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PRE-PACKAGED INSOLVENCY RESOLUTION REGIME - NEED OF THE HOUR

Siddharth Srivastava,[⊥] *& Raunak Singh Rahangdale*[ø]

ABSTRACT

The COVID-19 outbreak and subsequent lockdowns caused havoc on the economy, with MSMEs bearing the brunt of the damage. The lockdowns triggered a prolonged period of stress in the industry owing to the lack of cash flows, low demand, lack of man power and lack of capital, which eventually culminated into a widespread declaration of insolvency by the MSMEs. This was a matter of significant concern for the policy makers for MSMEs are regarded as the backbone of the Indian economy.

*The traditional approach, CIRP, was ineffective owing to its time consuming and cumbersome framework. Therefore, the Pre-Packaged Insolvency Resolution Process ("**PPIRP**") was adopted as a unique and well-tailored insolvency resolution framework for troubled MSMEs. In essence, it is a hybrid framework, that incorporates the virtues of both informal (out-of-court) and formal (judicial) insolvency proceedings.*

*With this article, the authors aim to provide a holistic understanding of **PPIRP** as implemented in India. The author has attempted to analyse the regulatory framework associated with the process vis-à-vis the rationale behind its adoption. The article also highlights the advantages and the lacunae in the approach adopted the regulatory authorities.*

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INTRODUCTION

As a welcome change to the existing regime for revival of distressed entities in India, the Insolvency and Bankruptcy Code, 2016 ("**IBC**"/ "**Code**") was introduced in the year 2016. The Code was brought in force to achieve, *first*, reorganization and insolvency resolution of ailing corporate debtors;[1] *second*, maximization of value of assets of the corporate debtor; and *third*, promotion of entrepreneurship, availability of credit and balancing the interests of all stakeholders.[2] The Code emphasizes on revival of a corporate debtor in a time bound manner aimed towards continuance of the corporate debtor as a going concern.

In achieving the above objectives, the Code has not only benefitted and added to the economic growth of the country but has also revamped the entire regime for resolution of debts of distressed entities. The drive by the Government of India towards bringing in economic reforms for enhancing ease of doing business in India has resulted in India's "Ease of Resolving Insolvency" ranking, in the Global Innovation Index, going up from 111 in 2017 to 47 in 2020.[3]

The Code and its ecosystem have so far flourished and evolved while witnessing several developments and addressing several issues and challenges faced by it. It is noteworthy that, owing to the COVID-19 pandemic situation, the Code has been further reformed to limit the impact of COVID-19 on the ailing corporate debtors[4]. The various stakeholders including the Legislature, the Judiciary, the Bankruptcy Law Reforms Committee **("BLRC")**, Insolvency Law Committee, other committees/ sub-committees, the Insolvency and Bankruptcy Board of India **("IBBI")**, the Insolvency Professional Agencies **("IPAs")**, and the

[1] Swiss Ribbons Pvt. Ltd. & Anr. v. Union of India & Ors., (2017) 9 SCC 1.
[2] Binani Industries Limited v. Bank of Baroda & Anr. 2018 SCC OnLine NCLAT 521.
[3] Sub-committee of the Insolvency Law Committee, PRE-PACKAGED INSOLVENCY RESOLUTION. PROCESS (October 2020) para 1.1. available at: https://ibbi.gov.in/uploads/resources/65b114e356eacaaa2dbd25b210f845da.pdf . (last visited Nov 1, 2021).
[4] The Insolvency and Bankruptcy Code (Amendment) Ordinance, 2020.

Insolvency Professionals, etc. have played a crucial role and contributed immensely to the evolution of the Code.

Apart from the Code, there are few other regimes in force in India, such as the Scheme of Arrangement or Compromise (hereinafter referred as "**SOA**") under the Companies Act 2013 and RBI framework intended towards addressing issues regarding distressed entities and their stakeholders.

It is also however noteworthy that the said frameworks have some of their own shortcomings. While the Code has been fairly successful in achieving its goal of resolving ailing corporate debtors through implementation of resolution plans, however, majority of cases under the Code have gone into liquidation. By the end of June 2021, a total of 4541 corporate insolvency resolution processes **("CIRPs")** have commenced, of which, 2859 have been closed. Out of the CIRPs closed, 653 have been closed on appeal or review or settled, 461 have been withdrawn, 1349 have ended in orders for liquidation; and 396 have ended in approval of resolution plans.[5]

Further, the proceedings under the above frameworks are initiated at a stage where the corporate debtor has reached a point of no return. By that time, most of the value of the corporate debtor is either eroded or diminished. Further, there is a confrontation of the interests of the corporate debtor and the creditors at the time of resolution/ recovery. Moreover, the frameworks are also not available for all kinds of entities. There have also been considerable delays in disposal of cases and there is a huge backlog of IBC related matters in various judicial forums. Considering the above, a need has been felt to further revamp the existing framework and to bring in force a more time and cost-effective hybrid regime which addresses the shortcomings of the existing framework.

[5] *Id.*

PRE-PACKAGED INSOLVENCY RESOLUTION REGIME IN INDIA

I. INTRODUCTION

With the above background, the Government of India constituted a seven-member sub-committee of Insolvency Law Committee (hereinafter referred as "**Committee**"), chaired by Dr M.S. Sahoo, Chairperson of Insolvency and Bankruptcy Board of India (hereinafter referred as "**IBBI**") and Member of ILC[6], to examine the possibility of introducing Pre-Packaged Insolvency Resolution Process ("**PPIRP**") in India. Pursuant to this, the Committee had prepared and submitted its report in October 2020[7]. Subsequently, the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2021 ("**IBC Ordinance**") was brought into force with effect from 04 April 2021 with a corrigenda to the IBC Ordinance on 05 April 2021, to amend the Code and *inter alia* introduce PPIRP for corporate persons classified as micro, small and medium enterprises under sub-section (1) of section 7 of the Micro, Small and Medium Enterprises Development Act, 2006 ("**MSMEs**")[8]. The Insolvency and Bankruptcy Code (Amendment) Bill, 2021 was later introduced and passed in the Lok Sabha and the Insolvency and Bankruptcy Code (Amendment) Act, 2021 ("**IBC Amendment**")[9] came into force on 11 August 2021 with the assent of the Hon'ble President of India. In this regard, IBBI has brought into force the IBBI (Pre-Packaged Insolvency Resolution Process) Regulations, 2021 ("**PPIRP Regulation**") with effect from 09 April 2021[10] governing the procedure for running of PPRIP.

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[6] Order No. 30/20/2020- Insolvency Section, Government of India, Ministry of Corporate Affairs dated 24 June 2020.

[7] Supra note 3 f.

8 Ministry of Corporate Affairs, *President promulgates Insolvency and Bankruptcy Code (Amendment) Ordinance, 2021*, press information bureau (April 2021). available at: https://pib.gov.in/PressReleaseIframePage.aspx?PRID=1710161.

[9] The Insolvency and Bankruptcy Code (Amendment) Act, 2021. Available at:https://ibbi.gov.in//uploads/legalframwork/0150ec26cf05f06e66bd82b2ec4f6296.pdf.

[10] Insolvency and Bankruptcy Board of India (Pre-packaged Insolvency Resolution Process) Regulations, 2021. available at :

Pre-pack mechanism, as a practice, has evolved in the United Kingdom and the United States of America. In this mechanism, the debtor company and its creditors conclude an agreement for the sale of the company's business prior to the initiation of formal insolvency proceedings.[11]

II. RATIONALE BEHIND PPIRP

PPIRP as a mechanism, in its essence, is a corporate rescue mechanism or a corporate restructuring mechanism which is a combination of both the formal (judicial proceedings) and the informal (out-of-court procedures and settlements) structure. It is a hybrid framework which is considered both time and cost efficient and also more effective in terms of resolution of stress.[12]

PPIRP, being a new addition to India's four-year old Code, offers an alternative way of turning around medium and small businesses. Unlike the CIRP, wherein upon commencement, the existing management of the corporate debtor is completely displaced and taken over by the resolution professional, in a PPIRP, the corporate debtor remains with the existing management, ensuring that there are least disruptions in the operations of the corporate debtor. This helps advance the growth of the corporate debtor as a going concern even while the revival process is undergoing. This also helps avoid erosion of the value of the corporate debtor and the loss of employment.

Due to the Covid-19 pandemic, MSMEs and their businesses have been the most impacted and were exposed to substantial financial distresses. MSMEs, therefore,

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https://ibbi.gov.in//uploads/legalframwork/0dd40b82af7a770d5e89c0d9e37bdb45.pdf (last visited Nov 1, 2021).

[11]Department of Economic Affairs, Ministry of Finance, The Bankruptcy Law Reform Committee (BLRC), Interim Report of the Bankruptcy Law Reform Committee (February, 2015), available at:https://www.finmin.nic.in/sites/default/files/Interim_Report_BLRC_0.pdf .

[12] Supra note 3, at para 3.13.

have been brought under the purview of PPIRP framework as it caters to their unique nature of business and simpler structures.

III. PPIRP FRAMEWORK IN INDIA

A. Applicability of PPIRP in India

As per the IBC Amendment, at this stage, PPIRP framework has been made applicable to a corporate debtor classified as MSMEs with a default threshold of INR 10,00,000/- to INR 1,00,00,000/-. MSMEs in the form of proprietorship, partnerships, Hindu Undivided Family (HUFs) are ineligible under the PPIRP framework.

B. Initiation of PPIRP

Under the PPIRP Framework, an application for commencement of PPIRP may be filed by the corporate debtor after obtaining approval from its financial creditors not being its related parties, representing not less than 66% in value of the financial debt due to such creditors[13], subject to conditions as laid down in Section 54A (2) of the Code. Prior to seeking approval of the financial creditors, the corporate debtor is required to furnish, *inter alia,* a base resolution plan which confirms to the requirements referred to in Section 54K of the Code.

C. Appointment of Insolvency Professional – Pre-Admission Stage

Under the PPIRP framework, the financial creditors of the corporate debtor, not being its related parties, representing not less than 66% in value of the financial debt due to such creditors, are required to propose the name of the insolvency professional to be appointed as resolution professional for conducting PPIRP of the corporate debtor.[14] The said resolution professional shall be required to prepare and furnish with IBBI, reports confirming *inter alia* compliance of the

[13] The Insolvency and Bankruptcy Code, 2016, §54A (3), No. 31, Acts of Parliament, 2016 (India).
[14] The Insolvency and Bankruptcy Code, 2016, § 54A (2)(e), No. 31, Acts of Parliament, 2016 (India).

corporate debtor with Section 54A and that the base resolution plan confirms to the requirements laid down in Section 54K.

The duties of the said resolution professional shall cease in case the corporate debtor fails to file an application for initiating PPIRP within the period as stated in 54A(2)(f) or the application for initiating the PPIRP is admitted or rejected by the Adjudicating Authority.

D. Application to the Adjudicating Authority

Subject to compliance with Section 54A of the Code, a corporate applicant may file an application along with the relevant documents stated therein with the Adjudicating Authority for initiating PPIRP. The Adjudicating Authority is required to admit or reject the application on the basis of its completion within 14 days of receipt of the application.[15]

On the admission of application, the Adjudicating Authority shall *inter alia* declare a moratorium under Section 14(3)(1) of the Code, appoint a resolution professional and cause a public announcement of the initiation of PPIRP to be made by the resolution professional.

E. Appointment of a Resolution Professional – Post-Admission Stage

The resolution professional is required to conduct the PPIRP of a corporate debtor and discharge duties in this regard *inter alia* including constitution of committee of creditors, confirming list of claims submitted by the corporate debtor, monitoring management of affairs of the corporate debtor, preparing information memorandum, etc.[16]

[15] The Insolvency and Bankruptcy Code, 2016, § 54C (4)), No. 31, Acts of Parliament, 2016 (India).
[16] The Insolvency and Bankruptcy Code, 2016, § 54F, No. 31, Acts of Parliament, 2016 (India).

F. Committee of Creditors ("CoC")

The Committee of Creditors shall be constituted within 7 days of commencement of PPIRP.[17] The provisions of Section 21 of the Code shall apply *mutatis mutandis* to a PPIRP.

G. Management of Affairs of Corporate Debtor: PPIRP Model

Under the PPRIP framework, a hybrid approach of debtor-in-possession with creditors-in-control model has been followed. Upon the commencement of PPIRP, the PPRIP framework allows the corporate debtor's management to continue to run the business during the PPIRP, unlike under CIRP, where on its commencement the powers of the board of directors and the management and control of the corporate debtor are vested in the resolution professional.

Provided however that, for certain crucial matters which require approval of the committee of creditors under a CIRP as stipulated in Section 28 of the Code are also applicable to PPIRP.

Additionally, to ensure efficiency in the PPIRP, management of the corporate debtor may be vested with the resolution professional in certain scenarios. In case, the CoC by vote of not less than 66% percent voting share resolves to vest the management of the corporate debtor with the resolution professional, the resolution professional shall make an application to the Adjudicating Authority. On such application, the Adjudicating Authority on being satisfied that the affairs of the corporate debtor are conducted in a fraudulent manner or if there has been gross mismanagement of affairs of the corporate debtor, pass an order vesting the management of the corporate debtor with the resolution professional.[18]

H. Resolution Plan

[17] The Insolvency and Bankruptcy Code, 2016, § 54I (1), No. 31, Acts of Parliament, 2016 (India).
[18] Insolvency and Bankruptcy Code, 2016 §54J (2), No. 31, Acts of Parliament, 2016 (India).

A corporate debtor is required to submit the base resolution plan, as submitted by it, to the financial creditors before the initiation of PPIRP to the resolution professional within 2 days of the PPIRP commencement date. The base resolution plan needs to follow the provisions of Sections 30 (1), (2) and (5) of the Code. The CoC may provide the corporate debtor an opportunity to revise the base resolution plan or invite prospective resolution applicants, as the case may be.[19]

The base resolution plan may be approved by the CoC if it does not impair any claims owed by corporate debtor to the operational creditors. When the CoC does not approve of the base resolution plan or if the base resolution plan impairs any claims owed by the corporate debtor to the operational creditors, the resolution professional is required to invite prospective resolution applicants who shall submit resolution plans so as to compete with the base resolution plan, based on criteria laid down by the resolution professional with the approval of the CoC.[20]

Based on the evaluation of the resolution plans received vis-à-vis the criteria laid down by the resolution professional and compliance with provisions of the Code, the resolution professional is required to present compliant resolution plans to the committee of creditors for its evaluation. Based on the evaluation, the CoC shall select a resolution plan from the resolution plans received.[21]

In case the selected resolution plan is found to be significantly better than the base resolution plan, then such resolution plan shall be selected for approval and submission to the Adjudicating Authority. If the selected resolution plan does

[19] Insolvency and Bankruptcy Code, 2016, § 54K (1), (2) and (3), No. 31, Acts of Parliament, 2016 (India).
[20] Insolvency and Bankruptcy Code, 2016, § 54K (4) and (5), No. 31, Acts of Parliament, 2016 (India).
[21] Insolvency and Bankruptcy Code, 2016, § 54K (9), No. 31, Acts of Parliament, 2016 (India).

not fulfil the above criteria, then the same will compete with the base resolution plan and one of them shall be selected for approval and submission to the Adjudicating Authority.[22]

The approval of resolution plan by the CoC shall be by a vote of not less than 66% of the voting shares for submission to the Adjudicating Authority.[23] The Adjudicating Authority shall, on being satisfied about the compliance/ non-compliance of the resolution plan with the terms of the Code, within 30 days of receipt of the resolution plan, either approve or reject the resolution plan and terminate the PPIRP.[24]

I. Termination of PPIRP

The Adjudicating Authority can terminate the PPRIP in case the resolution professional files an application with the Adjudicating Authority under Section 54N under the proviso of Section 54K (12) or under Section 54D (3) of the Code.

J. Time Period for Completion of PPIRP

The pre-packaged insolvency resolution process shall be completed within a period of 120 days from the PPIRP commencement date.[25]

IV. ADVANTAGES OF PPIRP

PPIRP is a blend of formal and informal mechanisms for resolving distress amongst the corporate debtors. It is also cost and time effective, as the mechanism involves minimal court involvement and simpler processes. Due to minimal court involvement in PPIRP, the burden on judiciary is also reduced. Furthermore, during the PPIRP, the corporate debtor continues to retain control of the business, therefore, causing minimal disruption to the corporate debtor's

[22] Insolvency and Bankruptcy Code, 2016, § 54K (10) and (11), No. 31, Acts of Parliament, 2016 (India).
[23] Insolvency and Bankruptcy Code, 2016, § 54K (13), No. 31, Acts of Parliament, 2016 (India).
[24] Insolvency and Bankruptcy Code, 2016, §54L (1) and (3), No. 31, Acts of Parliament, 2016 (India).
[25] Insolvency and Bankruptcy Code, 2016, §54D, No. 31, Acts of Parliament, 2016 (India).

business and helps in preventing employment losses. Though the framework provides for no participation of operational creditors, it promotes the interest of operational creditors by stipulating that the base resolution plan must not impair any claims owed by the corporate debtor to the operational creditors.

The most advantageous part of pre-packs in India is that it shall further the objectives of the IBC while positively impacting the Indian economy. Introduction of pre-packs would further strengthen India's position in terms of ease of doing business and in ease of resolving insolvency.

V. CONCERNS REGARDING PPIRP

It is often argued that the corporate debtors go into distress due to the actions of the management. It is also argued that the management's actions push the corporate debtors into insolvency. In such a scenario, letting the management to control the corporate debtor while undergoing PPIRP may pose a challenge and contribute to transparency issues. This may also turn out to be prejudicial to certain stakeholders of the corporate debtor.

Further, while entering PPIRP, since the corporate debtor is already in distress, the entire 'going concern framework' under PPIRP for the corporate debtor may fail as the corporate debtor may not be able to sustain itself during the PPIRP period.

CONCLUSION AND THE WAY FORWARD

COVID-19 pandemic has adversely impacted the country's economy. Its major impact has been faced by several MSMEs in India, thereby pushing them into distress and in need for swift and timely revival. Therefore, PPIRP, being the need of the hour, has been brought into force by the legislature. Introduction of PPIRP framework, being a hybrid combination of formal and informal mechanism for swiftly addressing the distress amongst MSMEs, would be the

first step towards building up of another robust structure to resolve distress amongst entities in India. In this regard, considering the shortcomings faced by the stakeholders under the existing frameworks, going forward, the PPIRP may be implemented not only for the MSMEs but also for other entities as well.

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Dr. Neeti Shikha & Urvashi Shah, Evaluating Bail-in as a Method of Resolution, 9(2) SCHOLASTICUS 13 (2022)

EVALUATING BAIL-IN AS A METHOD OF RESOLUTION

Dr. Neeti Shikha[⊥] *& Urvashi Shahi*[∅]

ABSTRACT

In light of the collapse of financial institutions of significance and such failure being associated with critical financial crises, it is the responsibility of the relevant authorities to prevent unregulated bankruptcy that might have adversely affected financial stability. In the light of the same, various elements are worth evaluating – bail-in provisions being one of such elements. Bail-in is a resolution method which constitutes writing down non-secured debt into equity. In this paper, the authors study bail-in as a resolution method, point out the associated risks, and compare bail-in and bail-out resolution methods to. Further, a cross-country comparative study of bail-in provisions is done to better understand its significance in insolvency resolution structures at a global level. More significantly, the paper analyses the Indian attempts to adopt bail-in method under the FRDI Bill.

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INTRODUCTION

There has been the failure and collapse of several big and sophisticated financial institutions in the global financial crisis. This leads to an extraordinary variety of authorities' actions to prevent unregulated bankruptcy that might have adversely affected financial stability. The focus has been widely placed on ensuring that each jurisdiction has an adequate financial safety net with a solid crisis management system. Emerging trends indicate that the financial safety net and crisis management framework should contain many important elements. One of the most popular resolution methods in the world is 'Bail in.'

"Bail-in" is a statutory power of the resolution authority to restructure the liabilities of financial distressed companies by converting and/or writing down non-secured debt into equity. Bail-in is one of the requirements of an effective resolution system as provided for in the FSB Key Attribute 3.5. Bail-in attempts to rectify the financial condition of the bank by decreasing the equity and liabilities of its creditors.[1] This is done by reducing equity and liabilities to as much as zero or converting liabilities into equity or equity issuance.[2] The core of a bail-in is the view that, under certain situations, certain creditors of an entity should be listed against the entity (in whole or in part), while other creditors of the same company stay intact.[3]

The bail-in also has the consequence of leaving all the creditors in a situation no worse than would be the case if it were liquidated under general insolvency law. In addition, bail-in became an effective option in financial-institute resolution

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[1] Edoardo Martino, *The Bail-in Beyond Unpredictability: Creditor's Incentives and Market Discipline*, EUROPEAN BUSINESS ORGANISATION LAW REVIEW, pp.798-800, (2020),https://doi.org/10.1007/s40804-020-00188-7.

[2]Matthias Lehmann, *Bail-in and Private International Law: How to Make Bank Resolution Measures Effective across Borders*, 66(1), INT COMP LAW Q, pp. 107-108, (2017).

[3]Simon Gleeson, *Legal Aspects of Bank Bail-Ins*, SP-205, LSE-FINANCIAL MARKETS GROUP PAPER SERIES, pp.5, (2012).

regimes around the globe, particularly after the 2007-09 GFC in which many governments relied on state funding, rescues or the use of taxpayers' money in an attempt to cope with the moral risk or assumption of the unavoidable state intervention to rescue financial-institutions.[4] A method to avoid the moral hazard issue, therefore, is to persuade market players to refrain from providing liquidity assistance or rescue and instead to resolve the financial institution despite its systemic significance.[5]

Bail-in approaches vary based on the kind of organisation (‘resolution entity') to which resolution tools would be used under the resolution strategy. A resolution entity may be a parent company, an intermediate or final operational or non-operating holding company, or an operating subsidiary, depending on the firm's organizational structure and resolution plan.[6] Many of the problems addressed in the context of bail-in execution, such as compliance with securities legislation and other regulatory obligations, and engaging with creditors and other stakeholders, are influenced by these distinctions.[7] The economic effect of bail-in is the same regardless of which approach to bail-in is taken or which type of entity resolution tools are used: a write-down of equity or other instruments of ownership of the firm, as well as a write-down and/or conversion into equity of all or parts of unsecured and uninsured creditor claims.[8]

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[4]Jacob Turner & Konrad Rodgers, *Challenging the Bail In*, 131 BANKING LAW JOURNAL,584, (2014).

[5] Tracy ChiyedzaMaguze, *EU Bank Recapitalisation and the Bail in Option: An Analysis of the Effects of Mandatory Bail in on Creditor's Property Rights*, Vol.5, UCL JOURNAL OF LAW AND JURISPRUDENCE, pp.207-209 (2016).

[6] Ronald W. Anderson, *Ownership and Control in Bail-in and Special Resolution*, London School of Economics FMG Workshop on the Design of Bail-in Arrangements and Special Resolution Regimes, pp.3-5, (2011), https://personal.lse.ac.uk/andersor/Ownership%20and%20Control%20160311.pdf.

[7] Barry Adler, *Financial and Political Theories of American Corporate Bankruptcy*, Vol. 45, STANFORD LAW REVIEW, pp. 311, (1993).

[8] *Principles of Bail-in Execution*, FINANCIAL STABILITY BOARD, pp. 1-5, (2018), https://www.fsb.org/wp-content/uploads/P210618-1.pdf.

As a result, the bail-in initiative's main goal is to recapitalize the nonviable bank so that it may continue to offer banking services without the need for a public bailout. Since the global financial crisis, a series of new international banking rules have been implemented to help reduce the risk of another financial crisis and to strengthen banks so that they are less likely to fail, with a "bail-in regime" being one of the measures that countries around the world are implementing.[9]

This paper is a part from a project funded by the Ministry of Corporate Affairs.

INDIA'S ADOPTION OF BAIL-IN

The FRDI Bill offered several tools to settle a failing financial firm, including transfer of its assets and liabilities, mergers or even liquidation. Bail-in provision was one of the resolution options allowed for in the Bill. This provision enabled a financial firm on the brink of not being saved by restructuring its debt internally. The provision has been criticized as high as possible for causing systemic risk and for putting numerous depositors at danger. This was one of the major reasons why FRDI Bill was withdrawn. Bail-in is a useful instrument for insolvency resolution and may effectively be used to alleviate stress in banks, if designed with protections. The Indian draft Bill allowed for these protections and was not as risky as the people believed it to be. One issue that is often made in relation to bail-in capital is that, given that it is the regulator's discretion to take out a bail-in trigger and the quantum of the resultant writing-down or conversion, bail-in debt holders cannot make a meaned pre-estimate of their risk of loss. This will make it difficult or impossible to price such debt on the market.[10] This was one of the

[9] Kabir S. Katata & Kingsley O. Nwaigwe, *Bail-In As An Alternative Failure Resolution Mechanism in Nigeria*, Vol. 30, NIGERIA DEPOSIT INSURANCE CORPORATION QUARTERLY, pp. 22-24, (2016).

[10] Gayatri Mann, *Resolving failure of Financial Firms: The FRDI Bill explained*, PRS LEGISLATIVE RESEARCH, https://prsindia.org/theprsblog/resolving-failure-of-financial-firms-the-frdi-bill-explained.

main reasons for such serious criticism and public reaction in the presentation of the FRDI bill in India.[11]

In India, for years the central bank has rescued financial firms. The FRDI Bill has substituted bail with Bail, which has provoked much outrage. Most nations have discussed at some point in history whether to implement bail-in or bail-outs for the recovery of financial services. We examine cross country experience in the following paragraphs and suggest that bail in India as recommended is the correct strategy.

BAIL IN VS. BAIL OUT- CROSS COUNTRY EXPERIENCE

There are numerous kinds of bank bailouts and bail-ins. Bailouts may be arranged in the form of capital injections like the TARP cases, and liquidity requirements, bank liability guarantees, government takeovers by banks or other bodies linked to banks, asset relief programs such as purchase of securities with huge inventories by banks, and public bank security certifications. All three kinds of bank rescues happened in the United States in reaction to the global financial crisis which began in the late 2000s and its subsequent events. Many of these kinds of bailouts were also carried out in Europe and elsewhere across the globe in reaction to the spreading of the international financial crisis from the US to other nations and to the subsequent European sovereign debt crisis. Bank rescues were generally unpopular during the World Financial Crisis and the European Sovereign Debt Crisis. [12]In part due to the widespread unhappiness with bailouts undertaken during the GFC and European sovereign debt crisis, governments have created bail-in regimes with large amounts of money, liquidity, guarantees

[11]Remya Nair &Asit Ranjan Mishra, *Govt decides to withdraw contentious FRDI Bill*, LIVE MINT, (July 2018), https://www.livemint.com/Politics/j4jq9XlPrA6mgsEVhK1hsJ/Controversial-bank-reconstruction-bill-may-be-pulled-out.html.

[12] Luca Leanza, Alessandro Sbuelz & Andrea Tarelli, *Bail-in vs Bail-out: Bank Resolution and liability structure*, 73, INTERNATIONAL REVIEW OF FINANCIAL ANALYSIS, pp.143, (2021).

or other assistance provided by private players. Major banks, in the U.S. and the EU, are now rescued via bail-in regimes through the Orderly Liquidation Authority and the BRRD.[13]

OLA was created by the 2010 Dodd-Frank Act. An OLA event occurs when a major BHC fails or fails, and its collapse will have severe negative effects on financial stability. The BHC is temporarily taken over by Federal Deposit Insurance Corporation (FDIC), which dismisses its management, although banks and other owned holding companies continue to function. Existing shareholders are wiped out and subordinated debt owners and potentially other uninsured creditors are converted into share capital by making the BHC adequately funded. The BHC is then returned with new administration to private entities. [14]

Note: Although no OLA bail-in event was triggered at the time of this writing for any BHC, this does not imply that OLA had no effect on BHC conduct or on financial system stability. The BRRD is the collection of bail-in regulations while the Single Resolution Mechanism (SRM) executes these rules. When an organisation approaches the threshold of nonviability and it is designated as "failing, or about to collapse," a bail-in mechanism enables regulators to quickly recapitalize an institution in distress before default, either by debt writing-off, or by converting it into shareholdings. In particular, the BRRD sets the hierarchy such that the bail-in first affects equity owners, followed up by subordinated debt holders, senior non-insured loan holders and uninsured depositors. This is to reduce taxpayers' and real economy expenses.[15]

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[13]1, ALLEN N. BERGER & RALUCA A. ROMAN, "TARP AND OTHER BANK BAILOUTS AND BAIL-INS AROUND THE WORLD," pp.6, (Academic Press 2020).
[14] *Id*. at 13.
[15]Emilios Avgoules & Charles Goodhart, *Critical Reflections on Bank Bail-ins,* 1, JOURNAL OF FINANCE REGULATIONS, pp. 6 (2015).

In the UK, the debate on rescue took centre stage during the 2008 financial crisis. In the course of the crisis, the UK government was obliged to step in and give trillions of pounds to help banks collapse to preserve broader economic financial stability.[16] The bail-in option is a new way for the Bank of England to resolve the banks, building societies and investment companies that fail (or probably fail) and to guarantee that the consequences of such failures are paid by shareholders and company creditors rather than taxpayers.[17]

In the Banking Act 2009 ("the Banking Act"), the Special Resolution Regime (SRR) conferred a variety of resolution authorities on the Bank of England and on HM Treasury. The Act 2013 of Financial Services (Banking Reform) provides an additional alternative for the Bank of England for banks, construction companies, investment businesses and certain banking group companies to resolve: the bail-in stabilization option. [18]

A comprehensive financial sector reform initiative has been undertaken at national, European and international levels since the financial crisis. The Government has established an Independent Banking Commission (ICB) to examine structural and associated non-structural changes in the UK banking industry to enhance financial stability and competitiveness. It reported in 2011, and the adoption of a bail-in tool was one of its main recommendations. The Parliamentary Banking Standards Commission (PCBS) also proposed bail-in powers in its June 2013 report. The Financial Stability Board (FSB) has suggested that resolution regimes establish a bail-in mechanism to enhance the toolbox for

[16]Graeme Wearden, *British government unveils £ 37bn banking bail-out plan*, THE GUARDIAN, (October 2008), https://www.theguardian.com/business/2008/oct/13/marketturmoil-creditcrunch.

[17]HM Treasury, *Consultation Outcome, Bail-in Power Implementation,* UK Government,(December, 2014).

[18]HM Treasury, *Bail-in powers implementation*: Summary of responses, UK Government, (December 2014).

managing the collapse of big and internationally systemic institutions, which is supported by the G20.[19]

Singapore offers a bail-in system for stressed financial firms. The Singapore Monetary Authority ("Act") has been modified to strengthen and expand the capabilities of the Monetary Authority of Singapore ("MAS") to orderly resolve troubled financial institutions ("FIs"). Most importantly, the MAS' rights to bail-in the ownership and liabilities of the troubled FI in order to assist in the recapitalization have entered into effect and will apply to qualifying instruments issued after or on 29 November 2018. [20]

To help implement the amendments, Regulations 2018 of the Singapore Monetary Authority ("RFI Regulations") were published and likewise came into force on 29 October 2018. MAS has consulted on draught versions of these rules from 16 July 2018 to 16 August 2018. MAS replied to the comments it received on 26 October 2018. MAS shall be authorized to bail out the ownership and obligations of a troubled FI. This is to assist in recapitalizing troubled FIs and to minimize depositors' risk and dependence on public money to 'rescue' distressed FIs.[21] The bail-in powers include the authority to cancel, change or convert an instrument, for example, the conversion of debt to equity and are subject to the permission of the finance minister. Upon approval, the Minister shall issue a bail-in certificate with effect before the appointment of the bail-in certificate notwithstanding restrictions on the basis of the contract, any written legislation or rule of law in force.

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[19] *Supra note* 17.
[20] Allen & Gledhill ,*New Resolution Regime for FIs in Singapore*, pp. 4, (2018), https://www.allenandgledhill.com/sg/publication/articles/8146/new-resolution-regime-for-fis-in-singapore.
[21] *Id*. at 20.

The RFI Regulations specify the scope of FIs and instruments subject to statutory bail-in, provide the information to be included on the bail-in certificate, and require a disclosure of any offering document in relation to an eligible instrument of the implications of a bail-in on the front cover.

FIs under the purview of MAS' bail-in powers include banks and holding companies which are incorporated in Singapore. MAS stated that MAS has taken a cautious approach, beginning with Singapore-incorporated banks and bank holding companies, since bail-in entails explicit damages for creditors, rather than just postponing contractual rights. MAS would continue to watch worldwide trends in bail-in regimes with non-bank FIs. In its reply, MAS said that only the unsecured component of qualifying partly secured instruments would fall within the purview of the MAS bail-in authorities. Vanilla furthermore usually would not satisfy the criteria of eligible instruments as set out in the RFI Regulations for senior securities, convertible bonds and Senior Exchangeable Bonds, Options and Warrants. Derivatives contracts are specifically excluded (as specified by the RFI Regulations) from the scope of eligible instruments.[22]

South Africa too adopted for bail in through the Financial Sector Laws Amendment Bill (FSLAB). FSLAB seeks to establish a resolution framework in South Africa compliant with the Key Attributes for Effective Resolution Regimes of the Financial Stability Board. Within the context of the strengthened resolution framework, bail-in will become an important mechanism for open-bank resolution strategies, which will most likely apply to banks that have been designated systemically important.

Countries	**UK***	**Singapore**	**Australia**	**South Africa**	**FRDI Bill (India)**

[22] Lucas Marc Fuhrer, *To BailOut or Not To Bail Out Systematically Relevant Financial Institutions: The Incentives Of Policy Makers,* 1, JOURNAL OF GOVERNMENT AND REGULATION, pp.88-90, (2012), http://dx.doi.org/10.22495/jgr_v1_i4_p7.

Eligible Instruments	Sequence justifies the eligibility of instruments for bail-in.	▪ Equity instrument (Addl. Tier 1 capital) ▪ Any unsecured liability (Addl. Tier1 and 2 capital) ▪ Contractual bail-in instruments	Additional Tier1 and Tier 2 capital instruments.	▪ First loss after capital ("FLC")** instruments. ▪ Unsecured liabilities.	Eligible instruments to be specified in form of regulations by the RC.
Excluded Instruments	▪ Protected deposits ▪ Secured debts ▪ Liabilities for holding client assets ▪ Liabilities of less than 7 days' maturity owed to financial entity ▪ Liabilities with remaining maturity of <7 days owed to settlement systems. ▪ Salary liabilities owed to employee or former employee ▪ Pension scheme liabilities	▪ Derivatives contract. ▪ Issuance before 29th Nov, 2018 [enactment of the Monetary Authority of Singapore ("**MAS**") Act] ▪ Secured portion of any liability ▪ Certain senior securities.	No excluded liabilities.	▪ Unsettled exchange traded transactions ▪ Certain derivatives instruments ▪ Deposits owed to the corporation for public deposits ▪ Unsecured transactions between certain settlement systems	▪ Liabilities to insured depositors. ▪ Liabilities for holding client assets ▪ Liabilities of original maturity upto 7 days. ▪ Liability owed to CCP ▪ Secured liability ▪ Liabilities owed to employee/workmen, including pension liabilities. ▪ Transaction pertaining to early termination rights.

	▪ Critical operations' liabilities ▪ Liabilities related to deposit insurance schemes (Further scope for exclusion)				
Sequence of Write-down	▪ Common Equity Tier-1 instrument ▪ Additional Tier-1 instruments ▪ Additional Tier-2 instruments ▪ Principal amount of subordinated debt ▪ Remaining eligible liabilities	Sequence to be determined according to eligible and excluded liabilities.	Sequence to be derived from eligible instruments.	▪ FLAC ▪ Unsecured liabilities.	Sequence to be inferred after considering eligible and excluded liabilities.
Safeguards	▪ Right to compensation if non-compliance of NCWO principle ▪ A business reorganisation plan to be submitted for stabilising,	▪ Right to compensation if non-compliance of NCWO principle ▪ Public interest to be seen ▪ Any widespread adverse	▪ Contractual recognition of bail-in in eligible instruments is mandatory. ▪ Constitutional principles for compensat	▪ Right to compensation if non-compliance of NCWO principle ▪ Pari Passu and creditor hierarchy to be followed.	▪ Pari Passu and creditor hierarchy to be followed ▪ Right to compensation if non-compliance of NCWO principle ▪ Contractual recognition of bail-in.

	after bail-in, in case of banking groups. ▪ Pari Passu and creditor hierarchy to be followed.	impact on financial system to be considered. ▪ Maximisation of creditors' interests.	ion may be made applicable.		▪ Continuity of critical functions ▪ Protection of client assets & funds, at least to the extent of protection in liquidation.

The legal powers proposed through the FSLAB (including proposed amendments to the creditor hierarchy contained in the Insolvency Act of 1936) provides the Resolution Authority with the legal certainty necessary to "bail-in" (i.e., write off or convert to equity) eligible bank debt instruments. The FSLAB introduces and defines "flac instruments" which allow for bail- in in a sequence and combination that respect the amended creditor hierarchy and a Key Attributes safeguard known as "no creditor worse off than in liquidation". This principle is premised on the idea that resolution should not result in an outcome in which a creditor or shareholder of a bank in resolution are economically worse off than they would have been under normal insolvency proceedings. [23]

Statutory bail-in allows for legal certainty on the part of the Resolution Authority to affect a bail-in as a credible resolution tool, allowing for the bank in resolution to recapitalize from within its balance sheet. Bail-in can be defined as the statutory imposition of losses on liabilities of a financial institution where such liabilities are not designed, by their terms, to absorb losses outside of an insolvency procedure. The first possible use of the bail-in tool under a bank resolution regime is therefore to capitalize an institution under resolution, and therefore a key determinant within the resolution framework becomes the level

[23]Roopnarain, Rivan Tock & Irwin Lim Ah, "*South Africa: Feasibility and Cost-Benefit Analysis of Using Bail-In as a Recapitalisation Mechanism Financial Sector Development Reform Program",* World Bank & Pricewaterhouse Coopers, Available at: http://documents.worldbank.org/curated/en/750901611343893707/South-Africa-Feasibility-and-Cost-Benefit-Analysis-of-Using-Bail-In-as-a-Recapitalisation-Mechanism .

of loss-absorbing capacity that a bank is required to maintain (the "recapitalization amount"). [24]

In principle, the recapitalization amount would equal the aggregate amount according to the resolution valuation necessary to absorb all losses, restore and maintain the bank's compliance with its licensing and authorization conditions for a (usually specified) period, as well as sustain market confidence in the institution. A secondary use of the bail-in tool is to reduce the principal amount of, or convert into equity, claims or debt instruments of the bank subject to other resolution tools – for instance debt instruments transferred to a bridge institution (in order to provide capital for that bridge institution), or claims or debt instruments that are transferred under the sale of business resolution tool or the asset separation resolution tool. Except for the bail-in resolution tool, these other resolution tools do not form part of the research scope and are therefore not actively discussed in this report. In a South African context, proposed amendments to the FSRA and the Insolvency Act, through the FSLAB, introduces a new tranche of loss-absorbing debt instruments i.e. "flac instruments". Flac instrument is be subordinated to other unsecured liabilities and be clearly intended for bail-in in resolution.

The Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017, that was cleared in 2018 and modified the Banking Act 1959 to give the Australian Prudential Regulation Authority[25] (Apra) stronger authority to handle dangers to a bank's solvency in a financial meltdown, is at the heart of the issue of bail in Australia. The 2018 change, in particular, provides Apra, which supervises Australia's financial institutions, the authority to allow

[24] *Id*. at 23.

[25]Paula Pyburne and Phillip Hawkins**, "***Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Bill 2017*"**,** Bills Digest no. 80, 2017–18**,** Parliament of Australia, available at: https://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/bd/bd1718a/18bd080 .

banks to convert into shares or write off a certain kind of financial instrument in order to stay afloat.[26] If this happened, unsecured creditors who had bought a hybrid security from a bank would have their money either converted into bank shares or wiped off completely. Malcom Roberts presented the Banking Modification (Deposits) Bill 2020[27] in February, proposing yet another amendment to the Banking Act 1959 to guarantee Apra cannot order a bail-in using depositors' funds.

RISKS ASSOCIATED WITH BAIL-IN

Though some countries have adopted for bail in, it is not free from, risk. In this part of the paper, we will discuss the Risks associated with Bail-In.

A big impetus has been developed to base resolution on the bail-in, which often seems like a 'chorus.' In most of the advanced countries worldwide the regulatory bodies have created or are in the development of resolution frameworks which enable banks or financial institutions to fail in theory without recourse to public support. [28]

The bail-in method aims at countering the two-fold danger of systemic instability and national debt. It is founded on the idea of penalties, i.e., that banking failure cost are transferred to where they are optimal: bank creditors and shareholders. Essentially, bail-in substitutes public subsidies with private penalties or private care/insurances requiring banks to absorb the risks they accept.[29]

Converting existing debt to bail-in debt should encourage creditors to assume an oversight role and therefore assist in reestablishing the integrity of the market.

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[26]Ian Paterson**, "**Banking regulation in Australia: Overview"**,** Thomson Reuters Practical Law (September 1, 2021) available at: https://uk.practicallaw.thomsonreuters.com/w0069098 .
[27]Banking Amendment (Deposits) Bill 2020, Parliament of Australia.
[28] *Supra note* 15.
[29] Benjamin Bernard, Agostino Capponi & Joseph E. Stiglitz, "Bail-ins and Bail-outs: Incentives, Connectivity, and Systematic Stability", National Bureau of Economic Research Working Paper Series, (August, 2017) Available at: http://www.nber.org/papers/w23747 .

For instance, while bank failure's possible costs would decrease on the part of creditors, these creditors would need to be alerted to the extent of leverage a bank carries and would reduce a very likely reasons of bank failures and high leverage management expenses. Shareholders usually have every all the motivation to leverage in order to maximize their equity return.[30]

Such surveillance could in turn lower the damage size in the case of a banking collapse: creditors could compel a bank to conduct itself quite carefully, particularly if rescue schemes enable earlier intrusion and closures than rescue schemes. In essence, it should also remove the 'too-big-to-fail' grant granted to major banks.

The question about when bail-in should be initiated, taking into consideration also the criteria of early intervention regimes, is a key problem. Identifying the proper moment for the bail-in tool in a procedure that goes outside specifically made sanctionable debt is among the most essential things for any banking supervisor. The thinking resulting to the choice of supervisors is very much like math and logical issues of the first and second order. If the supervisors begin bail-in prematurely, the complete loss measure might not be fully exposed, with the danger of additional bail-in. However, if the supervisor decides to utilize the bail-in mechanism later when the entire extent of creditors' losses is known, bank creditors who do not possess bailable liabilities risk an escape.

Bailing-in bank debts extending outside contractual commitments harm a larger spectrum of creditors, with more parties involved and thus more lengthy negotiations. In my perspective, the longer the resolution begins, the more important it is to focus on an early recovery period.

[30] *Supra note* 3.

There are many other problems as well. In the lack of a budgetary back-up for other financial components, if bail-in is activated prior to the remainder of the financial system is implemented, a creditor flight from other banks is certain that it spreads shocks across the banking system, albeit these banks maintain adequate D bail-in-able debt. [31]

Secondly, market trust in the bailed-in institutions should be rebuilt promptly to maintain franchise worth and repay state support for liquidity.[32] As described in Section 2 (a)(ii), this depends largely on how quickly the asset base of a particular bank is reconstructed. Had the organization entered a death spiral with clients, depositors and creditors quickly fleeing, correcting the tendency would surely constitute a hard job. If bank liabilities are not adequately outlined in a limited manner, the bail-in procedure will fail. Further liabilities must be correctly calculated to avoid repeating cycles of bail-in losses on banks' creditors, including unrecognized future losses.

Another question one needs to ask is who bears the responsibility? Banking institutions usually have 3 categories of creditors: Banking creditors, Investment business creditors and financial creditors. Only the third kind of creditors should be affected by bail-in when bank organizations are resolved, as bank creditors and investors are more likely to hold interests against undamaged operational affiliates.[33] Nevertheless, this is not the situation when the EU method requires a resolution at the point of the legal body. According to the BRRD, creditors can be excluded using 'carve-outs.' It is hardly unthinkable that the exclusion can be

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[31] *Supra note* 3.

[32] Gary Gorton & George Pennacchi, *"Financial Intermediaries and Liquidity Creation",* 45(1), THE JOURNAL OF FINANCE, pp.56-57,(1990). Available at: https://doi.org/10.1111/j.1540-6261.1990.tb05080.x.

[33] Lorenzo Gai, Federica Ielasi & Martina Mainini, *"The Impact of Bail-in Risk on Bank Bondholders",*15(9), INTERNATIONAL JOURNAL OF BUSINESS AND MANAGEMENT, pp. 105- 107, (2020). Available at: https://doi.org/10.5539/ijbm.v15n9p105 .

used to transfer the bail-in obligation unfairly to several other creditors, like bondholders and unsecured depositors.[34]

The impact of changing from bailout to bail-in, thus, with a wholly domestic bank, is basically shift the weight of losses to the pensioners and savers, from domestic payers to the taxpayers. It is not apparent if the latter have wider back and why they are better positioned to withstand bank rescue liabilities than the former.[35] Nevertheless, one viewpoint is that savers and/or their monetary representatives have taken an ex-ante decision to buy claims from the bank, but taxpayers did not have this alternative and therefore they could/should have performed a supervisory role. Although this is a legitimate observation, the countering viewpoint is that charities, small or medium-sized retirement funds, or private savers, for instance, do not actually have the competence to be effective bank monitoring through pension funds. Compelling them to incur the bank failure penalty would therefore scarcely enhance bank governance. On the other hand, it would lead only to allegations that they had been 'tricked' into purchasing bail-in-able debts.[36]

The handling of bailed-in creditors is usually more difficult, labor intensive and litigatory when creditors are granted new securities instead of getting their claims written down. Considering these charges, the initial creditors are likely to sell to the middlemen specializing in such circumstances like 'vulture' hedge funds.[37] In

[34] Holmström, Bengt, and Jean Tirole, *"Private and Public Supply of Liquidity",* 106, JOURNAL OF POLITICAL ECONOMY, pp. 1–40, (1998).
[35] Michele Fratianni & Francesco Marchionne, *"The banking bailout of the subprime crisis: size and effects"*, 63, PAOLO SYLOS LABINI QUARTERLY REVIEW, pp. 187-188, (2010).
[36] Emmanuel Farhi & Jean Tirole, "*Collective Moral Hazard, Maturity Mismatch, and Systemic Bailouts",* 102, AMERICAN ECONOMIC REVIEW, pp. 60–93, (2012).
[37] Daniel J. Brutti, *"Sovereign Debt Crises and Vulture Hedge Funds: Issue and Policy Solutions"*, 61(5), Boston College Law Review, pp.1820-1821, (2020).

the instance of the Co-op Bank, a collection of such hedge funds can be held in ownership.

Despite their numerous well-documented drawbacks, the bailouts provide governmental leaders with the ability to command and define who should operate the rescued bank. Some variants of the bail-in technique are not like that. In the USA, though, the FDIC's function as 'trustee' of the resultant bridge business should address this issue. However, the ensuing governing system elsewhere could grow undesirable to the people and government. While the new managers are guaranteed approval by the regulatory bodies, the ethos, motivations, and character of a financial institution whose ownership, for example, is managed through a group of hedge funds, are likely to vary from those of a bank saved by a bail-out.

There are also liquidity concerns with bail in. Once the bail-in procedure is initiated, it is extremely likely that the financial institutions can operate only with the emergency liquidity aid 'lifeline.' However, the degree of liquidity assistance that central banks and resolution funds can give can be restricted by the absence of enough high-quality collaterals and limitations on assistance, which might lead to taxpayer losses. This would be emphasized if several big financial organizations were to be dissolved simultaneously. Liquidity may, critically, be confined to maintaining vital business activities while other business components are handled.[38]

Although certain countries such as the United Kingdom may be formed by agreement to create bail-in regimes, another approach may lead to a flow of litigation. Consequently, bail-in systems are granted legislative effect in most countries, including the UK. However, this does not imply that the bail-in

[38] Thomas Phillippon & Aude Salord, *"Bail-ins and Bank Resolution in Europe",* 4, Geneva Reports on the World Economy Special Report, pp.21-25, (2017).

procedure will prevent lawsuits. Legal actions would both be brought up by shareholders who will see their interests flushed out and by creditors who will see the values of their assertions decrease or decline[39], and the 'no creditor worse off' principle implemented by both the DFA and BRRD as a creditor guarantor during the bail-in procedure is improbable to dissuade the predicted litigation stream. Indeed, the approach might increase the probability of lawsuit.[40]

While evaluating the efficacy of bail in, another important concern that rises is that of "funding". Two aspects exist, one static and one dynamic. Funding costs may not be an important problem in the event of bail-in-able debts, but adverse selection may be an issue. Firstly, the static question is another aspect by how much (big) banks' financing costs must increase if they are to bear a contractual bail-in obligation. There are several opinions on the prospect of an increase in bank funding charges. [41]

Further, banks' choice of assets may be affected by the bail-in-able debt. If banks are asked again to issue a minimum level of bail-in liabilities as a proportion of overall liabilities, it will significantly impose larger costs on institutions with substantial quantities of low-risk assets. Typically, these organizations retain very small capital levels as a fraction of their overall liabilities.[42] In addition, if

[39] Tito Cordella & Eduardo Levy Yeyati, "*Bank Bailouts: Moral Hazard v. Value Effect",* Vol.12(4), Journal of Finance Intermediation, pp.310-313, (2003).
[40] Walther, Ansgar, "*Jointly optimal regulation of bank capital and liquidity*", 48 (2-3) Journal of Money, Credit and Banking, pp. 415-448, (2016).
[41] Jose Antonio Ocampo, Stefano Zamagni, Ricardo Ffrench Davis & Carlo Pietrobelli, *"Financial Globalisation and the Emerging Economies",* Economic Commission for Latin America and the Caribbean, pp. 49, (2000). Available at: https://repositorio.cepal.org/bitstream/handle/11362/2229/S2000903_en.pdf.
[42] *Supra note* 39.

institutions are obliged to have bail-in capable liabilities in certain areas of a group, they face limitations on their funding methods and greater costs. [43]

CONCLUSION

In India, the provisions of the FRDI Bill permit the Resolution corporation, in consultation with appropriate regulator, to carry out bail-in through a scheme or an instrument.[44] It is pertinent to note here, just like UK, South Africa, Australia and Singapore, necessary safeguards like contractual recognition of bail-in in the instruments, creditor compensation rights if NCWO is not followed, respecting creditor hierarchy and *pari passu* principles have been embedded in the FRDI Bill with a view to avoid any abuse of powers by the resolution corporation. Even though the eligible instruments to be bailed-in will be specified by resolution corporation in form of regulations, certain liabilities like insured deposits (similar to UK), secured liabilities (similar to UK and Singapore), liabilities in form of salary owed to employees and pension scheme benefits (similar to UK), etc. have been excluded from this power, which is also not without any precedent.

The major reason for the public's backlash towards the FRDI Bill was due to the lack of understanding and apprehension towards the misuse of insured deposits.[45]As noted above, insured deposits are excluded from bail-in. The extant provisions of bail-in were not only supplemented with adequate safeguards but also, they are majorly in sync with the practices followed across best jurisdictions in this regard. Thus, the withdrawal of Bill was more of a political response than legal.

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[43]Gianluca Benigno, Huigang Chen, Christopher Otrok, Allesandro Rebucci & Eric R. Young, *"Financial Crises and Macro-prudential Policy"*, 89, JOURNAL OF INTERNATIONAL ECONOMICS, pp. 543–470, (2012).

[44]The Financial Resolution and Deposit Insurance Bill, 2016, § 52, Department of Economic Affairs.

[45] *Supra note* 11.

However, it is to be noted here that even though, as per FRDI Bill, insured deposits have been excluded from the application of bail-in, the coverage of insured deposits is presently very low in India i.e., 5,00,000, which makes the exclusion per se insignificant. This coverage limit is abysmally low, compared to the coverage limit of insured deposits approx. 1.84 crores in US and ₹1.5 crores in Australia. India stands at the lowest, in terms of coverage limit of insured deposits, in G-20 jurisdictions. Even though such deposits are excluded from being bailed-in, the low coverage limit still makes the provision of bail-in objectionable or controversial for the public, as a major chunk of their deposits will still be eligible for bail-in.

SCHOLASTICUS

Sudarshan Sen, Sohini Banerjee, Ulka Bhattacharyya & K.S. Roshan Menon, *Digital Identity, Privacy and Finance: Examining the Triad,* 9(1) SCHOLASTICUS 34 (2022)

DIGITAL IDENTITY, PRIVACY AND FINANCE: EXAMINING THE TRIAD

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ABSTRACT

The need to ascertain and document identity is not new. Identity enables distinguishing between persons, states and other entities, and may be based on features such as language, ethnicity and religion. States have traditionally favoured the adoption of formal identities, given due recognition through the law. Thus, the effectiveness of identity is ensured by State recognition. In this paper, the authors demonstrate that legal identity is essential to build inclusive institutions. The right to identity must thus be read as a right to 'effective legal identity' with universality, uniqueness and inclusivity at its core. Moreover, the paper seeks to adopt the lenses of privacy and finance in furthering the understanding of legal identity and improve the functioning of the existing identity regime in India. In so doing, the paper attempts to dive deeper into the triad of digital identity, privacy and finance. The overall objective is to erect a privacy preserving digital identity framework that is capable of addressing financial inclusion and AML/CFT concerns.

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INTRODUCTION

The intersection of identity, privacy and finance has been the site of much debate in the recent past. While each of these three pillars have their own dedicated set of interests at play, their interaction has led to some degree of tension. The aim of this paper is to explore the identity-privacy-finance triad, and understand how the implementation of digital identity can be reformed in India to further privacy preservation as well as financial inclusion.

Chapter II will explore the conceptual background of digital identity. In doing so, it will dive into the manner in which identity is an enabler for other rights, and plays a significant role in building inclusive and effective institutions. The chapter argues that the right to identity must be read as a right to '*effective legal identity*' with universality, uniqueness and inclusivity at its core. Chapter III provides a snapshot of how a robust digital identity regime may be implementing, by adopting the lenses of privacy and finance.

Further, Chapter IV focuses on the intersection between digital identity and privacy. By examining the conceptual underpinnings of privacy, as well as the Indian position on the right to privacy and the Aadhaar regime, the chapter seeks to reconcile two facets of dignity under Article 21 of the Constitution. Chapter V moves on to concentrate on the intersection between digital identity and finance. Based on an analysis of the Supreme Court decision in the Aadhaar judgment, the chapter submits some ideas for a more inclusive identity framework.

Chapter VI provides recommendations on an improved identity-privacy-finance triad. These recommendations cover various aspects such as the erection of a privacy preserving digital identity framework, and measures leveraging digital identity for greater access to finance. Chapter VIII contains concluding remarks.

CONCEPTUAL BACKGROUND TO DIGITAL IDENTITY

I. IDENTITY AS AN ENABLER

Identity refers to a set of features allowing persons, states and other entities to distinguish an individual or a collective from another.[1] These distinctions may be based on language, ethnicity, religion, culture or region,andrepresented through symbols or documents.[2]The need for documenting identities is not new.[3]States have traditionally preferred the adoption of a formal process to create identities for individuals, granting them recognition before the law. Sud and Van Sandt have argued that only States may create legally enforceable identities, since individuals cannot create meaningful identities by themselves.[4]The roots of identity lie in a social construct, but their effectiveness is guaranteed by recognition from the State through verification of credentials laid down by law.[5]

This chapter focuses on the functions of legal identity and its importance in building inclusive and effective institutions. We argue that the right to identity must be read as a right to '*effective legal identity*' with universality, uniqueness and inclusivity at its core. This approach has been adopted by the UN,which included legal identity for all as a part of its Sustainable Development Goals,[6]('**SDG**')targeting"access to justice for all and build effective, accountable

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[1]Yussef Al Tamimi, *Human Rights and the Excess of Identity: A Legal and Theoretical Inquiry into the Notion of Identity in Strasbourg Case Law*, Vol. 27(3), Social & Legal Studies, pp. 283–298, available at: https://doi.org/10.1177/0964663917722598.

[2] FRANCIS M. DENG, WAR OF VISIONS: CONFLICT OF IDENTITIES IN THE SUDAN vii (The Brookings Institution 1995); WILLIAM BLOOM, PERSONAL IDENTITY, NATIONAL IDENTITY, AND INTERNATIONAL RELATIONS 52 (Cambridge University Press 1990).

[3] Saskia Hin, Counting Romans, Princeton/Stanford Working Papers in Classics, 2007, available at: https://www.princeton.edu/~pswpc/pdfs/hin/110703.pdf.

[4]Mukesh Sud & Craig V VanSandt, *Identity Rights: A structural void in inclusive growth,* Vol.132(3), Journal of Business Ethics, 594, pp. 589-601 (2015), available at: https://doi.org/10.1007/s10551-014-2359-5.

[5]*Id.*

[6] Goal 16.9 UN General Assembly, Transforming our world: the 2030 Agenda for Sustainable Development, 21 October 2015, A/RES/70/1.

and inclusive institutions at a key level."[7]To understand the role of legal identity in achieving these SDGs we must first understand its meaning.

II. LEGAL IDENTITY

The United Nations ('**UN**') has defined legal identity as "the basic characteristics of an individual's identity, such as name, sex, place and date of birth, conferred through registration and the issuance of a birth certificate by an authorized civil registration following a birth".[8]

The distinction between legal identity and other forms of identity is therefore premised on their recognition by law.This recognition is granted by government-authenticated documents,[9] containing identity information such as the name, age, place of birth, sex, marital status, nationality or other forms of data.[10] Legal identity therefore creates a platform for formal identification enabling the government to tailor developmental objectives towards those recognized by law.

III. ACHIEVING SDGS THROUGH DIGITAL IDENTITY

The ability to formally identify oneself has become important for both civic participation and inclusion.[11] Rights such as the right to vote in elections, the right to identify as a national of a country and the right to travel abroad are facilitated by a legal identity.

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[7] Goal 16 UN General Assembly, Transforming our world: the 2030 Agenda for Sustainable Development, 21 October 2015, A/RES/70/1.

[8] The United Nations National Legal Identity Agenda, pp. 4 available at: https://unstats.un.org/unsd/demographic-social/meetings/2019/newyork egmcrvsims/docs/presentations/UNDP.pptx.

[9]Commonwealth Secretariat , *Legal identity for all*, vol. 43, COMMONWEALTH LAW BULLETIN, pp. 489-503 (2018).

[10]Id.

[11]World Bank, ID4D (Identity for Development) available at: https://datacatalog.worldbank.org/dataset/identification-development-id4d-global-dataset/resource/9a1617de-a64d-44bd-9fd8-730758bfa078.

The adoption of identity initiatives in low-income countries symbolizes the relationship that identity shares with poverty. The lack of identity is statistically evident,[12] with a sizable population of the affected being women[13] and persons located in sub-Saharan Africa and South Asia due to the effective lack of registration at birth.[14] These statistics further do not capture the denial of services due to the poor implementation of existing identity systems. These systems are often paper-based, making them prone to data errors and manipulation. Additionally, most identity documents are use-specific (voting cards, driving license, etc) and fragmented across government agencies, making them unfit for general use[15] and incapable of supporting inclusion or trustworthiness.[16] A solution to the identity gap lies in improving the trustworthiness of existing identity schemes, creating a secure mechanism for verification. A shift from the paper-based, poorly regulated identity systems is required for the same.

We identify digital identity as a key tool to achieve the objectives laid down by the SDGs, understanding their positive impact in the delivery of identity-centric services to rural areas through the use of technology.[17] Digital identity refers to

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[12]*Id.*

[13] GSMA, Digital Identity Opportunities for Women: Insights from Nigeria, Bangladesh and Rwanda (May 2019) available at: https://www.gsma.com/mobilefordevelopment/wp-content/uploads/2019/05/Digital-identity-opportunities-for-women-Insights-from-Nigeria-Bangladesh-and-Rwanda-Web.pdf.

[14]Ana Beduschi, *Digital Identity: Contemporary Challenges for Data Protection, Privacy and Non-Discrimination Rights*, BIG DATA AND SOCIETY JOURNAL, pp. 1-6 (2019).

[15]World Bank, ID4D Practitioners Guide (Draft for Consultation) 2019 available at: http://documents.worldbank.org/curated/en/248371559325561562/pdf/ID4D-Practitioner-Guide-Draft-for-Consultation.pdf.

[16]*Id.*

[17]Tanzania's Registration Insolvency and Trusteeship Agency partnered with the United Nations International Children's Emergency Fund and a mobile operator Tigo, to release a feature that records births in a central database. The program has registered 100,000 users in six months. GSMA Regulatory and Policy Trends impacting Digital Identity and the role of mobile (2016), available at: https://www.gsma.com/mobilefordevelopment/wp-content/uploads/2016/10/Regulatory-and-policy-trends-impacting-Digital-Identity-and-the-role-of-mobile.pdf.

identities, issued by the state or by private entities,[18] where information is stored and transmitted in the digital form.[19] This information may be demographic data, such as the individual's name or address, or biometric data such as fingerprints.[20]

The World Bank recognizes shifting from paper-based identity to digital identity as a key component for development.[21] The table below highlights certain differences between the two systems.

TABLE 1: DIFFERENCES BETWEEN PAPER-BASED IDENTITY AND DIGITAL IDENTITY

Parameters	Paper-based Identity	Digital Identity
Data collected	Demographic (names, address, etc.) or biometric(fingerprints)[22]	Same as paper-based identity.
Storage	In physical form such as files.	In digital form, electronic storage in data warehouses.
Security	Data is not encrypted, stored in files. Features such as signatures, affixed photographs may be duplicated or manipulated.	Data may be encrypted and stored within cards. Encrypted data is difficult to duplicate.

[18]The Omidyar Network, *Digital Identity and Privacy*, pp. 1-4 (2017). available at: https://www.omidyar.com/sites/default/files/file_archive/Digital_Identity_POV_Oct17.pdf. (last visited June 1, 2021).

[19] Claire Sullivan, *Digital Identity and Citizenship in Australia* , vol. 41, FEDERAL LAW REVIEW, pp. 557-585 (2013).

[20] World Bank Group, Study of Options for Mutual Recognition of National IDs in the East African Community, available at: http://documents.worldbank.org/curated/en/337501535031584335/pdf/129621-ACS.pdf.

[21]World Bank, Principles for Identification: For Sustainable Development towards the Digital Age, available at: http://documents.worldbank.org/curated/en/213581486378184357/pdf/Principles-on-identification-for-sustainable-development-toward-the-digital-age.pdf.

[22] World Bank Group, *Supra* note at 20.

Access to services	Data may not be machine-readable, making it difficult to link with other services.	Data is machine readable and can be linked with schemes for providing services.

The table above indicates that the shift from paper-based identity to digital identity facilitates linking of identities with other schemes and minimizes the risk of duplication of personal data. The Mc Kinsey Global Institute identifies the value-added with digital identity as threefold: an increase in the assurance of the accuracy of data, preserving the uniqueness of the data and the establishment of the digital identity of the user with their consent.[23]

IMPLEMENTING A ROBUST DIGITAL IDENTITY REGIME: LOOKING THROUGH THE LENSES OF PRIVACY AND FINANCE

I. LOOKING THROUGH THE LENS OF PRIVACY

Courts have restrained identity systems from using excessive personal data on the ground that it constitutes an unreasonable interference into private lives, indicating that the right to privacy fetters the right to legal identity.[24]The 'privacy versus identity' approach is not holistic, as robust privacy frameworks deter social harm and act as a public good, thus allowing individuals to make meaningful choices regarding their personal data.[25]

Noting that all forms of identity require data, we argue that identity and privacy are not competing concepts. Rather, a privacy compliant identity framework is a

[23] McKinsey Institute, Digital Identification: A Key to Inclusive Growth: Summary of Findings (2019) available at: https://www.omidyar.com/sites/default/files/Digital%20ID%20%E2%80%93%C2%A0A%20Key%20to%20Inclusive%20Growth%20.pdf.
[24]Julian J Robertson v. Attorney General of Jamaica, [2019] JMFC Full 04 para 145.
[25] Joshua Fairfield & Christopher Engel, *Privacy as a public good*, vol. 65(3), DUKE LAW JOURNAL, pp.384-457 (2015).

means to achieve an overall efficient digital identity. In understanding the role of privacy for efficient identity, we must first understand the meaning of the right.

Scholars have defined privacy as a right to be let alone,[26] protecting individuals from invasions into their private life.[27]This private life encompasses personal identity and aspects of social and physical identity[28] covering both physical and psychological integrity of persons.[29] Indicators such as gender identification, name, sexual orientation and sexual life form a part of this identity.[30] It must however be noted that scholarly work has sought to illustrate facets of privacy. A comprehensive definition of privacy seems elusive, and the challenges in synthesizing a robust definition for the term have discussed later.

A. Privacy compliant digital identity

We note that international conventionsrecognise the right of individuals to the protection of their personal data[31]and that the data-intensive systems that collect and retain biometric data must be used when States can demonstrate that they are necessary[32]yet these principles seem to imply that privacy is a set of restrictions on identity systems. Thisapproach can stifle measures that provide identity for all, for they leave the question of the extent of permissible limits on the right to privacy largely indeterminate. These limits are subsequently evaluated by courts which must address both judicial concerns -evolved through previous

[26]Samuel D Warren, Louis D Brandeis, *The Right to Privacy*, vol. 4(5), HARVARD LAW REVIEW, pp.193- 220 (1890).
[27]*Id.*
[28]Ana Beduschi, *Digital Identity: Contemporary Challenges for Data Protection, Privacy and Non-Discrimination Rights*, BIG DATA AND SOCIETY JOURNAL, pp. 1-6 (2019).
[29]X and Y v. the Netherlands, Series A no. 91, p.11 Section 22. (ECtHR, 26 March 1985).
[30]Pretty v. United Kingdom, Application Number 2346/02 (ECtHR, 29 April 2002).
[31]European Union, *Charter of Fundamental Rights of the European Union*, 26 October 2012, 2012/C 326/02 article 81.
[32] UN Human Rights Council, Report of the Special Rapporteur on the Right to Privacy, The Right to Privacy in the Digital Age, 3 August 2018 A/HRC/39/29 pp. 16.

decisions on privacy and regulatory concerns that deal with States' role in processing personal data.

Accuracy, uniqueness and proportionality are the driving principles for the data ecosystem surrounding identity.Processing minimum data relevant to the achievement of the objects of digital identityand restrictions in third party access to personal data shall help preserve the uniqueness of personal data and allay concerns related to the collection of excessive personal data.[33]

II. LOOKING THROUGH THE LENS OF FINANCE

Financial inclusion is a dominant benefit of formal identity systems. With time, the relationship between customers and financial institutions has become identity-centric,[34] with trustworthiness at its core.[35]Secured formal identity documents are a requirement to eliminate false identities from databases and connect those previously unbanked to bank accounts. Thus, it is important to revisit the role of identity in achieving financial inclusion and creating accountability in the provision of financial services.

A. Identity for financial inclusion: Understanding the role of Know Your Customer norms

Know Your Customer ('**KYC**') norms specify the manner in which identity systems are used by financial institutions for verification. The Financial Action Task Force ('**FATF**') recommends the verification of customer identities using

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[33] World Bank, ID4D Practitioners Guide (Draft for Consultation) http://documents.worldbank.org/curated/en/248371559325561562/pdf/ID4D-Practitioner-Guide-Draft-for-Consultation.pdf page 29; World Bank ID4D, Identity authentication and verification fees: Overview of current practices (April 2019) http://documents.worldbank.org/curated/en/945201555946417898/pdf/Identity-Authentication-and-Verification-Fees-Overview-of-Current-Practices.pdfpage 16.

[34]Benjamin Jessel et al, *Digital identity: The foundation for trusted transactions in financial services,* vol. 47, JOURNAL OF FINANCIAL TRANSFORMATION, pp. 143-150 (2018).

[35] McKinsey Institute, Digital Identification: A Key to Inclusive Growth: Summary of Findings (2019) available at: https://www.omidyar.com/sites/default/files/Digital%20ID%20%E2%80%93%C2%A0A%20Key%20to%20Inclusive%20Growth%20.pdf.

"reliable, independent source documents, data or information."[36] KYC norms lay out the list of documents that adhere to such standards of reliability, the purposes for which such documents may be used and the methods for KYC. In the era of digital identity, older KYC methods have given way to more dynamic, robust forms of KYC such as electronic-KYC ('**e-KYC**'), where the required processes are completed using electronic means.[37]The key here is to ensure robust KYC – norms must be such that they do not overburden users but at the same time, provide a high-degree of authentication of individual identity.

B. Identity for reducing illicit financial flows

In declaring the reduction of illicit financial flows ('**IFF**') an SDG, the UN recognized the key role of identity systems to improve coherence amongst law enforcement agencies required to reduce IFF.[38]The UN notes that the SDGs to combat IFFs, and to provide universal legal identity(Goal 16.4 and Goal 16.9 respectively) are interlinked, with legal identity enabling agencies to identify fraudulent/illicit transactions within the system.[39]

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[36] Financial Action Task Force, International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation (2012) available at: www.fatf-gafi.org/recommendations.html.

[37] L Perlemen & N. Gurung, *Focus Note: The Use of eIDs and eKYC for Customer Identity and Verification in Developing Countries: Progress and Challenges,* pp. 1-28 (2018). available at: http://www.citicolumbia.org/wp-content/uploads/2018/10/ekyC-paper-final-version-published-on-dfso-citi-web-site2.pdf.

[38] Goal 16.4 UN General Assembly, Transforming our world: the 2030 Agenda for Sustainable Development, 21 October 2015, A/RES/70/1; United Nations Inter-Agency Task Force for Financing Development, Coherent policies for combating illicit financial flows, pp. 1-8 (2016) available at: https://www.un.org/esa/ffd/wp-content/uploads/2016/01/Coherent-policies-for-combatting-Illicit-Financial-Flows_UNODC-OECD_IATF-Issue-Brief.pdf.

[39]United Nations Inter-Agency Task Force for Financing Development, Coherent policies for combating illicit financial flows, pp. 1-8 (2016) available at: https://www.un.org/esa/ffd/wp-content/uploads/2016/01/Coherent-policies-for-combatting-Illicit-Financial-Flows_UNODC-OECD_IATF-Issue-Brief.pdf.

Combating IFFs requires robustness of identity asinformation must be routinely updated to detect suspicious activities and determine whether the existing data collected is reliable and independent.

C. Combating IFFs vis-à-vis financial inclusion: Adopting a balanced approach

Developing economies require adequate KYC normsthat maintain financial integrity without creating barriers to financial inclusion.[40]The lack of documentation in developing countries risks exclusion from the formal financial sector if the verification requirements are too strict.[41]Excessive KYC norms in the presence of anuntrustworthy, non-universal legal identity also leads to the development of alternate, private KYC databases[42] thereby weakening regulatory oversight.

Regulatory oversight is also important in cases of collaborative customer due diligence. Often regulations are silent on questions of data sharing and the liability of systems in case of faulty KYC. Storing all KYC data in a single registry is also an important concern as it makes this database vulnerable to attacks. Accountability manifests in the form of maintaining open registers that allow for the verification of information shared between agencies, whilst responsibility implies improving efficiency in the linking of services.[43]For this, digital identity

[40] Centre for Global Development, Financial Regulations for improving Financial Inclusion, CGD Task Force pp. 9 (2019) available at: https://www.imf.org/external/np/seminars/eng/2016/finincl/pdf/041116_2.pdf.
[41] Douglas W. Arner et al, *The Identity Challenge in Finance: From Analogue Identity to Digitized Identification to Digital KYC Utilities*, vol. 20, EUROPEAN BUSINESS ORGANIZATION LAW REVIEW, pp. 55-80 (2019).
[42]United Nations Secretary General's Special Advocate For Inclusive Finance for Development, Annual Report, 2019, pp. 24 (2019). available at: https://www.unsgsa.org/files/8215/6942/4860/UNSGSA_2019_Annual_Report.pdf.
[43]Pierre Biscaye et al, *Review of National Identity Programs*, Evans School of Policy Analysis and Research, pp. 1-101 (2015).

frameworks must create models premised on accountability and responsibility to achieve these objects.

III. PRIVACY AND IDENTITY: RECONCILING TWO FACETS OF DIGNITY

The previous chapter has discussed that effective legal identity should be universal, unique and inclusive. Legal identity is often a precursor to accessing basic services like education, healthcare and banking.[44] The transition from paper-based identity to digital identity has spelt out several advantages by increasing the accuracy of data, minimising the risk of duplication, and preserving the uniqueness of data. These benefits have helped in making social schemes and financial services more efficient by weeding out bogus beneficiaries. Digital identity has the potential to bring about swift inclusion by affording access to critical government and market services.[45]

The lack of an official identity may render individuals invisible and lead to economic, political and social exclusion.[46] Recognition of this has led governments across the world to pilot national digital identification systems. While not within the scope of this paper, it is useful to note that the use of digital

[44]Ana Beduschi, *Digital Identity: Contemporary Challenges for Data Protection, Privacy and Non-Discrimination Rights*, BIG DATA AND SOCIETY JOURNAL, pp. 1-6 (2019).
[45]Mckinsey Global Institute, Digital Identification: A Key to Inclusive Growth (January 2019), available at: https://www.mckinsey.com/~/media/McKinsey/Business%20Functions/McKinsey%20Digital/Our%20Insights/Digital%20identification%20A%20key%20to%20inclusive%20growth/MGI-Digital-identification-In-brief.pdf (last visited June 1, 2021).
[46] World Bank Group & Global Partnership for Financial Inclusion, G20 Digital Identity On boarding (2018), available at: https://openknowledge.worldbank.org/bitstream/handle/10986/30484/129861WP-10-9-2018-17-26-21-GDigitalIdentityOnboardingReportlowres.pdf?sequence=1&isAllowed=y (last visited June 1, 2021).

identification and verification by private companies has also been on the rise.[47] Private digital identity solutions focus on addressing fraud and identity theft to guard against cybersecurity threats.[48] This is indicative of the priority accorded to digital identity by both governments and private entities today, and its prominence in the current regulatory agenda.

However, the previous chapter has noted that privacy poses a legal challenge to digital identity. The collection of personal data and its use in a broader public matrix raises significant privacy concerns. Thus, it is submitted that implementing a robust digital identity framework necessitates viewing identity through the lens of privacy.

I. CONCEPTUAL LOOK AT PRIVACY

A. The Elusive Pursuit to Define Privacy

Scholars and courts have identified various aspects of privacy, but there is no consensus on the interests that fall under privacy.[49] We submit that a better rubric to view privacy may be obtained by clubbing groups of interests under buckets. While such categorisations are not without their own divergences, it is nevertheless an attempt to bestow cohesion on the study of privacy. For instance, Tavani has argued that all aspects of privacy can be categorised under the non-intrusion theory, seclusion theory, limitation theory and control theory.[50] Similarly, Solove has identified the right to be let alone, limited access to the self,

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[47]Mastercard, Digital Identity: Restoring Trust in a Digital World, March 2019, available at https://www.mastercard.us/en-us/issuers/products-and-solutions/mastercard-digital-identity-service.html (last visited June 1, 2021).

[48]Research and Markets, Identity Verification Market by Component (Solutions and Services), Deployment Mode, Organization Size, Industry Vertical, and Region (North America, Europe, APAC, Middle East and Africa, Latin America) - Global Forecast to 2024 (May 2019).

[49] Elbert Lin, *Prioritising Privacy: A Constitutional Response to the Internet*, vol. 17(3), BERKELEY TECH. LAW JOURNAL, pp.1085-1154 (2002).

[50] Herman T. Tavani, *Philosophical Theories of Privacy: Implications for an Adequate Online Privacy Policy*, vol. 38(1), METAPHILOSOPHY AND BLACKWELL PUBLISHING, pp. 1-22 (2007).

secrecy, control over one's personal information, personhood and intimacy as headings.[51]

However, each of these conceptions viewed individually may be limited, as they tend to describe but an attribute of privacy. Such a description may be over-inclusive, under-inclusive or both.

Solove has submitted that thinking of privacy only as the right to be let alone equates privacy with isolation. To reproduce a common example - X is stranded on a desert island sansother human inhabitants. Arguably, X would enjoy a perfect state of privacy by virtue of being entirely inaccessible to other people - no one has physical access to X, no one has any information about X and no one pays attention to X.[52]

The above conception of privacy as right to be let alone neglects the notion that privacy must be viewed in the context of an individual's *relationship* with society. Thus, "the need for privacy is a socially created need".[53]*Perfect* privacy may not be a desirable state as it would deprive the individual of meaningful social interaction, essential services and necessary benefits.

B. Informational Privacy

The traditional framework to think about privacy has been in terms of physical spaces. This has led to the conception of privacy as solitude, reserve and intimacy.[54] It is thus not surprising that the literature of the 1960s and 1970s

[51]Daniel J. Solove, *Conceptualising Privacy*, vol. 90(4), CALIFORNIA LAW REVIEW, pp. 1087-1155 (2002).

[52] Ruth Gavison, *Privacy and the Limits of Law*, vol. 89(3) YALE LAW JOURNAL, pp. 421-471 (1980).

[53] BARRINGTON MOORE JR., PRIVACY: STUDIES IN SOCIAL AND CULTURAL HISTORY 73 (Routledge Revivals 1984).

[54] David Alan Sklansky, *Too Much Information: How Not to Think about Privacy and the Fourth Amendment*, vol. 102 CALIFORNIA LAW REVIEW, pp. 1069 (2014).

liberally made references to the 'sphere', 'realm' and 'domain' of privacy, and used the metaphor of being stripped naked to describe privacy invasions.[55]

However, the pervasive reach of technology and the digital economy has led to an odd conflation between privacy in general, and informational privacy in particular. In fact, such a conflation has prompted some scholars to conclude that privacy is a sinking ship which should be abandoned.[56] According to this strand, the interests protected by privacy may be subsumed by other rights.[57]

Such an all-or-nothing approach may be avoided by recognising that privacy cannot be reduced to informational privacy alone. Further, the pervasion of technology and mass data collection may only mean that *absolute* informational privacy is lost. As discussed above, perfect privacy may not be a desirable state. In the same vein, absolute informational privacy may not be desirable either, as it would deprive the individual of the benefits of the digital economy.

The discussion above also reveals an innate dichotomy in the right to privacy. While the language of privacy heavily revolves around non-interference by the state, the right itself seeks intervention by the state in the shape of legal protection against other individuals.[58] It is here that privacy looks to data protection to guide the safeguarding of our informational privacy, and the manner in which we can exert meaningful control over our information.

In a similar vein, it is worth noting that informational privacy is not an absolute right. It could be subject to limitations in countervailing public interest that warrant disclosure of information and may be tricky to define, and subjective to each jurisdiction. Further, public and private interests are sought to be balanced.

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[55] *Id.*
[56] Judith Jarvis Thompson, *The Right to Privacy*, vol. 4(4) PHILOSOPHY & PUBLIC AFFAIRS JOURNAL, pp. 295-314 (1975).
[57] *Id.*
[58] Ruth Gavison, *Supra* note at 52.

II. INDIAN POSITION ON PRIVACY AND IDENTITY

A. Privacy Ecosystem in India

The extant legal framework on privacy in India is limited. There is no explicit mention of the right to privacy in the text of the Constitution. However, the significance of privacy as a core constitutional value was established by the Supreme Court of India in *K.S. Puttaswamy*v. *Union of India* (‘**Puttaswamy I’**).[59] The Court unequivocally held that the fundamental right to privacy flows primarily from the right to life and personal liberty under Article 21, as well as other fundamental rights in Part III of the Constitution (insofar as they cover freedom and dignity).[60] It is interesting to note that the Court considered privacy to straddle across a spectrum of existing rights[61], and recognisedthatthe right is not in the nature of a constitutional amendment or law making.[62]

In its judgement, the Court recognised three aspects of privacy were recognised by the Court: bodily privacy, informational privacy and privacy of choice. Rooted in notions of life, liberty and dignity, it was held to contain the autonomy of body and mind, ability to make choices, and preserve a private space for oneself.[63]The Court also discussed the positive and negative domains of privacy. The negative domain of privacy instructs the state to not intrude upon a citizen’s life and personal liberty. However, this alone is not enough to ensure privacy. The positive dimension obligates the state to “take all necessary measures to protect the privacy of the individual”.[64] The Court also negated the argument of the

[59] 2017 10 SCC 1.
[60] K.S. Puttaswamy v. Union of India, 2017 10 SCC 1, pp. 262.
[61] *Id* at pp. 244.
[62] *Id* at pp. 262.
[63] *Id* at pp.168.
[64] *Id* at pp. 264.

Attorney General that privacy is an elitist construct, as the Constitution guarantees civil and political rights to all individuals.[65]The intimate relationship between freedom and development cannot be overlooked.[66]

The bench also went on to observe that privacy threats can arise from both state and non-state actors in the digital age. Acknowledging that informational privacy is a facet of the right to privacy, the Court urged the Union Government to institute a "robust regime for data protection". Such a regime would require balancing of individual interests and legitimate concerns of the state.

Moreover, encroachments on privacy cannot be arbitrary. To determine the reasonableness of an act restraining privacy,the Court laid down a three-part test of legality, need and proportionality that required satisfying before privacy was restrained.[67] In accordance with the test, the encroachment on privacy should first be backed by a law. Second, the restraint should be in pursuance of a legitimate state aim to ensure that it is reasonable under Article 14 of the Constitution. This is a safeguard against state arbitrariness. Third, the means of the encroachment should be proportionate to the purpose sought to be achieved by the law.[68] The three-part test applies to all invasions of privacy across the board and is not limited to informational privacy alone.

1. The Aadhaar Scheme

The object of the Unique Identification or 'Aadhaar' project was to provide Indian residents with a random and unique twelve-digit number linked to the individual's biometric data. This unique identifier would then serve as a proof of identity and proof of address across platforms.[69] It would ensure that there is no

[65] *Id* at pp. 216.
[66] *Id* at pp. 219; AMARTYA SEN, DEVELOPMENT AS FREEDOM (Oxford University Press 2000).
[67] *Id*.
[68] *Id*.
[69]Bidisha Chaudhuri & Lion König, *The Aadhaar Scheme: A Cornerstone of a New Citizenship Regime in India?*, vol. 26(2) CONTEMPORARY SOUTH ASIA JOURNAL pp.127-142 (2018).

duplication in identity, and beneficiaries for the delivery of social benefits could be accurately identified.[70]The scheme was launched in 2009 vide a Gazette notification issued by the erstwhile Planning Commission of India dated January 28, 2009.[71] While the scheme did not enjoy statutory backing at the time, the Aadhaar (Targeted Delivery of Financial Services and other Subsidies, Benefits and Services) Act ('**Aadhaar Act**') was passed in 2016, lending the scheme legislative credence.

In 2018, a five-judge bench of the Supreme Court heard a constitutional challenge to the Aadhaar Act ('**Puttaswamy II**'). The petitioners argued that Aadhaar is a "grave risk to the rights and liberties" of Indian citizens by violating constitutional values. It was also submitted that the scheme "has the potential to enable an intrusive state to become a surveillance state on the basis of information that is collected in respect of each individual by creation of a joint electronic mesh". Thus, it was argued that the Aadhaar Act struck at the right to privacy under Articles 14, 19 and 21 of the Constitution as upheld by the nine-judge bench in Puttaswamy I.[72]

The majority went on to uphold the decision in Puttaswamy I on the contours of the fundamental right to privacy. It was held that Aadhaar is a beneficial legislation and does not create a surveillance state. Moreover, the Aadhaar Act was found to strike a decent balance between the right to privacy and the right to life of the same individual in their capacity as a beneficiary.[73] Adequate safeguards were found in place (for example, minimal biometric data collection,

[70] K.S. Puttaswamy v. Union of India, (2019) 1 SCC 1, pp. 25, ¶ 24.
[71] Government of India, Planning Commission, Gazette notification No. A-43011/02/2009-Admn.I, available at https://uidai.gov.in/about-uidai/unique-identification-authority-of-india/about.html (last visited June 1,2021).
[72] K.S. Puttaswamy v. Union of India, (2019) 1 SCC 1, pp. 52.
[73] *Id* at 313.

end-to-end data encryption and statutory prohibition on sharing of core biometric data).[74]

The judgment led to the promulgation of the Aadhaar and Other Laws (Amendment) Ordinance, 2019 in March, 2019. Soon after, the Parliament enacted the Aadhaar and Other Laws (Amendment) Bill, 2019. The Aadhaar amendment has largely incorporated the decision in Puttaswamy II. The changes introduced have had a significant impact on industry. With the deletion of Section 57 of the Aadhaar Act, the ambit of Aadhaar usage has diminished. The amendment has underlined the voluntary nature of Aadhaar, with mandatory authentication for the provision of services requiring a law made by Parliament. Further, banking and telecom services have been identified as cases where Aadhaar may be voluntarily used for individual identity verification.

B. Erecting a Data Protection Framework: A Work in Progress

India does not have acomprehensive privacy legislation in place yet. A personal data protection law has been in the works since the constitution of the Committee of Experts under the Chairmanship of Retd. Justice B.N. Srikrishna in 2017. The Committee released the draft Personal Data Protection Bill, 2018 and companion report in July 2018. The Bill was introduced in the winter session of Lok Sabha in 2019 with some changes, and subsequently referred to a Joint Parliamentary Committee ('**JPC**'). It is expected that the draft law will be passed soon by the legislature. Its passage will effectuate a tectonic shift in the Indian privacy ecosystem, with Section 43A of the IT Act and the SPDI rules issued thereunder being replaced. It remains to be seen the final shape the law will take.

The framework pertaining to informational privacy, or data privacy, at present primarily consists of the Information Technology Act, 2000 ('**IT Act**') and the Information Technology (Reasonable Security Practices and Procedures and

[74] *Id* at 237.

Sensitive Personal Data or Information) Rules, 2011 ('**SPDI rules**') issued under Section 43A of the former. However, the SPDI rules do not apply to the State. Further, norms relevant to informational privacy are spread across multiple laws concerned with diverse sectors such as health, criminal justice and banking. This has meant a fragmented regulatory framework lacking an overall direction.

The proposed data protection legislation will apply across the board to processing of personal data by the State as well as private companies.[75] Thus, the State is a data fiduciary as it is capable of determining the purpose and means of processing personal data. The draft law has squarely borrowed the meaning of State from Article 12 of the Constitution.[76] Clause 3(26) of the draft law defines "official identifier" as any "number, code, or other identifier, assigned to a data principal under a law made by Parliament or any State Legislature which may be used for the purpose of verifying the identity of a data principal".

Clause 12 of the draft law delineates such scenarios. The State is permitted to process personal data sans consent for the performance of any function of the State authorised by the law in order to provide any service or benefit to the data principal, or the issuance of any certification, license or permit. The State is also permitted to process personal data sans consent under any law for the time being in force made by the Parliament or a State Legislature.[77]

Thus, while the State is at par with private entities in its status as a data fiduciary, it has been given room to carry out its governance and regulatory functions in a smooth manner. It must be noted that as the State can rely on non-consensual grounds for processing personal data, the specific legislation permitting such processing (for instance, the Aadhaar Act) must be narrowly tailored and privacy

[75]Draft Personal Data Protection Bill, 2019, cl. 2(A)(b).
[76]INDIAN CONST. art. 12.
[77]Draft Personal Data Protection Bill, 2019, cl 12(b).

compliant. The Srikrishna Committee in its report observed as much, stating that in the event of non-consensual processing by the State, "the onus of protecting the data will have shifted to the law which allows processing in each of these cases".[78] In order to ensure that the Aadhaar Act was privacy and data protection compliant, the Srikrishna Committee in its report suggested significant amendments to bolster privacy safeguards and secure autonomy of the UIDAI.[79]

In conceptual terms, privacy and identity may appear to be competing values at first glance. While informational privacy seeks to safeguard the individual's personal information, the establishment of identity requires the *sharing* of personal information with the State or private entities (like banks or credit scoring agencies). Thus, data protection, privacy and identity form a complex triad.[80]

We have observed above that absolute privacy may not be a desirable state. This chiefly stems from each individual's location within a broader societal matrix. In fact, the Supreme Court in Puttaswamy II observed that dignity (the fountainhead of privacy) has a social dimension shaped by the individual's relationship with others.[81] Dignity emphasises the role of the community, and the state, in forming collective goals and restrictions on individual freedoms. Therefore, privacy and identity need not be seen as competing values. Both can be traced back to dignity, and are essential for an individual's right to life.

IDENTITY AND FINANCE

[78] Justice B.N. Srikrishna, Chairman of Committee of Experts, A Free and Fair Digital Economy: Protecting Privacy, Empowering Indians (2018), pp. 74.
[79] *Id* at 98.
[80] Shraddha Kulhari, *Data Protection, Privacy and Identity: A Complex Triad in Building-Blocks of a Data Protection Revolution: The Uneasy Case for Blockchain Technology to Secure Privacy and Identity*, pp. 23-37 (2018).
[81] K.S. Puttaswamy v. Union of India, (2019) 1 SCC 1, pp. 201.

I. IDENTITY, ACCESS TO FINANCIAL SERVICES AND FINANCIAL INCLUSION

The recognition that access to financial services is important for economic growth and development, has gained currency over the years.[82] Financial services (and therefore by extension, the ability to access and use financial services) play an important role in fostering development. Financial inclusion, or the access to and the use of formal financial services, assists people in escaping poverty and managing financial emergencies, subsequently leading to developmental benefits.[83]

However, despite numerous benefits associated with financial inclusion, only about 69% of adults globally possess accounts at financial institutions.[84]While 94% of adults in high-income economies have an account, only 63% of those in developing economies have accounts.[85] This reveals a potential *account ownership gap*, to the tune of 31%. Further, while 72% of men have an account, only 65% of women possess the same, indicating a *gender gap* in account ownership to the extent of 7%.[86]More than half of this cohort, representing around 56% of all unbanked adults globally, are women.[87]

Access to financial services and the economic well-being of individuals, is predicated on the existence of effective legal identity, which remains a relevant concern both internationally and domestically. Consequently, concerns of

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[82]Stijn Claessens, *Access to Financial Services: A Review of the Issues and Public Policy Objectives*, vol. 21(2), THE WORLD BANK RESEARCH OBSERVER,pp.207-240 (2006).
[83]The World Bank, *The Global Findex Database 2017: Overview* (2017), available at: https://globalfindex.worldbank.org/basic-page-overview (last visited on June 1, 2021).
[84]*Id.*
Note: The statistics are for the period 2014-2017 as captured in the World Bank's Global Findex Database 2017, cited above.
[85]*Id.*
[86]*Id.*
[87]*Id.*

financial exclusion are integral to any discussion on access to financial services. Access to financial services, in turn, derives meaning from effective legal identity. Therefore, any discussion on legal identity and identification frameworks ought to necessarily be viewed from the perspective of financial inclusion.

II. IDENTITY AND ANTI-MONEY-LAUNDERING FRAMEWORKS

A. Understanding the regulatory framework surrounding money-laundering

Money laundering involving the false legitimisation of one's income and assets has been '*big business'*, by turning monetary proceeds of serious offences into '*clean*' money. Consequently, efforts at addressing money laundering must necessarily be global, especially when both finance and the transmission of funds operate beyond borders.[88] While the origins of global efforts to regulate money-laundering lie in the 'War on Drugs' in the 1980s, money-laundering itself has existed since the 1950s as a 'sophisticated, organised institutionalised system of alternative financial management'.[89] This development, in turn, led to the creation of bodies such as the Financial Action Task Force ('**FATF**') under the auspices of the Organisation for Economic Co-operation and Development (OECD) in 1989.[90]

Globally, the FATF has set out International Standards on Combatting Money Laundering and the Financing of Terrorism & Proliferation ('**FATF Recommendations**')[91], which countries adopt through specific domestic

[88]Martin Gill and Geoff Taylor, *Preventing Money Laundering or Obstructing Business? Financial Companies' Perspective on 'Know Your Customer' Procedures,* vol. 44(4), BRITISH JOURNAL OF CRIMINOLOGY, pp.582-594, 583 (2004).
[89]*Id.*
[90]*Id.*
[91] Financial Action Task Force (FATF), *International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation: the FATF Recommendations* (June 2019), available at: http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF%20Recommendations%202012.pdf (last visited June 1, 2021).

legislative measures, based on specific circumstances.[92] Originally conceptualised to address the risks of the financial system being used to *launder 'drug money', the* FATF Recommendations have undergone multiple revisions[93]. The FATF Recommendations have been endorsed by over 180 countries across the world, and are recognised as being the universal standard for anti-money laundering ('**AML**') and countering the financing of terrorism ('**CFT**').[94]

In India, the Prevention of Money Laundering Act, 2002 ('**PMLA**') is the relevant legal enactment which incorporates global standards on AML/CFT in the domestic context. The PMLA has been enacted in pursuance of India's commitment to adopting national AML legislation.[95] Amongst other things, the PMLA defines the offence of – and criminalizes–money-laundering,[96] and sets up dedicated and detailed enforcement mechanisms.[97] The PMLA is supported by a network of critical subordinate legislation supporting its implementation, chief of which is the Prevention of Money Laundering (Maintenance of Records) Rules, 2005 ('**PMLA Rules**').

III. PRINCIPLES UNDERLYING AML REGIMES, CUSTOMER DUE DILIGENCE AND KNOW YOUR CUSTOMER NORMS

A key aspect of AML regimes concerns the pivotal role of the financial services industry in combatting money-laundering.[98] The financial services industry is

[92] *Id.*
[93] *Id.* (Notably in 1996, 2001 and 2003.)
[94] *Id.*
[95] The Prevention of Money-Laundering Act 2002, No. 15, Act of Parliament, 2003 (India).
[96] The Prevention of Money-Laundering Act 2002, §3-4, No. 15, Act of Parliament, 2003 (India).
[97] The Prevention of Money-Laundering Act 2002, § 6, Chapter VI, Chapter VIII, No. 15, Act of Parliament, 2003 (India).
[98] Louis de Koker, *Money laundering control and suppression of financing of terrorism: some thoughts on the impact of Customer Due Diligence Measures on financial inclusion*, Vol. 13(1), JOURNAL OF FINANCIAL CRIME, pp. 26-50 (2006).

required to prevent money-laundering through the use of its services.[99] This usually involves financial institutions and other businesses employing '*Customer Due Diligence*' ('**CDD**') measures. CDD measures, in turn, are distinguished as being slightly broader than 'Know Your Customer' ('**KYC**') measures.[100] KYC norms aim to gather sufficient information about customers in order to build their profiles.[101]'Importantly, sound KYC measures form a vital element in the effective management of banking risk, in the view of the Basel Committee on Banking Supervision ('**Basel Committee**').[102] The Basel Committee, in fact, has viewed sound KYC policies and procedures as being '*critical*' in ensuring the safety and soundness of banks and the integrity of banking system.[103]

In the Indian context, the obligation on banking companies, financial institutions and intermediaries to verify identity and carry out CDD/KYC measures flows from the PMLA.[104] Further, this obligation is detailed and operationalised in terms of the PMLA Rules.[105]

I. THE FATF RECOMMENDATIONS

Recommendation 10 and CDD

As indicated previously, the FATF Recommendations form the basis for applying the CDD regime in the AML/CFT context.[106]

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[99]*Id.*

[100]*Id.*

[101]*Id.*

[102]*See,* Basel Committee on Banking Supervision, *Customer Due Diligence For Banks* (October 2001), available at: https://www.bis.org/publ/bcbs85.pdf (last visited June 1, 2021).

[103]*Id.*

[104]The Prevention of Money-Laundering Act 2002, §11 A to 15, No. 15, Act of Parliament, 2003 (India).

[105]The Prevention of Money-Laundering (Maintenance of Records) Rules, 2005, Rule 9.

[106] Louis de Koker, *Supra* note 98.

In terms of the FATF Recommendations, Recommendation 10 specifically sets out the standard on CDD. Specifically, Recommendation 10 places an obligation on financial institutions to:

(a) Prohibit the opening of and operation of anonymous accounts, or accounts in fictitious names;

(b) Carrying out CDD during (i) establishing business relations; (ii) carrying out specific transactions; (iii) suspicions of money laundering or terrorist financing; or (iv) in a situation of doubt regarding the veracity or authenticity of previously identified consumer identification data.[107]

Recommendation 10 requires each of the CDD measures to be applied basis a risk-based approach ('**RBA**'). The instrument also requires customer identity to be verified before or during the course of establishing a business relationship. Financial institutions are required to not open accounts, commence business or perform transactions should the specified CDD measures not be able to be undertaken. Further, financial institutions are mandated to apply CDD measures to all new customers, as well as existing customer on the twin bases of risk and materiality.

In the Indian context, the CDD obligation on financial institutions is detailed extensively in Rule 9 of the PMLA Rules.[108]

[107]It is significant to note that FATF Recommendations require the above principle to be set out specifically in law, while the manner of imposing specific CDD obligations is left to individual nations.

[108]The Prevention of Money-Laundering (Maintenance of Records) Rules, 2005, Rule 9.

Interpretive Note to Recommendation 10 and CDD

The Interpretive Note to Recommendation 10 ('**Interpretive Note 10**') is a source of valuable insight into how various aspects of Recommendation 10 operate in practice. In relation to CDD for Legal Persons and Arrangements, Interpretive Note 10[109] states that identifying and verifying the identity of the customer is important. To achieve this end, financial institutions are required to identify and verify customer identity by *inter alia* collecting information about customers pertaining to name, legal form and proof of existence.

II. THE INTERACTION OF FINANCIAL INCLUSION, ANTI-MONEY-LAUNDERING CONCERNS AND PRIVACY: ANALYSING JUSTICE KS PUTTASWAMY V. UNION OF INDIA (2018).

The judgement of the Supreme Court in *Puttaswamy II*,[110] represented the culmination of the nearly decade-long challenge against the Aadhaar scheme, since its inception in 2009. The decision of the five-judge bench in *Puttaswamy II*, dealt in extensive detail with a number of issues (most notably, the inter-relationship between the Aadhaar scheme and privacy rights, discussed in an earlier Chapter of this paper), ultimately upholding the validity of the Aadhaar Act 2016 and the manner of its enactment, subject to certain invalidations, including the declaration that Section 57 of the Aadhaar Act, 2016 was unconstitutional.[111]

However, while the decision in *Puttaswamy II* represents a landmark insofar as the Supreme Court's analysis of privacy rights *vis-à-vis* the Aadhaar scheme is

[109] Financial Action Task Force (FATF), *International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation: the FATF Recommendations* (June 2019), Interpretive Note 10, Part C, available at: http://www.fatfgafi.org/media/fatf/documents/recommendations/pdfs/FATF%20Recommendations%202012.pdf (last visited June 1, 2021).
[110] Justice KS Puttaswamy v. Union of India , (2019) 1 SCC 1.
[111] *Id* at 560, *para* 1173.

concerned, the same cannot be said of its exposition of how the Aadhaar framework interactswith financial inclusion and anti-money laundering concerns.

Accordingly, this section attempts to view *Puttaswamy II* from the perspectives of its discussions on identity, money-laundering concerns and how the doctrine of proportionality intersects with the same,in order to demonstrate that *Puttaswamy II* is a missed opportunity to further the discourse insofar as furthering financial inclusion through unique identity *via* Aadhaar, is concerned.

A. Identity and money-laundering

(i) Observations on identity

On the theme of identity, in *Puttaswamy II*, the Supreme Courtindicated that Aadhaar was a '*unique identifier*',[112] and that the Aadhaar architecture was intended to provide a unparalleled *'unique identity*' to citizens.[113] In fact, the Supreme Court, observed that Aadhaar provided identity to the most marginalised sections of society, and was in fact a '*document of empowerment*'.[114] Bhushan J., in *Puttaswamy II* noted the Attorney General's submission that the United Nations' had described India's Aadhaar programme as having the ability to foster inclusion by giving the most marginalised an official identity.[115] Bhushan J., also took note of SDG 16.9 which aimed to provide legal identity to all by 2030.[116]

Observations on money-laundering

In relation to the discussion on money-laundering concerns, one of the specific challenges in *Puttaswamy II* concerned the validity of amendments made to Rule 9 of the Prevention of Money Laundering (Maintenance of Records) Rules, 2005

[112]*Id* at 152 , *para* 2.
[113]*Id* at 172, *para* 55.
[114]*Id* at 172, *para 56*.
[115]*Id* at 227, *para* 138.
[116]*Id* at 227, *para* 139.

via the Prevention of Money Laundering (Maintenance of Records) Second Amendment Rules, 2017. Through this, submission of Aadhaar numbers to reporting entities was made mandatory, effectively making the linking of Aadhaar with bank accounts mandatory. Holding the amendment unconstitutional, a majority of the Supreme Court in *Puttaswamy II* viewed that the number of individuals likely to launder black money through bank accounts, would likely be limited. They noted that there had been a 'ritualistic incantation' of money-laundering and black money, and no explanation had been provided as to why linking Aadhaar with bank accounts was important.[117] The majority also held that while there may exist a legitimate State aim in preventing money-laundering, making Aadhaar mandatory for all bank accounts–without proper targeting – was improper.[118]

The State's lack of arguments to convince the Supreme Court about why money-laundering was a serious concern was specifically highlighted by Chandrachud J., in his minority opinion.[119]Recognising the seriousness of money-laundering and the State's prerogative to address this challenge, Chandrachud J., emphasized that the State had failed to demonstrate how the linking of bank-accounts with Aadhaar mandatorily, was a proportionate measure.[120]

Identity, anti-money laundering and the doctrine of proportionality in Puttaswamy II: The great unravelling

The primary argument against the validity of the Aadhaar project was premised on the invasion of the fundamental right to privacy on grounds of '*better targeting*' and eliminating welfare leakages, as being flawed and violative of Article 21.[121] Arguments advanced highlighted the issue of the purported welfare benefits of

[117]*Id* at 318, *para* 434.
[118]*Id* at 318, *para* 435.
[119]*Id* at 269-271, *para* 286-296.
[120]*Id* at 271, *para* 296.
[121]*Id* at 259, *para* 247.

Aadhaar being insufficiently proven (*inter alia*, due to the lack of sufficient data) and inadequate demonstration that less invasive methods would have been non-feasible.[122] These arguments were countered by the State on the basis that the Aadhaar legislation satisfied the test of proportionality.[123]

In response to this, the Supreme Court's views were that the Aadhaar Act indeed satisfied a legitimate State aim.[124] Similarly, though all elements of the proportionality test were satisfied, the stumbling block really was the balancing requirement of the proportionality test, which the Supreme Court delved into in some detail. This aspect of *Puttaswamy II* is interesting, not in the least because, there were no arguments addressed, and consequently no discussion, by the Court, on the interaction of financial inclusion, money-laundering, identity and Aadhaar.

While the Supreme Court delved deep into discussing various aspects of this sub-test, there is indeed a curious absence of how the potential benefits of the Aadhaar scheme from the perspective of providing '*identity*' (and consequently serving to curb money-laundering). This is despite there being sufficient recognition that Aadhaar is usefulin providing a unique identity to individuals, and thereby according dignity.

In this regard, it should also be noted that while, for instance, particular aspects of *Puttaswamy II* appear to further the cause of unique identity, such as by upholding previous decisions upholding the linking of PAN Cards with Aadhaar on the basis of proportionality doctrine,[125] other aspects undermine the same. The latter aspect is best highlighted by the Supreme Court striking down the

[122]*Id* at 259, *para* 247.
[123]*Id* at 260, *para* 252.
[124]*Id* at 263-264, *para* 266-269.
[125]*Id* at 314, *para* 425.

amendments to Rule 9 of the PMLA Rules, 2005 (which made the linking of Aadhaar numbers to bank accounts mandatory) on the grounds of failure to satisfy the proportionality doctrine. The major reason put forth for this surrounds the impermissibility of targeting every account on suspicions of money-laundering, since the same would be hit by the vice of being 'over-broad'.[126]

On the whole however, while *Puttaswamy II* is important insofar as its exposition on the Aadhaar framework is concerned, it does not delve deep into exploring what is increasingly becoming critical in a world where access to finance and financial services is indeed predicated on the existence of unique identity, viz. the interactions of identity and AML concerns with larger questions of proportionality of measures aimed at arriving at 'unique' identity. *Puttaswamy II* does contain extensive observations on non-satisfaction of the proportionality doctrine by various aspects of the Aadhaar project, but what is missing from this exposition are arguments and discussions which view the provision of unique identity and AML concerns as significant factors in using the proportionality doctrine. Thus, the doctrine of proportionality is where concerns of financial inclusion and anti-money laundering '*unravel'*, in *Puttaswamy II*.

To be fair, the judgement is marked by a lack of argumentation addressed to the Court on these critical aspects. Regardless, in the absence of arguments or discussion specifically on the interaction of financial inclusion, identity and dignity, perhaps it is fair to state that *Puttaswamy II* is a missed opportunity to further the discourse insofar as enabling financial inclusion through providing a unique identity *via* Aadhaar, is concerned.

[126]*Id* at 315-319, *para* 426-236.

III. THE WAY AHEAD: IDEAS FOR A MORE INCLUSIVE IDENTITY FRAMEWORK IN LIGHT OF PUTTASWAMY II

While the judges on the Bench, in *Puttaswamy II*, touched upon isolated aspects of identity, financial inclusion and anti-money-laundering, in part, largely no specific arguments were presented before the Bench discussing the interaction of these aspects, particularly on the critical issue of financial inclusion. Consequently, while different judges expressed individual views on the issues of identity, concerns of financial inclusion and the challenge posed by money-laundering, critical discussions on the triad of identity, financial inclusion and anti-money laundering in the context of the Aadhaar scheme, are missing in the Supreme Court's judgement in *Puttaswamy II*.

Puttaswamy II largely did not address the interaction between identification, financial inclusion and anti-money laundering concerns. Consequently, there was an absence of discussion on how some of these interactions may have helped pave the way for a more inclusive identity framework in the Indian context, valuing the imperatives of identity, inclusion and AML concerns equally and holistically. To that extent, *Puttaswamy II* represents a missed opportunity to explore the interaction between identification, financial inclusion and anti-money laundering concerns.

Moving forward however, the design of a more inclusive identity framework in the Indian context, may be informed by a number of aspects highlighted in *Puttaswamy II*. For instance, the majority in *Puttaswamy II*recognised that identification is a pre-requisite for economic empowerment, and that an official identity can indeed be a '*document for empowerment*'. Judges in *Puttaswamy II* also observed that identity, in fact, fosters inclusion and empowers the most vulnerable. At the same time, preserving financial integrity by addressing AML concerns as a legitimate State aim must not create disproportionate impact on

those the very identity seeks to empower. Towards this end, balancing personal autonomy with the individual's right to lead a dignified life require a delicate balance.[127]

RECOMMENDATIONS ON AN IMPROVED IDENTITY-PRIVACY-FINANCE TRIAD

Previously, we have discussed the significance of effective legal identity as an enabler, and indicated that digital identity is its most efficient form. We have also attempted to locate digital identity within the matrix of privacy and finance. This has led to analysis of the digital identity- privacy- finance triad. In this chapter, we shall offer recommendations for an improved identity-privacy-finance triad, with the object of putting in place a privacy preserving digital identity framework that is capable of addressing financial inclusion and AML/CFT concerns.

I. RECOMMENDATIONS ON IDENTITY

A. Effective legal identity:

The right to identity should be read as a right to 'effective legal identity' hinged on universality, uniqueness and inclusivity. The right to identity enables access to justice, the formation of inclusive institutions, the increased participation of citizens in governance, and financial inclusion. In this regard, legal identity that enjoys the formal sanction of the law, is a precursor to availing various services like healthcare, education and credit.Digital identity schemes should be promoted as they promote trust in identity, and enable the delivery of identity-centric services through the use of technology.

(i) Significance of identity in achieving financial inclusion:

The role of identity in achieving financial inclusion should be revisited, thus ensuring accountability in the provision of financial services. Policymakers need to adopt a balanced approach towards combating IFFs whilst not harming

[127] *Id* at 216, *para* 116.

financial inclusion. Digital identity frameworks based on accountability and responsibility could achieve these objects.

II. RECOMMENDATIONS ON ERECTING A PRIVACY PRESERVING DIGITAL IDENTITY

A. Holistic conception of privacy:

Privacy must be viewed in the context of an individual's relationship with society. Perfect privacy may not be a desirable state as it would deprive the individual of meaningful social interaction, essential services and necessary benefits. Similarly, an absolute degree of informational privacy would effectively deprive individuals of the benefits of the digital economy. In order to realise the right to privacy, individuals should be able to exert meaningful control over their personal information. This is made possible by a robust data protection regime.

i. Privacy intrusions must be proportionate:

Intrusions into the right to privacy must flow from legitimate aims in larger public interest laid down by the Supreme Court: 'protecting national security', 'preventing and investigating crime', 'allocation of resources for human development', 'protection of the revenue', 'encouraging innovation and the spread of knowledge', and 'preventing the dissipation of social welfare benefits'. Such encroachments on privacy cannot be arbitrary, and must satisfy the three-part test of legality, need and proportionality before privacy is restrained.

ii. Balancing of privacy and identity:

Identity and privacy should not be viewed as competing concepts. Rather, ensuring that the digital identity framework is privacy preserving would mean instituting a better form of digital identity. A privacy compliant identity regime must accommodate both judicial and regulatory concerns. It is necessary to balance two possible competing facets of dignity. While the first facet of dignity

secures privacy and personal autonomy to an individual, the second allows the same individual to lead a *dignified* life. The latter is also a component of Article 21 of the Constitution. Identity, and the benefits it brings, are enablers for an individual to lead a dignified life. Thus, balancing between the two facets of dignity is vital.

iii. Privacy by design and privacy impact assessments:

In order to improve the existing digital identity framework to ensure proportionality and privacy preservation, we recommend the adoption of privacy by design measures, and periodic privacy impact assessments. Privacy by design refers to the early incorporation of privacy principles at the stage of designing systems. This is useful in determining the means of processing personal data at later stages. The adoption of privacy by design would mean that the Aadhaar framework should be reviewed to identify gaps where privacy by design could be cemented in. This would ensure that personal data is collected in a proportionate manner, in a manner that is respectful of data minimization.

Further, conducting periodic privacy impact assessments would help in monitoring the implementation of privacy by design measures. The findings of the impact assessment should be released to the public in order to promote transparency, accountability and trust in the digital identity regime.

III. RECOMMENDATIONS ON LEVERAGING IDENTITY FOR FINANCE

A. Striking a balance between customer identification, and access and inclusion:

We have previously discussed how KYC measures are necessary in combating money-laundering concerns. However, the degree and scope of each measure must be carefully examined in light of its potential to exclude persons from accessing financial services. Herein, a risk-based approach, allowing for flexibility in operation and tailor-made to suit the needs of individual customers (as

provided in Interpretive Note 10 to Recommendation 10 of the FATF Standards), is a middle path between securing the needs of effective legal identification *and* concerns of access and exclusion.

This approach, allowing flexibility in application of CDD standards, exists in a preliminary manner under Rule 9 (2A) of the PMLA Rules, as well as the RBI Master Direction on KYC (2016) [Section 23]. These provisions deal with certain relaxations and flexibilities afforded to holders of '*small accounts*' in terms of standard KYC processes. Such small accounts are subject to transaction and deposit restrictions, in lieu of which simplified KYC processes are adopted. While this is an example of operationalising the requirements of Interpretive Note 10, it also leaves open possibilities of what could be done even further to balance needs of effective identification with concerns of access and exclusion. This, then, is definitely an area where policy-makers should focus attention and effort.

B. Considerations for an improved identity framework:

While the Supreme Court, in Puttaswamy II, has observed that Aadhaar was a 'document of empowerment', its judgement leaves many questions unaddressed. Critical discussions on the triad of identity, financial inclusion and anti-money laundering in the context of the Aadhaar scheme, are missing in the Supreme Court's judgement in Puttaswamy II. Consequently, discussions on a more evolved legal identity framework in the Indian context should ideally take into account certain concerns which flow from the judgement.The satisfaction of the doctrine of proportionality is vital for any measure which seeks to curtail the fundamental right to privacy.In a world where access to financial services is predicated on the existence of unique identity, concerns of financial inclusion and AML will form part of the test of proportionality, when evaluating the legitimacy of such identity.

IV. RECOMMENDATIONS FLOWING FROM COMPARATIVE PERSPECTIVES

A. Treatment of Authentication Requests:

Privacy measures can make authentication requests secure. While incoming privacy law may be coded with the responsibility to identify categories of personal data and provides individual centric measures to protect such personal data, we propose certain context-and-sector sensitive measures to ensure that the data protection safeguards remain robust.

Ideally, authentication requests must generate a minimum amount of data, with such data to be stored in silos and under adequate data security safeguards. At the end of the identity database, digital signatures or verification ID so generated must be confidential and anonymised. At the same time, the database may maintain an audit trail of authentication requests for security reasons. Due care must be given to identify such security concerns with exceptions permitting the retention of information being strictly worded under law.

Further, requesting entities must develop mechanisms that require the consent of the individual to store data pertaining to authentication. Since such data is financial data, the consent of the individual must be explicit – the bank must inform the user of any harm that such processing may cause, and provide the individual the opportunity to consent to different categories of data relevant to such processing. This requirement for explicit consent, however, may be suitably tailored to retain a 'high degree of authentication' for the purposes of banking. Such a requirement is also consistent with the differential regulation contemplated by the previous chapter.

(i) Collaborative Data Protection Audits:

While audits feature in most data protection laws, including the PDP Bill, such audits may turn out to be insular – they may not necessarily stress on inputs from sectoral regulators, and are constrained in their application to entities that are regulated by such regulators. While it is possible that the relevant regulator trains specific persons to act as capable auditors, it is however recommended that financial sector regulators collaborate with data protection authorities to conduct collaborative data protection audits. Such audits can provide inputs on the adequacy of data security frameworks adopted by banks, the standard of encryption to be used by the banks, the degree to which such data should be anonymised, the framework for cross-border transfers of such data amongst other things.

A key component of such audits shall be risk assessment. At the core of AML/CFT regulations lies the understanding that risk is variable – it differs amongst countries, customers and business areas.[128] High risk areas must be separately highlighted by the audit, with recommendations on the application of privacy obligations. For example, if some accounts attempt to transfer vast sums of money to offshore accounts in a tax haven, the relevant details of such transfers may be subject to a modified application of the rights of erasure and retention. Going forward, designing such audits that contain provisions for risk assessment shall be key towards maintaining the balance between privacy and AML/CFT regulations.

CONCLUSION

This paper endeavored to explore the significance of the right to legal identity in building inclusive and effective institutions. Legal identity creates a platform for

[128]M. Bergstrom, *The Many Uses of Anti Money Laundering Regulation – Over Time and into the Future*, vol. 19(5), German Law Journal, pp.1149-1167 (2018).

formal identification, enabling the government to tailor developmental objectives towards those recognized by law.

Such legal identity is critical in securing various political and economic rights. Thus, it plays a significant role in building inclusive and effective institutions. For example, rights such as the right to vote in elections, the right to identify as a national of a country and the right to travel abroad are predicated upon a legal identity. On the contrary, the lack of an official identity may render individuals invisible and lead to economic, political and social exclusion.

Our paper identifies digital identity as the most trustworthy and secure form of legal identity, and an enabler of development. By analyzing the legal challenges to the implementation of an identity regime through the dual lenses of privacy and finance, we conclude that privacy and identity are both facets of dignity under Article 21 of the Constitution. While the first facet of dignity secures privacy and personal autonomy to an individual, the second allows the same individual to lead a dignified life. Therefore, balancing between the two facets of dignity is vital.

On the relationship between identity and finance, we note that the inter-linkages between AML/CFT frameworks, identity and the potential for inadvertent financial exclusion must inform broader discussions on improving legal identity frameworks. In order to ensure efficient authentication, it is important to link financial services to unique identification attributes that are less likely to be duplicated. It is also necessary to safeguard such personal data from exploitation. The paper concludes with recommendations on a reformed identity-privacy-finance triad.

SCHOLASTICUS

Raghavi R., *Business Interruption Insurance and the Covid-19 Pandemic- A Dialogue on the Developing Concerns*, 9(2) SCHOLASTICUS 73 (2022)

BUSINESS INTERRUPTION INSURANCE AND THE COVID-19 PANDEMIC- A DIALOGUE ON THE DEVELOPING CONCERNS

Raghavi R.[⊥]

ABSTRACT

The purpose of a business interruption insurance is to cover the losses that businesses endure due to the occurrence of an event that triggered the loss. The onset of the COVID-19 pandemic and the resultant lockdown imposed in almost all parts of the world has brought many businesses to halt and forced them into losses. While claiming business interruption insurance is largely contingent upon a material damage to property, this paper seeks to analyse if the pandemic induced loss can be successfully used to claim indemnification from insurers under business interruption insurance. At this juncture where the issue is at its peak in jurisdictions such as the United States of America ["U.S.A"] and the European Union, this paper seeks to highlight the key aspects including defenses posed by the insurance companies, judicial interpretation of the insurance contract, legislative action, among others. Such an approach would aid in the pursuit of discussing the developing issues in this regard, in India.

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INTRODUCTION

The foremost rule in insurance policies is that losses arising from only those perils that are covered in the policy, also known as insured perils, would be eligible to be claimed. This is no less true for policies that offer business interruption insurance. Simply put, business interruption insurance is a type of coverage that seeks to make good the loss suffered owing to an event that resulted in the interruption of the conduct of business, thereby resulting in the loss. It is important to understand that business interruption insurance is a type of insurance that is a tightly constructed part of broader policies that offer commercial insurance.[1]It is known commonly as business interruption insurance, it is termed differently in different jurisdictions, though offering indemnification for similar sets of perils that a business could face.

The widespread pandemic triggered hundreds of claims under business interruption insurance policies during the first few months of 2020 itself.[2] This is especially true of businesses such as restaurants and hotels that suffered a great blow, unprecedented and irrecoverable.[3] When most of these claims were denied, lawsuits followed. Many of these lawsuits are still pending and a significant percentage of them have been filed in the United States. The most important considerations in these lawsuits seem to be the checking for material damage to property, also known as business premises, as a prerequisite for the claim. Moreover, the insurers are using multiple defenses including that of exclusion clauses and *force majeure* to defend their liability under the insurance contracts. At

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[1] THE INSTITUTE OF COMPANY SECRETARIES OF INDIA, INSURANCE LAW AND PRACTICE.327 (ICSI 2019).

[2] *Yelp, Yelp: Local Economic Impact Report*, YELP, (September 2020), available at: https://www.yelpeconomicaverage.com/business-closures-update-sep-2020. (last visited Nov 3, 2021).

[3] Ervin Cohen & Jessup LLP,*Business Interruption Insurance Coverage: A Guide for Restaurants*, JD SUPRA(June 26, 2020), https://www.jdsupra.com/legalnews/business-interruption-insurance-57035/. (last visited Nov 3, 2021).

this juncture, it becomes necessary to understand the issue from a global perspective to study its impact as to how it would be handled in India.

Chapter 2 of this paper would offer a brief study on the approach to be taken in claims under business interruption insurance. This chapter would also focus on how and under which insurance contracts are business losses covered in India.

Chapter 3 aims to provide a picture of the pandemic and its resultant effects on business interruption insurance policies. This chapter would also track the judicial approach in this regard.

In continuation, chapter 4 would offer insights on the *force majeure* defense and address the legislative measures taken in the U.S. before commenting on Insurance Regulatory Development Authority of India's ["IRDAI"] stand in India. In conclusion, the paper would sum up the possible outcome of these claims and recommend measures that could be taken to limit ambiguity in the long run in this regard.

INVOCATION AND WORKING OF BUSINESS INTERRUPTION INSURANCE

I. OBJECT AND OPERATION

More often than not, business interruption coverage is best identified as a consequence of the material damage provision in a policy. It covers financial losses that occurred as a direct consequence of the interruption of business, which would cover loss of profits, or rent, wages of employees, among others. The idea is that profits are the main reason and a driving force behind a business and interruption of business is a risk to that and this risk is insured by this coverage. This insurance seeks to cover what the business would have done in that period, if not for the interruption.[4] In India, the business that opts for insurance mostly opt the 'industrial all risk' policy or the other common one, the

[4] National Union Fire Ins. Co. of Pittsburgh v. Anderson-Prichard Oil Corp., 141 F.2d 443 (1944).

Standard Fire and Special Perils ["SFSP"] Policy. These policies are taken to cover physical damage to the property by an insured peril. Business interruption is oftentimes covered in these policies in combination with the material damage to property. The reason to combine them in a group is for the purpose for which they are used.[5]

This is the reason why the occurrence of material and direct damage to property is a prerequisite to claim for a business loss under these policies. The necessity for a physical damage that prevents business operations or has caused a loss to it remains a key criterion for invoking business interruption insurance as it is a consequential policy.[6] An example would aid in understanding the working of this kind of insurance. For instance, fire occurs in a factory that has availed a SFSP policy, where business interruption is also covered in the terms. Here, the indemnification would not only mean restoring the property, but would also cover for the loss in that period where the business was interrupted due to fire till the period when the property is made usable for business operations again. Therefore, time also becomes an important consideration here as it covers direct and indirect consequential losses due to damage to property.[7]

II. Underwriting and pre-requisites

Since the business interruption insurance is a consequential and a time-oriented loss, underwriting process for the same is also slightly complex.[8] From the viewpoint of the insurer, the factors that ought to be taken into consideration for the purposes of underwriting would include mitigation of damages, the performance of the business and its seasonality, potentiality to cause business

[5] Clyde M. Kahler, *Business Interruption Insurance,* Vol. 161(1), THE ANNALS OF THE AMERICAN ACADEMY OF POLITICAL AND SOCIAL SCIENCE, pp. 77-84 (1932).
[6] Peter E. Kanaris, *Analytical Approach to Business Interruption, Extra Expense, And Civil Authority Coverage Issues,* Vol. 43 (1), Tort TRIAL & INSURANCE PRACTICE LAW JOURNAL, pp. 113-138 (2007).
[7] LONDON BUSINESS INTERRUPTION ASSOCIATION, *Guide to business interruption insurance and claims*, available at: http://london-bia.org/lectures/LBIABIManual.pdf. (last visited Nov 3, 2021).
[8] David A. Langner, *Business Interruption Insurance: Other Coverage*, Vol. 19, CPCU ANNALS.,72, pp.70-76 (1967).

interruption on the occurrence of damage to premises, etc. For the insured, the key requisites in order to claim for indemnification would be i) loss or damage to property and business; ii) the loss should be one that arises from a cause that is covered as an insured peril; and iii) the peril should have a proximate cause with the business interruption. The manner in which the material damage to property and proximate cause is established is a concern that would be addressed in the next chapter.

III. Business interruption insurance as a contract of indemnity

The courts in India also have noted that the business interruption insurance is a contract of indemnity and one cannot earn profits in this regard, while ironically, only claim the profits lost in the period of interruption.[9] The general practice is that the loss arising due to lack of operating income and increase in operating expenses are added and the costs of running the business in the time where it was not operational shall be deducted from the same in order to arrive at the indemnification amount[10]. However, one issue that could arise here is when a startup or a relatively new firm purchases this insurance and makes a claim. Here, it might be difficult to assess the 'business losses' in the absence of any previous performance reports. But despite these considerations, the common practice is to calculate the loss using the standard turnover over the past year.[11]

IMPLICATIONS OWING TO COVID-19

[9] Indo-Rama Synthetics India Ltd. v. Iffco Tokio General Insurance Co. Ltd., 2019(2) ArbLR250 (Delhi).

[10] Nick Sutton, *Business Interruption Insurance: A Lifeline For Financially Distressed Businesses Potentially Facing Insolvency?* MONDAQ, (31st March 2021) https://www.mondaq.com/uk/insurance-claims/1045426/business-interruption-insurance-a-lifeline-for-financially-distressed-businesses-potentially-facing-insolvency. (last visited Nov 3, 2021).

[11] *Business Interruption Insurance*, NEW INDIA ASSURANCE, http://wwsw.newindia.co.nz/Resources/Download/Business%20Interruption/BUSINESS%20INTERRUPTION%20COVER.pdf (last visited June 28, 2021).

I. RULES ON INTERPRETATION

The current increase in business interruption insurance claims gave way to a number of novel issues relating to invocation of the business interruption insurance contracts all over the world. A major portion of these issues lie in the interpretation of the insurance contract, which would ultimately decide if the claim covers the loss incurred due to the pandemic.

At the outset, it is imperative to understand that the insurance policy is a contract at the end of the day and the terms contained in it govern the parties.[12] The foremost rule is that the courts have to give effect to the plain meaning ought not to rewrite a contract while interpreting the same.[13] However, it is also settled that theterms of the policy must be read in such a manner so that it gives effect to the reasonable expectations of all parties to the policy, including the insured and the beneficiaries of the policy. Additionally, the coverage terms should be interpreted broadly and if there is any ambiguity, the same should be decided in favour the insured, as viewed by the court in *Canara Bank v. M/s. United India Insurance Company Limited.*[14] This is the principle of *contra proferentem* which stipulates that where there are two interpretations, the one that is against the party who worded the policy should be preferred.[15] It should also be noted that the exclusion clauses in the policies ought to be read in a narrow manner.[16] Keeping in mind these principles, it is important to interpret the new challenges faced due to the pandemic in reading business interruption coverage policies.

II. DAMAGE TO PROPERTY

The direct and material damage to the property being the criterion for allowing the claim, the interpretation of this term in the absence of any definition in the

[12] Shree Ambica Medical Stores v. Surat People's Cooperative Bank Limited,AIR 2020 SC 803.
[13] General Assurance Society Ltd. v. Chandumull Jain, AIR 1966 SC 1644.
[14] Canara Bank v. M/s. United India Insurance Company Limited (2020) SLT 200.
[15] United India Insurance Co. Ltd. v. Orient Treasures (P) Ltd., (2016) 3 SCC 49.
[16] Canara Bank v. M/s. United India Insurance Company Limited., (2020) SLT 200.

contract or in the presence of an ambiguous one becomes important. The standard definition adopted in the west is the "distinct, demonstrable, physical alteration of the property".[17] The judicial interpretation of this requirement post the onset of the pandemic has seen a mix of liberal and the traditional interpretations, with the majority of the decisions tilting towards the traditional approach, to the relief of the insurers. Certain decisions in the U.S.A have clearly ruled that the COVID-19 pandemic cannot be considered as one that caused a 'direct physical loss to the property; most of these decisions did not even address the matter as to whether 'damages due to virus' is an exclusion in the coverage while ruling so.[18]

In one of the very few cases that favoured the insured, the court had viewed that *loss* could be interpreted to mean *loss of use* as the policy was worded 'direct physical *loss of* or damage to' covered property. The Court found that the term 'damage' would be rendered superfluous if the word 'loss' did not include 'loss of use'.[19] However, the court has not decided the merits of the case yet.

Similarly, in Canada, the court, in a case involving business interruption claim under an all-risk coverage, rejected the idea that that a tangible physical damage ought to have occurred and instead adopted a broad interpretation that treats the loss of function or use of premises as physical damage for the purposes of the claim.[20] The court noted that a narrow interpretation would be against the idea of a commercial all-risk policy and the policy-holders would be deprived of a vital aspect of the coverage.

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[17] Port Authority of New York and New Jersey v. Affiliated FM Insurance Company, 245 F. Supp. 2d 563 (D.N.J. 2001).

[18] *Turek Enterprises, Inc. v. State Farm Fire and Casualty Co.*, No. 20-11655 (E.D. Mich. Sept. 3, 2020); *Malaube v. Greenwich Insurance Company, No.* 22615-CIVWILLIAMS/TORRES, 2020 WL 5051581.

[19] *Studio 417, Inc. v. Cincinnati Ins. Co.*, Case No. 20-cv-03127-SRB.

[20] MDS Inc v. Factory Mutual Insurance Company 2021 ONCA 594.

In the United Kingdom ["U.K."]., the Supreme Court, ruled much to the relief of thousands of policy holders. The court had selected 21 sample policy wordings that offered protection to businesses from disease outbreak (disease clause- cover business interruptions following the occurrence of a 'notifiable disease'), denial of access to premises owing to order of public authority, and a mixture of these two or the hybrid clause. The court found that the COVID-19 virus was declared as a notified disease in the U.K. and the general exclusion in the policy that excluded epidemic and disease does not exclude business interruption claims arising from the pandemic.[21]

III. ACTION OF CIVIL AUTHORITIES

Another covered peril is loss due to prohibition of access by civil authorities or excavation due to civil authorities. This kind of insurance is also commonly taken up by the insured in the west, where it would cover losses due to a prohibition of access to the business premises by the public authority. This is commonly known as the civil authority's prohibition coverage. Wherever the contracts include this peril, the insured takes the approach that the pandemic induced lockdown is construed as 'prohibition of access by civil authorities'. This constitutes as a proximate cause with the business interruption loss. Based on this approach, claims have been initiated.

The courts have previously viewed that damage to property is not essential to initiate claims for business interruption under civil authorities' prohibition coverage. In a case where the governor had imposed a curfew, following riots, owners of cinema halls and restaurants were allowed to initiate claims irrespective of there being no damage to property as such.[22] However, it also needs to be

[21] FCA v. Arch Insurance (UK) Ltd and others [2020] EWHC 2448 (Comm).
[22] Sloan v. Phoenix of Hartford Insurance Company, 46 Mich. App. 46, 207 N.W.2d 434 (1973).

noted that general advisory issued cannot be equated to an order.[23] Therefore, it would be interesting to see how claims initiated on this basis are decided.

IV. MAIN PURPOSE RULE

The Indian courts have used the principle of *contra proferentem* in the context of business interruption insurance as well. In *Gujarat Guardian Ltd. v. New India Assurance Co. Ltd. & Ors.*,[24] the court found that where two views were possible, it ought to take the view that favours the insured. It ordered for the insurer to pay for the claim along with interest. Apart from this *contra proferentem rule,* it would also be pertinent to note the 'main purpose rule' in insurance contracts where the exclusion clause is capable of two different interpretations. This rule provides thateffort must be taken to harmonize the exclusion clause and the 'main purpose' of the policy contract and even read down the exclusion if needed, instead of allowing the exclusion clause to snipe successfully at the main purpose.[25] This approach could be suited to favour the insured, especially in all-risk coverage policies.

DEFENSE OF INSURERS AND GOVERNMENTAL ACTION

I. FORCE MAJEURE

There have also been debates as to whether this pandemic can be considered as an Act of God. In this current set up, where the trend is such that performance of contracts is being rendered infructuous due to *force majeure,* the burning question is whether insurers can claim this defense to protect them from their liability to pay. The liberal approach is that this pandemic is not an Act of God

[23] Penton Media, Inc. v. Affiliated FM Ins. Co., 245 F. App'x 495 (2007).
[24] Gujarat Guardian Ltd. v. New India Assurance Co. Ltd. &Ors., 2016 SCC OnLine NCDRC 1891.
[25] Skandia Insurance Co. Ltd. v. Kokilaben Chandravadan AIR 1987 SC 1184.

per se and therefore, where the damage is not saved by any exclusion clause in the insurance contract, the insurers cannot escape liability claiming the happening of a *force majeure* event.[26] The paper finds this approach to be the need of the hour in order to practically save industries, especially those small businesses that are essentially dying. Many risk policies contain a *force majeure* that could exclude pandemics. But if they do not have a specific virus or disease exception, there are good chances for the insured to recover their losses under the policy.[27]

II. LEGISLATIVE ACTION IN THE UNITED STATES

Apart from the judicial interpretation of these contracts, there have been some legislative measures in the U.S.A, both in the federal as well as the state level. A Federal bill introduced in, as early as, April 2020 requires those insurers who provide business interruption coverage to cover losses from a viral pandemic, a government authority-ordered closure of business or evacuation, or an event of power disruption effected for the purposes of public safety.[28] It renders void those insurance contracts in force that exclude these events from coverage. Exception to this rule covers instances where the insurer can reinstate the exclusions, provided the insured authorizes the reinstatement in writing, or in the event the insured fails to pay the corresponding premium increase after providing adequate notice of the same. However, significant challenges are expected to this bill.

State bills include those where COVID related closure of business would be deemed as 'property damage',[29] creation of a rebuttable presumption that

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[26] Brody Viney et al., *Supporting Small Business through Coronavirus: Ideas from Experts and Leaders across NYC*, CENTER FOR AN URBAN FUTURE, pp. 1-20 (2020).

[27] Zubin Behramkamdin Vidya Nair, *The COVID-19 pandemic and its impact on the insurance sector*, BAR & BENCH (June 13, 2020) https://www.barandbench.com/columns/covid-19-pandemic-and-its-impact-on-insurance-sector. (last visited Nov 3, 2021).

[28] Business Interruption Insurance Coverage Act 2020, 2019-2020, H.R.6494, 116th Congress (U.S.A).

[29] Providing for Insurance Coverage for Business Interruption, 2019-2020, H.B. 2372 of. 2019–2020 (Pennsylvania, U.S.A).

COVID -19 was present in the premises,[30] among others. Most of these bills are made applicable to smaller size businesses with employees lesser than 200-250.[31] From this, it can be understood that the legislative measures that are taken, are aimed at welfare.

III. MEASURES BY IRDAI

In the last year, even before the announcement of the first nationwide lockdown, The Confederation of All India Traders had issued a letter requesting the finance minister to look into this issue. It was urged that the IRDAI ought to be advised to introduce policy coverage for business interruption due to the pandemic.[32] The IRDAI, in July 2020, took note of the consideration that the pandemic, which started as a health and life crisis moved on to disrupt the economic activities in the country. Noting that there is a need to address long term solutions for the issues such as huge claims for business interruption without material damage to property, it constituted a working group to study the issue of the need to set up a pandemic risk pool in this regard.[33]

The report of this working group, after making a detailed study of the pandemic induced loss and the budget considerations for a pool of such a large magnitude, recommended that the coverage for business interruption at the immediate time period ought to focus on sectors such as wages for MSME workers and migrants.[34] It was opined that the pool money in the budget ought to cover fire

[30]Assemb. B. 1552, Reg. Sess. (Cal. 2020) (U.S.A).
[31]Sen. B. SB477, Reg. Sess. (La. 2020) (U.S.A).
[32]*Ians, COVID-19: CAIT urges insurance cover for disrupted business*, ECONOMIC TIMES, (March 16, 2020), https://auto.economictimes.indiatimes.com/news/industry/covid-19-cait-urges-insurance-cover-for-disrupted-business/74645531. (last visited Nov 3, 2021).
[33] Insurance Regulatory and Development Authority of India, *Working Group to Study and make recommendations on formation of an Indian Pandemic Risk Pool*, (July 8, 2020), Available at: [Ref. No. IRDAI/RI/ORD/MISC/182/07/2020].
[34] Insurance Regulatory and Development Authority of India, *Report of the Working Group on Formation of an Indian Pandemic Risk Pool*, (September 2020), available at:

and marine insurance as a priority over business interruptions as these types of insurance are still not highly penetrated in India.

CONCLUSION

The pandemic and the subsequent lockdown resulted in the unprecedented rise in the number of claims for business interruption insurance. The post COVID-19 world would bring in a paradigm shift in the way business risks are perceived and this would give way for the need to issue a wider product and coverage for interruption insurances. However, in addition to the legislative lacuna in this regard, there is also inaction from the part of the insurance companies. Though judicial interpretation could bring in some clarity in this regard, progressive action by the regulatory authorities and the insurance companies' compliance to them only would bring the necessary long-term implications.

Such progressive action could typically be implemented in the form of a bill proposing indemnification for at least MSME industries possessing business interruption insurance, as a short-term measure. A portion of the pandemic risk pool could be exhausted for the same so that the insurers in their sole capacity do not end up facing the brunt of the situation. Such a welfare deed would immensely aid these industries that suffered business losses as a result of the pandemic, irrespective of whether 'material damage' could be proved or whether there was a pandemic exclusion under the insurance policy. Further, IRDAI can issue appropriate directions to insurers in public interest in exercise of its powers under Section 34 of the Insurance Act,[35] as and if needed.Since the IRDAI itself has noticed the relatively low penetration of business interruption insurance in

https://www.irdai.gov.in/ADMINCMS/cms/whatsNew_Layout.aspx?page=PageNo4242&flag=1. (last visited Nov 3, 2021).

[35] The Insurance Act, 1938, §34, No. 4, Acts of Parliament, 1938 (India).

India,[36] appropriate guidelines that operate as incentives both for the insurers and the insured can be framed, as a long-term measure.

The legislative efforts both by the federal and state levels in the U.S.A and other jurisdictions in the world might face issues relating to the validity of the provisions. However, in a situation such as the present one, that caused the economy to wreak havoc, measures in public interest are needed. Policies in the near future on business interruptions that would cover instances such as the present one, would be priced exorbitantly if left unregulated. Though the concept of business interruption insurance is not highly popular but only evolving in India, the lessons learnt from the pandemic can hopefully aid in the framing of a well-rounded policy by the regulatory authorities in India at this developmental stage itself.

[36] Insurance Regulatory and Development Authority of India, *Report of the Working Group on Formation of an Indian Pandemic Risk Pool*, (September 2020), available at : https://www.irdai.gov.in/ADMINCMS/cms/whatsNew_Layout.aspx?page=PageNo4242&flag=1. (last visited Nov 3, 2021).

SCHOLASTICUS

Varda Saxena, *Decoding the Creditor's burden While Auctioning Non-Performing Assets*, 9(2) SCHOLASTICUS 86 (2022)

DECODING THE CREDITOR'S BURDEN WHILE AUCTIONING NON-PERFORMING ASSETS

Varda Saxena[⊥]

ABSTRACT

Secured creditors have been instrumental in auctioning assets that are converted into non-performing assets due to unpaid debts. The following article analyses such sales under the Transfer of Property Act, 1882 ("TOPA") and the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act ("SARFAESI"), 2002, while examining the checks and balances set out in these statutes for ascertaining the title of the property as against the doctrines of caveat emptor and caveat venditor, which have been preferred over the 'as is' manner of sale while dealing with the illegitimate title over goods and transfer of encumbrances. The article aims to explore the legitimacy of the sale of a secured asset when it is auctioned in an 'as is, where is, whatever is' manner under Section 13 of the SARFAESI Act without disclosing pending suits and encumbrances. The analysis would unveil the duties of the Seller /Secured Creditor for undertaking reasonable care and the measures which fulfil the threshold of reasonable care under the SARFAESI Act and Section 55 of TOPA, for overcoming the impediments caused by an 'as is, where is' sale by ascertaining legitimate title, pending suits and encumbrances via Section 26 of the SARFAESI Act.

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INTRODUCTION

The domain of property is a constellation of numerous relationships between people, which are identified and expanded in various statutes governing sales. The vastness of the property web has been created to ensure utility maximization and preference satisfaction of each party.[1] However, ordinal rankings of people's choices while buying or selling property are also bolstered by the various morals, rights, and equitable obligations[2] created by the laws. Such obligations originally stem from religious or socio-cultural aspirations, such as the Jewish conception of mercantile honesty,[3] which obligated the seller to bear the duty of disclosure. This view was endorsed by various Biblical[4] and Rabbinical elaborations[5] encompassing attitudes and conduct in the marketplace. Such views upheld extreme disdain against fraud and misdirection.[6] These views have crept inside the judicial and statutory discourse in a complex form. The present article addresses these complexities and analyses one of the tributaries of the network of property laws.

When borrowers are unable to pay back the loan amount provided by a financial institution, the amount gets converted into a non-performing asset.[7] It results in auctioning of the property attached as security. These assets are defined in Section 2(1)zd of the Act of 2002.[8] Due to this conversion, the secured goods are sold in an auction after the issuance of a notice. For this purpose, the Secured

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[1] STEPHEN R. MUNZERA THEORY OF PROPERTY 4 (Cambridge University Press) (1990).
[2] *Id*. at 6..
[3] Daniel G. Ashburn, "*Appealing to a Higher Authority?: Jewish Law in American Judicial Opinions"*, Vol. 71 UNIVERSITY OF DETROIT MERCY LAW REVIEW,295 (1994).
[4] The Bible, Deuteronomy 23:19.
[5] The Torah, Exodus 23:7, 9.
[6] Sheldon Gardner & Robert Kuehl, "*Acquiring an Historical Understanding of Duties to Disclose, Fraud, and Warranties"*, Vol. 104 COM. L.J. 168, 170 (1999).
[7] The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, § 2, No. 54, Acts of Parliament, 2002 (India).
[8] *Id.* at § 2 (1) zd.

Creditor causes the issuance of a notice detailing the debt and requesting the borrower to realize the amount within 60 days of receiving such notice.[9] If the debt remains unpaid, the asset is sold in an auction[10] which might occur on an 'as is, where is, whatever is' basis, which is found to legitimize the sale of encumbrances.[11] However, in relation to encumbrances, improper title, or other undisclosed information surfaces post the effectuation of sale, it disrupts the preference satisfaction of the buyer. Such disruption creates room for dispute and litigation,[12] and courts usually uphold that either the buyer should have been aware of the defects by carrying out proper checks,[13] or the seller ("Secured Creditor") should have been aware of the same.[14] The auction of such non-performing assets occurs as per Section 13 (2) and 13 (4) of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002. The following article argues that in cases of such unsatisfactory property transfers, the Secured Creditor should be obligated to adhere to a higher threshold of checks, making the principle of *caveat venditor* of paramount importance as against *caveat emptor*. Hence, instead of rigidifying the sale of such assets, the Secured Creditor needs to be held accountable for the lacunae in ascertaining the nature and title of all non-performing assets. The following section discusses the role of 'as is' clauses in the auctioning of properties.

AUCTIONING NON- PERFORMING ASSETS

[9] *Id*. §13 (2).
[10] *Id*. § 2 (1) zc.
[11] In re Mount Mettur Pharmaceuticals Ltd.,Company Petition No. 274 of 2009, available at: https://www.mca.gov.in/Ministry/pdf/salenotice_mountmettur_19122017.pdf. (last visited Nov 3, 2021).
[12] Florrie Young Roberts, "*Disclosure Duties in Real Estate Sales and Attempts to Reallocate the Risk*", Vol. 34 CONNECTICUT LAW REVIEW, 2 (2001).
[13] V.Sambandan v. The Punjab National Bank, 2017 AIR CC 2266.
[14] Jai Logistic v. The Authorised Officer, Syndicate Bank, (2010) 7 MLJ 353.

'As is, where is, what is and whatever is' is a clause that is usually mentioned in the notices of auction issued by secured creditors (financial institutions).[15] This clause grants the total control of the asset to the highest bidder in the auction. Such control includes the asset's physical and legal conditions thereafter the Secured Creditor loses control over all the attached charges and responsibilities.[16] This manner of sale leads to the plausibility of the sale of an asset with pending encumbrances, improper title, or other defects. Secured Creditors tend to overlook the claims of buyers by applying the principle of *caveat emptor* and stating that the buyer is responsible for carrying out due diligence.[17]

This clause usually comes into play when Secured Creditors wish to dodge refund requests due to later discovery of pending encumbrances or other defects in the title.[18] Due to this lacuna, the buyers have been misled in multiple instances. It was concluded in *Rekha Sahu v. U.C.O Bank,*[19] that the Secured Creditor's official must undertake due diligence and disclose all material details while selling an asset, according to Section 55 of ("TOPA"). Further, in *Atishaya Construction Pvt. Ltd. v. Central Bank of India,*[20] it was upheld that the clause can no longer grant immunity to the creditor/seller. The Creditor will have to make good the losses caused to the buyer. Judicial discourse has also highlighted that whenever the encumbrances cause the transfer of property to be cumbersome or leaves the buyer dispossessed, the sale can be invalidated, and the buyer can claim a refund without security forfeiture.

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[15] In re Crystal Credit Corporation Ltd. Company Petition No. 389 of 2001, available at: http://www.mca.gov.in/Ministry/pdf/SaleNotice_17122020.pdf. (last visited Nov 3, 2021).
[16] S. Shanmuganathan v. Indian Overseas Bank, AIR 2017 Mad 228.
[17] The Corporation Bank & Another v. Dr. Jayesh Kumar Jha, M.A.T 291 of 2019.
[18] Varda Saxena, *Understanding the 'As is' Clause of Auction: SARFAESI Act, 2002*, Legal Entrepreneurship Cell (Mar. 20, 2021), https://lecjgls.wixsite.com/lecjgls/post/understanding-the-as-is-clause-of-auction-sarfaesi-act-2002. (last visited Nov 3, 2021).
[19] 2013 SCC OnLine All 13203.
[20] Atishaya Construction Pvt. Ltd. v. Central Bank of India, 2014 SCC OnLine Guj 9204.

Due to this conundrum, the courts have upheld the principle of *caveat venditor*, which means that the seller should be aware of the defects and disclose them before selling them.[21] In *Mathew Varghese v. M. Amritha Kumar,*[22] the Apex Court stated that according to Rule 8(6)(f) of the Security Interest (Enforcement) Rules and Section 55 of the TOPA, the purchasers should be made aware of the nature of the property, the extent of liability on the said property, any other encumbrances, the minimum bidding price, and the complete liability of the borrower to the Creditor. Similarly, in *Janatha Textiles v. Tax Recovery Officer*, the Supreme Court stated that *"in view of Sections 55(1)(a) and (b), Transfer of Property Act, 1882, it was incumbent upon the appellant SFC to disclose to the respondent about the non-existence of the independent passage to the unit. It was also the duty of the appellant SFC to inform the respondent that the passage mentioned in the revenue record was not fit for the movement of vehicles."*[23]

The responsibility to ascertain the material features of the property is also directed towards the purchasers only if the auction notice specifies that such duty is cast on them.[24] However, in all other circumstances, the seller/secured Creditor is bound to disclose all material facts. The courts have also upheld that even if the encumbrance certificate is made available to the purchaser before the sale, it will not be construed as strict compliance with Rule 8(6). The Banks are bound to disclose even the disclosure order of the attachment of the Tax department in the sale order itself.[25] Even though such provisions and precedents are in place,

[21] Mandava Krishna Chaitanya v. UCO Bank, Asset Management Branch, 2018 SCC Online Hyd. 196.
[22] Mathew Varghese v. M. Amritha Kumar, AIR 2015 SC 50.
[23] Janatha Textiles v. Tax Recovery Officer, (2008) 12 SCC 582.
[24] *Supra* note 14.
[25] Chemstar Chemicals & Intermediates (P) Ltd. v. The Commercial Tax Officer, Chennai, 2010 SCC OnLine Mad 5136.

the principle of *caveat emptor* has still been in use. However, the seller has several statutory duties which are to be adhered to and the same is discussed below.

DUTIES OF SELLER BEFORE SALE COMPLETION

The inception of the doctrine of Rugged Individualism[26] paved the way for the birth of the concept of *caveat emptor*. The law did not stand in loco parentis to buyers for their protection in business. Hence, the doctrine originated from *laissez-faire* principles, which state that, *"buyer deserved whatever he got if he relied on his own inspection of the merchandise and did not extract an express warranty from the seller."*[27] This doctrine protected the sellers from lawsuits and promoted the public policy discourse of reducing judicial burden.[28] However, this doctrine reflected the virtues of medieval laws. The concept worked well for agricultural societies and farm acreage but lacked the grit for complex property relations.[29]

Hence, it would be unwarranted to apply the medieval doctrines to a growing financial market. However, the practice of holding the buyer to a threshold of discovering all encumbrances and incidents is still prevalent in the modern world. The courts have been hesitant in granting buyers any relief against the non-disclosure of information on behalf of sellers. There have been cases like *United Bank of India v. Official Liquidators and Ors.,*[30] where the Apex Court stated that the official liquidator of the property could not guarantee or warranty the sale of immoveable assets and the purchaser would not be entitled to compensation, deduction in price or damages in case any unknown claims, encumbrances or liens are discovered. Additionally, the judgment in the Kenneth Builders case,[31]

[26] Allison Dunham, "*Vendors' Obligation as to Fitness of Land for a Particular Purpose*", Vol. 37 MINNESOTA LAW REVIEW, 108, 110 (1953).
[27] Roberts, *supra* note 12 at 4.
[28] *Id*. at 5.
[29] *Id*. at 7.
[30] (1994) 1 SCC 575.
[31] Delhi Development Authority v. Kenneth Builders & Developers Ltd, (2016) 13 SCC 561.

highlighted that the duty is cast on the buyer to inspect the property before buying. It has also been confirmed in the case of *Vishal N. Kalsaria v. Bank of India*[32] that the SARFAESI Act's mandate needs to be realised in consonance with Section 55 of TOPA ("**Transfer of Property Act**"), 1882. However, the principle of *caveat emptor* embodied by these judgments are contrary to the practice of *caveat venditor* which has been highlighted while specifying the threshold for due diligence which the parties should have undertaken before the sale.

The following issues can be considered as some of the material factors/defects influencing the buyer's consent to contract—defects in title, encumbrances, the covenant of title, and misdescription of property.

However, the deficiencies for which a remedy is provided to the buyer need to be latent defects. In the case of *Flight v. Booth*,[33] it was established that the defects should be such that the buyer would not purchase the asset if the defects were known to him. Hence, the purpose for which the property is being sold also has to be factored in while assessing the claim. In the case of *Re Pucket &. Smith Contract*, an underground sewer and drainage system constituted a material defect as the land was to be used for construction purposes.[34] Further, it is material to observe whether the property's usage becomes inconvenient due to intentional non-disclosure of details related to its accessibility.[35] This is because the absence of the right to use land is a material objection to the title.[36]

Hence, it is the duty of the Secured Creditor to ensure the perfection of the title, as Section 17 of the Specific Relief Act, 1963 ("**SRA**")specifies that unless the seller/secured creditor states otherwise, it has to be presumed that no reasonable

[32] Vishal N. Kalsaria v. Bank of India, (2016) 3 SCC 762.
[33] Flight v. Booth, (1834) 1 Bing (NC) 370.
[34] Re Puckett & Smiths Contract, (1902) 2 Ch 258.
[35] Haryana Financial Corporation v. Rajesh Gupta, AIR 2010 SC 338.
[36] DINSHAW FARDUNJI MULLA, THE TRANSFER OF PROPERTY ACT, 1882 (12th ed. 2014).

doubt exists in the title of the asset.[37] Only a title lacking any reasonable doubt can be considered a marketable title and can be enforced.[38] However, the following defects of title can also occur— a notification not amounting to a proposal[39] to transfer intended acquisition as per the Land Acquisition Act,[40] encumbrances,[41] restrictive covenants,[42] a party-wall notice placing the liability to contribute to the rebuilding of the property on the owner;[43] easements,[44] onerous covenants in a sale of lease-hold property,[45] or the fact that the agreed root of title is a voluntary conveyance.[46] However, these material defects need to be differentiated with the circumstance when the Secured Creditor does not own the property, in which case, it does not amount to a material defect but fraud.[47]Apart from the availability of marketable title, the covenant of title is another factor that the seller is impelled to disclose.

COVENANT OF TITLE: DUTIES AND REMEDIES FOR BREACH

Section 55 (1), of TOPA, is applicable in cases of ascertaining the title before completion of sale. In the case of *Babu Bindeshri v Mahant Jairam*,[48] the seller was sued to claim specific performance of the contract because he did not provide a guarantee of a proper title. The suit was dismissed as it was not mandatory to present an absolute guarantee of title. However, this did not disentitle the buyer from claiming specific performance.[49] Once the sale has been concluded, and

[37]The Specific Relief Act, 1963, § 17, No. 47, Acts of Parliament, 1963..
[38] Rajendra Kumar Bhandari v. Poosammal, AIR 1975 Mad 379.
[39]*Supra* note 35.
[40] Lallubhai Rupchand v. Chimanlal ManilalAIR 1935 Bom 16.3.
[41] Mahomed Siddiq v. Li Kan Shoo, AIR 1925 Rang 372.
[42] Nottingham Patent Brick & Tile Co v. Butler, (1886) 16 QBD 778.
[43] Carlish v. Salt, (1906) 1 Ch 335.
[44] Heywood v. Mallalieu, (1883) 25 Ch D 357.
[45] Reeve v. Berridge, (1888) 20 QBD 523.
[46] Re Marsh and Granville (Earl), 24 Ch D 11.
[47] Royal Star Trading Company v. IFCI Ltd., 2011 SCC OnLine Del 2909.
[48] Babu Bindeshri Parshad v. Mahant Jairam Gir, (1887) ILR 9 All 705.
[49] Surendra Maneklal Kathia v. Bai Narmada, AIR 1963 Guj 239.

conveyance has been accepted, the seller's omission to disclose material facts under Section 55(l)(a) of TOPA is fraud. The implied covenant of title supersedes the principles of caveat emptor as it applies to lawful evictions by the actors with a dominant title. It imports an absolute warranty of the title professed to be transferred and the seller's power to deal with it.[50]

For defects that surface after the conveyance,[51] the buyer has a remedy against the seller even if he had knowledge of the defect when the parties were contracting.[52] The buyer is entitled to get damages and get a refund of the purchase money.[53] However, the seller cannot be held accountable for the title, which he has not promised to transfer. Hence, if the promise is for an occupancy right,[54] the seller cannot be held liable if a title paramount evicts him. Apart from the event of non-disclosure of title, the seller is also assumed to not misdescribe the property or indulge in active concealment. The repercussions arising from the same have been discussed below.

MISDESCRIPTION AND FRAUD

Several jurisdictions such as California[55] and Ohio[56]have held that the 'as is, where is, whatever is' clause does not impede the conduct resulting in misrepresentation and wilful fraud, which includes active concealment and affirmative representation of material details.[57] Whenever the seller misdescribes the title, it amounts to a breach of the covenant for the title. However, a breach does not provide remedies for a misdescription of property and corporeal

[50] Kanshi Ram v. Jaimal Singh, AIR 1923 Lah 590.
[51] Vishvanath Ganesh Joshi v. Bala Kaku Kapadi,AIR 1916 Bom 279.
[52] Ram Chunder Dutt v. Dwarkanath, (1889) ILR 16 Cal 330.
[53] Kali Din v. Madho, AIR 1923 All 169.
[54] Kulla Mal v. Umra, 61 IC 604.
[55] Cooper v. Jevne, 56 Cal.App.3d 860.
[56] Starinki v. Pace, 535 N.E.2d 328.
[57] Roberts, *supra* note 12 at 22.

misdescription.[58] In such cases, the buyer can file a suit for mutual mistake or fraud as per Section 26 of the Specific Relief Act,1963. However, if the misdescription gets discovered before the execution of the conveyance, the buyer can rescind the contract or claim damages. But this remedy is only available if the misdescription was such that if the buyer were aware of it before, he would not contract with the Creditor.[59] In cases of non-material misdescriptions, the seller will be liable to compensate the buyer.[60] The non-disclosed information can be intrinsic or extrinsic.

The difference between the two can be understood via the exchange-promise dichotomy which postulates the disclosure of intrinsic and extrinsic information. The distinction between intrinsic and extrinsic information is that intrinsic information relates to the inherent conditions of a property, such as a termite infestation, which can be uncovered only when the seller straightforwardly discloses the information. However, extrinsic information includes market prices, the surrounding conditions of the property which influence the sale and trade trends.[61] The intrinsic information related to the property can be specifically significant for the buyer. Hence, when bolstered by sanctions, the duty to disclose can preclude non-beneficial exchanges for both parties, making the seller the disadvantaged party. On the other hand, however, there is an all-pervading duty to disclose extrinsic details, which includes information related to the general environment in which the contract was formed.[62] The disclosure of this information may not result in desirable or complete disclosure, causing

[58] RN Dawar v. Ganga Saran Dhama, AIR 1993 Del 19.
[59] *Supra* note 33.
[60] Administrator-General of Bengal v. Aghore Nath Mookerjee, (1902) ILR 29 Cal 420.
[61] Gary Lawson, "*The Ethics of Insider Trading*", Vol. 11, HARVARD JOURNAL OF LAW & PUBLIC POLICY, 727,740 (1988).
[62] W. PAGE KEETON ET EL, , PROSSER & KEETON ON TORTS § 106 (5th ed.1984).

uncertainty in property titles formed by promissory transactions.[63]Hence, in certain jurisdictions, courts apply the "Bespeaks Caution" doctrine[64], which is effective in protecting against securities fraud claims of buyers if the sales agreements contain proper cautionary language and risk disclosure clauses.[65] The doctrine is a protective net for parties issuing securities and their representatives as it suggests inclusion of forward-looking statements embodying cautionary language. The doctrine suggests that these statements should be constructed according to the specific contractual situation to negate responsibility for any post-sale discovery. These statements are specific and are not like boilerplate clauses in general agreements.[66] Such cautions have been regularly noticed in 'as is' clauses which usually include undiscovered encumbrances. The doctrine has been called the "common law doctrine" in some cases[67] as it is a judicially created doctrine. However, it is a misnomer as common law requires promisors to put their promisees in positions as good as they would have occupied had the promisors performed.[68] Therefore, elaborating on the promisors' duty, the following section deals with the duty of the secured creditors to disclose all encumbrances.

ENCUMBRANCES: BUYING PENDING LITIGATION AND DEBTS

[63] Christopher T. Wonnell, "*The Structure of a General Theory of Nondisclosure*", Vol. 41 CASE WESTERN RESERVELAW. REVIEW,338 (1991).
[64] Jonathan B. Lurvey, "*Who Is Bespeaking to Whom? Plaintiff Sophistication: Market Information, and Forward-Looking Statements*", Vol. 45 DUKE L.J. 579 (1995).
[65] Gardner, *supra* note 6 at 182-83.
[66] Grossman v. Novell, Inc., 120 F.3d 1112, 1120,1123 (10th Cir. 1997).
[67] See, e.g., Western Washington Laborers Employers Pension Trust v. Panera Bread Co., 2009 WL 3756619, at 3 (E.D. Mo. Nov. 6, 2009); In re XM Satellite Radio Holdings Sec. Litig., 479 F. Supp. 2d 165, 187 (D.D.C. 2007); and In re Nokia Oyj (Nokia Corp.) Sec. Litig., 423 F. Supp. 2d 364, 392 (S.D.N.Y. 2006).
[68]Randy E. Barnett, "*A Consent Theory of Contract*". Vol. 86, Colum. L. Rev. 269 (1986).

The auction notices hold a clause[69] wherein it is stated that the property being sold in an 'as is where is whatever is' may contain all known and unknown encumbrances during the sale. Further, it places the duty on the buyer to ascertain these encumbrances. However, it was stated in the judgment of the Midas Electronics case[70] that such clauses could not be enforced, and it is the duty of the Creditor to disclose all such associations as per Rule 6 of Rule 8 of the Security Interest (Enforcement) Rules, 2002. Moreover, if the property is sold with encumbrances, the Secured Creditor's duty to discharge such encumbrance can also be borne after completing the title covenant under Section 55(2) of TOPA.[71] Further, if the buyer takes the onus to discharge the encumbrance due to the seller's default, the buyer can hold the seller accountable to indemnify him as per Section 69 of the Indian Contract Act, 1872.[72] This argument is also bolstered by the application of Section 13 of the S.R.A.[73], under which the buyer can be made to make good the encumbrance. However, this is different from the scenario when the buyer explicitly agrees to payoff the encumbrance irrespective of the circumstances. If such an agreement is in place, the purchaser cannot hold the creditor accountable.[74]

In the case of *Capital Hotel and Developers Ltd. v. DDA*,[75] the Court held that "the Creditor has a duty to inform the auction bidders about the pendency of litigation and it was for the bidders to consider whether the same was a cloud on the title or not." Further, it was stated that considering the 'as is, where is, whatever is'

[69]Axis Bank: Public Notice for Auction, Available at: https://www.axisbank.com/docs/default-source/default-document-library/auction-notice-tender-document_rohini-oil-millc6fb02babe576bf08df9ff0a000b8c1c.pdf.
[70] Midas Electronics Pvt. Ltd. v. Small Industries Development Bank of India, (2016) 230 DLT 312.
[71] Asset Reconstruction Company (India) Ltd. v. Florita Buildcon Private Ltd.,AIR 2017 Bom 25.
[72] Manishanker v Ramkrishna, (1904) 6 Bom LR 832.
[73]*Supra* note 37 at §13.
[74] R Muninarayana Reddy v. CP Chimanswamy Gownder, AIR 1952 Mys 120.
[75]W.P.(C) 1513/1999, decided on 22.09.2004.

manner of the auction means that a buyer purchases the lawsuit along with the property, the Creditor cannot enforce the transaction without the buyer's consent. Non-consensual transactions can be annulled. The bench referred to Section 55 of TOPA and stated that "*even if there was no impediment to the transfer, the cloud arising from pendency of litigation entitled the purchaser for disclosure of such information and non-disclosure would give a right to the purchaser to back out of the transaction*."[76]

In cases where encumbrances cause the transfer of property impossible or which disrupt the buyer's right to possess the said property, the seller can be sued for damages under Section 55(2) of TOPA.[77] Also, in suits of specific performance of sale, the seller discharges the encumbrance before effectuating the transfer.[78] Therefore, the buyer's knowledge about the encumbrance is considered immaterial.[79] However, even if the property does not have encumbrances, the Creditor needs to produce an encumbrance certificate as per the 2002 Rules. Hence, documents like releases of mortgages need to be evidenced by the signature of relevant authorities.[80]

DUTY OF THE SELLER AFTER SALE

Under Section 55(l)(e) of TOPA, the duty of the seller emerges from the English law principle of taking care of the property pending completion.[81] The duty can be enforced after completion and includes the duty to provide reasonable repairs. After providing such repairs, the seller has a right to receive the profits and rents accruing from the asset between the time the contract is entered and completed under Section 55(4)(a) of TOPA. This is so that the seller can be indemnified for the expenses accrued during the repairs. The parties can also agree that the seller

[76] *Supra* note 46.
[77] Gobardhan Das v. Afzal Husain, AIR 1932 All 553.
[78] Kathamuthu Pillai v. Subramaniam Chettiar, (1926) 50 Mad LJ 228.
[79] *Supra* note 51.
[80] Shirinivasdas v. Meherbai, (1917) ILR 41 Bom 300.
[81] Rayner v. Preston, (1881) 18 Ch.D. 1.

will bear the expense of all public charges due on the date the possession was granted and not on the date when the sale was effectuated.[82] In cases where the seller states that he is selling the property with discharged encumbrances and does not do so because unpaid interest already exists on the property, he cannot be permitted to accrue advantage from his own wrong.[83]

Hence, even in the presence of 'as is' clauses, it has been argued that whenever the buyer signs the agreement relying on the seller's description coupled with 'as is' clauses, encumbrance certificate and the sales agreement, the belief itself is permeated with fraud, hence it should not be enforced. Fraud makes a contract voidable, enforcement of clauses that waive the seller's liability, such as the exculpatory clauses and 'as is' clauses,[84] are against public policy.[85]

CONCLUSION

The article aimed to explore the dichotomy created by the 'as is, where is, whatever is' clauses which revolve around the paramountcy of the doctrine of *caveat emptor*. It was argued that the said doctrine is regressive, and the usage of the same by courts in such exclusionary clauses should be stopped. The disclosure of both extrinsic and intrinsic information should be facilitated by leaning towards common law principles of ethical completion of promise, instead of using forward-looking clauses and adoption of approaches such as the Bespeaks Caution Doctrine. It should be noted that Indian legislations like the Specific Relief Act and precedents highlighted in the paper allocate a higher threshold of disclosure as against the theory of caveat emptor. The analysis postulates the sale of a perfect title, which can only be effectuated once the buyer

[82] Govindram Gordhandas Seksaria v. State of Gondal, AIR 1950 PC 99.
[83] Arun Prakash Barhal v. Tulsi Charan Basu, AIR 1949 Cal 510.
[84] Roberts, *supra* note 12 at 24.
[85] The Indian Contract Act, 1872, §23-24, Act No. 9, Acts of Parliament, 1872.

has complete knowledge of the covenants, claims, pending litigation and encumbrances attached to the asset.

The paper presented moral, economic, and legal facets of enforcing 'as is' clauses in auctioning non-performing assets. It is suggested that the buyer should only be expected to adhere to discharging the encumbrances and dues which have been disclosed in an authorised manner. Further, the onus should not fall on the buyer to ascertain the title of the property because it might lead to confusion and mistakes in guaranteeing the title being transferred. Hence, the Secured Creditor should be expected to maintain a higher threshold of due diligence and guarantee the title being transferred to avoid flouting laws and decreasing litigation. It was argued that incorporation of exclusionary clauses does not discharge the creditor from the misrepresentation or wilful negligence carried out in ascertaining the title. Hence, these clauses do not act as a mechanism which impedes litigation. The creditor has to comply with Section 55 of the TOPA and disclose all intrinsic and extrinsic factors to avoid fraudulent transfers, which would subsequently be invalidated, resulting in decreased satisfaction of both the parties. Lastly, the courts should indulge in public policy debates surrounding the usage of such exclusionary clauses to promote a liberal judicial discourse that advocates against the fraudulent or disadvantageous sale of properties. Moreover, such sales cannot be given effect to, considering non-disclosure would act as a manifest defect in consent, vitiating the basis of the auction in itself. Hence, financial institutions/secured creditors should be held to the threshold of performing due diligence while ascertaining the title of securities before announcing a call for auction.

SCHOLASTICUS

Atharv Arya, *Changing Trends in Prudential Norms: Analyzing the NPA Crisis*, 9(2) SCHOLASTICUS 101 (2022)

CHANGING TRENDS IN PRUDENTIAL NORMS: ANALYZING THE NPA CRISIS

Atharv Arya[⊥]

ABSTRACT

The Prudential Norms are witnessed to have demonstrated an erratic nature; the Asset Classification norms have been seen to changing frequently. The lockdowns in the present pandemic have become a big menace as it has led to a standstill in various sectors which has raised financial stress at alarming rates in the Banking system. These exacerbated problems in the banking sector as projected by the quarterly results. There has been a tremendous rise in the non-performing assets which is problematic not only for the present but also for the foreseeable future. The first part of the paper deals with the change of landscape in the prudential norms with respect to the asset classification of NPA. This change in NPA norms has been introduced as a causal effect of the pandemic in the banking sector. The second part of the paper deals with the impact of the change in NPA norms. This paper brings forth to the readers the impact that these norms can cause in the foreseeable future by analyzing the status quo of the market and with the quarterly reports published by the banks. The caveat this paper does not provide with any long-run solution but aids in the lucid understanding of the changes being made in the prudential norms due to spike in the bad debt in the market.

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INTRODUCTION

Over the recent years, the attention of everyone has been drawn towards the Prudential Norms on the Income Recognition and the Asset Classification. The hardship and crisis faced by the **'YES Bank'** in the year 2019[1] and the 'Nation-Wide Lockdown' in 2020[2]had brought forth the importance of norms and regulations pertaining to NPA. In the year 2019, the core issue that lay before the Reserve bank of India was pertaining to the computation of NPA. This paper will lucidly try to bring forth the recent Reserve bank of India notifications, regulations that have changed the landscape of NPA norms. These norms have tried to ease the burden of the individuals, MSME sector, etc. by giving deferment period/moratorium period and by way of introducing loan restructuring policy. Besides highlighting the recent circular pertaining to NPAs norms this paper tries to cover the aspect of mismanagement(under-reporting) of NPAs by manual computation and as to how the Covid relief packages have hampered the Reserve bank of India stability rate. The paper covers various judicial pronouncements that have helped in interpreting the circulars that were released by the Reserve bank of India. The focal point of the paper is to put forth to its reader two questions. Firstly, Whether the asset classification is done by manual computation is just? Secondly, seeing the *status quo* of the NPA ratio will the financial institutions be able to recover the debts or will they face a hardship?

INCEPTION OF THE NPA SYSTEM

[1]Anand Adhikari, *'YES Bank Was on The Verge of Going Belly Up; Here's What Q3 Results Reveal*', BUSINESS TODAY (2020) (available at: https://www.businesstoday.in/industry/banks/story/yes-bank-q3-result-verge-going-belly-up-what-results-reveal-252123-2020-03-15) (last visited October 7, 2021).

[2]'Government of India Issues Orders Prescribing Lockdown for Containment of COVID19 Epidemic in The Country' (Press Information Bureau 2020) (available at: https://www.mha.gov.in/sites/default/files/PR_NationalLockdown_26032020_0.pdf (last visited October 7, 2021).

NPAs, a system of classification of assets was introduced by the Reserve bank of India in 1985 when prudential norms were introduced.[3]Reserve bank of India had advised the Banks to classify their loans and advances into 4 categories as follows:

- Standard Assets
- Substandard Assets
- Doubtful Assets
- Loss Assets

Standard Assets are considered as Performing Assets, whereas other types of assets stated above are considered as NPAs.[4]

The Standard Asset Category has been classified into three further sub-groups which are enlisted as follows[5]:

SMA-0	1-30 days
SMA-1	31-60 days
SMA-2	61-90 days

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[3] Dr. K.C. Chakroborty, Deputy Governor, Reserve Bank of India, Two decades of Credit Management in Indian Banks: looking back and moving ahead (November 18, 2013) (available at: https://rbidocs.rbi.org.in/rdocs/Speeches/PDFs/NPA181113BS.pdf).

[4]*Prudential Norms on Income Recognition, Asset Classification and Provisioning - Pertaining to Advances*, Reserve Bank of India - Master Circulars (2001), https://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx%3FId%3D449 (last visited June 1, 2021).

[5] Reserve Bank of India, Prudential Framework for Resolution of Stressed Assets, RBI/2018-19/203, (Notified on June 7, 2019), https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11580 (last visited June 1, 2021).

To curtail the foreseeable chaos, the Reserve Bank of India released certain laudable notifications in order to ease the repayment of loans that were undertaken. These relief packages granted a moratorium period that is deferment of interest during the period of 1 March 2020 to 31 May 2020 which was later again extended for 3 months hence giving relief in total of six months.

But these notifications had certain ambiguities which are dealt with as we move further. The Regulatory package failed to address the issue of asset classification of the accounts that were already in default prior to March 1, 2020.

The First regulatory Package that was brought forth by the Reserve Bank of India was on March 27, 2020.[6] This notification had certain ambiguities due to which a lot of litigation was faced pertaining to the asset classification. In the case of *Anant Raj Limited v. Yes Bank Limited* the high court held that "moratorium on asset downgrade should also apply to accounts whose overdue was prior to March 1, 2020, and also stated that a *status quo* is to be maintained for the borrower's account."[7]As per the Prudential norms on Income Recognition, Asset Classification and Provisioning("IRAC") pertaining to Advances ageing of payment for 90 days from the due date would lead to an automatic downgrade of such assets to NPA category. [8]The High Court in the case of *Transcon Skycity Pvt. Ltd. & Ors. v. ICICI Bank Limited* gave certain clarity as to asset classification and held that the period of moratorium would be excluded from the calculation of 90 days for NPAs classification.[9]

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[6]Reserve Bank of India, COVID19 Regulatory Package - Asset Classification and Provisioning, RBI/2019-20/220, (Notified on April 17, 2020), https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11872&Mode=0 (last visited June 24, 2021).

[7]Anant Raj Limited v. YES Bank Limited, 2020 SCC OnLine Del 587.

[8]Reserve Bank of India, Prudential Norms on Income Recognition, Asset Classification and Provisioning - Pertaining to Advances, RBI/2015-16/101, (Notified on July 1, 2015), https://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx%3FId%3D449 (last visited June 24, 2021).

[9]Devika Sharma, *Duration of lockdown not to be reckoned for purpose of computing 90-day NPA declaration period*, SCC Blog (May 1 2020), available at:

I. APRIL CIRCULAR

The litigation that was triggered by the March circular got settled when the Reserve Bank of India issued another circular on April 17, 2020 ("Asset Classification Circular").[10] This Circular incorporated that all accounts classified as standard as of February 29, 2020, even if overdue, the moratorium period, wherever granted, shall be excluded by the Lending Institutions from the number of days past-due for asset classification under the Norms.[11]

Hence this circular brought forth clarity that assets that are standard irrespective of the fact that there was default and come under the category of SMA-2 as on February 29, 2020, there would be no further downgrade of asset and that there will be a standstill and that the asset will not fall into the category of NPAs until the end of the Specified Period as notified by the Reserve Bank of India.

II. MAY CIRCULAR

The key highlights of this circular were that the Moratorium Period had been extended by another three months i.e. from June 1, 2020, to August 31, 2020.[12]As far as the NPAs is concerned the assets will not downgrade as per the Prudential

https://www.scconline.com/blog/post/2020/05/01/bom-hc-duration-of-lockdown-not-to-be-reckoned-for-purpose-of-computing-90-day-npa-declaration-period/ (last visited June 24, 2021).

[10]Reserve Bank of India, COVID19 Regulatory Package - Asset Classification and Provisioning, RBI/2019-20/220, (Notified on April 17,2020), https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11872&Mode=0 (last visited June 24, 2021).

[11]*Id.*

[12]Reserve Bank of India, COVID-19 – Regulatory Package, RBI/2019-20/244, (Notified on May 23, 2021), https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11902&Mode=0 (last visited June 24, 2021).

Framework for Resolution of Stressed Assets.[13] The Asset classification will be followed as laid down in the March and April circular*(mutatis mutandis*).[14]

III. AFTERMATH

After the expiry of the Regulatory Package, the Reserve Bank of India issued notification for restructuring of loan known as Resolution Framework 1.0.[15] in 2020, and recently in May 2021 another circular was pushed in for Loan restructuring 2.0 (**Resolution Framework 2.0 for COVID Related Stressed Assets of Individuals, Small Businesses and MSMEs.**)[16]

The Common drawback of these circulars was that the interest on interest was being levied loans were being constantly charged and was getting eventually getting accumulated irrespective of the fact of the moratorium period. These circulars did not exempt the interest (Compound Interest) to which the issue was brought before the Apex Court. The Apex Court in the year 2021 had waived off the Compound interest that was levied by the Financial Institutions.

On March 23, 2021, the Apex Court in the case of *Small Scale Industrial Manufacturers Association v. UOI & Ors.*[17] "All lending institutions shall immediately put in place a Board-approved policy to refund/adjust the 'interest on interest' charged to the borrowers during the moratorium period, i.e. March 1, 2020, to August 31, 2020 (moratorium period)".[18] "Irrespective of whether

[13]*Id.*
[14] *Id.*
[15]Reserve Bank of India, Resolution Framework for COVID-19-related Stress, RBI/2020-21/16, (Notified on August 6, 2020), https://rbi.org.in/Scripts/NotificationUser.aspx?Id=11941&Mode=0 (last visited June 24, 2021).
[16]Reserve Bank of India, Resolution Framework – 2.0: Resolution of Covid-19 related stress of Individuals and Small Businesses, RBI/2021-22/46, (Notified on June 4, 2021) https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12085&Mode=0 (last visited June 24, 2021).
[17]Small Scale Industrial Manufactures Assn. v. Union of India, (2021) 8 SCC 511.
[18]*Id*.

moratorium had been fully or partially availed, or not availed, in terms of the **March Circular** and Circular that was sent out in **May** (Covid-19 Regulatory Package) and also ordered that the Lending institutions shall disclose the aggregate amount to be refunded /adjusted in respect of their borrowers based on the above reliefs in their financial statements for the year ending March 31, 2021."[19]

ISSUES WITH RESPECT TO NPAS

The NPAs can broadly be classified into (i) Gross NPAs ("**GNPA**") (ii) Net NPAs. Gross NPA is the sum total of all loan assets that are classified as NPAs as per Reserve bank of India guidelines as on the balance sheet date.[20] It reflects the quality of loans made by banks. The high level of NPAs is a cause of worry to any financial institution. Financial Institutions tend to show a better balance sheet so that there is an influx of funds.

I. IMPACTS OF NPAS

It is quintessential to have a correct figure of NPA as misleading would have repercussions as listed below:[21]

- Jeopardizing the interest of shareholders
- Compromise the interest of depositors.
- Jeopardize the growth of banks
- Deteriorate the creditworthiness of Financial Institution

[19] *Supra* note 10.
[20] S. Vardharajan, *Mounting NPAs Of Public Sector Banks*, THE HINDU BUSINESS LINE, Jan 23, 2018, available at: https://www.thehindubusinessline.com/money-and-banking/mounting-npas-of-public-sector-banks/article7218781.ece, last visited October 20, 2021.
[21] K. Hafsal, AnandaraoSuvvari and S. Raja Sethu Durai, *Efficiency Of Indian Banks With Non-Performing Assets: Evidence From Two-Stage Network DEA*, 6(1), Future Business Journal (2020).

- Hamper Economic Growth

The brunt of the repercussions on mismanagement of NPAs can be seen by the case of Yes Bank. The bank had drastically failed in monitoring its NPAs due to which there was a lot of hue and cry in the market. The Reserve bank of India had put in a lot of effort to aid and help the bank recover from its Liabilities. Not only the Reserve bank of India but the other banks also stepped in to generate liquidity. 'Yes Bank' had issued a public offer in order to generate liquidity, State Bank of India along with other banks had infused ₹10,000 crore as equity capital. State bank of India in order to infuse capital had acquired 49% stake(shareholdings) in the Yes Bank.[22]

This crisis that Yes Bank faced was due to the under-reporting of NPAs by and that was subsequently assessed by the Reserve bank of India which YES bank had declared as per the mandate issued by Reserve bank of India for disclosures.

II. MANUAL COMPUTATION FOR NPA CLASSIFICATION: AN EXPLOITATIVE ROUTE

Manual computation refers to the process of manually classifying NPA's into its stipulated categories. The banks as per circular : Master Circular – Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances[23] vividly covers the aspects and the calculation method to compute NPA classification. The banks under this method were fabricating figures and were blindsiding the actual figures. This can be seen if we refer to Table 1 in the Annexures which shows material deviance of actual figures from the figures as

[22] Press Trust of India, *SBI Approves Rs 7,250 Cr Fund Infusion Into Yes Bank, To Pick Up 49% Stake,* BUSINESS STANDARD, March 12, 2020, available at: https://www.business-standard.com/article/pti-stories/sbi-to-invest-rs-7-250-cr-for-yes-bank-rescue-120031201304_1.html, (last visited October 22, 2021).

[23]Reserve Bank of India, Master Circular - Prudential Norms On Income Recognition, Asset Classification and Provisioning Pertaining To Advances, RBI/2013-14/62, (Notified on July 1, 2013), https://rbidocs.rbi.org.in/rdocs/notification/PDFs/62MCIRAC290613.pdf (last visited June 24, 2021).

opposed to those submitted by Yes bank. This is all because the Banking institutions have been negligently disregarding the compliances and that some major blunders done by them jeopardize not only the banking sector but the economy at large. The circular on **Divergence in the asset classification and provisioning** mandates disclosure of material divergence (if any) by the banks.[24] Hence this Table 1 highlights the material divergence that is there due to banks erroneous figures.

Moreover, In December 2020 yet again Yes bank's reported bad loans were at 15.36% of advances and the Apex Court had added ₹8,322 crore NPAs[25] (NPAs) from a mix of retail, corporate and small businesses. This speaks volumes that how inefficient the financial institution has become concerning the calculation of its NPA and that there is an under-reporting. Since there is an increase in the GNPAs it is really important for RBI to monitor the NPA stats as the banks are more prone to do under-reporting in order to show good books and have an inflow of investments.

Notably, the Reserve bank of India as a mandate imposed that by 30thJune2021 all banks have been advised to upgrade their systems and make an automated asset classification (investments as NPA/NPI)and that also to conform to the

[24]Reserve Bank of India, Disclosure in the "Notes to Accounts" to the Financial Statements - Divergence in the asset classification and provisioning, RBI/2018-19/157, (Notified on April 1, 2019), https://rbi.org.in/Scripts/BS_CircularIndexDisplay.aspx?Id=11521 (last visited June 24, 2021).

[25]Press Trust of India, *YES Bank asset quality stress at peak; has many positives: CEO*, BUSINESS TODAY, January 24, 2021, available at: https://www.businesstoday.in/current/corporate/yes-bank-asset-quality-stress-at-peak-has-many-positives-ceo/story/428945.html, (last visited Jun 24, 2021).

guidelines within the stipulated time.[26] The notification dated September 14, 2020 lucidly envisages the guidelines for automatic asset classification.[27]

The reason for this is to curb the menace of manual calculations which often questions transparency. Hence an automated process will ensure better transparency.

RESERVE BANK OF INDIA'S STABILITY DATA

Reserve Bank of India in its Quarterly Financial Stability Report as of January2021 has disclosed that:

"GNPA ratio of all SCBs may increase from 7.5 per cent in September 2020 to 13.5 per cent by September 2021 under the baseline scenario; the ratio may escalate to 14.8 per cent under a severe stress scenario."[28]

It is very much evident from Table 2 statistics that the GNPA's are having an impact on the stability as there is a stress on asset ratio. This is pretty much indicative of the fact that since 2020 they have had a deterred ratio. This ratio could would have worsened with a greater percentage had the moratorium period had continued. But it is pertinent to note that loan restructuring (Resolution Framework 1.0,2.0) for now will not create a big liability but in the long run would simply create more instability in the banking sector.

All banks are having a toll on their NPA ratio which is evident from Table 3 which shows the quarterly reports of the banks. *That is to say that the NPA is on a rise which is very much evident from the Table 3 and this rise can be fatal if the loan restructuring*

[26]Reserve Bank of India, Automation of Income Recognition, Asset Classification and Provisioning processes in banks, RBI/2020-21/37, (Notified on September 14, 2020) https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11964&Mode=0 (last visited June 24, 2021).

[27]*Id.*

[28] Reserve Bank of India, RBI releases the Financial Stability Report, (Notified on July 01, 2021), available at: https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=50949s (last visited June 25, 2021).

framework continue in the manner they are functioning as of now. Adding to that "The State-run banks are seen being the worst-affected among other banks with their GNPA ratio expected to increase to 16.2 percent by September 2021 under the baseline scenario from 9.7 percent in September 2020. And to a high of 17.6 percent in a severe stress scenario."[29]

CONCLUSION

Prudential norms have been a remained a dormant topic until recently. The Yes Bank instance and the Covid-19 has brought into limelight prudential norms pertaining to asset classification. The change in landscape in prudential norms can be witnessed in the afore discussed chapters. The paper dwelled and discussed various reliefs that were offered by the Reserve Bank of India during the lockdown crisis. But the most quintessential part that is brought forth by this paper. the issue and complexities that might be unforeseeable for now but can be a hazard in the foreseeable future. By analyzing the Yes bank case the importance of automatic downgrade of assets has been brought into the spotlight. This aspect was of quintessential importance to be discussed as during these times the banks were more prone to under-reporting and that would have been more problematic. The role of the judiciary has been also seen as to be helpful for analyzing the circulars and aiding in the best interest of the public. The various circulars as introduced by RBI have tried to aid and behoove the individuals, various sectors that were taking a hit by the Covid crisis. But it is also pertinent to note that and have an idea beforehand of what the market might foresee within the next few years. With the worsening of the economy, it is essential to monitor the repercussions that these Covid Relief packages might

[29] Abhijit Lele & Raghu Mohan, *Banks' gross NPAs may rise to 13.5% by Sept: Financial Stability Report,* BUSINESS STANDARD, January 12, 2021, available at: https://www.business-standard.com/article/finance/banks-gross-npas-may-rise-to-13-5-by-sept-financial-stability-report-121011200076_1.html (last visited Jun 25, 2021).

have. This paper has tried to draw a picture that what the recent trends have been with respect to prudential norms of asset classification and how it is of epitome importance to keep a track of them.

ANNEXURES

Yes Bank's History of Dodgy Accounts

Rsmn	FY2016	FY2017	FY2019
Gross NPAs Reported	7,490	20,186	78,826
Gross NPAs as assessed by RBI	49,257	83,738	1,11,596
Divergence in Gross NPA	**41,767**	**63,552**	**32,770**
Net NPAs Reported	2,845	10,723	44,848
Net NPAs as assessed by RBI	36,032	58,916	67,838
Divergence in Net NPAs	**33,187**	**48,193**	**22,990**
Provisions for NPAs	4,645	9,463	33,977
Provisions for NPAs as assessed by RBI	13,225	24,821	43,757
Divergence in Provisions	**8,580**	**15,358**	**9,780**
Reported Net Profits	25,395	33,301	17,203
Net Profits as assessed by RBI	19,784	23,161	10,840
Divergence in Net Profits	**-5,611**	**-10,140**	**-6,363**
Divergence (%)			
Gross NPA	**557.6**	**314.8**	**41.6**
Net NPA	**1,166.6**	**449.4**	**51.3**
Provisions	184.7	162.3	28.8
Net Profits	**-22.1**	**-30.4**	**-37.0**

Source: Yes Bank

TABLE 1: *Divergence Disclosure of Yes Bank* <https://hemindrahazari.com/2019/11/20/legacy-of-the-past-yes-banks-divergence-should-alarm-the-market/>

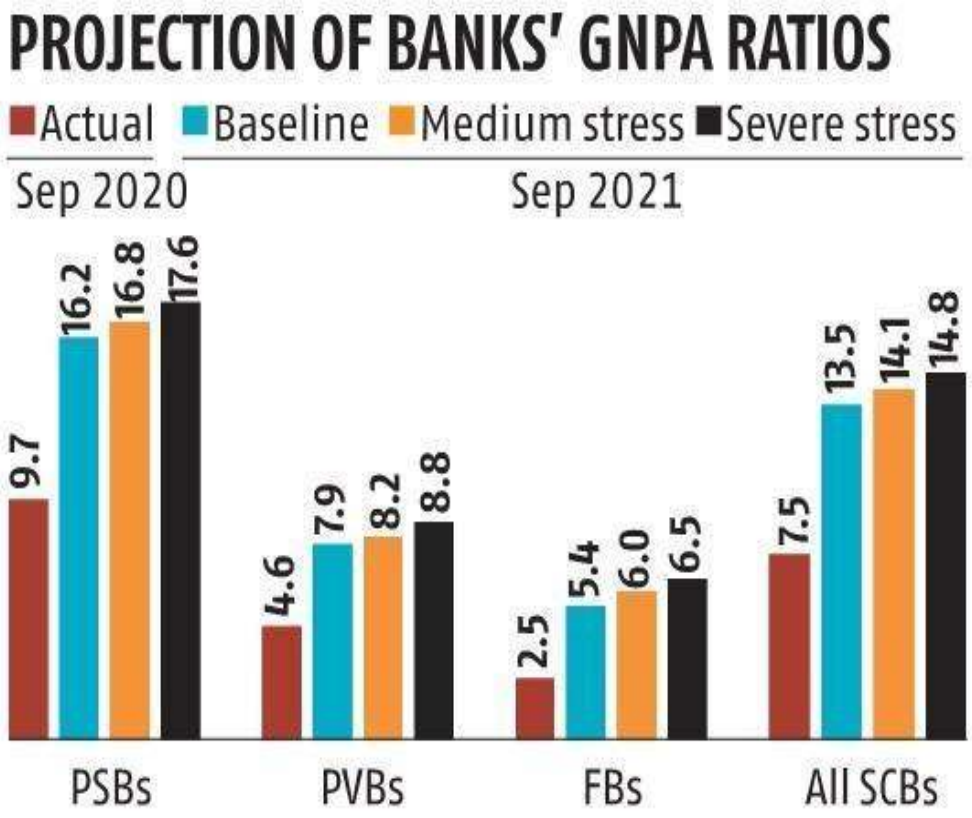


TABLE 2: *RBI Stability Report* <https://www.Reserve Bank of India.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=1168>

Trends for Q3 show pro forma NPAs are higher *(in %)*

Bank	Gross NPA	Pro forma Gross NPA
State Bank of India	4.77	5.44
HDFC Bank	0.81	1.38
ICICI Bank	4.72	5.42
Axis Bank	3.44	4.55
YES Bank	15.36	20.00
Kotak Mahindra Bank	2.26	3.27
RBL Bank	1.84	4.57
IndusInd Bank	1.74	2.93
Federal Bank	2.71	3.38
Bank of Baroda	8.48	9.63
Bajaj Finance	0.55	2.86
HDFC	1.67	1.91
Union Bank	13.49	15.28
DCB Bank	1.96	3.70
IDBI Bank	23.52	24.33
Ujjivan SFB	1.00	4.80
Canara Bank	7.46	8.95
Bandhan Bank	1.10	7.12

Source: Q3 results

TABLE 3: *Quarterly reports of banks* < https://www.thehindubusinessline.com/data-stories/data-focus/higher-pro-forma-gross-npas-indicate-rising-stress/article33752884.ece>

SCHOLASTICUS

Pooja Dhamor & Vaishnavi Bansal, *Regulating Commercial Wisdom of the Committee of Creditors: Viability of the Proposed Code of Conduct,* 9(2) SCHOLASTICUS 115 (2022)

REGULATING COMMERCIAL WISDOM OF THE COMMITTEE OF CREDITORS: VIABILITY OF THE PROPOSED CODE OF CONDUCT

Pooja Dhamor[⊥] *& Vaishnavi Bansal*[ø]

ABSTRACT

While the supremacy enjoyed by the Committee of Creditors ("CoC") in the light of its commercial wisdom has been critical to the success of the Code, in the recent past, it has been the same commercial wisdom and protection from judicial scrutiny has been facing criticism, primarily in the light of huge haircuts. This has raised questions on the efficacy of the system brought in by the IBC and alleged ineffective resolution. These concerns were voiced in the Parliamentary Standing Committee Reports and were worked on by the government. As a result of the efforts to resolve these concerns, IBBI released a code of conduct to regulate the CoC. However, it wasn't clarified whether the code of conduct will be made 'mandatory or will act as a prescriptive code without consequences for non-compliance. In this paper, the editors study the implications of such code of conduct, navigate a middle ground and, explore other alternative approaches to resolve these raging issues.

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INTRODUCTION

Two of the several unique features of the regime under the Insolvency and Bankruptcy Code, 2016 ("IBC" / "Code") are (a) its provisions for collective mechanism to resolve insolvency; and (b) its ability to separate commercial and judicial aspects of the insolvency process.[1]

These features can be said to be realized by the key element of the CoC in the corporate insolvency resolution process. This can be said in the sense that while CoC clearly provides a collective mechanism for insolvency resolution, it is also endowed with an escape from unnecessary judicial meddling in its course of action. This shield from judicial scrutiny is provided under the ambit of commercial wisdom of the CoC – which shall not be intervened with by any judicial interference.

The supremacy enjoyed by the CoC in the light of its commercial wisdom, while being in line with the objectives of the Code, has been facing criticism in the recent past. A majority of the critique was directed towards the huge haircuts in the insolvency resolution which indicated an inefficiency in the unfettered functioning of the CoC.

When the issue of huge haircuts was brought before the government, the Secretary to Ministry of Corporate affairs, in the reply on behalf of the government, had put the entire blame on the decision-making ability of the CoC which plays a predominant role in the entire process.[2] In light of the same, the Standing Committee observed a sincere need for putting a professional code of

[1] Economic Survey 2016-17 (as cited in the Parliamentary Committee).

[2] 32ND STANDING COMMITTEE, part-I, para 23, available at: https://www.ibbi.gov.in/uploads/whatsnew/fc8fd95f0816acc5b6ab9e64c0a892ac.pdf. (last visited Nov 7, 2021).

conduct in place.[3] Following up on the same, the Insolvency and Bankruptcy Board of India ("IBBI") introduced a discussion paper on 27 August, 2021.[4]

In this paper, the editors attempt to lay down the structure of the CoC under the existing regime [Part-I]. Next, we elaborate on the supremacy enjoyed by the CoC in the garb of its commercial wisdom [Part-II]. Furthermore, we highlight the concerns arising out of unfettered discretion endowed to the CoC [Part-III]. We further discuss the IBBI proposal to impose a professional code of conduct on the functioning of the CoC [Part-IV]. Finally, we discuss the implications of the same before concluding [Part-V].

COC UNDER THE EXTANT REGIME OF THE IBC

This part deals with the existing framework on CoC under the Insolvency and Bankruptcy Code, 2016 ("IBC" / "Code"), its composition, as well as its significance in the Corporate Insolvency Resolution Process (CIRP). Finally, it ends with highlighting the judicial precedents

I. MEANING OF THE COMMITTEE OF CREDITORS UNDER THE INSOLVENCY AND BANKRUPTCY CODE, 2016

CoC, in accordance with Section 21(1) of the IBC, is a committee which is required to be constituted by the Interim Resolution Professional ("IRP").[5] Essence of this provision is rooted towards making the creditors adopt a collective approach in terms of the insolvency process, as against going on individually.[6]

[3] 32ND STANDING COMMITTEE, part-II, para 3, page 22, *Id.*
[4] INSOLVENCY AND BANKRUPTCY BOARD OF INDIA, DISCUSSION PAPER (Aug 27, 2021) available at: https://ibbi.gov.in/Discussionpaper-CIRP-27Aug2021.pdf (last visited Nov 10, 2021).
[5] Insolvency and Bankruptcy Code, 2016, § 21(1), No. 31, Acts of Parliament, 2016 (India).
[6] Municipal Corporation of Greater Mumbai (MCGM) vs. Abhilash Lal and Others (2019) SCC Online SC 1479.

It is one of the most important elements of the Corporate Insolvency Resolution Process ("CIRP") under the Code as the CoC is given the ultimate power to use its commercial wisdom in making business decisions regarding restructuring and turnaround of the Corporate Debtor. In furtherance of this, the CoC has a responsibility to evaluate a corporate debtor and how its distress is to be resolved.

While a Resolution Professional ("RP") merely supervises the process of obtaining and approving a resolution plan, the final and decisive power to accept or reject the same lies only with the CoC. This CoC can then either replace the IRP with a new person appointed as the RP or it can decide to allow the person who held the position of IRP to continue as the RP.

II. COMPOSITION OF THE COC

The composition of the CoC is also carried out in accordance of the provision given under Section 21 of the IBC. It states that Section 21 shall comprise of all the financial creditors – both secured as well as unsecured.[7] In the event where a financial debt is owed as a part of a consortium to more than two financial creditors, there the CoC will include each financial creditor wherein the voting share will be divided based on the proportion of the debt owed.[8] In the event, a financial creditor or its representative is a related party of the corporate debtor; it shall not have any rights to participate or vote in the CoC despite the financial debt owed to it by the corporate debtor.[9]

In two cases, which are, (a) in absence of any financial debt; or (b) when all financial creditors are related parties to the corporate debtor; the CoC will

[7] Insolvency and Bankruptcy Code, 2016, § 21, No. 31, Acts of Parliament, 2016 (India).
[8] Section 21(6), *Id.*
[9] *Id.*

comprise of: (i) the 18 largest operational creditors by value, (ii) one workmen's representative; and (iii) one representative of the employees.[10]

If at all, a corporate debtor has only its creditors in class with no eligible financial creditors, the CoC will comprise of only Authorized Representative.[11]

III. REQUIREMENT TO OBTAIN PRIOR APPROVAL FROM THE COC

As per the Code, each member of a CoC will get a voting share. In accordance with Section 5(28) of the IBC, a financial creditor's voting share is based on the percentage of the financial debt the corporate debtor owes to that particular financial creditor.[12] Similarly, each creditor is required to vote in line with the voting share allotted to it under Section 24(6) and Section 24(7) of the IBC – as determined by the RP in accordance with the CIRP Regulations.[13]

A wide array of items is listed under Section 28 which shall be approved by the CoC by a minimum vote of 66% of the voting share.[14] In absence of such approval, the actions of RP will be void and will allow the CoC to report the RP to the IBBI for non-compliance.[15] These include raising excess interim finance, creation of security interest over corporate debtor's assets, etc.[16]

Apart from the matters given under Section 28, a few other matters also require prior approval from CoC. These include: extending a CIRP from 180 to 270 days under Section 12 of the IBC;[17] disposing of unencumbered CD assets outside the

[10] *Id.*
[11] Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 16B (2016).
[12] Insolvency and Bankruptcy Code, 2016, § 5(28), No. 31, Acts of Parliament, 2016 (India).
[13] Insolvency and Bankruptcy Code, 2016, § 24, No. 31, Acts of Parliament, 2016 (India).
[14] Insolvency and Bankruptcy Code, 2016, § 28, No. 31, Acts of Parliament, 2016 (India).
[15] *Id.*
[16] *Id.*
[17] Insolvency and Bankruptcy Code, 2016, § 12, No. 31, Acts of Parliament, 2016 (India).

ordinary course under Regulation 29 of the CIRP Regulations;[18] changing from IRP to RP under Section 22 of the IBC[19], or replacing RP under Section 27 of the IBC;[20] and Section 30 of the IBC requires approval of the resolution plan.[21]

Furthermore, any application admitted under Sections 7, 9, or 10 of the IBC can only be withdrawn after an approval by the way of 90% voting shares of the CoC is obtained.[22] Lastly, any other item that needs the CoC's approval under the IBC or the associated Rules can be adopted with a 51% voting share.[23] An example for the same would be the CoC's approval of eligibility conditions for resolution applicants under Section 25(2)(h) of the IBC.[24]

SUPREMACY OF THE COC IN THE CIRP

Rule 11 of the NCLT Rules 2016 provide for the inherent powers of the Adjudicating Authority.[25] The rationale behind the same was to ensure justice and safeguard against abuse of the process of tribunal. However, time and again the same has been challenged in parallel to the supremacy of the commercial wisdom of the CoC.

In the case of *K. Shashidhar v. Indian Overseas Bank and Ors.*[26] and *Committee of Creditors of Essar Steel v. Satish Kumar Gupta*,[27] Supreme Court reiterated the grounds given in Section 30(2) and Section 61(3) and clearly stated that the judicial review of the decisions of the CoC shall be limited to these grounds only,

[18] Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 29 (2016).
[19] Insolvency and Bankruptcy Code, 2016, § 22, No. 31, Acts of Parliament, 2016 (India).
[20] Insolvency and Bankruptcy Code, 2016, § 27, No. 31, Acts of Parliament, 2016 (India).
[21] Insolvency and Bankruptcy Code, 2016, § 21, No. 31, Acts of Parliament, 2016 (India).
[22] Insolvency and Bankruptcy Code, 2016, § 12A, No. 31, Acts of Parliament, 2016 (India).
[23] Insolvency and Bankruptcy Code, 2016, § 21(8), No. 31, Acts of Parliament, 2016 (India).
[24] Insolvency and Bankruptcy Code, 2016, § 25(2)(h), No. 31, Acts of Parliament, 2016 (India).
[25] National Company Law Tribunal Rules, Rule 11 (2016).
[26] K. Shashidhar v. Indian Overseas Bank and Ors. (2019) 12 SCC 150.
[27] Committee of Creditors of Essar Steel v. Satish Kumar Gupta, (2019) SCC OnLine SC 1478.

emphasizing on the primacy of the commercial wisdom of the CoC.[28] The court noted that the legislature has consciously not provided any ground to challenge the commercial wisdom of the individual financial creditors or the collective decision of the CoC before the Adjudicating Authorities and thus neither of the Adjudicating Authorities have the jurisdiction to reverse the commercial wisdom of the dissenting financial creditors.[29] It cannot delve into the analysis or evaluation of the commercial decisions of the CoC nor can enquire into the fairness of the decision.[30] Similarly, in *Swiss Ribbons Private Limited and Anr v. Union of India* also, the Apex Court recognised that the IBC is an economic legislation and the approach of judiciary in such legislations should be hands off approach.[31] All in all, the position is that while the Code has adopted a few Rules, Rule 11 has been deliberately left out to ensure that the CoC supremacy prevails.

In *Maharashtra Seamless Limited v. Padmanabhan Venkatesh and Others,* an appeal was filed against a decision by the NCLAT ordering the successful resolution applicant to change its resolution plan because the resolution plan's worth was less than the corporate debtor's liquidation value.[32] The Supreme Court pointed out that the Code does not require the resolution applicant to equal the liquidation value, and that the valuation procedure is intended to aid the CoC in making a resolution plan determination.[33] The Supreme Court, citing Essar, decided that rather than assessing the resolution plan on the basis of quantitative analysis, the court should defer to the creditors' commercial wisdom.[34]

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[28] Insolvency and Bankruptcy Code, 2016, § 30(2) & § 61(3) No. 31, Acts of Parliament, 2016 (India).
[29] *Supra* note 26.
[30] *Id.*
[31] Swiss Ribbons Private Limited and Anr v. Union of India (2019) 4 SCC 17.
[32] Maharashtra Seamless Limited Vs. Padmanabhan Venkatesh and Others, 2020 SCC Online SC 67.
[33] *Id.*
[34] *Id.*

In *Ebix Singapore Private Limited vs Committee of Creditors of Educomp Solutions Limited*, the Adjudicating Authority's ruling allowing the resolution applicant to withdraw its resolution plan, which had been accepted by the CoC, was challenged in court.[35] The resolution applicant in this case had requested withdrawal on the grounds that its resolution plan had been rendered commercially unviable due to the lapse of significant time and severe and inordinate delays in the CIRP, and that the corporate debtor's financial position and profile may have significantly changed and/or deteriorated.[36] The NCLAT rejected these arguments, holding that when the CoC approves the resolution plan, the Adjudicating Authority lacks authority to accept or authorise the resolution applicant's withdrawal application.[37] Despite the fact that the resolution plan would only be binding on all parties if approved by the Adjudicating Authority, and that the resolution applicant had filed a withdrawal application prior to such approval, it was determined that the Adjudicating Authority could not intervene with the CoC's majority decision.[38] The Supreme Court reiterated that a plan once approved by the CoC cannot be withdrawn by the Resolution Applicants.

The recent decision by the Supreme Court of India in the matter of *Kalpraj Dharamshi v. Kotak Investment Advisors Ltd.* constitutes to be the latest position of the Courts on the same. In this case, the Supreme Court stated that the legislature purposefully did not provide NCLT or NCLAT any jurisdiction or power to examine the business decision made by CoC in accepting or rejecting the settlement plan.[39] It stated that the only acceptable venue for evaluating such alternatives and making a decision in the bankruptcy process is a CoC, in which

[35] Ebix Singapore (P) Ltd. v. Committee of Creditors of Educomp Solutions Limited, (2021) SCC OnLine SC 707.
[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] Kalpraj Dharamshi v. Kotak Investment Advisors Ltd., (2021) SCC OnLine SC 204.

all financial creditors receive votes according to the amount of debt they carry. The NCLT's discretion, which is limited by Section 31, is confined to examining the resolution plan "as approved" by the required percent of financial creditors voting share. Even in that investigation, the reasons on which NCLT might reject the Resolution Plan are those set forth in Section 30(2) where the resolution plan fails to meet the stated standards.

CONCERNS ARISING OUT OF UNFETTERED DISCRETION TO THE COC

I. HAIR-CUT ISSUES

Evidently, the CoC is endowed with the critical decision making and has a huge responsibility on its shoulders. However, there are several recent experiences to establish that this responsibility is not balanced by sufficient accountability in return.

In the recent past, there have been several cases where the lenders have agreed to the massive haircuts. Haircuts are defined as the difference between the total amount that could be claimed and the final amount received. Some amount of haircuts is usually needed in the insolvency resolution. Therefore, while the haircuts in themselves are not so problematic, the issue is with the frequency of these haircuts and the significantly reduced amount of recoveries post these haircuts. The haircut, or the loss to banks on their claims in concluded cases, increased to 60% in fiscal 2021, up from a 55% average in prior years.[40] In only the first quarter of 2021, haircuts amounted to a stunning 74% of the claims lodged by lenders against defaulters.[41]

[40] ETBFSI, *Haircut under IBC rises to 60% in fiscal 2021, half the closes cases liquidated*, THE ECONOMIC TIMES (Nov 7, 2021) https://bfsi.economictimes.indiatimes.com/news/banking/haircut-under-ibc-rises-to-60-in-fiscal-2021-half-the-closes-cases-liquidated/83140859
[41] *Id.*

One such instance is wherein the *Videocon Industries Limited* case, the CoC agreed for the haircut as high as 95.85% - many equating it to a shave.[42] The same was condemned by the Court as well but it found its hand tied in the light of the commercial wisdom.[43] Similarly, in the Tamil Nadu based *Siva Industries and Holdings*, the CoC agreed for a 93.5% of the haircut which the NCLT Chennai later rejected.[44] Such practices speak volume against giving the unfettered power to the CoC in the name of commercial wisdom.

II. INEFFICIENCY IN TERMS OF UNNECESSARY DELAY

The court in the Essar Steel referred to the Bankruptcy Law Reforms Committee ("BLRC") Report of 2015 which clearly enunciated that speed is of the essence while working for the insolvency law.[45] This is attributable to two major reasons: One, without full clarity of the ownership and control, significant decisions cannot be made, making it difficult to keep the organisation afloat.[46] Second, the assets also suffer from high rate of depreciation with passing time, further lowering the liquidation value.[47]

However, there have been several instances where the members of the CoC has caused such inordinate delays in the CIRP that it has turned disastrous for the Corporate Debtor's assets. The Standing Committee Report also highlighted the problem of delay in resolution process with more than 71% cases pending for

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[42] Ashutosh Kumar, A Code for Creditors, Business Today, (Nov 19, 2021) available at: https://www.businesstoday.in/magazine/industry/story/a-code-for-creditors-308229-2021-10-06 .
[43] *Id.*
[44] *Id.*
[45] Bankruptcy Law Reforms Committee, THE REPORT OF THE BANKRUPTCY LAW REFORMS COMMITTEE (Nov, 2015) available at: https://ibbi.gov.in/BLRCReportVol1_04112015.pdf (last visited Nov 10, 2021).
[46] *Supra* note 27.
[47] *Id.*

more than 180 days.[48] This is clearly in deviation to the original intended objectives of the Code.

The major cause of delays is due to the fact that many a times, the members of the CoC nominated by the financial institutions are not given decision making authority, leading to a time consuming process of getting internal approvals.[49] There are also various other delaying tactics used by the members of the CoC like remaining absent from the voting,[50] postponing the issuance of Expression of Interest.[51] Other less talked issue is the power of the CoC in accepting the delayed resolution plans which create tremendous procedural uncertainty, not only discouraging genuine bidders but also cause significant delays.[52] These practices also laid the reason for the courts and the committees to suggest code of conduct for the CoC members.[53]

IBBI DISCUSSION PAPER ON COC CODE OF CONDUCT

When the problem of massive haircuts was brought to the attention of the government, the Secretary to the Ministry of Corporate Affairs responded on behalf of the government by blaming the entire process on the CoC's decision-making abilities, which plays a key part in the process.[54] In the light of this, the

[48] Standing Committee on Finance, IMPLEMENTATION OF INSOLVENCY AND BANKRUPTCY CODE: PITFALLS AND SOLUTIONS (August 2021) available at: https://www.ibbi.gov.in/uploads/whatsnew/fc8fd95f0816acc5b6ab9e64c0a892ac.pdf (last visited Nov 12, 2021)
[49] Jindal Saxena Financial Services Pvt. Ltd. v. Mayfair Capital Private Limited, (2018) SCC OnLine NCLT 93; SBJ Exports & MFG Pvt. Ltd. v. BCC Fuba India Limited, (2017) SCC OnLine NCLT 20679.
[50] Kamineni Steel & Power India Pvt. Ltd v. Indian Bank and Ors., (2018) SCC OnLine NCLAT 654.
[51] STCI Finance Limited v. Parinee Developers Private Limited, (2020) SCC OnLine NCLT 843.
[52] *Supra* note 2 at 24.
[53] Kamineni Steel & Power India Pvt. Ltd v. Indian Bank and Ors., (2018) SCC OnLine NCLAT 654; REPORT OF THE INSOLVENCY LAW COMMITTEE (Feb 2020), Para 12.3, available at : http://www.mca.gov.in/Ministry/pdf/ICLReport_05032020.pdf (last visited Nov 7, 2021).
[54] *Supra* note 2.

32nd Parliamentary Standing Committee on Finance in its report dated 3 August 2021 stated that a professional code of conduct is urgently needed to regulate the conduct of CoC.[55] The Committee believed the same to be crucial in order to ensure overall efficacy of the Code. Incorporating the feedback received on the issue from various sources, on August 27, 2021, IBBI consequently released a discussion paper.

The IBC has given the CoC immense amount of power and authority, including the authority to determine the best potential resolution plan for a company's long-term survival. According to the IBBI Discussion Paper, it is only reasonable that such authority must be accompanied with accountability. The CoC must make judgments that are fair, follow the tenets of transparency, members of the CoC shall perform their roles with integrity, and act in line with the Code's objectives while making decisions. Furthermore, members shall not misrepresent any facts or situations and disclose details of any conflict of interest.

IMPLICATIONS OF THE CODE OF CONDUCT

This part analyses the possible implications the notification of code of conduct would bring with itself. Firstly, currently, it is unclear whether the Code will be incorporated in the Regulations/Acts as "law" or will stay as a prescriptive code of conduct with no consequences of non-compliance.

I. PRESCRIPTIVE OR MANDATORY

There is a double-edged jeopardy since in case the Code is made merely prescriptive without any mandatory compliance requirements, there are large chances of it being flagrantly ignored. Contrarily, in case if the Code is made mandatory, it poses a significant risk of increased litigation. Making it mandatory will not only undermine the widely established principle of commercial wisdom

[55] *Supra* note 3.

but will also be a major blow to the time bound objective of the Code. As per the legal framework, the CoC approval is required at each and every stage of the CIRP and imposing additional procedural guidelines will only further delay the process. In addition to this, it would also increase judicial review of the CoC decisions. In identifying the sources of delay, adjudicating mechanisms were identified as one of the two important sources of delay.[56] Also, judicial delay was one of the major reasons of the failure of our erstwhile insolvency law framework,[57] therefore, it puts the objectives and the future of the IBC in jeopardy.

II. ADOPTING COMPLY-OR-EXPLAIN APPROACH TO THE CODE OF CONDUCT

In case the Code of Conduct is introduced, instead of imposing comply-or-else approach (which might lead to humungous delays at each step of CIRP and severely dilute the commercial wisdom aspect of the CoC), a comply-or-explain approach can be adopted. This will allow establishing a transparent and will increase the reliability on the members of the CoC. Such an approach facilitates the purpose of introduction of the code of conduct, while respecting the key commercial wisdom aspect of the Code.

III. ALTERNATIVE SOLUTIONS

There are a few other approaches which have been explored as an alternative to simply bringing in a Code of Conduct – with the risks and dilemmas of prescriptive versus mandatory, as explained above.

[56] *Supra* note 35.
[57] Krishnadas Rajgopal, *Don't let judiciary delays fail IBC: Supreme Court*, THE HINDU, (Nov 10, 2021) https://www.thehindu.com/business/Industry/dont-let-judicial-delays-fail-ibc/article36441200.ece .

A. Intersectional Approach:

Since CoC's members are usually well-regulated entities regulated by the Reserve Bank of India or the Securities and Exchange Board of India in most cases. Instead of making the Code of Conduct mandatory, it might be a prudent idea to work on intersectional law. This can be done by extending the regulatory framework applicable to members of the CoC (under RBI/ SEBI etc.) and modifying it to the situations under IBC.[58] While providing this extension, it can be kept in mind that such an extension is not considered "law" for the purposes of Sections 30(2) and 61(3) of the IBC while still discouraging non-compliance with the Code of Conduct.[59] This allows striking a balance between avoiding the pitfalls of prescriptive nature along with ensuring that a door to unnecessary litigation hasn't opened up.

B. Exploring insolvency resolution via Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs)

To offer a solution to the increasing problem of haircuts, another alternative approach was suggested by Mr. Uday Kotak in form of exploration of new platforms such as REITs and InvITs. Such platforms appeal to a broader investor base because of more predictable distribution cashflows, including substantial worldwide pools of long-term capital in pension funds, endowment funds, sovereign wealth funds, and other institutions.[60] In fact, some of the cashflows created over time may be used to help finish some of the delayed projects that were the source of the problem in the first place. The fact that REITs and InvITs are overseen by the SEBI's regulatory framework may give extra assurance to the

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[58] Rajat Sethi, *An Alternative Approach to a Code of Conduct for the Committee of Creditors in an IBC Process*, S&R ASSOCIATES, (Nov 5, 2021) https://www.snrlaw.in/an-alternative-approach-to-a-code-of-conduct-for-the-committee-of-creditors-in-an-ibc-process/ .

[59] *Id.*

[60] Uday Kotak, *IBC : How do we reach the promised land?*, Quinquennial of Insolvency and Bankruptcy Code, 2016, (2021) Insolvency and Bankruptcy Board of India, p. 206.

CoC in terms of monitoring the platforms' continuous activities. Furthermore, incorporating certain enabling elements in the Code can help in encouraging using these alternative approaches instead of a straitjacket formula of adopting huge haircuts or proceeding with liquidation.

1. More participation of non-members of CoC in CIRP

Often the stakeholders who aren't the members of the CoC are left wondering and feeling unjustified by decisions of the CoC, such as huge haircuts, etc. It can be argued that non-financial creditors lack adequate sophistication to evaluate feasibility and incentives to take haircuts, even to the extent that they are valid. In this light, having a channel to allow more participation or communication with these stakeholders. Therefore, another idea can be creating an objections window where stakeholders outside CoC can address their concerns to the CoC, which shall receive a written reply.[61] This will allow the stakeholders an opportunity to understand the commercial rationale behind the successful resolution plan – be it cookie cutting, taking huge haircuts or anything else. While this might increase the CIRP process a bit, (a) it can be customized such that it runs parallel to other stages of CIRP, hence not requiring too much additional time; (b) it will reduce the likelihood of unnecessary litigation which often arises from unsatisfactory commercial decisions; and (c) goes a long way in increasing transparency and CoC accountability.

CONCLUSION

The Code, as its key principles, has endowed CoC with huge responsibilities and immense power in terms of giving its commercial wisdom a protection from judicial scrutiny. CoC has long enjoyed unchallenged support to its commercial

[61] Shreya Prakash, *Increasing participation of non-financial creditors while approving resolution plans*, Quinquennial of Insolvency and Bankruptcy Code, 2016, (2021) Insolvency and Bankruptcy Board of India, p.239.

wisdom from both the legislature as well as judicial precedents. However, of late, demands to regulate CoC have been made more rigorously.

Acting on the criticism and feedback, the IBBI in its discussion paper introduced a code of conduct. The editors argue that a mandatory code of conduct will go against the spirit of the IBC and lead to a barrage of disputes. Since CoC plays an important role at each step, a way to challenge its supremacy can be used to unnecessarily delay the process. Contrarily, a prescriptive code of conduct is toothless in delivering the purpose for which it was created. We suggest a comply-or-explain approach as a middle ground to this dilemma.

Furthermore, we also study a few other innovative alternative approaches which could be used to deal with the intense issues concerning CoC's commercial wisdom. Firstly, we study an intertwining approach where members of the CoC will be regulated by their respective regulating body (RBI/SEBI) bringing in desired effects in the IBC regime without increasing judicial scrutiny of the CoC supremacy. Secondly, we examine more active involvement of alternative resolution methods like via REITs and InvITs, which might offer a respite from the existing inefficiencies in terms of getting a good value of corporate debtor. Finally, we discuss how more participation of stakeholders outside CoC in the resolution plan might help alleviate these issues.