rise, Global Forum on International Investment, OECD (2017), **https://www.oecd.org/investment/globalforum/2017-GFII-Background-Note-MA-trends.pdf** accessed on 6 July 2018.

385 **Silvia Amaro**, Cross-border megadeals fall for the first time since 2013 amid trade and political concerns, CNBC, (3 July 2018), **https://www.cnbc.com/2018/07/02/trade-and-politics-hit-cross-border-megadeals.html** accessed 4 July 2018.

386 **Silvia Amaro**, SocGen chairman calls on regulators to help strengthen Europe's banks, CNBC, (9 July 2018), **https://www.cnbc.com/2018/07/09/socgen-chairman-calls-on-regulators-to-help-strengthen-europes-banks.html**, accessed 11 July 2018.

of so-called trade war was a renunciation of deal of $117 billion between Qualcomm, Inc. and Broadcom, Inc. which are U.S. and Singapore based companies respectively.[387] Also, the subsidiary of Alibaba and MoneyGram deal was restrained by the American Government.[388]

Countries like India which has a lot of speculations about venturing in global transactions and often meddles through political or legal restrictions. The Saudi Arabian Aviation Company Jet-Etihad and Jet Airways deal is a good sample to evaluate the factors challenging trans-border deals as there were obstructions and support for the deal. Other foreign investors are wary in investing in India looking to the tiresome deal of Jet-Etihad. Sometimes the companies have to pass through the net of security and potential issues. For instance, the SNOPC, a Chinese oil company, was thwarted by the US Senate. It is vital to recognize that information gathering in a foreign market is more difficult, more time consuming, and more complex (because of different rules, for example) than at home.[389]

CONCLUSION

In the era of globalization, where the world is steadily becoming boundaryless with the advent of advanced technologies it must not count whether a transaction or deal is domestic or international. For economic self-sufficiency of nations, it is call of the day to indulge in global deals. There is a need for foreign investments, merger and acquisitions for benefiting the businessmen and national prosperity. The states are required to be more flexible with their regulations and laws governing such transactions. The procedural challenges involved in different phases of M&A can be mitigated with the combined efforts of acquirer, aquiree and the involved states. The stringent provisions made by nations to hinder global trade do not comply with the welfare of nations. The trade war will only impede the financial structure and can cripple national growth.

8. BLOCKCHAIN BOOM & CORPORATE FINANCE REVOLUTION: THE FUTURISTIC SOLUTIONS OR MERE SUPERSTITIONS?*

387 **Elizabeth Balboa**, Trade Wars Aside, First Half Of 2018 Sees Highest Value Of Cross-Border M&A In A Decade, Benzinga, (05 July 2018), **https://www.benzinga.com/general/education/18/07/11982084/trade-wars-aside-first-half-of-2018-sees-highest-value-of-cross-bor** accessed 7 July 2018.

388 Joe Mont, The compliance challenges of cross-border deals, compliance week, (13 June 2018), **https://www.complianceweek.com/news/news-article/the-compliance-challenges-of-cross-border-deals#.W0YX9NJLjIU** accessed 11 July 2018.

389 Cross-border PMI: Understanding and Overcoming the Challenges, the Boston Consulting Group, 2, **https://www.bcg.com/documents/file48163.pdf** accessed 03 July 2018.

Abstract

Distributed ledger technology is widely touted as the next big innovation after the advent of the internet and the digital age. The system runs on a de-centralized blockchain platform that is diametrically opposite to conventional centralized command engines. Blockchain systems provide unique advantages that may be realized across banking, finance, corporate, real estate, fashion and even Government sectors. This paper aims to study the scope of application of blockchain solutions in corporate finance systems. The paper will specifically focus on five capital raising avenues that are arguably mature enough and well-suited to benefit from the blockchain boom. They are post-trade plumbing in capital markets, electronic shareholder voting system, mining mutual fund units, peer-to-peer lending and online crowdfunding. The initial three systems relate to traditional capital market methods, whereas the latter two concern alternative finance. While discussing the scope for blockchain applications in these capital raising routes, the paper will analyzeexisting distributed ledger solutions implemented in foreign jurisdictions and understand the legal framework that exists with respect to the same. Following a discussion on the pertinent capital raising systems in India, the paper will delve into potential applications of blockchain technology in the Indian scenario and the legal ambiguities involved therein. Wherever relevant, the regulations that exist in foreign jurisdictions will be discussed to suggest legal changes in the Indian context. The paper will also deal with the disadvantages in implementing blockchain solutions, in order to provide a holistic picture of the scope for advancements in international financial markets through the implementation of distributed ledger technology.

Keywords: *Blockchain, Corporate Finance, Cryptocurrency, Capital Markets.*

INTRODUCTION

Corporate finance is witnessing great technological advancements through the integration of blockchain with capital markets and businesses. Traditional financing systems like banks and equity capital markets are experimenting with blockchain applications that are touted to have the potential to replace them. International legal and accounting firms are also wary of DLT developments and they scramble to incorporate blockchain applications into their service offerings to better address client needs and market demands. Businesses and governments around the world are jumping on the blockchain bandwagon. Dubai aims to become the

blockchain capital of the world by 2020[390] while Sweden, Georgia and Ghana are employing blockchain applications to track land records.[391] Several Indian states such as Andhra Pradesh, Telangana and Maharashtra are undertaking pilot projects to identify blockchain solutions to e-governance hurdles.[392]

However, there is looming disconcert owing to regulatory uncertainty. Governments are in the process of understanding the unique regulatory questions posed by this technology-enabled disintermediation software. The UK, Australia and Singapore, among other countries have created regulatory sandboxes to nurture blockchain innovations in a controlled ecosystem. The UK Financial Conduct Authority prescribes limitations on client risk exposure and provides certain legal compliance exemptions to fintech innovators.[393] This approach reduces legal ambiguity and adopts a test-and-learn method of rule-making.[394] From the innovator's perspective, the lowered thresholds of compliance help concentrate focus on building fintech wonders and provides better access to investments. India needs a regulatory sandbox approach to develop laws that achieve synergy between new technology, investor protection and effective regulatory oversight.[395]

The aim of this paper is to understand the immense potential that can be realized by introducing blockchain solutions to corporate financing avenues. The first part of the paper will provide a short note on DLTand the basic concepts behind the same. The second section will discuss a select few blockchain applications that arerevolutionizing conventional capital markets. It will be followed by a discourse on the potential applications of blockchain in alternative finance, in the third section. With the help of five blockchain applications that augment existing corporate finance systems, the developing legal landscape in foreign jurisdictions will be discussed and the implications for India will be briefly visited. The paper will be concluded with a short note on the future of blockchain in corporate finance and capital markets.

PART I: BLOCKCHAIN BASICS

[390]SaqrEreiqat, Blockchain in Dubai: Smart cities from concept to reality,IBM BLOCKCHAIN BLOG, April 10, 2017. Available at https://www.ibm.com/blogs/blockchain/2017/04/blockchain-in-dubai-smart-cities-from-concept-to-reality/

[391]Will Blockchain revolutionise global real estate next?,THE HERALD, September 19, 2017.

[392] The Governments are employing blockchain solutions with the help of Broadridge and start-ups such as SimplyFi, Zebpay and Snapper Technologies. See MugdhaVariyar&Varshal Bansal, Blockchain tech is joining e-gov dots in AP, Telangana, ECONOMIC TIMES, June 27, 2017.

[393]Regulatory Sandbox, FCA PRESS RELEASE, April 11, 2015. Available at https://www.fca.org.uk/firms/regulatory-sandbox.

[394]Financial Conduct Authority provides update on regulatory sandbox, FCA PRESS RELEASE, June 15, 2017. Available at https://www.fca.org.uk/news/press-releases/financial-conduct-authority-provides-update-regulatory-sandbox.

[395]SamraatBasu, The future of crypto-financing in India, MINT, October 3, 2017.

Blockchain is a decentralized highly secure peer-to-peer system that removes the need for trusted third parties and facilitates instant transactions.[396] The blockchain system functions as a distributed ledger that records timestamped transactions that may not be unilaterally altered. The process of recording transactions on the ledger is called mining.[397] The originally envisioned blockchain prototype requires all transactions to be greenlighted by all nodes that form part of the distributed ledger. This ensures that hacking is nearly impossible and the system remains transparent. Complete transparency provided a solid basis for the reliability of the blockchain ledger that was not based on personal trust.

However, such a rigid method of authorization leads to security concerns and cost and time inefficiencies in large-scale ledger facilitated transactions. Hence, the blockchain platform has been re-innovated to allow pre-identified nodes to approve transactions and retain control over alterations of the ledger. Similarly, several modified versions of the blockchain ledger exist in the market.[398] Ethereum is one such blockchain system and it supports smart contracts that have tremendous potential to revolutionize capital market transactions.

Smart contracts refer to ethereum applications that facilitate automatic performance of pre-negotiated contractual terms. This system removes the need for third-party intermediaries like lawyers and banks since the terms of the digital contract are coded in a distributed ledger that cannot be unilaterally altered. Agreements will self-execute once trigger events like deadlines are met as smart contracts incorporate algorithmic protocols that do not rely on a centralized commanding engine.

In brief, the key elements of a blockchain or DLT are fourfold:[399]

(1) A distributed ledger that records time-stamped information;

(2) A network of participants or nodes that can access the ledger and make alterations based on the specific configuration;

(3) A consensus mechanism that is essentially a set of algorithms that nodes execute to approve the records on the ledger; and

(4) Cryptography in order to secure storage and prevent hacking.

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[396] Satoshi Nakamoto, Bitcoin: A Peer-to-Peer Electronic Cash System,BITCOINORG (2008).

[397] Judd Bagley, What is Blockchain Technology? A Step-by-Step Guide For Beginners, BLOCKGEEKS, 2016.

[398]Building on the Blockchain,Nasdaq Blockchain Report, March 2016.

[399]Evaluating DLT, ASIC Information Sheet 219 (INFO 219), issued in March 2017. http://asic.gov.au/regulatory-resources/digital-transformation/evaluating-distributed-ledger-technology/

Smart contract applications are currently being employed by fintech companies for issue of private securities on Nasdaq[400] and BorsaItaliana[401].Several more bourses such as those in Chile and Japan et al are in the process of implementing blockchain solutions.The primary areas in capital markets where blockchain can be applied are:[402]

(1) Post-trade plumbing, which refers to clearing, settlement and custody of securities.

(2) Regulatory transparency, which mainly entails periodic disclosures, provisions against insider trading and reporting and audit requirements; and

(3) Issuer-investor relationship, which majorly involves contracting of terms and conditions, execution of the agreement and management of shareholding, collateral. This section provides a brief discourse on the trailblazing blockchain solutions to mechanisms and processes in international financial markets and attempts to demonstrate their applicability to analogous systems operating in the Indian markets.

Post-Trade Plumbing

The advent of algorithmic trading led to the operation of stock exchanges in a computerized platform that had the capacity to support around 10,000 transactions per second. Post-transaction plumbing takes longer time periods and actual transfer of ownership and delivery is generally delayed by a day or two. This leads to business latencies since capital that could otherwise be utilized, is unnecessarily stuck in the T+3 process. Shorter time intervals would also minimise counterparty risks and reduce collateral requirements. However, the extended settlement intervals applicable today are not the result of mere technological limitations. It is a combination of factors ranging from market practices to regulatory requirements.[403]Hence, blockchain implementation may not necessarily reduce the time period to T+0 without regulatory overhaul. It is important to note that in a T+0 system, short-selling of securities

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[400]Nasdaq Linq Enables First-Ever Private Securities Issuance Documented With Blockchain Technology, NASDAQ RELEASE, December 30, 2015.

[401] The London Stock Exchange owns the Italian Stock Exchange. See Roger Aitken, IBM's Blockchain Securities Collaboration With LSE Heralds New Trading Opportunities,FORBES July 19, 2017.

[402]Laura Shin,Why Nasdaq Is Even More Optimistic About Blockchain Than It Was 3 Years Ago, FORBES, February 23, 2017.

[403] Milos Dunj, Post-Trade Clearing & Settlement Processing Optimization: An Opportunity for Blockchain?,May 3, 2016. Available at https://letstalkpayments.com/post-trade-clearing-settlement-processing-optimization-an-opportunity-for-blockchain/

may not be possible, thereby eliminating a major chunk of market liquidity that comes from such sophisticated trade.

United States

The Securities and Exchange Commission (SEC) recently replaced the T+3 formula and introduced a T+2 settlement system for shares, ETFs, municipal securities, specified mutual funds and certain limited partnerships that are listed.[404] The Treasury bill is the only security that can be settled in less than a day in the US.

European Union:

Target 2 Securities (T2S) is a service for Central Securities Depository that provides a single IT platform for settlement of all national and cross-border securities transactions in the Europe in Central Bank money.[405] The integrated model provides faster and easier settlement of securities in Europe and even facilitates settlement of foreign securities at significantly shorter intervals. T2S is a remarkable development upon the diverse settlement mechanisms that previously existed across Europe. The advantages of a uniform pan-European settlement method spills over into financial markets across the world.

Australia

Australia recently announced a collaboration with JP Morgan Chase to build a blockchain solution to digitize the Australian Stock Exchange (ASX's) share registry.[406]ASX may not implement a holistic blockchain system owing to the troubling transparency of the DLT. Market participants would not want rival traders and brokers to track their trading activities. Hence, major modifications to the DLT are required before ASX can employ a blockchain application. The aim is to allow peer-to-peer trade clearance and create sub-networks for individual transactions. For instance, a chain of brokers may be configured to record the time, nature and the number of transactions and the price of shares traded. The ASX should also create an overarching centralised digital platform, alterable only by Government authorities.

India

Indian capital markets have followed the T+2 rolling settlement mechanism from the financial

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[404] Sarah Lynch, SEC shortens settlement cycle for securities trades,REUTERS, March 22, 2017.

[405] Hans Degryse, Mark Van Achter & Gunther Wuyts, Plumbing of Securities Markets: The Impact of Post-Trade Fees on Trading and Welfare,SOCIAL SCIENCE RESEARCH NETWORK WORKING PAPER SERIES (October 2016).

[406] Adrian Lee &KIHoon Hong, How blockchain technology is about to transform sharemarket trading, The Conversation- Australia, February 4, 2016. Available at https://theconversation.com/how-blockchain-technology-is-about-to-transform-sharemarket-trading-53807

year 2003-4.[407] SEBI is mulling over the idea of introducing T+5 hours rolling settlement for certain types of equities, in the near future.[408] The existing Indian financial market system is relatively advanced for a developing country at this stage of economic growth.[409] Indian stock exchanges, depositaries and clearing corporations have shown willingness to adapt to technological developments in the past. It would not be surprising if NSE and BSE announce plans to adopt blockchain solutions to post-trade plumbing, as seen in the case of ASX.
Technological disruption of post-trade processing in international capital markets would be welcome. Blockchain platforms could be employed as the base for financial transactions in fully dematerialized markets such as Singapore. However, owing to the linear nature of the blockchain ledger, the potential of blockchain applications to support large-scale data retrieval and analytics that exist in traditional capital markets remains unclear.[410]

Electronic Shareholder Voting System

Nasdaq successfully tested a blockchain solution to improve existing proxy voting system for companies listed in the Tallin Stock Exchange of Estonia. The DLT application supports remote voting and delegation of voting power. Delegation happens through transfer of tokens representing ownership to one's preferred proxy. The system allows for the votes to be tracked. Hence, shareholders have a way of ensuring that the proxy followed the instructions given, which is absent in the present system.[411]
In India, Section 105 of the Companies Act 2013, allows proxies to vote on behalf of members. The instrument of proxy must be duly signed and written and the proxy would not have any right to speak in a shareholder's meeting. There is no recourse available to shareholders under the Companies Act in cases where the proxies do not vote in accordance with the instructions given. Electronic shareholder voting on a blockchain platform would allow shareholders to configure the instructions into the ledger and thereby avoid breaches by the proxy. NSE and BSE should consider providing such DLT services to listed companies.

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[407]T+2 rolling settlement-Cash Market- Risk Management, SEBI Circular, SEBI/MRD/SE/AT/47/03, December 30, 2003.

[408] Badri Narayan, How about T+3 hours settlement in stock market?,BUSINESS LINE, November 4, 2016.

[409] Pallavi Sethi, Financial Innovation In Indian Capital Market, 2(11) INT'L J INN R&D (Nov. 2013).

[410]Christopher Tozz, To Conquer Financial Services, Blockchain Needs Scaling Solutions, NASDAQ,August 17, 2017.

[411] Anna Irrera, Nasdaq successfully completes blockchain test in Estonia, REUTERS, January 23, 2017.

Mining Mutual Fund Units

Nordic bank SEB and Nasdaq have announced a joint project to test a developed prototype for a mutual fund trading platform based on blockchain technology. The fund markets are seen by SEB and Nasdaq as ripe ground for a blockchain trial, because, in contrast to the equities market, which relies on a Central Securities Depository (CSD), the Swedish fund market lacks a central, primary point for registering holdings. The aim is to create a faster, simpler, more effective and reliable fund market that increases productivity, reduces manual work and the risk for errors. Using blockchain, the market can replace the costly processes that are normally used to ensure secure trading, including paper-driven processes and follow-up telephonecalls. [412]

In India, there is a centralized body that oversees the listing of mutual fund schemes. Reg 32 of SEBI (Mutual Funds) Regulations, 1996 mandates the registration of close-ended mutual fund schemes. A close-ended fund is one that has a predetermined maturity period and allows subscription only at the time of launch.[413] Investors can trade in the units of the scheme on the stock exchanges where the units are listed.[414] Some close-ended schemes also provide periodic repurchase at NAV related prices.[415] But it is mandatory for at least one of the two exit routes to be provided. Peer-to-peer verification and confirmation may not be possible in such a strictly monitored system. However, under the overarching regulations, it is possible to implement blockchain solutions for trading in mutual fund units during the transaction, determination and settlement stages.

PART III: DLT IN ALTERNATIVE FINANCE

India's alternate lending sector is the third largest in the world and it provides capital access to numerous local fintech startups.[416]Alternative finance refers to capital raised using non-

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[412] Tom Turula, Nasdaq and SEB are setting blockchain free on the Swedish mutual fund market,BUSINESS INSIDER (NORDIC), October 2, 2017.

[413]SEBI FAQs for investors, Investments in Mutual Funds, May 2017

[414]Reg 37, SEBI (Mutual Funds) Regulations, 1996.

[415]Reg 33, SEBI (Mutual Funds) Regulations, 1996.

[416] Abhishek Kothari, How India's online lending startups compare to their global counterparts, VCCIRCLE, 5 June, 2017. Available online at https://www.vccircle.com/how-do-indian-lending-firms-compare-to-their-global-counterparts/

traditional instruments that may not be intermediated through conventional banking channels or capital markets.[417]The World Bank estimates that more than 20 crore small and medium-sized enterprises (MSMEs) in developing countries lack the ability to secure traditional bank loans owing to the informal nature of their businesses and their lack of collateral and credit history.[418] The post-recession caution of traditional banking systems against lending to MSMEs led to the creation of an alternative finance industry.[419]Alternative financing activities range from equity and reward based crowdfunding to private placements and standard peer-to-peer lending.[420] The broad spectrum of alternative financing activities are supported through shadow banking mechanisms that include cryptocurrencies and smart contracts built on blockchain platforms.

Online P2P Lending

Peer-to-peer (P2P) lending entities operated in a regulatory lacuna until RBI notified them as non-banking finance companies in September 2017. The RBI further issued Master Directions on October 4, 2017 to regulate peer-to-peer lending platforms,[421] incorporating several proposals from its 2016 consultation paper on P2P lending firms.[422]

Faircent is an online P2P lending marketplace in India.[423] The lending process adopted by Faircent is threefold. After initial verification by the platform, the prospective borrowers and potential lenders are connected based on their specified requirements. Once the parties contract the terms of the loan, the escrow account of the lender is debited. Repayments are scheduled as EMIs credited to the lender's escrow account through the digital account of the

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[417]F.ALLEN, E. CARLETTI, J.QIAN&P.VALENZUELA, HANDBOOK OF THE ECONOMICS OF FINANCE, Chapter 11: Financial Intermediation, Markets, and Alternative Financial Sectors (2012).

[418]Roger Crook,How Asia Is Adapting To The Alternative Finance Revolution, FORBES, June 16, 2017. Available at

https://www.forbes.com/sites/outofasia/2017/06/16/how-asia-is-adapting-to-the-alternative-finance-revolution/#49593b263d21

[419]Small Business Lending in the United States 2013, U.S. Small Business Administration, Office of Advocacy, 2014. https://www.sba.gov/advocacy/small-business-lending-united-states-2013; See also Rob Straathof, 17 Bankable Facts about Alternative Finance in 2017, MONEY HIGH STREET, April 3, 2017.

420P.Baeck, L.Collins&B.Zhang, Understanding Alternative Finance: The UK Alternative Finance Industry Report 2014(Cambridge University & Nesta)

[421] Non-Banking Financial Company – Peer to Peer Lending Platform (Reserve Bank) Directions, 2017, RBI/DNBR/2017-18/57.

[422]Reserve Bank of India, Consultation Paper on Peer to Peer Lending, April 2016. Available at https://rbidocs.rbi.org.in/rdocs/content/pdfs/CPERR280416.pdf

[423] The official website of Faircent can be accessed here: https://www.faircent.com/

borrower. The time duration of the transactions are extended due to the involvement of traditional banking intermediaries. Shifting to ethereum smart contracts would make the transactions quicker and more transparent and reliable.

Virtual Token Sales

An initial coin offering (ICO) is a form of crowdfunding that allows companies to raise capital online through issue of tokens created using a blockchain platform.[424] For instance, Kik is a major teenage online chat app that is currently in the process of issuing cryptocurrency coins to its users for performing transactions on the application, thereby upgrading its payment systems to the blockchain.[425]

United States

The SEC recognizes the legality of token sales funded through digital and fiat currencies.[426] The ICO shall fall under the ambit of Federal Securities laws[427] only if the token sale qualifies as offering, buying, selling or performing an activity involving *'securities'* as defined under S.2(1) of the Securities Act, 1933. Once SEC determines that an ICO token qualifies as a *'security',* SEC registration becomes mandatory and extensive reporting obligations under the Securities Exchange Act, 1934 come into play.

Australia

Based on the circumstance of the ICO, it may only be subject to the general law and the Australian consumer laws regarding the offer of services or products. In certain cases, the ICO may fall within the ambit of the Corporations Act. Information sheet 225 provides guidance on the classification of ICOs based on the attributes of the offerings regardless of whether ICO is hosted in Australia or abroad.[428]

India

India's first ICO was kickstarted on October 1st, 2017 to fund social service activities and the

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[424] Charlie Morris, Bitcoin is not a fraud – it's dotcom 3.0, MONEYWEEK, September 22, 2017.

[425] Robert Hackett, Cryptocurrency Gets Its Biggest Test Yet,FORTUNE MAGAZINE, July 21, 2017.

[426]Investor Bulletin: Initial Coin Offerings, US Securities and Exchange Commission, July 25, 2017.

[427] Federal Securities laws include Securities Act of 1933, Securities Exchange Act of 1934, Investment Company Act of 1940, Investment Advisers Act of 1940 and Trust Indenture Act of 1939, as amended subsequently.

[428] Initial Coin Offerings, ASIC Information sheet 225 (INFO 225), issued in September 2017. Available at http://asic.gov.au/regulatory-resources/digital-transformation/initial-coin-offerings/

tokens are termed as *'indicoins'*.[429]However, Indians have invested in numerous ICOs across jurisdictions. BitcoinGrowthFund's recent successful ICO to retail investors saw 50% retail investment coming from India.[430]

A sector in the Indian alternative finance market where blockchain could be applied is online marketplaces for trading in private securities. The biggest digital platforms soliciting investments with promises of high returns are GREX Alternative Investments Market (GREX), LetsVenture, Termsheet, Equity Crest and Tracxn.[431]Electronic crowdfunding platforms charge listing fees, fund raising commission (circa 2-6% of funds raised) and in some cases, seek 0.5-1% equity in companies for whom they have raised capital. Because of such active involvement, there is an expectation of return created. The researcher shall focus specifically on GREX since the virtual organisation has been in the limelight recently.

GREX is a virtual market that facilitates primary capital raising and secondary market transactions in unlisted companies. It has successfully escaped the scrutiny of SEBI by structuring itself in such a way that it would not qualify as a stock exchange and also stay clear of equity crowdfunding, which is illegal in India.[432] Recently, SEBI sent notices to GREX and the unlisted companies obtaining online funding through the webpage.[433] SEBI argued that it is an offer to more than 200 people and thereby a deemed public offer under S.42(4) of the Companies Act, 2013. Further, SEBI argued that the nature of the transactions facilitated by GREX make it a stock exchange. GREXwas accused of being in violation of Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012 since it does not meet the 100 crore net worth threshold[434] and 1000 crore minimum transaction requirement[435]. Earlier, upon a single click, all the information in relation to the specified unlisted companies were available. SEBI argued that the information contained all the essentials of a private placement offer letter and concluded that since it is freely available to anyone with internet access, the 200 limit is exceeded. Subsequently, GREX revamped its

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[429]Indicoin – India's first ICO to begin on 1st October,NEWSBTC, September 27, 2017.

[430]BitcoinGrowthFund raises ₹95 cr via initial coin offering,BUSINESSLINE, June 1, 2017.

[431]Anirudh Laksar, Sebi taking a fresh look at crowdfunding norms,MINT, March 17, 2017.

[432]Only reward-based crowdfunding and donor-based crowdfunding are legal in India.SeeIs Crowdfunding Legal in India? SEBI Regulations & It's Implications, ZINGOHUB CROWDFUNDING HANDBOOK, 17 October, 2016.

[433]Shailesh Menon, Sebi warning turns off crowdfunding tap for startups,ECONOMIC TIMES, September 9, 2016.

[434] Reg 14(1), Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012.

[435]Exit Policy for De-recognized/ Non-operational Stock Exchanges, CIR/MRD/DSA/14/2012,SEBI Circular dated May 30, 2012.

operations and now companies are required to submit their latest PAS-5 and GREX estimates the number of share allotments that have already happened in the particular financial year. Based on the figure, dedicated mailing lists are created and the company information is shared with a limited number of potential investors so as to not exceed the 200 threshold prescribed under S.42(2) of the Companies Act, 2013.

GREX case is just one example of the regulatory lacuna surrounding online crowdfunding in India.[436] SEBI issued a consultation paper on crowdfunding in 2014.[437] It is expected to issue guidelines by the end of 2017 mainly to provide eligibility criteria for start-up based and digital trading platforms.[438] SEBI also issued a caution note to investors in 2016, warning against unauthorized electronic platforms that are '*similar to stock exchanges*'.[439]Though crowdfunding investments made in India are not regulated by SEBI, similar investments made abroad are curtailed by remittance thresholds. However, such investments are not considered share purchase in India regardless of whether the ICO involves equity-based crowdfunding or not. This creates problems because the ICO could eventually be termed as an offer of securities in the concerned foreign jurisdiction. Owing to the non-involvement of SEBI, the Indian investors would not be liable to the reporting requirements that the investors from the host jurisdictions will be subject to. Something similar happened in the case of DAO wherein the US SEC held that the tokens issued by the virtual organization qualify as securities.[440] This changed the nature of the transactions closed by investors from across the globe and raised several legal questions. Fortunately, or unfortunately rather, no legal consequences ensued in this particular case since the digital entity in question went defunct soon after the completion of the ICO. Hopefully, SEBI will soon clarify the legal position on equity- ICO investments made by Indians abroad and crypto-token sales in India.

CONCLUSION

It is unlikely that any significant overhaul of international corporate finance will result from blockchain applications in the near future. It may be reasonably predicted that the DLT solutions will mainly exist within the existing infrastructural ecosystem to increase the

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[436]Shwetha Chandrashekar, Equity-Based Crowdfunding as an Early-Stage Financing Alternative: Critique of the Regulatory Proposals in India, INDIAN CORPORATE LAW, March 27, 2016.

[437]Consultation Paper on Crowdfunding in India, SEBI, June 17, 2014.

[438] Anirudh Laskar, Sebi close to finalizing crowdfunding norms, MINT, August 14, 2017.

[439]PR No.: 137/2016.

[440]Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Securities and Exchange Commission, Release No. 81207 / July 25, 2017.

efficiencies of current processes. The fundamental issue in the widespread expansion of blockchain technology lies in its inherent scaling limitations. The distributed ledger can only support a limited number of blocks of transactions at efficient speeds. Beyond that, the mining speed would reduce and transactions would be delayed.

Further, there has been no proof of concept for any sustainable solution to address failure of the DLT. There is a pressing need for post-hack recovery mechanisms, answers to data feed issues, and upstream security issues and problems that affect the execution timeframes at al.The lack of replacement options within the blockchain ledger is also concerning. A major function of intermediaries is to ensure that if one counterparty is unable to fulfill their part of a transaction the others can be saved from loss and systemic risk is thereby reduced. There is no blockchain prototype to resolve such unanticipated issues and provide risk mitigation. The concept of sidechains is being mooted, however. Sidechains are blockchains backed by pre-identified central authorities that verify, approve and record transactions on the ledger. The concept of a sidechain defeats the aim of decentralisedmedium but it is the only tenable alternative. For instance, if a clearinghouse is providing services on a DLT, it could also operate sidechains to be prepared for contingencies.

Hence, it is likely that blockchain solutions will not replace the current capital markets ecosystem, at least in the next two decades. This technology has the potential to fundamentally re-architect processes global finance industry. It is crucial that countries create a regulatory sandbox to foster such fintech revolutions. Right now, this new technology will work simply to make existing solutions more efficient. In the near future, applications of blockchain technology will satisfy needs that cannot be met with today's technological advancements. The next phase is when blockchain will deliver solutions to address needs that business and markets did not realize they had.

9. THE ROLE OF SFIO WITH REGARD TO CORPORATE GOVERNANCE*

Abstract

Corporate governance is an indispensable ingredient of running any good business today. With the increasing incidence of corporate frauds and scams, its importance in protecting the interests of all the stakeholders cannot be undermined. An effective fraud investigation framework plays an important role in maintaining corporate governance. The Serious Fraud Investigation Office (SFIO) was granted statutory status by the Companies Act, 2013, along with requisite authority and powers to conduct investigations. Over the last few years, the SFIO has conducted and completed investigations in several landmark corporate fraud cases. With the number of fraud cases rising exponentially, there have been concerns about the ability of SFIO to manage the cases efficiently. In this research, the role of SFIO in corporate fraud investigation and the important statutory provisions in the Companies Act, 2013 have been explored. To understand the judicial framework, study of some of the landmark cases have been carried out wherein investigations have been completed and some prominent fraud cases where the investigation is underway. This research also examines how the SFIO fares in comparison with equivalent investigation agencies and framework in the UK and the US. The conclusion analyses some of the laudable initiatives of the SFIO and provides suggestions for modifying the structure and investigative framework to convert it into an agency at par with some of the best in the world.

Keywords: Corporate Governance, fraud, investigation, Serious Fraud Investigation Office (SFIO), penalty and punishment, whistle blowers, Ministry of Corporate Affairs.

INTRODUCTION

Governance in business was unheard of a few decades ago. Today, almost all organisations focus on integrity, accountability and risk management as part of their governance practice. "Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to

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encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society."[441] It is the framework of rules and practices by which a board of directors ensures accountability, fairness and transparency in a company's relationship with its all stakeholders (financiers, customers, management, employees, government and the community).[442]

Corporate governance developed primarily because of two main reasons. One was the wave of financial crisis which swept Brazil, Russia and many Asian countries in 1998, leading to destabilisation of global economies. The other was corporate frauds and scandals which came to light in the United States and European countries due to poor governance practices. Corporate governance in India gained importance after the Satyam fraud. [443]

The Watergate scandal in the mid-1970s triggered the need for corporate governance in the United States. Legislations were enacted for reporting on internal financial controls. However, several businesses collapsed in the 1980s, leading to the setting up of the Treadway Commission, which suggested the formation of a proper control environment and internal audit committees for the internal control of companies. [444]

The UK was also hit by scandals, notable among them being the Bank of Credit & Commerce International scandal, Barings Bank scandal, Polly Peck scandal, Maxwell scandal, etc. The Cadbury Report by Sir Adrian Cadbury in 1992 and the Greenbury Report in 1995 laid the initial framework for corporate governance. Several other reports and reviews followed till 2008 when the global financial crisis damaged the banking and financial system. The Walker Review in 2009 made major recommendations on corporate governance, which came out as the new version of the Corporate Governance Code in 2010.[445]

The Organisation for Economic Co-operation and Development (OECD) laid down the first principles of corporate governance in 1999. The World Bank along with OECD came out with a MoU to reform corporate governance in individual countries. A new version of the principles was released by OECD in 2004 in order to formulate the regulatory framework in

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[441] SIR ADRIAN CADBURY, Report Of The Committee On The Financial Aspects Of Corporate Governance (December 1, 1992), available at http://www.ecgi.org/codes/documents/cadbury.pdf (last visited on August 6, 2018)

[442] Corporate Governance: Definition, BUSINESS DICTIONARY, http://www.businessdictionary.com/definition/corporate-governance.html (last visited on August 10, 2018)

[443] Dr. Qazi Mohd. Usman, Corporate Governance and its Efficacy in Present Era, 2 JAMIA LAW JOURNAL, 61-77 (2017), available at http://docs.manupatra.in/newsline/articles/Upload/9AC15474-4ED0-420D-93FC-222CC85A9D20.%20Dr.%20Qazi%20Mohd.%20Usman__corporate%20law.pdf (last visited on August 13, 2018)

[444] Corporate Governance: International Perspective (U K.; U.S.A.; Japan and Germany Model), SHODHGANGA, available at http://shodhganga.inflibnet.ac.in/bitstream/10603/96836/10/10_chapter%203.pdf (last visited on August 5, 2018)

[445] Supra Note 3

OECD and non-OECD countries.

India has carried forward the legacy from the past British colonial rule in the form of the Companies Act, which has gone through numerous amendments and revisions. The establishment of Securities and Exchange Board of India (SEBI) in 1992 was one of the important developments for protecting investors and regulating corporate governance. This was followed by several reports and recommendations by committees, including the Kumar Mangalam Report, RBI Report, Naresh Chandra Committee Report and Narayana Murthy Committee Report.[446] The Satyam fraud in 2008 resulted in renewed efforts to bring about reforms in corporate governance. This culminated in the passing of the Companies Act, 2013, which brought about major changes with new provisions and regulations in corporate governance.

The Naresh Chandra Committee had in its 2002 report recommended the establishment of Corporate Serious Fraud Office along the lines of the SFO in the UK. The Central Government set up the Serious Fraud Investigation Office (SFIO) in 2003 as a body of the Ministry of Corporate Affairs.[447] The SFIO is headed by a Director not below the rank of a Joint Secretary to the Government of India having knowledge and experience in dealing with the matters related to corporate affairs and also consists of experts from various disciplines.[448] The SFIO is a multi-disciplinary team and the experts are appointed by the Central Government from various fields such as banking, corporate affairs, taxation, forensic audit, capital market, information technology and law. The Companies Act, 2013 has granted statutory status to SFIO and has vested it with the requisite legal authority and powers to conduct investigation.

In our study we will explore the role of the SFIO in detail along with its statutory provisions and the major cases which are under investigation. We will compare it with similar fraud investigation processes in other countries such as the UK and the US. We will examine whether the SFIO plays a strong and effective role in corporate fraud investigations while upholding corporate governance and conclude with our recommendations.

NEED FOR RESEARCH

Corporate fraud can result in damages running into crores of rupees for companies, their investors, clients and suppliers. Moreover, it shakes the confidence of shareholders and

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[446] Santosh Pande and Kshama Kaushik, Study on the state of Corporate Governance in India: Evolution, Issues and Challenges of Future, IICA, http://iica.in/images/Evolution_of_Corporate_Governance_in_India.pdf (last visited on August 6, 2018)

[447] Animesh Tiwary, SFIO – A go-to Investigating Agency for White Collar Crimes, I PLEADERS, July 5, 2018, https://blog.ipleaders.in/sfio-investigating-agency/ (last visited on August 4, 2018)

[448] Companies Act, 2013, No. 18 of 2013, Section 211

stakeholders; in particular it impacts companies, institutions and also has a damaging effect on the society. Further, frauds result in companies opting for increasing levels of operational controls, which have a cascading effect on costs, and therefore their competitiveness in the market and can impact entire industrial sectors.

The scenario in India that triggered corporate governance reforms involved a major failure of non-banking financial institutions, the phenomenon of vanishing companies and a stock market scam. There was a need felt for an organisation which would focus entirely on solving such complex white collar crimes. It is against this backdrop that the Government decided to set up the SFIO. The sole purpose behind establishing the SFIO was to protect the interests of the investors, who bear the actual risks by investing their money.[449] They can be considered the real owners of the company, while its management may be under the Board of Directors. Fraud can happen at any level in the company, from the lowest level staff to the director level. Corporate fraud investigation, therefore, plays an important role in corporate governance.

JUDICIAL POSITION & STATUTORY PROVISIONS

In the Companies Act, 2013, Section 211 deals with the establishment of the SFIO and provides it with the statutory backing. It has its head office in New Delhi and regional offices in Mumbai, Hyderabad, Kolkata and Chennai. [450]

Section 212 deals with the investigation into the affairs of a company by the SFIO. Investigations into the affairs of a company may be ordered by the Central Government:

- On the receipt of a report of the Registrar or Inspector under Section 208;[451]
- On intimation of a Special Resolution passed by a company that its affairs are required to be investigated;[452]
- In the public interest, or
- On request from any Department of Central Government or State Government.[453]

The SFIO takes up cases for investigation which are normally characterised by the following:

- Complex cases having inter-departmental and multi-disciplinary consequences;
- Cases in the interest of public to be decided on the basis of size, i.e., money misappropriated or on the basis of number of people affected; and

[449] Supra Note 7.
[450] SFIO Locations, SERIOUS FRAUD INVESTIGATION OFFICE, https://sfio.nic.in/SFIOmap.aspx
[451] Section 208 of Companies Act, 2013 provides for submission of inspection report in writing to the Central Government after inspection of the book of accounts by the Registrar or Inspector.
[452] Ibid Note 11.
[453] Companies Act 2013, No. 18 of 2013, Section 212.

- Possibility of the investigation leading to an improvement in the law, system or procedures. It will investigate cases received from the Ministry of Corporate Affairs.

Section 212(2) provides that if a case has been handed over to the SFIO, it will not be investigated by any other Central Government or State Government department. Further, any existing investigation in the matter will be transferred to SFIO.[454]

Under Section 217, the Investigating Officer is vested with various powers including the power to take assistance of any officer or employees for the investigation of a company's affairs. He can examine a person on oath and also impose fines in case his orders are not complied with. This enables better coordination for prosecution of offences under the Indian Penal Code. The company and its officers and employees are responsible for co-operating with the Investigating Officer and providing all information, documents and assistance required by him for the investigation.[455]

The Director, Additional Director or Assistant Director is empowered under Section 212 to arrest a person and should inform the person the grounds for such an arrest. Within 24 hours of the arrest, the person has to be produced before a Judicial Magistrate or Metropolitan Magistrate having the jurisdiction.[456]

If the Central Government so orders, the SFIO has to submit an interim report which gives the preliminary findings. After completion of the investigation, a final report is submitted. Based on the final report, the Central Government takes a decision whether to initiate prosecution against the company, its officers and employees – past or present, or any other person involved directly or indirectly. In case of a prosecution, the SFIO represents the case on behalf of the Central Government.

The Special Court will take cognizance of any offence only upon receiving a complaint in writing from;

(a) The Director, or

(b) Any officer of the Central Government so authorised.[457]

Section 447 provides for punishment of any person found guilty of fraud. The punishment is imprisonment for a term not less than six months (three years in case the fraud involves public interest) and can extend up to ten years, and shall also be liable for fine which shall not be less than the amount involved in the fraud and can extend up to three times the fraud amount.[458]

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[454] Companies Act 2013, No. 18 of 2013, Section 212(2).
[455] Companies Act 2013, No. 18 of 2013, Section 217.
[456] Companies Act 2013, No. 18 of 2013, Section 212(10).
[457] Companies Act 2013, No. 18 of 2013, Section 212 (6) Proviso
[458] Companies Act 2013, No. 18 of 2013, Section 447.

The Companies Act, 2013 has made stringent provisions to contain corporate frauds.

Section 220 provides more powers to the Inspector to seize documents without taking any permission from any authority, if there are reasonable grounds to do so. The Inspector has the freedom to make copies of the documents, take extracts or make identification marks before returning the same.[459]

Section 221 empowers the Tribunal to freeze the assets of a company under investigation for a period up to 3 years,[460] while Section 228 makes the entire investigation process applicable *mutatis mutandis* to a foreign company.[461] Section 229 specifies the situations under which a person is punishable for fraud.

A major change in the Act is the manner of conducting cross border investigation. A large number of fraud cases have a cross border footprint. The Central Government is empowered to enter into an agreement with foreign governments for seizing of documents and evidences available in the foreign country and even cross examination of witnesses staying there. The SFIO has to approach the courts of the country with a letter of request.[462]

The SFIO has investigated several landmark cases since its inception in 2003. The last few years have seen a sudden increase in the cases, more so after the Companies Act, 2013 added more power and teeth to the role of SFIO.

Some of the notable landmark cases include the Satyam scam, Reebok fraud case, Saradha Chit Fund scam and Deccan Chronicle loan default case. We will explore some of these landmark cases and also some of the more recent cases where investigation is underway.

REEBOK [463]

Reebok India had filed an FIR in 2012 against their top executives - MD and CFO alleging fraud to the tune of Rs.870 crores. An SFIO probe was ordered in May 2012 and after detailed investigation they submitted their final report in Aug 2013. The top executives would over-invoice their franchisees and partners to show higher sales in order to meet the annual targets. The goods were stored in secret warehouses and not sent to the partners. The sales were later reversed. Loans were taken from banks by producing fake invoices and deposits were raised from high net worth individuals in order to finance their operations. This issue surfaced when

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459 Companies Act 2013, No. 18 of 2013, Section 220.

460 Companies Act 2013, No. 18 of 2013, Section 221.

461 Companies Act 2013, No. 18 of 2013, Section 228.

462 Somak Mukherjee, The Serious Fraud Investigation Office, SCRIBD, https://www.scribd.com/document/281146689/The-Serious-Fraud-Investigation-Office-Corporate-Law (last visited on August 8, 2018).

463 SFIO names KPMG arm in Reebok chargesheet, THE INDIAN EXPRESS (New Delhi edition), March 4, 2014, available at https://indianexpress.com/article/business/business-others/sfio-names-kpmg-arm-in-reebok-chargesheet/ (last visited on August 13, 2018)

Adidas acquired Reebok International and started checking into the Indian operations in 2011. They hired KPMG India's forensic arm to investigate the irregularities.

SFIO filed the chargesheet in March 2014 wherein KPMG India and its auditing arm BSR & Co. were named along with the former sacked executives of Reebok India. The auditors were charged with criminal breach of trust for helping the top management to falsify financial statements and accounts of the company. The chargesheet also named their statutory auditor Narasimhan & Co. for their weaknesses in control and failure to detect the falsification of financial statements due to which the fraud continued for so many years. SFIO also observed that KPMG and its affiliate BSR & Co. had not acted professionally while conducting the forensic investigation. The investigation should have been properly designed and supervised, which was clearly lacking.

DECCAN CHRONICLE HOLDINGS LTD. (DHCL) [464]

In 2012, a forensic audit was conducted by a consortium of banks in which DHCL was found to have an exposure to the banks of around Rs.5000 crores. The Ministry of Corporate Affairs ordered an investigation of DHCL in early 2013 for possible violations of Companies Act. The SFIO submitted its report in Sep 2013. DHCL and its directors were charged with violations of the Companies Act in as many as 20 sections, including sections 209 and 211 for non-conformities in accounting standards and financial statements, sections 269 and 309 for contravening the provisions of directors' remuneration, section 295 for entering into related party transactions and section 628 for making false statements. The report also confirmed that DHCL's management availed money from banks by selling non-convertible debentures and other commercial documents.

KINGFISHER AIRLINES [465]

Kingfisher Airlines went bankrupt in 2012 and an SFIO probe was ordered into its affairs. The SFIO submitted a detailed report in Oct 2017 on the wrongdoings in the airline, following which the government, regulators and banks have initiated strict action to zero in on the guilty. The SFIO report points to several violations of the Companies Act by Vijay Mallya, Kingfisher Airlines and officials and also serious lapses in corporate governance. The report also questions the role of the independent directors, whether they failed to discharge their

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[464] Shubham Batra, SFIO charges Deccan Chronicle Holdings with Companies Act violations, THE ECONOMIC TIMES, October 25, 2013, available at https://economictimes.indiatimes.com/markets/stocks/news/sfio-charges-deccan-chronicle-holdings-with-companies-act-violations/articleshow/24683566.cms (last visited on August 5, 2018)

[465] PTI, Kingfisher Airlines probe: Govt officials, bank executives under lens for violations, LIVE MINT, October 8, 2017, available at https://www.livemint.com/Companies/fLyIRbrsBdQE6X570zc1uO/Kingfisher-Airlines-probe-Govt-officials-bank-executives-u.html (last visited on August 7, 2018)

duties during their tenure at the airline. Banks sanctioned loans to Kingfisher in spite of its weak balance sheet and poor credit rating. Kingfisher brand valuation was done by only one valuer, when regulations require at least two valuation reports for sanctioning loans on the basis of brand. The report also mentions about some government officials conniving with Mallya in getting loans from banks without required due diligence.

Bhushan Steel [466]

After a dream run spanning many years, Bhushan Steel ended in the bankruptcy courtroom in July 2017, with total debts at over Rs.46,000 crores. It is amongst the first major cases of insolvency resolution which was completed and was acquired by Tata Steel. The company was also under investigation from SFIO since last few months. In Aug 2018, Neeraj Singhal, the erstwhile promoter and managing director of Bhushan Steel was arrested by SFIO, the first such arrest by the agency since it was established in 2003. He was produced in court and remanded in judicial custody till August 14. He has been accused of diverting and siphoning off funds through a number of transactions. SFIO resorted to the arrest for the first time as it has claimed to be in possession of material which has revealed that Neeraj Singhal is guilty of serious corporate fraud punishable under Section 447 of the Companies Act, 2013. SFIO also claimed that the erstwhile directors and promoters of the company were not co-operating with the investigation, failed to appear before the investigating team and concealed material facts.

AIRCEL [467]

In June 2018, the government ordered an SFIO probe against telecom operator Aircel and its two group companies Aircel Cellular and Dishnet Wireless. There were several complaints received against the operations of Aircel. The Registrar of Companies, Mumbai recommended an investigation and the Ministry of Corporate Affairs ordered the probe after a preliminary check to see if there is a genuine case. The charges being investigated are the possible diversion of funds and violations of the Companies Act and other laws governing the company. The company had filed for bankruptcy in Feb 2018 and owes around Rs.50,000 crores to its investors and creditors.

PUNJAB NATIONAL BANK: NIRAV MODI, MEHUL CHOKSI AND OTHERS [468]

One of the latest cases is the Rs.140 billion Punjab National Bank fraud, where Nirav Modi

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466 TNN, SFIO's first-ever arrest: Bhushan Steel ex-MD, THE TIMES OF INDIA, August 10, 2018.

467 Sidhartha, Government orders SFIO probe against Aircel, arms, THE TIMES OF INDIA, June 14, 2018.

468 Veena Mani & Indivjal Dhamsana, SFIO gives reports on 30 Nirav Modi firms; inspects NuPower Renewables, BUSINESS STANDARD, June 14, 2018.

is the main accused. SFIO investigation was ordered by the government in 107 companies and 7 limited liability partnerships belonging to Nirav Modi, his uncle Mehul Choksi and related parties. A multi-agency probe involving CBI and Enforcement Directorate is also proceeding into the case involving fraudulent Letter of Undertakings. Petitions have been filed against individuals, groups and companies belonging to Nirav Modi and Mehul Choksi by the Ministry of Corporate Affairs before NCLT Mumbai bench. The investigation by SFIO has been completed in more than 30 companies.

COMPARATIVE STUDY

We will explore how SFIO and the fraud investigation process compares with equivalent agencies or processes in the UK and the US and also examine some of their recent cases, which will give a peek into the working of their agencies.

The Serious Fraud Office (SFO) in UK

The SFO was established in 1998 under the Criminal Justice Act, 1987 and covers England, Wales and Northern Ireland but does not cover Scotland, Isle of Man and Channel Islands. The SFO Board is chaired by the Director. [469] It consists of General Counsel, Chief Operating Officer and 3 Non-Executive Directors.[470] The staff includes lawyers, forensic accountants, analysts, digital forensic experts, investigators and other specialists.

Some of the unique characteristics of this specialist organisation are discussed below:[471]

- It takes on a small number of cases involving large economic crimes. The Director of SFO decides which cases to take based on Statement of Principle and various considerations.
- The SFO handles cases not only related to serious and complex fraud, but also cases involving bribery and corruption.
- Complaints regarding possible criminal activity can come from a wide number of sources including whistle-blower, victims, self-report by the corporation, media as well as law enforcement agencies.
- It is a unique organisation as it investigates as well as prosecutes. Each case consists of stages which include (a) intelligence gathering or pre-investigation, (b) investigation and prosecution, (c) trial and (d) recovering proceeds of crime.
- The SFO works with other law enforcement partners including the UK Government departments, Attorney General's Office, Home Office and Ministry of Justice. It also works with overseas partners such as the US Department of Justice on common matters.

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[469] About Us, SERIOUS FRAUD OFFICE, https://www.sfo.gov.uk/about-us/ (last visited on August 12, 2018)
[470] Ibid Note 29.
[471] Id. Note 29.

FRAUD SECTION OF CRIMINAL DIVISION, US DEPARTMENT OF JUSTICE (DOJ)

The US does not have a separate agency which takes care of serious economic crime. It is the responsibility of the Fraud Section of the Criminal Division of the US Department of Justice. The Fraud Section plays an important and unique role in handling complex white collar crime cases throughout the country. There are 3 litigating units – the Foreign Corrupt Practices Act (FCPA) Unit, the Health Care Fraud (HCF) Unit and the Securities & Financial Fraud (SFF) Unit. [472] The Fraud Section also has a Strategy, Policy & Training (SPT) Unit and the Administration & Management Unit.

Some of the unique characteristics of this Fraud Section are: [473]

- Investigation and prosecution of complex white collar crime which includes corporate fraud, securities, investment fraud, government program and procurement fraud and health care fraud.
- Its jurisdiction covers international criminal violations and includes bribery of foreign government officials in violation of the Foreign Corrupt Practices Act.
- It complements the efforts of the US Attorney's Offices to combat white collar crimes.
- The section plays a crucial role in developing the Department's policy and advises on matters of legislation, crime prevention and public education while implementing enforcement initiatives.
- In order to meet its objectives, the Section aims to develop knowledge, skills and judgement. It does so by providing training, mentoring and supervision of their professionals and attorneys.
- In Feb 2017, the Fraud Section published a guide titled "Evaluation of Corporate Compliance Programs".[474] It summarises the Section's views on the best practices of an effective compliance program, the framework for evaluating a company's compliance program and remedial efforts when resolving a criminal investigation. [475] The Guidance provides a roadmap to companies on how the Fraud Section assesses the effectiveness of corporate compliance programs and remedial efforts. It therefore acts like a tool for the

[472] Fraud Section Home, THE UNITED STATES DEPARTMENT OF JUSTICE, https://www.justice.gov/criminal-fraud (last visited on August 12, 2018).

[473] Supra Note 32.

[474] Samir Kaushik, Kristen Bamberger and Brooke Schultz, Department of Justice Fraud Section Provides Guidance on Evaluating Corporate Compliance Programs, JONES DAY PUBLICATIONS, February 2017, available at https://www.jonesday.com/Department-of-Justice-Fraud-Section-Provides-Guidance-on-Evaluating-Corporate-Compliance-Programs-02-27-2017/ (last visited on August 14, 2018).

[475] Ibid Note 33.

companies to design and implement compliance programs and evaluate their programs for any deviations, before any DOJ scrutiny actually arises.

Some important and recent cases handled by the SFO and DOJ have been discussed briefly respectively.

Güralp Systems Ltd. Case (UK) [476]

Güralp Systems is an engineering company which specialises in producing seismic testing equipment. The founder Dr. Cansun and the MD Andrew Bell conspired to bribe a public official and employee of the Korea Institute of Geoscience and Mineral Resources. This activity happened between April, 2002 and September, 2015. The SFO conducted a criminal investigation that started in December, 2015. Both the men have been charged with conspiracy to make corrupt payments contrary to Section 1 of the Criminal Law Act, 1977 and Section 1 of the Prevention of Corruption Act, 1906.

EURIBOR Manipulation Case (UK) [477]

Christian Bittar of Deutsche Bank and Moryoussef of Barclays Bank worked together, in this case, to submit falsified EURIBOR (Euro Interbank Offered Rate) data. EURIBOR is a key financial benchmark rate used for financial deals around the world. This fraud was done for their personal gain and also worked to the advantage of the banks where they were working. This happened when the financial crisis was at its peak. They were able to beat the system and remain undetected for several years.

The SFO started investigation way back in 2012 which culminated in August 2018 after six years. Bittar was sentenced to five years four months, ordered to pay all SFO's costs and a confiscation order of £ 2.5 million. Moryoussef was sentenced to eight years. A retrial of three others from Barclays Bank has been sought by the SFO as the jury was unable to reach any verdict on them.

Takata Corporation (US) [478]

Takata Corporation is one of the biggest suppliers of safety related equipment for automobiles. Between 2000 and 2015, they falsified and manipulated the test data of their

[476] Güralp Systems founder and former Managing Director charged with corruption over South Korea contracts, SFO (News Releases), August 17, 2018, https://www.sfo.gov.uk/2018/08/17/guralp-systems-founder-and-former-managing-director-charged-with-corruption-over-south-korea-contracts/ (last visited August 18, 2018).

[477] Senior bankers sentenced to more than 13 years for rigging EURIBOR rate, SFO (News Releases), July 19, 2018, https://www.sfo.gov.uk/2018/07/19/senior-bankers-sentenced-to-more-than-13-years-for-rigging-euribor-rate/ (last visited on August 16, 2018).

[478] Takata Corporation Pleads Guilty, Sentenced to Pay $1 Billion in Criminal Penalties for Airbag Scheme, DEPARTMENT OF JUSTICE, OFFICE OF PUBLIC AFFAIRS (Justice News), February 27, 2017, https://www.justice.gov/opa/pr/takata-corporation-pleads-guilty-sentenced-pay-1-billion-criminal-penalties-airbag-scheme (last visited on August 14, 2018).

airbag inflator to show better performance than actual, thereby defrauding customers and auto manufacturers. In spite of the inflators giving problems in the field, leading to injuries and death, the company's executives did not share the factual data. This was investigated by a multi-departmental team consisting of the Fraud Section, FBI, Department of Transportation, Trial Attorneys and the Office of International Affairs which is part of the Criminal Division.

Takata pleaded guilty and was sentenced to pay a criminal penalty of $1 billion and three years' probation. They were also ordered to implement rigorous internal controls, co-operate fully with the ongoing investigation, including investigation of individuals and retain an independent compliance monitor for a term of three years.

National Medicare Fraud (US) [479]

In July 2017, the HCF Unit of the Fraud Section initiated a nationwide swoop on National Health Care system with the involvement of 41 US Attorney Offices and the largest Medicare Fraud Control Units. This strike resulted in charges against 412 individuals, which included 115 doctors, nurses and other medical professionals. They were charged with false billings in Medicare and Medicaid schemes to the tune of $1.3 billion. Over 120 were charged with prescribing and distributing opioids and dangerous narcotics, leading to an opioid epidemic. Billing was being done for prescription drugs and medications that were never ever purchased or distributed to beneficiaries. In several cases, beneficiaries and co-conspirators were paid kickbacks in exchange for the beneficiary information on the basis of which fraudulent bills were submitted. This was the largest strike in terms of the number of individuals charged and the amount lost.

CONCLUSION

In three years between 2014 and 2017, the SFIO investigated 366 cases, with 181 prosecutions filed during the same period.[480] Since its inception in 2003, the SFIO has completed 312 investigations, out of which 186 were completed between 2014 and 2017, which amounts to almost 70% of the total investigations completed in last 15 years.[481] During 2017-18 alone, the SFIO was assigned investigations involving 225 entities.[482] The number of large financial

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[479] National Health Care Fraud Takedown Results in Charges Against Over 412 Individuals Responsible for $1.3 Billion in Fraud Losses, DEPARTMENT OF JUSTICE, OFFICE OF PUBLIC AFFAIRS (Justice News), July 13, 2017, https://www.justice.gov/opa/pr/national-health-care-fraud-takedown-results-charges-against-over-412-individuals-responsible (last visited on August 13, 2018).

[480] SFIO investigated 366 cases in 3 years, OUTLOOK THE NEWS SCROLL, July 18, 2017, https://www.outlookindia.com/newsscroll/sfio-investigated-366-cases-in-3-years/1101831 (last visited on August 14, 2018).

[481] Investigations Completed (FY wise), SERIOUS FRAUD INVESTIGATION OFFICE, https://sfio.nic.in/archives.aspx (last visited on August 16, 2018)

[482] Ministry of Corporate Affairs, SFIO investigation 21 cases involving 225 companies in 2017-18, CORPORATE CASES,

fraud cases almost doubled in 2017-18 as compared to the previous year.

After the Companies Act, 2013 granted statutory status and more powers to the SFIO, the agency has been playing a very important role in corporate fraud investigation. The improvement in performance can be attributed to the reforms in SFIO over the last few years, including the power to make arrests and provision for setting up a special court to deal with economic offenders. We have recently seen the first such arrest made by SFIO of Neeraj Singhal in the Bhushan Steel case. Special courts have been set up under the Companies Act, 2013 to try big offences. As of April 2018, there are 28 special courts across the country.[483]

The SFIO has been doing a stellar job in investigating serious frauds in the country, within the boundaries of the resources and statutory powers that have been conferred on it. The SFIO has also been working on an "Early Warning System" (EWS), the idea of which came in 2009 after the Satyam fraud. A Market Research & Analysis Wing (MRAW) has been set up as part of the SFIO for analysing media reports related to financial fraud and conducting market surveillance on companies. An expert committee was constituted to find out ways to strengthen MRAW. On the basis of its recommendation, a forensic lab was set up in SFIO with appropriate technology and skilled technical manpower.[484] The new system is expected to help in the early detection of fraud and safeguard unsuspecting investors.

New fraudulent cases have been increasing in a big way over the last few years, primarily attributed to the government's crackdown on shell companies, *benami* properties and black money. Suspicious transactions involving a huge amount of money post demonetisation have also been referred to the SFIO, resulting in an overload of cases. There have been serious concerns raised on the ability of the SFIO to handle such a large number of cases in its current capacity and is urgently in need of skilled resources. Further, innovative reforms are required to tackle the onslaught of fraudulent cases. We can take a leaf or two out of the UK SFO and the US Fraud Section as we explore below some suggestions on the way forward.

- The sanctioned staff strength of SFIO is 133, but it has been working at around half this strength.[485] There is a need to set up a recruitment panel to fill up the positions on a war

August 7, 2018, https://www.corporate-cases.com/2018/08/sfio-investigating-21-cases-in-2017-18.html (last seen on August 16, 2018).

[483] List of special courts – Companies Act 2013, AISHMGHRANA LAW GOVERNANCE RESPONSIBILITY, April 27, 2018, https://aishmghrana.me/2018/04/27/list-of-special-courts-companies-act-2013/ (last seen on August 14, 2018)

[484] Tabrez Ahmed and Radheshyam Prasad, Role of Serious Fraud Investigation Office (SFIO) in Protection of Investor's Interest: An Overview, RESEARCH GATE, Jaunuary 2014, available at https://www.researchgate.net/publication/273189171_Role_of_Serious_Fraud_Investigation_Office_SFIO_in_Protection_of_Investor's_Interest_An_Overview (last seen on August 17, 2018).

[485] Kumar Vikram, Big financial fraud cases nearly doubled in a year, THE NEW INDIAN EXPRESS, April 29, 2018, available at http://www.newindianexpress.com/nation/2018/apr/29/big-financial-fraud-cases-nearly-doubled-in-a-year-1807734.html (last seen on August 18, 2018).

footing and also explore expansion beyond its sanctioned strength, particularly setting up new offices and strengthening the existing regional offices.

- The SFIO receives complaints from various sources, including its newly established early warning system. However, they are passed on to the Central Government, who in turn decides which cases are to be investigated by SFIO. It is recommended that SFIO be given independence in deciding which cases to investigate, on the lines of the UK SFO.
- After submitting the investigation report to the Central Government, the SFIO can initiate prosecution only when it receives approval to do so. The SFIO should be converted into a strong independent investigation and prosecution body, capable of taking its own decisions. A dependence on the Central Government can most often result in interference as seen in the Saradha scam and the CBI investigation into Coalgate.
- The early warning system has not developed to the extent it was expected. There is a need to examine if it can be strengthened further, as the successful and efficient implementation of such a system is important for SFIO.
- The SFIO currently investigates only corporate frauds. There is a need to widen its scope of operations to cover bribes and corruption as well, on the lines of its counterpart agencies in the UK and US.
- As companies are required to submit documents to the Registrar of Companies (ROC) as part of the legal compliance requirements, the ROC could well be the first level of problem detection. There is a need to further strengthen scrutiny at the ROC level, which would form the base for any SFIO investigation.
- Corporate governance involves coordinated action of various enforcement agencies. There is a need to create linkages between complaints made by individuals with the police and other regulatory bodies with the SFIO. The SFIO should also be able to work seamlessly with the other regulating bodies, failing which the investigation can get severely hampered. The Saradha scam investigation is an example of how the process can get delayed due to inter-state, inter-agency coordination.

Implementing the above suggestions would involve changes to the legislation as well as the structure of SFIO. It is an attempt well worth, considering that the SFIO would get converted into an agency at par with the best investigation and prosecution agencies in the world.

10. OUTBOUND MERGERS - A DISTANT DREAM? - ANALYSING THE NEW CROSS-BORDER MERGER FRAMEWORK UNDER THE COMPANIES ACT, 2013*

Abstract

Outbound cross-border mergers were not permitted under the Companies Act, 1956, which provided only for inbound mergers. This was amended in the Companies Act 2013, which provided for outbound cross-border mergers under Section 234, in order to facilitate and further India's burgeoning growth and rising foreign investment. This was finally notified in 2017, and RBI rules were put in place in 2018, to govern such transactions. These rules allow for such cross-border mergers to take place with the deemed approval of the RBI.

The paper seeks to analyse the new framework put in place under the Companies Act, 2013, for the facilitation of outbound cross-border mergers. In doing so, it assesses the adequacy of the existing provisions of law in allowing for successful outbound mergers. It first introduces the current framework, and differentiates it from the 1956 Act. Thereafter, it discusses the requirements for and impact of regulatory approvals to outbound mergers. In the final section, this paper points out the various potential roadblocks to successful completion of an outbound cross-border merger under the existing framework, with specific reference to tax laws, securities law, foreign exchange law and jurisdictional challenges. Through the course of this paper and with specific reference to the previous section, the authors also make recommendations as to how existing issues as pointed out may be remedied, so as to ensure that India's cross-border merger framework is conducive to foreign investment and in consonance with international best standards.

INTRODUCTION

Mergers and acquisitions ("M&A") form an indispensable facet of business in the modern age. With the rise of mammoth, multi-national corporations all over the world, along with a burgeoning global start-up culture, M&A has become more important and common place than it ever was before.

India, being the fastest growing major economy in the world,[486] has an important role to play on the global stage in matters of M&A.[487] On account of the complex nature of these business transactions, as well as their far-ranging impact on stakeholders, M&A transactions require stringent, and complex legal regulation. This has resulted in the creation of a specialised field of law in M&A, with expert lawyers and firms guiding companies through their transactions and ensuring that they are compliant with the law.

As mentioned earlier, India is fast catching up to other developed economies in terms of its activity in the M&A sphere, especially with regards to cross-border M&A. As a result, there was immense pressure upon the Government of India (herein, the concerned department primarily being the Ministry of Corporate Affairs) to update and upgrade the existing Indian law on M&A. Thus, the Companies Act, 2013, brought in a sea change in terms of regulations of cross-border M&A, permitting for the first time, **outbound mergers**, wherein the resultant company would be a **foreign company.**[488]

While there has been a significant development in the law relating to both mergers and acquisitions, both at the domestic and cross-border level, this paper does not address all such developments. The scope of this paper is restricted to **cross-border merger provisions under the Companies Act, 2013.** Within this, the paper deals exclusively with **outbound mergers**, as they have been allowed for the first time under the new Act.

This paper seeks to analyse these provisions, and how they are different from the provisions that existed under the earlier 1956 Act. More importantly, this paper seeks to assess the adequacy of these provisions in facilitating fruitful outbound mergers. In a later section, this paper also deals with the potential roadblocks to the fruitful implementation and application of this law, with special reference to RBI, SEBI and tax regulations, along with other

[486] Kiran Stacey and James Kynge, 'India Regains Title of World's Fastest-Growing Major Economy' Financial Times (28 February 2018) <https://www.ft.com/content/cb5a4668-1c84-11e8-956a-43db76e69936> accessed 12 December 2018.

[487] PricewaterhouseCoopers, 'Mergers and Acquisitions: The Evolving Indian Landscape' PwC (10 February 2017) <https://www.pwc.in/assets/pdfs/trs/mergers-and-acquisitions-tax/mergers-and-acquisitions-the-evolving-indian-landscape.pdf> accessed 12 December 2018.

[488] Companies Act 2013, s 234.

provisions of the Companies Act, 2013. While doing so, it makes recommendations as to what changes may be brought to the existing framework, so as to improve the ease and likelihood of successful implementation.

Through this, this paper hopes to make constructive suggestions as to what steps may be taken by the Government, both in terms of amendment of existing legislation, or putting into place new regulations, so as to ensure that cross-border mergers, specifically, **outbound** mergers take place in a fruitful manner, and that interests of all Indian stakeholders are protected.

RELEVANCE AND IMPORTANCE OF CROSS BORDER MERGERS

Before analysing the framework for cross border mergers in India, it is necessary to understand what a cross border merger is, its different types, and most importantly, its relevance in the present context. A cross border merger is essentially a merger that takes place between two entities based in two different countries.[489] Such a merger, for the purposes of this paper, may be of two types from the perspective of a country. An **inbound merger** is a merger where the resultant company is present in the country of the home entity, whereas, in an **outbound merger**, the resultant company is present in the country of the foreign entity.[490] It is important to understand the relevance and importance of such transactions from the perspective of companies themselves. There are a number of reasons that may motivate a company to carry out a cross border merger, in spite of whatever complicated legal requirements they are subjected to, such as size, technological transfer, synergy, etc.[491] The JJ Irani Committee Report, 2005 also acknowledges various reasons for mergers, such as to access market through a reputed source, eliminate competition, reduce tax liability, set off liability of one company as against another,[492] and describes this process as an essential business strategy for a company to attain inorganic growth.

'Diversification' is also an important strategy for which cross border mergers are an essential tool, enabling companies to expand. Diversification, in this sense, means the expansion of companies into different markets and the provision of different goods or services. International mergers would not only allow the company market access across borders, but

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[489] Eva-Maria Kieninger, 'The Law Applicable to Corporations in the EC' (2009) 1 Rabel Journal of Comparative and International Private Law 607, 616.

[490] Harald Gesell, 'Outbound Cross-Border Mergers Protected by Freedom of Establishment' (2007) 4 ECFR 308, 309.

[491] Moshfique Uddin, Cross Border Mergers and Acquisitions – UK Dimensions (2014) 11.

[492] Ministry of Corporate Affairs, 'Report of the Expert Committee on Company Law' (2005) 113.

would also do so while reducing the risks and costs of entering foreign markets.[493] Along with this, the firm can also expand its portfolio of goods and services provided by merging with another firm specializing in a varied market. Another motivation for cross border mergers is the synergy of firms. In essence, this means that in case of a merger, the total value of the resultant firm is greater than the value of the two separate firms.[494] This can generally occur due to transfer of technology, mobilization of resources, transfer of management skills and best practices, etc.

Therefore, from the above, it is clear that cross border mergers are relevant from the perspective of companies for economic reasons, thus making it necessary that any regulations to allow and govern such transactions must be conducive to such economic choices that companies may make. Whether the current framework is capable of doing so is something that will be analysed in further sections of this paper.

THE INDIAN LAW ON CROSS-BORDER MERGERS

This section of the paper will deal with the position of law with respect to cross-border mergers in India in light of the Companies Act, 2013 and other rules and regulations such as the Companies (Compromises, Arrangements and Amalgamation) Rules, 2016, and the Foreign Exchange Management (Cross Border Merger) Regulations, 2018.

Previously, in the Companies Act of 1956, under Sections 391-394, while cross border mergers were permitted, these were only allowed **for inbound mergers; i.e., a foreign company merging with an Indian company.** The 1956 Act did not provide for **outbound mergers, or mergers of Indian companies with foreign companies.** The new Companies Act of 2013 made a significant change to this provision by providing for both inbound as well as outbound mergers under Section 234, by stating that RBI approval would be required for a foreign company merging into an Indian company and *vice-versa*.[495]

This provision of the Companies Act was finally notified in 2017 through an amendment to the Companies (Compromises, Arrangements and Amalgamation) Rules, 2016.[496] Through this amendment, a foreign company can merge with an Indian company, and an Indian company can merge with a foreign company from certain jurisdictions, the requirements for which have also been specified in this amendment to the 2016 Rules. These requirements are as follows:

[493] Uddin (n 6) 14.
[494] Scott C Whitaker, Cross Border Mergers and Acquisitions (2016) 28.
[495] Companies Act 2013, s 234(2).
[496] Companies (Compromises, Arrangements and Amalgamations) Amendment Rules 2017, r 2.

(i) Outbound mergers are permitted with companies in jurisdictions whose securities regulator is a signatory to the International Organization of Securities Commission's Multilateral Memorandum of Understanding, or to a bilateral agreement with the SEBI.[497]

(ii) Outbound mergers are also permitted with jurisdictions whose central bank is a member of the Bank of International Settlements, and is not identified by the Financial Assistance Task Force as a jurisdiction with strategic Anti-Money Laundering or deficiencies in Combating the Financing of Terrorism, or a jurisdiction that has not made sufficient progress on working towards these deficiencies.[498]

(iii) These rules also provide for the valuation of the foreign, or transferee, company in case of outbound mergers. According to the rules, the transferee company has a duty to ensure that its valuation must be conducted by members of a professionally recognised body in its jurisdiction, and that such valuation is compliant with the "internationally accepted principles of accounting and valuation".[499]

Apart from this, the companies must satisfy the conditions for mergers set out in Section 230-232 of the Companies Act, 2013 which deal with mergers in general, before filing an application for merger before the National Company Law Tribunal (NCLT).

REGULATORY APPROVALS TO CROSS BORDER MERGERS

Given the complex nature of an outbound cross-border merger, there are several regulatory approvals that are required for the transaction to be successfully concluded. Some of the most pertinent of these are discussed in this section, which also points out any issues that may arise out of the current regulatory framework.

THE RESERVE BANK OF INDIA (RBI)

Under Section 234 of the Companies Act, 2013, any cross-border merger, regardless of whether inbound or outbound, requires prior approval of the RBI before the initiation of such merger transaction. However, the requirement for prior approval of the RBI was effectively removed by the RBI itself in its Foreign Exchange Management (Cross Border Merger) Regulations, 2018. It stated that there shall be *"deemed approval"* of cross border mergers if it is compliant with the regulations.[500] In order to do this, a certificate showing compliance with the 2018 regulations must be given to the NCLT along with the application

[497] Companies (Compromises, Arrangements and Amalgamation) Rules 2016, annexure B.
[498] Companies (Compromises, Arrangements and Amalgamation) Rules 2016, annexure B.
[499] Companies (Compromises, Arrangements and Amalgamation) Rules 2016, r 25A(2)(b).
[500] Foreign Exchange Management (Cross Border Merger) Regulations 2018, r 9(1).

that is to be made.

The deemed approval of the RBI is subject to certain conditions being fulfilled. One of the conditions is that a person must hold shares of the resultant entity in an outbound merger in accordance with the FEMA 120(2), and the securities must be acquired in accordance with the Liberalised Remittance Scheme (LRS).[501] Along with this, the other requirements such as the office of the Indian company, in case of an outbound merger, must be a branch office under the Branch Office regulations,[502] etc.

The provision of deemed approval, in the opinion of the authors, is helpful as it reduces the time taken and the regulatory hurdles that have to be crossed in order to effectuate a cross border merger. It enables companies to merge without having to invest time and resources on such an approval, along with the application that is already required to be made to the NCLT.

THE NATIONAL COMPANY LAW TRIBUNAL (NCLT)

The Cross Border Merger Regulations (issued by the RBI) also provide for other regulations to govern cross border mergers, and facilitate sanctioning of both inbound and outbound mergers by the NCLT. While there is already a deemed approval by the RBI in case of cross border mergers, as stated above, there is still a requirement for an application to the NCLT as prescribed by the Companies Act, 2013.[503]

On the receipt of such an application, if it is shown to the NCLT that a compromise has been proposed with reference to the merger and under such a scheme if any part of the company is to be transferred to another company or to be divided among multiple companies, the NCLT has to order a meeting of creditors and members of the company.[504] In such a meeting, three-fourths of the members and creditors present and voting would have to agree to the compromise and such an agreement would be binding on the companies.[505]

POTENTIAL ROADBLOCKS UNDER THE EXISTING FRAMEWORK AND THE WAY FORWARD FOR SUCCESSFUL FACILITATION OF OUTBOUND CROSS-BORDER MERGERS

The previous two sections have stated the current position of law with respect to cross border mergers. However, it is necessary to understand the effectiveness of these provisions in terms of facilitating such mergers, **particularly since there has been no outbound merger under**

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[501] According to the LRS, an Indian person may hold $250,000 in foreign securities per financial year.

[502] Foreign Exchange Management (Establishment in India of a branch office or a liaison office or a project office or any other place of business) Regulations 2016, r 5(1).

[503] Companies Act 2013, ss 232, 234(1).

[504] Companies Act 2013, s 232(1).

[505] Companies Act 2013, s 230(6).

the new provisions as of writing this paper.

While the current provisions have been praised for their clarity and for benefitting both MNCs and major Indian corporations alike by insolvency professionals[506] as well as M&A experts,[507] there are however, some roadblocks due to certain provisions, or a lack thereof. While pointing out these issues, this section also makes recommendations as to the way forward, that is, how these issues may be remedied.

ISSUES RELATING TO TAX LAWS (THE INCOME TAX ACT, 1961)

One of the problems that foreign companies may face while setting up in India is that there is no **tax neutrality** in place for **outbound** cross border mergers, unlike in the case of inbound mergers. The Income Tax Act, 1961 under Sections 47(vi) and 47(vii) provide for tax neutrality in case the resultant company is an **Indian company** – effectively excluding outbound mergers.[508]

'Tax neutrality' means a tax system that is 'neutral', in which case a company does not have to change its economic choices from what it would normally make in case of such a tax system.[509] In the context of the Income Tax Act, 1961 in India, this means that the company is free from capital gains tax.[510] However, the aforementioned provisions of the Income Tax Act provide such neutrality only in case of inbound mergers and amalgamations, that is, transactions resulting in the formation of an Indian company.

Since an outbound merger would entail the resultant company to be a foreign company, the merging Indian company would be subject to capital gains tax on the transfer of assets during the merger, and in terms of the shareholders, the shareholders receiving shares of the foreign merging company would also be subject to such tax. Such tax would serve as a deterrent to foreign companies from considering merging with Indian companies. Given that such an exemption already exists for inbound mergers, it is likely that the lack of equal treatment in case of outbound mergers is a matter of oversight. It is recommended that a similar provision be notified with regards to outbound mergers as well, at the earliest, so as to negate the

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[506] Ruchika Chitravanshi, 'RBI Rolls Out Regulations for Cross Border Mergers' Economic Times (New Delhi, 28 March 2010) <https://economictimes.indiatimes.com/news/economy/policy/rbi-rolls-out-regulations-for-cross-border-mergers/articleshow/63523129.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst> accessed 12 November 2018.

[507] Shivani Saxena, 'Cross Border Merger: The Five Year Wait is Over… Maybe…' Bloomberg Quint (New Delhi, 3 April 2018) <https://www.bloombergquint.com/law-and-policy/cross-border-mergers-the-five-year-wait-is-overmaybe#gs.kcNz3Pw> accessed 12 November 2018.

[508] Income Tax Act 1961, s 47.

[509] Douglas A. Kahn, 'The Two Faces of Tax Neutrality: Do They Interact or are They Mutually Exclusive?' (1990) N Ky L Rev 1, 1.

[510] Income Tax Act, 1961, s 45.

deterrent effect of the current position of law.

Additionally, it is explained in the subsequent section how the Indian office would be a 'branch office' of the resultant company. In light of this- such a branch office may be considered a "Fixed Place PE (permanent establishment)"[511] of the resultant foreign company. The drawback of this is that taxes of the branch office will be computed at a higher rate,[512] providing further deterrent for the foreign company from merging with the Indian company. Another possible result is that the company may choose to close down the Indian branch office entirely, leading to loss of employment for Indian nationals.

Therefore, from the above, it is clear to the researchers that there are certain ambiguities in the tax laws and the tax framework is not completely conducive to the effective carrying out of cross border mergers, particularly outbound mergers. To this effect, certain amendments ought to be carried out to the Income Tax Act, 1961, so as to bring outbound mergers within the fold of the beneficial exceptions generally provided to M&A transactions.

ISSUES RELATING TO FOREIGN EXCHANGE LAWS (FEMA ACT, 1999, AND OTHER APPLICABLE REGULATIONS)

If an Indian company merges with a foreign company, then, in the resultant company, the erstwhile office of the Indian company shall now be considered to be a branch office of the resultant company.[513] This creates a whole host of unique issues. According to the Foreign Exchange Management (Establishment in India of a branch office or a liaison office or a project office or any other place of business) Regulations, 2016 [hereinafter referred to as the "FEMA 22(R)"], a branch office of a foreign company is allowed to undertake only a limited range of activities.[514]

Such activities include professional services, export and import of goods, IT services, technical support services, etc. However, activities such as manufacturing of goods is not a part of this list of permitted activities. Therefore, in a scenario where the Indian company prior to merging with the foreign company was engaged in manufacturing activities, such manufacturing activities would have to close down in the Indian office after the merger.

Thus, in such a case, a foreign company cannot merge its manufacturing arm or subsidiary

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511 Income Tax Act 1961, s 92F(iiia).

512 AFIGEC, 'Permanent Establishment in India- Branch or Subsidiary?' PrimeGlobal (7 September 2015) <http://www.afigec.com/data/en/pdf/113/permanent-establishment-in-india.pdf> accessed 12 December 2018.

513 Foreign Exchange Management (Cross Border Merger) Regulations, 2018, r 5(3).

514 Foreign Exchange Management (Establishment in India of a branch office or a liaison office or a project office or any other place of business) Regulations, 2016, sch I.

with an Indian company. Considering that India is a manufacturing hub with cheaper labour and cost of production as compared to developed countries,[515] manufacturing in India may be seen as a lucrative merging opportunity for foreign companies, which has currently been stifled by the RBI.

In the opinion of the researchers, keeping in mind that the bar on manufacturing concerns may be a strong dissuading factor against outbound mergers, the regulations should possibly be amended to bring manufacturing within the limited range of activities allowed, in the special case of outbound mergers resulting in branch offices. By making a qualified amendment, it allows RBI to remain the loop about any such transaction, while at the same time preserving the original intent behind the exclusionary phrasing of the regulation.

ISSUES RELATING TO SECURITIES LAW (SEBI ACT, 1992 AND OTHER APPLICABLE REGULATIONS)

Certain pertinent issues of securities law also arise in the case of outbound cross-border mergers. These issues primarily fall within the legal mandate of foreign exchange regulations dealing with securities, and SEBI regulations. *First,* from the perspective of Indian shareholders or promoters, an outgoing merger with a foreign company can be problematic as the LRS (Liberalised Remittance Scheme) allows for a person to hold foreign securities only up to $250,000.[516] Given that the resultant company of an outbound merger is a foreign company, all those holding shares (or other securities of the company) of a value greater than $250,000 would face an issue.

However, in the opinion of the researcher, this issue can be circumvented if shareholders in case of outbound mergers were allowed to hold IDRs (Indian Depository Receipts). This is because, in this case they would not be holding shares themselves, but only depository receipts for the same. However, the Foreign Exchange Management (Transfer or Issue of Any Foreign Security) (Amendment) Regulations, 2004, which applies to outbound mergers,[517] only allows for the issuance of ADRs (American Depository Receipts) and GDRs (Global Depository Receipts) which do not serve the purpose here as Indian citizens still cannot hold foreign exchange over the prescribed amount in the LRS.

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[515] Mohit Bhalla, 'Average Cost of Factory Labour at Less Than $2 Per Hour Gives India a Big Advantage of Wage Arbitrage' (New Delhi, 3 April 2018) Economic Times <https://economictimes.indiatimes.com/opinion/interviews/average-cost-of-factory-labour-at-less-than-2-per-hour-gives-india-big-advantage-of-wage-arbitrage-bain-and-co-worldwide-managing-partner-manny-maceda/articleshow/63554253.cms> accessed at 12 December 2018.

[516] Foreign Exchange Management (CAT) Amendment Rules 2015, para 1, sch III.

[517] Foreign Exchange Management (Cross Border Merger) Regulations, 2018, r 5(3).

In the case of a listed Indian company, an outbound merger is even less likely to work under the existing framework. This is because of the following reasons:

COMPLIANCE WITH EXISTING SEBI GUIDELINES AND COMPLIANCE POST-MERGER

The Indian listed entity would be required to comply with SEBI Guidelines prior to the merger. However, at present there are no specific guidelines issued by SEBI in this regard, as a result of which any merger is likely to be a regulatory nightmare.

ISSUANCE OF SHARES TO INDIAN SHAREHOLDERS

As a result of the merger, the resultant foreign company would have to issue shares to the Indian shareholders. Usually, in the case of a merger, this is done via a 'share swap transaction'.[518] Such a transaction is essentially where consideration to be paid to foreign promoters in a merging company is not done in the way of cash, but in the form of shares of the merging company. For instance, the failed Bharti Airtel and MTN merger in 2011 involved a share swap transaction.[519] However, neither the rules and regulations issued thus far by all the concerned authorities, nor the Companies Act itself, deal with share swap transactions and the position of law is unclear on the same in the context of cross border mergers.

DIFFICULTY IN TRADING SHARES OF NEWLY MERGED ENTITY

Even if a logistical and regulatory arrangement is worked out by which shares of the newly merged foreign company are issued to Indian shareholder, there still remains the practical concern of how these shares are to be traded or transferred by the said Indian shareholders. Given that the shares are of a foreign company, shareholders would, in all likelihood require to be compliant with FEMA regulations and face issues in selling/ trading such shares.

UNCHARTED WATERS FOR INDIAN INSTITUTIONAL INVESTORS

In many listed entities in India, a large part of the shares are held by institutional investors such as the Life Insurance Corporation of India (LIC), which is regulated by its own act[520] and the Insurance Regulatory and Development Authority of India (IRDAI) or mutual funds/ asset management companies which are regulated by the SEBI and RBI amongst others.[521] These regulations are fairly restrictive in nature and may not have envisaged the institutions that they seek to regulate holding shares in foreign companies. This gives rise to another

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518 See generally ET Contributors, 'What is a Share Swap Deal?' The Economic Times (19 February 2018) <https://economictimes.indiatimes.com/wealth/invest/what-is-a-share-swap-deal/articleshow/62960015.cms> accessed 12 December 2018; Spandan Saxena and Ashwin Bhat, 'India: M&A Through Share Swap/Stock Swap Arrangements' Mondaq (7 September 2018) <http://www.mondaq.com/india/x/732580/Shareholders/MA+Through+Share+SwapStock+Swap+Arrangements> accessed 12 December 2018.

519 Esha Shekhar, 'Cross-Border Mergers in Light of the Fallout of the Bharti-MTN Deal' (2011) 4 NUJS L Rev 101.

520 Life Insurance Corporation Act 1956.

521 See generally Securities and Exchange Board of India (Mutual Funds) Regulations 1996.

regulatory blank space, which is important to be filled for outbound cross-border mergers to be successfully carried out.

In the opinion of the researchers, all of these lacunae need to be addressed so as to facilitate outbound cross border mergers actually taking place. While the dangers of over-regulation are well known,[522] in the absence of any regulations, it is the shareholders who suffer the brunt of the resultant problems. Thus, while so far it is primarily the RBI that has responded to these newly notified provisions of the Companies Act, it is of imperative importance that SEBI too take cognisance of the change in law and notify regulations as may be necessary so as to protect the rights of Indian shareholders.

ISSUES RELATING TO JURISDICTION IN THE CASE OF DISPUTE RESOLUTION

The last section of this paper deals with the issue of jurisdiction. There is wide-ranging consensus across the board on the fact that the interests of Indian shareholders do in fact need to be protected. However, there is little to no literature available or discourse undertaken on how the Government or other regulatory bodies such as the RBI and SEBI seek to protect these interests, given that the resultant company of an outbound merger is a foreign company incorporated in a foreign jurisdiction and subject to foreign laws. Thus, the primary question that arises is- whether Courts in India, primarily the NCLT, can effectively enforce decisions over companies incorporated outside India.

This brings to the fore the concept of the 'long arm jurisdiction' of the NCLT. Long arm jurisdiction essentially means the ability of local courts to exercise powers over foreign entities or persons[523] – in this case, that would be the application of the powers of the NCLT over resultant foreign companies.

In terms of statutory provisions, while the Companies Act, 2013 states that it applies to companies incorporated outside India,[524] this only applies when at least 50% of the paid up share capital is owned by Indian citizens or companies incorporated in India. Therefore, under the provisions of the Companies Act, the NCLT's jurisdiction would apply only in the case where the resultant company is at least 50% owned by Indian citizens or companies, which may not be helpful in the case of outbound mergers, as in such a case, it may be an Indian

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[522] See generally Nobert Michel, 'Time To Fix The Overregulation Problem In Financial Markets' Forbes (3 May 2016) <https://www.forbes.com/sites/norbertmichel/2016/05/03/time-to-fix-the-overregulation-problem-in-financial-markets/#7c5fe9b33db8> accessed 12 December 2018; Herbert Grubel, 'Why We Need Less Regulation of Capital Markets' Wall Street Journal (3 October 2002) <https://www.fraserinstitute.org/article/why-we-need-less-regulation-capital-markets> accessed 12 December 2018.

[523] GW Jr Foster, 'Long-Arm Jurisdiction in Federal Courts' (1969) 1 Wis L Review 9, 10.

[524] Companies Act 2013, s 379.

company merging with a larger foreign company.

Further light on the long arm jurisdiction of the NCLT was shed in the case of *Vikram Bakshi* v. *Connaught Plaza Restaurants Ltd*.[525] In this case, a joint venture was entered into between the petitioner and McDonald's Corporation (a company incorporated in Delaware, through its Indian subsidiary, McDonald's India), where both the parties held a 50% shareholding each. In this case of oppression and mismanagement, although the Tribunal did not explicitly deal with the issue of jurisdiction, the remedies it provided to the petitioner were of such nature that the assets of the foreign company (in this case, McDonald's Corporation) located outside of India would not be adversely affected.

Importing this line of judgement into the context of outbound mergers, it is clear that the NCLT would hold very little power over foreign resultant companies. In case the company has less than a 50% Indian shareholding, it is unclear how the NCLT would enforce its decisions in case of a violation of the Act or other Regulations against such foreign company. The only area where the NCLT can enforce its rights in such a scenario would be the Branch Offices and other Indian assets of the resultant company.

Given this scenario, in the view of the researchers, the most useful way forward would be the **signing of cooperative jurisdiction agreements** between countries wherein outbound mergers take place. Such agreements are primarily seen in the case of taxation issues, manifesting in the form of double-taxation avoidance agreements and other such allied agreements.[526] However, such cooperative jurisdiction agreements in the case of mergers have also been seen in the international business community, with the most prominent one being the **US-EU Merger Working Group**, which provides for cross-jurisdiction best practices to be followed.[527] It would be in India's best interest to follow this model and enter into such agreements, either at the bilateral or multilateral level, so that disputes that may arise with regards to companies that are the result out of an outbound merger can be resolved without jurisdictional conflict issues.

The concept of cooperative jurisdiction agreements is not alien to Indian company law, as the Insolvency and Bankruptcy Code, 2016 provides for the Central Government to enter into agreements with other countries to enforce provisions of the Code.[528] However, there is no

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[525] Vikram Bakshi v Connaught Plaza Restaurants Ltd [2017] 140 CLA 142.

[526] See Parvatha Vardhini, 'All you wanted to know about DTAA' The Hindu Business Line (16 May 2016) <https://www.thehindubusinessline.com/opinion/columns/all-you-wanted-to-know-aboutdtaa/article8607732.ece> accessed 12 December 2018.

[527] US-EU Merger Working Group, 'Best Practices on Cooperation in Merger Investigations' (European Commission, 14 October 2011) **<http://ec.europa.eu/competition/mergers/legislation/best_practices_2011_en.pdf>** accessed 12 December 2018.

[528] Insolvency and Bankruptcy Code 2016, s 234.

similar provision within the Companies Act to enter into such agreements. Therefore, it is a suggestion of the researchers that a provision for such agreements be inserted into the Companies Act through which cross border mergers can be effectuated.

CONCLUSION

In conclusion, it is certain that the notification of an outbound cross-border merger provisions under the Companies Act, 2013 is a step forward by India Inc. to broaden its base in international markets and give Indian companies more freedom to make economic choices that benefit their business.

At the same time, it must be kept in mind that while lack of regulation may sometimes benefit big businesses (which too, does not always hold true, as has been illustrated in this paper) it is often the shareholders' interests which are unfairly compromised. This becomes especially pertinent when shareholders are left without feasible share transfer options or dispute resolution mechanisms on account of cross-jurisdictional issues.

Thus, in our opinion, it is of imperative importance that all the involved regulatory bodies take cognisance of the gaping holes that exist under the current framework and either amend existing Acts and regulations or issue new ones so as to make the process of outbound mergers a watertight one, in terms of taxation, securities issues, as well as jurisdictional issues. This will go a long way in boosting India's business strength and increased compliance with secure regulations will benefit all stakeholders across the board.