

Banking and Finance – Legal Milestones in 2019 and a Look Ahead

28 February 2020

This update covers:

a. The Year that Was	2
b. Major Legal Developments in 2019	2
• New Regime for External Commercial Borrowings	2
• Supreme Court strikes down RBI Circular on Resolution of Stressed Assets	3
• RBI's new framework for resolution of stressed assets	3
• Developments under the Insolvency and Bankruptcy Code	4
• Essar Steel Judgement	4
• Insolvency Framework for Financial Service Providers	6
c. Looking Ahead	6

1 The Year that Was

In 2019, the Indian economy witnessed a decline in its growth rate with a slump in demand in various sectors such as real estate, aviation, construction and automobiles. Consequently, the Ministry of Finance was tasked to take measures to alleviate the growing concerns of the state of the Indian economy and the banking sector.

To improve the landscape of the Indian banking sector, the Finance Ministry announced the amalgamation of ten public sector banks into four major banks, subsequently reducing the total number of Indian public sector banks from 27 to 12. Once the merger takes effect, the enhanced capital base is expected to enable public sector banks to offer larger loans.

Following the recommendations made by the Bimal-Jalan expert committee, the Reserve Bank of India (RBI) decided to provide surplus funds to the Indian government which is expected to revive economic growth in a time of scarce consumer demand and scant investment.

Additionally, this year saw a significant overhaul in the process of stressed asset management. The RBI introduced a new framework for resolution of stressed assets – aimed at bringing about a change in the approach of banks to monitor exposures and resolution of non-performing assets. Simultaneously, the year saw major developments under the Insolvency and Bankruptcy Code, 2016 (IBC)

through legislative amendments and important court decisions such as in the Essar Steel insolvency case which provided a much-needed closure to legal quagmires.

In 2019, the banking and finance sector witnessed major developments with the Supreme Court striking down RBI's circular on resolution of stressed assets and the RBI subsequently introducing a revised framework. The year also saw judicial and legislative developments in the insolvency and bankruptcy space and an overhaul of the External Commercial Borrowings framework. This update summarises some of these developments along with our expectations for the year 2020.

2 Major Legal Developments in 2019

2.1 New Regime for External Commercial Borrowings

On 16 January 2019, the RBI introduced the new External Commercial Borrowings (ECB) framework, in supersession of its extant master directions.

The new ECB framework has simplified the three-track regime for ECBs into a dual framework governing foreign currency ECBs on one hand, and INR-denominated ECBs on the other. Additionally, masala bonds are also subsumed within the INR ECB framework. To further simplify the process, the following changes have been made under the new framework:

- a. the minimum average maturity period for all ECBs is now capped at 3 years, subject to certain exceptions;
- b. any entity eligible to receive FDI can also borrow under the ECB framework, as also units in special economic zones, registered societies/ trusts and NGOs;

UPDATES

- c. the list of eligible lenders has been revised to cover residents of Financial Action Task Force or International Organization of Securities Commission compliant countries, equity-holding individuals and multilateral financial institutions;
- d. the ECB limits have been revised and eligible borrowers can borrow up to USD 750 Million (approx. Rs. 5,250 crores) through ECBs; and
- e. the negative list of end uses for which the ECB may be used remains largely unchanged.

2.2 Supreme Court strikes down RBI Circular on Resolution of Stressed Assets

The RBI issued a revised circular on the framework for resolution of stressed assets on 12 February 2018 (February 12 Circular). This framework provided for early identification and reporting of stressed assets and strict timelines for resolution, failing which a petition would have to be filed under the IBC. However, the Supreme Court in *Dharani Sugars and Chemicals Limited v. Union of India* through its order dated 2 April 2019 struck down the February 12 Circular for falling foul of the Banking Regulation Act, 1949.

The Court referred to the Section 35AA of the Banking Regulation Act, 1949 that empowers the Central Government to authorize the RBI to direct any bank to initiate the corporate insolvency resolution process against debtors for a 'default' under the IBC. The Court held that section 35 AA of the Banking Regulation Act, 1949 refers only to specific defaults by specific debtors as authorised by the Central Government. However, February 12 Circular acted as a general direction to initiate IBC proceedings under certain circumstances without any specific authorisation and hence, failed to comply with the requirement stipulated under Section 35AA of the Banking Regulation Act, 1949. Therefore, the February 12 Circular was struck down and all proceedings initiated under it discontinued.

2.3 RBI's new framework for resolution of stressed assets

After the February 12 Circular was struck down by the Supreme Court, the RBI issued a revised framework called 'Prudential Framework for Resolution of Stressed Assets' through a circular dated 7 June 2019 (Revised Circular). The Revised Circular introduced the following major changes:

- a. the lenders are required to finalise the resolution strategy within a 30-day review period from the date of default, after which the lenders will have 180 days to implement the resolution plan;
- b. in transactions pertaining to syndicate lending, the lenders may enter into an inter-creditor agreement which will provide for rules to be observed by the lenders while finalising and implementing the resolution plan. Further, a decision taken by 75% of the lenders by value and 60% of the lenders by number will be binding on all lenders;
- c. the resolution plan must comply with Section 29A of the IBC which prevents certain categories of persons from acquiring ownership of the stressed debtor through the resolution process; and
- d. in order to encourage speedy resolution, the Revised Circular includes additional provisioning requirements that are attracted upon delays beyond the permitted timelines. For a delay beyond 180 days, 20% additional provisioning is attracted while for a delay beyond 365 days, an additional 15% provisioning is attracted.

Importantly, the Revised Circular simply recognises the lender's choice to initiate insolvency proceedings, while also preserving RBI's powers to issue specific directions for initiation of insolvency resolution proceedings. By contrast, the February 12 Circular was mandatory in nature and applied generally under

UPDATES

certain circumstances without any specific authorisation to initiate proceedings under the IBC against errant debtors.

2.4 Developments under the Insolvency and Bankruptcy Code

The government has continued its focus on plugging gaps in the IBC through regular amendments and therefore, initiated two rounds of amendments to the IBC in 2019.

The following key changes were made through the IBC (Amendment) Act, 2019:

- a. Earlier the IBC stipulated that the payment to operational creditors should not be less than the amount that they would receive if the corporate debtor were to undergo liquidation. However, post the amendment, the amount must not be less than the higher of: (i) the amounts which the operational creditors would be entitled to in the event of liquidation of the corporate debtor; or (ii) the amount such operational creditor would receive if distributions were made according to the priority specified in the liquidation waterfall under section 53 of the Code;
- b. The existing timeline of 180 plus 90 days for the completion of the resolution process has been revised to 330 days (including time spent in legal proceedings);
- c. The NCLT has to record reasons for failing to ascertain the existence of debt within the prescribed timeline;
- d. The authorised representative of a particular class of financial creditors would vote in the committee of creditors as per the decision taken by a vote of more than 50% of the voting share of the financial creditors of the respective class of financial creditors; and
- e. An approved resolution plan would also bind the government and local authorities to whom a debt in respect of payment of dues is owed.

Subsequently, the IBC (Amendment) Ordinance, 2019 made the following key changes:

- 1 Minimum thresholds introduced for certain classes of creditors before they can initiate insolvency proceedings. For instance, in the case of real estate projects, a joint application by at least 100 allottees of the same real estate project or 10% of total allottees under the project, whichever is less;
- 2 Governmental permits, licences, concessions, etc., granted to the corporate debtor would not stand terminated due to insolvency if the dues in that regard are paid as required;
- 3 The resolution professional would be permitted to treat certain goods as critical to preserve the value of the corporate debtor and prohibit termination of supply of such goods; and
- 4 The corporate debtor will be offered immunity from being prosecuted for any offence committed prior to the initiation of the corporate insolvency resolution process, so long as the resolution process has led to a change in the management of the corporate debtor and provided the new management is not connected to the offence or the erstwhile management of the corporate debtor.

2.5 Essar Steel Judgement

The much-awaited judgement of the Supreme Court in the insolvency proceedings of *Essar Steel* was pronounced on 15 November 2019. The Supreme Court put to rest doubts and settled important issues concerning the Corporate Insolvency Resolution Process (CIRP) under the IBC. It also clarified the scope of powers of the Committee of Creditors (CoC) of a corporate debtor and set aside the order of the National Company Law Appellate Tribunal (NCLAT) by which decisions of the CoC of Essar Steel were modified/set aside.

UPDATES

The judgement also upheld the constitutional validity of the IBC (Amendment Act), 2019 with some relaxation on the timeline for completion of the CIRP.

The key highlights from the judgment are as follows:

- a. The Supreme Court reaffirmed the supremacy of the commercial wisdom of the CoC to decide the CIRP of a corporate debtor by accepting/rejecting a resolution plan. Whilst considering the feasibility and viability of a resolution plan, the CoC is required to consider all aspects of the plan, including the manner of distribution of funds to various classes of creditors (which is binding on all stakeholders). The CoC is empowered to suggest an amendment to the commercial proposal of a prospective resolution applicant if so required.
- b. The scope of judicial review available to National Company Law Tribunal (NCLT) and NCLAT is limited and they cannot trespass a business decision of the majority of the CoC, provided that the resolution plan is in compliance with the IBC and applicable regulations. It is clarified that the ultimate discretion of distribution of funds to each class or subclass of creditors is with the CoC, provided that interests of all stakeholders are protected. Without interfering with merits of the commercial decision taken by the CoC, the NCLT has to adjudicate whether the resolution has met with the following parameters: (a) to keep the corporate debtor as a going concern during the CIRP; (b) to maximise the value of the corporate debtor's assets; and (c) to protect the interests of all stakeholders, failing which, the NCLT may send the resolution plan back to the CoC to re-submit such plan after satisfying the said parameters.
- c. Financial and operational creditors are two separate classes of creditors under a resolution plan and cannot be treated equally. Financial creditors get priority over operational creditors in the repayment waterfall since they provide capital for the corporate debtor.
- d. The Supreme Court held that the CoC can constitute a sub-committee for the limited purpose of negotiating with resolution applicants or for performing other ministerial or administrative acts. It clarified that such acts have to be ultimately approved and ratified by the CoC. Therefore, the CoC cannot delegate all its powers to the sub-committee.
- e. The decision of the NCLAT that the guarantor would be relieved from payment (of any residual debt not approved under the resolution plan) once a resolution plan is approved by the CoC, has been set aside by the Supreme Court and found to be in violation of Section 31(1) of the Code, which makes an approved resolution plan binding on the guarantors (amongst others).
- f. The Supreme Court observed that the distribution of profits made during the CIRP will not be utilised towards payment of debts of any creditor.
- g. The 330-day time limit prescribed for the completion of insolvency resolution proceedings is not sacrosanct. It may be extended in exceptional cases where the litigant is not responsible for the delay, to ensure that the time taken in legal proceedings does not harm the litigant.
- h. The provisions brought in by the Amendment Act, 2019 to provide for a minimum value to be paid to operational creditors and dissenting financial creditors under a resolution plan were held to be beneficial to the stakeholders, and constitutionally valid.

2.6 Insolvency Framework for Financial Service Providers

To provide a robust mechanism to resolve the ongoing distress in the financial services sector, the Ministry of Corporate Affairs (MCA) notified the Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, 2019 (FSP Rules) on 15 November 2019. This has extended the insolvency framework applicable to corporate debtors under the IBC to financial service providers (FSPs), as may be notified by the MCA from time to time (in consultation with appropriate regulators). Currently, the framework has been made applicable to systemically important Non-Banking Financial Companies (Notified NBFCs).

Under the FSP Rules, an FSP can be referred to insolvency only by the 'Appropriate Regulator' that has been notified for that category of FSP (and not by a financial or operational creditor). The Central Government has the power to notify the 'Appropriate Regulator' for different classes of FSPs. A number of modifications have also been made to the IBC to provide special powers to such Appropriate Regulator in respect of a CIRP of an FSP. In this regard, the RBI has been notified as the 'Appropriate Regulator' for the Notified NBFCs.

3 Looking Ahead

While the Indian economy has been noticeably slow in 2019, global rating agencies have predicted that the GDP growth will likely recover in the next couple of years. The implementation of IBC being in its third year, it is expected that the final resolution of various companies undergoing the insolvency resolution process could potentially lead to the recovery of over Rs. 1,00,000 crores.

On the legislative front, following the trend from last year, the Government may introduce further changes to the IBC to address insolvency and bankruptcy of companies that belong to the same group. Additionally, given the growing discussion on the inclusion of trusts and societies within the ambit of the IBC, it would be interesting to see if affirmative actions are taken by the Government on that front.

Finally, with the mega-merger of the public sector banks, it is expected that lending by the public sector banks will also increase, which in turn could revive the Indian economy. However, it is also possible that fewer *albeit* inter-linked large banks could make the Indian economy vulnerable to greater financial risks.

Therefore the expectation is that 2020 would be significant for the Indian banking and finance sector, which currently stands at the cusp of dealing with challenges from the year gone by and opportunities which the new fiscal year could bring despite an expected global slowdown.

For a round-up of some of the key legal developments across sectors in 2019 and a brief insight on what to expect in 2020, please read our sector-wise updates, which can be accessed at: <https://trilegal.com/knowledge-repository/page/2/?title=milestone>

If you require any further information about the material contained in this newsletter, please get in touch with your Trilegal relationship partner or send an email to alerts@trilegal.com. The contents of this newsletter are intended for informational purposes only and are not in the nature of a legal opinion. Readers are encouraged to seek legal counsel prior to acting upon any of the information provided herein.