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On behalf of the Board, we extend our gratitude to the authors who dedicated their time to contribute to this issue. The topics covered, focusing on contemporary aspects of Banking, Securities, and Insolvency laws, reflect the authors' persistence and cooperation throughout the editing process. Their efforts facilitated the timely and seamless release of this issue. We hope that readers find this edition to be a valuable resource, fostering informed discussions on banking and financial laws. Should our readers have any queries, suggestions or feedback for us, write to us at: scholastocus.nluj[at]gmail[dot]com.

Bhavya Kansara & Vanshika Agrawal

Editors-in-Chief

Abir Lal Dey, Ananya Ghosh & Arnav Sinha, *First Loss Default Guarantee: Financial Inclusion through Digital Lending?*,11 (1) SCHOLASTICUS 8 (2024).

FIRST LOSS DEFAULT GUARANTEE: FINANCIAL INCLUSION THROUGH DIGITAL LENDING?

Abir Lal Dey[⊥]*, Ananya Ghosh*[ø]*& Arnav Sinha*[⊤]

ABSTRACT

Touted as the game changer in the fintech sector, the Reserve Bank of India's (RBI) new first loss default guarantee (FLDG) Guidelines are creating a positive outlook in the digital lending space. Prior, to the new FLDG Guidelines, the then-existing rules and regulations pertaining to FLDG in digital lending transactions were ambiguous. The fintechs who wished to introduce newer and fresher lending products to their customers incorporating FLDG structures were constrained to do so due to the lack of clarity in this regard. Thus, the new FLDG Guidelines are a welcome move and extremely encouraging for the fintech ecosystem. This will further augment deeper partnerships and alliances between Banks, NBFCs, regulated entities and new-age fintechs thus penetrating access to credit and fuel growth for the unserved and underserved.

The authors through this paper have deliberated the genesis of FLDG Guidelines and its impact on the fintech and digital lending sectors. Digital lending has been emerging significantly and has played a momentous role in augmenting financial literacy and financial inclusion in India. The RBI's FLDG Guidelines might be the much-needed magic elixir to the uncertainty-stricken default loss guarantee arrangement in digital lending, leading to the dawn of a new era of possibilities in the fintech sector. This paper is an attempt to answer these vital regulatory changes in the fintech ecosystem.

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I. INTRODUCTION

Financial technology or fintech has been thriving in India due to the digitalisation boom witnessed in the country in the past few years. As per a Boston Consulting Report, India's fintech sector is expected to be multiplied by an approximate revenue of six times by the year 2030.[1]

The impetus towards this mushrooming of fintechs instead of traditional brick-and-mortar solutions is primarily due to the demand for alternative credit mechanisms which the 'play-it-safe' traditional banking systems are hesitant to provide. Newer versions of technological solutions are surpassing their previous versions on a day-to-day basis. This technological momentum has not left any stone unturned in the digital lending space as well. Fintechs have developed from their nascent stages of serving niche audiences to households by providing various integrated solutions to their ever-increasing customer base. Along these developments, one such concept introduced and employed by fintechs is the concept of first loss default guarantees *a.k.a* FLDG.

FLDG may be in the form of a contractual arrangement in a lending transaction, wherein a fintech company or lending service provider ("**LSP**") i.e. FLDG provider agrees to compensate the lender for loss that occurred by the lender when the borrower defaults on its repayment commitments

[1] Vidisha Debsarkar, *Fintech Industry: Marketing trends based on consumer behaviour and challenges faced by the sector*, THE ECONOMIC TIMES (Jan. 16, 2022), available at: https://brandequity.economictimes.indiatimes.com/news/marketing/fintech-industry-marketing-trends-based-on-consumer-behaviour-and-challenges-faced-by-the-sector/88928682.

in return for compensation, which may be charged as additional commission or fees. FLDG became so popular in lending transactions that the FLDG providers started providing up to nearly a hundred per cent guarantee on the defaults of the borrower, essentially stepping into the shoes of the lender, as far as credit exposure is concerned.

The sudden rise in the fintechs necessitated the Reserve Bank of India ("**RBI**") to act as the watchdog for the fintech sector and introduce guidelines and directions to ensure that digital lending by the fintech players is adequately monitored. These guidelines and directions by the RBI ensures that the ambit of digital lending does not go astray and turn into a bane for these platforms, and the lending products introduced by them, crucially serve as the boon for promoting financial inclusions in the country.

It was only a matter of time before the RBI noted the increased usage of FLDG in digital lending transactions through synthetic business structures and therefore, after due contemplation, RBI introduced the Guidelines on Default Loss Guarantee in Digital Lending on June 8, 2023 ("**FLDG Guidelines**"), which governs the FLDG arrangements between Regulated Entities ("**REs**") and LSPs or between two REs.

The term "regulated entity" is an umbrella term that covers commercial banks, small finance banks, cooperative banks, and non-banking financial companies ("**NBFCs**"). LSP is an agent of a RE, which undertakes the functions of the RE, such as customer acquisition.[2] As a requirement, LSPs are mandated to be incorporated under the Companies Act, 2013 to be

[2] The Reserve Bank of India, Guidelines on Digital Lending, RBI/2022-23/111,DOR. CRE.REC.66/21.07.001/2022-23, at cl. 2.5, available at: https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12382&Mode=0.

eligible for providing default loan guarantee ("**DLG**") structures under paragraph 3 of the FLDG Guidelines.

It may be observed that before the FLDG Guidelines, the RBI's Report of Working Group on Digital Lending including Lending through Online Platforms and Mobile Apps dated November 18, 2021[3], prohibited unregulated entities from participating in synthetic structures, such as FLDG.

The FLDG Guidelines brings necessary clarity required for lending arrangements between fintechs (who are eligible to act as LSPs) and REs, which have the potential to alter the landscape of this space acting as a pathbreaking milestone for India's digital lending and fintech space. The FLDG Guidelines serves as a powerful tool to promote innovation in the digital lending space with the development of transformative financial solutions.

Banks are wary of extending loans to high-risk areas with a higher probability of bad loans. These areas generally suffer from information asymmetry due to borrowers' limited credit past, and include sectors such as the MSME, agriculture, and blue-collar, among others.

This collaboration brought in by the FLDG Guidelines will ensure that banks (which have capital and licenses to lend) are working in harmony with the fintechs (which have technological backing). The fintechs can therefore

[3] *Report of the Working Group on Digital Lending including Lending through Online Platforms and Mobile Apps*,RESERVE BANK OF INDIA (Nov. 18, 2021), available at:https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=1189.

focus on innovation and security. They can use big data and secure banking data with the help of technology. The fintechs, which cannot lend directly, can ensure that the banks undertake certain services such as sourcing the loan and recovery and the fintechs carry out the underwriting work, and the customer acquisition, among others. In case the loan becomes a bad loan, the default loss guarantee model will ensure that a certain percentage of the loss is covered by fintech.

Therefore, by framing the FLDG Guidelines, RBI approved the FLDG program thus facilitating the sharing of credit risks between unregulated entities and REs. The FLDG providers act as shock-absorbers and provide guarantees to the REs in the event of default by the borrowers. With this green signaling of the FLDG Guidelines, a percentage of the default in the loan of the registered entity is guaranteed by the LSPs[4]or fintech.

Through the new FLDG arrangements between banks/NBFCs and fintechs, the trust towards the fintechs in the eyes of banks/NBFCs will increase the reliability towards fintechs, which helps improving the business relationships with the backing of fintech's underwriting capabilities.

In this paper, an attempt has been made to analyse the FLDG Guidelines from an all-encompassing viewpoint. A micro and a macro attempt have been undertaken with a worm's eye view and at the same time a bird's eye view to solve the labyrinth of queries in the FLDG space. ***First***, the authors have delved into the historical background and scheme of statutes prior to

[4] Guidelines on Digital Lending dated September 2, 2022, issued by the RBI defines a 'Lending Service Provider' under Clause 2.5 as *"an agent of a Regulated Entity who carries out one or more of lender's functions or part thereof in customer acquisition, underwriting support, pricing support, servicing, monitoring, recovery of specific loan or loan portfolio on behalf of REs in conformity with extant outsourcing guidelines issued by the Reserve Bank*."

the introduction of the FLDG Guidelines on June 8, 2023. ***Second***, an attempt has been made to provide a detailed, in-depth analysis of the structure of the FLDG Guidelines ***Subsequently***, the authors have analysed the increase in financial inclusion in India resulting from the clarity provided by the FLDG Guidelines to the fintech space. ***Thereafter***, the authors have highlighted the loopholes in the FLDG Guidelines and followed by remedial recommendations in the FLDG Guidelines. The authors conclude this paper with an all-encompassing viewpoint of the FLDG Guidelines.

II. HISTORICAL TRAIL LEADING TO THE FLDG GUIDELINES

With the boom of internet connectivity in India, both mobile and web-based, the country has witnessed immense growth in the usage of technology in the lending space. This overlap of technological development and financing in India has directly resulted in the development of "digital lending" in Indian markets. In simple terms, digital lending is the process of providing credit through online platforms, avoiding traditional intermediaries like banks.

Since its inception, digital lending has been marked by constant development of newer and more complex forms of lending products to achieve improvements in quality, inclusion, and efficiency, which made digital lending a lucrative space for banks, financial institutions, and other players in the Banking, Financial Services and Insurance ("**BFSI**") sector in India. Due to the spurt but unregulated growth of the digital lending space in India, it was inevitable for the RBI to step in and take note of the

unintended consequences and concerns attached to the growth of digital lending in India.

A. RBI Working Group Report and Its Reservation on FLDG

In view of the developments, the RBI constituted a Working Group ("**Working Group**") on digital lending on January 13, 2021, to study all aspects of digital lending activities by regulated as well as unregulated players so that appropriate regulatory measures can be put in place to focus on enhancing customer protection and making the digital lending ecosystem safe and sound while encouraging innovation. The Working Group submitted a report on November 21, 2021 titled "**Report of the Working Group on Digital Lending including Lending through Online Platforms and Mobile Apps**"[5] ("**Working Group Report**"), which underlined various precautionary measures for the digital lending space in India.

The Working Group Report underlined the concept of synthetic lending structures such as the FLDG as a means for unregulated LSPs, as defined under the Digital Lending Guidelines, to circumvent the RBI's prudential norms while undertaking lending transactions. As observed in the Working Group Report under paragraph 3.3.1.2:

> "*A synthetic structure enabling unregulated entities to lend without complying with prudential norms is through credit risk sharing arrangements by way of a "First Loss Default Guarantee (FLDG)" extended by the LSPs. Under this, the LSP provides certain credit enhancement features such as first loss guarantee up to a pre-decided*

[5] RESERVE BANK OF INDIA, *supra* note 3.

> *percentage of loans generated by it. From the LSP's perspective, offering FLDG acts as a demonstration of its under-writing skills whereas from the lender's perspective, it ensures platform's skin in the business.* ***For all practical purposes, credit risk is borne by the LSP without having to maintain any regulatory capital. The loan portfolio backed by FLDG is akin to off-balance sheet portfolio of the LSP wherein the nominal loans sit in the books of the lender without having to partake in any lending process.***"[6]

Additionally, the Working Group Report further delved into its reservations on FLDG by stating that the same allows for LSPs to undertake "balance-sheet lending" while not satisfying the "principal business criteria" in addition to other operational risks posed by FLDG. The Working Group Report under paragraph 3.3.12 underlined that:

> **"*In some cases, the LSP, as a non-banking non-financial company (NBNC) may be undertaking balance sheet lending in partnership with a bank/ NBFC or on stand-alone basis, while not satisfying the principal business criteria to remain outside regulation.****Besides, there are higher operational risks which arise due to increasing reliance of lenders on third-party service providers. With increasing share of digital lending in retail/ personal space, there is a potential for risk build-up because of these platforms. This may also be adding to counterparty risks posed by the platform to its lending partners*.**"[7]**

The Working Group Report under paragraph 3.1.2. specifies that financial activity is treated as a principal business when a company's financial assets constitute more than 50 % (fifty per cent) of the total assets and income from financial assets constitute more than 50% (fifty per cent) of the gross

[6] *Id* at para. 3.3.1.2.
[7] *Id* at para. 3.3.1.2.

income[8]. A company fulfilling both these criteria may acquire registration from the RBI to operate as an NBFC.

Additionally, the Working Group Report was also concerned about the passing of the costs associated with the implementation of FLDG onto the borrowers resulting in higher interest rates. The Working Group Report under paragraph 5.3.4.3. specifically draws concerns in employing such mechanisms in digital lending as the same may lead to unethical and non-transparent loan pricing – having a significant bearing on the interest rate charged to customers:

> "*…Specifically, in digital lending, it has been observed that -*
>
> - *The existence of layer(s) between the borrower and the balance sheet lender leads to non-transparent and unethical loan pricing. The regulated entities are at times not aware of the additional charges/ fees being levied by their third parties.*
> - *As has been explained in Section 3.3.1.2, credit risk sharing mechanisms have also emerged in the form of first loss default guarantee. Internal cost compensation arrangement between the balance sheet lender and the LSP has a bearing on the interest rates being charged to the customers.*
> - *Costs associated with FLDG or any other such mechanism are passed on by the platforms to the borrowers resulting in higher interest rates*."[9]

B. Recommendations On FLDG Under The Working Group Report

However, unsurprisingly, the Working Group, in its list of recommendations submitted to the RBI under the Working Group Report

[8] *Id* at para. 3.1.2.
[9] *Id* at para. 5.3.4.3.

specifically recommended the prohibition of structures such as the FLDG under paragraph 3.4.3.1:

> "*To prevent loan origination by unregulated entities,* ***REs should not be allowed to extend any arrangement involving a synthetic structure, such as, the FLDG to such entities. REs should not allow their balance sheets to be used by unregulated entities in any form to assume credit risk****."*[10]

Thus, the Working Group specifically recommended the RBI to prevent REs from extending any arrangement involving synthetic structures such as FLDGs. When the draft of the Working Group Report was released for stakeholder comments, it was suggested that FLDG may not be done away with altogether and the same may be allowed considering the capital adequacy ratio of the LSP. It was suggested that a capital adequacy ratio of about 15-20% (fifteen to twenty per cent) may be imposed on LSPs to prevent any systemic risks. This would encourage the LSPs to become regulated by the RBI and acquire a certificate of incorporation accordingly.

C. Guidelines on Digital Lending

Basis Working Group Report, the RBI issued Guidelines of Digital Lending on September 2, 2022 ("**Digital Lending Guidelines**")[11]. However, in what be seen as an endorsement of the Working Capital Report's reservations on FLDG and their consequent recommendations, Digital Lending Guidelines failed to provide specific provisions to govern structures like FLDG. It was widely reported[12] that the RBI's reservations

[10] *Id* at para. 3.4.3.1.
[11] RESERVE BANK OF INDIA, *supra* note 2.
[12] Hitesh Vyas, *RBI permits loan default guarantee in digital lending: Will it boost fintech activity?*,THE INDIAN EXPRESS (June 09, 2023), available at:

on FLDG were that it could pose a 'systemic risk', something which was of concern under the Working Group Report. LSPs, which will provide FLDGs, will in essence be undertaking balance-sheet lending without acquiring registration with RBI which may pose a challenge to RBI's efforts in preventing consumer fraud. The matter of specific concern was primarily that since these LSPs are generally unregulated, they would lack adequate supervision. The high credit risk undertaken by them will not be backed by strong risk management, debt-to-equity ratio requirements, capital adequacy requirements etc. This would, in turn, expose fintech platforms to a high degree of risk and at the same time expose them to potential losses, and therefore would mean an imprudent decision for the regulated entities to enter into.

D. Increased Ambiguity on FLDG

This lack of clarity on the FLDG structures increased with the promulgation of the Digital Lending Guidelines has created more confusion given the ambiguity in the Digital Lending Guidelines. *Prima facie,* it appears that the Digital Lending Guidelines prohibit structures such as the FLDG. However, paragraph 15 of the Digital Lending Guidelines suggests that for loss-sharing arrangements in case of default such as FLDGs, the REs are 'advised' to adhere to the provisions of the **Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021 dated September 24, 2021**, ("**Securitisation Directions**") especially, for synthetic securitisation contained in paragraph (6)(c). Securitisation Directions under paragraph 6(c) specifically prohibited

https://indianexpress.com/article/explained/explained-economics/rbi-permits-loan-default-guarantee-in-digital-lending-to-boost-fintech-activity-8654538/.

REs from taking exposures in the form of synthetic securitisation; leading to further confusion on the RBI's stance on structures like FLDG and casting the impression that the RBI is, if not explicitly, but impliedly, preventing REs from employing FLDGs into their lending transactions.

E. FLDG Guidelines –much-needed clarification on FLDG?

In the absence of clear directions, REs like banks had stopped entering into such arrangements with fintech players, posing a threat to their business in the digital lending space. The fintech industry was demanding that the RBI allow FLDG arrangements basis the suggestions purported by them and in line with suggestions of the Working Group Report.

This has since been modified with the FLDG Guidelines wherein the RBI has laid down the model with stricter restrictions on the partnership between fintech players and REs. With the FLDG structure laid down at present through the FLDG Guidelines, an upper cap of 5% (five per cent) on the total default guarantee has been implemented[13].

In view of the above, a detailed analysis of the FLDG Guidelines has been provided in the next section herein.

[13] The Reserve Bank of India, Guidelines on Default Loss Guarantee (DLG) in Digital Lending, RBI 2023-24/41, DOR.CRE.REC.21/21.07.001/2023-24, available at: https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12514.

III. UNDERSTANDING THE STRUCTURE OF THE FLDG GUIDELINES

FLDG is a contractual arrangement whereby LSP, as a licensed third-party, guarantees a certain percentage of the default in the loan portfolio of a RE entered into outsourcing agreements.[14] The duration of the agreement should be at least as long as the tenure of the loans with the farthest repayment schedule in the underlying portfolio.[15] This ensures that there is a safeguard against any potential risks in the portfolio of the lender.[16] However, it is to be noted that FLDG is different from a co-lending arrangement given that an FLDG arrangement only secures the default by way of guarantee, which does not entail any transfer of underlying loan exposure from the books of the RE to the books of the guarantee provider whereas a co-lending arrangement envisages the sharing of the loan exposure as per a pre-determined understanding between two lenders.

In the recent times, the guarantee providers have started charging fees against the guarantee as opposed to the earlier practice of sharing of the residual income provided in exchange for the guarantee. This exposed them to significant risks since they had to absorb the first loss and at the same time, the residual income is variable in nature. With the FLDG Guidelines,

[14] *Id* at cl. 4.
[15] *Id* at cl. 10.
[16] Team Finserv, *FAQs on Default Loss Guarantee in Digital Lending*, VINOD KOTHARI CONSULTANTS(Jun. 9, 2023), available at https://vinodkothari.com/2023/06/faqs-on-default-loss-guarantee-in-digital-lending/.

the parties may mutually decide on a contract on the amount to be given to the fintech lending service provider.[17]

A paramount point for observation is the 5% (five per cent) cap on FLDG arrangements prescribed under the FLDG Guidelines. This move has been made to ensure that the total default guarantee by the fintech platform does not go beyond the said upper limit prescribed therein.

Additionally, REs can provide a guarantee only when the fintech provides a guarantee in the form of cash deposited[18], or fixed deposits which are maintained with scheduled commercial banks with a lien (security interest over a property) marked in favour of the regulated entity, or with bank guarantee marked in favour of the regulated entity. This security mechanism ensures that the fintech/LSPs that are providing the guarantee are capable enough to fulfil their obligation in the case of default.

The RBI, as a financial regulator, avoids situations where the borrowings are provided to a person or any entity without sufficient safeguards. Therefore, RBI has provided conditions such as the requirement of a board-approved policy before entering into a default loss guarantee transaction. There are also requirements such as maintaining the standard of ownership and accountability. This has been encompassed by the introduction of credit risk management policies, credit underwriting requirements, regulatory capital requirements, and due diligence

[17]Sibasish Panda & Ayush Shandilya, *Viewing the RBI's New DLG Guidelines through a Fintech Company's Lens,* IRCCL (Aug.6, 2023), available athttps://www.irccl.in/post/viewing-the-rbi-s-new-dlg-guidelines-through-a-fintech-company-s-lens.
[18] *Id.*

requirements, amongst others. The diligence requisites, to be undertaken by the REs prior to entering into a partnership with an LSP would include the eligibility criteria, nature and extent of the default loss guarantee cover, and the manner of reviewing the default loss guarantee arrangement, provisions for fees (if any) to be paid to the default loss guarantee provider. Fintech entities with their technological capabilities may be able to support the gauging of the creditworthiness of borrowers and may use big data and artificial intelligence while analysing the banking data to ensure that bad loans are avoided. REs have been permitted to opt for a 'first loss default guarantee' within a duration of 120 (one hundred and twenty) days.[19]The purpose of the RBI as demonstrated through this attempt points towards the commitment of the RBI, commitment to timely address the resolution of defaults.

Further, RBI has also mandated stricter disclosure norms[20] such as the requirement for LSPs to publish the details of the total number of portfolios and the amount on which the FLDG was provided on their websites[21] to ensure greater transparency in the process. It will also ensure transparency in the market, analysis of the risks, promoting healthy competition, and strengthening the credit underwriting standards.

The REs are required to obtain necessary information each time enters it into or renews its previous FLDG arrangement to ensure that LSPs have the capability to honour the guarantee provided. The LSP would also be

[19] RESERVE BANK OF INDIA, *supra* note 13,cl. 9.
[20] RESERVE BANK OF INDIA, *supra* note 13, cl. 11.
[21] Naina Sood, *FLDG Explained: New rules, changes, and how the new framework impacts borrowers, fintechs,* YOURSTORY (June 10, 2023), available at:https://yourstory.com/2023/06/fldg-explained-new-rules-changes-impact-borrowers-fintechs-banks.

required to provide a certificate from a statutory auditor on the guaranteed amount, the number of REs it is dealing with, and the portfolios against which the guarantee is being provided. Further, there should be information on past default rates pertaining to similar portfolios. The FLDG Guidelines thereby encompasses all mitigating factors to avoid financial risks.

Hereinafter, the financial inclusivity promoted by the FLDG Guidelines has been delved in the next section.

IV. FINANCIAL INCLUSIVITY PROMOTED THROUGH THE FLDG GUIDELINES

It is expected that the FLDG Guidelines will provide the fintech space with much-needed clarity on the relation between the REs and the LSPs, thereby promoting financial inclusivity in the BFSI space. The enumeration of the positive outcomes of the FLDG Guidelines has been enlisted below:

A. Level playing field – with a separate guideline to cater to default loss guarantee

The FLDG Guidelines will provide a level playing field to the fintech players by opening more possibilities of collaboration and help in reducing compliance costs, aid business expansion and expand the customer base for lenders and fintech players governed by the FLDG Guidelines as opposed to synthetic securitisation[22], governed under the Securitisation Guidelines.

[22] The Reserve Bank of India, Master Direction - Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021 (Updated as on December 05, 2022),RBI/DOR/2021-22/85, DOR.STR.REC.53/21.04.177/2021-22,para. 5(y), available at: https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12165.

The FLDG Guidelines will ensure that all participants operate within a consistent and fair regulatory framework. The FLDG Guidelines, applicable to the default loss guaranftee arrangements between REs and LSPs or between two REs, have also been distinguished explicitly by the RBI from the provisions of loan participation[23] as provided under the Master Direction - Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021.[24] This is the manner in which the FLDG Guidelines have differentiated itself from the Digital Lending Guidelines[25], wherein the RBI had directed the REs to adhere to the provisions of the Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021, pertaining to synthetic securitisation.[26]

B. Bolstering foreign investment

FLDG Guidelines provide the fintechs to structure their business in a uniform manner providing their investors with greater clarity[27] on their compliance with the applicable laws. The FLDG Guidelines will ensure necessary safeguardsfor private sector banks and foreign banks, having most of their digital lending portfolio unsecured and specifically, the third-party app sourced loans in private sector banks which are unsecured. Since interest income plays an important role in the revenue stream of a

[23] The Reserve Bank of India, Master Direction – Reserve Bank of India (Transfer of Loan Exposures) Directions, 2021,(Updated as on December 05, 2022), RBI/DOR/2021-22/86,DOR.STR.REC.51/21.04.048/2021-22, para. 9(e), available at: https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12166.
[24] *Id.*
[25] RESERVE BANK OF INDIA, *supra* note 2,cl. 15.
[26] *Id.*
[27] RS Sanjanaa, *Securing Borrowers, Shielding Lenders: RBI's Default Loss Guarantee Regulations,* INDIACORPLAW (June 23, 2023), available at:https://indiacorplaw.in/2023/06/securing-borrowers-shielding-lenders-rbis-default-loss-guarantee-regulations.html.

credit/lending platform, FLDG Guidelines will boost the fintech players by providing them with an opportunity to increase their revenue as the FLDG Guidelines would now ensure creditability and trust in the space of digital lending in India.

C. Augmenting credit availability:

With the clarity provided to the fintech sector through the FLDG Guidelines, credit availability through digital lending methods will be given a significant impetus thereby enhancing partnership between institutions like banks, REs, NBFCs and new age fintech companies, who are willing to enter into the digital lending space. This would in turn improve the acceptance towards FLDG structures, therefore promoting greater penetration to the at-present financially excluded regions and increased transparency.[28]

D. Mitigation of risk

The risk that the REs possess from potential losses mitigates significantly with the cap of 5% (five per cent) risk sharing guarantees provided by the LSPs, thereby maintain a balance in the books of the REs. This also allows REs avoid into risky transactions and lending arrangements, therefore resulting in improved and prudent risk management.

[28] Nirav Choksi, *RBI's new FLDG guidelines propel FinTech innovation and financial inclusion*,FINANCIAL EXPRESS (June22, 2023), available at:https://www.financialexpress.com/industry/banking-finance/rbis-new-fldg-guidelines-propel-fintech-innovation-and-financial-inclusion/3136838/.

This cautious approach of restricting the DLG cover on any outstanding portfolio to a maximum of 5% (five per cent) of the amount of loan portfolio, serves as a threshold to avoid risks of the LSPs. In the case of implicit guarantee arrangements,[29]the fintechs has been barred from bearing a performance risk of more than 5% (five per cent) of the underlying loan portfolio.[30] The RBI has also expanded the scope of the definition of 'direct lending to government'. As per the FLDG Guidelines, implicit guarantees can now include 'direct lending to government' and may not be classified as 'synthetic securitisation' or 'loan participation',[31] provided that they are subject to the same requirements as explicit guarantees. This would consequently result in risk mitigation significantly. Additionally, the FLDG Guidelines clearly indicate that this arrangement shall be distinguished from 'synthetic securitisation' and 'loan participation'. The rationale behind this must have been the decision to dissociate the FLDG Guidelines from other directions and guidelines of the RBI, to provide clarity and reduce confusion or overlaps, therefore paving the way for newer opportunities in the fintech space.

The cap of 5% (five per cent) on guarantees would also induce the regulated entities to undertake prudent decisions when undertaking lending arrangements. At this juncture, it may be pointed out that prior to the promulgation of the FLDG Guidelines, with the absence of the cap of guarantees under the FLDG Guidelines, certain fintech partnerships

[29] *Id.*
[30] RESERVE BANK OF INDIA, *supra* note 13,cl.6.
[31] *Id.*

offered up to 100% (one hundred per cent) FLDG coverage.[32] This resulted in numerous REs being exposed to higher risks of default, as a means of generating more business.

With the restriction now imposed on the guarantees that may be given by the REs, the RBI will effectively prevent REs from entering into such arrangements. REs will now be required to undertake prudent lending decisions in consonance with the FLDG Guidelines.

E. Promoting partnerships between fintechs and regulated entities

The FLDG Guidelines seeks to facilitate partnerships between REs and the upcoming fintechs. The REs and the fintech companies are required to abide by the FLDG Guidelines thereby ensuring better uniformity in the same and resulting in an increased transactions of such nature in the future. This would improve financial literacy and digital penetration in the country, which is still significantly deprived of financial inclusion.

F. Boon for Micro, Small and Medium Enterprises ("MSMEs")

The MSME sector, which is generally deprived of the benefits which the borrowers in a traditional banking sector avail, due to their constraints in size, has found their ray of hope with the FLDG Guidelines. In view of the

[32] Rohit Arora, How the *RBI's* FLDG guidelines are set to transform digital lending in India, THE ECONOMIC TIMES (July 1, 2023), available at:https://bfsi.economictimes.indiatimes.com/news/policy/how-the-rbis-fldg-guidelines-are-set-to-transform-digital-lending-in-india/101400979.

FLDG Guidelines, the REs will be interested to delve into the MSME sector and less reluctant to extend micro-sized loans to MSMEs. This has been made possible due to the FLDG Guidelines whereby strong underwriting platforms would be utilised by the fintech platforms to analyse the customer base. The backing provided through the guarantees would provide the regulated entities with the much-needed comfort and confidence to extend loans to the MSME sector.

Therefore, it can be observed that there would be greater clarity reducing the cloud of confusion in the FLDG space. The traditional lending systems in India are slowly getting replaced due to the recent developments such as demonetisation, the Unified Payment System (UPI) and the post-COVID shift towards digitisation. The clarity provided by the FLDG Guidelines would have a rippling effect on increasing digital lending and would have a positive correlation to increasing financial inclusivity in the country, benefiting stakeholders across the board. The scrutiny to determine eligibility criteria, guidelines for disclosures, due diligence requirements, customer safeguard techniques and other such tools serve as a protective mesh. With the well-structured FLDG framework, fintechs can ensure that proper credit availability no longer remains a coveted dream and converts into a reality for the otherwise deprived MSME sector, amongst the other underserved sectors.

However, the FLDG Guidelines are not devoid of certain improvements, which need timely redressal. In the following section, we have delved into the loopholes and provided our recommendations on the same.

V. LOOPHOLES AND SUITABLE SOLUTIONS

It can be observed from the structure of the default loss guarantee that the DLG offered to an RE can solely be in the form of cash deposits with the RE, or through fixed deposits maintained with scheduled commercial banks with lien marked in favour of the regulated entity. In addition to the aforementioned, bank guarantees in favour of the RE are permitted. It can be viewed that this arrangement of close linkage to traditional banking arrangements, makes the complete process of FLDGs a 'pseudo-digital' in nature.

As per the FLDG Guidelines, the REs shall be responsible for recognising individual loans in the portfolio as non-performing assets and thereafter, it shall make the requisite provisioning. Recovery from a loan, for which a default loss guarantee has been invoked, needs to be shared with the lending service provider as per their contractual arrangement. The above shall apply irrespective of the presence of the first loss default guarantee at the portfolio level, and the amount of default loss guarantee invoked shall not be set off against the underlying individual loans. The reason behind this is not clear, since the amount invoked in respect of default loss guarantee would subsequently reduce the outstanding in respect of that loan.[33]In the case of non-performing assets, the RBI expects the non-performing asset to continue to be recognised in the books of the lender. This approach of

[33] Sawant Singh & Aditya Bhargava, *Default loss guarantees in digital lending revisited*, LAW.ASIA (Aug.14, 2023), available at: https://law.asia/digital-lending-revisited/.

not setting off the loan is therefore in line with the non-performing assets system, which needs to be carefully navigated.[34]

It is to be noted that even if the guarantee is provided in a manner such that it is pre-agreed and deposited with the recipient i.e., the regulated entity, upfront, it can still be utilised by the regulated entity only when there is proportionate disbursement. However, the lending service provider is required to provide a declaration certified by a statutory auditor on the aggregate default loss guarantee amount which is outstanding. It shall also include the number of regulated entities and the portfolios against which the default loss guarantee has been provided. There shall also be information on the default rates in the past on such portfolios and other information, as required by the regulated entity, to ensure that the default loss guarantee would be honoured. It is viewed that this requirement is not reasonable because the guaranteed commitment has already been funded. Therefore, such a detailed inquiry for the default loss guarantee amount, which is outstanding, with an auditor's certificate might be a futile exercise.[35]

It is also to be noted that the FLDG Guidelines might also attract borrowers who are default-prone since they would have an assurance that a certain portion of their loan is covered. This means that FLDG Guidelines might attract borrowers who have a greater tendency to commit defaults, subsequently affecting the loan portfolio. Better quality checks on the creditworthiness of the Borrower might tackle this problem.

[34] *Id.*
[35] Team Finserv, *supra* note 16.

Contrary to the above, it can be argued that the hard limit of 5% (five per cent) on the amount credited as the default cover can be said to be a mechanism to ensure that the regulated entities are vigilant themselves while providing the loans since their risks are still significantly higher than the fintech lending service provider. However, it may be argued that 5% (five per cent) is still a relatively low percentage to facilitate greater access to credit for the fintech platforms.It is also to be noted that sectors such as student loans etc., lack adequate credit history and both banks and NBFCs avoid the facilitation of such loans. Some lenders have provided credit in these sectors provided that fintech companies protect them against any potential losses. With a hard cap of 5% (five per cent) on the guarantee, the lenders would still face significant risks and may be deterred from furthering such loans. With a higher percentage, the lending service providers would have more skin in the game. This will then foster faith amongst the regulated entities towards the lending service providers. A higher percentage would also ensure that different lending service providers target different percentages, as long as there is abidance with the upper cap. That will promote better competition in the marketplace, improving efficiency in the system in the long run.

It is also noteworthy that the FLDG Guidelines provide the regulatory framework, however, they fail to consider the sector default rates.[36]The FLDG Guidelines undertake a generalised approach that overlooks the nuanced sector-specific details such as varied default rates. In case a sector

[36] *Id.*

has a greater propensity to default, there shall be lower possibility of the fintechs providing the guarantees. Instead of having a fixed cap, a sector-wise analysis will ensure that default-prone portfolios are provided with a low percentage of cover whereas specific sectors with a low-default history are provided with higher cover. MSME sectors generally have a low default rate[37]. It is imperative that the risk isanalysed and managed prudently. A higher cap of 10% (ten per cent) or 20% (twenty per cent) will ensure that there is flexibility and competition in the fintech sector. They shall therefore compete to access credit and at the same time also have risk safeguards. This higher cap of 10% (ten per cent) or 20% (twenty per cent) may have sub-limits for different sectors and this should also be coupled with periodic revisions, basis market analysis of historical data and present trends. This will ensure a more tailored approach instead of a one-size-fits-all approach like the one taken at present.[38]

The FLDG Guidelines will open up the market for fintech, by promoting their partnership with regulated entities, without having to wait for NBFC licenses. However, there can be attempts by regulated entities to have the bigger size of the pie and have a greater hold on the revenue share.[39] This can be monitored by adequate oversight by the RBI. Given RBI's focus in this area, it can be viewed that any scope of lacunae will be avoided by it to ensure proper implementation of the FLDG Guidelines.

[37] TNN, *MSME default rate lowest in biz loans*, THE TIMES OF INDIA (May 8, 2020), available at: https://timesofindia.indiatimes.com/business/india-business/msme-default-rate-lowest-in-biz%20loans/articleshow/75610706.cms.
[38] RESERVE BANK OF INDIA, *supra* note 13.
[39] *Id.*

VI. CONCLUSION

The RBI has made sincere attempts to encourage all stakeholders in the fintech space through the FLDG Guidelines and avoided the grey areas of overlap with other laws such as those on synthetic securitisation. Thus, entities would be required to structure their existing setup and compliances in accordance with the FLDG Guidelines.

As stated above, it can be suggested that once the RBI is satisfied withthe practical success of the FLDG Guidelines, the existing cap of 5% (five per cent) on the underlying loan portfolio may be eventually increased to 10% (ten per cent) or 20% (twenty per cent), the introduction of which may with itself bring in better competition among market players, subsequently improving efficiency.

After the COVID-19 pandemic, several borrowers could not repay their loans successfully on account of the economic hit caused due to the pandemic. This has already created a situation whereby lending service providers owe default guarantees to their partner-regulated entities. Sectoral assessments could have aided in avoiding such scenarios. Once these hindrances are successfully addressed, it can be viewed that the FLDG Guidelines will be a complete success.

It can be concluded that the FLDG Guidelines will encourage financial inclusion. They provide greater clarity and also set clear boundaries while creating the proper ambience for developments and innovations in the fintech space resulting in groundbreaking products in the financial space. Whilst the FLDG Guidelines do require updates in line with relevant

market practices, it is encouraging to see that the RBI is open to exploring the new instruments that emerge in the lending market with the onset of digital lending and fintech. Given, the rise of the fintech sector in India and the positive approach taken by the RBI, it can be observed that the future for the fintech sector in India is bright.

Dr. Ankit Srivastava & Ms. Dhanya Jha, *Securities and Exchange Board of India&'Finfluencers': A tussle between Regulations and Financial Inclusion*, 11 (1) SCHOLASTICUS 35 (2024).

SECURITIES AND EXCHANGE BOARD OF INDIA&'FINFLUENCERS': A TUSSLE BETWEEN REGULATIONS AND FINANCIAL INCLUSION

Dr. Ankit Srivastava[⊥] *& Dhanya Jha*[ø]

ABSTRACT

The rise of "finfluencers" on social media presents challenges in regulating their activities, particularly in areas like investment advice outside the purview of SEBI. This paper questions categorizing finfluencers as Registered Investment Advisors or Research Analysts, proposing a Code of Conduct, regulatory checks, and collaboration instead. Despite interventions from ASCI and a SEBI Consultation Paper, applying existing IA/RA regulations is seen as impractical. The article emphasises a targeted approach to combat fraudulent activities, suggesting a Code of Conduct over strict registration requirements. It argues against imposing professional regulatory frameworks on content creators, emphasising the need to distinguish between financial advice and awareness. The proposal includes mandatory disclosures for finfluencers to ensure transparency, accountability, and prevent fraudulent practices. Advocating for collaboration between SEBI and finfluencers, the article suggests a dedicated grievance redressal mechanism and monitoring unit. While recognising investor protection, it concludes that regulations should align with the risks associated with finfluencers, advocating for a nuanced approach combining a Code of Conduct, collaborative efforts, and targeted monitoring.

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I. INTRODUCTION

For decades, the dissemination of financial knowledge has been an uphill battle. With little to no formal source, people have traditionally relied on family, friends, and peers for financial planning. From a macro-economic perspective, financial literacy leads to sensible investments, spending, and savings ultimately resulting in a better allocation of resources in the economy.[1]Despite the profound significance of financial literacy,at an individual as well as an economic level, financial advocacy efforts havebeen consistently unimpressive. The Asian Development Bank reports that less than 30% of adults in India meet the threshold of financial literacy as set by the Reserve Bank of India.[2] However, in recent times, a drastic shift has been observed in this arena, courtesy of the avenues brought forth by social media.

The reliance of common peopleon social media all across the country has given rise to a new community of influencers. An influencer is a person who has the power to actively affect or influence consumers and their choices on account of their knowledge, position, or relationship with their audience.[3] These content creators have been tapping into entertainment, art, food studies, medicine and even finance. In particular, influencers who

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[1] Olivia S. Mitchell &AnnamariaLusardi, *Financial Literacy and Economic Outcomes: Evidence and Policy Implications,* vol. 3(1), JOURNAL OF RETIREMENT, pp. 107-114 (2015).

[2] Asian Development Bank, *In India, financial literacy programs are lifting families out of debt and fueling new prosperity,* ASIAN DEVELOPMENT BANK, available at: https://www.adb.org/results/india-financial-literacy-programs-lifting-families-out-debt-fueling-new-prosperity.

[3] *ASCI issues final guidelines for influencer advertising on digital*, THE ADVERTISING STANDARDS COUNCIL OF INDIA, May 27, 2021, available at: https://www.ascionline.in/wp-content/uploads/2022/09/press-release-influencer-guidelines-2021.pdf.

indulge in giving financial advice are termed as '**finfluencers**'. The etymology of the term is essentially a conglomerate of the two terms i.e., finance and influencer. These finfluencers propagate financial literacy by creating captivating content about mutual funds, asset allocation,investment vehicles etc. While the importance of financial literacy cannot be emphasised enough and such dissemination of knowledge is welcomed, it has been observed that numerous influencers are engaging in extending advice, recommendations, and opinions regarding investment products and public offers— a domain which is governed by the Securities and Exchange Board of India ("**SEBI**").

Traditionally, financial advice relating to the securities market is regulated by SEBI which is a regulatory body established to protect the interests of the investors in securities and to promote the development and regulation the securities market.As per SEBI, only Registered Investment Advisors ("**IAs**")[4] can offer financial advice relating to investments, sale and purchase of securities and investment products while Registered Research Analysts ("**RAs**")[5]can offer opinions on listed entities and public offers on the basis of their analysis. Since most of the finfluencers are neither registered IAs or RAs, they fall outside the ambit of SEBI (Investment Advisors)

[4] Securities and Exchange Board of India (Investment Advisers) Regulations, 2013, Reg 2(1), No. LAD-NRO/GN/2012-13/31/1778, The Gazette of India Extraordinary Part-III-Section 4, 2013 (India).
[5] Securities and Exchange Board of India (Research Analysts) Regulations, 2014, Reg 2(u), No. LAD-NRO/GN/2014-15/07/1414, The Gazette of India Extraordinary Part-III-Section 4, 2013 (India).

Regulations, 2013[6] and SEBI (Research Analysts) Regulations, 2014.[7]Consequently, this absence of regulation has given rise to cases of manipulation, fraud, and other securities fraud. This paper seeks to analyse the current ecosystem of this burgeoning industry, along with examining whether finfluencers should be treated as IAs and RAs. The paper argues against the proposition of treatingfinfluencers as unregistered entities.The paper also puts forth suggestive regulations in form of a Code of Conduct for such influencers along with highlighting the need for a collaborative approach, and grievance redressal mechanism.

II. CURRENT LEGISLATIVE FRAMEWORK

Finfluencers provide insights, opinions, advice, and personal experiences regarding finance-related matters, covering topics such as budgeting, investments, cryptocurrency, stock market, etc. Apart from sharing financial knowledge which fosters financial literacy, these finfluencers also engage in giving out recommendationson what stocks to invest in, what investment products to purchase, and through what platforms to trade. While doing so, these finfluencersdo not divulge their underlying interests in the product or investment. This is particularly concerning since, these finfluencerscan exploit their outreach to the masses to further their individual interests or the interests of a third-party service-provider, distributor or brand by giving fake reviews or over-exaggerating claims for

[6] Securities and Exchange Board of India (Investment Advisers) Regulations, 2013, No. LAD-NRO/GN/2012-13/31/1778, The Gazette of India Extraordinary Part-III-Section 4, 2013 (India).
[7] Securities and Exchange Board of India (Research Analysts) Regulations, 2014, No. LAD-NRO/GN/2014-15/07/1414, The Gazette of India Extraordinary Part-III-Section 4, 2013 (India).

their sponsors without revealing the same to the audience.[8]Finfluencers even manipulate their followers into designed 'pump' and'dump' schemes for making individual profits.[9]These unethical practices foster disruption in the capital marketand are against investor's interests and are detrimental to market integrity.

Keeping in view the absence of regulations or guidelines for finfluencers, the Advertising Standards Council of India ("**ASCI**") issued an Addendum laying down guidelines specifically for health and financial influencers.[10] This addendum was an addition to the ASCI Guidelines on Advertising in Digital Media. Considering the pervasive influence of social media and the need to protect the interest of consumers, these guidelines laid downthat all advertisements must have adisclosure labelwhen there is a material connection between the advertiser and influencer *vis-à-vis* monetary compensation, free or discounted products, services, etc. Further, the Addendum laid down specific guidelines for financial influencers, prescribing all influencers providing any advice relating to the stock and/or investmentsto register themselves with SEBI and abide by the disclosure requirements as mandated by financial sector regulators. However, these guidelines are not binding to all since ASCI is a self-regulatory body.

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[8]*ASCI issues final guidelines for influencer advertising on digital,* THE ADVERTISING STANDARDS COUNCIL OF INDIA, May 27, 2021, available at: https://www.ascionline.in/wp-content/uploads/2022/09/press-release-influencer-guidelines-2021.pdf.

[9] Nikhil Rampal, *Pump & Dump: How Sebi Caught Arshad Warsi& others 'manipulating' stock prices in 'finfluencer' scheme,* THE PRINT(Mar. 03, 2023), available at: https://theprint.in/business/pump-dump-how-sebi-caught-arshad-warsi-others-manipulating-stock-prices-in-finfluencer-scheme/1413718/.

[10]*Guidelines for influencer advertising in Digital Media,* THE ADVERTISING STANDARDS COUNCIL OF INDIA, available at: https://www.ascionline.in/wp-content/uploads/2023/08/guidelines-for-influencer-advertising-in-digital-media.pdf.

On the other hand, SEBI has released a Consultation Paper to restrict the association of registered entities with unregistered finfluencers.[11]Through the Consultation paper, the intent of the regulator to have all finfluencers register as IAs/RAs is conspicuous as the paper mentions that many of the finfluencers are "*effectively unregistered and unauthorised Investment Advisers (IAs) or Research Analysts (RAs).*" The rationale behind doing so is to bring finfluencers within the regulations governing IAs and RAs. While regulations for the finfluencers are surely necessary, it is not viable to treat finfluencers at par with the IAs and RAs and squarely apply the existing IA/RA Regulations to them.

III. WHY FINFLUENCERS CANNOT BE TREATED AS RA/IAS?

The proposition of applying the extant regulatory framework for IAs and RAs to finfluencers is not feasible for two reasons i.e., ***first***, there is a stark difference in the work profile of IAs/RAs and finfluencers; and ***second***, this step would lead to the industry becoming an exclusive profession.

A. Distinction between the Work Profile of IAs/RAs and Finfluencers

An IA provides investment recommendations to its clients after conducting a risk assessment based on the clients' profile and a thorough assessment

[11] *Consultation Paper on Association of SEBI registered intermediaries/regulated entities with unregistered entities (including Finfluencers),* SEBI (Aug. 25, 2023), available at: https://www.sebi.gov.in/reports-and-statistics/reports/aug-2023/consultation-paper-on-association-of-sebi-registered-intermediaries-regulated-entities-with-unregistered-entities-including-finfluencers-_75932.html.

of the securities' performance and profits.[12]On the other hand, a research analyst is a person prepares and/or publishes research report, gives 'buy/sell/hold' recommendations or opinions on public offers.[13]For registering as an IA or RA,a **minimum five years of experience in activities relating to financial products or markets or securities or fund or asset or portfolio management is required**[14] along withadvanced level of qualifications such as a post-graduate degree or post-graduate diploma in finance, capital market or allied subjects.[15]IAs and RAs are also required to maintain tangible assets of net worth above one lakh rupees.[16] Whereas, finfluencers are essentially people with an influential presence on social media, curating content on topics pertaining to finance. Finfluencers create content using creative means such as skits, parodies, memes, etc. that are appeasing to masses. They integrate knowledge with creativity to augment audience engagement. On juxtaposing the character of the two professions, we assess that it is not plausible to mandate finfluencers to register with SEBI as IAs and RAs. The finfluencers*via* their

[12] Securities and Exchange Board of India (Investment Advisers) Regulations, 2013, Reg 16, No. LAD-NRO/GN/2012-13/31/1778, The Gazette of India Extraordinary Part-III-Section 4, 2013 (India).
[13] Securities and Exchange Board of India (Research Analysts) Regulations, 2014, Reg 2(u), No. LAD-NRO/GN/2014-15/07/1414, The Gazette of India Extraordinary Part-III-Section 4, 2013 (India).
[14] Securities and Exchange Board of India (Research Analysts) Regulations, 2014, Reg 7(1)(iii), No. LAD-NRO/GN/2014-15/07/1414, The Gazette of India Extraordinary Part-III-Section 4, 2013 (India).
[15] Securities and Exchange Board of India (Investment Advisers) Regulations, 2013, Reg 7(i)(a), No. LAD-NRO/GN/2012-13/31/1778, The Gazette of India Extraordinary Part-III-Section 4, 2013 (India).
[16] Securities and Exchange Board of India (Investment Advisers) Regulations, 2013, Reg 8, No. LAD-NRO/GN/2012-13/31/1778, The Gazette of India Extraordinary Part-III-Section 4, 2013 (India).

videos do not act as fiduciary agents for the benefit of their clients. The job of a finfluencer is not to provide customised advice to each member of their audience by a risk assessment or to prepare research reports on listed entities on the stock market. If finfluencers are mandated to register themselves as IAs or RAs, it will be counter-intuitive since the role of finfluencers is not to provide investment advice *per se.*

It is pertinent to note that only advice relating to the securities market or investment product and portfolio falls under the ambit of "investment advice" as defined by Securities and Exchange Board of India (Investment Advisers) Regulations, 2013[17] whereas finfluencers offer guidance on multiple subjects from budgeting, side hustles, credit planning, financial psychology, etc. Therefore, financial advice which is given by finfluencers is not confined to the securities market solely. Some finfluencers merely provide explanatory notes, updates on developments in the stock market, etc. which cannot be labelled as "investment advice" as defined in the SEBI (Investment Advisors) Regulations.[18] There are two things that are intertwined in the present case, *i.e*., financial advice and financial knowledge or awareness. The former can be regulated by SEBI but it would not be right to intervene with the latter. Viewing this in context of the Indian framework, we observe that finfluencers are not authorised to give

[17] Securities and Exchange Board of India (Investment Advisers) Regulations, 2013, Reg 2(l), No. LAD-NRO/GN/2012-13/31/1778, The Gazette of India Extraordinary Part-III-Section 4, 2013 (India).
[18] Securities and Exchange Board of India (Investment Advisers) Regulations, 2013, Reg 2(l), No. LAD-NRO/GN/2012-13/31/1778, The Gazette of India Extraordinary Part-III-Section 4, 2013 (India).

'investment advice'[19] however, they are not prohibited by any law to make videos on general financial knowledge. The regulator ought to take into account this distinction rather than baldly applying RA/IA regulation to finfluencers or even mandate all finfluencers for registering with the regulator.

B. Monopolising and Restricting Entry into Profession

There are 1314 IAs and 1026 RAs in the whole country.[20] The numbers clearly manifest the industry of registered IAs and RAs is already characterised with limited participation and entry. This is due to the stringency in the regulatory framework *vis-à-vis* the qualifications, licensing, and other compliances. The existing regulatory framework for the IAs and RAs has been criticised[21] for being restrictive and stringent to the extent that the profession remains confined to a relatively few numbers of people.For instance, all IAs are mandated to taken a license retainment examination every three years;[22] SEBI sets a limit on the number of clients an IA can advise,[23]*inter alia*. The people in the profession find it difficult to adhere to such extensive compliances.Therefore, the application of such a

[19] *Id.*

[20]Recognised intermediaries, SEBI, available at: https://www.sebi.gov.in/sebiweb/other/OtherAction.do?doRecognised=yes.

[21] *4th time a charm for investment advisor rules (2020),* THE ECONOMIC TIMES(Jan. 30, 2020), available at: https://economictimes.indiatimes.com/markets/stocks/news/view-4th-time-a-charm-for-investment-advisor-rules/articleshow/73758860.cms?from=mdr.

[22] *Only Sebi-RIAs Can Offer Financial Advisory Services: Here's What You Should Know (2024)*, OUTLOOK INDIA (Aug 29, 2023), available at: https://business.outlookindia.com/policy/only-sebi-rias-can-offer-financial-advisory-services-heres-what-you-should-know.

[23] Securities and Exchange Board of India (Investment Advisers) Regulations, 2013, Reg 13, No. LAD-NRO/GN/2012-13/31/1778, The Gazette of India Extraordinary Part-III-Section 4, 2013 (India).

regulatory framework on finfluencers who merely give generic advice or create educational content and not act as fiduciary agents giving financial advice for consideration, would only stifle the finfluencer industry. Further, if finfluencers are to register themselves as RAs and IAs they would be required to comply with the aforementioned qualifications such as a post-graduation degree, substantial experience, and net worth. This would be an unfeasible rather radical change for all finfluencers who are often self-taught and make videos based on their personal experiences or individual research.

Further, there is no need to bring all finfluencers under the IA/RA regulations since there is only a need to prevent fraudulent activities and unethical advertisements which work against the interest of the populace. Currently, finfluencers frauds have been dealt with by SEBI by invoking the provisions of the SEBI Act, 1992[24] and SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003[25] ("**PFUTP Regulations**"). Therefore, we already have provisions that apply to all persons engaging in fraudulent and unfair practices in the securities market. SEBI has applied these provisions to impose a fine of Rs. 6.5 crores and a one-year ban for violating norms pertaining to investment advisers on a YouTuber for allegedly offering varied packages for advisory services through his website without a SEBI-mandated registration.[26] In

[24] The Securities and Exchange Board of India Act, 1992, No. 15, Acts of Parliament, 1992 (India).
[25] SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003, No. S.O. 816 (E), The Gazette of India Extraordinary Part-II-Section 3-Sub-Section (ii), 2003 (India).
[26] Re: Mansum Consultancy Private Limited, SO/AA/EFD2/2023-24/7081.

March 2023, SEBI banned 9 entities for releasing misleading information about Sharpline Broadcast Limited and recommending their audience to buy the shares of Sharpline thereby colluding a pump and dump scheme.[27]This concerted action violated Section 12A of the SEBI Act and Regulations 3 and 4 of the PFUTP Regulations.[28] Since, the PFUTP Regulations are applicable to all persons and have a bearing when it comes to holding the miscreants liable, the need of the hour is to regulate the space by way of the Code of Conduct so as to safeguard the investors' interest.

IV. SUGGESTIVE FRAMEWORK

For the aforementioned reasons, IAs/RAs and finfluencers cannot be placed at the same threshold. However, this does not rule out the need for regulations to optimally regulate the finfluencers spaceand keep illegitimate and fraudulent practices under check. Owing to their massive reach and attractive content, finfluencers are approached by brands and financial service providers to promote or advertise their investment products or services. While some finfluencers deliver honest content and reviews, certain miscreants misuse their outreach to mislead the audience into pump and dump schemes, false reviews and opinions or to further their personal interests The need to regulate finfluencers arise from the fact that in certain situations, conflicting obligations come into existence when finfluencers advertise, or promote a particular security or brand or sponsor. Ethically, it is the responsibility of the finfluencers to disclose all conflicts of interest before promoting a product so that the audience is aware of the underlying

[27]*Jatin Manubhai Shah, In re (Unfair Trade Practice)*, 2010 SCC OnLine SEBI 138.
[28] *Id.*

agenda behind the post and thesuitability of the product or service for them.For ensuring the same, the paper proposes that SEBI should frame a Code of Conduct to regulate finfluencers by mandating certain disclosures in order to prevent the perpetuation of any frauds or malpractices in the securities market through this medium.

A. Code of Conduct And Disclosure Requirements

In furtherance of the interests of all consumers, the market regulator should mandate a Code of Conduct for finfluencers so as to caution these content creators of their obligations and consequences of non-adherence to any violations of the PFUTP Regulations. This suggestive Code of Conduct will mandate all finfluencers to disclose whether the content of the video is sponsored, whether they are receiving any compensation or benefits for talking about the securities or products in their videos, whether they are in any way associated with the product or platform they are promoting. Such disclosures will bring into light the existing conflict of interests of the finfluencers and will help them in analysing the risks and the profits associated with a financial instrument.The Code will also lay down the type of content that falls in the domain of finfluencers and what is permissible. The Code should strictly prohibit finfluencers from creating a false sense of urgency for any stocks or public offers. The Code should also caution finfluencers from talking about high-risk securities.Further, the finfluencers must protect risks and benefits in a balanced way through their videos,

cautioning users about the risks involved.[29]The Code of Conduct shouldbe applicable to all irrespective of them being registered with the regulator. This will ensure that every person who uses social media as a medium to talk about financial advice is legally bounded to follow the Code. For instance, the European Securities and Markets Authority ("**ESMA**")[30] has brought all finfluencers under the purview of the EU Market Abuse Regulations. These regulations apply to everyone whorecommends on investment instruments *via* any platform. These regulations mandate such people to disclose identities, present recommendations in an objective way, and disclose all relationships or circumstances that would impair objectivity.

SEBI has expressed concerns about finfluencers not having adequate expertise to give financial advice.[31] This can be resolved by way of mandating finfluencers*vide* the Code of Conduct to back their claims by research and provide the sources of the research to the audience. This will serve two purposes, i.e., ***first***, it will deter finfluencers from making unsubstantiated claimsand ***second***, it will aid consumers in determining if the content is credible and making informed decisions for themselves. This ensures that the interests of the consumers are being taken into account or

[29] M. Huertas, *EU reiterates rules to regulating "Finfluencers",* PWC LEGAL (July 23,2023), available at: https://legal.pwc.de/en/news/articles/eu-reiterates-rules-to-regulating-finfluencers.

[30] *ESMA's statement on investment recommendations on social media,* ESMA(Oct. 28, 2021), available at: https://www.esma.europa.eu/sites/default/files/library/esma70-154-2780_esmas_statement_on_investment_recommendations_on_social_media.pdf.

[31] *Consultation Paper on Association of SEBI registered intermediaries/regulated entities with unregistered entities (including 'Finfluencers'*), SEBI (Aug. 25, 2023), available at: https://www.sebi.gov.in/reports-and-statistics/reports/aug-2023/consultation-paper-on-association-of-sebi-registered-intermediaries-regulated-entities-with-unregistered-entities-including-finfluencers-_75932.html.

not. The proposed Code of Conduct must also take into account the distinction between Investment advice which can only be given by registered entities and financial literacy/advocacy which cannot be labelled as "Investment advice" and regulated by SEBI. Inspiration can be drawn from the Financial Market Authority of New Zealand ("**FMA**")[32] that has recognised this distinction between registered entities and finfluencers*vis-à-vis* what category of content falls under the domain of finfluencers is off-limits for finfluencers. The FMA Guide lays down illustrations as to what is permissible for finfluencers to talk about and what type of content should be avoided. This Guide states that it is permissible for finfluencers to talk about financial matter in general and to share factual information. The Guide also cautions finfluencers from talking about high-risk instruments and other matters that fall in the domain of licensed entities. For instance, sharing general information like one should have a diverse portfolio and asset allocation is permissible for finfluencers. However, recommending the audience to invest Company A's funds would not be suitable.

B. Advocacy and Collaborative Approach

To ensure fairness, transparency, and accountability there must be adequate advocacy at consumer-level. SEBI and finfluencers must together have a collaborative approach in raising awareness regarding the malpractices present in the current regime. It is crucial to educate consumers about the malpractices to watch out for, to choose their content wisely, and not follow

[32]*A guide to talking about money online, Financial Markets Authority*, FINANCIAL MARKETS AUTHORITY (GOVT. OF N.Z.) (June 28, 2021), available at: https://www.fma.govt.nz/library/articles/guide-to-talking-about-money-online/.

any advice given online blindly. The regulator must also engage and collaborate with finfluencers to propagate advocacy about the violations and illegal practices. Recently, the Financial Conduct Authority of the UK[33] invited finfluencers to a roundtable discussion to educate them about illegal methodologies and the risks involved in financial promotion. SEBI can also adopt a similar cooperative approach to educate finfluencers on such aspects as the key to protect the interests of all stakeholders in the digital ecosystem lies in self-regulation. The regulators ought to have a liberal approach as finfluencers can change the financial industry for the better. By collaborating with finfluencers, SEBI can ensure that its advisories, regulations, and even consultation papers reach to the masses. Finfluencers have more outreach than IAs and RAs and through a collaborative approach, SEBI can use it to advance financial advocacy/literacy.

C. Monitoring and Grievance Redressal Mechanism

It is crucial to have a portal or platform to investigate and redress complaints against finfluencers. SEBI must designate a portal through which complaints can be made against finfluencers who are indulging in malpractices. A grievance redressal mechanism would ensure that all violations made by finfluencers are reported and would deter them from making unsubstantiated and misleading claims. Further, SEBI should employ a designated unit to monitor online content and keep and check on perpetrators violating the Code of Conduct and indulging in fraudulent

[33] *FCA and Asa Team up with Sharon Gaffka to warn fin-fluencers of risks of promoting illegal 'Get Rich Quick' schemes*, FCA(Apr. 6, 2023), available at: https://www.fca.org.uk/news/press-releases/fca-asa-sharon-gaffka-warn-finfluencers-illegal-get-rich-quick-schemes.

practices. This monitoring unit will serve as an additional limb to the regulatory framework in order to investigate content that is misleading and does not adhere to the disclosure requirements. While it is difficult to monitor a vast amount of content across various platforms, the regulator can begin by categorisingfinfluencers based on past complaints against them, suspicious associations, and outreach. The data and trends collected fromsuch monitoring can also be used as a market study to analyse the ways through which the finfluencers engage in malpractices. This data collection and study can aid policymakers to better understand financial advice in the digital ecosystem and regulate it more efficiently.

V. CONCLUSION

Finfluencers play an imperative role in enriching inclusivity and enhancing accessibility of financial knowledge. There is a need for SEBI to balance its regulatory approach so as to not quash this emerging industry. Limiting the profession to IAs and RAs would confine financial literacy to a confined subset of people. Expecting finfluencers to register themselves as IAs and RAs is not viable owing to the distinct characteristics of the two professions, they cannot fall under the same regulations. While the concerns about finfluencers providing unsolicited 'investment advice' and engaging in fraudulent activities are valid, the same can be resolved by laying down appropriate mandates in the Code of Conduct to prevent them from encroaching in the domain of RAs and IAs and adhering to compliances while promoting financial instruments or services. In addition to this, monitoring mechanisms and a grievance redressal system will ensure that the Code is being complied with and will aid the regulator in keeping a

check on miscreants. The regulator must also have a collaborative approach with finfluencers since they open multiple avenues for financial inclusivity. Undoubtedly, the protection of investors is important but regulations should be commensurate with the risks associated with finfluencers.

Anoop Rawat & Devansh Rathi, *Scuffle between Prevention of Money Laundering Act and Insolvency and Bankruptcy Code, 2016 – Unveiling the scope and shortcomings of Section 32A of The Code*, 11(1) SCHOLASTICUS 52 (2024).

SCUFFLE BETWEEN PREVENTION OF MONEY LAUNDERING ACT, 2002 AND INSOLVENCY AND BANKRUPTCY CODE, 2016 – UNVEILING THE SCOPE AND SHORTCOMINGS OF SECTION 32A OF THE CODE

Anoop Rawat[⊥] & Devansh Rathi[ø]

ABSTRACT

*The Insolvency and Bankruptcy Code, 2016 ("**Code**") when seen at loggerheads with Prevention of Money Laundering Act, 2002 ("**PMLA**") has transpired in contradictory conclusions by different courts and tribunals. The primacy of either of the statutes has not been established in light of polar judgements. The article highlights different junctures of the intersection of the two statutes. i.e., properties can be attached before or during the Corporate Insolvency Resolution Process ("**CIRP**") has commenced or after the CIRP has been completed. While the article has reiterated the law laid down via judicial precedents and provisions of the Code where the properties are attached before or after the completion of CIRP, the issue pertaining to supremacy of Code or PMLA holds on to where the properties are attached during the CIRP.*

The article has also highlighted the coming of Section 32A of the Code and has discussed the scope and ambit of the Code and its validity during the liquidation stages. Since Section 32A of the Code can be triggered only on the approval of a resolution plan, the issue pertaining to the attachment of the properties during the CIRP lingers.

Since the issue of supremacy of Code or PMLA is being currently adjudicated before the Hon'ble Supreme Court, one may hope that the issue of attachment made by PMLA authorities during CIRP is settled once and for all.

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I. INTRODUCTION

The enactment of the Insolvency and Bankruptcy Code, 2016 ("**Code**" or "**IBC**") has been perceived as a benison by the creditors of those corporate entities that were unfit to service their debt. Not only has the Code replaced the erstwhile Sick Industrial Companies Act regime which was a major malefactor behind deferred to nil recoveries for the creditors but has also witnessed a dominant change to 'creditor in control' from 'debtor in possession'. Since its enactment, the Code on numerous occurrences was seen at loggerheads with other laws such as the Recovery of Debts due to Banks and Financial Institutions Act of 1993, Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act of 2002, Companies Act of 2013, *et cetera*. Despite being in its nascent stage, courts/ tribunals have placed the Code on a higher pedestal.

The rationale behind keeping the Code at a higher pedestal than other acts can be made parallel with the reasons for its enactment in the first place, *i.e.* bringing a more swift mechanism in order to remove tardy procedural gaps being showcased by erstwhile Indian laws to resolve the insolvency of an entity.[1] Bringing the implementation of the resolution framework under one roof was another motive in the absence of which the financially stricken entity would have plummeted into a further dilapidated state.[2] The above

[1] Insolvency and Bankruptcy Board of India, *The Report of the Bankruptcy Law Reforms Committee* (2015), available at: https://www.ibbi.gov.in/BLRCReportVol1_04112015.pdf.
[2] *Innoventive Industries Ltd v. ICICI Bank*, (2018) 1 SCC 407.

objectives made way for the Code to prevail over other similar laws that are related to financial governance and the revival of entities.[3]

However, at times, the Code was seen at a clash with the Prevention of Money Laundering Act, 2002 ("**PMLA**") at different stages of the Corporate Insolvency Resolution Process ("**CIRP**") of a corporate debtor. There have been several instances wherein the Code and PMLA have been in conflict with one another. The courts/ tribunals by relying on different provisions and purposes of both the legislatures have rendered varying conclusions and explanations.

On the basis of the aforesaid, the article aims not only to dissect and scrutinise the conflict between Code and PMLA by relying on various judicial precedents but also intends to unearth the scope of Section 32A of the Code[4] and to finally arrive at away forward.

II. PMLA AND IBC – LAWS ENTAILING POLAR TENETS?

The preamble of PMLA *inter-alia* states its primary objective as to "*prevent money laundering and to provide for confiscation of property derived from, or involved in, money-laundering and for matters connected therewith or incidental thereto*". The enactment of PMLA by the legislature was to ensure that assets/ properties, that may have been obtained from commission of an offence and which is prescribed as 'proceeds of crime', be confiscated in favour of the Union Government. Such an approach by the Parliament towards seizing the

[3] *State Bank of India v. Monnet Ispat& Energy Ltd,* 2017 SCC OnLine NCLT 3795.
[4] The Insolvency & Bankruptcy Code, 2016, § 32(A), No.31, Acts of Parliament, 2016 (India).

properties is a globally acceptable one, where many international communities including the Financial Action Task Force and United Nations *via* various recommendations and conventions respectively have bolstered practicing and enacting laws to refrain and disrupt individuals who have garnered assets by way of illegal activities. Hence, PMLA is a comprehensive legislation *inter-alia* for preventing money laundering and connected activities such as confiscating proceeds of crime, setting up agencies and mechanisms for coordinating measures for combating money-laundering *et cetera*.[5]

The Code, on the other hand, has its own set of objectives which primarily aims at reorganisation and resolution of the distressed entities in a time bound manner. Maximisation of the value of the assets of such distressed entities during the CIRP is another important intent of the Code. The Code also aims at bolstering entrepreneurship as the persons in the management of such distressed entities are removed and replaced by unrelated new management. It is important to highlight that revival of the distressed entity is instrumental not only for that entity but also for the economy at large in the sense that when a CIRP is concluded successfully by the implementation of a resolution plan, the then distressed entity is brought back into the economic mainstream as it is able to repay its restructured debts, which, in turn, enhances the viability of credit in the hands of banks and financial institutions.[6] The resolution scheme under the Code also aims

[5] T S SHAH, COMMENTARIES ON PREVENTION OF MONEY LAUNDERING ACT, 2002, 27 (Current Publications, 2006).
[6] *Swiss Ribbons Pvt. Ltd. v. Union of India*, (2019) 4 SCC 17.

to look after the interests of all stakeholders including but not limited to the workers/ employees, creditors, investors *et cetera* of the corporate debtor.

Thus, it can be safely said that the Code aims at ensuring the revival of the distressed entity as a going concern. The Code is thus a beneficial legislation that puts the corporate debtor back on its feet.[7]

On the basis of the aforesaid, PMLA and IBC are enacted to pursue two different sets of objectives. While PMLA *inter alia* aims at seizing those assets of an entity that are a result of 'proceeds of crime', Code, on the other hand, *inter alia* aims at protecting all the assets of the corporate debtor in order to ensure value maximisation and a smooth resolution. Though on *prima facie* reading, it appears that the PMLA and IBC may come at cross paths with one another but the issue of supremacy of these two legislations over one another would populate if these two legislations appear to be at loggerheads with one another. It is important to highlight that these two legislations can interdict with one another at several stages of CIRP of a corporate debtor – (i) properties of the corporate debtor may be attached by the relevant authority under PMLA before the commencement of the CIRP of such entity; (ii) properties of the corporate debtor may be attached by the relevant authority under PMLA post the completion of the CIRP of the distressed entity; and (iii) properties of the corporate debtor may be attached by the relevant authority under PMLA during the CIRP of such entity.

The article in the coming segment will examine the convergence of PMLA and IBC at different stages of the CIRP by relying on various judicial

[7] *Id.*

precedents and also by relying on various provisions of the Code, primarily Section 32A of the Code.

III. INTERSECTION BETWEEN PMLA AND IBC

As described aforesaid, PMLA and IBC may interact with one another at three different junctures that can be enumerated as follows:

A. Attachment before the CIRP of the corporate debtor

An asset of the company may be attached by the investigating authority under the PMLA. Subsequently, the said company undergoes insolvency and an insolvency professional is appointed under the Code to keep the said company as a going concern to ensure its smooth revival. Under the provisions of the Code, insolvency professional - interim resolution professional or resolution professional, as the case may be, is required to take control and custody over the assets over which the corporate debtor has ownership rights.[8] In fulfilment of the said statutory duty, the insolvency professional may file an application before the Hon'ble National Company Law Tribunal ("**NCLT**" or "**Adjudicating Authority**") seeking de-attachment of the said asset so that the same can be included in the estate of the corporate debtor.

The aforesaid situation has been dealt by the Hon'ble National Company Law Appellate Tribunal ("**NCLAT**") in the case of*VarrsanaIspat Limited v.*

[8] *supra* note 4,§18(f).

Deputy Director, Directorate of Enforcement[9] where the Hon'ble NCLAT while upholding the order of the Hon'ble NCLT *inter alia* held that since the attachment by the enforcement directorate was made much prior to the insolvency of the corporate debtor, the resolution professional cannot take advantage of provisions of Section 14 of the Code. The Hon'ble NCLAT also observed that the objectives of PMLA relates to 'proceeds of crime' and the offence of 'money – laundering' and to that extent Section 14 will not come to the rescue. It is relevant to note that the judgement passed by the Hon'ble NCLAT has been affirmed by the Hon'ble Supreme Court[10].

The said stand has also been reiterated by the Hon'ble NCLAT in the case of *Directorate of Economic Offences v. Binay Kumar Singhania*[11] where it was *inter alia* held that since the properties were attached before the declaration of moratorium, the appellant cannot be asked to de-attach the properties in question.

On the basis of the aforesaid, it is settled that the properties attached before the CIRP of the corporate debtor would continue to be attached and won't be affected by provisions of the Code.

B. Attachment after the completion of CIRP of the corporate debtor

Properties attached after the completion of the CIRP of the Corporate Debtor will be protected in terms of Section 32A of the Code. The said

[9] *VarrsanaIspat Limited v. Deputy Director, Directorate of Enforcement*, 2019 SCC OnLine NCLAT 236.
[10] *VarrsanaIspat Limited v. Deputy Director, Directorate of Enforcement*,Civil Appeal no. 5546 of 2019 (Supreme Court of India).
[11] *Directorate of Economic Offences v. Binay Kumar Singhania*, 2021 SCC OnLine NCLAT 159.

Section *inter alia* provides immunity to the properties of the corporate debtor in relation to an offence committed prior to the CIRP and where such property is covered under a resolution plan that has been approved by the Hon'ble NCLT and which has resulted in a change of management to a person who was not (i) promoter or in the management or in the control of the corporate debtor or a related party of such person; and (ii) a person with regard to whom the relevant investigating authority has, on the basis of material in its possession, reason to believe that he had abetted or conspired for the commission of the offence, and has submitted or filed a report or a complaint to the relevant statutory authority or court.[12]

It is relevant to note that Section 32A has been introduced to allay the apprehensions of the bidders who were reluctant to bid for the distressed entity as they did not want to take any liability for offences committed prior to CIRP.[13] The chances of impending investigations and initiation of criminal cases falling on bona fide persons could desensitise such bidders to participate in the resolution process. No resolution applicant would capitalise in a distressed entity which is already canopied by various investigations and whose assets are provisionally attached by investigating authorities, leading to never ending litigations to acquire the same.[14] Little

[12]*supra* note 4.

[13] Ministry of Corporate Affairs, Report of Insolvency Law Committee (Feb. 2020), available at: https://ibbi.gov.in/en/resources/reports.

[14]Devansh Rathi, *Leaving IBC in the Lurch: Issues Unattended by NCLAT in JSW-BPSL Case*, THE INDIAN REVIEW OF CORPORATE AND COMMERCIAL LAWS, available at:https://www.irccl.in/post/leaving-ibc-in-the-lurch-issues-unattended-by-nclat-in-jsw-bpsl-case.

to no participation by the prospective bidders would substantially hinder the Code's objective of maximisation of the value of the assets of the corporate debtor. Hence, the introduction of Section 32A can be perceived to provide protection to the resolution applicants against the past liabilities of the corporate debtor and stimulate them to be a part of the resolution process. Another impetus for the enactment of Section 32A could be the attachment of the assets of Bhushan Power and Steel, one of the accounts under the 'dirty dozen', by the Enforcement Directorate after the resolution plan submitted by JSW Steel was approved by the Hon'ble NCLT.[15]

Hence, in light of the aforesaid, Section 32A was introduced *via* the Insolvency and Bankruptcy Code (Amendment) Act, 2020 with an objective to provide immunity to the property(ies) of the corporate debtor in relation to its past offences committed prior to the initiation of the insolvency resolution process. The relevant extract of the Statement of Objects and Reasons provide that:

> *"2. A need was felt to give the highest priority in repayment to last mile funding to corporate debtors to prevent insolvency, in case the company goes into corporate insolvency resolution process or liquidation, to prevent potential abuse of the Code by certain classes of financial creditors, to provide immunity against prosecution of the corporate debtor and action against the property of the corporate debtor and the successful resolution applicant subject to fulfilment of certain conditions, and in order to fill the critical gaps in the corporate insolvency framework, it has become necessary to amend certain provisions of the Insolvency and Bankruptcy Code, 2016"*

[15] *Id.*

"3. …

(vii) to insert a new section 32A so as to provide that the liability of a corporate debtor for an offence committed prior to the commencement of the corporate insolvency resolution process shall cease under certain circumstances;"

(emphasis supplied)

The constitutionality of Section 32A, along with other provisions introduced *via* the Insolvency and Bankruptcy Code (Amendment) Act, 2020 were challenged before the Hon'ble Supreme Court in the case of *Manish Kumar v. Union of India.*[16]The Hon'ble court while upholding the constitutionality of Section 32A, *inter alia* held that:

"257. … The provision is carefully thought out. It is not as if the wrongdoers are allowed to get away. They remain liable. The extinguishment of the criminal liability of the corporate debtor is apparently important to the new management to make a clean break with the past and start on a clean slate. We must also not overlook the principle that the impugned provision is part of an economic measure. The reverence courts justifiably hold such laws in cannot but be applicable in the instant case as well. The provision deals with reference to offences committed prior to the commencement of the CIRP. With the admission of the application, the management of the corporate debtor passes into the hands of the Interim Resolution Professional and thereafter into the hands of the Resolution Professional subject undoubtedly to the control by the Committee of Creditors. As far as protection afforded to the property is concerned there is clearly a rationale behind it.

[16]*Manish Kumar v. Union of India*, (2021) 5 SCC 1.

Having regard to the object of the statute we hardly see any manifest arbitrariness in the provision."[17]

From the aforesaid, it is evident that Section 32A intends to protect the properties of the corporate debtor from the past liabilities committed by the erstwhile management. However, any liability that arises from the investigations conducted on the corporate debtor's actions prior to the commencement of the CIRP will be affixed on the personnel of the corporate debtor who were responsible for such liability. Hence, to that extent, Section 32A while protecting the new management and the properties of the corporate debtor from any past liabilities committed before the commencement of the CIRP, intends to penalise those persons who were responsible for the conduct of the business of the corporate debtor at the time of the commission of such offence. Hence, if any attachment is made by the investigating authorities under the PMLA after the resolution plan has been approved by the Hon'ble NCLT and there is a change in the management of the corporate debtor and other conditions as stipulated in Section 32A are fulfilled, the said property would be protected from any such attachment. Also, the Hon'ble NCLT in the case of *STCI v. DSK Southern Projects Limited*[18]directed the Enforcement Directorate to release the attachments made before CIRP when the resolution was approved under Section 31 of the Code, citing the properties to be protected by virtue of Section 32A(2) of the Code.

[17]*Id.*
[18]*STCI v. DSK Southern Projects Limited*, IA 383/2022 in CP (IB) 178/ MB-IV/2021 (NCLT Mumbai Bench).

C. Attachment during the CIRP of the corporate debtor

On a *prima facie* glance of the provisions of IBC, one may note that any asset attached by the investigation authority during the CIRP of the corporate debtor would be protected by virtue of Section 14 of the Code. However, the jurisprudence on the same is unsettled, with one set of cases giving primacy to IBC over PMLA while another set of cases giving PMLA an upper hand.

In the CIRP of Leo Meridian Infrastructure Projects and Hotels Limited which was initiated in April 2019, an application was filed by the resolution professional of the said corporate debtor against the order of the provisional attachment imposed by the enforcement directorate vide order dated 30 December, 2019[19]. The resolution professional contended that since moratorium is ongoing, no attachments can be made by the Enforcement Directorate. However, rejecting the said argument, the Hon'ble NCLT upheld the attachment order on the basis of various precedents laid down. The Hon'ble NCLT *inter alia* relied on the Hon'ble NCLAT decision of *Andhra Bank v. Sterling Biotech Ltd.*[20] where it was held that if it is found that the assets of the corporate debtor are from proceeds of crime, it is always open to the enforcement directorate to seize such assets and act under the PMLA. Reliance was also placed on another decision of the Hon'ble NCLAT in *Rotomac Global Private Limited v. Deputy*

[19] *Andhra Bank v. Leo Meridian Infrastructure Projects and Hotels Ltd*., 2018 SCC OnLine NCLT 2675.
[20] *Andhra Bank v. Sterling Biotech Ltd.*,2019 SCC OnLine NCLAT 1403.

Director, Directorate of Enforcement[21] which held that *"the 'Prevention of Money Laundering Act, 2002' or provisions therein relates to 'proceeds of crime', we hold that Section 14 of the 'I&B Code' is not applicable to such proceeding."*

The resolution professional in the CIRP of Era Infra Engineering Limited which was initiated in 2017, challenged orders of attachments dated July, 2020 and August, 2020 passed by the enforcement directorate under PMLA before the Hon'ble High Court of Delhi, arguing that once the moratorium had come into effect, enforcement directorate stood denuded of jurisdiction to exercise powers under the PMLA[22]. The issue before the Hon'ble High Court in the present matter was with regard to the impact of moratorium that is imposed in terms of Section 14 of the Code, would have on the powers of enforcement directorate to enforce an attachment. The Hon'ble High Court held that provisions of PMLA were not subservient to moratorium. It was *inter alia* held that if the moratorium prevents the enforcement directorate from exercising its power during the moratorium that would not only run contrary to the legislative policy of the PMLA but also would undermine the efforts of the legislature to combat the offence of money laundering. In fact, it would deprive the authorities charged with implementing the provisions of PMLA as an essential weapon in their quest to confiscate proceeds of crime. Hence, the Hon'ble High Court ruled that

[21]*Rotomac Global Private Limited v. Deputy Director, Directorate of Enforcement*, 2019 SCC OnLine NCLAT 961.
[22]*Rajiv Chakraborty, Resolution Professional of EIEL v. Directorate of Enforcement,* 2022 SCC OnLine Del 3703.

the power of the enforcement directorate to attach under PMLA would not fall within the ambit of Section 14(1)(a) of the Code.[23]

On the other hand, tribunals/courts in the following cases have placed IBC on a higher pedestal. The Hon'ble NCLAT in the case of *Directorate of Enforcement v. Sh. Manoj Kumar Agarwal,*[24]where the provisional attachment was confirmed subsequent to the initiation of CIRP, held that proceedings under the adjudicating authority of PMLA are civil in nature and Section 14 of the Code hits institution and continuation of proceedings before the said adjudicating authority. It was also held that while Code and PMLA are both special statutes, Code being a recent enactment, would prevail.

Another case which has upheld the supremacy of the Code is *Punjab National Bank v. Director, Directorate of Enforcement*[25]where the Appellate Authority under PMLA held that "*The proceedings before the Adjudicating Authority under PMLA is civil in nature and hence, in view of Section 14 of IBC, the proceedings before the Adjudicating Authority of PMLA cannot continue.*"

Hence, on account of the aforesaid divergent views taken by courts/ tribunals, the law is unsettled over the supremacy of the two legislations.

IV. SECTION 32A: ITS SCOPE AND LIMITATIONS

[23]*Id.*
[24]*Directorate of Enforcement v. Sh. Manoj Kumar Agarwal*, 2021 SCC OnLine NCLAT 121.
[25]*Punjab National Bank v. Director, Directorate of Enforcement*, 2019 SCC OnLine ATPMLA 5.

Though Section 32A has been introduced in the backdrop of the Hon'ble NCLAT order in *JSW Steel Ltd. v. Mahendra Kumar Khandelwal*[26] and with a holistic objective to bolster the bidders to participate in the insolvency resolution process by protecting the assets of the corporate debtor against the past liabilities of the erstwhile management, the said section provides protection only on a trigger event, i.e. approval of a resolution plan under the Code which results in change of management and where the said property is covered under the approved resolution plan.

The said trigger event of approval of the resolution plan under Section 31 of the Code, makes the ambit of Section 32A limited. Due to its limited scope, the said section does not come to the rescue of the properties attached during the CIRP of the corporate debtor and where the CIRP is still ongoing and no plan has yet been approved by the Hon'ble NCLT. Hence, this has led to divergent views of the courts/ tribunal regarding the primacy of PMLA or IBC till the time no plan has been approved by the Hon'ble NCLT, as described above.

Recently, the Hon'ble NCLAT while acknowledging the scope of Section 32A in the case of*P. Eswaramoorthy v. Deputy Commissioner of Income Tax*[27]held that:

> *"91. Only when a Resolution Plan was approved by the 'Adjudicating Authority' ('Tribunal'), Section 32A of the I & B Code, 2016, gets attracted. In reality, an 'Adjudicating Authority' ('Tribunal'), cannot traverse upon matters which is beyond its 'scope'. .... In short, the 'Appellant / Liquidator',*

[26]*JSW Steel Ltd. v. Mahender Kumar Khandelwal*, 2020 SCC OnLine NCLAT 55.
[27]*P. Eswaramoorthy v. CIT*,2023 SCC OnLine NCLAT 866.

cannot take umbrage, either under the ingredients of Section 32A, coupled with Section 60(5) of the I & B Code, 2016."

(emphasis supplied)

The Hon'ble NCLAT in *Kiran Shah v. Enforcement Directorate*[28] pointed out that Section 32A only bars attachment after approval of the plan by NCLT and since in the said case, there was no approval of the plan, the appellant cannot press into service the ingredients of Section 32A(2).

A. Section 32A and Liquidation

Albeit the aforesaid, whether Section 32A will come to the rescue of the corporate debtor during the stage of liquidation or not? To be specific, whether the properties attached during the liquidation can be allowed to be sold by virtue of Section 32A of the Code?

On a cursory reading of section 32A (2), the expression '*sale of liquidation assets*' implies that the said section will be applicable when the corporate debtor is undergoing liquidation proceeding. However, on the basis of the limited scope of Section 32A during CIRP, whether the said section will come into picture only when the liquidation proceedings are complete or the same can be applied during the ongoing liquidation? The said issue arose before the Hon'ble NCLT in *Anil Goel v. Deputy Director, Directorate of Enforcement, Delhi*[29]where an application was filed by the liquidator against

[28]*Kiran Shah v. Enforcement Directorate*, 2022 SCC OnLine NCLAT 2.
[29]*Anil Goel v. Deputy Director, Directorate of Enforcement, Delhi*, I.A.(IB) No. /KB/2020InC.P. (IB) No. 543/KB/2017(NCLT Kolkata Bench).

the attachment of the assets by the enforcement directorate stating that the liquidator is unable to proceed with the sale of the corporate debtor as a going concern as no willing buyers are interested to take over the corporate debtor due to the pending attachment. The Respondent, on the other hand, *inter alia* submitted that (i) Section 32A would not come into picture as such an application can only be filed by a successful resolution applicant; and (ii) Section 32A can only be invoked where the resolution plan has been approved or where the liquidation proceedings are complete. However, rejecting the said contentions and allowing the liquidator to sell the attached assets, the Hon'ble NCLT inter alia held that-

> *"12. A reading of section subsection (2) of section 32-A with the object behind the introduction we are of the considered opinion that 32-A is also applicable to liquidation proceedings. Under the object as well as under section it is specifically dealt with that the section is applicable to prevent insolvency in case the company goes into CIRP or liquidation. .... The above said discussion no doubt enables us to hold that the 32-A is also applicable to the assets of the CD undergoing liquidation and a liquidator can file an application like the one in hand…"*

The Hon'ble High Court in the case of *Nitin Jain, Liquidator of PSL Limited v. Enforcement Directorate* was confronted with the issue whether properties of the corporate debtor can be attached once a liquidation measure in terms of the Code has come to be approved. "The Hon'ble High Court while discussing the intent behind the introduction of Section 32A, *inter alia* held that "*the power to attach as conferred by Section 5 of the PMLA would cease to be exercisable once any one of the measures specified in Regulation 32 of the Liquidation*

Regulations 2016[30] *comes to be adopted and approved by the Hon'ble NCLT*." The expression ―sale of liquidation assets must be construed accordingly.[31]

Hence, on the basis of the aforesaid precedents, Section 32A will shield the assets of the corporate debtor against any attachments, during the stage of liquidation.

V. JURISDICTIONAL LIMITATION OF NCLT *VIS-À-VIS* PMLA AND IBC

From another perspective, the adjudication of the issues related in a case where the properties of an entity, that is undergoing CIRP, are to be/ have been attached would be dealt by which statute, augments the clash between the said legislations. Section 60(5)(c) of the Code provides that "*any question of priorities or any question of law or facts, arising out of or in relation to the insolvency resolution or liquidation proceedings of the corporate debtor or corporate person under this Code*" will be entertained and disposed off by the Hon'ble NCLT. The scope of the said Section was deliberated by the Hon'ble Supreme Court in the case of *Embassy Property Developments Pvt. Ltd. v. State of Karnataka &Ors.*[32], where the Hon'ble Apex Court inter alia held that –

> *"36…The only provision which can probably throw light on this question would be Sub-section (5) of Section 60, as it speaks about the jurisdiction of the*

[30]Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016, Regulation 32, No. IBBI/2016-17/GN/REG004, The Gazette of India Extraordinary Part-III-Section 4, 2016 (India).
[31]*Nitin Jain Liquidator PSL Limited v. Enforcement Directorate: Through Assistant Director*, 2021 SCC OnLine Del 1255.
[32]*Embassy Property Developments Pvt. Ltd. v. State of Karnataka*, (2020) 13 SCC 308.

> *NCLT. Clause (c) of Sub-section (5) of Section 60 is very broad in its sweep, in that it speaks about any question of law or fact, arising out of or in relation to insolvency resolution. ... Let us take for instance a case where a corporate debtor had suffered an order at the hands of the Income Tax Appellate Tribunal, at the time of initiation of CIRP. If Section 60(5)(c) of IBC is interpreted to include all questions of law or facts under the sky, an Interim Resolution Professional/Resolution Professional will then claim a right to challenge the order of the Income Tax Appellate Tribunal before the NCLT, instead of moving a statutory appeal under Section 260A of the Income Tax Act, 1961. Therefore, the jurisdiction of the NCLT delineated in Section 60(5) cannot be stretched so far as to bring absurd results*…."
>
> (Emphasis supplied)

Though the aforesaid observations of the Hon'ble Supreme Court were in respect of Income Tax Act, 1961, however, similar reference can be drawn to the issues that can arise in proceedings under PMLA. In apropos to the aforementioned, several issues in relation to PMLA, such as whether the properties attached were 'proceeds of crime' or not, have to be adjudicated by the adjudicating authority under PMLA. The said stance has been bolstered by the Hon'ble NCLAT in the case of *Kiran Shah* (supra) where it was held that NCLT is not empowered to deal with the matters falling within the purview of PMLA authorities. Recently, the Hon'ble NCLT[33] directed the interim resolution professional, who filed an application under

[33]*Chandra Prakash IRP For May Fair Leisures Ltd v. Directorate of Enforcement Department of Revenue*, IA 608 of 2020 in CP (IB) 213 of 2018.

Section 60(5) seeking the de-attachment of properties, to approach the competent forum under PMLA.

VI. WAY FORWARD

On the basis of the scattered position of law, the insolvency professionals are running from pillar and post to de-attach the properties in order to lead a successful resolution of the distressed entity. Advocates of the Code may argue that Code being a latter legislation should prevail over PMLA. One may also argue that attachment under PMLA proceedings being civil in nature, Section 14 shall be applied to that extent.[34]Advocates of the Code may also argue that giving primacy to PMLA over Code is diluting the effect of Section 14 and Section 238 of the Code and hence the primary intent of the legislature to revive the distressed entity may not be accomplished. Insolvency professionals, on various occasions, have also tried using Section 32A(2) of the Code to protect and de-attach the properties of the corporate debtor. However, the said approaches have not been whole-heartedly accepted by the courts/tribunals.

On the question of conflict between PMLA and Code, it has been held by Hon'ble NCLAT[35] that even if a property is attached in a PMLA proceeding, the said property should be made available to the resolution professional to fulfill the objectives of the Code. However, on other hand,

[34]*Rajiv Chakraborty, Resolution Professional of EIEL v. Directorate of Enforcement,* 2022 SCC OnLine Del 3703.
[35]*Id.*

Hon'ble NCLAT[36] has also held that PMLA is a special legislation to tackle and curb money laundering and ought to receive precedence over the Code to the extent of properties which are 'proceeds of crime'. It is also relevant to note that Hon'ble NCLAT in *Kiran Shah* (supra) has held the judgement of *Manoj Kumar Agarwal* (supra) to be incuriam.

While it may seem that in light of decisions of Hon'ble Delhi High Court in *Rajiv Chakraborty* (supra) and the Hon'ble NCLAT in *Kiran Shah* (supra), PMLA proceedings have been given an upper hand and the scuffle has been resolved. However, one may note that the issue is actually far from being settled.

The Hon'ble Supreme Court is presently adjudicating upon an issue in *Ashok Kumar Sarawagi v. Directorate of Enforcement*[37] where a provisional attachment order has been passed more than two years after initiation of the CIRP, but before receipt of resolution plans by resolution applicants. The Supreme Court vide its order dated 14th December, 2022 has permitted the continuation of the resolution process but has directed that the approval of resolution plans by the NCLT be subject to express permission of the Supreme Court.

With the issue finally having found its way to the Hon'ble Supreme Court again, it will be interesting to see how the Hon'ble Supreme Court chooses to balance two specialised legislations and the debate over their primacy when both the laws are in conflict at the same time. The outcome to the said proceedings will also resolve the issue of attachment made by PMLA

[36] *JSW Steel Ltd. v. Mahender Kumar Khandelwal*, 2020 SCC OnLine NCLAT 55.
[37] *Ashok Kumar Sarawagi v. Enforcement Directorate,* 2022 SCC OnLine SC 1713.

authorities during CIRP, which as of today has not been settled in light of inconsistent judgements.

Manisha Shroff *et al.*, *Green and Sustainable Bonds: The Next Step for India*?, 11 (1) SCHOLASTICUS 74 (2024).

GREEN AND SUSTAINABLE BONDS: THE NEXT STEP FOR INDIA?

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ABSTRACT

*Green and sustainable bonds are fixed-income instruments used to raise capital for environmentally friendly projects. These bonds are issued by businesses and governments to fund various initiatives like infrastructure development, research, and personnel expenditures while promoting transparency among stakeholders. The market for green bonds has grown significantly, with the European Investment Bank, the International Bank for Reconstruction and Development, and the World Bank being major issuers. These bonds have been issued in multiple countries and currencies, reaching USD 2.3 trillion globally by 2023, with USD 351 billion raised in the first half of that year alone. The article outlines the steps involved in issuing green bonds, emphasising transparency in project selection and allocation of proceeds. It also highlights the importance of guidelines like the Green Bond Principles (**GBPs**) in the absence of global rules for bond issuance. India has established its Sovereign Green Bond Framework but faces challenges like defining project criteria, sustainability benchmarks, and certification standards. The article suggests that green bonds can help India balance its development goals with environmental responsibility, supporting initiatives like waste management, afforestation, and renewable energy. Thus, green bonds offer a financial tool for India and the world to promote sustainable growth and combat climate change while attracting funds for eco-friendly projects. They have the potential to contribute significantly to a more environmentally sensitive economy.*

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I. INTRODUCTION

A. Green and Sustainable Bonds

A "bond" is a "fixed income instrument" that serves as evidence of a loan made to a borrower (usually a corporation or government).[1] Bonds are generally issued by businesses and governments (at all levels) to raise capital for investment in infrastructure (such as roads, schools, and dams), research and development, personnel expenditures, and capital expenditures (such as acquisition of new assets). Interest payments (the coupon) are a standard feature of bonds. In comparison to the other market-linked securities available in the market such as stocks and fixed income, bonds attract a lower degree of risk.[2] A "green" bond signifies a commitment by the issuer to exclusively use the funds raised to finance or refinance "green" projects, assets, or businesses.[3]

Green bonds are a form of fixed-income investment instrument issued with the express purpose of funding initiatives designed to improve the environment and combat climate change. These bonds typically have the same credit rating as the issuer's other financial obligations as they are often

[1]Jason Fernando, *Bond: Financial Meaning with Examples and How they are priced*, INVESTOPEDIA (Mar. 9, 2023), available at:https://www.investopedia.com/terms/b/bond.asp.
[2]Rahul Jain & Ashika Jain, *What is aBond?*,FORBES (Mar. 20, 2023, 4:14 PM), available at: https://www.forbes.com/advisor/in/investing/what-is-a-bond/.
[3]*Green bonds: Mobilising the Debt Capital Markets for a low-carbon transition*,OECD (Dec. 2015) at 1, available at:https://www.oecd.org/environment/cc/Green%20bonds%20PP%20%5Bf3%5D%20%5Blr%5D.pdf (last visited Dec 1, 2023).

asset-linked and backed by the insuring entity's balance sheet.[4]These bonds can be thought of as a loan used to fund a green initiative. Borrowers will issue these securities to fund environmental improvement projects including recycling and reforestation. Investors might expect a return on their investment when their bonds mature.

Sustainable bonds are debt instruments whose interest or principal payments are used to fund or re-fund environmental and social initiatives.[5]Sustainable bonds cover a wider range of environmental concerns.

For instance, the proceeds from a sustainable bond could be used to support initiatives that work to increase gender parity or provide access to higher education for those living in low-income communities. These kinds of endeavours do not qualify for funding via a green bond because they do not improve environmental conditions.[6] Thus, green and sustainable bonds are considered suitable because of their combined social and environmental benefits.[7]

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[4]*Understanding Green, Social and Sustainability Bonds*, PIMCO, available at: https://europe.pimco.com/en-eu/resources/education/understanding-green-social-and-sustainability-bonds (last visited on Jul. 18, 2023).

[5]Telephone Interview with Dan Krieter, Director, BMO Capital Markets Fixed Income Strategy Group (May 7, 2019).

[6]Sumit Kumar, *A Quest for Sustainium (Sustainability Premium): Review of Sustainable Bonds*, ACADEMY OF ACCOUNTING AND FINANCIAL STUDIES JOURNAL,Apr. 2022, at 1.

[7]*Green Bonds: Mobilising the debt capital markets for a low-carbon transition*, OECD (Dec. 2015), available at: https://www.oecd.org/environment/cc/Green%20bonds%20PP%20%5Bf3%5D%20%5Blr%5D.pdf.

B. Need for Green and Sustainable Bonds

The market for green bonds saw a major spurt in 2014, with issuances tripling from a year earlier, topping USD 38 billion,[8] owing to the increased focus on addressing climate change and the growing investor interest in environmentally conscious financial products. As these securities allow issuers and investors to demonstrate their dedication to environmental actions, their prevalence is expected to increase.[9] Raising capital through a green bond or sustainable bond offering presents a chance to attract new investors concerned with environmental, social and governance ("**ESG**") factors.

The issuance of a green bond further presents an excellent promotional opportunity for a company to demonstrate its dedication to environmental responsibility. In the U.S.A., governments that issued Qualified Energy Conservation Bonds ("**QECB**") earlier, now replaced by the New Clean Renewable Energy Bonds ("**CREBs**"), may be eligible for federal tax credits and subsidies.[10] Companies that take measures to improve their energy efficiency may be eligible for tax credits and other incentives from

[8]Q1 2015 Bloomberg for Sustainable Finance Analysis, Bloomberg New Energy Finance (2015);Impact Investing Committee, NEPC, *An Introduction to Green Bonds,* ALTERNATIVE INVESTMENT ANALYST REVIEW, Q2 2016, at 6.
[9]Patrick Henry, *What are green bonds and why is this market growing so fast?*,WORLD ECONOMIC FORUM (Oct.26, 2021), available at:https://www.weforum.org/agenda/2021/10/what-are-green-bonds-climate-change/.
[10]UPDATE: Qualified Energy Conservation Bonds and New Clean Renewable Energy Bonds Eliminated Under Tax Cuts and Jobs Act, Office of Energy Efficiency and Renewable Energy (Feb. 2018), available at: https://www.energy.gov/scep/slsc/articles/update-qualified-energy-conservation-bonds-and-new-clean-renewable-energy-bonds.

the federal government.[11] The issuance of green bonds is a potential source of funding for such endeavours. Green and sustainable bonds also help contribute towards environment-friendly long-term goals of the nations with a chance for investors to promote a shift towards a sustainable lifestyle.

Green and sustainable bonds help with portfolio diversification and are increasingly used by institutional investors since they help with transparency amongst stakeholders.[12] Thus environmental concerns can now make use of inventive market-based solutions. Given the diversity of emerging economies, the literature suggests that green bond policies and regulation initiatives be country-specific rather than 'one-size-fits-all'.

C. Influence of Green and Sustainable Bonds in India towards Global Change

India's first issue of green bonds raised USD 2 billion towards projects on climate change mitigation, adaptation, environmental protection, resource and biodiversity conservation, and net zero objectives.[13] India aims to reach 450 GW of renewable energy-producing capacity by 2030.[14] According to India's Nationally Determined Contribution ("**NDC**"), the country will need about INR 11 lakh crores (USD 170 billion) per year from 2015 to 2030 to take climate action, for a total of INR 162.5 lakh crores (USD 2.5

[11] *Id.*
[12] *Green Bonds – The Process*, KPMG (Mar. 2016), available at: https://assets.kpmg.com/content/dam/kpmg/pdf/2016/04/green-bonds-process.pdf.
[13] *Id.*
[14] *India to have 450 GW renewable energy by 2030: President*, THE ECONOMIC TIMES (Jan. 31, 2020), available at: https://economictimes.indiatimes.com/small-biz/productline/power-generation/india-to-have-450-gw-renewable-energy-by-2030-president/articleshow/73804463.cms?from=mdr.

trillion).[15] Even though the energy sector in India is one of the fastest expanding in the world and has been garnering significant investments, substantial increase in investment at the sector level will be needed to help India achieve its climate targets and sustainable development goals.[16]

Some of the obstacles in the bond market include insufficient capacity in terms of management or issuance experience and a lack of alignment of interests across various government departments. The lack of fiscal incentives for green bonds or an official system of green bond classification that conforms with market-based frameworks means that supply is also constrained despite the market's global demand. To appeal to a wider range of investors as the market expands, it will be necessary to implement new methods of setting green bonds apart from their more-traditional counterparts.

II. HISTORY OF GREEN AND SUSTAINABLE BONDS

The European Investment Bank ("**EIB**") issued its inaugural Climate Awareness Bond in 2007 for EUR 600 million. The International Bank for Reconstruction and Development ("**IBRD**") then began marketing USD 300 million in green bonds.[17] The World Bank issued USD 14.4 billion in

[15]Neha Khanna, Dhruba Purkayastha & Shreyans Jain*, Landscape of Green Finance in India 2022*, CLIMATE POLICY INITIATIVE (Aug. 10, 2022), available at: https://www.climatepolicyinitiative.org/wp-content/uploads/2022/08/Landscape-of-Green-Finance-in-India-2022-Full-Report.pdf.
[16]*Id.*
[17]*Green Bonds: Key Numbers and Trends*, MOODY'S INVESTORS SERVICE(2018), available at: https://www.moodys.com/sites/products/ProductAttachments/MIS_Green_Bonds_2018_key_trends.pdf.

green bonds between 2008 and 2020, maintaining its position as a leading issuer of such instruments.[18] One hundred and eleven projects all around the world have benefited from this funding, with most of the money going towards sustainable transportation (27%), sustainable agriculture and land use (15%), and renewable energy and efficiency (33%).[19] As of 2023, USD 2.3 trillion has been raised by green and sustainable bonds worldwide.[20]

One of the World Bank's earliest green issuances went towards funding the Rampur Hydropower Project, which aimed to connect northern India's electrical grid to a source of low-carbon hydroelectric power. Green bond issuances help fund the project, which generates about 2 MW yearly and prevents 1.4 Mt of carbon emissions. The total amount of green bonds issued in 2014 was USD 36.6 billion, which is more than three times as much as the USD 10.6 billion issued in 2013. While USD 40 billion will have been issued by November 2015, this is less growth than was anticipated by some industry watchers.[21]

Only USD 2.6 billion was issued in green bonds in 2012.[22] The United Nations Framework Convention on Climate Change ("**UNFCCC**")

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[18]*Id.*

[19]Jennifer Laidlaw, *Green bond market to rebound in 2019 with 20% growth, Moody's says*, S&P GLOBAL (Jan. 21, 2019), available at: https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/49663417.

[20]*From India to Indonesia, Green Bonds Help Countries Move Toward Sustainability*, WORLD BANK (Apr. 10, 2023), available at:https://www.worldbank.org/en/news/feature/2023/04/10/from-india-to-indonesia-green-bonds-help-countries-move-toward-sustainability.

[21]*Id.*

[22]*Record $269.5bn green issuance for 2020: Late surge sees pandemic year pip 2019 total by $3bn*,CLIMATE BONDS INITIATIVE(Jan. 24, 2021), available

officially certified green bond issuance as a 'climate action' at its 21st session of the Conference of the Parties (COP21), held in 2015. The bulk of the activity emerged in 2016 and was driven by Chinese borrowers responsible for USD 32.9 billion, i.e., more than a third of the total. However, interest has been displayed by countries from across the world, with the European Union and the United States leading the initiative. Therefore, to accommodate the growth of the green bond market and the rising interest from investors, it became necessary to establish performance criteria.[23]

Numerous financial institutions, credit rating firms, and service providers in 2014 introduced green bond indices. The goal of these indices is to make it easier for investors to make decisions by giving transparent risk-reward information. Investors could choose from four distinct "families" of green bond indices as of November 2015, each with their calculation methodology and eligibility thresholds for green bonds (based on factors including currency, size, rating, and non-financial qualities like second-party opinions). A few examples are the Standard & Poor's("**S&P**") Green Bond Index, the Green Project Bond Index from S&P, the Solactive Green Bond Index, and indices from Bank of America Merrill Lynch and Barclays MSCI.[24]

at:https://www.climatebonds.net/2021/01/record-2695bn-green-issuance-2020-late-surge-sees-pandemic-year-pip-2019-total-3bn.

[23] *Id.*

[24] *Id.*

Green bond issuance hit a record high of USD 161 billion in 2017, representing investment from across the world.[25]The market's awareness of climate change contributed to a resurgence the following year after growth slowed in 2018 to USD 167 billion.[26] In 2019, USD 266.5 billion was issued in green bonds, and in 2020, over USD 270 billion.[27] Green bonds have been issued in twenty-three different jurisdictions and 23 different currencies as of 2022. This number includes markets from the G20.[28] But, as of 2023, the green and sustainable bonds market has raised USD 2.3 trillion worldwide.[29] In the first half of 2023 alone, the green bonds market raised USD 351 billion worldwide.[30]

III. FUNCTIONING AND ISSUANCE OF GREENBONDS

Sustainable bonds and green bonds are being issued by an increasing variety of issuers, from international organisations like the World Bank to national governments through sovereign green bonds to multinational corporations like Apple and Unilever. Green bonds may appear to be issued in the same way as conventional debt securities. However, the distinctive characteristics

[25]Jean-Florent Helfre& Elise Depetiteville, *Measuring the impact of green bonds*, S&P GLOBAL (Oct. 5, 2022), available at:https://www.spglobal.com/esg/insights/blog/measuring-the-impact-of-green-bonds.
[26]*Green bonds up 25% in 2nd quarter after volatile start to 2022*, CLIMATE BONDS INITIATIVE (Aug. 4, 2022),available at:https://www.climatebonds.net/2022/08/green-bonds-25-2nd-quarter-after-volatile-start-2022.
[27]Ministry of Finance, Framework for Sovereign Green Bonds, 2891146/2022/Finance Unit (2022).
[28]Ministry of Finance, Union Budget of India 2022-2023,para.103,(2022), available at: https://www.indiabudget.gov.in/budget2022-23/index.php.
[29]WORLD BANK, *supra*note20.
[30]*Global green bond issuance reaches record high of $351bn in first six months of 2023 amid evolving regulatory landscape*, LINKLATERS (Jul. 20, 2023),available at:https://www.linklaters.com/en/about-us/news-and-deals/news/2023/july/global-green-bond-issuance-reaches-record-high-of-351bn-in-first-six-months-of-2023.

of these bonds and the projects they fund have given rise to several market practices that require closer inspection.[31]The International Capital Markets Association ("**ICMA**") has outlined four Green Bond Principles ("**GBPs**"):[32]

1. Use of proceeds
2. Process for project evaluation and selection
3. Management of proceeds
4. Reporting

A green bond can be built using the four pillars as a set of rules to follow. The first step involves assembling a Green Bonds Project team capable of determining whether the project qualify for financing (Pillar 1), which can include everything from clean transport to renewable energy, and then developing the processes to choose the best one (Pillar 2). Since transparency plays such a crucial role in the issuance process, Pillar 3 and 4 deal with post-receipt aspects of the issuance, such as the creation of processes dealing with efficient and transparent allocation of the proceeds and reporting to the investors where the proceeds have been allocated.

[31]*World BankSustainable Development Bonds & Green Bonds: Impact Report 2022*, WORLD BANK,31 (June 2022), available at:https://thedocs.worldbank.org/en/doc/33420eed17c2a23660b46dc208b01815-0340022023/original/World-Bank-IBRD-Impact-Report-FY22.pdf.
[32]*Green Bond Principles*, INTERNATIONAL CAPITAL MARKET ASSOCIATION (June 2021),available at:https://www.icmagroup.org/assets/documents/Sustainable-finance/2022-updates/Green-Bond-Principles-June-2022-060623.pdf.

Green bond guidelines like the GBPs are significant because presently there are no global rules for bond issuance or structure.[33]

As was previously explained, the process of issuing green bonds is very similar to that of issuing conventional debt securities. KPMG,[34] an asset management firm, has laid out the required procedures, which include registering the bond, issuing information disclosures, obtaining a credit rating, etc. By categorising the issuance of these bonds into three phases—pre-issuance, issuance, and post-issuance—we can gain a high-level understanding of the process.

In the pre-issuance phase, a green bond framework is developed, which requires the use of the four GBPs mentioned before. However, another crucial stage before issuance is for an external party to examine the bond's green credentials to instil investor trust. There are three options:

1. Certification is evaluated by a qualified body against a recognised standard, such as the Climate Bonds Standard,
2. Credentials of the green bond are evaluated by independent audits conducted by auditors in accordance with the International Standard on Assurance Engagements("**ISAE**") 3000 accounting standards, or

[33]Caroline Flammer, *Corporate Green Bonds*, 142JOURNAL OF FINANCIAL ECONOMICS499 (2021).
[34]*Sustainability Bond Guidelines*, INTERNATIONAL CAPITAL MARKET ASSOCIATION,4 (June 2021),available at:https://www.icmagroup.org/assets/documents/Sustainable-finance/2021-updates/Sustainability-Bond-Guidelines-June-2021-140621.pdf.

3. Second Party Opinions ("**SPO**") may be utilised to give research-based assessments of the sustainability of the green bonds.[35]

The issuing phase involves getting the bond into circulation. Similar to conventional bonds, issuing documents like the prospectus or private placement memorandum are used for issuing green and sustainable bonds. Multiple methods, such as an annexure of compliance with the features of the green bond framework are included in the prospectus to advertise the green and sustainable bond's environmental and climate-friendly features.

The green bond framework covers a wide array of key post-issuance activities viz. allocation of funding, report writing, and project oversight. Issuers may also conduct post-issuance audits in the form of either comprehensive reviews of the bond's environmental credentials (post-issuance review) or periodic assessments by a reviewer (Report Audit) to provide investors with more peace of mind.[36] The proceeds of such bonds typically cannot be utilised until the project has achieved its Key Performance Indicators ("**KPIs**") as projected. Further, only if the KPIs have been achieved, is when the issuer pays less interest on the debt. However, if the same has not been achieved, the issuer ends up paying a higher interest on the debt. With KPIs, there is an increased emphasis on the transparency of the functionality of green and sustainable bonds.

[35]*Green Bond Handbook: A Step-By-Step Guide to Issuing a Green Bond*, INTERNATIONAL FINANCE CORPORATION, 25(Mar. 29, 2022), available at:https://www.ifc.org/content/dam/ifc/doc/mgrt/202203-ifc-green-bond-handbook.pdf.
[36]KPMG, *supra* note 12.

IV. INSTANCES ON GREEN AND SOVEREIGN BONDS

Green bonds have been successful in attracting capital for environmentally friendly initiatives in a variety of countries. Green bonds have been used by the World Bank to finance a total of USD 12.3 billion in projects since 2008, with most of the money targeted towards initiatives in East Asia and the Pacific, South Asia, Latin America and the Caribbean. The issuance of green bonds by corporations has likewise shown meteoric growth, from USD 5 billion in 2013 to USD 95.7 billion in 2018.

It is important to note, however, that green bonds have met with varying degrees of success in various regions around the world.[37]The European Union is one area where green bonds have been quite successful. In 2020, the Euro was the greatest currency for green bond issuances, and France, Germany, and the Netherlands were among the top five green bond-issuing countries in the world.[38] Furthermore, in 2020, the European Union accounted for 51% of all green bond issuances.[39] However, as of 2022, China has been leading with the biggest green bond market which is itself distributed between more than 220 projects.[40]

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[37]*How to Issue Green Bonds, Social Bonds and Sustainability Bonds*, CLIMATE BONDS INITIATIVE, 21 (Jan. 2021),available at:https://asianbondsonline.adb.org/green-bonds/pdf/How%20to%20Issue%20Guide%20English%20FINAL%20PRINT.pdf.

[38]Jorge Liboreiro, *Green bonds: Can the EU really become the world's largest issuer of climate-conscious finance?,*EURONEWS (Sept. 24, 2021),available at: https://www.euronews.com/my-europe/2021/09/13/green-bonds-can-the-eu-really-become-the-world-s-largest-issuer-of-climate-conscious-finan.

[39]European Parliament Research Service, European Green Bonds: A standard for Europe, open to the World(Jan. 12, 2022).

[40]Karoline Kan, Rebecca Choong Wilkins, Sheryl Tian Tong Lee & Adrian Leung, *A $300 Billion Bond Market Holds the Key to Solving the Climate Crisis*, BLOOMBERG (Nov. 23, 2022),

It is becoming increasingly difficult for emerging markets like India to compete with established ones like the European Union, the United States, and China.[41] However, emerging markets are starting to gain traction in several regions, including Southeast Asia, where countries like Indonesia, Malaysia, Singapore, Thailand, and the Philippines are participating in the green bond market.

Green bonds have been used to finance a wide range of renewable energy projects, including the operation of a run-of-the-river hydro plant in Malaysia by Telekosang Hydro One and the construction and expansion of seven new and nine existing solar power facilities in Thailand by B. Grimm. Green bonds, however, encounter obstacles in these locations due to the high costs of issuing green bonds and the inadequate credit absorption capacity of many medium and small firms[42] as a consequence of the high costs of the projects that are proposed to be financed by green bonds and the consequent need for larger issuances.

Green bonds are gaining popularity in India and the surrounding region, with an expected USD 7 billion in new funding in 2021 (increasing the total value of green deeds to date to USD 18.9 billion). Adani Green Energy (USD 2.2 billion), Azure Power Energy (USD 414 million), Renew Energy (USD 1 billion), and Vector Green Energy (USD 166 million) are just a few of the companies that have successfully issued green bonds for renewable

available at:https://www.bloomberg.com/graphics/2022-china-green-bonds/#xj4y7vzkg.

[41]WORLD BANK, *supra* note 20.

[42]Caroline Flammer, *supra* note33.

energy projects. Other prosperous South Asian issuers include Sri Lanka's Seylan Bank (sustainable agriculture) and Bangladesh's SAJIDA Foundation.[43]

Increasing international commitments to combat climate change, such as the COP26 Mandate to Mitigate Climate Change, the Sustainable Development Goals (SDGs) of the United Nations Development Programme, and the Paris Agreement which aim to keep global rising temperatures below 2%, while limiting the increase to 1.5%, elevate the importance of green bonds. Finance initiatives help governments reach such obligations with the help of green bonds. For instance, a bond that has been certified by the Climate Bonds Initiative as meeting their stringent scientific requirements will be in line with the Paris Agreement.[44]

V. MARKET GROWTH AND IMPACT OF GREEN BONDS

Corporations are frequently taking the drivers' seat when it comes to issuing bonds in various jurisdictions. As of 2021, non-financial corporations have issued 65% of all green, social, and sustainable ("**GSS**") bonds, while government-backed companies have issued 21%.[45] It should be emphasised, however, that this may not be the case in other countries, and that the largest issuers of green bonds in China are state-related

[43]KPMG, *supra* note12.
[44]European Parliament Research Service, *supra* note 39, at 2.
[45]*India Sustainable Debt State of the Market*,CLIMATE BONDS INITIATIVE, 6 (May 2022), available at: https://www.climatebonds.net/files/reports/cbi_india_sotm_2021_final.pdf.

organisations, in contrast to the trends in other markets where private issuers are in the driver's seat.[46]

Green bonds have been issued not just by international and regional development banks but also by national institutions like the Seylan Bank in Sri Lanka and the Bank of the Philippine Islands.[47] The involvement of the bank as underwriter of these bonds is equally crucial. An underwriter acts as a neutral third party (often a financial institution) that takes on some of the issuer's risk throughout the issuing process. For instance, MIDF Amanah Investment Bank acted as the underwriter for the Malaysian Telekosang Hydro One offering.

Further, as was previously indicated, state-related entities play a significant role in green bond issuances in China, and 21% of GSS bonds in India were issued by government-backed enterprises. Additionally, governments in various nations, like France and India, have issued sovereign green bonds, the French government, for example, issued two €7 billion worth of sovereign green bonds in 2017 and 2021. Debt security markets, such as those where green bonds are issued, are heavily regulated by governments. Green bonds fall under the purview of the Securities Exchange Board of India's ("**SEBI**") laws on non-convertible securities, which govern the debt

[46]Dina Azhgaliyeva, Anant Kapoor &Yang Liu, *Green bonds for financing renewable energy and energy efficiency in South-East Asia: a review of policies*, 10, JOURNAL OF SUSTAINABLE FINANCE& INVESTMENT113 (2020).
[47]CLIMATE BONDS INITIATIVE,*supra*note45.

security market in India.[48] SEBI recently introduced disclosures such as the perceived social and environmental risks concerning the issue of green bonds and the use of proceeds to fund the relevant projects, details of an indicative estimate of the distribution of proceeds raised, and details of the project amongst others to be made before the issuance of green bonds.[49]

A. Key Challenges with Green and Sovereign Bonds

According to the European Parliamentary Research Service, bond issuance faces three obstacles: (i) a lack of a clear definition of a green bond, (ii) cumbersome assessment procedures, and (iii) a shortage of investable projects. There is no agreed-upon definition or standard for what constitutes a "green bond," while standards like the Climate Bond Standard are out there. To provide uniformity for green bonds, the European Union is pursuing a set of guidelines. A political agreement was reached in 2021 on a proposal for the European Union Green bond standard that would establish a voluntary standard for green bonds complying with it to be recognised as European green bonds.[50]

[48] *Climate Bonds Taxonomy*, CLIMATE BONDS INITIATIVE(Sept. 2021), available at: https://www.climatebonds.net/files/files/Taxonomy/CBI_Taxonomy_Tables-08A%20%281%29.pdf.

[49] Securities and Exchange Board of India, SEBI/HO/DDHS/DDHS-RACPOD1/P/CIR/2023/023, Revised Disclosure Requirements for Issuance and Listing of Green Debt Securities (2024), available at: https://www.sebi.gov.in/legal/circulars/feb-2023/revised-disclosure-requirements-for-issuance-and-listing-of-green-debt-securities_67837.html.

[50] CLIMATE BONDS INITIATIVE, *supra* note 45.

B. Lessons from the European Union

As was previously indicated, the European Union has been a significant market for green bond issuance.[51] The European Union has been working on a standard for greenbonds while other organisations focus on reassuring investors through green bond frameworks and external evaluation.[52] The proposal for this was published in 2021, and a political agreement for the development of the standards was obtained in 2023, although the rules themselves have not yet been published.[53] These changes need to be placed in the context of European Union (EU) initiatives to categorise sustainable investments, such as the EU taxonomy issued by the Technical Expert Group on Sustainable Finance, which stipulates that an investment must achieve one of the following goals to be considered "green": Keeping a healthy ecosystem, preventing pollution, and mitigating climate change..[54]

With the proposed European Union Green Bond Standard ("**Standard**"), issuers would be able to voluntarily adhere to regulations that define what it means for a bond to be certified as a European Green Bond.[55] A fact sheet must be filled out before the green bond is issued (Article 8 of the Standard), allocation reports must be filed annually (Article 9 of the Standard) until all available funds are allocated, and an impact report must

[51]*Proposal for a Regulation of the European Parliament and of the Council on European Green Bonds*, COM (2021) 391 final (July 6, 2021).
[52]CLIMATE BONDS INITIATIVE, *supra*note 37, at 30.
[53]European Commission MEX/23/1301,Daily News 01 / 03 / 2023(Mar. 1, 2023).
[54]Lin Lin&Yanrong Hong, *Developing a Green Bonds Market: Lessons from China*, 23 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 144, 166 (2022).
[55]European Commission, Financing Sustainable Growth (Jan. 8, 2020).

be filed at least once throughout the bond's lifetime (Article 10 of the Standard).

VI. INDIAN REGULATIONS ON GREEN AND SUSTAINABLE BONDS

A. Sovereign Green Bonds

Throughout the years, authorities in India have worked to strike a balance between environmental protection and economic development. Keeping its developmental needs in mind, India has also set a lofty Nationally Determined Contribution (NDC) under the Paris Agreement on a "best-effort basis."[56] India's central government has issued sovereign green bonds to the public as a means of funding environmental initiatives. The Union Budget 2022-23 proposed the issuance of Sovereign green bonds as part of an effort to drastically lower the carbon intensity of the economy.[57] It states:

"As a part of the government's overall market borrowings in 2022-23, sovereign green bonds will be issued for mobilising resources for green infrastructure. The proceeds will be deployed in public sector projects which help in reducing the carbon intensity of the economy."[58]

India's central government became the latest member of the Sovereign Green Bonds Club on 25 January 2023. The rupee-denominated onshore debut was issued by the Reserve Bank of India in two separate USD 1

[56]MINISTRY OF FINANCE, *supra* note27.
[57]MINISTRY OF FINANCE,*supra* note28.
[58]*Id.*

billion tranches and was significantly oversubscribed at yields six and four basis points lower than the average Indian sovereign bond, respectively.[59]

B. Sovereign Green Bond Framework

The responsibilities of the Government of India as a greenbond issuer are spelt out in the Green Bond Framework ("**Framework**") issued by the Department of Economic Affairs, Ministry of Finance. All green sovereign bonds issued by the Government of India are subject to the Framework. The success of the qualified projects will not affect the timely payment of principal and interest on the issuances under the Framework. Bondholders operating within this Framework are shielded from all project-related risks.[60]

The framework was developed to adhere to the International Capital Market Association's Green Bond Principles (2021),[61] which include four components and essential recommendations.

As per an independent evaluation by the Centre for International Climate Research (CICERO) the sovereign green bonds issued by the Government of India comply with the ICMA Green Bond Principles (2021),

The proceeds raised from sovereign green bonds must be used to finance and/or refinance expenditure for green projects that fall into the eligibility

[59]Neha Kumar, *Build on the success of sovereign green bonds*, THE HINDU BUSINESS LINE(Feb. 19, 2023, 7:25 PM), available at: https://www.thehindubusinessline.com/opinion/build-on-the-success-of-sovereign-green-bonds/article66529197.ece.
[60]INTERNATIONAL CAPITAL MARKET ASSOCIATION,*supra*note 32.
[61]*Id.*

category listed in Table 1 of the Framework.[62] This involves (i) Renewable Energy, (ii) Energy Efficiency, (iii) Clean Transportation, (iv) Climate Change Adaptation, (v) Sustainable Water and Waste Management, (vi) Pollution Prevention and Control, (vii) Green Buildings, (viii) Sustainable Management of Living Natural Resources and Land Use, and (ix) Terrestrial and Aquatic Biodiversity Conservation. All metro projects in the country have access to the public portion of their overall funding through equity investments, therefore the framework only permits equity in the case of metro projects under the 'clean transportation' category.

The framework further specifically excludes from its purview (i) projects involving new or existing extraction, production and distribution of fossil fuels, including improvements and upgrades, or where the core energy source is fossil-fuel based, (ii) nuclear power generation, (iii) direct waste incineration, (iv) alcohol, weapons, tobacco, gaming, or palm oil industries, (v) renewable energy projects generating energy from biomass using feedstock originating from protected areas, (vi) landfill projects, and (vii) hydropower plants larger than 25 MW.

The Ministry of Finance has formed the Green Finance Working Committee **("GFWC"),** which includes representatives from other relevant ministries. The GFWC is headed by India's Chief Economic Adviser, and it helps the Ministry of Finance with project review and prioritisation. As an added measure, the committee monitors and verifies important decisions regarding the issue of Sovereign green bonds. Green

[62] *Id* at para.2.1.

projects that fall within the framework's predetermined categories are chosen, funds are distributed, and the projects' impacts on carbon intensity and environmental benefits are evaluated.[63]

The proceeds must be paid into the Consolidated Fund of India **("CFI")** before they may be used for qualified green initiatives, as per the framework's additional requirements. In addition, the Public Debt Management Cell (**"PDM"),** that was established, was given the responsibility of tracking the proceeds within the pre-existing debt management rules and overseeing the distribution of monies towards sustainable projects.[64]

C. The SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021

SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021, as amended from time to time ("**SEBINCS Regulations**")[65], define a "Green Debt Security" as a debt security issued for raising funds to be utilised for renewable and sustainable energy including wind, bioenergy, other sources of energy which use clean technology, clean transportation including mass/public transportation, climate change adaptation including efforts to make infrastructure more resilient and energy efficiency including efficient and green buildings, sustainable waste management including recycling, waste to energy, efficient disposal of wastage, sustainable land use

[63] *Id* at para.2.2(i).
[64] *Id* at para.2.3.
[65] Securities and Exchange Board of India (Issue and Listing of Non-Convertible Securities) Regulations, Regulation 2(q), SEBI/LAD-NRO/GN/2021/39 (2021).

including sustainable forestry and agriculture, afforestation, biodiversity conservation, pollution prevention and control (including reduction of air emissions, greenhouse gas control, soil remediation, waste prevention, waste reduction, waste recycling and energy efficient or emission efficient waste to energy).

This also includes the sectors mentioned under the 'India Cooling Action Plan' launched by the Ministry of Environment, Forest and Climate Change. Products, industrial technologies, and processes that are optimised for the circular economy (including the development and implementation of reused, recyclable, and refurbished materials, components, and products, circular tools, and services), as well as environmentally friendly items, sustainable water management, including clean water and water recycling, and the maritime sector, including sustainable shipping, sustainable fishing, fully traceable sustainable seafood, ocean energy, and ocean mapping, supported by "blue bonds," support solar energy generation and the upstream and downstream industries related to it, supported by "yellow bonds" and the infrastructure changes necessary to put these initiatives into effect, supported by "transition bonds".[66]

Explanation: Intended Nationally Determined Contributions (INDCs) refer to the climate targets determined by India under the Paris Agreement at the Conference of Parties 21 in 2015, and at the Conference of Parties 26 in 2021, as revised from time to time.

[66] *Id.*

The obligations and requirements of a green debt security issuer are detailed in the Master Circular issued by SEBI ("**SEBI Master Circular**"), dated 10 August 2021, as amended from time to time.[67] Chapter IX of the SEBI Master Circular lays down disclosure requirements before, during, and after the issuance and listing of environmentally friendly securities. An issuer's initial disclosures must include a statement on the environmental sustainability objectives of the issue of green debt,[68] brief details of the decision-making process followed/proposed for determining the eligibility of project(s), the process to be followed for determining how the projects or assets fit within eligible green projects under SEBI NCS Regulations, details of taxonomies, green standards/certifications, and details of alignment of the objective of the issue with the SEBI NCS Regulations.[69]

In addition, the SEBI NCS Regulations require the disclosure of how the issue proceeds will be monitored and the proposed uses of the issue's assets, an estimate of how those proceeds will be dispersed, the temporary locations where any net proceeds that are not immediately put to use will be held, the nature of any social or environmental risks that the issuer foresees, and a review or certification of the project's quality by an independent party. In addition, the SEBI Master Circular specifies the issuer's ongoing obligations and the nature of its disclosures.

[67]Securities and Exchange Board of India, Master Circular for issue and listing of Non-convertible Securities, Securitised Debt Instruments, Security Receipts, Municipal Debt Securities and Commercial Paper, SEBI/HO/DDHS/PoD1/P/CIR/2023/119 (2024).
[68]Securities and Exchange Board of India, *supra* note49, para.4.
[69]*Id.*

D. Analysis of the Framework

As part of its dedication to sustainable development and green financing, the government has introduced the Framework. Unlike the current green bonds regime in India, the redemption of debenture is subject to the provisions of the SEBI NCS Regulations. Investors are reassured that their principal and interest payments will be made regardless of how well the qualified project turns out to be, which encourages them to buy the bonds.

There are, nonetheless, several ambiguities in the Framework that call for legislative clarification. Quantitative cut-offs for the various project types are not outlined in the Framework. For illustration, there has been no minimum standard or certification established for the building of low-carbon structures. Similarly, no sustainability benchmarks are mentioned, and assessment criteria and/or certification for choosing green expenditure-eligible projects.

The agency notes certain potential problems with the Framework, including the fact that the criteria for picking eco-friendly initiatives are broad. Uncertainty about the kind of costs that could be financed, and the wider climatic hazards associated with those costs result from the projects' loosely defined categories. In general, the Framework's project categories lack measurable limits because it might encourage spending on climate-disrupting biofuels, solid biomass, and bioenergy facilities.

It also points out that natural forests could be replaced with monoculture plantations—which are less biodiverse and less robust to climate change—

if eligible expenditures under the framework are broadened to include such projects.

VII. CONCLUSION

By directing funding towards environmentally beneficial projects, green bonds have become a crucial financial instrument in encouraging sustainable development. Green bonds offer a promising way to raise money for projects addressing these environmental issues in the face of urgent threats posed by factors of climate change and resource depletion, among others. India can benefit greatly from the smart use of green bonds given its fast-expanding economy and increased awareness of environmental issues. As investors increasingly look for possibilities that fit with their preferences for ESG factors, green bonds have recently seen significant growth on a global level. These bonds give issuers the ability to raise money expressly for initiatives that have a positive environmental impact, like the adoption of renewable energy systems, eco-friendly transportation options, and waste management initiatives. India can draw domestic and foreign investors who are seeking to support sustainable ventures while also seeking profitable returns on their investments by tapping into this market.

Greenwashing is perceived to be a major challenge for the market in green bonds and other sustainable investments. The concept of Greenwashing can be understood as a practice of making false or misleading claims about the green credentials of a company or a project. It is seen as a challenge

because the funds generated through the bonds may be diverted to another product and also, it is difficult to evaluate the benefits of green projects. Greenwashing is perceived to be a major challenge for the market in green bonds and other sustainable investments. This is because the funds generated through the bonds may be diverted to another product. Additionally, it is difficult to evaluate the benefits of green projects.

However, the issuance of green and sustainable bonds has its own set of challenges. The issue of greenwashing continues to pose a significant challenge within the market for green bonds and other sustainable investments. Similar issues plague the operation of carbon markets. Further, the World Bank has predicted that depending on policy choices, low- and middle-income countries may require substantial expenditures between 2015 and 2030 to accomplish infrastructure-related SDGs. The pandemic and subsequent economic collapse have left underdeveloped economies with few resources to combat the virus. Green infrastructure projects need both public and private funding, as governments may be unable to provide all the necessary funds on their own. It has been noted, however, that private sector incentives do not line with the very long-term, low-interest rates of green projects due to the hazards involved.

India can use several ways to maximise the potential advantages of green bonds in several ways. The first step would be to strengthen legal frameworks and establish standardised processes for the issuance of green bonds. This would increase transparency and boost investor trust. Funds would be allocated to initiatives that benefit the environment if there were clear criteria for project appraisal, reporting channels, and monitoring

procedures. Second, to discover and prioritise green initiatives, the nation can use public-private partnerships. This will help to facilitate the development of a strong pipeline of investment prospects. Additionally, it is crucial to raise awareness of green finance among investors and issuers alike. This goal can be met by holding workshops and educational campaigns, which will encourage the use of green bonds in more areas of the economy. A more robust and sustainable financial ecosystem would be built through cooperative efforts involving financial institutions, regulators, and environmental specialists.

Green bonds give India the chance to reconcile its aspirations for development with its commitment to environmental care. India can unleash the potential of green bonds to foster sustainable growth, reduce environmental risks, and advance the global fight against climate change by creating supportive legislative frameworks, raising awareness, and cultivating eco-sensitive collaboration. Green bonds can be successfully incorporated into India's wide range of sustainable programs, which include waste management plans, afforestation campaigns, and renewable energy initiatives. By efficiently leveraging these financial tools, India can demonstrate its commitment to combating climate change and protecting its natural resources while also attracting finance for its green projects. Green bonds are well-positioned to play a crucial part in defining a sustainable future for both India and the global world as we strive to create an economy that is more environmentally sensitive.

Nihas Basheer, Anu Swaraj Venmalasseril & Anannya Chitranshi, *Need for Special Resolution of Financial Service Providers under the Indian Insolvency Regime*, 11(1) SCHOLASTICUS 102 (2024).

NEED FOR SPECIAL RESOLUTION OF FINANCIAL SERVICE PROVIDERS UNDER THE INDIAN INSOLVENCY REGIME

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ABSTRACT

*Financial Service Providers ("**FSPs**") in India, handling substantial consumer funds, are crucial for the economy and require a dedicated resolution framework. Recognising this need, the Indian government has made efforts to introduce such a framework. The challenges observed in the resolution of the IL&FS crisis underscore the absence of a specific regulatory process outside the Indian Insolvency and Bankruptcy Code, 2016 ("**IBC**"). Stakeholder concerns, including bail-in provisions and deposit insurance adequacy, further complicate the process, especially for public sector banks. The article emphasises the necessity of a separate resolution framework for FSPs, citing the fragmented and non-uniform current framework in India. It highlights recommendations from international bodies like the IMF and the Basel Committee, acknowledging the recent introduction of the Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, 2019. However, it argues for more specific tools and measures to effectively address the unique challenges faced by FSPs in their insolvency and resolution processes. The article concludes by advocating for the development of a dedicated resolution framework for FSPs in India to ensure financial stability and protect retail depositors.*

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I. INTRODUCTION

Financial Service Providers ("**FSPs**"), unlike corporate entities, perform vital economic functions,[1]and are generally tasked with handling large amounts of consumer funds, especially in comparison with their own resources.[2]In addition to the fragile structure of FSPs such as banks,[3]the systemic risk associated with its failure including the effect on other segments of society, the domino effect on other FSPs in case of balance sheet inter-linkage, as well as the threat of moral hazard form sufficient basis for the formulation of a law that regulates the insolvency of FSPs different from corporate.

The insolvency regulatory framework in India captured under the Indian Insolvency and Bankruptcy Code, 2016 ("**IBC**"/"**the Code**") was intended to capture the insolvency framework regulating entities/persons other than FSPs, and at the time of its introduction did not govern insolvency and

[1]Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions*(16 October 2014 and as revised in 2019 and 2022)("**Key Attributes**"), available at: https://www.fsb.org/wp-content/uploads/r_141015.pdf; Insolvency and Bankruptcy Code, 2016 ("**The Code**") § 6(17): these include (a) accepting deposits; (b) safeguarding and administering assets belonging to third parties; (c) effecting contracts of insurance; (d) managing assets consisting belonging to third parties; (e) rendering advice in relating to buying/selling/subscribing to financial products, availing financial services, or exercising rights related to financial services; (f) establishing/operating investment schemes; (g) maintaining/transferring records of financial product ownership; (h) underwriting; or (i) selling/providing/issuing stored value/payment instruments or providing payment services.

[2]Ministry of Finance, Department of Economic Affairs, Report of Committee to Draft Code on Resolution of Financial Firms, (Sept. 21, 2016), available at:https://dea.gov.in/sites/default/files/report_rc_sept21_1.pdf.

[3]Pratik Datta, Varun Marwah&Ulka Bhattacharyya, *Resolving Financial Firms In India: The Way Forward*, 13 NUJS L. Rev. 1 (2020).

bankruptcy resolution mechanisms to FSPs.[4] However, given that no separate insolvency regime was introduced for FSPs by then and given the impending insolvency of certain FSPs,[5] the Central Government notified the Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, 2019 ("**the Rules**").[6] The Rules make Corporate Insolvency Resolution Process ("**CIRP**") and liquidation provisions, subject to modifications[7], applicable to notified systemically important FSPs excluding banks,[8] and *vide* notification dated November 18, 2019, the Ministry of Corporate Affairs ("**MCA**") has brought non-banking financial companies ("**NBFCs**") and housing finance companies having asset size equal to or more than Rs 500 Crores (INR Five Hundred Crores)[9] under the purview of the Rules.

While the introduction of the Rules addressed the impending requirement for achieving resolution in relation to FSPs which were in financing trouble at the time, it also resulted in the insolvency framework for corporates being extended to FSPs with modifications which still lacks the tools to handle

[4]IBC extends the application only to Corporate Persons, from whose definition FSPs have been explicitly excluded; IBC §3(7): *"["corporate person"] means a company as defined in clause (20) of section 2 of the Companies Act, 2013 (18 of 2013), a limited liability partnership, as defined in clause (n) of sub-section (1) of section 2 of the Limited Liability Partnership Act, 2008 (6 of 2009), or any other person incorporated with limited liability under any law for the time being in force but shall not include any financial service provider;"*.

[5]Reserve Bank of India, Press Release No. 2019-2020/1295, Application for initiation of corporate insolvency resolution process against Dewan Housing Finance Corporation Limited filed under the Insolvency and Bankruptcy Code, 2016, (Nov.29, 2019), available at: https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=48747.

[6]Ministry of Corporate Affairs Notification No. G.S.R. 852(E), dated 15 November 2019.

[7]Ministry of Corporate Affairs, Press Information Bureau, dated 15 November, 2019.

[8]The Rules rr.2. r/w Code ss.227.

[9]Ministry of Corporate Affairs, Notification No. S.O. 4139(E), dated 18 November, 2019.

the specific challenges that churn out in the insolvency and resolution procedure of FSPs. In this backdrop, this article will aim to highlight the rationale for the development of a separate resolution regime for FSPs.

II. SPECIAL RESOLUTION REGIMES FOR FSPS: GLOBAL INSIGHTS

The UNCITRAL Model laws on Cross-Border Insolvency Law[10] and Enterprise Group Insolvency[11] specificallyallow States to exclude the application of the model law to "*banks or insurance companies*". In its discussion leading up to this opt-out provision, the report of the Working Group in its Twenty-First Sessions called for the exclusion of all "financial service institutions" from the ambit of the model law altogether[12]. The rationale at the time was that particular issues arising out of resolution of such entities were not adequately dealt with in the model law, and many aspects were still under study by major international forums[13].

The International Monetary Fund ("**IMF**") also supports this position and in a working paper addressing the need for special regimes for resolution of FSPs sets out the following: "*There is a strong case for financial institutions to be subject to a special insolvency (resolution) regime*."[14] The working paper spells

[10]UNCITRAL Model Law on Cross-Border Insolvency (May 30, 1997), Article 1(2).
[11]UNCITRAL Model Law on Enterprise Group Insolvency with Guide to Enactment (July 15, 2019), Article 1(2).
[12]Report of the Working Group on Insolvency Law on the Work of Its Twenty-First Session (New York, Jan. 1997), para. 179.
[13]*Id.*
[14]Martin Cihak&ErlendNier, '*The Need for Special Resolution Regimes for Financial Institutions—The Case of the European Union*.', INTERNATIONAL MONETARY FUND (Sept. 1, 2009), available at: https://www.imf.org/en/Publications/WP/Issues/2016/12/31/The-Need-for-Special-Resolution-Regimes-for-Financial-Institutions-The-Case-of-the-European-23286.

out the shortcomings of applying ordinary bankruptcy proceeding to FSPs one of which is that the authorities in charge of ensuring financial stability has little to no control over the actions taken by the court or a court appointed administrator who oversees the resolution process. It succinctly points out that while a court appointed administrator tries to maximise the creditor's claims, the authorities will have no wriggle room to take actions in ensuring financial stability by containing the systemic risk posed by the failure of such institution. Similarly, the Basel Committee on Banking Supervision, in its review of States' capacity to resolve FSPs under existing resolution regimes, recommended special resolution regimes and other measures targeting "*public interest*" – including maintenance of financial stability and the protection of retail depositors.[15]

Most of the developed jurisdictions have taken steps toward the development of special resolution framework, including the United States, the United Kingdom, and the European Union. The US in addition to the Federal Deposit Insurance Corporation has under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010 ("**Dodd Frank Act**") established the orderly liquidation authority, for the resolution of systemically risky non-banking financial institutions and other financial companies.[16]

Similarly in the UK, the Banking Act of 2009 introduced the Special Resolution Regime Code of Practice, which provides for a Special Resolution Regime ("**SRR**") for failing banks, with the Bank of England

[15]Basel Committee on Banking Supervision, Resolution Policies and Frameworks – Progress So Far (July 2011), available at: https://www.bis.org/publ/bcbs200.pdf.
[16] Dodd Frank Act, §204.

("**BoE**"), the Prudential Regulation Authority, the Financial Conduct Authorityand Her Majesty's Treasury operating as the resolution authorities. The SRR empowers the BoE with stabilising powers (direct transfer powers)[17] and puts in place Bank Insolvency procedurefor winding up.[18] The SRR was successfully applied on Dunfermline Building Society ("**DBS**"), wherein the BoE used its transfer powers, bank administration procedure and a bridge bank for resolution. ***First***, DBS's business was transferred to the Nationwide Building Society. ***Second***, special housing loans and related deposits of customers were transferred to a bridge bank, owned, and operated by the BoE – which was eventually sold off. The remainder of the business, specifically the worst quality assets was transferred to the Building Society Special Administration Procedure with KPMG as the administrator.[19]

The European Union also introduced the Bank Recovery and Resolution Directive and the Single Resolution Mechanism to establish the recovery and resolution of credit institutions and investment firms, and to regulate the funding architecture for such resolutions, respectively. Thus far, multiple European countries have come forward with additional legislation for special resolution including Germany, Netherlands, Spain and Switzerland.[20]

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[17]Her Majesty's Treasury, Banking Act 2009: Special Resolution Regime Code of Practice (2020), Chapter 7, para. 7.2 – 7.12.
[18]*Id*para.6.79.
[19]News Release, Bank of England(Mar. 30, 2009), available at:https://www.bankofengland.co.uk/-/media/boe/files/news/2009/march/dunfermline-building-society.pdf.
[20]*Working Group Report Group on Resolution Regime for Financial Institutions*,Reserve Bank of India, 186–189(Jan. 2014), available

III. REGULATORY FRAMEWORK IN INDIA

Indian policymakers have been advocating for a separate insolvency resolution regime for FSPs and multiple drafts have been tabled for discussion including the Report of Financial Sector Legislative Reforms Commission[21] and the Reserve Bank of India ("**RBI**") Working Group on Resolution Regime for Financial Institutions.[22] The former proposed a fast-track resolution organisation responsible for dealing with the resolution of systemically important entities such as banks and insurance firms. However, the draft never materialised. Similarly, the latter proposed the institution of a Financial Resolution Authority responsible for the resolution of all financial institutions and a Prompt Corrective Action ("**PCA**") framework for the establishment of triggers at various levels. Currently, only the PCA has been issued for commercial banks.[23]

For the formulation of a consolidated framework for the resolution of FSPs, the Indian Government proposed the Financial Resolution and Deposit Insurance Bill ("**FRDI**"/"**Bill**") in 2017 "*for establishment of a Resolution Corporation, designation of certain financial service providers and constitution of certain fund*"[24] and to repeal the Deposit Insurance and Credit Guarantee

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at:https://dea.gov.in/sites/default/files/Report%20of%20the%20Working%20Group%20on%20Resolution%20Regime%20for%20Financial%20Institutions%20.pdf.

[21]*Report of the Financial Sector Legislative Reforms Commission*, Government of India(Mar. 2013), available at: https://dea.gov.in/sites/default/files/fslrc_report_vol1_1.pdf.

[22] *Id*at 20.

[23]Reserve Bank of India, Notification No. DBS.CO.PP.BC.9/11.01.005 / 2002-03, dated 21 December 2002, and revised under Notifications No. DBS.CO.PPD. BC.No.8/11.01.005/2016-17 and DoS.CO.PPG.SEC.7/11.01.005/2021-22 dated 13 April 2017 and 14 December 2021 respectively.

[24]*Joint Parliamentary Report on Financial Resolution and Deposit Insurance Bill*,Lok Sabha(Aug. 2018),available at:https://prsindia.org/files/bills_acts/bills_parliament/2017/Joint%20Committee%20Report%20on%20the%20FRDI%20Bill%202017.pdf.

Corporation Act, 1961.[25] However, stakeholder concerns regarding bail-in provisions, adequacy of deposit insurance cover and applicability to public sector banks led to the eventual withdrawal of the Bill.[26]

In the absence of a separate framework and pursuant to the impending insolvency of Dewan Housing Finance Limited ("**DHFL**"),[27] the MCA notified the Rules. The Rules, however, only serve as an "*interim mechanism to deal with any exigency pending introduction of a full-fledged enactment to deal with financial resolution of Banks and other systemically important financial service providers*."[28]Notably, these Rules as on date do not apply to Banks and other categories of FSPs not falling under the ambit of systemically important financial institutions.[29]

The resolution of banks (other than certain cooperative banks) is dealt with under the Banking Regulation Act, 1949 ("**BR Act**")[30] while public-sector financial institutions are governed by their respective statutes which provide for resolution mechanisms under the oversight of the Central Government. They are exempt from winding up provisions under other legislations and only the Central Government is empowered to order this liquidation or

[25]*Id.*
[26]*Id* at 3.
[27]*Id* at 6.
[28]Ministry Corporate Affairs, Press Release No. 1591728, 'MCA notifies Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, 2019 (Rules)' (Nov.15, 2019), available at: https://ibbi.gov.in/uploads/press/c8661fa3ee5b9d40ca4f4e21eec5b05f.pdf.
[29]*Id* at 8.
[30]Banking Regulation Act, 1949 ("BR Act"), §3.

amalgamation.[31]Therefore, the resolution framework for various FSPs in India is fragmented and non-uniform.

IV. A CASE FOR DIFFERENTIAL TREATMENT

A. Scenario Prior to Notification of the FSP Rules

In the absence of a dedicated framework for the resolution of FSPs, the Central Government took refuge under the Companies Act to resolve the insolvency of Infrastructure Leasing & Financial Services Limited ("**IL & FS**") and its 347 subsidiaries ("**IL&FS Group Companies**").[32] The National Company Law Appellate Tribunal ("**NCLAT**") imposed an interim moratorium taking into account the nature of the case, larger public interest and economy of the nation as well as interest of the IL & FS.[33] In the process, the resolution consultant classified IL&FS Group Companies into three categories based on their ability to repay senior secured financial debt – Red, Amber, and Green.[34] While Green companies were declared solvent and allowed to continue repayment of financial debt, Amber and Red companies were restricted from making payments until the completion of the resolution process.[35] It was also proposed by the financial creditors

[31]State Bank of India Act, 1955,§ 45 & 35(9); Regional Rural Banks Act, 1976§23A, 23D and 26; The Banking Companies (Acquisition And Transfer Of Undertakings) Act, 1970, §18; Life Insurance Corporation Act, 1959, §38.

[32]Companies Act2013, §241 and 242. The Government relied upon Sections 241 and 242 of the Companies Act, 2013 to establish that the affairs of the company were being "*conducted in a manner prejudicial to public interest*."; Kumar Saurabh Singh and Aditi Bagri, '*Insolvency for financial services providers in India*', International Bar Association, available at: https://www.ibanet.org/article/45F9E439-48B4-474A-8CAB-39B89BBD17F6.

[33]*Union of India v. Infrastructure Leasing & Financial Services Ltd.*, 2018 SCC OnLine NCLAT 1074.

[34]*Id.*

[35]*Id.*

that Section 53 of the IBC be made applicable for the distribution of sale proceeds to creditors.[36]However, the NCLAT *vide* its Order dated March 12, 2020obviated to follow the waterfall mechanism under Section 53 of IBC on the grounds that "public interest" was involved.[37]This stemmed from the apprehension that if Section 53 is followed it would lead to shareholders who are public listed companies losing the money invested by them, which is also public money, in purchasing the shares of IL&FS.

In IL&FS's case, only the holding company and few other entities in the IL&FS Group were FSPs, and at the time neither the FSP rules nor regulations pertaining to the insolvency resolution of group entities were notified. Although provisions for group insolvency are yet to be crystalised in statute, precedence has established the practice of consolidation of intricately interlinked entities – which required the determination of financial interdependence between entities before consolidation or separation.[38] However, in the case of IL&FS, this consolidation was done without deliberation on such lines. It may also be noted that, contrary to the general norms for the resolution of FSPs, the resolution was undertaken without the involvement of relevant regulation authorities.[39] Further, the Committee of Creditors ("**CoC**") included IL&FS Group Companies (related party lenders) and was constituted post the H1 bid.[40] In this manner, the resolution framework deviated from established principles of

[36] *Id* para.10.
[37]*Id* para. 56 - 65.
[38]*State Bank of India v. Videocon Industries Limited*, 2019 SCC OnLine NCLT 745.
[39]Singh,*supra* note 32.
[40]Anurag Tripathi, *Jumping the Wall from East Berlin to West Berlin*, SCC OnLine Blog OpEd 19 (2020).

insolvency. In addition, the Government had to grapple with a lack of a centralising effect that would allow them to control, and which could engineer a calm period using their broad powers.

Essentially a form of bail-out,[41] the aftermath of the IL&FS crisis saw borrowing and lending transactions of NBFCs decline with a report suggesting that lending by NBFCs in the real estate sector had fallen by Rs 25,000 Crores (INR Twenty-Five Thousand Crores).[42]

Other instances of anomalies include the NCLT's approach in *Apeejay Trust v. Aviva Life Insurance Co. India Ltd*.,[43] wherein it was held that an operational creditor, having a claim in respect of leave and license and service tax amount was eligible to initiate CIRP against an insurance firm.[44] The rationale given was the operational creditor could trigger IBC against the insurance company since the claim was not in relation to any financial services provided by the insurance company.[45]

B. The FSP Rules as an Interim Solution

IL&FS's resolution highlighted the absence of regulatory processes to resolve FSPs outside the purview of the Code, and without judicial approval which can equally bind all stakeholders. Fortunately, *vide* the Government's Notification dated November 29, 2019, DHFL became the first FSP to be

[41] Joyjayanti Chatterjee, *The Case for a Specialised Resolution Law for Financial Institutions*, NLS BUS L REV. 43 (2018).
[42] '*IL&FS Default Impact: NBFCS, HFCS Lending To Real Estate Almost Halved In FY'19 To Rs 27,000 Cr, Says Report*', FIRST POST (July 25, 2019), available at: https://www.firstpost.com/business/ilandfs-default-impact-nbfcs-hfcs-lending-to-real-estate-almost-halved-in-fy19-to-rs-27000-cr-says-report-7055161.html.
[43] *Apeejay Trust v. Aviva Life Insurance Co. India Ltd.*, 2019 SCC OnLine NCLT 628.
[44] *Id* at11.
[45] *Id*.

admitted into CIRP under Rule 5 of the FSP Rules.[46] However, the absence of notification at that point in time, of clear rules regarding the treatment of third-party assets, gave rise to multiple litigations against the Corporate Debtor.[47]

The conundrum emerged in light of DHFL's capacity as a servicing or collection agent and the assets and receivables it held in trust under such capacity vis-à-vis the securitisation agreements entered into by it. Pursuant to the moratorium declared by the Bombay High Court,[48] DHFL was of the view that any transfer of collections from the securitised assets, and/or liquidation of cash collateral would be in violation of the Order. Thus, no collection was deposited in the respective collection and payout account and without a notification from the Central Government clarifying the position, the trustee's access to the cash collateral remained restricted[49]. The aggrieved banks moved interim applications seeking modification to the Order pursuant to which the High Court of Bombay *vide* its Order dated November 13, 2019, clarified that DHFL is not prevented from making payments overdue or payable under the securitisedon agreements in favour of the assignees of loans.

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[46] RBI, Press Release, Application for initiation of corporate insolvency resolution process against Dewan Housing Finance Corporation Limited filed under the Insolvency and Bankruptcy Code, 2016 (Nov. 29, 2019), available at:https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=48747.

[47] *Air Force Group Insurance Society v. R. Subramaniakumar*, 2022 SCC OnLine NCLAT 827; *Vinay Kumar Mittal v. Dewan Housing Finance Corpn. Ltd*., 2022 SCC OnLine NCLAT 42; *Raghu KS v. R. Subramaniakumar*, 2022 SCC OnLine NCLAT 2222.

[48] *Reliance Nippon Life Asset Management Ltd. v. Dewan Housing Finance Corporation Ltd.*, Commercial Suit (L) No. 1034 of 2019.

[49] Vinod Kothari, *Insolvency of FSPs and Third Party Rights Under Securitisation Contracts*(Feb.2020), available at: https://vinodkothari.com/2020/02/insolvency-of-fsps-and-third-party-rights-under-securitisation-contracts/.

Before this Order dated November 13, 2019 was passed there was also tension in the air as the charge holders (in relation to the debentures issued by DHFL), made a claim of having *pari-passu* charge over the receivables that were transferred via securitisation transactions by DHFL.[50]Although the Court did not rule specifically on this question of law, it asserted the concept of bankruptcy remoteness by keeping the securitised receivables outside the purview of the moratorium.

In remedy and to prevent any such future contingencies, the MCA in its Notification clarified that in context of receivables, if the FSPs are under an obligation to service or act as a collecting agent of third-party assets then the administrator shall continue to discharge the obligations of the FSP.[51]Similarly, in the case of maintenance of third-party assets in custody or possession of the FSP – who is under obligation to return them, the administrator is to return/transfer the assets as per the terms of the contract.[52] Thus, read with Rule 10 of the Rules, it was made clear that the moratorium period under Section 14 of the Code, and Rule 5(2) of the Rules did not apply to third-party assets.

However, DHFL's resolution also raised questions in respect to the role and accountability of the Administrator appointed under Rule 5(a)(iii), towards the CoC. In DHFL's case, the Administrator, and the Advisory

[50]*Edelweiss Asset Management Limited v. Dewan Housing Finance Corporation*, Commercial Suit (L) No. 1066 of 2019; Radhika Merwin, *DHFL Bankruptcy raises questions over securitisation*; THE HINDU(Aug. 17, 2020), available at: https://www.thehindubusinessline.com/money-and-banking/dhfl-bankruptcy-exposes-chinks-in-insolvency-code/article32377274.ece.
[51]Notification No. S.O. 464(E), Ministry of Corporate Affairs(Jan. 30, 2020), available at:https://www.mca.gov.in/bin/ebook/dms/getdocument?doc=ODM0Ng==&docCategory=NotificationsAndCirculars&type=open.
[52]*Id*.

Committee,[53] were appointed by the RBI prior to the admission of DHFL into CIRP and continued their roles during the resolution process[54]. Here, the concern stems from the fact that a resolution professional operates as a *de facto* agent of the CoC, however, an Administrator might serve the RBI first and foremost.

While the FSP Rules work to supplement the Code,[55] ambiguities remain with respect to the overarching insolvency resolution framework. In the case of *Shapoorji Pallonji Finance (P) Ltd. v. Rekha Singh*,[56] the court had to clarify that the insolvency resolution process can be initiated against a personal guarantor of an NBFC irrespective of any CIRP proceedings against the NBFC falling within the definition of the notified FSPs. The NCLAT iterated that reduction of the asset size of the NBFC below 500 crores during the pendency of CIRP proceedings would not take away the jurisdiction of the Adjudicating Authority as such conclusion would run contrary to the purpose of the insolvency and resolution process.

C. Resolution of Banks

Given the non-applicability of the FSP Rules to banks, the RBI exercised its powers under the Banking Regulation Act, 1949 in formulating a reconstruction scheme for YES Bank.[57]In paragraph 6 of the draft

[53]The Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, Ministry of Corporate Affairs, rule 5(c)(2019).
[54]*RBI supersedes DHFL board, appoints an administrator*, THE HINDU BUSINESS LINE (Nov. 20, 2019), available at: https://www.thehindubusinessline.com/money-and-banking/rbi-superseded-dhfl-board-to-initiate-nclt-proceedings-soon/article30028077.ece.
[55]*Sasakawa India Leprosy Foundation v. Union of India*, 2022 SCC OnLine Del 4901.
[56]*Shapoorji Pallonji Finance (P) Ltd. v. Rekha Singh,* 2023 SCC OnLine NCLAT 31.
[57] BR Act, ss.45, 36ACA.

reconstruction scheme 2020, the RBI proposed to write off the Additional Tier 1 Bonds ("**AT1 Bonds**")[58].This draft scheme invited suggestions and consequently the RBI published the final reconstruction scheme which omitted the clause that postulated writing down AT1 Bonds. Despite such omission in the final scheme of reconstruction, the Administrator went ahead and wrote off the AT-1 bonds. Adding onto the web of complexity, it may be noted that the order of write down prescribed in the information memorandum in respect of the respective AT-1 Bonds stipulates the writing down of common equity capital before writing down AT1 Bonds[59]. The act of writing down AT1 Bonds was initially set aside and quashed by the Bombay High Court[60]. It was held that after the bank is reconstituted the Administrator is not empowered to make a policy decision on writing off the debentures, nor does the approved reconstruction scheme allow for such writing off.[61]A stay of this order was granted by the Hon'ble High Court which was extended by the Apex Court *vide* its Order dated March 03, 2023[62]. The final order in this case is still awaited. In contrast, in the case of Credit Suisse's Contingent Convertible Bonds, the resolution authority was empowered by special legislation to write-off, which aided in the successful resolution of the bank.[63]

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[58]*Axis Trustee Services Ltd. v. Union of India*, 2023 SCC OnLine Bom 180 at para. 72.
[59] Manick Wadhwa &Anivesh Bharadwaj, *Riskier than Equity - Case Study of AT1 Write-Down of Yes Bank Limited* (Apr. 19, 2022),available at: https://ssrn.com/abstract=4087180 or http://dx.doi.org/10.2139/ssrn.4087180.
[60]*Axis Trustee Services Ltd. v. Union of India*, 2023 SCC OnLine Bom 180.
[61]*Id*para. 95 – 98.
[62]*Yes Bank Limited v. Axis Trustee Services Limited*, Special Leave to Appeal (C) No (s). 3717/2023.
[63] Edoardo Martino & Tom Vos, '*Credit Suisse CoCos: Why the Write-Down Makes Sense*', Oxford Business Law Blog(Apr. 16, 2023), available at:https://blogs.law.ox.ac.uk/oblb/blog-post/2023/04/credit-suisse-cocos-why-write-down-makes-sense.

According to a Fitch Ratings Report on YES Bank's bail-out: "*Absent a formal resolution framework for financial institutions in India, the onus ultimately falls on the regulator to orchestrate the process under powers provided by the RBI Act, which outlines voluntary or forced mergers as the available options*."[64]

V. CONCLUSION

From the above discussion, it is clear that Indian policymakers always envisioned a separate insolvency resolution regime for FSPs. While the FSP Rules have been notified for certain categories of FSPs, including NBFCs (and housing finance companies), as per the recommendations of the Executive Director of the RBI – there is still a need for a special resolution regime.[65] It should be noted that the implementation of a modified FRDI Bill was suggested in the same vein as the drafting of the FSP Rules.[66]

While the Rules have had a degree of success with DHFL, given that the principles of insolvency are the same as applied for corporate debtors, this is not a long-term solution. The resolution of notified FSPs, banks, and insurance companies under different legislations also presents a fragmented resolution regime, which does not provide the much-needed certainty to stakeholders.

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[64]'*Indian Govt Takeover of Yes Bank Highlights Systemic Risks*', Fitch Rating (Mar. 6, 2020), available at: https://www.fitchratings.com/research/banks/indian-govt-takeover-of-yes-bank-highlights-systemic-risks-06-03-2020.

[65]Report Of The Sub-Committee Of The Insolvency Law Committee For Notification Of Financial Service Providers Under Section 227 Of The Insolvency And Bankruptcy Code, 2016 (Oct. 4, 2019).

[66]*Id.*

Unlike corporate debtors, FSPs must prioritise financial stability over value maximisation and must have preventive trigger points prior to the occurrence to a default under Section 4 of the Code. Further, early termination of rights such as termination of financial contracts other than of essential goods and services,[67] in case of an FSP's default on any contract would adversely affect the FSP's business and could impact the economy as a whole. For example, if an FSP were to stop making payments to its creditors (a large part of which are other FSPs) there could be torpedo defaults. Further, there are instruments in the name of subordinated debt and perpetual debt which are issued by FSPs, which are not necessarily debt as understood from the perspective of the balance sheet of a corporate debtor, and which needs a different treatment from debt on the balance sheet of a corporate debtor.

Therefore, in addition to the Code, there is a requirement for a comprehensive legislation to address the insolvency/resolution of FSPs and a different set of standards and a waterfall for guiding such insolvency/resolution.

[67]Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016, rr.32.

Siddharth Srivastava & Avni Shrivastav,*Turbulence in the Indian Skies: Aviation Industries' Tryst with the Insolvency Regime*, 11(1) SCHOLASTICUS 120 (2024).

TURBULENCE IN THE INDIAN SKIES: AVIATION INDUSTRIES' TRYST WITH THE INSOLVENCY REGIME

Siddharth Srivastava[⊥] *& Avni Shrivastav*[ø]

Abstract

*The article investigates the recurring issue of insolvency in the Indian aviation industry, highlighted by the high-profile collapses of Kingfisher Airlines and Jet Airways. They delve into the industry's inherent challenges, such as high operational costs, fuel price volatility, and sensitivity to external factors. A significant portion of the paper is dedicated to analysing the handling of airline insolvencies under India's Insolvency and Bankruptcy Code ("**IBC**"). The authors discuss the unique challenges in this sector, including the intricacies of managing cross-border lease agreements and defaults. The role of resolution professionals in this context is also explored. Another critical focus is the impact of India's non-ratification of the Cape Town Convention. This decision has considerable repercussions for asset recovery in international insolvency cases, affecting the rights and protections of lessors, lessees, and creditors in the aviation industry. The article concludes with a discussion on the need for a more nuanced approach to managing airline insolvencies in India. The authors argue for reforms that balance stakeholder interests and encourage industry growth. They emphasise the importance of India aligning its insolvency processes with global standards, particularly through the ratification of the cape Town Convention, to enhance investor confidence and support the recovery and stability of the Indian aviation sector.*

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I. INTRODUCTION

In 1903, the Wright brothers introduced and inaugurated the air space with the first successful flight[1]. Since then, known as Wright Flyer to the Boeing today, the aviation industry has made breakthrough structural developments. However, the unrelenting surge in the industry has been challenged and curtailed by issues such as high fixed costs, volatility in fuel costs and vulnerability to external determinants.

Over the years, India has emerged as one of the largest domestic civil aviation markets[2], however, the paradox here is that such a burgeoning industry has also witnessed airline companies facing financial constraints leading to piling up bankruptcy petitions. Unfortunately, no cure-all has been found for such airline insolvencies and there are already instances where Indian airlines have failed to successfully exit from their financial distress.

One of the earliest instances of an airline being grounded was the high-profile airline, Kingfisher Airlines, which eventually turned into shambles[3].Amongst other reasons, a series of government policies had also contributed to the airline suffer a serious market failure. Similarly, four years

[1] John Uri, *115 years ago: Wright brothers make history at Kitty Hawk*, NASA (Dec. 17, 2018), available at: https://www.nasa.gov/history/115-years-ago-wright-brothers-make-history-at-kitty-hawk/.

[2] STATISTA, available at: https://www.statista.com/markets/419/topic/490/aviation/#statistic5.

[3] *History of India's private airlines dotted with high profile take off and crash landing*, ECONOMIC TIMES(May 2, 2023), available at: https://economictimes.indiatimes.com/industry/transportation/airlines-/-aviation/history-of-indias-private-airlines-dotted-with-high-profile-take-off-and-crash-landing/articleshow/99940195.cms.

ago the operations of Jet Airways were suspended, and the entire fleet was grounded.[4] The debilitated airline since then has been traversing its way through the insolvency regime of India, and even though its resolution plan has been approved for over a year[5], the airline is yet to take off and the operations are yet to recommence.

In this article we have analysed the insolvency regime in India and the industry specific nuances that arise in an airline insolvency.

II. OVERVIEW OF INSOLVENCY AND BANKRUPTCY CODE, 2016 AND THE INDIAN EXPERIENCE *VIS-À-VIS* AVIATION INDUSTRY

The Insolvency and Bankruptcy Code, 2016 ("**IBC**") is the poster child of an ideal model law empowering the restructuring and resolution of financially distressed firms in a fair and balanced manner by maximising recoveries to the debtor's claimants. The Insolvency Resolution Process under the IBC essentially functions in the manner where a resolution plan is proposed for all the stakeholders of the debtor, ideally within an outer timeline of 330 days.[6] The creditors and stakeholders are bound by such plan only if the creditors' committee (primarily comprising of financial creditors) accepts the plan. The plan is confirmed once the creditors' committee votes on the plan and approves it, and such plan receives further assent of the insolvency tribunal. Upon being confirmed, the creditors and stakeholders are bound to the treatment provided under such a plan.[7] A

[4]*State Bank of India v. Jet Airways (India) Limited*, 2019 SCC OnLine NCLT 7875.
[5]*Punjab National Bank v. Ashish Chhawchharia,* 2022 SCC OnLine NCLAT 4996.
[6]Insolvency and Bankruptcy Code, 2016, § 12, No. 31, Acts of Parliament, 2016 (India).
[7] Insolvency and Bankruptcy Code, 2016, § 31, No. 31, Acts of Parliament, 2016 (India).

cram down is triggered if the financial creditors reject the plan; however, fail to constitute the requisite majority to oust the plan.

In addition to the overview above, there are nuances to airline insolvency. Unlike a regular corporate insolvency, the proceedings against an airline company have to grapple with issues such as the purchase and lease agreements of aircraft, rules and regulations of the airline industry, and the cross-border agreements due to the industry's mobile nature of business.

Furthermore, the Insolvency Resolution Professional appointed to manage the operations and insolvency resolution of the airline would have to take charge of additional issues. The task awaiting a Resolution Professional in any insolvency includes assimilating all the information and dealing with counterparties and stakeholders. Given the nature of the airline industry, in the event of an airline insolvency, the Resolution Professional additionally has to deal with cross-border defaults and provisions for the same in the airline's contracts like lease agreements, termination of leases and sub-leases, initiating necessary action to recover property from various jurisdictions depending, upon the size and geographical reach of the airlines, understanding the status of the aircraft owners and lessors and whether they can regain possession of their aircrafts and deciphering the stake of customers of the airline.

Since the implementation of IBC, the insolvency proceedings against Jet Airways have set the precedent with respect to airline insolvency in India. The operations of Jet Airways came to a halt in 2019 and underwent an insolvency resolution procedure under IBC for almost two years and have been struggling to implement the approved plan since then. The

repossession by leasing firms of aircrafts and aircraft objects held by Jet Airways was one of the many issues faced during the insolvency resolution of Jet Airways[8].

Despite the structural hurdles, a Resolution Plan for Jet Airways was approved by the NCLT in 2021 and such plan under law is binding not only on Jet Airways, but also on its workers, members, creditors, guarantors, and any stakeholders engaged in the resolution plan, including the Central Government, any State Government, or any local body to whom a debt is owed.

However, as has been witnessed in numerous cases, despite the approval of resolution plans by the NCLTs, the promoters, lenders, workmen, government authorities and resolution applicants have often been in conflict for numerous reasons consequently thwarting the resolution plan's implementation. There are certain issues that are faced across industries, such as the challenge that has been raised by the employees and workmen in various cases against the deduction accorded to them in terms of the unpaid provident fund and gratuity dues. While the issue has been settled by the Supreme Court directing that all unpaid provident fund and gratuity dues of employees should be settled *in toto,* in an aviation industry insolvency where there are substantial gargantuan liabilities owed towards creditors, such rulings would require lenders to incur some haircut, which

[8] *Jet Airways Boeing 777 fleet at risk of repossession as airline delays bank repayment,* BUSINESS TODAY(April 8,2019), available at: https://www.businesstoday.in/industry/aviation/story/jet-airways-boeing-777-fleet-at-risk-of-repossession-as-airline-delays-bank-repayment-183597-2019-04-08.

is seldom acceptable to them.[9] Besides such pan-industry issues, aviation insolvencies bring their own industry-specific peculiarities as well, such as the requirement for reinstatement of operations on the debtor's historic slots.[10] Reinstating the debtor's historic slots should generally not pose significant difficulties. However, if the company has experienced a prolonged operational halt during the insolvency process, it could become challenging for potential resolution applicants to regain access to the debtor's previously held positions and historic slots.

The impending resolution and implementation of the resolution plan can thus loom like a dark cloud over the future of these companies. Owing to these anomalies, resolution applicants can find the task of finalising a resolution plan that can pass the muster of approval from the creditors and the courts gruelling. India is yet to see if in the current insolvency regime, an aviation company undergoing insolvency would emerge successful from the resolution process and see the light of the day or head for liquidation.

III. OVERVIEW OF THE CAPE TOWN CONVENTION

Given that the assets of an airline company are often moved through different countries and jurisdictions, it was felt that at a global level a regime is required that would give and safeguard the rights of owners, lessors, lessees, and creditors of an airline company. The Cape Town Convention

[9]The Supreme Court affirmed the order passed by the NCLAT in the matter of *Jet Aircraft Maintenance Engineers Welfare Association v. Ashish Chhawchharia, Resolution Professional of Jet Airways (India) Limited*, 2022 SCC OnLine NCLAT 418.

[10]*Troubles of Indian aviation Industry,* THE HINDU(May 13,2023), available at: https://www.thehindu.com/news/national/explained-the-troubles-of-indias-aviation-industry/article66836343.ece.

on International Interests in Mobile Equipment[11] and the Protocol on Matters Specific to Aircraft Equipment[12] ("**Cape Town Convention**") was drafted to cover this lacuna and work as a body of law that would apply uniformly throughout the globe. While India has signed the Cape Town Convention, the same is yet to be ratified and therefore its provisions are still not enforceable in India.

Once an airline company enters the insolvency regime, the courts are customarily required to go beyond their domestic insolvency regime, particularly when dealing with creditors, lessors, or lessees whose primary jurisdiction is beyond their domestic territory. The Cape Town Convention enables courts to traverse through jurisdictions and deal with the peculiarities of airline insolvency. The Cape Town Convention provides two alternative remedies upon admission of an airline company into insolvency, **Alternative A and Alternative B**. Both these alternative remedies essentially provide for a standby period during which creditors can assess and with court assistance, repossess the aircraft or aircraft object if the debtor has not cured the defaults. However, the degree of protection accorded in these alternatives varies.

Under Alternative A, upon occurrence of an insolvency event, if the debtor or the administrator fails to cure all defaults and do not agree to comply

[11] UNIDROIT & ICAO, Convention on International Interests in Mobile Equipment, signed at Cape Town on 16 November 2001, available at: https://www.unidroit.org/instruments/security-interests/cape-town-convention/.
[12] UNIDROIT & ICAO, Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment, signed at Cape Town on 16 November 2001, available at: https://www.icao.int/sustainability/Documents/CPTConvention_Protocol_AnnexB.pdf.

with the future contractual obligations by the end of the standby period, the debtor or the administrator will be required to relinquish their possession over the aircraft or the aircraft object. On the other hand, in Alternative B, upon the request of the creditor, the debtor or the administrator is required to give notice to the creditor on whether it will be able to cure all defaults and perform future contractual obligations or if the creditor can take repossession of the aircraft or aircraft object.[13]The degree of protection varies as unlike, in Alternative A where the creditor if guaranteed that either the debtor or administrator will cure the defaults or surrender the aircraft or aircraft object, in Alternative B, it becomes prudent for the lessor or financier to act swiftly and request the debtor or administrator to clarify their intent in terms of curing defaults or granting repossession.

IV. AVIATION INDUSTRY *VIS-À-VIS* IBC: LOOMING PENDENCY AROUND THE CAPE TOWN CONVENTION

India, not being a signatory to the Cape Town Convention has had dire consequences in situations of airline insolvency and bankruptcy, as the courts in India are impeded from enabling recovery of assets of airline companies, particularly those located outside the Indian jurisdiction.

Under IBC, upon insolvency being initiated, a moratorium is imposed on the debtor that is akin to an automatic stay, thus protecting the debtor and

[13]Jeffrey Wool and Andrew Littlejohns, *Cape Town Treaty in the European context: The case for Alternative A, Article XI of the Aircraft Protocol*, Airfinance Annual, available at: http://awg.aero/wp-content/uploads/2019/10/capetowntreatyinthe-europeancontext.pdf

its assets from actions against it while it is being reorganised and its insolvency is being resolved. Being subject to the automatic stay relief, the debtor is protected and has the right to protect its property and assets and the creditor is precluded from exercising any remedy to recover its debt or from repossessing its collateral[14].

Aircrafts and aircraft objects and parts are considered as high value capital assets and typically airlines acquire such assets through capital or financial leasing[15]. Considering that airline assets are capital-intensive, grounding such assets for a long duration not only causes loss of financial value of such assets, but also imposes colossal financial obligation that is incurred in maintenance of these assets. It is in such situations that the Cape Town Convention comes to the rescue of the creditors by providing them a window to assess and repossess the aircraft or aircraft object. However, given that India has not ratified the Cape Town Convention, moratorium imposed on the debtor casts a shadow on the creditors from recovering their assets. The most crucial lacuna of the absence of provisions honouring the Cape Town Convention has been felt in relation to such assets.

To address this lacuna, on October 3rd2023, a notification was issued by the Ministry of Corporate Affairs stating that the provisions of moratorium will not apply to transactions, arrangements or agreements under the Cape Town Convention relating to aircraft, aircraft engines, airframes, and helicopters.[16]

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[14]Insolvency and Bankruptcy Code, 2016, § 14, No. 31, Acts of Parliament, 2016 (India).
[15]BIJAN VASIGH ET AL., AIRCRAFT FINANCE: STRATEGIES FOR MANAGING CAPITAL COSTS IN A TURBULENT INDUSTRY (J. Ross Publishing, 2012).
[16] Ministry of Corporate Affairs, S.O. 4321(E)- *Notification under Section 14(3)(a) of IBC for transactions, arrangements or agreements , under the Convention and the Protocol, relating to aircraft,*

While aircrafts, aircraft objects and parts are now outside the purview of moratorium, it is still of paramount importance that the Parliament ratifies the Cape Town Convention as that would instil greater confidence in the intending creditors resulting in reduction of the risk applicable to asset-based financing and leasing transactions. Such risk reduction can also result in reduction in the cost of aviation credit and bring down the lease rentals. As a domino effect, the reduction in the lease rentals will also be beneficial for the passengers and customers as reduced lease rentals can lead to a dip in the pricing and increase the levels of service.

Pursuant to the recent developments in the aviation industry in India, the Parliament is contemplating passing a bill to ratify the Cape Town Convention under a specific legislation titled "The Cape Town Convention Act"[17]. Such ratification to implement the Cape Town Convention in India shall assist in discharging of the treaty obligations and availing benefits of the treaty that India has acceded to.

The ratification of the Cape Town Convention also becomes important to protect the rights and status of the lessors. If the lessors are not permitted to repossess their assets, under the IBC regime, such contractual arrangements will be considered as operational leasing arrangements and accordingly the debt owed to the lessors would be termed as operational debt. The classification as operational creditors will not only limit the

aircraft engines, airframes and helicopters, dated October 03, 2021, available at: https://www.mca.gov.in/content/mca/global/en/acts-rules/ebooks/notifications.html.

[17]*The Cape Town Convention Bill, What is it and why is India introducing it?,*BUSINESS STANDARD(June 26, 2023), available at: https://www.business-standard.com/india-news/the-cape-town-convention-bill-what-is-it-and-why-is-india-introducing-it-123062600444_1.html.

decision-making and bargaining power of such lessors but would also put them in the bottom of the hierarchy that helps determine the priority of payments.

On the flip side, however, if the Cape Town Convention is ratified in the form it has been proposed by the Ministry of Civil Aviation, we are likely to end up in a scenario where both the IBC and the Cape Town Convention Act, when passed, will contain non-obstante clauses. A non-obstante clause assists in determining the supremacy of legislation, in the event the two legislations are conflicted. The precedent rule also remains that in the event of conflict between two legislations containing the non-obstante provision, the latter legislation will prevail[18]. While such provision will grant added protection to the lessors and contractual parties, it would also imply that the debtor would be unable to seek continuation of the contractual arrangements during the insolvency resolution process. Such non-obstante provisions could thwart the attempt of the debtor to continue its operations as a going concern during its insolvency resolution and remain operational. If Cape Town Convention holds primacy over IBC, the termination of leases and contractual arrangements that are essential for the operations of the debtor would become possible and permissible.

V. CONCLUSION

While Jet Airways is the only Indian airline company that has undergone the insolvency resolution process, it is not the only instance of an airline company in India facing a downfall. While Kingfisher Airlines and Sahara Airlines witnessed a downfall in the pre-IBC era, in the post-IBC regime

[18]*Solidaire India Ltd. v. Fair Growth Financial Services Ltd.*, (2001) 3 SCC 71.

also there have been looming bankruptcies. The petition for insolvency initiation has already been admitted in Go First and another rival low-cost airline has been firefighting to stay afloat and keep itself out of an insolvency situation and it can only be hoped such attempts are not too little too late[19]. India's oldest and largest fleet held by Air India also in the recent past faced unprecedented losses and was on the brink of collapse when the Tata Group emerged as its white knight and saved the catastrophic downfall[20].

Such frequent instances of airline companies failing to keep themselves afloat is bad news for the aviation industry and confers a negative reputation on the Indian aviation industry, as even one airline going bust shakes the confidence of lenders, lessors, and other stakeholders and makes them wary of the Indian aviation space. Such negative reputation also translates to high lease rentals and stringent contracts, which overall leads to skyrocketing costs of operation for airlines.

The way means of transport have emerged over the last few years particularly in the aviation industry, there is an increasing need on countries to have easy access to aircrafts and aircraft objects. It has been a market trend for airlines to procure such aircrafts and aircraft objects on lease due to the general high costs in procurement and maintenance. At a glance, Cape Town Convention and IBC may appear to be at loggerheads, as the

[19] Monica Behura, *NCLT admits Go First Airlines Insolvency Plea,* ET LEGAL WORLD(May 10, 2023), available at: https://legal.economictimes.indiatimes.com/news/editors-desk/nclt-admits-go-first-airlines-insolvency-plea/100128468.

[20] Aijaz Basit, *Air India: The History of India's Oldest Airline,* INDIA TIMES(October 01, 2021), available at: https://www.indiatimes.com/trending/social-relevance/air-india-history-in-timeline-550675.html.

Cape Town Convention principally acts as an impediment to the objective of the IBC to keep companies as a going concern, however, in the larger sense, the ratification of the Cape Town Convention would have myriad of great outcomes. ***First***, it would make India investor friendly in the global scale by according to investors due protection in the event of financial downfall of an airline. ***Second***, it would support secured asset-based financing which would further attract global participants. ***Last***, the airline industry is heavily regulated and there are numerous limitations that are imposed in relation to the manner in which such airlines can operate and the ease with which enforcement actions can be taken. Further, given that the assets of this industry traverse across jurisdictions, by ratifying the Cape Town Convention, India would become a part of the global regime which can not only help tackle leasing arrangements but also streamline solutions in the event of conflict of laws and cross-border issues in distressed situations.

Further, airlines going bust is a global phenomenon as it is a high-risk business demanding deep pockets. It may also not be all gloom for the Indian aviation industry, as airline players going off the market gives space and scope for new players to emerge. However, it is only beneficial if these winding up airlines are making space for more robust players replacing them instead of more of the same models emerging.

Aditya Hiremath, *Materiality –Principle that evades determination in the context of Insider Trading: Reincorporating "Material Events" in the UPSI Definition*, 11(1) SCHOLASTICUS 133 (2024).

MATERIALITY – THE PRINCIPLE THAT EVADES DETERMINATION IN THE CONTEXT OF INSIDER TRADING: REINCORPORATING "MATERIAL EVENTS" IN THE UPSI DEFINITION

Aditya Hiremath[⊥]

ABSTRACT

The determination of materiality in securities law is a concept that has evaded precise determination across jurisdictions owing to its characteristic nature of being a mix of both subjective and objective criteria. The SEBI has observed that leaving the determination of materiality of information up to listed entities themselves has not led to prompt disclosures of such information to the stock exchanges despite having a price sensitivity effect on share prices. The SEBI has expressed its intent on reincorporating "material events" as part of the UPSI definition in order to ensure that listed entities report all material information with an element of impact on share prices to the stock exchanges in the interest of combating insider trading. However, doing so may conflate the concepts of 'materiality' and 'UPSI', leading to unnecessary complications. In light of the same, the author has proceeded to evaluate determination of materiality across jurisdictions, identify problems in the current status quo, and recommend solutions to ameliorate the situation.

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I. INTRODUCTION

It has become more commonplace amongst listed companies to incentivise top performance with respect to their executive management through providing for a framework that allows the top management to capitalise upon the direct correlation between increasing stock prices and shareholder wealth through the offer of voluminous stock options and purchase plans.[1] This has also had the deleterious effect of incentivising the use of "material", "unpublished price sensitive information" to manipulate stock market behaviour. Unmitigated insider trading risks a loss of investor confidence and creates unnecessary instability within the secondary market. The very phenomenon of insider trading is at odds with a democratic investment environment. This is precisely why the market regulators across the world have been fighting tooth and nail to cull the menace of insider trading. UPSI is defined as "*any information, relating to a company or its securities, directly or indirectly, that is not generally available which upon becoming generally available, is likely to materially affect the price of the securities*.[2]" The Committee of the Fair Market Conduct, through its report[3] on August 08th , 2018, recommended that "material events" be omitted from the definition of UPSI since it was observed that disclosure of material information is already inclusive under Regulation 68 of the Listing Obligations and Disclosure

[1] Core, J.E., Guay, W.R.Larcker, D.F., *"Executive equity compensation and incentives: a survey"* 9ECONOMIC POLICY REVIEW 27 (2003).

[2] Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015, Regulation 2 (1)(n), LAD-NRO/GN/2014-15/21/85, The Gazette of India Extraordinary Part-III-Section 4, 2015 (India).

[3]Amendments toSEBI (PFUTP) Regulations andSEBI (PIT) Regulationstoimplement recommendationsofthe Committee on Fair MarketConduct, SEBI,available at: https://www.sebi.gov.in/sebi_data/meetingfiles/oct-2018/1539342662909_1.pdf.

Requirements[4] Regulations and that not all of this information may be price sensitive. Therefore, the committee recommended the removal of the same from the definition of UPSI under PIT Regulations.

However, the Securities and Exchange Board of India noticed that the omission of 'material events' from the UPSI definition has had the effect of a lack of prompt disclosure of material information as UPSI – this issue has come to the fore in light of observations by the SEBI that material events that do have an effect on prices of stocks and that should rightfully come under the definition of UPSI, are not being reported to the stock exchanges.[5] The SEBI noticed that only those events were being reported as UPSI that were explicitly mentioned under the definition of UPSI in the PIT regulations. The situation comes across as a glaring lacuna that seems to allow insiders to get away scot-free with insider trading. In order to remedy the situation, the SEBI has released a consultation paper[6] seeking to realign the definition of "Unpublished Price Sensitive Information" by

[4] Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, Regulation 68, SEBI/LAD-NRO/GN/2015-16/013, The Gazette of India Extraordinary Part-III-Section 4, 2015 (India).

[5]Ranjith Krishnan Subramanian &Usha Ganapathy, *Sebi to realign UPSI definition with material events to curb insider trading*, LIVEMINT (May 30,2023, 11:18 PM), available at: https://www.livemint.com/money/personal-finance/sebi-proposes-to-redefine-upsi-to-deter-insider-trading-aligning-it-with-material-events-disclosure-for-greater-transparency-11685468934515.html.

[6]Consultation Paper on proposed review of the definition of Unpublished Price Sensitive Information (UPSI) under SEBI (Prohibition of Insider Trading) Regulations, 2015 to bring greater clarity and uniformity of compliance in the ecosystem, SEBI, available at: https://www.sebi.gov.in/reports-and-statistics/reports/may-2023/consultation-paper-on-proposed-review-of-the-definition-of-unpublished-price-sensitive-information-upsi-under-sebi-prohibition-of-insider-trading-regulations-2015-to-bring-greater-clarity-and-uni-_71337.html.

reincorporating the provisions as mentioned under Regulation 30 of the SEBI Listing Obligations and Disclosure Requirements, 2015.

II. MATERIALITY WITH RESPECT TO INSIDER TRADING LAW IN THE UNITED STATES

Section 10 (b)(5) of the Securities Exchange Act, 1934[7] prohibits the use of "manipulative or deceptive devices" in contravention to rules laid down by the commission for investor protection. This is the chief legislative provision on the practise of insider trading in the states.

The determination of materiality in the USA is often predicated upon the commonly referred to ***TSC-Basic rubric*** which is based upon two prominent US Supreme Court definitions on the determination of materiality[8]. A fact is material "if there is a 'substantial likelihood' that a reasonable investor would view it as "significantly altering the 'total mix' of available information.[9]" What this entails is a determination of whether such information, if released, would tend to have a substantial effect on the already existent public information available on the concerned entity.

The Security and Exchange Commission ("**SEC**") ruled in the case of ***Inre Cady, Roberts & Co***.[10] that a corporate insider is required to refrain from engaging in trading activities involving their company's shares unless they have previously revealed any material non-public information within their knowledge. The approach has been to ensure that insiders abstain from

[7] Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (2000).
[8] *TSC Industries v. Northway, Inc*., 426 U.S. 438, 449 (1976);*Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).
[9] *Id.*
[10] *In re Cady, Roberts & Co.,* 40 S.E.C. 907, 911 (1961).

trading or ensure appropriate disclosure prior to trading in the interest of investors at large.

In the United States, material, non-public information is equivalent to asymmetric information with price-moving potential.[11] "Materiality" is concerned with three primary determinations:

1) That the information is of a non-public nature (Therefore, creates information asymmetry).
2) That the information is related to the future financial performance of the company.
3) When such information is released to the public, investor behaviour in reaction to such a release will affect the stock price movement.

It is not necessary that non-public information is always material. The materiality of non-public information "depends on public disclosure". Therefore, without public disclosure, materiality cannot be said to be proved. The challenge for the securities regulator lies in demonstrating the significance of undisclosed information as "material" before it is publicly announced.

Since it was held in the judgement in the case of ***United States v. Newman*** [12]that 'scienter' or 'intent' is required to be proved in cases of commission of securities fraud, the burden of proof on the prosecution is even greater.

[11]Viktoria Dalko, Michael H. Wang,*Why is insider trading law ineffective? Three antitrust suggestions*, 33 STUDIES IN ECONOMICS AND FINANCE 704, 709 (2016).
[12]*United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).

III. MATERIALITY WITH RESPECT TO INSIDER TRADING IN IRELAND

Section 108 of the Companies Act, 1990 lays down the provision against insider trading and bears a strong resemblance to the Indian PIT Regulations, 2015. The use of the phrase "likely materially to affect the price of securities"[13] is similar to "is likely to materially affect the price of securities" in Regulation 2(1)(n).[14]

Unlike in the case of US securities law, Irish plaintiffs have a higher burden to prove materiality since the information must be of such magnitude that it would have certainly resulted in altered investor behaviour.[15] It is clear that Irish insider trading law is inclined towards the 'price sensitivity standard'. In the landmark ***Fyffes v. DCC*** case[16], the chief issue at hand was whether the defendant was in possession of 'price sensitive information' at the time of trading activities. The case involved the sale of shares whilst withholding of negative information evidenced in two reports about a certain company's shares. Concurrently, there had been positive news developments surrounding the company on two fronts: - there were talks of an ongoing merger with a major competitor and talks on a major expansion of the company's online business. Justice Laffoy ruled that such information, even if price sensitive, must be viewed in relation to the existent information already available to investors. Justice Laffoy ruled that

[13] Companies Act, No. 33, Acts of Parliament, § 108(1990) (Ireland).
[14] *supra* note 2.
[15] Jeremiah Burke, *Ireland Goes Bananas: Irish Insider Trading Law and Price-Sensitivity after Fyffes v. DCC*, 30 HASTINGS INTL & COMPARATIVE L. R. 453, 469 (2007).
[16] *Fyffes v. DCC* [2005] IESC 3.

it was unlikely that the negative information could have offset the effect of the positive speculations around Fyffe in this context. Justice Laffoy also observed that while making stochastic estimates of price sensitivity by comparing information known to the insider at the time of making a trade and a hypothetical assessment of the effect of market disclosure, events (later reactions of the market) may be weighed and compared with past events only if there is a "parity of information" and if "market conditions were the same on both dates". Although this appeals to logical analysis, practically, it is unlikely that these conditions shall be met simultaneously - thereby, making prosecution difficult[17].

IV. RECONCILING THE "RATIONAL INVESTOR" STANDARD AND THE "PRICE SENSITIVITY STANDARD" IN CHINESE SECURITIES LAW

A. The Rational Investor Standard

This standard follows that in determining materiality, the influence that a certain event/(s) shall have on "a rational investor's decision to trade in general circumstances" is evaluated.[18] It incorporates the price sensitivity standard and explains that when the general movement in securities prices aligns with the shift in investors' choices, it indicates that investors'decisions are impacted by this information, following which materiality is determined.

[17] *Id.*

[18] Yuxin Li, Yifan Wang, *Determination of Materiality of Misrepresentation of Securities after Elimination of Preliminary Procedures*, 11 J. OF EDU., HUMANITIES AND SOCIAL SCIENCES 134, 140 (2024).

In a certain case, a company - CSC Technology violated their obligation to provide accurate profit forecasts and deliberately inflated their 2013 operating income, causing misleading statements and false records in their publicly disclosed asset reorganisation documents. As a consequence, they were fined RMB 700,000. Additionally, investor claims litigation was initiated thereafter.[19]

The defendant argued that some of the plaintiffs' trading behaviour of buying several times after the disclosure date was not out of reliance on false information, but was actually the use of the rational investor standard. Therefore, there had been no causal relationship between the investor's investment behaviour and the securities misrepresentation behaviour- which means that the securities misrepresentation behaviour is not significant. This could be a manner in which materiality is determined. However, the major downside to this approach is the fact that this approach may not be successful as a deterrent. This is because the materiality of the event is sometimes determined using cause and effect analyses through court proceedings once litigation has been instituted by the concerned parties. Since the objective of the regulator would be to ensure that insiders/outsiders who have access to such sensitive information disclose the fact that they do have such information, such individuals would have to be cognisant of the fact that the information they possess could be deemed to be material UPSI. The test is subjective in comparison to the more objective price sensitivity standard.

[19] *Id* at 137.

B. The Problem with the Price Sensitivity Standard

It is not a matter of doubt that the price and volume of trading is influenced by a multitude of factors such as positive/negative news about the entity's founders, reports by reputed auditing and ratings agencies, the introduction of new government policies, new product launches, etc., As stated earlier in the case of ***Fyffes v. DCC***[20], the exact price impact of an event is not measured in isolation, but rather in comparison to all such other relevant information concerning the entity or even the industry it belongs to. Therefore, making stochastic estimates of price impacts of isolated events may prove to be imprecise. This is where the rational investor standard comes into play – explaining that the event must be of such magnitude that in general circumstances, the event/(s) must lead to a corresponding shift in investor choices in relation to changing market prices of securities.

V. INDIAN INSIDER TRADING LAW AND MATERIALITY

The Securities Appellate Tribunal ("**SAT**") expressly laid down in the case of ***Anil Harish v. Securities and Exchange Board of India***[21]that "to bring home the charge of insider trading, one of the essential requirements is that the information must be price sensitive information". This points to the fact that the SAT has adopted the price sensitivity standard as a pre-requisite to insider trading prosecution.

In the ***Electrosteel Steels Ltd***. case before the Securities Appellate Tribunal, the tribunal delivered in its judgement that "the emphasis is on

[20]*In re Cady, Roberts & Co.,* 40 S.E.C. 907, 911 (1961).
[21]*Anil Harish v. Securities and Exchange Board of India*, 2012 SCC OnLine SAT 92.

disclosure; not otherwise" and that only those facts can be excluded from disclosure which have unequivocally no relevance to the issuer or issue.[22] This seems to point towards an approach that encourages disclosure of information on the application of a test of a lower standard of materiality in pursuit of positive corporate governance.

In the case of ***Suzlon Energy Ltd. v. SEBI***[23], the SAT ruled that "the words material/materiality" refers to anything "which is likely to impact an investor's investment decision" and "depends on the facts of each case".

The Supreme Court, in its judgement in the case of ***Vishal Tiwari (Adani Group Investigation) v. Union of India***[24], noted that the SEBI had clarified in its note that the key pillars of investor protection instituted by it are mandated disclosures to ensure "free and fair price discovery" and "equal access to material information" to allow all investors to take informed investment decisions.

An understanding of the above judgements here does not restrict 'materiality' to that information that would or could have a bearing on the price sensitivity of the shares of the company. Herein lies the ambiguity regarding whether all material information must be disclosed to the public or only that information that is considered to be "price sensitive".

The SAT has also laid emphasis on the legislative intent behind the LODR regulations in the case of ***B. Renganathan v. Securities and Exchange***

[22]*ElectrosteelSteels Ltd. v. Securities and Exchange Board of India*, 2019 SCC OnLine SAT 244.
[23]*Suzlon Energy Ltd. v. SEBI*, 2021 SCC OnLine SAT 953.
[24]*Vishal Tiwari (Adani Group Investigation) v. Union of India*, (2024) 4 SCC 332.

Board of India[25] by stating that the LODR makes a clear distinction between those events that are required to be disclosed by listed entities to the stock exchanges without the application of any standard of determination of materiality (Para A of Part A of Schedule III of the LODR) and those events that are required to be disclosed upon a determination of their materiality (Para B of Part A of Schedule III of the LODR). The list of events is seemingly exhaustive and the clear intent behind the wording of these provisions raises a question as to what objective the SEBI would seek to achieve by reincorporating "material events" within the UPSI definition – the law is apparently already clear. In the interest of corporate governance, mandating disclosure of material information irrespective of its price-sensitivity is a positive move and has already been incorporated into extant legislation.

VI. A CHANGING LEGISLATIVE DETERMINATION OF MATERIALITY

It is pertinent to observe that the previously effective PIT Regulations of 1992 provided for the definition of "price sensitive information" as follows:

"*Price sensitive information means any information which relates directly or indirectly to a company and which if published is likely to materially affect the price of securities of company*."[26]

The conjunction "and" used between "any information which relates directly or indirectly to a company" and "which if published is likely to

[25] *B. Renganathan v. Securities and Exchange Board of India*, 2021 SCC OnLine SAT 96.
[26] Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992, Regulation 2 (ha).

materially affect the price of securities of company" indicates that the legislative intent has not been to restrict materiality to the price sensitivity standard – "price sensitive information" itself incorporates a more than price sensitive definition of information that must be reported to the stock exchanges. However, the explanation to the very same provision provides for seven events that "shall be deemed to be price sensitive information" (including events such as "issue and buy back of securities" and "significant changes in policies, plans or operations of the company"). What may be concluded from the same is that the SEBI had intended on providing for an exhaustive list of events that may be deemed to be price sensitive. However, the inherent subjectivity of wordings such as "significant changes" leaves open the debate on classification of such information.

On the other hand, Regulation 2 (1) (n) of the Prohibition of Insider Trading Regulations, 2015[27] provides that:

> *""Unpublished price sensitive information" means any information, relating to a company or its securities, directly or indirectly, that is not generally available which upon becoming generally available, is likely to materially affect the price of the securities."*

The above-mentioned definition points to the unequivocal legislative adoption of the price sensitivity standard. The price-sensitivity test is a suitable assessment method as it includes a broad spectrum of information, even if it may not always be reliable.[28] Additionally, this test aligns with the rationale behind insider trading regulations, which aim to shield insiders

[27] *supra* note 2.

[28] Ahal Besorai, *Tentative Information, Inside Information, Price-sensitive Information and Materiality*, 3 J. OF FINANCIAL CRIME. 268, 269 (1996).

from liability when they cannot derive any financial gain. If there is no effect on the price, insiders cannot profit from their actions.

The High-Level Committee to review the PIT Regulations of 1992 had expressed that a higher standard must be adopted with respect to classification of UPSI – irrespective of the impact on price sensitivity, no event or fact must be classified as UPSI as a matter of automatic mandate.[29] By reincorporating all "material events" into the UPSI definition, the SEBI may be forcing an effect of excessive regulation.

However, Regulation 30 of the SEBI (Listing Obligations and Disclosure Requirements),2015 already explains materiality using phrases such as "which is likely to result in discontinuity or alteration of event or information already available publicly".[30] This resembles the "total mix" rationale forwarded by the US Supreme Court in the ***TSC verdict***.[31]

VII. INHERENT CHALLENGES IN THE CURRENT STATUS QUO

In creating insider trading legislation, behavioural economics is often overlooked. What cannot be discounted is the tendency of managerial personnel to claim credit for positive outcomes but shun blame for those that are negative[32] in a practise termed "plausible deniability". It may also be observed that most management ecosystems lack the deployment of

[29]Report of the High Level Committee to Review the SEBI (Prohibition of Insider Trading) Regulations, 1992, para.31.
[30]Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements), 2015, Regulation 30(4)(i)(a), SEBI/LAD/-NRO/GN/2015-16/013, The Gazette of India Extraordinary Part-III-Section 4, 2015 (India).
[31]*TSC Indus. v. Northway*, 425 U.S. 438 (1976).
[32] Theodora C. Welch, Eugene H. Rotberg, *Transparency: panacea or a Pandora's box?* 25 J. OF MANAGEMENT DEVELOPMENT. 937, 939 (2006).

"cause and effect analyses".[33] This means that most managers are not asked about or taken to task directly and individually for issues that the company runs into as a whole. This makes the enforcement of insider accountability more challenging. In addition to this, it is extremely challenging to determine what exact fact/event is determinative of materiality.[34] Therefore, always tracing a material event back to its human source is a task that can be far more challenging than it appears to be. Determinations regarding materiality require professional discretion, and it is impossible to establish a universal set of rules to determine thresholds in every situation.[35]

There is no doubt that the prices of market securities are determined by investor behaviour. The definition of price sensitive information is predicated upon stochastic estimates of "rational investor" behaviour. However, *ex ante* estimates in and of themselves are not always precise. For example, an event/(s) consisting of negotiations with the CEO of a company regarding his resignation may or may not be material - say the CEO demands higher pay in return for his continued service to the company, an initial disagreement by the company management may not definitively lead to the CEO's resignation since the management may provide a counter offer or persuade the CEO not to resign through a long-term promise of a salary hike in the future. It is also not an easy task to estimate the economic impact of such a resignation on shareholder confidence. Also, however may be the level of sophistication of the

[33] *Id.*
[34] *Basic Inc. v. Levinson*, 485 U.S. 224, 232 (1988).
[35] Carla Edgley, *A genealogy of accounting materiality*, 25 CRITICAL PERSPECTIVES ON ACCOUNTING. 255, 255(2014).

investor, even a typical investor may make irrational trading decisions.[36] What may be thought of as rational or reasonable investor behaviour may be, in hindsight, viewed at as irrational market exuberance – as evidenced by the frenzy for dot com internet stocks in the late 1990s.

VIII. A DIVE INTO THE IMPLICATIONS OF REALIGNING THE DEFINITION OF UPSI - A POSSIBLE CONFLATION OF "MATERIAL NON-PUBLIC INFORMATION" AND "PRICE-SENSITIVE INFORMATION"

The Indian legislature has already made a differentiation between the two by virtue of the sections provided within the Securities and Exchange Board of India Act, 1992. Section 12 A(e) of the SEBI Act lays down that "dealing in securities while in possession of 'material' or 'non-public information' is prohibited".[37] The inherent wording of this provision leaves the rational reader to understand that this provision is inclusive – material or non-public information may or may not be price sensitive - a material fact "need not be outcome-determinative".[38] On the other hand, Section 15G of the very same act titled "Penalty for Insider Trading" specifically mentions the phrase "dealing in securities" and "on the basis of unpublished price sensitive information".[39] It is apparent from a reading of the same that the SEBI's intent was to differentiate the two terms – "material non-public information" and "unpublished price sensitive information". Had the

[36] Jeremiah Burke, *Ireland Goes Bananas: Irish Insider Trading Law and Price-Sensitivity after Fyffes v. DCC*,30 HASTINGS INTL & COMPARATIVE L. R. 453, 471 (2007).
[37]Securities and Exchange Board of India Act, 1992, §12A (e), No. 15, Acts of Parliament, 1992 (India).
[38]*Folger Adam Co. v. PMI Indus*., Inc., 938 F.2d 1529, 1533 (2d Cir. 1991).
[39] Securities and Exchange Board of India Act,1992, § 15G,No. 15, Acts of Parliament,1992 (India).

intention not been so, the wording of the two sections could have very easily been made out to mention solely "unpublished price sensitive information". Similarly, Regulation 68 of the SEBI (Listing Obligations and Disclosure Requirements) 2015[40] explains that listed entities must report all such events which "are material, all information which is price sensitive and/or have bearing on performance/operation of the listed entity". By reincorporating "material events" as under the definition of UPSI, the SEBI could very well conflate the two concepts. This may have the effect of creating an extremely low standard of materiality – a counterintuitive outcome could be that investors are bombarded with company trivia to such an extent that it lessens the quality of conducive investment decision making.[41]

Reincorporating material events into the UPSI definition may lead to a shift of focus[42] from the price sensitivity standard as characterised by the ***Anil Harish v. Securities and Exchange Board of India***[43]judgement as well as that of the Supreme Court in the case of ***Balram Garg v. SEBI***[44] to that of the determination of the often-subjective determination of materiality. What may seem to be non-material to insiders within the company – say an

[40] Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements), 2015, Regulation 68, SEBI/LAD/-NRO/GN/2015-16/013, The Gazette of India Extraordinary Part-III-Section 4, 2015 (India); *Vikramaditya Chandra, In re*, 2020 SCC OnLine SEBI 208.

[41] *TSC Industries, Inc. v. Northway*, Inc., 426 U.S. 438 (1976).

[42] Sumit Agrawal*, SEBI proposes amendment to Insider Trading Regulations: But is it necessary?,* MONEYCONTROL(May 24,2023, 8:30 AM), available at: https://www.moneycontrol.com/news/opinion/sebi-proposes-amendment-to-insider-trading-regulations-but-is-it-necessary-10648061.html.

[43] Jeremiah Burke,*supra*note 15.

[44] *Balram Garg v. SEBI*, (2022) 9 SCC 425.

event that has a low statistical impact on stock prices may lead to stoking up sentiments of risk aversion should the same be disclosed to public investors in light of reputational damage to the company. Public investors may still "infer a cause-effect relationship between the event and share price performance irrespective of its statistical significance".[45] This, in turn, may have significant consequences for the shift in stock prices of the company. Therefore, reliance on insiders' judgement of the more general 'materiality standard' (although necessary in certain cases) may lead to undesirable outcomes.

IX. SOLUTIONS

A. Guaranteeing that the Stock Exchanges will Decide upon the Timing of Release of Information

The biggest argument that firms have with respect to mandatory corporate disclosures is the fact that disclosures of key events and information within the company to their investors would be equivalent to full disclosures to their competitors, thereby eliminating their competitive advantage.

Ensuring mandatory disclosure of "material events" to the stock exchanges with the added caveat that it would be up to the stock exchanges themselves to decide upon the timing of release of such information to the general public would have a two-fold positive effect in the current paradigm:

[45] Benjamin A. Leisawitz, *Matrixx Initiatives, Inc. v. Siracusano: Rejection of the Statistically Significant Standard Reopened the Door to Securities Fraud Strike Suits*, 36 DEL. J. CORP. L. 675, 689–90 (2011).

1) It would create the barrier of uncertainty to possible large-scale, timed insider trades. Thus, eliminating any unfair advantage that insiders may have accrued due to information asymmetry.
2) It would avoid the feared situation of immediate compulsory disclosures to competitors.

The SEBI must take up the onus of clarifying any doubts on the same by way of an official clarification to the listed companies. Doing so and then proceeding with reincorporating material events into the UPSI definition would lead to win-win outcomes for all stakeholders involved.

B. Ensuring a Precise Determination of a "Reasonable Investor" through SEBI Clarifications

The determination of materiality of information may be made on myriad grounds such as the quantitative character of an event itself say, news regarding the possible withdrawal of funding by investors amounting to USD 50 million or the quantitative magnitude of market reaction to such an event should the public be made aware of such an event/(s). In light of this statement, it may be prudent to lessen the ambiguity around the meaning of the word "materially affect the price of securities" – would we be referring to the market reactions of experienced, sophisticated investors or relatively inexperienced investors? Regardless of this determination, it is pertinent to understand the "**Fraud on market theory**" which explains that in a properly functioning stock market, share prices reflect the relevant information about the company and its operations that is available. Consequently, deceptive statements can deceive buyers even if they don't

directly depend on those false statements.[46] Material information, even if not price sensitive, if untrue or deceptive, must be brought to the knowledge of investors. It becomes all the more important to ensure that the domino effect of market reactions to misleading market information is effectively avoided.

In light of the ***TSC-Basic*** judgements in the United States, the court introduced a comparison between the word "might" – mere possibility and "would" – great probability or even inevitability. Upon a reading of Regulation 2 (1)(n) of the 2015 PIT Regulations[47], the words "is likely to materially affect the price of the securities" indicate towards the adoption of the latter distinction. However, the prices of market securities are determined by a multitude of factors.[48]With respect to prosecution in cases of insider trading, what must be kept in mind is that "the measure of proof in civil or criminal cases is not an absolute standard and within each standard there are degrees of probability."[49] Since the price sensitivity standard evaluates investors' reaction to information, a definitive and exhaustive list of material events cannot be provided for. This is because *ex ante* predictions/analyses as well as human behaviour do tend to be stochastic in nature.

[46]*Peil v. Speiser*, 806 F.2d 1154, 1160 (3rd Cir. 1986).
[47]*supra* note 2.
[48]John Egan, *How Are Stock Prices Determined: The Factors that Affect Share Prices of Listed Companies,* TIME (Jun 28, 2023, 2:22 PM), available at: https://time.com/personal-finance/article/how-are-stock-prices-determined/.
[49]*Mousam Singha Roy v. State of West Bengal* (2003) 12 SCC 377.

C. Mandating Internal Classification of material, non-public Information on the Basis of Estimated Range of Economic Impact on Share Prices

Regulation 3(5) of the SEBI PIT Regulations 2015 mandates heads of listed companies to maintain a secured digital database containing information on UPSI, its nature, and the individuals who have cognisance of such information.[50] This is an extremely important provision since its implementation allows for the tracing of material information to its source as well as communication of the same. Mandating classification of information on events by their estimated economic value of impact on the company's performance may be an ideal step towards ensuring greater corporate governance and regulatory outcomes in the stock market. The SEBI has recently released a consultation paper signifying its intent to proceed with the same – materiality is proposed to be internally determined through estimated economic impacts amounting to the lesser of either 2% of turnover, 2% of net worth or 5 percent of 3-year average profit/loss after tax on the basis of audited standalone financial statements.[51]Material non-public information that has a tendency to effect stock prices to a certain monetary standard may be mandated to be disclosed. However, a possible downside to this approach could be that the same might lead to overcomplicating the already slightly subjective classification of material

[50] SEBI Listing Obligations and Disclosure Requirements, 2015, Regulation 3(5), SEBI/LAD-NRO/GN/2015-16/013, The Gazette of India Extraordinary Part-III-Section 4, 2015 (India).

[51]Consultation Paper on Review of disclosure requirements for material events or information under SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, available at: https://www.sebi.gov.in/sebi_data/attachdocs/nov-2022/1668240795810.pdf.

information. Regulation 30 (4)(ii) of the LODR[52] already mandates listed entities to formulate their own materiality determination policies based on the criteria for materiality already laid down in Regulation 30 (4) (i) of the LODR.[53]This existing provision already ensures a certain amount of objectivity towards determination of materiality. However, the problem lies wherein the internal policies on determination of materiality of such listed entities are inherently subjective just like the criteria determined in Regulation 30(4)(i). Although providing for an all-inclusive and exhaustive list of material events is impossible, mandating determination through estimated economic impact as laid down in the SEBI consultation paper would ensure that Regulation 30 (4)(ii) achieves its intended purpose through reducing the inherent subjectivity of the exercise of determination of materiality.

X. CONCLUSION

Irrespective of the decision/(s) that the SEBI takes, it is pertinent to ensure that there is some clarity regarding the adoption of the specified standard of materiality – whether a lower one is adopted as described in the case of the United States, or a higher standard as laid down by Irish insider trading law (the unequivocal adoption of the price-sensitivity standard).

[52]Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, Regulation 30(4)(ii), The Gazette of India Extraordinary Part-III-Section 4, 2015 (India).
[53]Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, Regulation 30 (4)(i), The Gazette of India Extraordinary Part-III-Section 4, 2015 (India.

It is worth noting that existing legislation already mandates the disclosure of information which have a bearing on the performance of the entity. The scope of this Regulation 68 of the 2015 Listing Obligations and Disclosure Requirements is already wide enough to mandate all material disclosures.[54] It is hard to understand how reincorporating material events into the UPSI definition would lead to more favourable reporting outcomes. Rather, the SEBI must work to clear up the ambiguities surrounding the determination of materiality through official clarifications. ***First***, by clarifying that the stock exchange shall have full authority to decide upon the release of material information, SEBI could reassure listed entities that material information is not disclosed to their competitors with immediacy whilst also creating a barrier against well planned out, large-scale, timed insider trades. ***Second***, SEBI may benefit from clearing the air surrounding the determination of a 'reasonable investor' in relation to investment behaviour that leads to fluctuations in the market price of shares. ***Third***, SEBI must proceed to seek to reconcile both the reasonable investor standard along with the price sensitivity standard to arrive at the most reasonable standard of determination of materiality through implementing the suggestions on internal classification of materiality based on economic impact already explained in its consultation paper. The same would serve to instil a sense of order amidst the chaos.

In light of the presence of a multitude of theories, precedents, and legislations on the determination of materiality in foreign jurisdictions, it is

[54]Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, Regulation 68, The Gazette of India Extraordinary Part-III-Section 4, 2015 (India).

wise to ensure that the UPSI definition is made as unequivocal as possible whilst still allowing leeway to classify certain events that "would" be considered to be material by reasonable investors (going by the rationale in the *Basic* case). A complete exhaustive list of material events would be impossible to provide for since ***first***, stochastic estimates of impact of material information may not be precise since it is hard to estimate market reaction amidst all other material information already available to investors. ***Second***, the variability of business environment factors with the efflux of time may lead to the discovery of new 'material events' based on facts and circumstances beyond comprehension in the present day.

Anshuman Srivastava & Navyashree Bhat, *Harmonizing Corporate Insolvency: Exploring Mediation as a catalyst for efficient resolution under Insolvency and Bankruptcy Code, 2016*, 11 (1) SCHOLASTICUS 156 (2024).

HARMONIZING CORPORATE INSOLVENCY: EXPLORING MEDIATION AS A CATALYST FOR EFFICIENT RESOLUTION UNDER THE IBC

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Abstract

*This article aims to examine the current legislative framework under the Insolvency and Bankruptcy Code, 2016 ("**IBC**") of the Corporate Insolvency Resolution Process ("**CIRP**") and highlighting the operational challenges such as delays, creditor disenfranchisement, and a creditor-unfriendly disposition. The authors then explore how mediation, a form of alternative dispute resolution ("**ADR**"), can serve as a proactive precursor to the CIRP, aiming to streamline the resolution process and mitigate disputes. They further delve into the global landscape of insolvency resolution mechanisms, emphasising on the successful integration of mediation in various jurisdictions. Drawing upon some judgements and international practices, the authors suggest a legislative amendment to the IBC to incorporate mediation before initiating CIRP. The authors conclude by advocating for a paradigm shift towards mediation, urging the adjudicating authority to promote and facilitate this alternative approach, ultimately contributing to the timely and efficient resolution of corporate insolvency.*

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I. INTRODUCTION

The objective of creating the Insolvency and Bankruptcy Code, 2016 was to concentrate on relieving stress in those enterprises or businesses that were chronically ill through resolution or liquidation. This situation was evidenced at the time of bringing the code by the growing amount of Non-Performing Assets ("**NPAs**") in the banking sector which the previously existing system was neither able to address effectively nor sufficiently. Whenever any company becomes insolvent, there's an evaluation of the corporate debtor's ("**CD**") viability by the creditor, who then work to save it with a resolution plan. Distressed entity can adopt either of the method for resolution: (a) the Pre-packaged Insolvency Resolution Process ("**PPIRP**"), which either closes without resolution or uses a resolution plan to rehabilitate the CD, or (b) the Corporate Insolvency Resolution Process, which resolves the dispute through liquidation of the CD or by coming up with a resolution plan.[1]Around the world, a procedure similar to CIRP has only been used as a last resort[2]—that is, after all other options, including mediation, settlement, and arbitration, have been explored.

II. CIRP PROCESS UNDER IBC: A COMPREHENSIVE UNDERSTANDING

[1]*Pre-Packaged Insolvency Resolution Process*, Insolvency and Bankruptcy Board of India, available at:https://www.ibbi.gov.in/uploads/whatsnew/a650764a464bc60fe330bce464d5607d.pdf.

[2]Ashok Haldia, *Let's promote mediation as a way to resolve IBC delays*, LIVE MINT (June 24, 2022), available at: https://www.livemint.com/opinion/online-views/lets-promote-mediation-as-a-way-to-resolve-ibc-delays-11656002273450.html.

The entire process is centered around the authority of the National Company LawTribunal ("**NCLT**").[3] The creditor, either operational or financial, or a CD itself, when there is a default on payment, may commence the CIRP. Thereon, the requests are accepted once the creditors fulfil the stipulations under Sections 7,[4]9,[5] and 10.[6]Once an application is accepted into the process, the appointment of the Interim Resolution Professional ("**IRP**") takes place, who begins to preside over the management. They conduct investigations with respect to the fiscal affairs and status of the CD, and invite claims from creditors who wish to recover debts. Based on these claims, a Committee of Creditors ("**COC**") is formulated, whose main responsibility is to take decisions regarding the resolution process. During this, and till the end of the process, Section 14 puts a moratorium on certain activities of the CD such as institution or continuation of pending suits, transfer of its assets, recovery of property by an owner or lessor, and so on.[7] The COC may go on with the appointment of an independent resolution professional who may or may not be same as the IRP.[8]

Further, within 180 days of the commencement of the CIRP, a resolution plan which details the restructuring of the entity, must be ratified by the COC.[9] The entire process must necessarily conclude within 330 days[10]. It starts with a public announcement detailing the insolvency of the CD and

[3]Insolvency and Bankruptcy Code, 2016, § 5(1), No. 31, Acts of Parliament, 2016 (India).
[4]*Id* at § 7.
[5]*Id* at § 9.
[6]*Id* at § 10.
[7]*Id* at§ 14.
[8]*Id* at § 5(27).
[9]*Id* at§ 12.
[10] The Insolvency (Amendment) Act, 2019, Notification S.O. 2953(E).

asks interested persons to submit a resolution plan. The COC evaluates all plans so received and deliberates upon the most viable solutions. Once a plan is decided by vote, the RP files an application to the Adjudicating Authority, who approvesthe plan. After approval, it is applicable to the debtor and other parties as authorised by the NCLT.

The process, while being a big step in this area, is still riddled with flaws. Some problems that come to the forefront are that; ***First***, the COC does not have the operational creditors, who end having no rights in the resolution process despite having a claim in the debt recovery; ***Second***, the minimum default for an approach under the process is INR 1 crore, ***Third***, it is a long-drawn process - while the process needs to be finished within 330 days, many a times its commencement itself takes up a lot of time and ***Fourth***, the Code in general is not creditor-friendly and often results in the value of the asset being reduced when it reaches the operational creditors.[11] All of this make it prone to 'disputes,'which are dealt with under Section 5(6) of the Code.

These disputes aredealt with through adjudication by an authority, be it the NCLT or the National Company Law Appellate Tribunal ("**NCLAT**"). Bodies like the Debt Recovery Tribunal ("**DRT**"), are also involved in facilitating recovery of loans from insolvent entities. These mechanisms inevitably put one party in a position of gain and other ofloss, which may not be what either party wish for in the long run. This gives rise to a need

[11] Ishan Bakshi, *How the bankruptcy code is moving away from its promoter-averse approach*, THE INDIAN EXPRESS (Apr. 16 2021), available at: https://indianexpress.com/article/opinion/columns/insolvency-and-bankruptcy-code-amendments-modi-govt-7275456/.

for a different mechanism within the system of the CIRP, such as forms of ADR like meditation.

III. MEDIATION: A PRECURSOR TO CIRP

In India, court litigation has been heavily relied upon for corporate insolvency resolution, with very little preference given to using out-of-court options (or mediation). Additionally, mediation has only been relevant in situations where a hybrid approach of "litigation first, then court reference" is used.[12] Although the IBC came up with effective insolvency resolution in India, regrettably, the delays in the process may become wide-ranging.[13] The framework relies heavily on courts and a major contributing factor to the delays is the volume of lawsuits that arise between different parties during the resolution process.[14]

The timeline to complete the process of CIRP originally was 180 days, which could be extended by 90 days, making the maximum period of completion 270 days. Despite this, according to the IBBI Newsletter of July to September 2020,[15] out of the 4008 cases admitted under the CIRP, the resolution plan was approved only in 277 cases. Out of 1,942 cases

[12]Ishana Tripathi, *The Indian Viewpoint on Mediation*, 40 AMERICAN BANKRUPTCY INSTITUTE JOURNAL 84-85 (2021).
[13]*Id.*
[14]Sunny Verma, *Lenders' differences, legal challenges behind delay in resolutions under IBC*, THE INDIAN EXPRESS (May 13, 2019), available at: https://indianexpress.com/article/explained/lenders-differences-legal-challethenges-behind-delay-in-resolutions-under-ibc-5724351/.
[15]*The Quarterly Newsletter of the Insolvency and Bankruptcy Board of India*, July-September 2020, Vol. 16, Insolvency and Bankruptcy Board of India (IBBI).

undergoing resolution, 1,442 had been going on for more than270 days.Similarly, as per the IBBI newsletter for July to September, 2023,[16] up until September 30, 2023, there were 7058 CIRP cases admitted out of which only for 808 the resolution plan has been approved and 2001 CIRP processes are ongoing out of which more than 67% have been ongoing for more than 270 days. Out of these totals admitted CIRP cases, liquidation orders have been passed in 2049 cases.[17]

In both these years, the timeline for the CIRP can be seen to be extended by the Adjudicating Authority under Section 12(3)[18] of the Code, leaving them 60 odd days to complete the process as per the timeline prescribed in the code.So, this process might take almost a year's time and if during this period or after the expiry of this period the resolution plan is not received by the tribunal, then liquidation process would kick in.

It may be argued that there is a mandatory timeline of 330 days within which CIRP has to be completed, but the Supreme Court in the case of ***Committee of Creditors of Essar Steel India Limited Through Authorised Signatory v. Satish Kumar Gupta***[19] held that:

"……..while leaving the provision otherwise intact, the term "mandatorily" is struck down as being manifestly arbitrary under Article 14 of the Constitution of India and as being unreasonable restriction on the litigant's right to carry on business under Article 19(1)(g) of the Constitution. The effect of this declaration is that ordinarily the time taken in relation to the CIRP must be completed within the outer limit of 330 days from

[16]*The Quarterly Newsletter of the Insolvency and Bankruptcy Board of India*, July-September 2023, Vol. 28,Insolvency and Bankruptcy Board of India (IBBI).
[17]*Id.*
[18]*Supra* note 3 at § 12(3).
[19]*Committee of Creditors of Essar Steel India Limited Through Authorised Signatory v. Satish Kumar Gupta*, (2020) 8 SCC 531: 2019 SCC OnLine SC 1478.

the insolvency commencement date, including extensions and the time taken in legal proceedings. If the delay or a large part thereof is attributable to the tardy process of the Adjudicating Authority and/or the NCLAT itself, it may be open in such cases for the Adjudicating Authority and/or NCLAT to extend time beyond 330 days. It is only in exceptional cases that time can be extended, the general rule being that 330 days is the outer limit within which resolution of the stressed assets of the Corporate Debtor must take place beyond which it is to be driven into liquidation."[20]

Herein, the "short-time" period left to complete the process is considered as a loophole, as no particular timeline for the same has been mentioned in the order.

Due to this cumbersome and time-taking process, the authors propose mediation as a method to deal with insolvency resolution procedures. Many different Alternate Dispute Resolution methods including mediation have been put to use in the cases of corporate insolvency by many different countries such as the United States, United Kingdom, European Union, Japan etc. These countries have also recognised the various advantages of these methods. ADR, in general and mediation, in particular, provides a paradigm of 'win-win' situation for the parties besides decreasing the probability of any kind of 'lose-lose' state. Herein, negotiations take place between the parties under the supervision of a neutral third-party. These negotiations help differentiate the problem from the persons themselves and reach a common outcome,[21] unlike adjudication, wherein the standard

[20]*Analysis of Time Limit under Section 12 of the Insolvency and Bankruptcy Code, 2016 (IBC) for completion of CIRP*, IBC LAWS(Sept. 20, 2020),available at: https://ibclaw.in/analysis-on-time-limit-under-section-12-of-the-code-for-completion-of-cirp/.

[21]Edward J. Kelly and Natalija Kaminskienė, *Importance of emotional intelligence in negotiation and Mediation*, vol. 2, INTERNATIONAL COMPARATIVE JURISPRUDENCE (2016).

practice is a 'lose-win' situation[22]. Such a situation may end up being detrimental for business relations and this in our opinion can lead to breaking business ties besides hampering the trust and confidence between business partners.

IV. GLOBAL PERSPECTIVES ON INSOLVENCY PROCEDURES

Several other countries have been successful in adopting mediation to resolve disputes relating toinsolvency processes. In the last decade, International Institutions have focused on ADR and more specifically mediation in insolvency matters. With insolvency applying to growing enterprises and individuals, the use of these mechanisms has gained more importance. This has led to several countries opting to include one or more of them in their legal systems, giving the concerned parties dispute resolution routes to follow other than just adjudication.

The United States of America was one of the first countries to bring this change into their dispute resolution process in the 1980s,and since then it has become a key characteristic of their legal system. Bankruptcy courts in the US have mediation programmes to settle claims. Amongst these courts Delaware Bankruptcy Courts see the highest number of bankruptcy cases, and this court mandates mediation in every dispute.[23]The change began with a pre-reorganisation mediation plan which was set-up for thousands

[22]B. F. Tennille, L. Applebaum &A.T. Nees, *Getting to Yes in Specialized Courts: The Unique Role of ADR in Business Court Cases*, vol. 11, PEPPERDINE DISPUTE RESOLUTION LAW JOURNAL (2010).

[23] Marcos A. Ramos*, Delaware Bankruptcy Court: Mandatory Mediation Update*, vol. 18(3), BANKRUPTCY AND INSOLVENCY LITIGATION COMMITTEE, (2013).

of claimants when Greyhound Lines Inc. went bankrupt.[24] It is an example of multi-party dispute resolution where the debtor individually dealt with the creditors. In this, the creditors first had to fill a claim form for lost wages, medical bills, and other damages. The parties had engaged in mediation for a period of 60 days, if the creditors refused to participate in negotiation for damages, or if it failed. If a mutual agreement was not reached, then parties resorted to arbitration. Half of the claims were resolved in the first stage itself.[25] In 1998, the US legislature passed the Alternative Dispute Resolution Act, which mandates the federal district courts to utilise ADR in "all civil actions, including adversary proceedings in bankruptcy,"[26] thereafter mediation is being used by several bankruptcy courts in the US.[27] Following this, mediation proceedings have been successful in cases like ***Lehman Brothers Holdings Inc. v. Elevator Holdings***[28]in 2008, which involved more than three thousand claimants.The court had mandated compulsory mediation for the disputes arising out of the bankruptcy of one of the Lehman Brothers' group companies. More than a hundred mediations were conducted and successfully settled, showing the efficacy of mediation in such complex situations. It has also been successful in international insolvency cases such

[24] Nancy Welsh, *You've Got Your Mother's Laugh: What Bankruptcy Mediation Can Learn from the Her/History of Divorce and Child Custody Mediation*, vol. 17(427), AMERICAN BANKRUPTCY INSTITUTE LAW REVIEW (2010).
[25] M.L. Desgrosseillier& G. Shelter,*The Use of Alternative Dispute Resolution Procedures to Resolve Tort Claims,* vol.18(1),BANKRUPTCY NORTON JOURNAL OF BANKRUPTCY LAW AND PRACTICE (2009).
[26]Alternative Dispute Resolution Act of 1998 (28 U.S.C.A), Section 654.
[27] Jacob A. Esher, Am. Bankr. Inst., Compendium Of Bankruptcy Court Local Rules On ADR(21st Annual Winter Leadership Conference 2009).
[28]*Lehman Brothers Holdings Inc. v. Elevator Holdings*,WIPO 710: WIPO Case No. D2008-0688.

as ***In re: MF Global Holdings Ltd***.,[29] which led to global settlement, as it involved creditors from countries outside of the US as well. The matter was settled through multiple settlements involving different entities.Thus, the US has a cemented practice of ADR, more specifically mediation. It becomes much easier for parties to opt for such an option when it is a known practice, and information regarding it is widely available.

Chancery courts in the United Kingdom facilitate mediation in the insolvency context. Like the position of the US, it puts the use of ADR as a requirement on the courts for amicable settlement.[30]The Chancery Guide recommends ADR as it helps litigants save costs, and to settle disputes while preserving their "commercial relationships and market reputation," and provides a variety of solutions.[31] Courts readily grant stays at early stages of claims to incorporate mediation. Such an order gives parties the right to extend the stay for up to three months, at the end of which parties should be able to tell the court the steps they wish to take. However, the court is reluctant to grant such stays when the claim has reached the stage of directions of trial being given.[32] Further, in ***Fulham Football Club v. Richards*,**[33]it was held that parties in insolvency disputes can approach arbitration to settle, given that third party rights and public policies were not infringed. If creditors are dissatisfied with the resolution process, they

[29]*In re: MF Global Holdings Ltd.,* Case No. 11-15059 (MG).
[30]HM Courts & Tribunals Service Chancery Guide, Feb., 2016, available at: https://www.judiciary.uk/wp-content/uploads/2016/02/chancery-guide-feb-2016.pdf.
[31]*Id.*
[32]*Id.*
[33]*Fulham Football Club v. Richards* [2010] EWHC 3111 (Ch).

may decide mutually to go to the route of ADR.[34] Hence, while the UK has a practice of mediation within the insolvency regime, it is mostly restricted to the Chancery Division, and is yet to become as mainstream as it is in the US.

ADR in insolvency came to be accepted in the European Union gradually by way of case laws. The European Commission has proposed the Directive on Harmonisation of Insolvency Regulation, applicable to all the members of the European Union.[35] Many members have introduced pre-insolvency dispute resolution methods which are more debtor-centric.[36]For example, in France, insolvency proceedings comprise of an ad hoc mandate and conciliation. Germany's procedure of insolvency allows the creditor and the debtor conclude the proceedings through negotiation.

Japan has a Turnaround ADR system.The term 'turnaround' signifies debt restructuring, which mandates mediation for insolvency and reorganisation.[37] No court is involved in the process, rather three professionals are chosen as mediators. A debtor is expected to continue to

[34]Shreyas Jayasimha, Punthi Shah &Tushar Tyagi,*The Role of Arbitration and Mediation in Insolvency,*AARNA LAW (Jul. 13 2023), available at: https://www.aarnalaw.com/the-role-of-arbitration-and-mediation-in-insolvency/#_ftnref15.

[35] European Commission Proposal for a Directive on Insolvency, Restructuring and Second Chance Measures to Increase the Efficiency of Restructuring, Insolvency and Discharge Procedures and Amending Directive 2012/30/EU 2016 COM,available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52016PC0723.

[36] European Law Institute, Rescue of Business in Insolvency Law, 2017, available at: http://www.europeanlawinstitute.eu/fileadmin/user_upload/p_eli/Publications/Instrument_INSOLVENCY.pdf.

[37] Tomohiro Okawa, *Overview of Turnaround ADR and Recent Amendment*, Nagashima Ohno & Tsunematsu (June 2020), available at: https://www.noandt.com/en/publications/publication20392/.

operate the business as a going-concern.[38]It promotes negotiation between debtors and their creditors, overseen by licensed mediators, and is one of the most sought-after out-of-court debt restructuring schemes in Japan.[39]

Singapore also uses "plan mediation" in such proceedings with the use of mediation centres and experienced mediators. Inplan mediation, a mediator helps stakeholders decide the restructuring plan, and resolve any disputes in relation to jurisdiction of the insolvency proceedings.[40] The Singapore High Court recognised the benefits of the plan mediation in ***Re IM Skaugen***,[41] where it was observed that, "*the mediator can assist to iron out many of the wrinkles and creases that frequently erupt in a restructuring and which perhaps are not best resolved in the adversarial cauldron of the court."*

Vietnam's Civil Procedure Code of 2015 recognised results of mediation, while it was formally introduced into the system through the Decree 22 on commercial mediation.[42] Although, it has been included in statute books, the actual use of the mechanism remains difficult.

Tunisian law allows conciliation to reach a settlement to reschedule debts and prevent bankruptcy.[43] Certified public accountants are appointed to act as conciliators to help the creditors and debtors through an amicable

[38]*Id.*
[39]*Id.*
[40] Kenneth Lim Tao Chung and Chew Jing Wei, *ADR in Insolvency Proceedings*, Singapore Global Restructuring Initiative, Centre for Commercial Law in Asia (Feb. 7 2023), available at: https://ccla.smu.edu.sg/sgri/blog/2023/02/07/adr-insolvency-proceedings.
[41]*Re IM Skaugen* SE [2019] 3 SLR 979.
[42] Decree No. 22/2017/ND-CP on Commercial Mediation.
[43]Business Reorganisation Assessment (Tunisia), European Bank for Reconstruction and Development available at: https://ebrdrestructuring.com/storage/uploads/documents/13472%20EBRD%20(Tunisia%20Country%20Profile%20ARTWORK).pdf

settlement procedure.[44] The debtor requests for such a procedure to be initiated, and remains in control of the management. A ratified settlement agreement become binding on the creditors who participated in the process.[45]

On the other hand, countries like Chile and Peru have developed an inclination towards arbitration in relation to insolvency disputes. In Peru, a specialised administrative agency looks after all bankruptcy proceedings.[46] The CoC is empowered to make decisions regarding the proceedings, and is also given an option to decide if all disputes arising from the reorganisation plan or liquidation will be subject to arbitration. In Chile, the insolvency law[47] provides for the possibility to arbitrate both liquidation and reorganisation proceedings[48]. However, liquidation and reorganisation proceedings continue to be heard primarily by courts, and arbitrations do not generally involve international creditors.

The emerging use of mediation as a mechanism in insolvency and bankruptcy related matters can be a guiding force for India to formally incorporate it into its legal system. It can be used a preventive measure, and ensures that meaningful ways of saving an ailing company can be found.

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[44]*Id.*
[45]*Id.*
[46] Adam Brenneman *et al.*, *You Have Options: The Use of AlternativeDispute Resolution in Insolvency Proceedings*, EMERGING MARKETS RESTRUCTURING JOURNAL (2017), available at: https://www.clearygottlieb.com/-/media/organize-archive/cgsh/files/2017/publications/emrj-spring-2017/you-have-options-the-use-of-alternative-dispute-resolution-in-insolvency-proceedings.pdf.
[47]Law for Reorganisation and Liquidation of Assets for Companies and Individuals, Law No. 20.720.
[48]*Id.*

V. SUGGESTIONS AND WAY FORWARD

The discussion till now highlights the shortcomings in the CIRP with respect to timely resolution. As previously mentioned, mediation can act as a beacon of hope for speedy resolution of insolvency cases. To effectuate this proposition in the Indian context, it is pertinent to understand the existing jurisprudence.

In the case of ***Gayatri Polyrub Pvt. Ltd. v. Anil Kohli.***,[49]NCLAT held that the objective of the IBC is to revive the CD and that liquidation is to be seen as the last resort. Also, on reading the code it becomes clear that the code aims to provide for time-bound solutions. Besides, when most CIRP processes usually take more than the prescribed timeline and liquidation orders are also in big numbers, it becomes crucial to look for a better and more efficient method of resolving the issue.

NCLAT in its two decisions allowed the parties to opt out of the CIRP process, as they came up with their own solution and agreed on a settlement agreement. In the case of ***Vivek Bansal v. Burda Druck India Pvt. Ltd.***[50]the CIRP application made under Section 9 of the code was accepted by NCLT and later the IRP was appointed and moratorium was imposed. But before the COC was constituted, the parties settled the matter and agreed on a settlement agreement. Thereafter the CD appealed in the NCLAT to quash the order of the NCLT with respect to the IRP and the moratorium period. The court besides allowing the withdrawal from the CIRP process, also ruled that failure of the CD to adhere to the settlement

[49]*Gayatri PolyrubPvt. Ltd. v. Anil Kohli*, 2023 SCC OnLine NCLAT 700.
[50]*Vivek Bansal v. Burda Druck India Pvt. Ltd.*, 2020 SCC OnLine NCLAT 582.

agreement will give rise to the operational creditor's right to revive the CIRP proceedings.

In another case of ***ICICI Bank Limited v. OPTO Circuits (India) Limited,***[51] wherein the case of *Vivek Bansal v. Burda Druck India Pvt. Ltd.* was referred to, an application under Section 7 of the code was made to the NCLT and similar to the above caselaw a settlement agreement on payment of dues was agreed upon by the parties. The court on an appeal by the CD ruled in favour of the withdrawal from the CIRP and also gave the right to the appellant to resume the CIRP process in case the debtor fails to adhere to the settlement in strict sense.

From these case laws it can be understood that due to a settlement agreement between the parties, they were allowed to withdraw from the CIRP process by the tribunal. This would have not only saved them cost and time but also the commercial relationship. Relying on these case laws the authors propose to make it a practice for the parties to the CIRP process to go through mediation before starting the CIRP.

At the time when the applicant approaches the tribunal with an application under Section 7, 9 or 10 to initiate the CIRP process against the CD, the tribunal should ask them to try and solve the matter through mediation. If the parties agree and go for mediation and it turns out to be successful then the burden over the tribunals would be lessened and so will be the time taken and cost involved in the CIRP process. If the parties do not want to go for mediation or if the mediation process fails, the parties can undergo

[51]*ICICI Bank Limited v. OPTO Circuits (India) Limited*, 2022 SCC OnLine NCLAT 186.

CIRP process. To execute this there would be a need to amend Section 7, 9 and 10. Section 7(4) can be amended to add the words – ***"The adjudicating authority shall on receipt of the application inform the creditor that the parties may go for mediation to settle the dispute and also acquaint them with the benefits of the same."*** Similar line can be added to Section 9(5) and Section 10(4). The benefits which shall be told by the tribunal could be on the lines of the benefits iterated by the Chancery Guide, UK, which are lesser costs, preservation of the business and the commercial relationship and a variety of solutions.

Recently, the Indian Government came up with Mediation Act, 2023, **("Act")** which aims to promote and facilitate mediation, especially institutional mediation, for resolution of disputes, commercial or otherwise.[52] The act gives details about various aspects of mediation, such as mediation agreement, where will mediation not apply, appointment of the mediator etc. Section 5[53]of the Act provides for pre-litigation mediation and states that even in the absence of a mediation agreement, the parties can voluntarily agree to settle the dispute through mediation before filing the suit. But this section would apply to the tribunals which will be notified by the central government and till now no such notification has been released. This means that the parties who have some kind of mediation agreement or mediation clause, currently they would benefit from the act and not others.

[52]The Mediation Act, 2023, No. 32, Acts of Parliament, 2023 (India).
[53]The Mediation Act, 2023, § 5(1), No. 32, Acts of Parliament, 2023 (India).

Besides making provision in the Code for introducing mediation, we believe that the whole process regarding the same should also be stated in the Code for clarity. Due to the fact that the Central Government has not notified the tribunals under Section 5(2) of the act yet, hence, we propose the addition of ***"Section 7A"*** tothecode.This Section would entail the entire process of mediation required under Sections 7(4), 9(5) and 10(4).The authors suggest that such amendment should make provisions regarding the appointment of mediators, panel of mediators, timeline for the appointment of mediators and completing the whole process, presentation of report by the mediator and the future course of action. The authors suggest that provision to the following effect can be added in the Code, "***After informing the parties about going for mediation to solve the dispute under Section 7(4), the Tribunal can either appoint the mediator on the suggestion of the parties or in absence of any suggestion, the tribunal shall appoint the mediator on its own."*** Further, if the parties decide to appoint the mediator on its own, elaborative regulations should be introduced. Additionally, if the tribunal is to appoint the mediator, the same can be added in the code to the following effect, "***In case the parties request the tribunal to appoint a mediator, the tribunal will appoint one from the panel of mediators which it maintains***".The panel so maintained by, the tribunal should havemediators with experience in the field of restructuring and insolvency from which the Tribunal can select them, if the need arises.

In order to ensure that the process is completed in a time-bound manner, a timeline must be prescribed. Thus, the authors suggest that the mediator

should be appointed within seven days from the date of informing the decision of adopting the process of mediation. Also, the process of mediation shall be completed within 120 days, and an extension of maximum 60 days can be allowed.

Additionally, in line with the above mentioned NCLAT decisions,Section 7A can include the clause that reads that, ***"After mediation is completed, the mediator shall present before the tribunal, the settlement or non-settlement report. In case of settlement report not being followed in its entirety in the future, the creditor can re-instate the CIRP process afterwards and if a non-settlement report is filed then the Tribunal shall start with the CIRP process."***Similarly, for Section 9(5) and 10(4) of the Code, the procedure can be incorporated by way of reference.

VI. CONCLUSION

From the above discussion it becomes unambiguous that the process of CIRP is cumbersome and time taking as mostly the process is never completed within the mentioned time-period. Hence, going for mediation before starting the process of CIRP can prove to be a blessing for the people and they should opt for it. Various jurisdictions have embraced ADR mechanism to solve dispute and even NCLAT has allowed to withdraw from the process as a settlement agreement was agreed upon. NCLT is anyways burdened with a lot of cases, going for mediation wont only lessen the burden but ensure better protection of justice in other cases. The government and the tribunal should encourage people to take up the path of mediation before initiating the CIRP process which will let them

decide the terms and conditions as per their convenience and comfort. The result of the mediation process would be better suited for the parties as they themselves have agreed upon something. The rate of liquidation in CIRP cases is quite high which means that many businesses are getting shut, which not only affects the CD financially but also hampers his/her relations with the creditors who in the future may not be willing to help the debtor at all. In order to uphold the aim and objective of the IBC, which is time bound resolution, mediation can be thought of as a viable option which generally ends in a win-win situation for both the parties and would be helpful in maintaining the trust of the creditors and upholding the debtors right under Article 19(1)(g).