Emerging trends in corporate and Commercial Laws of India

NLIU – TRILEGAL SUMMIT
ON CORPORATE AND COMMERCIAL LAWS
2019

30 – 31 AUGUST, 2019

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A COLLECTION OF ARTICLES AND ESSAYS

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2019 Edition

9 789388 822978

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Published by:

The Centre for Business and Commercial Laws
National Law Institute University
Kerwa Dam Road
Bhopal
cbcl@nliu.ac.in

Typeset and Produced by:

EBC Publishing Pvt. Ltd.
34-A, Lalbagh, Lucknow – 226 001
U.P., India
Website: www.ebctechnologies.in Email: contact@ebctechnologies.in

Foreword

Continuing with the past practice, the 5th NLIU – Trilegal Summit on Corporate and Commercial Laws is being hosted on the 30th and 31st August of 2019. The students of NLIU, ably supported by the Chairperson, Prof. (Dr.) Ghayur Alam have invited research articles and essays on diverse issues relating to Corporate and Commercial Laws. These themes include Mergers and Acquisitions, Foreign Investments, Contemporary Developments in e-commerce, recent developments and the evolution of Insolvency and Bankruptcy Code (IBC) and future directions, Capital Markets, Insurance, Banking, White Collar Crimes, Law and Technology including blockchain and cryptocurrencies which have an impact on Corporate and Commercial laws, digital economy and anti-trust issues and other compliances. This list by no imagination is exhaustive. The amendments made to various legislations and the decisions of judiciary and tribunals would add colour to the discussion during the presentations at this summit.

Out of research papers and essays presented at this Summit, 15 articles and essays will be selected by experts on the basis of quality of the papers. Papers which reflect an interdisciplinary approach, problem solving recommendations along with suggestions for improvement of these laws and legal institutions would be selected for publication. Even those articles and essays so selected, would be reviewed in the light of deliberations and would be updated before taken up for publication. This would ensure the inclusion of all contemporary developments along with the critical analysis in the light of both theory and practice.

Once the publication is released, I hope that it would be well received by the students, practitioners, teachers and the researchers alike to promote the culture of research and publication in the areas of Corporate

and Commercial laws. I hope that the team of students and teachers would take all efforts to ensure that this publication finds a place in the library of all National Law Universities, leading Law Schools and other libraries in the country in order to bring more and more contributions from experts for the future publications. That is the way this publication will be moving.

I would like to place on record my sincere appreciation for the efforts taken by the Centre for Business and Commercial Laws (CBCL) towards organising this Summit and congratulate Trilegal and Eastern Book Company (EBC) for extending their support in the publication of this journal. I also would like to congratulate the students who have taken active part in organising this summit and Prof. (Dr.) Ghayur Alam for guiding the CBCL at NLIU. I wish the deliberations every success and hope that the proceedings be published immediately thereafter with a clear mission of contributing to the literature on this ever growing sphere of Corporate and Commercial laws.

—Prof. (Dr.) V. Vijayakumar
Vice Chancellor, National Law Institute University, Bhopal

Preface

It is a matter of immense pleasure to write the preface to this collection of articles and essays on diverse themes in Corporate and Commercial Laws. We, at the National Law Institute University (NLIU) have been endeavouring to promote legal research and conduct national and international events on topical and contemporary legal issues. The Centre for Business and Commercial Laws (CBCL) in collaboration with one of India's leading law firms, Trilegal, is organising the NLIU—Trilegal Summit on Corporate and Commercial Laws, 2019.

The previous Summits focusing on key issues pertaining to mergers and acquisitions, in 2016, 2017 and 2018 were a resounding success, witnessing submissions and participation by law students from across the country. This Summit is in continuance of the successful legacy though in an expanded format covering all areas of Corporate and Commercial laws. Through this Summit, we seek to provide accessible platform to the students to discuss, debate and learn various dimensions of Corporate and Commercial Laws.

Building on the above narrative, this book begins with *A Need to Relook the Merger Control in the Digital Economy—an Analysis*, by Anoop George and Shreya Bambulkar. In this article, the authors seek to bring to light the insufficiencies of applicable Competition Law provisions in the context of data driven mergers. They attempt to address the ongoing debate on the challenges posed by the growing digital market whilst identifying necessary amendments and changes to be incorporated within the current Competition Law regime in India.

An optimal liability solution for Independent Directors by Sarath Ninan Mathew, questions the equity liability framework in India. The

paper delves into the liability concerns of independent directors along with an analysis on the theoretical construct behind imposing such liability and further, develops solutions on the foundation of ensuring accountability with minimal disincentivisation.

Measuring the Impact in Impact Investment by Ayushi Goel and Aarvi Singh explores the dynamics of impact investments with a focus on the ambiguity posed by utilisation of these funds for unethical purposes. It concludes with a special reference to the measurement of impact and regulatory reforms.

Issuance and Listing of Shares with DVR: Evaluating a "Make in India" Initiative from the Lens of Corporate Governance and Shareholder Democracy by Aadhya Kancharla discusses the implementation of a comprehensive framework by SEBI in reference to the provision of allowing start-ups to issue shares with superior voting rights to its promotors. The author questions its efficacy and attempts to analyse it in parlance with corporate governance practices.

Resolution of Financial Service Providers: Time for a "New Deal"? by Vedant Malpani and Srihari Gopal focuses on the lack of an effective regime for financial service providers and examines the FRDI bill along with its shortcomings in depth. The authors further provide suggestions in line with an international framework for a prospective financial insolvency regime and its implementation in India.

Pricing Algorithms and Collusion under Competition Law in India by Akanshha Agrawal, discusses the anti-competitive nature of pricing algorithms in context of the Uber Ola decision by the Competition Commission and questions the order, seeking to bring out the threats and discrepancies brought forth to fair competition by these technologies.

Commodum Ex Injuria Sua Nemo Habere Debet: Conflict between Sections 29-A of IBC and 230 of the Companies Act 2013 by Arjun Gaur attempts to address the apparent conflict arising between Section 29-A of the IBC and Section 230 of the Companies Act by providing a harmonious interpretation while addressing the apparent incongruity caused by such conflict.

Regulating and Deregulating Initial Coin Offerings: A Cross Jurisdictional Analysis by Gokul Holani and Arpita Pande, analyses the issues relating to Initial Coin Offerings causing a disruptive trend globally across jurisdictions. The authors focus on a possible regulatory framework for India, upon a comprehensive analysis of the best international practises.

Sailing the Rough Waters: A Study of Duties of Directors and Creditor Protection under Companies Act, 2013 by N Raghav Harini, discusses the recognition of directorial duty owed towards creditors and analyses the same in context of Section 166 of the Companies Act, 2016 with a keen focus on the concept of limited liability and stakeholder approach. The author furthers supplants this theory by examining the shareholder and pluralist model of duties.

Rejection of Claims by Resolution Professional: Scope and Remedies by Aman Vasavada, reviews the scope of a resolution professional to reject the claim of a creditor during the Corporate Insolvency Resolution Process and further appraises the various remedies that may be available to such creditor in light of judicial pronouncements and provisions of the Insolvency and Bankruptcy Code, 2016

Equity Crowdfunding in India: Present Perspectives and Prospects by Ayush Wadhi and Swati Shekhar deals with rising phenomenon of Crowdfunding and its possible inclusion within the Indian legal system. The authors analyse the Consultation Papers on Crowdfunding released by the SEBI and explore probable future prospects with suggestions for a regulatory crowdfunding paradigm in India.

Social Stock Exchanges: A Small step in Regulation, a Giant Leap for Impact Investment by Tanya Vinod Nair, puts forth the advent of social financing in the impact investment sector. It attempts to provide an understanding of the concept in addition to certain legislative changes to make the current capital market regime in India ready for a social stock exchange.

To Enforce or Not to Enforce: The Impacts of Ipso Facto Clauses on Indian Insolvency by Samidha Sanjay Mathur and Aditya Anand,

discusses the ambit of ipso facto clauses on the insolvency process and attempts to draw an analysis on its implications and treatment in both foreign jurisdictions and in the Indian context. The authors have examined its role in the Insolvency and Bankruptcy Code, 2016 along with the consequences it has on stakeholders and conclude the paper with suggestions on incorporating a scheme which provides better safeguards within the insolvency process.

Assessing The Feasibility Of Pre-Packaged Administration In Corporate Insolvency Proceedings In India – Is It The Need Of The Hour? by Tushar Kumar, is a critical analysis of the viability of introducing pre-packaged insolvency under the Insolvency and Bankruptcy Code, 2016 along with cogent reasoning to strengthen this viewpoint.

Institutionalizing Whistle-blower Mechanism in Insider Trading Regime: Overhauling Evidence and Enforcement Challenges by Shubham Gupta, addresses the introduction of an amendment by SEBI in pursuance of providing protection to whistle-blowers within the Insider Trading Regime and discusses its shortcomings and discrepancies.

I hope that this book will enrich the existing literature on the subject. Every author deserves our thanks and gratitude.

Our Vice-Chancellor, Prof. (Dr.) V. Vijayakumar has completed one year with us. In the last one year we have witnessed that he can work 24 x 7. We are really thankful to him for providing meaningful leadership. Trilegal and EBC, our partners of the event deserve our special thanks for helping us organise the event and bring out this publication. Our students are the real role players, they work day and night and give their best to the task assigned to them. I am grateful and thankful to all of them and offer my heartiest congratulations to the CBCL, the student body, especially to Mr Shounak Banerjee, Mr Mudit Nigam, Mr Suyash Bhamore, Ms Gunjan Garg and all other members who made this event and the book a success.

—Ghayur Alam
Chairperson, Centre for Business and Commercial Laws
National Law Institute University, Bhopal

Message from Trilegal's desk

With the vision of a USD 5 trillion Indian economy by 2025, the business landscape in India looks promising in the long term. There has also been a multilateral shift in the legal and regulatory framework in the recent past with several policy measures intended to support accessibility to local markets and initiatives to fast track the projected growth, making India one of the fastest growing major economies of the world.

Against this backdrop, the NLIU-Trilegal Summit on Corporate and Commercial Laws 2019 is aimed at providing all stakeholders insights into general Corporate and Commercial laws, including their applications and impact. Trilegal has been collaborating with Centre for Business and Commercial Laws (CBCL) ever since the First Edition in 2016. CBCL's vision of fostering research in corporate laws is synonymous with Trilegal's efforts in engaging with law schools and encouraging students to understand cognitive aspects of Corporate and Commercial Laws. The Summit aims to have an absorbing discussion on the key issues affecting the corporate world and contribute to the growth of knowledge and research in Commercial Laws, whilst increasing the awareness and aptitude of students in these fields.

A collection of the best 15 articles and essays to be presented during the Summit have been collated as a composite book, providing detailed analysis of various pertinent topics across Corporate and Commercial Laws. The topics covered are increasingly relevant today and have thrown up interesting challenges for regulators and lawyers. I am glad to know that the topics dealt by the students focus on genuine challenges faced by various companies and reflect on the excellence in the quality of research thus undertaken by them.

I am extremely grateful to the Vice Chancellor and the Faculty of NLIU, the editors of this volume, the members of CBCL and Trilegal teams for their dedicated efforts in making the summit a grand success. I would also like to congratulate all the participants for thoughtful and insightful contributions – my personal best wishes.

—Yogesh Singh
Partner, Trilegal

Message from Team CBCL

On behalf of the entire team at the Centre for Business and Commercial Laws (CBCL) of National Law Institute University, Bhopal, we extend our heartiest congratulations to all the students who contributed articles and essays for the NLIU-Trilegal Summit on Corporate and Commercial Laws, 2019. The Summit began in 2016 as "one of a kind" event by NLIU and Trilegal as a way of encouraging law students to undertake research in niche issues of business laws. This partnership was a culmination of CBCL's vision to promote research in business laws and Trilegal's efforts in recognising merit, engaging with law students and encouraging research.

After successful editions of the Summit, the Summit was expanded in 2018 to include Corporate and Commercial Laws in its ambit. Now in 2019, the Summit has transformed into a full-fledged platform for corporate lawyers, practitioners and members of regulatory bodies. It also features a counselling and training session taken by partners from Trilegal. All of this presents a unique and rare opportunity for participants to engage directly with experienced professionals and learn from them first-hand. This Summit also features one of the nation's premier publishing company—Eastern Book Company (EBC) as our publishing partner. Further, the attractive prizes and offers by Trilegal and EBC makes the Summit a must for any ambitious law student looking to explore and make a career in Corporate Law.

Continuing the tradition of a record number of submissions, the expanded ambit of the Summit is now bigger than ever before. After a comprehensive review process taken by CBCL and Trilegal, we present the final 15 submissions in this commemorative book for the Summit which covers themes like Competition Law issues in a digital economy,

trends in the Insolvency Laws of India, legal issues in capital markets and also discusses the advent of social financing in the impact investment sector among other issues of contemporary relevance in business laws.

We are grateful to Prof. (Dr.) V Vijayakumar for his encouragement and support in organising this Summit. We are also indebted to our Chairperson, Prof. (Dr.) Ghayur Alam for his constant and valuable inputs at each step. He has been a guiding force of the Summit and we thank him for his efforts in ensuring that the Summit is a success.

Lastly, we hope that the success of this Summit and the future editions in the coming years induces more and more students to take up academic research in the field of Commercial Laws as a stepping stone towards a rewarding and meaningful corporate career.

—Shounak Banerjee
Convenor, CBCL, 2019-2020

—Mudit Nigam
Co-Convenor, CBCL, 2019-2020

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A Need to Relook the Merger Control in the Digital Economy – An Analysis

—Anoop George† & Shreya Bambulkar‡

ABSTRACT

How to best cope with the ongoing debate in the competition law and policy regarding the digital market and the new challenges it poses? A question that the competition authorities all around the world are trying to answer. In the wake of WhatsApp/Facebook merger this question has become more pressing than ever as this combination escaped the scrutiny of many competition authorities including India. In today's world, where access to consumer data makes or breaks a market player, data driven mergers needs a closer scrutiny. Concentration of data with just one market player can have a disastrous effect to the competition in the relevant market. Jurists all around have different opinions about how to effectively deal with this challenge and a few competition commissions have taken different actions to address the challenges posed by the dynamic digital market. There is a need to analyze all the different opinions and actions to understand what is best suited for the completion policy of India. In India, the turnover/ asset threshold for pre-merger notification and the current assessment for "appreciable adverse effect on competition" is not sufficient to deal with the complexities and challenges posed by data driven mergers. Thus the paper makes a critical analysis of the legislative and judicial approach towards data driven mergers by various competition authorities, the ineffectiveness of the current thresholds for merger control in India and the loopholes of the current assessment of market power. This paper is an attempt to identify the necessary amendments to the current competition law regime in India.

† Student at Indian Law Society's (ILS) Law College, Pune.
‡ Student at Indian Law Society's (ILS) Law College, Pune.

INTRODUCTION

In today's intensely competitive market, companies struggle to enter the market and generate considerable market share. Consumer's data lies at the core of any business model and it largely explains the market power acquired by the major players in the dynamic market. Data driven mergers are the transactions that aim at acquiring, combining and/or monetising large amounts of commercially valuable data gathered from multiple sources and formats[1]. These data driven mergers have the potential to hamper the competition to a substantial extent. This can be avoided by subjecting such mergers to the scrutiny of the competition authorities. However, considering the current competition law regime in India, the notification requirements for merger control are based on turnover and assets, which do not always cover all data driven mergers.

The Chairperson of the Competition Commission of India (CCI) recently suggested reviewing the anti-competitive effects big data can have in mergers and acquisitions (M&A) and revisiting the Section 5 thresholds to compensate for not accounting big data as an "asset".[2] The Ministry of Corporate Affairs has constituted a Competition Law Review Committee to review the competition Act/Rules/Regulations in view of changing business environment and recommend changes if required.[3] This paper is our attempt to contribute towards the much needed amendments to the Competition Act, 2002.

The authors in the first chapter try to understand the meaning, relevance and challenges presented by big data to the competition regime. The authors further evaluate the concept of data driven mergers and its impact on competition law by analysing the substitutability of big data in the market and also by understanding the judicial trends regarding data driven mergers. Consumer welfare depends on the existence of competitive markets. Market concentration resulting from mergers could

1. Andressa Lin Fidelis and Zeynep Ortac, "Data driven mergers: a call for further investigation of dynamic effects into competition analysis", SEMANTIC SCHOLAR (23-7-2019, 10:45 AM), <https://pdfs.semanticscholar.org/0ce4/5469241cf59b9ecfcfe145e7c0447d29aff2.pdf>.
2. Competition body chief calls for review of M&A processes, *The Hindu Business Line,* 11-5-2018.
3. Ministry of Corporate Affairs, Invitation for Public Comments on Competition Act, 2002. <http://www.mca.gov.in/Ministry/pdf/InvitingComments_16112018.pdf>.

negatively impact choice and may increase price.[4] Transactions involving data transfer have a potential of foreclosing the market and creating entry barriers for new entrants.

This paper analyses the relevance of current notification threshold under Section 5 of the Act in light of the WhatsApp/Facebook merger and the dynamic digital market and further analyses the notification threshold requirements under different jurisdictions to better understand the changes that are needed in the Indian notification requirement. In dynamic markets, merger control is a major tool to prevent the market structure becoming encrusted in a manner opposing innovation. It covers not only concentrations between competitors but also those along the added-value chain. However, the digital economy demonstrates specific characteristics with the high significance of multi-sided platforms. The authors consider the current legal regime in India to be not sufficiently equipped to deal with this situation.

The authors conclude by suggesting three additions to the Act, firstly, introduction of a new transaction value based threshold for notification in addition to the existing threshold, secondly, adding an enabling provision so that the competition commission has the power to review combinations *suo moto* even if such combinations do not meet the notification criterion, and finally, the introduction of additional standards and metrics in evaluating Appreciable Adverse Effect on Competition (AAEC) in the relevant market keeping in mind the dynamic nature of the digital market.

There is a need to build necessary supplementary legal framework along with the amendments to competition law. Although the paper does not specifically deal with the data protection and privacy aspects involved in the data mergers, the authors suggest additional measures to improve the enforceability of the individual rights of content providers and users in the digital economy. The unlawful exploitation of third-party data can also lead to an abuse of market power. Thus, there is need for an effective data protection and privacy related legal framework to tackle these problems which are not limited to just concentration of market power.

4. Monopolkommission, "Competition policy: The challenge of digital markets", Monopolkommission (21-7-2019, 10:45 PM), <http://www.monopolkommission.de/images/PDF/SG/s68_fulltext_eng.pdf>.

BIG DATA

Meaning

The term "big data" can be defined as the data that is so huge in quantity that it is not possible to process it using the conventional methods. It is a constantly varying factor that has the capability of changing our lives in a fraction of seconds. Big data is characterised by four V's- the volume of data; the velocity at which data is collected, used, and disseminated; the variety of information aggregated; and the value of the data.[5]

The increased access to internet at our convenience makes sure that all consumers create data that can be traced by companies for their own use. The tools and data needed for the creation of a service is already present with the company even before the service reaches the market. This is because data allows the companies to take a peek at the consumer's needs and preferences even before they have used the service.[6]

Big data as company's asset

1. Companies use big data for innovative and creative purposes that aids production efficiency, greater client base and more customer satisfaction that results into increased economic efficiency.
2. As a crucial input, online companies can use the data collected to deliver more customised, high quality, refined and innovative products and services. For example, by learning consumer behavior through the search queries.
3. Big data allows better understanding of the human behavior, customer preferences, habits, shopping pattern, conduct that help to match the supply side of the market with the demand side.
4. Data collected in the context of one product or service can be used to explore and enter into new business opportunities and new markets.

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5. Stucke, Maurice E. and Allen P. Grunes, *Big Data and Competition Policy*, 16 (Oxford University Press 2016).
6. D. Daniel Sokol and Roisin E. Comerford, "Does Antitrust Have a Role to Play in Regulation Big Data?" in Roger D. Blair and D. Daniel Sokol (eds.), *Cambridge Handbook of Antitrust, Intellectual Property and High Tech*, 6 (Cambridge University Press, 2016).

Big data as a threat to competition

1. Where a company's growth is highly dependent on collection, processing and utilising data, if the firm collects data to such a large extent that it gets entrenched it can gain the ability to use the data for various purposes. One such purpose could be to eliminate the competition in the market by creating entry barriers. This situation can arise when small companies do not possess the means to access the data already present with the corporate giant and thus their chances to compete with them is reduced.
2. The company being in a position to control the access to data in any given market at any point of time, can create a monopoly by not sharing the information at all, or sharing it in such a way that it creates exclusionary effects on competitors, e.g. by charging exorbitant prices for accessing data. As a result, no competitor will have the required capacity to challenge or even enter the market where this merged giant is present. Thus, it can create entry barrier in the market
3. In many markets, a merger between an established undertaking and an innovative newcomer has only a low impact on the existing market structure because of the newcomer's low market shares or even the absence of horizontal overlap. However, in data-related markets, such a merger could result in differentiated data access and increase the concentration of data related to this market if the newcomer has access to a large database (gained on another market for instance).[7]
4. Data driven mergers will increase the competitors' costs to survive in the market as the competitors have to incur huge expenditure and investments to collect the same volume of data in a given market. This can eventually lead to a huge gap between the merged company and the other competitors that in turn can lead to the merged company creating a monopoly.

7. German Monopolies Commission (Monopolkommission), "Special Report No. 68: Competition policy: The challenge of digital markets", Monopolkommission (21-7-2019, 10:40 PM), <http://www.monopolkommission.de/images/PDF/SG/s68_fulltext_eng.pdf>. [hereinafter "special report"].

5. A combination of different data troves could raise competition concerns if the combination of data makes it impossible for competitors to replicate the information extracted from it.[8]

DATA DRIVEN MERGERS AND NON-SUBSTITUTABILITY OF DATA

In the current dynamic market scenario, the mergers like Facebook/Whatsapp,[9] Microsoft/LinkedIn,[10] Verizon/Yahoo[11] have gained the attention of competition authorities from almost every jurisdiction.

The critical issues to be considered to assess the post-merger effects of data driven mergers are;

1. Whether the data within the access of the merged entity is unique and non-substitutable
2. Whether the dataset within the access of the merged entity is the only source of the data and thus, its control by the merged company creates entry barriers in the market

Recent merger cases involving the transfer of control over big data concluded that these mergers would not lead to competition problems because there was sufficient number of other data sources available to the various players in the market. Reliance on claims on the availability of alternative big datasets implicitly assumes that these big datasets are substitutable. Unfortunately, this assumption has not been tested and the potential implications have not been explored in merger control cases. These cases, neither define a separate market for big data, nor do they assess the closeness of substitution between big datasets. Some of these cases are discussed below.

The Federal Trade Commission (FTC) investigated number of mergers where big datasets were involved, including Google/DoubleClick[12],

8. Nestor Duch-Brown, Bertin Martens and Frank Mueller-Langer, "The Economics of Ownership, Access and Trade in Digital Data", JRC Digital Economy Working Paper,(2017-01), European Union (19-7-2019, 11:45 PM) <https://ec.europa.eu/jrc/sites/jrcsh/files/jrc104756.pdf>.
9. Facebook/Whatsapp, Case No COMP/M.7217, decided on 3-10-2014. [hereinafter "Whatsapp"]
10. Microsoft/LinkedIn, Case M. 8124, decided on 6-12-2016. [hereinafter "LinkedIn"]
11. Verizon/Yahoo, Case M. 8180, decided on 21-12-2016.
12. Google/Doubleclick, Case No COMP/M.4731, decided on 11-3-2018.

Telefónica UK/Vodafone UK/Everything Everywhere[13], Microsoft/YahooSearch[14], Facebook/WhatsApp[15], Microsoft/LinkedIn[16]. These cases mostly involved vertical M&A and the investigation focused on whether some part of the big data generated by the merging parties qualified as an essential input and whether the data so involved gave the merged entity an unfair advantage over its competitors or such merger resulted in creating entry barriers in the relevant market. However, none of these merger assessments undertook a formal analysis of the closeness of substitution between various big datasets.

The Google/Waze acquisition was investigated by the UK Commission and it was cleared on the grounds of insufficient scale of big data accumulation rather than through a formal assessment of the closeness of substitution between big datasets[17]. The Alliance Data Systems Corp/Conversant (NYSE: ADS)[18] merger was investigated by the German Commission (GC) but again, with no formal assessment of closeness of substitution between big datasets.

The Department of Justice (DOJ) successfully challenged the Bazaarvoice/PowerReviews merger but the focus in that assessment was on how big data can reinforce network effects and once again no closeness of substitution between big data was evaluated.[19]

Big data gains value only when it is processed and transformed into insights according to its purpose and use. Therefore, closeness of substitution between two big datasets must be assessed by evaluating to what extent the users consider these insights as close substitutes. For example, the big data collected by Google (focusing on user search) can be viewed as being a close substitute of the big data collected by Facebook (focusing on social networking activity) for a specific group of advertisers only if

13. Telefonica UK/ Vodafone UK/ Everything Everywhere /JV, Case No COMP/M.6314, decided on 4-9-2012.
14. Microsoft/Yahoosearch Business, Case No COMP/M.5727, decided on 18-2-2010.
15. Whatsapp, s*upra* note 9.
16. LinkedIn, s*upra* note 10.
17. Norbert Maier, "Closeness of substitution for 'big data' in merger control", Copenhagen Economics (21-7-2019, 10:45 PM). <https://www.copenhageneconomics.com/dyn/resources/Filelibrary/file/3/173/1540561809/closeness-nom-2018-10-15.pdf>, [hereinafter "Norbert"].
18. Alliance Data Systems Corporation; Conversant, Inc., Transaction No 20141572, decided 24-9-2014.
19. *United States of America* v. *Bazaarvoice, Inc.*, Case No. 13-cv-00133-WHO, decided on 2-12-2014. [hereinafter "Bazaarvoice"].

these advertisers view the generated customer profiles from those two big datasets as close substitutes[20].

A discussion paper by the Canadian Competition Authority concludes that for the case when data is traded "*the closeness of competition between two firms selling data will depend on the extent to which customers view their products as substitutable*", then it draws a wider conclusion when claiming that "*two sources of data are more likely to be viewed by customers as substitutable when they provide the same or similar information (e.g. similar financial data)*".[21]

Though the authorities around the globe initially based their decisions on the assumption of substitutability of data without any proper basis, the jurisprudence has undergone several changes where they have started assessing the substitutability of data in the relevant market. The next chapter is a study into the changing jurisprudence in understanding the relevance and substitutability of big data and data driven mergers.

JUDICIAL APPROACH TOWARDS DATA DRIVEN MERGERS

Various competition commissions have realised the importance and the impact that data driven mergers can have on the competition on the relevant market. A few of the decisions by various commissions on data driven mergers are summarised below.

In Apple/Shazam[22] the European Commission (EC) looked at the data related issues in detail and held that "*The integration of Shazam's and Apple's datasets on user data would not confer a unique advantage […] because Shazam's data is not unique and Apple's competitors would still have the opportunity to access and use similar databases*".

The merger of Immonet/Immowelt[23] was cleared by the GC. It was found that this merger can prevent the relevant market from tipping into a monopoly in favor of the market leader and strengthen the multi-homing user pattern. The merger provided the opportunity for the growth

20. Norbert, *supra* note 17.
21. Canada Competition Bureau, Big data and innovation: Implications for competition policy in Canada, Competition Bureau (21-7-2019, 10:45 PM), <http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/vwapj/Big-Data-e.pdf/$file/Big-Data-e.pdf>.
22. Apple/Shazam, Case M.8788, decided on 6-9-2018.
23. Immonet/Immowelt, Case No B6-39/15, decided on 20-4-2015.

of a second big platform to promote multi-homing by service users, thus increasing the competition.

EC cleared the merger between Facebook and WhatsApp,[24] while considering the possibility of the merged entity having access to Facebook and WhatsApp's user data, it was concluded that the merged entity lacked the technology ability and incentive to combine the datasets of the two companies[25]. However, Whatsapp changed its privacy policy soon after the merger. EU then charged Facebook a fine of 110 million EUR for providing incorrect information[26]

In IMS (Intercontinental Medical Statistics) Health/Cegedim Business[27] the EC cleared the merger but with commitments that IMS Health shall provide access to data to third parties. The Commission held that the competitors will not be able to access to the same data present with the merged entity due to the practical difficulties to substitute/ replicate the data in the market.

In CTS Eventim/ Four Artists[28] GC prohibited the planned merger, between the leading ticketing system provider in Germany and a company that organises and markets concerts for national and international artists, considering the anti-competitive implications due to access to data which is not available to its competitors.

FTC (Federal Trade Commission) held that the proposed combination of CoreLogic's and DataQuick's national assessor and recorder bulk data businesses would lessen the competition. This would lead to the merged entity unilaterally gaining market access and raising the price for the consumers. Thus, FTC in 2014 proposed a settlement; to license to the competitors the data that DataQuick provides to its customers. This will allow them to be effective competitors in the market.[29]

In the matter of Reed Elsevier NV/ ChoicePoint Inc,[30] it was observed that Lexis Nexis (a wholly owned subsidiary by Reed Elsevier) and

24. Whatsapp, *supra* note 9.
25. *Ibid*, at 184-186.
26. European Commission, Mergers: Commission fines Facebook €110 million for providing misleading information about WhatsApp takeover, European Commission, (21-7-2019, 10:45 PM) <http://europa.eu/rapid/press-release_IP-17-1369_en.htm>.
27. IMS Health / Cegedim Business, Case No COMP/M.7337, decided on 19-12-2014.
28. CTS Eventim/Four Artists, Case No B6-35/17, decided on 23-11-2017.
29. CoreLogic, Inc, FTC Matter/ File No 131 0199, decided on 15-6-2018.
30. Reed Elsevier NV, FTC Matter/File Number: 081 0133, decided on 5-6-2009.

ChoicePoint are substantial competitors in the relevant market of electronic public records services for law enforcement customers. FTC held that the said acquisition will make new entry into the relevant market substantially difficult because of the time and cost associated with developing the public records and matching the level of data already present with the resulting entity.

In the matter of Bazaarvoice/ PowerReviews, the parties completed the merger without the pre-merger notification. Hence, DOJ challenged the same and through its investigation concluded that Bazaarvoice bought PowerReviews knowing that it was acquiring its most significant rival and hoping to benefit from diminished price competition which is in violation of Section 7 of the Clayton Act.[31] The DOJ rejected the argument that there are adequate substitutes for the parties' PRR (Product Ratings and Reviews) platforms. The DOJ concluded that other social commerce products do not collect the same type of structured, product-level data associated with ratings and reviews and, therefore, customers do not view these products as substitutes for PRR platforms. Thus, there will be substantial barriers to entry. The US District Court ordered the divestiture of assets by Bazaarvoice.[32]

The jurisprudence related to data driven mergers have come a long way from basing their decision on the assumption that data is always substitutable to understanding the relevance and impact of big data. The competition commissions across jurisdictions have started assessing the impact data driven mergers can have on the competition in relevant market by analysing the availability of similar data among its competitors, analysing the impact of merged data and creation of entry barriers for new players. As seen above in certain cases the commissions have concluded that there is alternate data available in the market and the competitors can match the competition in the market and in certain case the commissions have found the need of data driven mergers to keep the competition alive by not allowing concertation of data with just one dominant market player. In many other cases commission have allowed mergers on conditions that ensure availability of data to competitors and in many other cases the commissions have rejected the

31. Bazaarvoice, *supra* note 19.
32. *Ibid.*

proposed mergers due to reasons of difficulty in duplication of data or due to creation of entry barriers in the market or due to concentration of data with one just one player in the market so as to affect the competition in the market.

TRANSACTION VALUE - A NEW THRESHOLD FOR MERGER CONTROL

The traditional approach for merger control across majority of the jurisdictions is to assess mergers on the basis of the turnover/asset threshold. The current turnover/asset threshold cannot accommodate the data driven mergers. This is highlighted by the recent Srikrishna Committee report refers to big data in the light of protection of privacy of individuals whose data can only be collected with their explicit consent.[33] The report is silent about the ownership of any such data collection. On the other hand, the Telecom Regulatory Authority of India has, in its press release[34], recommended that users are the owners of their data collected by enterprises in the digital ecosystem and the latter are just custodians of the data provided to them. Though the press release constitutes only a bare recommendation, if accepted, this would imply that the users' big data cannot be an "asset" of the enterprise holding it. Thus, at this juncture, the law neither includes nor can be construed to include big data under the definition of an "asset" which can render a transaction notifiable to the CCI.

The consequence of this traditional regulatory technique is that the acquisition of a company which previously had little or no turnover can remain exempted from control if the purchaser is a world market leader with turnover in the billions. The current notification system does not cover cases where young companies are acquired, for instance in the technology sector, which have considerable market potential but currently have marginal turnover. Thus, market-leading companies can eliminate new competitors from the market at an early stage by acquiring them before they grow into serious competitors.

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33. A Free and Fair Digital Economy: Protecting privacy, Empowering Indians, Committee of Experts under the Chairmanship of Justice B.N. Srikrishna (23-7-2019 3:19 PM), <http://meity.gov.in/writereaddata/files/Data_Protection_Committee_Report-comp.pdf>.
34. Information Note to the Press (Press Release No. 78/2018), Telecom Regulatory Authority of India (16-7-2018), <https://www.trai.gov.in/sites/default/files/PRNo78162072018.pdf>.

The classic example of a merger escaping scrutiny of the authorities can be seen in the Facebook/ WhatsApp[35]. The market potential of the WhatsApp Messenger service was hardly expressed in past turnovers, when the company was taken over by Facebook in 2014 for a record price of USD 19 billion. Accordingly, the acquisition did not meet the notification requirements of jurisdictions that used turnover/asset thresholds. The EC was only able to carry out proceedings in this regard because the transaction was notifiable in three Member States under the national notification thresholds and Facebook had requested for these proceedings to be remitted to the EC[36]. Thus, it would be beneficial to take account of the transaction value as an alternative to the company's past turnovers.[37] Certain jurisdictions have taken note of this lacuna in the notification threshold and made changes to the same. We have analysed these changes in the Austrian, German and American jurisdictions.

Austria and Germany

Austria

Given the challenges posed by the Facebook/WhatsApp merger, the Austrian legislator introduced a new transaction value based threshold in Austrian merger control at the end of 2017 aiming to "avoid the formation of monopolies in the sensitive digital markets".[38] The Austrian merger control regime is set out in Part I, Chapter 3 of the Austrian Cartel Act 2005 (KartG). The 2017 amendment introduced a new threshold i.e "value of transaction" for notification of a given merger. Section 9(4) of KartG provides that the mergers have to be notified to the Federal Competition Authority if the value of the transaction is more than EUR 200 million.[39]

35. Whatsapp, *supra* note 9.
36. Elias Deutscher, "A critical reassessment of the EU Commission's merger control in data-driven markets", European University Institute, (26-7-2019, 10:40 PM) <https://cadmus.eui.eu/bitstream/handle/1814/58064/WP_2018_13.pdf?sequence=1&isAllowed=y>
37. Special report, *supra* note7.
38. Kartell- und Wettbewerbsrechts-Änderungsgesetz, Explanatory memorandum to the Austrian Cartel and Competition Law Amendment Act 2017 Govt. of Austria, (21-7-2019, 10:40 PM), <https://www.parlament.gv.at/PAKT/VHG/ XXV/I/I_01522/index.shtml#tab-Uebersicht>
39. "Bundesrecht konsolidiert: Gesamte Rechtsvorschrift für Kartellgesetz 2005", Section 9(4) KartG (in the version of BGBl I No. 56/2017).

The aim of the amended threshold is to cover cases where current turnover and the purchase price for the company differ to a disproportionate extent. The high purchase price in such takeovers is often an indication of innovative business ideas with great competitive market potential.[40]

By the end of September 2018, 13 filings have been submitted to the Austrian Commission under Section 9 (4) KartG. Moreover, there have been more than 20 informal consultations sought on whether or not the new transaction value threshold was met in that particular case.[41]

Germany

The 9th amendment to the German Act, Against Restraints of Competition 2017 (ARC), introduced the transaction value threshold for the notification of a merger. Section 35 (1a) of ARC states that the provisions on the control of concentrations shall apply if the consideration for the acquisition exceeds EUR 400 million.

USA

The Hart-Scott-Rodino Antitrust Improvement Act of 1976 requires notification of certain mergers and acquisitions that meet the threshold requirements to the FTC and Anti-Trust Division in the DOJ.[42] The revised threshold for transaction value is 90 million applicable from 3 April 2019.[43]

Section 5(a) of Federal Trade Commission Act (15 USC Section 45), declares unfair methods of competition and unfair or deceptive acts or

40. Bundeskartellamt, "Guidance on Transaction Value Thresholds for Mandatory Pre-merger Notification (Section 35 (1a) GWB and Section 9 (4) KartG)", Bundeskartellamt,(21-7-2019, 10:40 PM), https://www.bundeskartellamt.de/SharedDocs/Publikation/EN/Leitfaden/Leitfaden_Transaktionsschwelle.pdf?__blob=publicationFile&v=2.
41. Federal Competition Authority Austria, Digitisation, Transaction Value Thresholds in Merger Control and Associated Challenges, European Union, (21-7-2019, 10:40 PM), <http://ec.europa.eu/competition/information/digitisation_2018/contributions/austrian_competition_authority.pdf>.
42. Federal Trade Commission, Hart-Scott-Rodino Antitrust Improvements Act of 1976 and Regulations Thereunder; Amended Statement Concerning Filing Fees, *Federal Trade Commission*,(21-7-2019, 10:40 PM), <https://www.ftc.gov/sites/default/files/documents/hsr_statements/54-fr-48726/891124-54fr48726.pdf>.
43. Federal Trade Commission, FTC Announces Annual Update of Size of Transaction Thresholds for Premerger Notification Filings and Interlocking Directorates, *Federal Trade Commission*, (21-7-2019, 10:40 PM), <https://www.ftc.gov/news-events/press-releases/2019/02/ftc-announces-annual-update-size-transaction-thresholds-premerger>.

practices in or affecting commerce as unlawful. Section 7 of the Clayton Act (15 USC Section 18) prohibits mergers and acquisitions where the effect may be substantially to lessen competition, or to tend to create a monopoly.

Legislators in US have proposed what they call "Better Deal" legislation to change the standard of US merger review.[44] This bill proposes both to reduce the burden of proof on the agencies to intervene in mergers with anti-competitive potential, and to shift the burden of proof to the parties to prove that a merger will not be anti-competitive in cases of large-size mergers and mergers that cause significant increases in market concentration. A conclusion that a transaction "*may cause more than a de minimis amount of harm to competition*" is sufficient to make it illegal. Among the factors to be considered are the transaction's impact on market concentration and the value of the transaction ($5 billion, to be adjusted annually).

Europe

Article 1 of EU Merger Regulation 2004 provides only for the turnover thresholds for pre-merger notification.

The European Consumer Organisation (BEUC, from the French name Bureau Européen des Unions de Consommateurs) has made the following recommendation to the European Commission on the procedural and jurisdictional aspects of EU merger control:

> The EU Merger Regulation should include in its rules on jurisdiction two additional criteria based on the value of transfer and, in case of two-sided markets, on the number of consumers affected by the operation. This would allow DG Competition to consider mergers between companies that do not reach the turnover thresholds but nevertheless have the potential to disrupt competition due to the number of consumers that will be aggregated by the purchasing company.[45]

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44. A Better Deal: Cracking Down on Corporate Monopolies, Democrats Senate(21-7-2019, 10:40 PM), <https://www.democrats.senate.gov/imo/media/doc/2017/07/A-Better-Deal-on-Competition-and-Costs-1.pdf>.
45. European Consumer Organisation, EU Merger Control: BEUC's Comments On Jurisdictional Thresholds, European Union, (21-7-2019, 10:40 PM), <http://ec.europa.eu/competition/consultations/2016_merger_control/european_consumer_organisation_contribution_en.pdf>.

The European Parliament has also provided similar recommendations after their study on the challenges to the competition policy in digital economy[46].If the recommendations of either the European Parliament or the BEUC are implemented the EU will also be equipped with a similar notification threshold as compared to the US, Germany and Austria.

India

Merger control in India is structured, in procedural terms, as ex-ante control. The duty to report a transaction is triggered by "notification requirements" (turnover thresholds). However, the current design of the notification requirements leads to gaps in control in the digital economy as seen in the WhatsApp/Facebook merger.

Section 5 thresholds ascertain which transactions need to be notified to the CCI for analysing the possibility of AAEC. As the law stands today, if the combined value of assets of the enterprises is higher than rupees one thousand crores or the combined turnover of the enterprises is higher than rupees three thousand crores, the transaction would be notifiable. However, the *De Minimis* exemption renders the combination not notifiable if the target enterprise *i.e.* the enterprise being acquired, has either assets worth less than rupees 350 crores or turnover worth less than rupees 1000 crores.[47]

The CCI must be equipped with the necessary tools to assess possible anti-competitive effects of such corporate reorganisations. The current notification criteria based on turnover thresholds are insufficient to allow the CCI to assess important mergers between companies whose assets are based on consumer data.

FACTORS TO BE CONSIDERED TO DECIDE APPRECIABLE ADVERSE EFFECT ON COMPETITION

The need for transaction value as a new threshold to bring the data driven mergers before the competition authorities for assessment has been already emphasised in the previous chapter. However, this change

46. European Parliament, "Challenges for Competition Policy in a Digitalised Economy" (Study for the ECON Committee, Directorate-General for Internal Policies, Economic and Monetary Affairs), (2015).
47. Competition Act, 2002 (12 of 2003), Acts of Parliament, 2003.

will prove to be futile if there is no corresponding amendment in Section 19(3) of Competition Act, 2002 that provides the factors to be considered for assessing AAEC. These factors are: creation of barriers to new entrants in the market; driving existing competitors out of the market; foreclosure of competition by hindering entry into the market; accrual of benefits to consumers; improvements in production or distribution of goods or provision of services; promotion of technical, scientific and economic development by means of production or distribution of goods or provision of services. After analysing different jurisdiction, suggestions for the possible factors that will help to assess the AAEC of a particular merger are discussed in detail below:

1. Network effects

"Network effects" refers to how the use of a good or service by a user impacts the value of the same product to other users. Such effects may be "direct" (when the effect depends on the number of other users from this group using the service) or it may be indirect (when the effect depends on the number of other users from other group using the service)

The negative network effects can be seen as a potential barrier to entry or an element of such barrier and thus as a factor which limits competition.

2. Single homing/ Multi homing

The existence of a possibility to use several platforms at the same time is called multi-homing. This depends upon various factors including the costs of changing and on whether fixed costs are charged to use a particular platform. In case of high switching costs, innovative competitors are then unable to enter the market and generate their share even if they possess the potential. This creates dynamic market inefficiencies.[48]

Many academics see multi-homing as a factor likely to reduce market power.[49] If multi-homing is present in the market of both buyers

48. Farrell J. and Klemperer P., Coordination and Lock-in: Competition with Switching Costs and Network Effects, Handbook of Industrial Organisation 927 (2007).
49. David S. Evans and Richard Schmalensee, The Industrial Organisation of Markets with Two-Sided Platforms, 3 Competition Policy International, 151-179, (2007).

and sellers, the probability of concentration in the market is reduced. However, if one of the two parties face single-homing, the market can quickly "tip" in the favor of the merged entity.

3. Economies of Scale in Combination with Network Effects

Online platforms and networks often generate high economies of scale (proportionate saving in costs gained by an increased level of production), as their setting up and operation have high fixed costs but low variable costs. Scale effects create difficulties for potential providers to enter the market as they need to make considerable infrastructure investments in the initial period itself. Moreover, economies of scale may also result in specialisation by the merged entity, which may be difficult to replicate by market entrants at affordable costs and/or within an acceptable period of time.

4. Access to Competitively Relevant Data

This criterion aims at covering competition concerns arising from the huge volume of personal data generated by the use of online services. Difficulties in acquiring or replicating personal data of similar breadth and depth may result in high entry barriers and, respectively, in the marginalisation of competitors. Nevertheless, it is not sufficient to consider this factor in isolation. The authority should make a factual assessment of each case by considering other factors as well.

5. Multi-sided market considerations

Multi-sided markets are where the companies are active towards more than one group of users/customers. The special characteristics of multi-sided platforms pose a challenge for competition law regime and its assessment requires an overall view to be taken. The following factors have to be considered while examining the multi sided platforms-

i. The inter-dependence of the multi sided platforms—

Sides of the platform cannot be regarded in isolation mainly because of the indirect network effects. The platform provider thus has to design its business model in such a way that it takes account of the market

conditions of all sides of the platform simultaneously. Hence market power can only be assessed if the interdependences between the sides of the platform are taken into consideration. For example, if in order to compete in one side of a multi-sided market, the side X, it is necessary to first enter the side Y, because the data obtained in this side are necessary to compete in the side X, the new firm wanting to enter the market will face a double entry barrier.

ii. Combination of the data after expansion of the platforms by way of mergers, acquisitions etc.—

The concentration-related combination of data with the merged entity enables it to prevail over competitors solely by virtue of permanently possessing superior knowledge e.g., the user preferences. This can be used by the merged entity to expand into directly adjacent digital markets as well as into other non-related markets even before its actual competitors have a chance to react.

Including new factors to assess the data related aspects of a merger is crucial in the light of the recent market trends. All mergers need not necessarily create AAEC by fitting into the traditional factors that form part of Section 19(3) currently. That does not necessarily mean that it will not create anti-competitive effect in the market. The above-mentioned factors will aid the competition authorities to understand the actual and potential threat to the competition in the correct manner. Thus, the assessment must be done in a wider sense encompassing all factors to ensure a critical scrutiny of the merger in hand.

ENABLING PROVISION

The acquisition of WhatsApp by Facebook for almost $19.3 dollars was a deal affecting around 1.7 billion users in the world[50] and yet, it did not trigger notification to the CCI as the Section 5 thresholds were not met. The reliance on the thresholds considering only the assets and the turnover is problematic in cases of such enterprises which do not hold assets or

50. Nisha Kaur Uberoi, How CCI should look at M&A deals in digital economy, *Livemint*, 12-4-2018. (21-7-2019, 10:40 PM) <https://www.livemint.com/Opinion/R2jJb12xH9BX9heTYleESK/How-CCI-should-look-at-MA-deals-in-digital-economy.html>.

produce turnover in India. The problem is further aggravated because of the *De Minimis* exemption which exempts such mergers from the scrutiny of the CCI. This is possible because the exemption only assesses the value of assets and turnover for its application.

The aforementioned can be read with Section 8(1) of CCI (Procedure in regard to the transaction of Business relating to Combinations) Regulations, 2011, which dictates that the CCI has the power to initiate a *suo moto* inquiry in cases where a combination has not been filed as contemplated under sub-section (2) of Section 6 of the Act. As the *De Minimis* rule is an exemption to the application of Section 5, any transaction exempted by it is not a Combination and, as a result, the CCI loses its power to *suo moto* inquire into cases of acquisitions of small enterprises holding big data.

In a written contribution prepared by the CCI for the proceedings of the "*Roundtable on the Definition of Transaction for the Purpose of Merger Control Review*", 2013 held by the Competition Committee of the OECD, CCI stated that: "*So far, there has been no instance where the Commission had taken cognizance of a merger or acquisition, which do not qualify as combination, under the provisions of the Competition Act. However, the Commission, being the expert body ....., may consider taking cognizance of a merger or acquisition that do not qualify as a notifiable combination, and may take appropriate action within the framework of the Competition Act....*"[51]

Therefore, the CCI, as India's expert competition regulatory body, should retain a regulatory jurisdiction which enables them to take *suo moto* cognizance of combination which it prima facie believes to cause AAEC in the Indian markets. The source of this power can be traced to Section 18 of the Competition Act, which casts a statutory duty upon the CCI to "*eliminate practices having adverse effect on competition, promote and sustain competition, protect the interests of consumers, and ensure freedom of trade carried on by other participants, in markets in India*". Such a duty of the CCI necessarily carries with it the simultaneous right to regulate all practices/transactions which in the opinion of

51. Bose, Avirup (2014), "A Review Is Needed: Why India's Antitrust Regulator Should Scrutinize the Facebook-WhatsApp Merger", Competition Law Insight, (21-7-2019, 10:40 PM), <https://ssrn.com/abstract=2534732>.

the CCI causes or is capable of causing anti-competitive harm.[52] But this right to regulate is not legally recognised under the Act.

Currently, in China, the competition authority does not face this hurdle because the competition law legal regime has provided the authority with certain powers. Article 4 of the Provisions of the State Council on Notification Thresholds of Concentrations of Undertakings[53] states that where a concentration does not meet the required threshold, the Commission reserves the power to initiate an investigation in accordance with law and thus restrict competition.

There is a need for a similar enabling provision under the Indian competition law regime. This will allow CCI to take *suo moto* cognizance of those cases where mergers/ acquisitions do not meet the threshold requirements otherwise. This power can also solve the problem created by the *De Minimis* exception currently. This will ensure higher coverage of all concentration transactions and the chances of such a concentration causing AAEC post-merger will be minimal.

CONCLUSION

Big data, when processed with adequate processing power and a potent algorithm, can certainly be exploited in making huge chunks on profits. The big data held by enterprises is currently not a consideration in rendering a transaction notifiable. This needs to be reviewed as investments may not be very high as in the case of new technology companies. In such cases, the future potential will need to be estimated. Such a determination will require some sort of enabling framework as the system may not be equipped to deal with such eventualities.[54] Inclusion of big data in the purview of "asset" under Section 5 might not be the best way to deal with this situation as the companies cannot be considered as actual owners of this data and any such move will create many consumer protection and consumer privacy issues. Thus, considering the current legal framework across jurisdictions and legal research and recommendation

52. *Ibid.*
53. Decree of the State Council of the People's Republic of China No.529, 2008.
54. Karunjit Singh and Deepshikha Sikarwar, A liberal competition law in the works to facilitate M&As, *Economic Times*, (21-7-2019, 10:40 PM), <https://economictimes.indiatimes.com/news/economy/policy/a-liberal-competition-law-in-the-works-to-facilitate-mas/articleshow/69316407.cms>.

by different committees the authors conclude that the best way to deal with the new technology oriented market is to add transaction value as an additional ground for notification requirements for merger control.

Further there might arise a situation where a merger will not trigger the notification threshold mentioned in the Act as seen in the WhatsApp/ Facebook merger, but this shouldn't prohibit the CCI to analyse or scrutinise a particular transaction. The *De Minimis* exemption and Section 8(1) of the Combination Regulations, 2011, not only absolves big data possessing enterprises from notifying their M&A transactions to the CCI, but also incapacitates the CCI for scrutinising such transactions. Thus, it is undoubtedly reasonable to amend the law and entrust the CCI with such power so as to remove this incapacity.

Considering the dynamic nature of the digital market, the ability of the traditional factors under Section 19(3) of the Act to determine AAEC is limited. Thus, there is a need to introduce additional factors to determine the AAEC under the Act. After analysing the changes made in similar provisions of different jurisdictions across the world the authors feel that the recommended factors will address the new challenges raised by the digital markets and data driven mergers.

Measuring the Impact in Impact Investment

—*Ayushi Goel*† *and Aarvi Singh*‡

ABSTRACT

There is a saying money can buy everything but not happiness, but the same is being challenged by the good Samaritans fund called impact investment. It is an investment with "feel good factor" where the money collected from investors are utilised for social services, innovations etc. The dichotomy of social investment is that; it may seem lucrative of serving those who need it most but at the same time may become a potential mechanism to construct an image of a company; for example a drug manufacturing pouring chemicals in rivers may project its image by advertisement of being a social investor. Thus, the ethical, moral, financial and legal strands must be clearly sorted out and the investment must be able to make a change. Another problem with impact investment is the undefined meaning of impact and the yardstick to measure it. The risk is high in such investment as no one knows what the planning of the impact maker is and even if it is known how would that be implemented remains in murky water. A complete mechanism need to be placed for proper utilisation of money with an assurance of good returns to investors. The compliances need to be relaxed for investment and at the same time a regulatory mechanism needs to be created to supervise the influx and output of the fund. This paper explores the nuances of the impact investment as a nascent and upcoming industry in India, with special reference to measurement of impact and regulatory reforms. The future awaits to witness how Lockean investment would change the Hobbesian world.

Keywords: Impact Investment, Compliances, Regulatory mechanism, Impact measurement.

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INTRODUCTION

In his book[1], Yuval Noah Harari points out that one of the major ethical dilemmas of the modern man arises out of passive ignorance. He relates the following anecdote. The modern man of a first world country buys shares in a big corporation that promises a decent return. The corporation has its factory situated in a distant third world country, dumps toxic chemical waste into water-bodies, employs children for hazardous work, makes its employees work under inhuman working conditions, and lobbies against any strong environmental legislation. The question that Harari raises is, "whether the investor is morally complicit in the corporation's wrongdoings, despite not having malafide intentions himself". Harari concludes by saying that in the present century, "the greatest moral imperative is the imperative to know". He says, "there is something amiss with the intentions of those who do not make an honest effort to know". Ignorance cannot be a shield and one should make an honest effort to know where one's money is going. This brings us to our present discussion: impact investment. To the enlightened modern investor, financial return is as important as ensuring that any part of their portfolio is not invested in, say, "running sweatshops in a third-world country". Impact investment offers to the modern, informed-investor, the perfect blend of ensuring financial gains as well as making sure that it comes with reduced socio-environmental costs or with greater socio-environmental returns.

CHAPTER I: UNDERSTANDING IMPACT INVESTMENT

Meaning, Definition, and Contemporary Relevance

This article relies upon the definition of impact investment devised by the Global Impact Investment Network (GIIN) "impact investments are investments made into companies, organisations, and funds with the intention to generate social and environmental impact alongside a financial return. They can be made in both emerging and developed markets, and target a range of returns from below market to market rate, depending upon the circumstances."

1. Yuval Noah Harari, *21 Lessons for the 21st Century*, 183 (1st edn. 2018).

Impact investment is not a charity, there is a definitive aspect of expectation of financial returns, hence the word *investment*. However, it does have a social aspect, in that the kind of avenues the investment is going into, are socially or environmentally noble in some or the other way. Within the umbrella of impact investment, there are two broad types. One, investment with the expectation of market returns. Two, investment with the knowledge and acceptance of returns less than the market rate.

After improving its Ease of Doing Business Ranking, India is on a trajectory of rapid economic development. However, there still remains the socio-economic disparity and stark contrasts cutting across regions and sectors. India continues to have some of the worst socio-economic indicators in education, healthcare, livelihood, and sanitation. This is where the question of attracting more social and sustainable investment comes into picture.

The divide is sharp and yet, the strings are interconnected and any act in one part of the world will impact someone living in another part. The smokes of chimneys in US are submerging lands in Indonesia. The fate of humanity lies in preserving the planet and as a result the UN came with 2030 Agenda. The UN Agenda of 2030 for sustainable development included the 5Ps: People, Planet, Prosperity, Peace and Partnership[2] aims at a symbiotic existence of all forms of life on planet. The execution of this noble thought is slow but steady, one of the ways to achieve a balanced growth of combining industrial progression with ecological prosperity is the impact investment. Impact investment is basically a planned, stratified management of social, economic problems and not another method of addressing global issues. The term was first introduced to the world in 2007 by Rockfeller Foundation at Bellagio Center in Italy where the major focus was to create community consciousness in wealthy corporates.[3] The investor unlike philanthrope is interested in assured returns along with a fulfilment of social cause.[4] The reason why impact investment is likely to prosper in future is investor would be interested not

2. United Nations, Transforming Our World: The 2030 Agenda for Sustainable Development, available at, <https://sustainabledevelopment.un.org/post2015/transformingourworld>.
3. Anna Katharina Höchstädter and Barbara Scheck, "What's in a Name: An Analysis of Impact Investing Understandings by Academics and Practitioners", 132(2) Journal of Business Ethics, 449 – 475 (December, 2015).
4. Eric Thurman, "Performance Philanthropy", 28 HARV. INT'L REV. 18 (2006).

only in the return but also in outcome and thus, the supervision halo will continue to revolve around the investing structures.[5] In this investment structure, the risk is high and return is not always above expectations.

The issue with impact investment lies at three front: definitional, subject matter and measurement strategy. The word impact investment is often interchanged with social investment or socially responsible investment.[6] The term though used synonymous yet differ in their outcome and goal. Social investment focus is limited to the social issues whereas impact investment can also include investment in startups, ecological goals etc. Socially responsible investment is more corporate based structure where investment focuses on social issues in it the setup is like that of a firm.[7] The underlying problem with an undefined meaning is that it creates suspicion in the minds of investors.[8] The problem with subject matter is that what constitute the variables of impact is not clear and nor is the method to measure the impact still rating systems like Global Impact Investing Network, Impact Base and Total Social Impact are there to bring some uniformity in the system. These ratings are social metric system measuring potential investor's fund with stakeholders and outcome over the entire unit.

Avenues for Impact Investment

In India, there is huge potential for impact investment, 373 millions Indians live below the poverty line[9] and the nation continues to be ranked low in HDI index. In context of social investment, India is a ready market and any a well structured industry balancing financial investment with non-financial goals will work wonder. Besides these social problems multiple startups in various sectors like space (Dhruva

5. Amit Bouri, "How Standards Emerge: The Role of Investor Leadership in Realizing the Potential of IRIS", Innovations, 148 (Summer, 2011).
6. J.C. Short, T.W. Moss and G.T. Lumpkin, Research in Social Entrepreneurship: Past Contributions and Future Opportunities, 3(2) Strategic Entrepreneurship Journal, 161-194 (2009).
7. Stephen Dillenburg, Timothy Greene and Homer Erekson, "Approaching Socially Responsible Investment with a Comprehensive Ratings Scheme: Total Social Impact, 43(3) Journal of Business Ethics", 167 – 177 (March, 2003).
8. K. Harji and E. T. Jackson, "Accelerating Impact: Achievements, Challenges and What's Next in Building the Impact Investing Industry", 7 (New York, NY: The Rockefeller Foundation, 2012).
9. <http://www.in.undp.org/content/india/en/home/presscenter/pressreleases/2019-MPI-India.html>

Space, Aniara Space, Earth2Orbit, TeamIndus, Bellatrix Aerospace and Astrome Technologies)[10], food, hospitalities have begun and are desperately searching for investment. The government needs to create a friendly space for the investors and assure that that the mechanism functions smoothly.

The desirable avenues for impact investment are the initiatives that seek to tackle pressing local challenges through environmentally sustainable or socially inclusive models, or both. For example, a CNG-based taxi cab service with women drivers for female passengers.

Affordable healthcare is another desirable avenue. For example, an enterprise that provides affordable home nursing and caretaking solutions for the elderly and the differently-abled. This is especially important for a middle-class family where both the spouses are working. This solves the twin social problem of providing care for the elderly as well as reducing the trend of abandoning one's elderly to old-age homes.

Some other examples of desirable avenues include, affordable and eco-friendly housing.

Impact investment is a creative exercise is finding out the pressing social and environmental concerns, and underserved[11] communities or target populations and developing socially-inclusive models to address the same through accessible and affordable products and services. In the above example, the elderly of the middle-class is an example of an underserved community with very few products addressing these issues. A socially-inclusive model would perhaps include the skill development and vocational training of the local, unemployed youth, and then placing them in these households as caretakers.

CHAPTER II: IMPACT MEASUREMENT

Importance of Measuring Impact

Without a proper track record of performance, the Indian impact investment industry stands to lose out on a number of good investment

10. 7 Space Startups in India Reaching for the Stars, *Analytics India Magazine*, <https://www.analyticsindiamag.com/6-space-startups-india-reaching-stars/> (Jan, 2017)
11. Paul Brest and Kelly Born, "Unpacking the Impact in Impact Investing", SSIR (14-8-2013),<https://ssir.org/articles/entry/unpacking_the_impact_in_impact_investing> (last accessed 26-7-2019).

opportunities of high. Being a new industry, impact investors do not have access to well-curated data to point them towards good investment avenues, they are left to rely on their instincts, word-of-the-mouth, or other informal sources of information

Owing to the very nature of impact investment, it becomes difficult to fully assess its results.

Sometimes it may be difficult to categorise which indicators to give prominence while deciding whether a particular portfolio or initiative can be termed social–local communities often laud coal companies for job creation and affordable energy despite the loud protests of environmentalists.

Impact measurement is important in order to serve as a tool of due diligence for the future potential investors. AIF (Alternative Investment Funds) Regulations allow foreign impact investors to also invest in an India based fund. Now, it may so happen that the investor does not have reliable local networks to provide him with unbiased and accurate information necessary for conducting his due diligence. And, not every information is available on the internet. Therefore, a centralised impact measurement system under SEBI could be the panacea. If not, private agencies may take up the same.

With impact measurement, at the outset, it is important to realise that it is no one-dimensional activity. That, investors cannot simply look at, say, the performance of the investee company in the last three quarters and decide to invest. Impact measurement is more layered than that for the simple reason that human beings are not facts and figures. Social objectives come with varying social, political, regulatory risks and friction. Reducing re-offending rates may be a much more difficult task in districts that are plagued with poverty. Therefore, success of the same cannot be compared with a similar goal undertaken in say, a first world country.

What follows is only a part of an ongoing effort. Impact measurement is a much more comprehensive activity and requires a continuous development of tools and methodology.

Methodology for Measuring Impact

1. Setting a concrete goal: One of the primary reasons why impact investment does not attract a lot of investors is the absence of proper fixed indicators for measuring social change. For this, while setting up an impact fund with a set social goal, let the goal not just be an abstract ideal, but also quantify it at the very outset. To give an example, 2012 Peterborough Prison in the UK issued an SIB (Social Impact Bond) with the objective of reducing the re-offending rates of short-term prisoners. The goal was quantified in the following manner. The indicator chosen to measure impact was re-conviction rate of the prisoners released. In short, the abstract ideal needs to be converted into a mathematical equation with a proportionate (or inverse) relationship between the positive (or negative) indicator and the value of return accruing to the investors, so as to yield hard data that can then be used for measuring impact.
2. Choosing Impact Field: First and the foremost, it is for the investor to narrow down his chosen social or environmental field where he would like to create an impact. The next thing is to decide whether or not he is willing to accept less than market returns in pursuit of goals and the lock-in period.
3. Risk and Return Division: The next step towards impact measurement is to divide the study under two heads. One, risk measurement. Two, return measurement.
4. Categorisation: Identify different sectors in need of impact investment and categorise them in order of risk (social risks, political risks, economic risks, and regulatory risks). For this, data collection sources and strategies need to be looked into. For this, inspiration can be sought from Schedule VII of the Companies Act which lays down activities that can be contributed to as part of companies' CSR initiative. Inter alia, it includes[12], eradication of hunger, poverty, malnourishment, skill development, vocational training, women empowerment, animal welfare, and so on.

12. Paul Brest and Kelly Born, "Unpacking the Impact in Impact Investing", SSIR (14-8-2013),<https://ssir.org/articles/entry/unpacking_the_impact_in_impact_investing> (last accessed 26-7-2019).

5. Choosing Indicators: Collate the above data into ratings. For this, standardised indicators need to be chosen. These indicators can include, inter alia, success rate (percentage of goals achieved), divide the target space into units. These can be, people given employment, toilets constructed, families benefitted, etc. Then, see what was the cost per unit of social change. This will be the cost of creating impact per person or per family, and so on. Then the social costs being suffered be calculated and presented say, in terms of, security and dignity of women forced to relieve themselves in public. Then, if in the subjective opinion of the investor, the financial cost of creating impact is justified in view of the social costs and offset by the financial returns generated, then the investor can shortlist that and projects with similar goals and then compare and contrast them. This step may rightly be called the cost-benefit analysis, where ultimately the investor has to see if the social benefit the project is targeting is justified for the financial cost. If he agrees, he can go ahead and invest. If not, he may want to explore some alternative projects that offer a better cost-benefit ratio.
6. Factoring-in by-products: If there are any positive by-products[13] of the project, they go on the benefit side, if negative, they go on the cost side. E.g., the objective is to build say "x" number of toilets in a village, but it also results in employment of local labor.
7. Keeping the spirit intact: The next step is based upon the spirit of impact investment. In pursuit of one social or environmental objective, investors should not lose sight of other social and environmental factors. So, the next step is to factor in the social and environmental costs associated with the project itself minus its projected goals. To illustrate, this can include indicators like whether the enterprise pays the employees above minimum wage, whether there is a wage gap between the male and the female employees, and so on. The list is not exhaustive and can include many more indicators. The important thing to note is that, these indicators may be different from the goal itself but have social and environmental attributes to them. For this, the agency can make a comprehensive checklist postulating scenarios that usually occur in the course of

13. *Ibid.*

running an enterprise of a particular description. Based on these, the enterprise needs to be rated on an appropriate scale. This rating then needs to be looked at when doing a cost benefit analysis of the project and if it is negative then it offsets the benefit and if positive then it offsets the cost.

8. Due diligence: One form of impact measurement is pre-investment due diligence. This can include all the above steps.
9. Monitoring: A second form would be monitoring, where the investor keeps a continuous track of the detailed day to day operation of the enterprise to ensure that things are going well and if needed, actions can be taken in a timely fashion ranging from advisory to other depending upon what the terms of the contract lay down. The advantage is that it is preventive in nature and can stop the blunders or errors from happening. Not only that, it also provides the investor with valuable impact literature for which otherwise special post-op efforts will not have to be taken to collect.
10. Assessment: Another form of impact measurement takes the shape of assessment where the decision of re-investment is contingent upon whether the project delivered to their expectations. This should primarily involve the assessment of whether the concrete equation goal has been achieved at the end of the project or the time period or if the question is being asked at an earlier stage than proportionately so.
11. Removing the Impact Paradox: A paradox which may arise and needs to be guarded against is that, one should not just look at the goal and the intended outcome in the target population[14], they should also be on a lookout for any other factors that may have become active during the relevant period and brought about that outcome either partially or completely and directly or indirectly. These factors need to be accounted for and only the effective contribution of the project needs to be considered. For this, the agency should undertake a field study to run a few elementary checks like, whether a new welfare policy has been introduced during the same period, or another impact fund has become active in the same area, make questionnaires for the target population and ask them what

14. <https://ssir.org/articles/entry/unpacking_the_impact_in_impact_investing>.

all contributed towards achieving the goal in their opinion. If there is any other relevant factor that can be attributed to for the success, chances are that it will be revealed through these methods. Also, the agency can develop a more sophisticated methodology for the same.

12. Objectivity: Finally, the data collection will come through multiple sources but analysis should be done by an impartial third party platform or agency. Otherwise, there might be a fear of intentionally leaving out important details like simultaneous welfare scheme that became active during the same duration which had some contribution towards reaching the goal, albeit indirectly.
13. Affordability: There should also be an effort to make these services as affordable as can be. Investors will shy away from availing the same if the same turns out to be heavy on the pocket. There is no harm in these services being paid for, as the volume of effort that does into collecting, analysing data, and developing tools for the same needs to be rewarded. It is always better that the customers (prospective investors) pay for the services rather than funds and investees paying for it, in order to maintain the integrity and impartiality of the platform.

CHAPTER III: IMPACT INVESTMENT FROM A REGULATORY PERSPECTIVE

In India, the Alternative Investment Funds (AIF) Regulations, 2012 issued by the Securities and Exchange Board of India (SEBI) are the only specific piece of rules dealing exclusively with impact investment in India. According to the AIF Regulations, Indians, NRIs, or foreign investors are allowed to participate in impact investment.

The AIF Regulations are quite comprehensive and investor-friendly. To take an example, the AIF Regulations mandate that the manager or the sponsor of the fund should have a specified continuing interest in the fund. Notably, this continuing interest cannot be by way of waiver of management fee. This acts as a safety net for the investors by ensuring that the fund managers or sponsors do not act contrary to investor-interests.

The current regulatory mechanism is majorly a single window clearance system. Simplicity robustness, unity of regulatory authority is

desirable in any regulatory system as too many regulators spoil the fabled broth. However, there still remain certain areas that need some degree of improvement and consideration. The next section identifies such areas and suggests reforms.

Problematic Areas and Suggested Regulatory Reforms

1. The Government can consider easing the tax burden in order to make impact investment a lucrative option.
2. Incentivising operational engagement: Operational engagement[15] is when the investor brings not just financial but also human capital to the table. This can be in the form of technical expertise or general advisory. Not only does this make the investor more involved in the process, thereby protecting his interests indirectly but is also good for the investee-enterprise that stands to benefit from the expertise of seasoned financial professionals. This may be done through monetary exemptions. This will have the effect of incentivising the positive trend of investor involvement while not making it a rigid requirement under the regulations.
3. An appeal against an order rejecting application for registration under Rule 8 of AIF Rules should lie with the Securities Appellate Tribunal (SAT).
4. Minimum investment limit: Under the AIF Regulations, an investor is required to contribute a minimum of Rs. 1 Crore, with the only exception of angel fund, this minimum limit can be lowered to bring in more potential investors.
5. Technology Transfer: Allowing impact investment in the form of technology transfer can be considered and whatever be the mutually agreed upon valuation can be regarded as the monetary value of the impact investment. To this end, the government can consider revising the upper limit of outbound lump-sum payment at more than USD 2 million.[16]

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15. Paul Brest and Kelly Born, "Unpacking the Impact in Impact Investing", SSIR (14-8-2013), <https://ssir.org/articles/entry/unpacking_the_impact_in_impact_investing> (last accessed 26-7-2019).
16. Department for Promotion of Industry and Internal Trade, FAQs, <https://dipp.gov.in/investors/Investor%20Guidance/frequently-asked-questions>.

6. Impact Investment and CSR: A recent notification by the Ministry of Corporate Affairs amended the VII Schedule to the Companies Act, 2013. The amendment has broadened the scope of the Schedule by recognising Funds other than just PM Relief Fund for Disaster Relief. Similarly, there should be a provision within the CSR law allowing for impact investment to be counted towards CSR. As of now, the CSR policy of India does not count allow earning of profits from any activity taken under CSR. A possible solution to this could be an arrangement with mandatory re-investment of any surplus in same or different impact funds. Although, in spirit, this arrangement is not in violation of CSR norms, a provision explicitly allowing SIBs as part of the approved CSR method would not only clear the mist surrounding it but also introduce the concept of impact investment at a much larger scale.
7. Transparency: Potential investors do their research before investing. So, it does not bode well for the impact investment industry as a whole if the investors are not satisfied with what they see or how much they are able to access and see. The current routine disclosure requirement under AIF Rules should come with a penalty, in order to ensure strict compliance by funds and enterprises.
8. Some essential boilerplate clauses: Barring the AIF Rules, impact investment in India is largely regulated through contracts, be it between investors and fund, sponsors and fund, manager and fund, fund and investee, or investor and investee. Therefore, it is important to include some mandatory boilerplate clauses to protect interests of everyone and not let anyone be exploited owing to a lack of awareness. Impact investment is relatively new and the Indian investor is not very well-informed. Firstly, there must a mandatory requirement to have a contractual clause that addresses an eventuality where if there is a key change in the metrics of the goal, then what its relationship with the outcome will be or, whether such a decision is subject to a vote of say, 75% investors by value. Secondly, there must be a clause delineating whether the parties agree for the investee to have an external audit or allow the investor to inspect the books. Thirdly, an essential pre-determined clause as to the preferred exit strategy. For e.g., whether both the investor and the investee agree that selling the company, in the future,

may be a choice. Fourthly, clauses pertaining to repayment schedules. Some impact investors have come up with a "novel repayment model" that is more suited to the spirit of impact investment, instead of fixed repayment deadlines, the debtor pays if the returns cross a pre-determined level. So, the parties should pre-determine whether the investee will have the benefit of a relaxed amortisation schedule.

9. IPR and Impact Investment: Green innovations are those which either have a positive environmental effect or have a reduced environmental cost that the existing peer technology. Fast-tracking of green patent applications will have the effect of indirectly benefitting the case of environmental impact investment as any investor is drawn to a robust and efficient intellectual property regime.
10. Dispute Resolution: An efficient dispute resolution mechanism forms an important part of any industry to ensure that the failure of one project does not have spillover effects in the rest of the impact investment industry. Failure of an enterprise should not disgruntle the impact investors. An efficient, transparent, and predictable redressal mechanism is required so that the faith of the investor community in this nascent industry does not dwindle, while also making sure that project developers are not exploited either. In the case of debt-financing, if the project fails to deliver, issues like delayed repayment might give rise to disputes. Regulation 25 of the AIF Regulations provide that the parties may mutually decide upon the method of dispute resolution in advance. Should the parties decide to pursue litigation, it is important to set up separate AIF tribunals, as conventional judges may not be well-versed in the nuances of impact investment. It is important to ensure that there are experts on the tribunal so as to maintain the predictability of outcome and set a consistent line of jurisprudence in order to inspire the confidence of potential investors.

CONCLUSION

Doing good needs money just as it needs good intentions. Philanthropy has its limits because, firstly, it is too idealistic to hope that more and more people will give up their money in return for nothing. Secondly, it

is largely scattered and lacks direction. Consolidation of funds lying in various places is the foremost driver for social change. The larger the volume of investment, more concrete activities and initiatives taken, therefore, one has to look towards impact investment as an upcoming player for driving social and environmental change. In order to bring in greater capital and potential investors towards impact investment, it is important to clear the fog that surrounds impact investment. In order to do the impact investment industry needs to have a definitive structure, be clear on the definition of impact, its indicators, data collection and analysing mechanism, exit opportunities, and dispute resolution mechanism. It is important that investors perceive the impact investment industry with legitimacy. The faith of the investor community should not dwindle. An illustrative example of the same would be the chit fund finance companies, because of a few companies that eloped with investors' money, now investors look at the industry as a whole with suspicion.

Expectations of getting a market return may not be true for most impact ventures, so awareness regarding that needs to be spread amongst the prospective inspectors.

Impact investment is important for India particularly because not only does it bring in capital and resuscitates local industry and entrepreneurship, it brings in systemic development in socio-environmental sectors of the economy. It is not idealistic or desirable that the public sector be doing everything. The image of pre-liberalisation India, where the GoI was involved in everything from manufacturing cigarettes to running hotel chains is a painful one to conjure. So, impact investment is a welcome industry.

More importantly, impact measurement needs to develop alongside impact investment itself. Impact measurement is an integral part of the process and the impact investment industry along with all its stakeholders stands to gain from a stable, sophisticated, accessible, affordable, impartial, impact measurement agencies. Till date, philanthropy has not been able to put in place an assessment system[17] for gauging the actual social/environmental contributions of non-profits this is one of the reasons why philanthropy cannot fully tap into its potential of orchestrating

17. Paul Brest and Kelly Born, "Unpacking the Impact in Impact Investing", SSIR (14-8-2013), <https://ssir.org/articles/entry/unpacking_the_impact_in_impact_investing> (last accessed 26-7-2019).

scalable social change is because of an imperfect feedback system that does not allow the philanthropic capital from being contributed in a directed, pointed, and channelised way. Therefore, it is imperative for the impact investment industry to not meet the same fate.

The union between financial return with social result is thus a win-win situation.

Resolution of Financial Service Providers: Time for a "new deal"?

—Vedant Malpani† *and Srihari Gopal*‡

ABSTRACT

The paper delves into the need for an effective regime for resolution of financial institutions in India. The bankruptcy of Infrastructure Leasing and Financial Services Ltd. raised alarm regarding the lack of an effective regime for Financial Service Providers, which is becoming the need of the hour with the alarming rise of bad debts among financial institutions. In the first part of the paper, the authors seek to analyse the present regime for insolvency in India, namely the IBC and Schemes of Arrangement under the Companies Act. The text seeks to evaluate the potency of these regimes to deal with such insolvency, and study the FRDI Bill, which was India's failed attempt at introducing a separate regime to deal with financial insolvency. The FRDI Bill had received widespread criticism for its lack of safeguards for depositors as well as the controversial "Bail-in" clause.

Additionally, the text also analyses the international framework for a prospective financial insolvency regime provided by the Financial Stability Board, as implemented in Europe in the form of the Banking Resolution and Restructuring Directive (BRRD, and in the United States as the proposed Chapter 14 Bankruptcy. The authors aim to study some of the best practices which are implemented in these regimes, and discuss certain possible solutions which could be implemented in India.

Keywords: Insolvency, Financial Service Providers, FRDI Bill, Banking Resolution and Restructuring Directive, Chapter 14 Bankruptcy.

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INTRODUCTION

The year 2018 marked a decade since the fall of Lehman Brothers and the subsequent subprime mortgage crisis which saw the fall of the so called "*titans*" of the financial world. The crisis worsened because of the lack of a sound financial insolvency legal framework, resulting in financial institutions having to be bailed out through taxpayer's money. Ironically enough, 10 years later, India seems to be on the verge of a similar crisis, with the fall of the financial giant Infrastructure Leasing and Financial Service Ltd. (hereinafter "IL&FS"), which is now facing a whooping 90,000 crore debt. Still worse, India is as unprepared as it was back then to face the crisis, with the new Insolvency and Bankruptcy Code not having being applicable to financial firms like IL&FS.

This paper seeks to analyse possible recourses for insolvency and debt restructuring of financial firms under the existing regime i.e. through the Insolvency and Bankruptcy Code, 2016 (hereinafter "IBC") and the Companies Act, 2013. The paper then goes on to analyse the Financial Resolution and Depositors Insurance Bill, 2017 (hereinafter "FRDI Bill") a failed attempt made by India to introduce an exclusive regime for the resolution of financial firms. Lastly, we also seek to analyse the different resolution regimes across the world and come up with the possible recommendations from practices globally which can be incorporated in the proposed legal framework for debt restructuring and insolvency of financial firms in India.

RESOLUTION REGIMES IN INDIA: IBC AND SCHEMES OF ARRANGEMENT

A. Insolvency and Bankruptcy Code

Prior to the enactment of the IBC there existed several statutory instruments for the insolvency resolution process in India. These included the Sick Industries Act, 1985, Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, Recovery of Debt Due to Banks and Financial Institutions Act, 1993 and the Companies Act, 2013. The numerous statutory instruments provided for a disparate mechanism of debt restructuring, asset seizure and realisation of outstanding debts which led to immense confusion in the legal system and

there was an urgent need of an overhaul.[1] The IBC was thus enacted to address the lacunae of a legal framework to deal with bankruptcy and provide a consolidated law for insolvency and bankruptcy of companies, partnerships and individuals in a time bound manner.[2] Although IBC was deemed to be a consolidated law, it excluded its applicability to financial service providers like Banks, Insurance Companies, Stock Exchanges and Non-Banking Financial Companies (hereinafter "NBFC").[3]

The Insolvency process under the IBC can be triggered by filing an application under Section 7 of the IBC by the financial creditor before the National Companies Law Tribunal (hereinafter "NCLT"). Thus in order to trigger the insolvency process under the code, the corporate debtor needs to fall under the definition of a corporate person as defined under IBC.[4] Under the definition of a corporate person, the drafters of IBC had intentionally provided for the exclusion of financial service providers from coming under the purview of the code. This exclusion was made on the basis of a report of the Financial Sector Legislative Reforms Commission (hereinafter "FSLRC") which made recommendations for the failure of financial firms in the then proposed Indian Financial Code, 2013.[5] The Commission recommended that financial service providers are deemed to be systemically important and hence should be subject to a micro-prudential regulation and thus suggested to establish a Resolution Corporation. The rationale, scope and extent of micro-prudential regulation are primarily motivated by consumer protection. The obligations owed by certain financial service providers have an adverse impact on the consumers. For example, if bank deposits are lost due to a bank failure it will adversely impact consumers whose savings are with the bank. If a "Too Big To Fail" financial service provider fails, it will adversely impact the entire financial system and the economy. This combination of harsh consequences of failure, problems limiting self-regulation, the ability of

1. Nishith Desai Associates, A Primer on Insolvency and Bankruptcy Code, 2016, (19-7-2019, 22:48 PM), <http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research_Papers/A-Primer-on-the-Insolvency-and-Bankruptcy-Code.pdf>.
2. Insolvency and Bankruptcy Code, 2016 (31 of 2016), S. 2, Acts of Parliament (India).
3. Insolvency and Bankruptcy Code, 2016 (31 of 2016), S. 3 (7), Acts of Parliament, (India); Ministry of Finance, 2016-17, The Financial Bill, Budget Speech by Arun Jaitley (29-2-2016), <https://www.indiabudget.gov.in/budget2016-2017/ub2016-17/bs/bs.pdf>.
4. Insolvency and Bankruptcy Code, 2016 (31 of 2016), S. 3 (7), Acts of Parliament, 2016 (India).
5. Sikha Bansal, "NBFCs and IBC: The Lost Connection", (11-10-2018), <https://barandbench.com/nbfcs-and-ibc-the-lost-connection/>.

markets to ensure safety and soundness and inherent difficulty of fulfilling certain obligations, creates a case for regulation organised around securing the safety and soundness of certain financial service providers.[6] Thus the drafters of the IBC envisioned a comprehensive legal framework as suggested by Justice Sri Krishna's FSLRC for the failure of a financial service provider and hence excluded financial service providers from the ambit of the IBC.[7]

Although financial service providers do not fall under the purview of the IBC, the Central Government has the power to formulate rules and notify a financial service provider to be referred for resolution of insolvency under the IBC.[8] The Government failed to invoke the power given under Section 227 of the IBC and put IL&FS which is a financial service provider under the procedure under the IBC.[9] Companies which are subsidiaries of a financial service providers but do not provide financial services should be able to avail the provisions of IBC and should be disjointed from the holding company in cases of group insolvencies. Thus, in light of the above there is an urgent requirement to have a comprehensive framework for resolving group insolvencies in India.[10]

At this juncture therefore, it is imperative to determine who is a "financial service provider" and what constitutes a "financial service". A financial service provider as defined under the IBC is a person engaged in the business of providing financial services in terms of authorisation issued or registration granted by a financial sector regulator, like the RBI, SEBI, IRDAI etc.[11] Thus, a financial service provider must be the one that provides financial services as well as be regulated by or registered

6. Government of India, Report of the Financial Sector Legislative Reforms Committee, Analysis and Recommendations, 1, (2013), <https://ibbi.gov.in/uploads/resources/March%202013,%20Report%20of%20the%20Financial%20Sector%20Legislative%20Reforms%20Commission%20-%20Vol%20I.pdf>.
7. Government of India, Report of Bankruptcy Law Reforms Committee, Rationale and Design, 1, (2013) <https://ibbi.gov.in/uploads/resources/BLRCReportVol1_04112015.pdf>.
8. Insolvency and Bankruptcy Code, 2016 (31 of 2016), S. 227, Acts of Parliament (India).
9. Manaswi Agarwal, Aayush Mitruka, "Resolving IL&FS: Desperate times call Desperate Measures" (5-7-2019, 9:30 PM), <https://indiacorplaw.in/2018/10/resolving-ilfs-desperate-times-call-desperate-measures.html>.
10. *Ibid.*
11. Insolvency and Bankruptcy Code, 2016 (31 of 2016), S. 3 (17), Acts of Parliament (India).

by a financial sector regulator.[12] A financial service as provided under the IBC includes services such as accepting of deposits, safe guarding and administering assets consisting of financial products, operating investment schemes and providing credit facilities.[13] The definition of financial services is not exhaustive in nature and the rule of "*ejusdem generic*" shall apply.[14]

The NCLAT in its recent ruling in the case of *HDFC Ltd.* v. *RHC Holdings*[15] held that Non-Banking Financial Corporation fall under the ambit of financial service providers and are hence beyond the jurisdiction of the IBC. The Tribunal placed reliance on its previous decision in *Randhiraj Thakur* v. *Jindal Saxena Financial Services Private Limited*[16] which held that since the Appellant Company was an NBFC it would be outside the purview of the IBC as the code is a self-contained code which is exhaustive in nature when it comes to re-organisation and insolvency resolution. Since an exception has been carved out while enacting the code, NBFC being financial service providers kept out of the purview of the IBC.[17]

Since there was a lacuna in the legal framework to resolve insolvency of financial firms, a Committee entrusted with the task to propose a legal framework submitted the Draft Financial Resolution and Deposit Insurance Bill, 2016 to regulate financial service providers. The FRDI Bill was expected to provide a comprehensive resolution framework to deal with bankruptcy situations in the financial sector entities. However, The Joint Parliamentary Committee withdrew the FRDI Bill due to apprehensions raised by stake holders concerning provisions like the bail-in instrument and the adequacy of deposit insurance cover.[18]

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12. Megha Mittal, "State of Perplexity- Applicability of IBC on NBFCs, IBC acts as an invisible shield for NBFCs classified as FSPs" (5-7-2019, 10:28 PM), <http://vinodkothari.com/wp-content/uploads/2019/01/Article-FSPs-and-NBFCs.pdf>.
13. Insolvency and Bankruptcy Code, 2016 (31 of 2016), S. 3 (16), Acts of Parliament (India).
14. Sikha Bansal, "NBFCs and IBC: The Lost Connection", (5-7-2019, 11:09 PM), <https://barandbench.com/nbfcs-and-ibc-the-lost-connection/>.
15. *Housing Development and Finance Corporation* v. *RHC Holdings Pvt. Ltd.*, 2019 SCC OnLine NCLAT 398.
16. *Randhiraj Thakur* v. *Jindal Saxena Financial Services Pvt. Ltd.*, (2018) SCC Online NCLAT 743.
17. *Ibid.*
18. Remya Nair, Govt. withdraws FRDI Bill in Parliament following backlash, (7-8-2018, 11:47 PM), <https://www.livemint.com/Industry/Ff29jhSKgcOxZkjkipHY5K/Govt-withdraws-FRDI-Bill-from-Lok Sabha.html> .

B. Schemes of Arrangement Mechanism

Sections 230 to 232 of the Companies Act, 2013 provides for Schemes of Arrangements and compromises between a company and its creditors and shareholders. Historically these provisions have rarely been used by the Government for debt restructuring and has been mostly used for corporate restructuring.[19] The few instances when the Government has used this route is to address the problem of failure of various private sector banks which were compulsorily amalgamated with PSB's to protect the interest of depositors. A few instances when such cases have occurred is when Benares State Bank (BSBL) amalgamated with Bank of Baroda on 19 June, 2002; and United Western Bank amalgamated with Industrial Development Bank of India (IDBI) on 3 October, 2006. Only one commercial bank has faced liquidation, the Bank of Karad in 1992.[20]

Section 230 of the Companies Act, 2013 provides for an arrangement or a compromise between a company and its creditors. An application for such a compromise or arrangement has to be made by the company or any of its creditors or a member of the company to the NCLT. This application which contains the scheme of debt restructuring has to be approved by not less than 75 per cent of the secured creditors in value. Once a scheme is approved by the statutory majority, it becomes binding on the dissenting minority.[21]

Although corporate debt restructuring is a tedious process with a lot of procedural hurdles, it is an appropriate route for companies as complex as IL&FS. Under this route equity rights of the shareholders are maintained as compared to insolvency where the firm equity is worth nothing, and the scheme also offers a flexible multi-faceted revival plan, which is customised to the need of the company undergoing debt restructuring. Unlike IBC, Section 230 does not require a default to be committed by a corporate debtor to trigger it. Thus, this would allow group entities with healthy companies also to be a part of it if need be.

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19. Manaswi Agarwal, Aayush Mitruka, "Resolving IL&FS: IBC vs Schemes of Arrangement" (5-7-2019, 9:30 PM), <https://indiacorplaw.in/2018/10/resolving-ilfs-ibc-vs-schemes-arrangement.html>.
20. Prasenjit Bose, "FRDI Bill 2017: Inducing Financial Instability" (27-12-2017), <https://www.epw.in/engage/article/frdi-bill-2017-issues-and-concerns>.
21. ITW Signode India P. Ltd, In re, 2004 SCC OnLine AP 258: [2004] 121 Comp Cas 66 (AP).

As Schemes of Arrangement is the only alternative available, it has also been widely criticised due to the onerous procedural requirements, lack of fixed timeline causing long delays and lack of an explicit provision for a moratorium period during the pendency of the scheme petition before the NCLT. Thus as this mechanism is not adequate and efficient enough to provide a robust mechanism to solve the problem of corporate debt restructuring of financial institutions, we need a comprehensive exclusive framework like the FRDI Bill.

THE FRDI BILL

The FRDI Bill was the first of its kind initiative by the Government of India, which sought to establish a separate resolution regime exclusively for resolution of financial institutions. The FRDI Bill, which was introduced in the monsoon session of the Lok Sabha in 2017, sought to establish a resolution corporation, which would monitor risk faced by financial firms, resolve them in case of failures, act as a liquidator for financial institutions and provide deposit insurance, among other functions.[22] The FRDI Bill was a consolidated legislation with the best global practices and introduced concepts such as bail-in provision, bridge service providers and formulation of a central resolution corporation, which had never been used by the Indian banking system. While the bill was a progressive step towards filling in the lacuna in the legal system for coping with the bankruptcy of financial firms, it raised many apprehensions in the minds of depositors because of the vaguely explained bail-in clause. Due to widespread public outcry, the Government had to withdraw the bill in August, 2018.[23]

22. Financial Resolution and Deposit Insurance Bill, 2017, S. 13, Bill No. 165 Acts of Parliament, 2017 (India).
23. *ET Online*, "The Bill that Spooked bank customers across India has been withdrawn" (7-8-2018, 01:59 PM), <https://economictimes.indiatimes.com/industry/banking/finance/banking/the-bill-that-spooked-bank-customers-across-india-has-been-withdrawn/articleshow/65304709.cms?from=mdr>.

A. Salient features of the bill.

(*i*) *Applicability*

The FRDI Bill is applicable to all financial service providers, i.e. Covered Service Providers and Insured Service Providers.[24] Covered Service Providers under the bill include financial market infrastructure institutions, banking institutions insurance service providers, and other financial institutions such as systemically important financial institutions.[25] Insured Service Providers on the other hand include banks to whom deposit insurance coverage is given. The Financial Resolution and Deposit Insurance Corporation (hereinafter "FRDIC") should compulsorily extend deposit insurance to all banks by registering them as Insured Service Provider.[26] The scope of applicability of the bill to branches of foreign financial firms which are incorporated outside India but are carrying out the business of providing financial service in India was limited as due to the transactional and infrastructural hurdles faced due to cross border insolvencies.[27]

(*ii*) *Establishment of an independent FRDIC*

The bill provided for the creation of a Resolution Corporation[28] which would be responsible for the overall resolution regime of all the financial firms which are at the verge of bankruptcy. The main function of the Resolution Corporation includes providing for depositors insurance, assessing risk and viability of financial institutions and act as a liquidator among others.[29]

(*iii*) *Assessing and classification of risk*

As adopted by countries globally, the FRDI Bill proposed a preventive approach rather than a curative approach. The resolution and restoration

24. Dept. of Economic Affairs Ministry of Finance, Report of the committee to Draft Code on Resolution of Financial Firms, 23 (2016), <https://dea.gov.in/sites/default/files/report_rc_sept21_1.pdf>.
25. *Ibid*.
26. *Ibid*.
27. *Ibid*.
28. Financial Resolution and Deposit Insurance Bill, 2017, S. 3(1), Bill No. 165, Acts of Parliament, 2017 (India).
29. *Ibid*.

plan depended on how severe the risk is to the viability of the service providers. Thus for assessing the risk, certain classifications were made, ranging from critical risk to viability being the highest to low the risk to viability being the lowest.[30]

(*iv*) *Introduction of Resolution tools*

The present mechanism for resolution of banking institutions in India allows for limited scope to initiate pre-insolvency measures backed by the legislation. The FRDI Bill provided for the contents of the restoration plans and stated the steps and strategy to restore the financial condition of the Covered Service Providers in the case of the restoration plans and exit from the resolution process. The main aim of the bill was to ensure that the services of the firm are not obstructed but is shared with the successor entity or bridge banks.[31] Thus keeping in line with the procedures being used globally the bill provided for the following tools of resolution—[32]

a. Transfer of whole or part of assets and liabilities of the Covered Service Provider to the FRDIC;

b. Creating a bridge institution;

c. Bail-in;

d. Amalgamation/Merger/Acquisition of the Covered Service Provider; and

e. Liquidation.

The key principle that should be used while choosing a specific resolution tool should be that no creditor should be left in a worse off position than they would have been, had the entire firm been placed in liquidation.[33]

30. Financial Resolution and Deposit Insurance Bill, 2017, S. 36 (5), Bill No. 165, Acts of Parliament, 2017 (India).
31. Rutuja Deshpande, Banking Institutions Insolvency Regime in India- A Glance at the Financial Resolution and Deposit Insurance Bill, *2017*, 3 Int'l J. of Law and Management Studies, (2011).
32. Financial Resolution and Deposit Insurance Bill, 2017, S. 48 (1), Bill No. 165 Acts of Parliament, 2017 (India).
33. Financial Resolution and Deposit Insurance Bill, 2017, S. 55 (1), Bill No. 165 Acts of Parliament, 2017 (India).

B. Why the Bill failed? The Bail-In provision

Upon its introduction in the parliament, the FRDI Bill faced huge outcry, primarily due to the inclusion of the bail-in provision. The bail-in clause, which allowed the Resolution Corporation to cancel, modify or change the nature of a liability owed by a failing bank, thereby allowing the complete undercut liability owed to depositors.[34] This raised an alarm among depositors, who felt that there were no adequate safeguards for depositors in this system.[35] The bill was therefore withdrawn, leaving the lacuna of law in this area still open.

While the lack of safeguards against bail-in was of concern, there were other far more alarming inadequacies in the FRDI Bill. With the IL&FS crisis pointing out the dire need for a resolution regime, substantial changes were to be made to the FRDI Bill if it was to be reintroduced as a viable system. Before going in detail into the inadequacies in the FRDI Bill and alternatives however, it would be relevant to look up the origins of the modern resolution systems and resolution regimes around the world.

RESOLUTION REGIMES AROUND THE WORLD

The sub-prime mortgage crisis of 2008 revealed the lacuna in the law of resolution for financial entities. The so called "Too Big to Fail" Financial Institutions had to be bailed out of insolvency by tax payers, through the notorious "Bail Out" schemes.[36] Following the subsequent international outcry, there was a call for regulations to reduce the likelihood and impact of failure of such financial institutions.

An important development occurred when the Financial Stability Board, which was established in 2009 London summit of the G-20, released a report titled *Key Attributes of Effective Resolution Regimes*

34. Financial Resolution and Deposit Insurance Bill, 2017, S. 52, Bill No. 165 Acts of Parliament, 2017 (India).
35. Shaji Vikraman, "FRDI Bill: Understanding the basis of bail-in and Depositors fear", (11-12-2017, 09:49 AM), <https://indianexpress.com/article/explained/frdi-bill-understanding-the-basis-of-bail-in-and-depositors-fear-4977004/>.
36. Rachelle Younglai, Kim Dixon, "Lehman's Fuld: Where was our bailout?" (6-10-2008, 7:55 PM), <https://www.reuters.com/article/us-financial-lehman/lehmans-fuld-where-was-our-bailout-idUSTRE4954DL20081006>.

for Financial Institutions, which aimed at providing a new harmonised international standard for resolution regimes for financial institutions. The Key Attributes, which focussed on Too Big To Fail Banks, was endorsed by the G-20 in 2011, and was subsequently used by States, including India, while formulating their domestic financial resolutions legislations.

The Key Attributes, which were 12 in number, significantly emphasised on the establishment of a Resolution Authority, which was to be a statutory body with operational independence[37], with a mandate to pursue financial stability and continue critical economic functions.[38] The attributes also provided for implementation of various "resolution tools", which included establishment of a "bridge institution" to temporarily carry out the functions of the failed firm[39], and the controversial "bail-in"[40], among others.

The Key Attributes played a major role in the drafting of the Banking Recovery and Resolution Directive (hereinafter "BRRD") in Europe and has also been significantly reflected in the proposed Chapter 14 insolvency regime in the United States. Furthermore, the committee which drafted the FRDI Bill emphasised on the standards laid down in the Key Attributes Report as being a major source while drafting the FRDI Bill.

However, even though the BRRD was passed, and Chapter 14 has gained widespread bipartisan support, the FRDI regime failed, despite all three systems proposing similar tools of resolution. Therefore, we seek to analyse the reason for failure by looking at other regimes, and proposing certain ways in which the issues with the FRDI Bill could be resolved.

37. Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2.5 (2014), <https://www.fsb.org/wp-content/uploads/r_111104cc.pdf>.
38. Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, 2.3 (2014), <https://www.fsb.org/wp-content/uploads/r_111104cc.pdf>.
39. Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions 3.2(vii) (2014), <https://www.fsb.org/wp-content/uploads/r_111104cc.pdf>.
40. Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions 3.5 (2014), <https://www.fsb.org/wp-content/uploads/r_111104cc.pdf>.

A. Insolvency Regime in Europe

(*i*) *Introduction*

The insolvency regime in Europe is governed by the BRRD. The BRRD has presented itself to be a robust mechanism, especially after it has been fully transposed into the domestic regimes of all States in 2018.[41]

The key elements that the BRRD mechanism regulated are:

1. Recovery and resolution planning;
2. early intervention measures made by the supervisor;
3. the application of resolution tools and powers in the event of an actual bank failure; and
4. cooperation and coordination between national authorities.[42]

These tools are used in the execution of the Single Resolution Mechanisms (hereinafter "SRM").

The primary authority for resolution under the BRRD is the Single Resolution Board (hereinafter "SRB"), which ensures the functioning of the Single Resolution Mechanism of insolvency and has been granted centralised decision making power in respect of resolutions. The SRB derives its power from the BRRD as well as the Single Resolution Mechanism Regulation. The SRB closely works with National Resolution Authorities of member countries, which carries out a multitude of functions like exercising jurisdiction over banks not directly under the SRB, comply with SRB instructions, and refer cases to the SRB whenever it requires the latter's assistance.[43]

The BRRD has provided for five "resolution tools" for the SRB's perusal:

(*a*) Sale of business tool: Allows for a transfer of shares, assets, rights and liabilities of the institution under resolution to a purchaser

41. Report from the Commission to the European Parliament and the Council: on the Application and review of directive on Bank Recovery and Resolution Directive and Single Resolution Mechanism Regulation, at (30-4-2019), <https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190430-report-bank-recovery-resolution_en.pdf>.
42. Single Resolution Board, "Resolution Q&A", <https://srb.europa.eu/en/content/resolution-qa> (last Visited 7-7-2019)
43. *Ibid*.

"on commercial terms", having regard to the circumstances of the case.[44]

(*b*) Bridge institution tool: It allows a temporary transfer of shares, assets, rights and liabilities to a publicly owned bridge bank, in an effort to continue the bank's critical functions[45]

(*c*) Asset separation tool: Under this tool, rights and liabilities are transferred to an asset management vehicle.[46]

(*d*) Bail-in: This tool allows the resolution authority to allocate incurred losses to owners and debt holders of the institutions. Through this measure, interests of existing shareholders are cancelled, diluted or transferred, and claims of unsecured creditors are written down or converted into equity to recapitalise the firm.[47]

(*ii*) *Safeguards*

The BRRD is widely considered as a depositor friendly regime due to provisions for extensive safeguards. For example, the *"no creditors worse off"* principle provided for in the key attributes[48] states that in application of any resolution tool the creditor should not be left in a worse off position than if the liquidation happened. The BRRD provides for the appointment of an independent person by the member States to determine what creditors would have gained had insolvency happened (keeping the date of receiving the communication from competent authority as the reference date) and set it off against what the creditors have actually gained through the said proceedings.[49] In case it is revealed that the amount gained through liquidation is higher, the shareholder or creditor is entitled to get the payment of difference from the resolution financing arrangements.[50] Further, special arrangements such as security arrangements, financial collaterals, set off and netting agreements[51] are protected during the resolution procedure.

44. Council Directive 2014/59/EU, Art. 38, 2014 OJ (L 173) 190, 348 (EC).
45. Council Directive 2014/59/EU, Art. 40, 2014 OJ (L 173) 190, 348 (EC).
46. Council Directive 2014/59/EU, Art. 42, 2014 OJ (L 173) 190, 348 (EC).
47. Council Directive 2014/59/EU, Art. 43, 2014 OJ (L 173) 190, 348 (EC).
48. Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, P. 5.3 (1st edn. 2014).
49. Council Directive 2014/59/EU, Art. 74, 2014 OJ (L 173) 190,348 (EC).
50. Council Directive 2014/59/EU, Art. 75, 2014 OJ (L 173) 190,348 (EC).
51. Council Directive 2014/59/EU, Art. 77, 2014 OJ (L 173) 190,348 (EC).

Another important aspect of BRRD is the emphasis on the business reorganisation plan.[52] Management of banking institutions have to submit a business reorganisation plan, which provides a detailed diagnosis of the factors that resulted in the crisis/failure, a description of measures aiming to restore the long term viability of the institution, and a timetable of those measures which are to be adopted, and a timetable for implementation of those measures. This plan has to be submitted within one month of application of the bail-in tool.[53] The plan will be assessed by the resolution authority, who will either approve or reject it and send it back to the relevant authorities with amends.

Re-organisation plans like these play an important role in restoring investor and depositor confidence, when the institution resumes its normal functioning.

(*iii*) *Contributed Single Resolution Fund: A unique feature*

The European Regime ensures the ready availability of funds for resolution at all times through the Single Resolution Fund (hereinafter "SRF"), which is a separate resolution fund aside from depositors insurance. Established by the SRM Regulation with an objective of ensuring a uniform practice of financing resolutions, the SRF is owned by the Single Resolution Board.[54] The fund pools in contributions raised from institutions in each of the member States within the Banking Union.[55] The fund, will only be used for the effective application of the resolution tools,[56] and only to fulfil "resolution objectives" provided for under the regulation, i.e. ensuring the continuity of critical functions, avoiding significant adverse effects on financial stability, protecting public funds by minimising reliance on extraordinary public financial support and protecting depositors and investors.[57] The SRM regulation provides for a target of reaching at least 1 per cent of the amount of covered deposits of all authorised credit institutions within eight years from 1 January 2016.[58]

52. Council Directive 2014/59/EU, Art. 52, 2014 OJ (L 173) 190,348 (EC).
53. *Ibid*
54. Commission Regulation 806/2014, 2014 OJ L (225) 1-90.
55. Commission Regulation 806/2014, Art. 67, 2014 OJ L (225) 1-90.
56. *Ibid*
57. Commission Regulation 806/2014, Art. 14, 2014 OJ L (225) 1-90.
58. Commission Regulation 806/2014, Art. 14, 2014 OJ L (225) 1-90.

Separate resolution funds such as the SRF is useful in dealing with systemic risks and contingencies and could serve as a multitude of functions, such as protecting uninsured creditors, preserving financial stability of bank during resolution, and most importantly, ensuring depositors confidence in financial institutions.[59]

While the phenomenon of separate contributed resolution funds is relatively new, the concept is steadily gaining traction and has been implemented by States in different ways in their resolution mechanisms.[60]

B. Resolution regime in the United States of America

(*i*) *The Dodd Frank Act*

Resolution regime for financial institutions is regulated by the Dodd Frank Act, which was introduced post the 2007-08 global financial crisis.[61] Prior to this, there was no formal resolution regime for insolvency of financial firms, as the US Bankruptcy Code, which is primarily used for resolving companies did not extend to such institutions.[62] The recourse available was conservatorship, which is an administrative non-judicial regime aimed at protecting the federally insured deposits of a failed institution through preservation of its assets, and receivership, which is liquidating the institution as a receiver governed by the Federal Deposit Insurance Corporation (hereinafter "FDIC").[63]

The Dodd Frank Act establishes a new resolution regime for financial firms, called the Orderly Liquidation Authority (hereinafter "OLA"). Being an administrative regime similar to that of the Conservatorship/Receivership model, the OLA is also governed by the FDIC. The act provides for orderly liquidation where a company is placed under the receivership of the FDIC based on a determination of default/danger of default

59. Oana M Croitoru, Marc C Dobler, Johan Molin, Resolution Funding: Who Pays When Financial Institutions Fail? , International Monetary Fund, (30-6-2019, 6:30 PM), <https://www.imf.org/en/Publications/TNM/Issues/2018/08/16/Resolution-Funding-Who-Pays-When-Financial-Institutions-Fail-46124>.
60. *Ibid*
61. Baird Weber, "The Dodd-Frank Wall Street Reform and Consumer Protection Act: Background and Summary", 1, (2017), <https://fas.org/sgp/crs/misc/R41350.pdf>.
62. 11 USC S. 109 (2017).
63. David H. Carpenter, Insolvency of Systemically Significant Financial Companies (SSFCs): Bankruptcy vs. Conservatorship/Receivership, 1, (2010), <https://www.everycrsreport.com/files/20100114_R40530_cf61545f09e94be0d813ccf35e370c3f108c8623.pdf>.

and the risks involved.[64] As a receiver, the FDIC takes on various duties such as creating of bridge financial organisations that can help assume assets or liabilities during liquidation, approving claims of the company, and transferring and selling assets.[65] The liquidation process is financed through the Orderly Liquidation Fund, a fund designated for the said purpose.[66]

The Dodd Frank Act, however, has garnered criticism over the years, most recently from President Trump, who through a memorandum had directed the treasury to examine the OLA. In the said report, the treasury criticised the OLA, stating that it gives "far too many administrative discretions granted to bail out creditors, thereby running the risk of ruining market discipline".[67]

The treasury in turn recommended the enactment of a new robust resolution regime, in an effort to restrict the scope of functioning of OLA and ensuring that the OLA would be used only as an emergency tool.[68] Further, in line with their new "bankruptcy first approach", they recommended the passage of the proposed "Chapter 14" bankruptcy.

(*ii*) *Chapter 14 Bankruptcy: Emphasis on need for judicial oversight*

Due to the criticism of the Dodd Frank Act, multiple Senate proposals were made for resolution of financial firms, all of which were substantially similar to those proposed for in a Chapter 14 Bankruptcy.[69] However, unlike some of these proposals, Chapter 14 does not seek to remove the OLA under the Dodd Frank Act completely, but rather wanted it to remain as a less viable alternative, which regulators can choose to use, if they require.[70]

In terms of resolution, Chapter 14 proposes for resolution of banks through the Single Point of Entry system, whereby only the top institution

64. 12 USC S. 5383 (2017).
65. 12 USC S. 5390 (2017).
66. *Ibid*.
67. US Dept. of Treasury, Orderly Liquidation Authority and Bankruptcy Reform, 2017, 1, (2017), <https://home.treasury.gov/sites/default/files/2018-02/OLA_REPORT.pdf>.
68. *Ibid*.
69. US Dept. of Treasury, Orderly Liquidation Authority and Bankruptcy Reform, 2017, 46, (2017), <https://home.treasury.gov/sites/default/files/2018-02/OLA_REPORT.pdf>.
70. Ryan Roessner, "Senate Judiciary Committee Hearing on Bankruptcy for Banks and Proposed Chapter 14", Harvard Law School Bankruptcy Roundtable, (22-6-2019, 6:30 PM), <http://blogs.harvard.edu/bankruptcyroundtable/tag/chapter-14/>.

would undergo bankruptcy, while the subsidiary companies would continue to operate normally and would be transferred to a debt-free company.[71] The main company would then be resolved with the losses being incurred by the creditors. It further propagates a two-entity recapitalisation model, whereby a financial company could file for bankruptcy and within 48 hours, transfer its assets and liabilities to a debt free bridge company. The asset to be transferred to the bridge company includes the ownership interests of operating subsidiaries, which in turn allows these entities to continue their operations. The FDIC, Federal Reserve, OCC, Commodity Futures Trading Commission and the SEC would have the authority to hear any issue regarding the Chapter 14 bankruptcy case.[72] The law also allows some of these regulators to initiate bankruptcy proceedings if certain conditions are met.[73]

Chapter 14 further requires a number of findings by the judiciary before a transfer to a bridge company can be made, specifically as to the necessity and impact of the transfer on the financial stability in the United States. The judges presiding over such cases are required to have knowledge of bankruptcy law,[74] and are to be "designated" for a particular case up to the point of transfer of assets.

An important aspect of the Chapter 14 bankruptcy is the emphasis on judicial review. The transfer of a company to a newly created bridge company cannot happen unless a court conducts a hearing and makes certain determinations based on evidence.[75] The court must allow transfer only upon satisfaction of various determinations, such as that of serious adverse effects, that the bridge company would be able to satisfy the debts of the company, and that the transfer does not provide any assumption of any capital structure debt by the bridge company.[76] Such oversight ensures that the resolution process happens smoothly and also provides stakeholders with an opportunity to challenge any arbitrary transfers.

71. *Ibid.*
72. Financial Institutions Businesses Act of 2017 S. 4, 11 USC S. 1184 (proposed).
73. Financial Institutions Businesses Act of 2017 S. 4, 11 USC S. 1403(a) (proposed).
74. Taxpayer Protection and Responsible Resolution Act of 2015 S. 4, 28 USC S. 298; Financial Institutions Businesses Act of 2017 S. 4, 28 USC S. 298 (proposed); Financial CHOICE Act of 2017 S. 123, 28 USC S. 298 (proposed).
75. Financial CHOICE Act of 2017, S. 122, 28 USC S. 1185(a), (c) (proposed).
76. Financial CHOICE Act of 2017, S. 122, 28 USC S. 1185(c) (proposed).

Even though Chapter 14 has not been implemented in the US, it has currently passed the House of Representatives with widespread bipartisan support.[77] This "bankruptcy first" approach seems to gaining attention across the world, with Europe leading the way with its robust BRRD regime. However, there are certain lessons to be learnt from these modern resolution systems, as can be seen from the particular case of Cyprus.

IMPLEMENTATION OF BAIL-IN: LESSONS FROM CYPRUS

Despite the growing popularity, resolution through the new framework for bank resolution have been done only once before, i.e. in Cyprus[78]. The crisis, which was triggered by the losses of Greek private sector involvement in late 2011, resulted in the failure of the banking sector.[79]

Two of their banks, the Bank of Cyprus and Laiki had grown to become over seven times the GDP, and inevitably became SIFIs. Moreover, the Cypriot banking system had become notorious for being tax havens for Russian oligarchs.[80] When crisis struck, both these banks went into insolvency, and the bail-in tool was applied.

Bail-in resulted in the customers of these bank with over 100,000 Euros losing over 40-60 percent of their deposits.[81] It also resulted in an unintended switch in ownership, whereby 10 of the largest shareholders of the banks post resolution turned out to be politically exposed Russian and Ukranian oligarchs, some of whom were closely associated with the Russian president.[82]

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77. US Dept. of Treasury, Orderly Liquidation Authority and Bankruptcy Reform, 2017, 24, (2017), <https://home.treasury.gov/sites/default/files/2018-02/OLA_REPORT.pdf>.
78. Martin Brown, Ioanna S Evangelou, Helmut Stix, "Banking crisis, bail-ins and money holdings", Vox CEPR Policy Portal (27-6-2019, 9:30 PM), <https://voxeu.org/article/banking-crisis-bail-ins-and-money-holdings-lessons-cyprus>.
79. Panicos Demetriades, "Failing Banks, bail-ins, and central bank independence: Lessons from Cyprus", Vox CEPR Policy Portal (27-6-2019, 10:30 PM) <https://voxeu.org/article/bank-bail-ins-lessons-cypriot-crisis>.
80. Yiannis Kitromilides, "The Cyprus 'bail-in' blunder: a template for Europe?", Open Democracy, (29-6-2019, 10:30 PM), <https://www.opendemocracy.net/en/can-europe-make-it/cyprus-bail-in-blunder-template-for-europe/>.
81. Srikanth Srinivas, FRDI Bill: An analysis of global experience explains why depositors in India should be indeed worried, *Firstpost*, <https://www.firstpost.com/business/frdi-bill-an-analysis-of-global-experience-explains-why-depositors-in-india-should-be-indeed-worried-4256375.html> (13-12-2017, 1:04 PM).
82. *Ibid*.

This situation could have been avoided had there been an independent oversight over the resolution process. Learning from the experience, resolution regimes should consider the need to incorporate some level of oversight over resolution proceedings.

ANALYSIS AND CONCLUSION- PROPOSAL FOR A NEW RESOLUTION REGIME IN INDIA

The FRDI Bill was one of the most ambitious endeavours of the Government in recent years. Having incorporated almost all of the Key attributes, the FRDI bill would have introduced a revolutionary system. Even though the FRDI Bill failed to come into force due to public outcry over the bail-in provision,[83] the IL&FS crisis revealed that the dire need for a specialised resolution system did not die with the demise of the bill. Therefore, in light of our analysis of the two regimes, we would like to propose the following changes to be made to the FRDI Bill:

1. **More detailed provisions with clearer safeguards:** The provisions of the FRDI Bill are not clear on many respects, especially when it comes to safeguards. For example, regarding the *no creditor worse off* principle of the key attributes, the FRDI bill simply provides that the corporation shall ensure that no creditor is left in a worse position as a result of application of any of the resolution tools, without providing any redressal in case it happens. The BRRD on the other hand provides for an independent person to be appointed to set off and calculate the difference between the two situations, and compensation in case the creditors are put in a worse off position. It also provides for the drafting of an independent business re-organisation plan, which maps out the exact process of the institutions resolution. Such a plan instils some level of confidence in depositors, and therefore could be imported to India.

   There are further no safeguards regarding what types of funds will be excluded from application of a bail-in, which is specifically

83. ET Online, "The Bill that spooked bank customers across India has been withdrawn", *The Economic Times*, (7-8-2018, 1:59 PM), <https://economictimes.indiatimes.com/industry/banking/finance/banking/the-bill-that-spooked-bank-customers-across-india-has-been-withdrawn/articleshow/65304709.cms>

provided for under the BRRD. More clarity needs to be provided regarding the safeguards to be implemented.

2. **Establishment of a pre-existing resolution fund in India:** The biggest highlights of the resolution mechanism in the BRRD is that the SRF, which is used exclusively for the purpose of implementing the resolution tools. While the FRDI Bill too provides for maintenance of a resolution fund, this fund is only for carrying out the resolution of Insured Service Providers[84], which are banking institutions which have paid deposit insurance under Section 29 of the FRDI Bill.[85] The narrow scope for the use of the fund indicates that it would not be used for resolution of any other financial service providers.

   Further, the act also provides that the financing of the Corporate Resolution Fund shall be maintained through fees collected from "Covered Service Providers", a broader term which is used for any banking institution, insurance company, NBFCs etc.

   This leads to an absurd result with no clarity, as the Corporate Resolution Fund is essentially financed from Covered Service Providers, but is only available for Insured Service Providers. Covered Service Providers are expected to pay fees for their own resolution.[86]

   Therefore, it is our suggestion that financing can be done through a resolution fund contributed by all covered financial institutions. A target can be set on a certain level of funds to be maintained with the resolution fund at all times, and restrictions can also be laid down regarding its use. This ensures a steady flow of funds with the resolution corporation at all times for resolution, rather than relying on fees paid by the failing institutions. A contributed fund can be further used for a wider array of purposes, such as bail-in, and funding of bridge institutions, in line with the Key Attributes.

84. Financial Resolution and Depositors Insurance Bill, 2017, S. 21, Bill No. 165, Acts of Parliament, 2017 (India)
85. Financial Resolution and Depositors Insurance Bill, 2017, Schedule 3, Bill No. 165, Acts of Parliament, 2017 (India).
86. Dept. of Economic Affairs Ministry of Finance, Report of the committee to Draft Code on Resolution of Financial Firms, 25 (2016), <https://dea.gov.in/sites/default/files/report_rc_sept21_1.pdf>.

3. **Need for oversight over the resolution process:** The most striking aspect of the resolution regime in the US is the presence of judicial oversight. An independent board of the judiciary consisting of members with an understanding of bankruptcy decides on whether there is a need for transfer of the company to another seller. This ensures that there are no illegal/unnecessary actions by the resolution authority and would keep their powers in check. The Cyprus incident revealed the problem of implementation of modern resolution tools with no oversight. Oversight by an authority would further ensure that aggrieved parties can raise issues against the resolution process if needed. This would increase the accountability in the system.

   Therefore, it is our suggestion that there needs to be a body with oversight over the entire resolution. This could be an independent body designated for the said purpose, the Insolvency and Bankruptcy Board of India or the NCLT, as courts often don't have jurisdiction when it comes to insolvency matters.[87]

The IL&FS crisis is a warning of an impending danger. With many public financial institutions accumulating more and more bad debts, it is imperative that many more financial institutions would be going into bankruptcy. India's preparedness to face such a crisis would solely be determined by its ability to come up with a regime that is both effective and one which can instil confidence in depositors.

87. Insolvency and Bankruptcy Code, 2016 (31 of 2016), S. 63, Acts of Parliament (India).

Pricing Algorithms and Collusion Under Competition Law in India

—*Akanshha Agrawal*†

ABSTRACT

From the point of view of competition, advent of new technologies promise several benefits, such as increased competition, lower prices, wider range of goods and services, etc. However, such promises of procompetitive advantages are often just the way of hiding the anti-competitive effects these technologies threaten to have. Pricing algorithms is one such innovation which promises to facilitate greater competition in the market. However, often times, such algorithms are used as mere tools for fixing prices in the market. The algorithms make it easier to execute anti-competitive agreements and escaping legal action. The anti-competitive impact of using pricing algorithms to execute price fixing agreement is now recognised across the globe. Therefore, it comes as a surprise that the Competition Commission of India dismissed a similar allegation against Uber and Ola (Cab Aggregators) without a careful analysis. The allegation of the Informant was that the Cab Aggregators and the drivers fix prices for taxi fare in the market by agreeing to determine prices using an algorithm. According to the Informant, this amounts to a hub and spoke collusion which is anti-competitive in nature. However, the Commission rejected this claim and held that for such collusion, an explicit agreement between the hub and spokes to collude on price is required. I argue that this is actually based on a mistaken understanding of the Commission. As similar algorithm-based agreements are now infiltrating the market, it is pertinent to reconsider the issue to ensure facilitation of competition in the market. In this paper, I seek to analyse the order given by the Commission and argue that the agreement between Cab Aggregators and their drivers tends to restrict

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competition by fixing prices in the market. Therefore, such an agreement is anti-competitive.

INTRODUCTION

With the advancement of science, a new and innovative technology is entering the market everyday. These technologies often have numerous advantages and promises, and are welcomed with open arms. Internet, Big Data, Artificial Intelligence and often unheard pricing algorithms are now more widely used than ever. From the point of view of competition, they seem to offer numerous procompetitive advantages such as price comparison, improved quality and wider range of goods and services at substantially lower prices. With so many promised procompetitive advantages, it is easy to get blindsided and forego the required analysis of the implications such technologies might have on competition. Due to the influence of such technologies, competition is no longer regulated by an invisible hand. It is quickly being replaced by a digital hand, granting the power to control competition to the powerful few. This forces us to re-think and re-conceptualise the Competition Law policies and introduce changes that have sorely been missing in order to deal with the Competition Law issues arising in this new digital market.

According to the available legal literature, there are four ways of using algorithms to facilitate collusion: using computers as messengers, hub and spoke collusion, tacit collusion by use of computers as predictable agent and use of artificial intelligence as digital eye.[1] In the first scenario, algorithms are used merely as a means of executing the human will. Humans enter into an agreement and then use computers or algorithms to implement or monitor such agreements. This kind of collusion is easiest to establish. In the second scenario, a central hub enters into vertical agreements with spokes. All the spokes are aware of the hub's agreements with different spokes. Due to such awareness, the spokes are deemed to have entered into an agreement to collude with each other. This does not necessitate any actual agreement between the spokes. In the third

1. Ariel Ezrachi and Maurice E. Stucke, *Virtual Competition: The Promise and Perils of Algorithm-Driven Economy* (2016).

scenario, competitors use one pricing algorithm, knowing that others are doing the same. As this algorithm is used to set prices for the products in the market, each competitor will set the same price for their products. However, there is no explicit agreement between the competitors to fix prices in the market. In the last scenario is the Artificial Intelligence used will regulate prices by itself. This does not necessitate any anti-competitive agreement or intent from the parties involved.

The offence of price-fixing by using a pricing algorithm was recognised for the first time in the 2015 case of *USA* v. *David Topkins*.[2] Topkins pleaded guilty for using sophisticated algorithms to fix prices for posters in the Amazon Marketplace. Ever since then, there has been a lot of hue and cry with regards to using pricing algorithms for antitrust violation. Such algorithm-based cartels require us to rethink collusion as limited to conversations in smoke filled rooms. Recently, Margrethe Vestager, European Commissioner for Competition and Andreas Mundt, President of German Federal Cartel Office released statements acknowledging that companies are colluding with the help of algorithms and they should not be allowed to evade anti-competitive laws by hiding behind the same.[3] In June 2017, the Antitrust Division of Department of Justice, and the Federal Trade Commission, USA, released a paper assessing the role of competition policy in digital age.[4] This concludes that as price fixing agreements are anti-competitive, it is irrelevant whether intermediaries such as pricing algorithms are used for executing the same. This is now accepted across jurisdictions and similar conclusions have been drawn

2. *United States of America* v. *David Topkins*, No CR 15-00201 WHO (N. D. Cal. 2015).
3. Tom Sims, Airlines Can't Blame Computer Models For Higher Fares, German Cartel Chief Says, *UK Reuters* (2017), <https://uk.reuters.com/article/uk-germany-airlines-pricing/airlines-cant-blame-computer-models-for-higher-fares-german-cartel-chief-says-idUKKBN1EM0KX>; "Algorithms and Competition: Bundeskartellamt 18th Conference on Competition", Berlin (16-3-2017), <https://ec.europa.eu/commission/commissioners/2014-2019/vestager/announcements/bundeskartellamt-18th-conference-competition-berlin-16-march-2017_en>.
4. Written Contribution from the United States for Item 10 of 127th OECD Competition Committee, 21-23 June 2017, <http://www.oecd.org/daf/competition/algorithms-and-collusion.htm>.

by the European Union[5], Italy[6], Russia[7], Singapore[8], Ukraine[9] and United Kingdom[10].

Even though the anti-competitive impact of pricing algorithms is being recognised across the globe, India seems to have fallen behind in understanding and acknowledging the same. In November 2018, the Competition Commission of India passed an order dismissing the case of alleged collusion against Uber and Ola (hereinafter Cab Aggregators) by using pricing algorithms.[11]

In this case, the Informant argued that the Cab Aggregators and the drivers share a hub and spoke collusion to fix taxi fare in the market which violates the provisions of the Indian Competition Act. The Cab Aggregators use mobile applications to connect the commuter and the driver. The application automatically presents the offer for a ride to the driver closest to the commuter. The driver does not have the option to negotiate upon the offer with the commuter, she can either accept or reject it. If the driver does not accept the offer within 15 seconds, the same is offered to next closest driver. This process continues till a driver accepts the offer. The Cab Aggregators use specific pricing algorithm for calculating the fare for the ride based on multiple factors such as surcharges, tolls, time and distance, etc. Here, all the drivers are required to sign Drivers Terms and Conditions binding them to accept the fare calculated by the pricing algorithm. Neither the driver, nor the commuter has any scope to negotiate on the same. The Informant argued that by doing so, the Cab Aggregators and the drivers are in a hub and spoke collusion

5. Written Contribution from the European Union for Item 10 of 127th OECD Competition Committee, 21-23 June 2017, <http://www.oecd.org/daf/competition/algorithms-and-collusion.htm>.
6. Written Contribution from the Italy for Item 10 of 127th OECD Competition Committee, 21-23 June 2017, <http://www.oecd.org/daf/competition/algorithms-and-collusion.htm>.
7. Written Contribution from the Russia for Item 10 of 127th OECD Competition Committee, 21-23 June 2017, <http://www.oecd.org/daf/competition/algorithms-and-collusion.htm>.
8. Written Contribution from the Singapore for Item 10 of 127th OECD Competition Committee, 21-23 June 2017, <http://www.oecd.org/daf/competition/algorithms-and-collusion.htm>.
9. Written Contribution from the Ukraine for Item 10 of 127th OECD Competition Committee, 21-23 June 2017, <http://www.oecd.org/daf/competition/algorithms-and-collusion.htm>.
10. Written Contribution from the United Kingdom for Item 10 of 127th OECD Competition Committee, 21-23 June 2017, <http://www.oecd.org/daf/competition/algorithms-and-collusion.htm>.
11. *Samir Agrawal* v. *ANI Technologies Pvt Ltd*, 2018 SCC OnLine CCI 86.

to fix prices. This leads to a violation of Section 3(3)(a) read with Section 3(1) of the Competition Act which prohibits agreement which "directly or indirectly determines purchase or sale prices". However, the Commission rejected such an allegation and dismissed the case.

According to the Commission, a hub and spoke relationship requires an express conspiracy to fix prices. Here, the hub uses a third-party platform to share sensitive information with the spokes. A hub and spoke cartel in the case of ride-sourcing or ride-sharing services will require either an agreement to set prices through the platform or the platform to coordinate prices between the drivers. However, in the present case, the pricing algorithm used by the Cab Aggregators determines the price by considering the personalised information on riders along with other factors such as time of the day, traffic, etc. As there is no express agreement between the drivers to fix prices, the Commission held that this does not amount to a hub and spoke collusion. However, this understanding of the Commission seems to be mistaken. The Commission has failed to understand the basics of a hub and spoke price fixing agreement and collusion under the Indian Competition Act.

According to the Competition Law in India, three requirements are to be met to establish that a cartel is anti-competitive. First, there should be an agreement by way of concerted action suggesting conspiracy; second, such an agreement should lead to fixing of prices in the market; and third, such an agreement should be with an intent to restrict or eliminate competition in the market.[12] I argue that the case of Uber and Ola satisfies these requirements.

1. An agreement by way of concerted action suggesting conspiracy

In a hub and spoke cartel, the central hub controls numerous spokes and each spoke participates in independent transactions with the hub. Through these transactions, the hub furthers a single, illegal enterprise. A hub and spoke is similar to traditional understanding of conspiracy in terms that it is not required for all the co-conspirators to know each other,[13] but it is necessary that each co-conspirator either knows or

12. *Hindustan Lever Ltd, Bombay* v. *The Monopolies and Restrictive Trade Practices Act*, (1977) 3 SCC 227: AIR 1977 SC 1285.
13. *Yash Pal Mittal* v. *State of Punjab*, (1977) 4 SCC 540: AIR 1977 SC 2433.

should have known about the conspiracy[14]. Therefore, the spokes are not required to enter into explicit agreements to further the conspiracy. However, each spoke either is or should have been aware of the hub's plan.

In *Interstate Circuit, Inc.* v *United States*, the Supreme Court, for the first time, found an anti-competitive price fixing agreement which we now know as hub and spoke collusion.[15] This case involved the issue of releasing movies in first run and subsequent run theatres. Interstate had a monopoly for the first run theatres in five cities. The movies were initially released in these theatres and tickets were sold at high prices. After this, the movies were released in subsequent run theatres for a lower price. Due to this, many consumers stopped going to the first run theatres and would wait for the movies to release in the subsequent run theatres. This caused huge losses to Interstate. Interstate decided to enter into an agreement with the owners of subsequent run theatres to show movies at a higher price so that it could continue making profit from the first run theatres. For reaching this agreement, Interstate sent letters to all the subsequent run distributors. Each of these letters included the addresses of all the other distributors. Therefore, each distributor was aware that the proposal is being considered by the other distributors. They were also aware that for the plan to be successful, each distributor needs to agree to the same. All the distributors accepted the scheme and participated in it. The Court held that as the distributors entered into an agreement with the knowledge of Interstate's plan, they impliedly entered into an agreement with each other. This agreement amounted to an anti-competitive price fixing agreement. Here, Interstate was the hub and the distributors were spokes.

It is important to note that there was no clear agreement to collude between the subsequent run distributors. However, each distributor was aware that the other distributors were considering the offer and cooperation by all is necessary for the plan to work out. They were also aware of the fact that successful operation of this scheme will lead to price fixing in the market, leading to a restraint in competition. The Court held that participation after such knowledge was enough to establish a

14. *RK Dalmia* v. *Delhi Administration*, AIR 1962 SC 1821.
15. *Interstate Circuit Inc* v. *United States*, 306 US 208 (1939).

conspiracy and an express written agreement was not required. Simply put, the Court here recognised that if spokes knowingly participate in an anti-competitive cartel, such participation is enough to establish that there was agreement to execute the same.

A similar standard was laid down by the Court of Justice of the European Union (CJEU) in the Eturas case.[16] Eturas, a common online travel booking system, had contracts with various travel agencies to offer bookings through its website. Each travel agency had a personal electronic account on the Eturas system, which worked like an email system. Through this system, the Eturas administrator sent a message to the travel agencies that the discount offered will be capped at 3%. Some of the travel agencies read the message and did not oppose the policy. The travel agencies were aware that the message was sent to all the agencies. Subsequently, the system underwent a technical change required to implement the particular measure. The CJEU held that Eturas (hub) entered into price fixing agreement with the travel agencies (spokes). Here, the travel agencies who knew about the policy change and did not oppose were presumed to have agreed to the same. As the particular policy would have an anti-competitive impact, such agencies were presumed to be a part of the anti-competitive agreement to fix prices. The Court held this to be a violation of Article 101 of the Treaty on the Functioning of the European Union which prohibits directly or indirectly fixing of purchase or selling prices.

In conclusion, a hub and spoke relationship does not require an express agreement between the spokes. If the spokes enter into individual agreements with the hub, having knowledge of the hub's plan, it can be presumed that the spokes agreed to the plan. Such a wide and inclusive definition of an agreement is also represented in the Indian Competition Act.[17] An agreement is valid whether or not it is formal or in writing. Existence of a valid agreement is inferred from a number of coincidences and indicia which may constitute evidence of the existence of an agreement.[18] It is well acknowledged that in cases of anti-competitive agreements, every effort would be made to ensure that any incriminatory

16. *"Eturas" UAB and Others* v. *Lietuvos Respublikos konkurencijos taryba*, C-74/14 [2016] 4 CMLR 19 ECLI:EU:C:2016:42 (2016).
17. Competition Act, 2002, S. 2(b).
18. In Re: Manufacturers of Asbestos Cement Products, 2014 SCC OnLine CCI 23,.

evidence cannot be found.[19] In such cases, even fragmentary and sparse evidence is accepted.[20] Therefore, under the Indian law, the definition of a valid agreement is very wide, and there is no need of direct evidence to establish the presence of such an agreement.

In the case of Uber and Ola, the fare price is determined by the pricing algorithm used by the respective Cab Aggregators. Such an algorithm is designed to fix prices in the market. The drivers are required to sign Terms and Conditions which binds them to agree to the calculated fare. They agree to waive their right to use any discretion on such fare. The drivers are also aware that anyone who is either driving for the Cab Aggregators or will do so in the future will have to agree to similar terms and conditions. Further, they are aware that the scheme of Cab Aggregators will work out only if there is unanimous agreement from the drivers. If with such knowledge, the drivers agree to the larger scheme of the cab aggregators, we can conclude that there is an agreement between Cab Aggregators (hub) and the drivers (spokes). In the event where such agreements are found to be anti-competitive, the drivers would be presumed to have agreed to such anti-competitive agreement. Now we need to examine if such an agreement leads to fixing of prices in the market.

2. The fixing of prices in the market

According to the Indian Competition Act, any agreement which directly or indirectly determines purchase or sale price in a market is a price fixing agreement.[21] This would effectively include any agreement which agrees on fixing prices, regardless of whether such agreement sets prices as discounted, high, stabilised or fixed. With the increased dependence of companies on price fixing algorithms to determine prices in the market, attempt has been made to further broaden this understanding. According to the definition given by Consumer Unity and Trust Society (CUTS), India, agreements to use a standard formula according to which price will be calculated is also covered under price fixing agreements in the

19. *Ibid.*
20. In Re: Reference Case No 01 of 2012 filed under section 19(1)(b) of the Competition Act, 2002 by Director General (Supplies and Disposals), Directorate General of Supplies and Disposals, Department of Commerce, Ministry of Commerce and Industry, Government of India, New Delhi, Ref Case No 01 of 2012 (CCI).
21. Competition Act, 2002, S. 3(3)(a).

Indian Competition Act.[22] This is following the widely accepted reasoning across jurisdictions that agreeing to use an algorithm to determine prices in the market amounts to fixing of prices.[23]

In the case of Cab Aggregators, the pricing algorithms are used to determine the fare for a ride. Neither the driver nor the commuter has any discretion on the same. They are bound to accept the fare determined by the Cab Aggregators. Even the Commission does not seem to be disputed on the fact that the Cab Aggregators are fixing prices in the market.[24]

According to Section 2(c) of the Competition Act, a cartel is an association of producers, sellers, distributors, traders or service providers who, by agreement amongst themselves, limit, control or attempt to control price of goods or services.[25] As the Cab Aggregators and the drivers enter into an agreement to fix prices in the market, it can be concluded that they form a cartel. Under the Indian Competition Act, a price fixing cartel has a presumption of anti-competitive behaviour against it.[26] However, this is a rebuttable presumption.[27] It is essential that such a cartel has intention to restrict or eliminate competition in the market.

3. Intention to restrict or eliminate competition

Price fixing cartels threaten to have a severe impact on the competition in the market. Therefore, certain jurisdictions follow what is widely known as the per se rule. According to this, the very existence of a price fixing cartel is per se anti-competitive.[28] However, the Indian jurisprudence follows the rule of reason, according to which, the legality of a price fixing agreement is determined by the impact it has on the competition in the

22. Study of Cartel Case Laws in Select Jurisdictions – Learnings for the Competition Commission, *CUTS* International and National Law University Jodhpur, Report Submitted to Competition Commission of India (15-10-2017), <http://www.cuts-ccier.org/CARTEL/pdf/Study_of_Cartel_Case_Laws_in_Select_Jurisdictions-Learnings_for_the_CCI.pdf>.
23. Online sales of posters and frames, Case 50223 (CMA 2016).
24. *Samir Agrawal* v. *ANI Technologies Pvt Ltd*, 2018 SCC OnLine CCI 86,.
25. Competition Act, 2002, S. 2(c) .
26. Competition Act, 2002, S. 3(3) .
27. *Sodhi Transport Co* v. *State of Uttar Pradesh*, (1986) 2 SCC 486: AIR 1980 SC 1099.
28. *White Motor Co* v. *United States*, 1963 SCC OnLine US SC 37: 372 US 253 (1963).

market.[29] Under the rule of reason, the nature of the restraint and the actual or probable impact of such restriction need to be analysed.[30] After the existence of price fixing agreement has been established, the burden is on the Opposing Party (in this case Uber and Ola) to establish that such an agreement does not have any anti-competitive impact.

The anti-competitive impact of using pricing algorithms has been recognised across jurisdictions. The main concern with regards to using pricing algorithms is that such algorithms can be used for easily monitoring and enforcing anti-competitive agreements that cannot be executed otherwise. Basically, algorithms make it easier to execute anti-competitive agreement and evade the law. This was seen in the case of Trod and GB eye Limited before the Competition and Markets Authority (CMA), UK.[31] In this case, Trod and GB eye agreed to use pricing algorithms so that they do not undercut each others' prices for posters and frames in the Amazon Marketplace. This would eliminate competition between two competitors in the market by using pricing algorithms. It is important to note that they merely agreed to use similar algorithms. There was no direct agreement to fix prices. However, the Court took notice of the fact that even though there is no explicit agreement to fix prices, the ultimate impact of it would be price fixing with view of eliminating competition. In light of this, the agreement was held as anti-competitive price fixing agreement. The Court here acknowledged that companies should not be allowed to execute anti-competitive agreements merely because they are using pricing algorithms.

Similarly, the European Commission held that using pricing algorithms for restricting competition in the market is anti-competitive.[32] Four manufacturers in the UK imposed fixed or minimum retail prices on their online retailers. Price fixing algorithms were used to enforce the same. By enforcing this agreement on the retailers, the manufacturers restricted the scope of competition between the retailers, effectively restricting competition in the market. This was held as an anti-competitive

29. *Tata Engineering and Locomotive Co Ltd* v. *The Registrar of the Restrictive Trade Agreement New Delhi*, (1977) 2 SCC 55: 1977 AIR SC 973.
30. *Hindustan Lever Ltd Bombay* v. *Monopolies and Restrictive Trade Practices Act*, (1977) 3 SCC 227: AIR 1977 SC 1285.
31. Online sales of posters and frames, Case 50223 (CMA 2016).
32. Antitrust: Commission Fines Four Consumer Electronics Manufacturers for Fixing Online Resale Prices (2018), <http://europa.eu/rapid/press-release_IP-18-4601_en.htm>.

price fixing agreement by the Commission. This case highlights the potential threat of using pricing algorithms due to the ease of enforcing anti-competitive agreements without leaving substantial evidence. These sensitive algorithms can make anti-competitive practices easier, quicker and less costly, while process of detecting it more difficult.[33]

It is important to understand the irrelevance of using pricing algorithms if the ultimate impact of an agreement is anti-competitive. Consider this statement by Maureen Ohlhausen, Federal Trade Commission:

> Is it ok for a guy named Bob to collect confidential price strategy information from all the participants in a market, and then tell everybody how they should price? If it isn't ok for a guy named Bob to do it, then it probably isn't ok for an algorithm to do it either.[34]

The intention to restrict or eliminate competition is seen from the impact of a particular price fixing agreement. If an agreement restricts or eliminates competition in the market, it is irrelevant whether pricing algorithms were used or not. It is a well-accepted principle that just as competitors cannot communicate directly with one another to set prices or restrict output; they also cannot use an intermediary to reach such an unlawful agreement.[35] The Competition Act aims to eliminate any agreement which has an appreciable adverse effect on competition, regardless of whether the competitors execute such an agreement directly or use an algorithm to do the same.

Consider the case of Cab Aggregators and the drivers without the pricing algorithm. The Cab Aggregators and the drivers will enter into an agreement to fix prices in the market. The Cab Aggregators will decide the optimum price for maximum profit based on market conditions and tell the drivers to set that price. The drivers will not have any opportunity to decide price by themselves and would be required to accept the price decided by the Cab Aggregators. Essentially, any scope of competing on

33. Pricing Algorithms: Economic Working Paper on the Use Of Algorithms to Facilitate Collusion and Personalised Pricing, CMA94 (8-10-2018), <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/746353/Algorithms_econ_report.pdf>.
34. Maureen Ohlhausen, "Remarks to the Concurrences Conference on Antitrust in the Financial Sector: Should We Fear The Things That Go Beep In the Night? Some Initial Thoughts on the Intersection of Antitrust Law and Algorithmic Pricing", Federal Trade Commission (23-5-2017), <https://www.ftc.gov/system/files/documents/public_statements/1220893/ohlhausen_-_concurrences_5-23-17.pdf>.
35. *Interstate Circuit Inc* v. *United States*, 1939 SCC OnLine US SC 42 : 306 US 208 (1939).

price will be eliminated. As such an agreement eliminates competition, it would be held anti-competitive

In the instant case, the intermediary used is the pricing algorithm. In the contracts entered into by the Cab Aggregators and its drivers, the drivers are not allowed to negotiate on the price. The drivers cannot offer a price lower than the price fixed by the algorithm. As the drivers are required to follow the fare decided by the Cab Aggregators, all the drivers will have the same price. Therefore, the drivers are not allowed to compete with each other in terms of price. This restricts competition in the market. This is the very intention behind executing such an agreement.

Here, it is interesting to note that Uber describes itself as a location-based app for hiring on-demand private drivers. It does not claim to be a company providing transportation services but to be one that merely provides an online platform to connect drivers and commuters.[36] However, if Uber had stayed true to this, it would be a platform similar to Zomato or Airbnb. In such a case, every driver on the platform would determine the fare for the rides. The drivers would have the opportunity to compete on the price to promote healthy competition. However, instead of doing this, Uber fixes prices for the drivers by using its pricing algorithms. Such a price fixing agreement is with the intention to restrict competition in the market. This has an appreciable adverse impact on competition. Therefore, it can be concluded that the Cab Aggregators use such algorithms with a view of eliminating competition in the market.

CONCLUSION

For establishing an anti-competitive cartel in India, three requirements are to be met: there should be an agreement, it should be used for fixing prices in the market and such price fixing should be with an intention to restrict or eliminate competition.

According to the Competition Act, an agreement is not required to be express, formal or in writing. Therefore, an agreement has a very wide an inclusive definition. The requirements for the same are further diluted in case of a hub and spoke collusion. In a hub and spoke collusion, the

36. Uber BV Terms and Conditions, <https://www.uber.com/en-IN/legal/terms/in/> (14-6-2019, date last accessed)

hub is required to execute a single, illegal plan. For this, the hub enters into an agreement with the spokes. The spokes are not required to enter into an agreement with each other. As the spokes enter into an agreement with the hub with the knowledge that other spokes will also do the same, it is assumed that they agreed and participated in hub's plan. In the case of the Uber and Ola, the Cab Aggregators are the hub and the drivers are the spokes. The drivers agree to use the pricing algorithms of the hub, knowing that other spokes in the market have agreed to use the same algorithm. According to existing jurisprudence on hub and spoke collusions, this will amount to a valid agreement between the Cab Aggregators and its drivers.

The pricing algorithms designed by the Cab Aggregators are used to set fare price in the market. This fare is non-negotiable. Both the driver and the commuter are bound to accept this fare price. It is an undeniable conclusion that this is a price fixing agreement. The Commission, too, seems to have accepted the fact that Cab Aggregators use the algorithm to fix prices in the market. The debate centres on the anti-competitive impact such a price fixing agreement has.

In the Indian scenario, a price fixing agreement is not per se anti-competitive. The impact that such an agreement has on competition needs to be analysed. Agreements to use standard formula for determining price have been recognised as anti-competitive price-fixing agreements. Further, the Competition Authority in UK and the European Commission have held that agreements which use algorithms to execute anti-competitive agreements cannot be excluded from the purview of Competition Act merely because of the presence of an intermediary in the form of algorithms. These cases duly stress on the need to put greater scrutiny into pricing algorithms due to the ease of executing anti-competitive agreements using them. In the instant case, the drivers are bound to follow the fare price determined by the pricing algorithms. Due to this, the drivers cannot negotiate or compete on the price. Such a price fixing agreement is inherently anti-competitive. It is concluded that the agreement between Cab Aggregators and drivers is anti-competitive, and is being allowed merely because the Cab Aggregators can hide behind the algorithms. This protection would not be granted in case of a similar agreement without the algorithm.

The Commission failed to develop an understanding of the issue at hand. It stressed on the need of having an explicit anti-competitive agreement and held that in the absence of an explicit agreement, there can be no collusion. Further, the Commission also failed to understand a hub and spoke collusion. It stated that such collusion exists when the hub and spokes agree to exchange sensitive information through a third-party platform. There should also be an agreement between all the drivers to use the platform to set prices in the market. As was discussed above, this is not the case. Therefore, it is pertinent that the Commission develops a deeper understanding of the issue to facilitate better competition in the market.

Regulating and Deregulating Initial Coin Offerings: A Cross Jurisdictional Analyses

—Gokul Holani† *& Arpita Pande*‡

ABSTRACT

The introduction of technology has brought about significant transformations in the financial markets. However, no trend has proved to be as disruptive as the unprecedented rise of Initial Coin Offerings (ICOs). Having blockchain technology at their core, ICOs have revolutionised capital formation process especially for start ups and SMEs. Since their introduction into markets, scholars, investors and issuers alike have been captivated by the opportunities and challenges that this novel form of fundraising has to offer. Disintermediation and a wider investor base as compared to traditional forms of fundraising are few of the reasons behind the global brouhaha surrounding ICOs. However, one of the most important reasons behind the boom of ICOs is the absence of legal obstacles due to the regulatory opacity surrounding ICOs in most of the jurisdictions across the globe. While the public interest continues to grow, authorities across jurisdictions are caught in a regulatory quagmire as they struggle to advance the competing goals of investor protection and financial innovation.

Do tokens qualify as securities? Can they be made subject to disclosure requirements normally applicable to the issuers of traditional financial instruments? Several such challenging questions crop up in a discussion on a possible regulatory framework for ICOs. Through this research paper the authors attempt to find answers to few of these questions in context of India by looking at the current state of law. The authors have also carried out an analyses of regulatory responses from across the globe in order to identify international best practices which can be included in a possible future framework.

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I. INTRODUCTION

The past few years have been characterised by the meteroic rise of block-chain technology as it continues to transform almost every sphere of life. The finance industry has had its own share of techonology – driven innovation with Initial Coin Offerings (ICO) emerging as one of the most popular application of block-chain technology in finance. An initial coin offering is a new and effective way that is used mainly by startups to raise money by issuing their own cryptocurrency called tokens.[1] The market figures are a testament to the burgeoning growth of ICOs globally. In 2016, more than USD 100 million were raised through ICOs globally[2] and the 2017, global issuance volume exceeded USD 3 billion,[3] outperforming venture capital in financing cryptocurrencies and blockchain startups for the first time.[4]

While ICOs continue their evolutionary journey of becoming the new normal of fundraising in this digital era, policymakers across globe are faced with the challenge of devising a reglatory framework for ICOs with limited understanding and resources. Depsite some progress in recent times to a large extent regulatory uncertainity looms over ICOs.

India is a tiny part of global ICO growth with about 30-40 recorded ICOs having taken place, most notable being online car rental services Drivezy which raised USD 5 million in its ICO.[5] However, due to the absence of a regulatory structure and a skeptical attitute of regulatory authorities towards ICOs, issuers are chosing foreign jurisdictions to raise capital through ICOs.

Through this research paper the authors aim to understand the functioning of ICOs, the response of regulatory agencies across jurisdictions

1. Benjamin Sherry, "What is an ICO?", *Investopedia* (26-7-2019, 6:27 PM), <https://www.investopedia.com/news/what-ico.>
2. Sid Kalla and Matt Chwierut, "2016: The Year Blockchain ICOs Disrupted Venture Capital", (26-7-2019, 6:17 PM), available at <https://www.coindesk.com/2016-ico-blockchain-replace-traditional-vc/.>
3. Olga Kharif, "One of the Most High-Profile Initial Coin Offerings Has Crashed 50%", (26-7-2019, 6:13 PM), <https://www.bloomberg.com/news/articles/2017-11-01/shining-star-of-initial-coin-offerings-crashing-back-to-earth.>
4. Arjun Kharpal, "Initial Coin Offerings Have Raised $ 1.2 billion and now surpass Early VC Funding", (26-7-2019, 6:02 PM), <https://www.cnbc.com/2017/08/09/initial-coin-offerings-surpass-early-stage-venture-capitalfunding.>
5. KV Kurmanath, "ICO Investments at nascent stage in India, tread carefully", (26-7-2019, 7:06 PM), <https://www.thehindubusinessline.com/info-tech/ico-investments-at-nascent-stage-in-india-tread-carefullyep/article24970555.ece.>

and on the basis of international best practices make few sugesstions for a future Indian framework of ICOs. In Part I of the paper , the authors discuss certain key concepts associated with ICOs. Part II of the paper is a compilation of the responses of regulators of selected jurisictions namely USA, Gibraltar, Russia, Switzerland, Singapore and Australia. Part III traces the reaction of Indian authorities to the growth of ICOs and the possibility of developing a framework for the same. While regulation of ICOs raises challenge on multiple fields of law the authors have limited their analyses to nature of ICOs in the realm of Securities Laws and the applicability of Anti-Money Laundering (AML) laws to the stakeholders in the ICO process. Further, few suggestions based on international best practices for a future Indian framework on issues such as regulatory certainity, investor protector, disclosure requirements in Part IV of the paper finally concluding in Part V of the paper.

II. THE FUNDAMENTALS OF ICO

What is an ICO?

An ICO is a fundraising mechanism where new projects sell an underlying crypto token in exchange for capital.[6] The capital can be in the form of cryptocurrencies or even fiat currency in certain cases. While ICO is the dominant terminology in the market, other terms used to describe the process such as Initial Token Offering, Initial Token Sale, Security Token Offering, Security Coin Offering are increasingly gaining popularity.

ICOs are enabled by the use of Distributed Ledger Technologies such as blockchain which facilitate transactions between independent third parties without the need of any central authority or intermediary.[7] As a form of fundraising they are usually used for early stage financing to meet expenses of initiation, running expenses and costs of the project until it finally goes live.[8] However ICOs can also be used in later stages of a project as an alternative to traditional sources of financing such as

6. Sean Au and Thomas Power, *Tokenomics: The Crypto Shift of Blockchains, ICOs and Tokens*, Packt Publishing Ltd, 2018.
7. *OECD*, Initial Coin Offerings for SME Financing, (26-7-2019, 7:22 PM), <https://www.oecd.org/finance/initial-coin-offerings-for-sme-financing.htm.>
8. Deloitte, "ICOs- The New IPOs? How to fund innovation in the crypto age", (26-7-2019, 7:29 PM), <https://www2.deloitte.com/content/dam/Deloitte/de/Documents/Innovation/ICOs-the-new-IPOs.pdf>.

venture capital.[9] Although projects raising funds through ICO are majorly technology driven, industries ranging from real estate to digital finance have considered ICO as a lucrative option.[10]

A Brief History of ICOs

While the term ICO entered public lexicon very recently, the concept of ICO has been in existence for quite sometime now. Master Coin fundraising carried out in July, 2013 is recognised as the first recorded token generating event.[11] The development of Ethereum in 2014 changed the ICO industry completely as it offered several advantages over existing technology, most defining being its scripting language which allows developers to write their own smart contracts and decentralised applications using its standard template thus doing away with the need to create a new blockchain for every ICO.[12] Just when it seemed that the golden era of ICOs had begun in 2016, hackers exploited vulnerability in the smart contract of a project called Decentralised Autonomous Organisation (DAO) and were able to steal USD 74 million and nearly a third of all Ethereum tokens in circulation at that time. While the attack left the industry in deep shock, in the very next year ICOs reportedly raised USD 1.3 billion globally despite being denounced by some commenters as Ponzi scheme.[13] Since then, the ICO industry has come a long way with newer innovations and trends cropping up almost on a daily basis.

Classification of Tokens

The understanding of tokens is central to ICOs and therefore it is important to discuss the classification of tokens. Currently no unified system for classification of tokens exists[14] but attempts have been made by indus-

9. *Ibid*.
10. Deloitte, "ICOs- The New IPOs? How to fund innovation in the crypto age", (26-7-2019, 7:29 PM), <https://www2.deloitte.com/content/dam/Deloitte/de/Documents/Innovation/ICOs-the-new-IPOs.pdf>.
11. *Ibid*.
12. Ivona Skultetyova, Short History of ICOs: From Crypto Experiment to Revolution in Startup Financing (2018); Marco Dell'Erba, Initial Coin Offerings: The Response of Regulatory Authorities, 14 N.Y.U Journal of Law and Business 1107 (2018).
13. Clifford Chance, Initial Coin Offerings: Asking the Right Regulatory Questions (December 2017).
14. Philip Hacker and Chris Thomale , "Crypto-Securities Regulation : ICOs, Token Sales and Cryptocurrencies under EU Financial Law", 15 European Company and Financial Law Review 645-696 (2018).

try players and regulators alike to classify them according to underlying economic function or target use. Broadly speaking three different types of tokens exist:

(*i*) payment token,

(*ii*) utility token, and

(*iii*) security/asset token.

A payment token is a token whose function is purely to operate as a means of payment. Thus, basically it is a type of currency, but which is not backed by any government, for e.g. Bitcoin. The utility token is the most popular category of token, issued in maximum number of ICOs. This kind of token provides access to the goods and services that the project will launch in the future often at discount or sometimes serves as a form of premium access.[15] The key point about utility tokens is that they are not issued as an investment asset.[16] Security/Asset tokens as the name suggests are digital assets. In the economic sense they operate as equities, bonds or derivatives[17] carrying voting rights, right to dividend, etc.

III. REGULATORY RESPONSES: GLOBAL PERSPECTIVE

The meteoric rise of ICOs in the past few years from "too small to care" to "too big to ignore" has proved to be a challenge for the market and regulators alike.[18] ICOs represent a typical case of regulation paradox. On one hand uncertainty or absence of the regulation is one of the reasons for rise of ICOs on the other hand letting the industry stay unchecked had led to various instances of fraud causing great losses to common investors.[19] The response of regulators across jurisdictions has been varied which can broadly be categorised—

15. ICO scoring, Types of Tokens: The four mistakes beginner crypto investors make, (26-7-2019, 11:10 PM), <https://medium.com/swlh/types-of-tokens-the-four-mistakes-beginner-crypto-investors-make-a76b53be5406>.
16. Sean Au and Thomas Power, *Tokenomics: The Crypto Shift of Blockchains, ICOs and Tokens*, Packt Publishing Ltd, 2018.
17. Swiss Financial Market Supervisory Authority FINMA (2018), *Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs)*, (26-7-2019, 10:42 PM), <https://www.finma.ch/en/news/2018/02/20180216-mm-ico-wegleitung/>.
18. *OECD*, Initial Coin Offerings for SME Financing, (26-7-2019, 7:22 PM), <https://www.oecd.org/finance/initial-coin-offerings-for-sme-financing.htm>.
19. Alfred Ruoxi Zhang et al., "The Regulation Paradox of Initial Coin Offerings: A Case Study Approach", SSRN 3284337 (2018).

1. complete ban (e.g. China[20] and South Korea[21]),
2. no position yet taken (e.g. India and Ukraine),
3. discussion with stakeholders and early stage regulation using existing laws (e.g. France and Australia),
4. specific laws on this subject matter (e.g. Gibraltar[22] and Malta[23]).

However, across jurisdictions regulators have emphasised on the need for a case-to-case basis approach, i.e. to verify each ICO individually before applying any securities law of the State. States have also emphasised on the need for categorisation of tokens acknowledging that individual characteristics of the different types of tokens and rights associated with them would lead to application of different laws. Another important trend noted across jurisdictions is the issuance of warnings by regulators. Almost all States have issued an investor warning as to susceptibility of ICOs to fraud and lack of remedies available to the investor, volatility of the ICO market and lack of regulatory regime pertaining to it. An analyses of few jurisdictions has been carried out to gauge the international regulatory responses to ICOs. This includes–

1. USA,
2. Gibraltar,
3. Russia,
4. Switzerland,
5. Singapore, and
6. Australia.

20. China Banking Regulatory Commission, (26-7-2019, 8:11 PM), <http://www.cbrc.gov.cn/Chinese/home/docview/BE5842392CFF4BD98B0F3DC9C2A4C540.html>.
21. Chan Sik Ahn, "South Korea: Cryptocurrency Regulation", (26-7-2019, 3:53 PM), <https://www.iflr.com/Article/3810459/South-Korea-Cryptocurrency-regulation.html?ArticleId=3810459>.
22. Gibraltar Financial Services Commission, Distributed Ledger Technology Regulatory Framework (DLT framework), (26-7-2019, 5:53 PM), <http://www.gfsc.gi/dlt>.
23. Malta Financial Services Authority, Consultation with the Financial Services Industry with Regards to the Virtual Financial Assets Regulations to be Issued under the Virtual Financial Assets Act, MFSA REF: 07-2018.

USA

ICOs operate in a complex regulatory and supervisory environment in the USA due to multiple agencies operating in this sphere.[24] The US Securities and Exchange Commission is the main regulatory body having jurisdiction over issuance of tokens. It applies the Howey Test developed by the Supreme Court in 1946 to decide whether a particular token qualifies as security by assessing whether the investment is made with the intention of making profits from a common enterprise that depends exclusively on the efforts of others.[25] As far as the disclosure obligations go, commentators have opined that under US Law, white papers must comply with anti-fraud and information requirements regardless of the classification of tokens as securities.[26] Further, every form of token will be under the scanner of AML and Counter Terrorist Financing (CFT) Laws providing additional safeguards against touted risks posed by ICOs. While most ICOs are carried out in the USA due to the high-risk taking attitude of investors, great regulatory uncertainty exists in USA especially regarding non securities ICOs.

Gibraltar

Gibraltar is a pioneer in the promotion of blockchain and ICOs.[27] In January 2018, Gibraltar became the first country to regulate the underlying technology behind ICOs when it introduced an authorisation requirement for providers of Distributed Ledger Technology.[28] The regulatory developments recognised that this area of law is evolving and therefore governance in such matters is better achieved through application of principles on areas such as the corporate governance and cyber security

24. KPMG International Cooperative, "The Pulse of Fintech Q4 2017- Global analyses of investment in fintech", (26-7-2019, 5:48 PM), <https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2018/02/pulse_of_fintech_q4_2017.pdf>.
25. *Securities and Exchange Commission* v. *W.J. Howey Co*, 1946 SCC OnLine US SC 95: 328 US 293 (1946).
26. Wöckener, K. Lösing, C. Diehl, T. and Kutzbach, A., "Regulation of Initial Coin Offerings", (26-7-2019, 8:53 PM), <https://www.whitecase.com/publications/alert/regulation-initial-coin-offerings>.
27. Wulf A. Kaal, "Initial Coin Offerings: The Top 25 Jurisdictions and Their Comparative Regulatory Responses", 1 STAN. J. BLOCKCHAIN L. & POL'Y 41 (2018).
28. Financial Services (DLT Providers) Regulation, 2018; Financial Services (Investment and Fiduciary Services) Act, 2018.

rather than rigid rules.[29] While Gibraltar does not categorise tokens, it has appreciated the differences between tokens based on their use - token with characteristics as securities and tokens that do not constitute securities.[30] While the earlier will be governed by the existing Securities Law of the country, the later will be governed by separate guidelines as to disclosure requirements, codes of practise, etc. Further, every form of token will be under the scanner of AML and CFT Laws providing additional safeguards against touted risks posed by ICOs.[31]

Russia

Central Bank of Russian Federation is the regulatory authority responsible for ICO and Cryptocurrency regulations.[32] A bill on digital financial assets was introduced in May 2018 to deal with several aspects of cryptocurrencies and other tokens.[33] Conservative in its approach the bill creates a distinction between qualified and ordinary investors. *Persons who are not qualified investors in accordance with Federal Law No. 39-—"On the Securities Market" dated 22 April 1996, can purchase tokens for a sum of no more than 50,000 rubles within one issue."*[34] Russia has also come up with comprehensive disclosure requirements for issuers and investors to tackle fraudulent transactions as well as preventing tax evasion and money laundering. Article 3.2 of the draft regulations require the public offer to issue tokens to contain information requirements that need to be mandatorily followed by the issuers. There has been an introduction of a regulatory sandbox in April, 2018 to test innovative financial services, products and technologies such as ICOs[35] testament of positive outlook of Russian regulators.

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29. Gibraltar Financial Service Commission, Distributed Ledger Technology Regulatory Framework (DLT framework), (26-7-2019, 5:53 PM), <http://www.gfsc.gi/dlt>.
30. Gibraltar Financial Service Commission, Distributed Ledger Technology Regulatory Framework (DLT framework), (26-7-2019, 5:53 PM), <http://www.gfsc.gi/dlt>.
31. Wulf A. Kaal, "Initial Coin Offerings: The Top 25 Jurisdictions and Their Comparative Regulatory Responses", 1 STAN. J. BLOCKCHAIN L. & POL'Y 41 (2018).
32. Central Bank of the Russian Federation Press Release, *On the Use of Private "Virtual Currencies" (Crypto Currency)* (26-7-2019, 9:42 PM), <http://www.cbr.ru/press/PR/?file=04092017_183512if2017-09-04T18 31 05.html>.
33. Draft Law No. 419059-7 on Digital Financial Assets.
34. Article 3.1, Draft Law No. 419059-7 on Digital Financial Assets.
35. Kirill Shilov, *STO Registration Procedures in the Russian Federation,* (26-7-2019, 6:32 PM), <https://medium.com/geekforge-academy/sto-registration-procedures-in-the-russian-federation-89e519d95934>.

Switzerland

The Swiss Financial Market Supervisory Authority (FINMA) which regulates financial affairs within Switzerland came up with guidance for ICOs in September 2017 stating that there exist no ICO-specific regulations in Switzerland; however, alluded to the possibility of regulating several ICOs within the framework of existing laws.[36] The Swiss classification of ICOs is one of the most detailed classifications published by any regulatory authority.[37] Not only does FINMA classify tokens based on their underlying economic function but also distinguishes between different phases of development namely–

1. pre-financing,
2. pre-sale,
3. pre- operational, and
4. operational[38]

This difference is while treating pre-finance and pre-sale ICOs as sale of securities if they are standardised and suitable for mass trading.[39]

Prospectus requirements under Swiss Code of obligation will be applicable if asset token or coins similar to shares and other securities are issued while in the remaining cases it can be presented almost in any form. Under the Swiss Law the Anti-Money Laundering Laws apply to payment tokens only as they represent a means of payment within the meaning of Anti-Money Laundering Laws. Utility tokens and asset tokens do not fall within the scope of AMLA.

In terms of legal certainty Switzerland has adopted a unique approach of issuing No – Enforcement Action Letters. An ICO may submit its white paper and other details to FINMA which after determining the

36. Swiss Financial Market Supervisory Authority FINMA (2017), *FINMA trifft Abklärungen bei ICOs, Press Release*, (26-7-2019, 9:42 PM), <https://www.finma.ch/de/news/2017/09/20170929-mm-ico/>.
37. David Stacher, '*Regulation of Initial Coin Offering: An International Comparison with Focus on Switzerland'*, Universität Basel (July 2018).
38. Swiss Financial Market Supervisory Authority FINMA (2018), *Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs)*, (26-7-2019, 10:42 PM), <https://www.finma.ch/en/~/media/finma/dokumente/dokumentencenter/myfinma/1bewilligung/fintech/wegleitungico.pdf?la=en>.
39. Swiss Financial Market Supervisory Authority FINMA (2018), FINMA publishes ICO guidelines. *Press Release*, (26-7-2019, 10:53 PM), <https://www.finma.ch/en/news/2018/02/20180216-mm-ico-wegleitung/.>

nature of the ICO would confirm compliance with regulatory requirements or inform the issuer about the adjustments required to be made in order to complying.[40]

Singapore

Monetary Authority of Singapore (MAS) issued a guide to digital token offerings. The regulatory body directed the ICOs with characteristics as securities to be governed by them.[41] MAS shall govern digital tokens that constitute characteristics of a share, a debenture, a unit in a business trust, a security based derivative contract or a unit in a collective investment scheme[42] and issuance of a prospectus is mandatory in such cases.[43] However, a list of exceptions as to where no requirement of preparing prospectus has been released as to furnish with a regulatory womb for the growth of ICO. There have also been regulations governing the intermediaries to such processes which unlike other jurisdiction are a unique step on part of Singapore. The intermediaries have been categorised as primary platform on which the digital tokens are offered, financial adviser who gives advices pertaining to such offer and trading platform where such tokens are traded post issue.[44] Such categorised intermediaries have to get respective licenses from MAS. Further, to regulate cross border transactions, extra-territoriality of these provisions has been provided with.[45] Further, every form of token will be under the scanner of AML and CFT Laws providing additional safeguards against touted risks posed by ICOs.[46]

Australia

The Australian Securities and Investments Commission (ASIC) is Australia's corporate regulator. In Australia, the Securities Laws have not been changed to specifically to regulate ICOs[47] and the main discus-

40. David Stacher, "Regulation of Initial Coin Offering: An International Comparison with Focus on Switzerland", Universität Basel (July 2018).
41. Monetary Authority of Singapore, A Guide to Digital Token Offerings.
42. *Ibid*, ¶2.3.
43. *Ibid*, ¶2.5.
44. *Ibid*, ¶2.8.
45. *Ibid*, ¶2.12.
46. *Ibid*, ¶3.
47. ASIC Information Sheet 219, Evaluating distributed ledger technology.

sion has centred on the application of existing laws to virtual currencies and token generating events. The Australian Government issued an Issues Paper on Initial Coin Offerings in January 2019. Under this ICOs have been categorised into two, i.e. financial products and non-financial products. There shall be applicability of consumer laws to all the ICOs. In addition to consumer laws, in case of ICOs categorised as financial products additional provisions as applied to financial products under the Corporations Act, 2001 that provides for compliance and reporting obligations shall be applicable. The financial products can be in the form of managed investment scheme, derivative, share offering and non-cash payment facility.[48] These regulations shall also be applicable at the stage of secondary market trading of tokens and ICO exchange platforms would be required to obtain license in Australia.[49] However unlike other jurisdictions so far discussed where retail investors are generally discouraged from investing in ICOs there has been a tax exemption provided to the capital gains on personal use assets acquired for less than $10,000 are disregarded for tax purposes.[50] Further, virtual currency exchanges and other digital currency-related services have been brought within the ambit of the Act and are now subject to mandatory registration and reporting obligations.[51]

IV. REGULATORY FRAMEWORK IN INDIA

The response of Indian authorities regarding ICOs is rather perplexing. The erstwhile Finance Minister Arun Jaitley while presenting budget for 2018-19 on 1 February, 2018 stated that though virtual currencies do not constitute legal tender, the Government has a positive outlook towards Fintech Industry and acknowledges its importance in the Digital India

48. Australian Securities and Investment Commission, "Initial Coin Offerings and Crypto-assets", (26-7-2019, 6:18 PM), <https://www.asic.gov.au/regulatory-resources/digital-transformation/initial-coin-offerings-and-crypto-assets/>.
49. Australian Securities and Investment Commission, "Licensed and Exempt Market Operators", (26-7-2019, 6:08 PM), <https://www.asic.gov.au/for-finance-professionals/market-infrastructure-licensees/licensed-and-exempt-market-operators/>.
50. The Treasury, Australian Government, Issues Paper on Initial Coin Offerings (January 2019).
51. Australian Government, A guide to preparing and implementing an AML/CTF program for your digital currency exchange business, (26-7-2019, 10:18 PM), <https://www.austrac.gov.au/business/how-comply-and-report-guidance-and-resources/guidance-resources/guide-preparing-and-implementing-amlctf-program-your-digital-currency-exchange-business>.

campaign.[52] Following this, there were whispers in Indian market that authorities were planning to introduce a favourable regulatory framework for ICOs. This optimism was resonated when post this statement, ICOs were able to raise USD 200 million in a single round.[53] However, two months later, on 6 April, 2018, RBI brought out a circular which prohibited dealing in virtual currencies.[54] The RBI notification was challenged before Delhi High Court on account of being in violation of fundamental rights in multiple petitions and the matter has been finally clubbed before the Supreme Court of India as Internet and *Mobile Association of India* v. *Reserve Bank of India*.[55] The apprehensive attitude of Indian authorities continued when RBI released a draft for a regulatory sandbox to assess the feasibility of Fintech Industry in India on 18 April 2019 but initial coin offerings were specifically excluded from this framework. It is worth noting that an inter-disciplinary committee was also proposed to be setup under the aegis of Ministry of Finance to examine the possible framework regarding ICOs on 12 April 2017. However, the committee is yet to publish its report. In light of this discussion it can be concluded that there exists a vacuum in Indian legal framework concerning ICOs.

This leaves several questions for the contemplation on a wide variety of issues ranging from taxation, banking, and privacy to name a few. However the authors have limited their analyses to issues surrounding Securities Laws and in this regard have attempted to answer questions like:

(*i*) What is the nature of ICOs – do they constitute offering of securities and/or whether they qualify as managed investments like Collective Investment Schemes (CIS), Alternative Investment Funds (AIF) or Mutual Funds (MF)?

(*ii*) How would the intermediaries involved in the ICO be regulated?

52. Arun Jaitley, Minister of Finance, Budget 2018-19 Speech, (26-7-2019, 10:16 PM), <https://www.indiabudget.gov.in/budget2018-2019/ub2018-19/bs/bs.pdf>.
53. ShalinaPillai,*Indianstartupsraisefundsviabitcoins*,(26-7-2019,8:36PM),<http://timesofindia.indiatimes.com/articleshow/63195590.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst>.
54. Reserve Bank of India, Prohibition on dealing in Virtual Currencies (VCs), DBR.No.BP. BC.104 /08.13.102/2017-18, RBI/2017-18/154.
55. *Internet and Mobile Association of India* v. *Reserve Bank of India*, W.P.(C) No. 000528 - / 2018.

(*iii*) What sort of obligations would arise for ICOs under the existing AML Laws?

Nature of ICOs

Tokens as Securities

The primary question that regulators across the jurisdictions have tried to answer is whether tokens qualify as securities and therefore can be subjected to their Securities Laws. While the reasoning adopted by different countries varies; however, all of them have stated that treating of securities as tokens is a fact specific enquiry and would be done based on the individual characteristics of the token issued.

In India, the definition of security is found in a non-exhaustive list which includes shares, scripts, stocks, bonds, debentures, debenture stock, or other marketable securities of a like nature.[56] Further, the list also includes CIS, MF, derivatives, and certificates of debt receivable. An exclusion also had been provided as to the insurance schemes. Since the definition includes an open-ended phrase "other marketable securities of like nature" this has left scope for the courts to interpret. The Hon'ble Supreme Court in *Sahara India Real Estate Corporation Ltd.* v. *Securities and Exchange Board of India*[57] observed that "The definition clause in Section 2(h) of SCRA is an inclusive one" and that the primary test for any instrument to fall within the open-ended clause of the definition is the marketability of the instrument. Marketable Securities are understood as something which is capable of being sold in the market without any restrictions, i.e. freely transferable[58], regardless of the market size.[59] Another defining characteristic of securities is the ability of an instrument to be listed on a stock exchange.[60]

56. Section 2(h), The Securities Contract (Regulation) Act, 1956.
57. (2013) 1 SCC 1, ¶ 111.
58. *Dahiben Umedbhai Patel.* v. *Norman James Hamilton.*, (1985)57 Comp Cas 700: 1983 (85) Bom LR 275, ¶ 28.
59. *Bhagwati Developers Pvt. Ltd.* v. *Peerless General Finance and Investment Company Ltd.*, (2013) 9 SCC 584: (2013) SCC Online SC 617, ¶ 17-19.
60. *Mysore Fruit Products Ltd.* v. *The Custodian*, 2005 (107) Bom LR 955, ¶ 7; *Dahiben Umedbhai Patel* v. *Norman James Hamilton*, (1985)57 Comp Cas 700: 1983 (85) Bom LR 275.

Asset tokens as free tradable akin to public equity investments[61] and there are virtual currency exchanges like Bitfinex and Poloniex which like regular stock exchanges facilitate trading of tokens distributed in ICOs.[62] Thus asset tokens can be considered securities within the current definition under Indian law. However, an important consideration is that the issuer must be an incorporated company or body which might prove to be an obstacle in application of Securities Laws since many ICO issuing organisations are not incorporated at the time of floating the ICO.

However, once the tokens qualify as securities, the issuers may be required to comply with the requirements of the Companies Act, 2013 and SEBI regulations. SEBI (ICDR) Regulations[63] mandates compliance of requirements like minimum promoter's contribution, filing of draft offer with SEBI, appointment of credit rating agency, filing of prospectus, etc.

ICOs as Funds

Since ordinarily ICOs raise funds for a specified project, many jurisdictions have considered the possibility of treating them as pooled funds. In India pooled funds can take three forms namely—CIS, AIF and MF.

CIS is defined in Section 11AA of the SEBI Act and has three elements–

1. Any scheme or arrangement offered by a person to which contributions are pooled and utilised.
2. With an aim to gain profits, income, produce or property.
3. Is managed by an entity on investor's behalf and they do not have day-to-day control over management.

61. Nareg Essaghoolian, "Initial Coin Offerings: Emerging Technology's Fundraising Innovation", 66 UCLA L. Rev; Richard Kastelein, "What Initial Coin Offerings Are, and Why VC Firms Care", Harvard Business School Rev. (24-3-2017),<https://hbr.org/2017/03/what-initial-coin-offerings-are-and-why-vc-firms-care> [<http://perma.cc/U67H-KDR3>].
62. US Securities and Exchange Commission, Investor Bulletin: Initial Coin Offerings, (26-7-2019, 8:50 PM), <https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings>; Michael R. Meadows, "The Evolution of Crowdfunding: Reconciling Regulation Crowdfunding with Initial Coin Offerings", 30 Loy. Consumer L. Rev. 272 (2018); Jonathan Rohr and Aaron Wright, "Blockchain-based Token Sales, Initial Coin Offerings, and the Democratisation of Public Capital Markets", 70 Hastings L.J. 463 (2019).
63. SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009.

Scrutinising ICOs to the elements of CIS, an ICO is generally an invitation to the investors to invest in a project.[64] The token generally has no utility apart from right to future profits which is popularly termed as appreciation of tokens.[65] Further, the investors lack say in a day-to-day management as the investors that hold them are not involved in the decision making and are not entitled to vote on the decisions of the developers.[66] Therefore, in cases where an ICO is floated with the above-mentioned characteristics, they shall be governed by the SEBI (Collective Investment Schemes) Regulations, 1999 and shall be required to be registered with SEBI.[67]

The second type of available funds in India is MF which are defined under Regulation 2(q) of the SEBI (Mutual Funds) Regulations, 1996. MFs are the funds generally established for investment in securities or gold and its related instruments and real estate assets. Therefore, only those ICOs where funds are invested in any of the above defined avenues shall qualify as MFs.

Further, the scope of fund regulation in India has a broad scope with the SEBI (Alternative Investment Funds) Regulation, 2012. Regulation 2(*i*)(*b*) defines AIF with three elements–

1. Privately pooled investment vehicle collecting funds from investors, irrespective of nationality.
2. Have a specific pre-defined purpose.
3. For the benefit of investors.

The above funds should not be covered under CIS or MF. Therefore, every ICO with characteristics as a pooled fund not covered under MF and CIS can be regulated as an AIF, widening the regulatory scope.

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64. Nareg Essaghoolian, "Initial Coin Offerings: Emerging Technology's Fundraising Innovation", 66 UCLA L. Rev. 294 (2019).
65. Laura Shin, Are ICOs For Utility Tokens Selling Securities? Prominent Crypto Players Say Yes, *Forbes* (26-7-2019, 7:50 PM), <https://www.forbes.com/sites/laurashin/2017/10/02/are-icos-for-utility-tokens-selling-securities-prominent-crypto-players-say-yes/#663eed-0434fa> [<https://perma.cc/BW2D-PUU9>].
66. Matt Chwierut, Token Rights: Key Considerations in Designing a Token Economy, (26-7-2019, 7:56 PM), <https://coinspectator.com/news/9312/token-rights-key-considerations-in-designing-a-token-economy> [<https://perma.cc/RT8R-ZXCL>].
67. Securities and Exchange Board of India, FAQ- Collective Investment Schemes.

Analysing the ICOs within the contours of AIF, an ICO may be a start-up or a business organisation[68] offering tokens globally to invest into a project.[69] There is a predefined purpose, which is enlisted into white paper issued by the organisation availing funding through the ICO process.[70] The token has generally no utility apart from the right to future profits which is popularly termed as appreciation of tokens[71] and therefore are for the benefits of the investors.

ICOs as Deposits

Deposits are regulated in India under the Companies (Acceptance of Deposits) Rules, 2014 defined under Rule 2(c) as any receipt of money by way of loan or a deposit or any other form. Another law dealing with deposits is the Banning of Unregulated Deposit Schemes Bill, 2019 which received the cabinet's approval recently.[72] From both the legislations it can be gathered that the underlying feature of deposit is the promise to return the amount after a specified period of time in cash, kind or service. However, the general feature of ICO is that it is not redeemable and the seller generally does not have an obligation to repurchase the tokens.[73] Therefore the possibility of regulation of ICOs under the law pertaining to deposits is rare as of now given the way ICOs are structured currently.

Another issue that stems up is that prescribes corporate form as an essential part of the definition of deposits. Thus, for an ICO to qualify as a deposit the issuer must be registered as a company.[74]. Given most ICOs are floated by virtual organisations often even before incorporation it is

68. US Securities and Exchange Commission, Investor Bulletin: Initial Coin Offerings, (26-7-2019, 8:50 PM) <https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings>.
69. Nareg Essaghoolian, "Initial Coin Offerings: Emerging Technology's Fundraising Innovation", 66 UCLA L. Rev. 294 (2019).
70. Connie Loizos, How to Stage an ICO, *Techcrunch*, (26-7-2019, 6:50 PM), <https://techcrunch.com/2017/05/24/how-to-stage-an-ico-and-other-related-questions-you-might-like-answered> [<http://perma.cc/RL5Q-M7D5>].
71. Laura Shin, Are ICOs For Utility Tokens Selling Securities? Prominent Crypto Players Say Yes, *Forbes* (26-7-2019, 7:50 PM), <https://www.forbes.com/sites/laurashin/2017/10/02/are-icos-for-utility-tokens-selling-securities-prominent-crypto-players-say-yes/#663eed-0434fa > [<https://perma.cc/BW2D-PUU9>].
72. Press Information Bureau, Government of India, Cabinet dated 10-7-2019.
73. Jonathan Rohr and Aaron Wright, "Blockchain-based Token Sales, Initial Coin Offerings, and the Democratisation of Public Capital Markets", 70 Hastings L.J. 463 (2019).
74. Rule 2(I)(c), Companies (Acceptance of Deposits) Rules, 2014.

unlikely that the rules pertaining to deposits can be utilised to regulate ICOs.

Intermediaries

Although the principle object behind ICOs was disintermediation, a process can never run in vacuum and there lies a role of intermediaries. It starts from listing of the project and white paper on the ICO exchange to distribution of tokens. The intermediaries involved in the process are miners, ICO exchange and ICO rating agencies. India lacks any form of regulations that responds to technical framework of ICO intermediaries.

ICOs exchange operates like the regular stock exchange listing projects. However, there lies differentiation as to the type of token being listed as ICO tokens share different characteristics like equity, utility. etc. In India, stock markets are regulated by SEBI[75] to which regulations[76] have been laid down. Similarly, an ICO stock exchange shall be regulated by SEBI in instances of it listing equity tokens or tokens as a nature of CIS, AIF or MFs.[77] However, there is void as to regulations pertain to other categories of tokens.

With traffic in ICOs increasing, various online platforms have started to offer ratings on ICO campaigns with details including founder's identity verification and credibility in market, financial health of ICO, etc. such that to provide investors with an informed choice. But much like ICOs exchange, regulations pertaining to rating agencies[78] are only applicable in cases of rating of tokens with characteristics like securities.

ICOs in the paradigm of AML Laws

In India the principal statute governing money laundering issues is the Prevention of Money Laudering Act, 2002 (PMLA). This is supplemented by a number of rules and regulations namely:

75. S. 11(2)(a), Securities and Exchange Board of India Act, 1992.
76. Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2018.
77. NSE, Regulatory Framework, (26-7-2019, 7:00 PM), <https://www.nseindia.com/int_invest/content/regulatory_framework.htm>
78. Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999.

1. Prevention of Money Laundering (Maintenance of Records) Rules, 2005,
2. Guidelines on AML Standards and CFT/Obligations of Securities Market Intermediares Under Prevention of Money Laundering Act, 2002 and rules framed thereunder (SEBI AML/CFT Guidelines) and the RBI Master Direction – Know Your Customer (KYC), 2016.

PMLA pertains to both, the prevention as well as the prosecution of money lauandering. It seeks to prevent money laundering by mandating record keeping and imposing reporting obligations on reporting entities[79] Thus the main question is, whether ICO-issuing entities would fulfil the requirements of a repoting entity and therefore be subject to reporting requirements mentioned in Section 12, PMLA?

Reporting entity under PMLA includes a banking company, financial institution, intermediary or a person carrying on a designated business or profession. Further, PMLA considers a person engaged in safekeeping and administration of cash and liquid securities on behalf of other persons to be a person carrying on designated business or profession.[80] Thus it is clear that persons dealing in tokens qualifying as securities can be covered within the ambit of PMLA and connected rules and regulations.

Whether cryptocurrencies or payment tokens fall within the purview of PMLA is a matter of discussion. Financial institution which is one of the reporting entities includes a chit fund company, a house finance institution, an authorised person, a payment system operator, a non-banking financial company.[81] Further a payment system means a system that enables payment to be effected between a payer and a beneficiary, involving clearing, payment or settlement service or all of them.[82] The above-mentioned definition appears to be wide enough to include cryptocurrencies within its scope. However since in India payments systems are regulated under the Payments and Systems Act, 2007 (PSSA) the provisions of PMLA have to be read in conjuction with PSSA to understand the legal status of payment tokens in India. While there is nothing in the PSSA to exclude virtual currency, industry experts have raised a number

79. Prevention of Money Laundering Act, 2002, S. 2(wa).
80. Ibid, S. 2(sa)(v).
81. Ibid, S. 2(l).
82. Ibid, S. 2(rb).

of arguments as to why cryptocurrencies do not constitute a valid payment system. In order to fall within the purview of PSSA, the instrument in question must store some monetary value. Few commentators have observed that cryptocurrencies may not have any stored value on them and even if they do have any value it is highly contigent on market speculation. Therefore it is unlikely that they would constitute a valid payment system under the current Indian regulation.[83] On the other hand some argue that a virtual currency blockchain do create a technology, which allows payments to be effected between two parties and therefore amounts to payment systems.[84] The authors subsribe to the latter view and consider cryptocurrencies to constitute a valid payment system and thereofore subject to the provisions of PMLA.

V. PROPOSED SOLUTIONS

Having regard to international best practices, the authors propose the following suggestions for regulation of ICOs in India –

For Bringing Legal Certainty

Allowing Self-Regulatory Organisations to take the lead

Recognising the information asymmetry that exists between most regulators and industry participants, many countries are of the view that the best way to go about ICO regulation is to ask those who are directly involved, i.e. the industry itself.[85] This is done by giving recognition to a self-regulatory organisation (SRO), which is essentially a non-governmental organisation having the power to create and enforce stand-alone industry and professional regulations and standards.[86] Japan is pioneering ICO regulation through SRO[87] and can serve as a model for India. The Japan Virtual Currency Exchange Industry Association, the Japanese SRO has the power to create and enforce rules, prescribe penalties and is

83. Ashwin Ramanathan et al., "Blockchain and Cryptocurrency Regulation, 2019".
84. Vaibhav Parikh et al., "'India', The Virtual Currency Regulation Review" (2018).
85. Ryan Clements, "Can a Cryptocurrency Self-Regulatory Organisation Work? Assessing Its Promise and Likely Challenge", (26-7-2019, 7:05 PM), <https://sites.duke.edu/thefinregblog/2018/06/21/can-a-cryptocurrency-self-regulatory-organisation-work-assessing-its-promise-and-likely-challenges/>.
86. <https://www.investopedia.com/terms/s/sro.asp> (26-7-2019, 7:10 PM),
87. Jeremy Firster, Priming Taiwan for Self-Regulatory Organisation, *TheNewsLens* (26-7-2019, 7:12 PM), https://international.thenewslens.com/article/97741.

currently working on KYC criteria for ICO participants and white paper disclosure obligations amongst other proposals.[88]

The concept of SROs is not alien to Indian financial regulators. SEBI has made use of a SRO to regulate the distribution of securities such as mutual fund products, portfolio management, etc.[89] SEBI identifies SROs as a first-level regulator that performs the crucial task of regulating intermediaries representing a particular segment of securities market on behalf of the regulator.[90] India can consider setting up of a similar SRO for ICO regulation till such time as the authorities are in a position to appreciate the nuances of the technology and risks associated with ICOs.

Experimenting with Regulatory Sandbox

Several countries are experimenting with regulatory sandboxes (RS) as a mechanism to achieve a balance between investor protection and innovation. An RS allows Fintech Companies to test and train their business models in a relaxed regulatory environment under the supervision of financial regulators. The concept of sandbox for regulation of Fintech innovations was popularised by UK's financial regulator, Financial Conduct Authority. Since then, regulatory sandboxes have been introduced in several countries like Canada, Bahrain, Russia and Switzerland to deal with the regulatory vacuum on this matter. In Canada, participating in the sandbox allows firms to register or obtain exemptions from Securities Law requirements under a process which is faster and more flexible than the standard application procedure.[91] Under the Swiss Law companies can claim sandbox exemptions in acceptance of deposits without a banking license subject to threshold amount requirements.[92]

India recently started its tryst with this model of regulation when in April 2018, RBI published the details of a regulatory sandbox for the Fintech Industry.[93] The RBI has stated that it may consider relaxing some of the regulatory requirements for sandbox applicants for a stipulated

88. *Ibid*.
89. SEBI (Self-Regulatory Organisations) Regulations, 2004.
90. SEBI, Consultation Paper on Self-Regulatory Organisations in Securities Market, dated April 2019.
91. Canadian Securities Administrators, CSA Regulatory, Sandbox, 2018
92. Olivier Favre et al., "Switzerland- Virtual Currency Regulation Review" (2018).
93. *RBI*, Draft Enabling Framework for Regulatory Sandbox, dated 18-4-2019.

duration on a case-to-case basis.[94] The entities wishing to participate in the sandbox must qualify as startup as per the existing law[95] and satisfy the regulator about its banking conduct, credit worthiness, ability to comply with data protection and privacy amongst other things.[96] While this might suggest a positive attitude of Indian authorities towards ICO regulation the problem lies in the fact that as of now ICOs and cryptocurrencies have been specifically excluded from thr purview of RS.[97] National Association of Software and Services Companies (NASSCOM) and Payments Council of India (PCI) have urged RBI to reconsider its position and include cryptocurrencies and ICOs as a part of the sandbox to develop a better understanding of their potential risks and benefits.[98]

Given the advantages offered by an RS to various stakeholders of the ICO process and that a mechanism for implementing it is already in place, the authors believe that Indian authorities should consider extending the fintech sandbox to ICOs and cryptocurrencies.

Investor Protection

ICOs have democratised financial markets by allowing retail investors to be a part of innovative ventures, funding of which was traditionally limited to qualified investors. However, ICO offerings are by default risky as they target early stage risk finance and retail investors do not have the requisite skills and resources to undertake such high-risk and high-volatility investments.[99]

Against this backdrop regulators see an immense challenge in balancing the competing interests of investor protection and inclusiveness in the ICO market. However, some jurisdictions have come up with a policy of limiting the investments made by retail investors for the time being to

94. *Ibid*, ¶6.2.
95. DIPP Notification No. GSR 364(E) dated 11-4-2018.
96. *RBI*, Draft Enabling Framework for Regulatory Sandbox dated 18-4-2019, ¶6.5.
97. *Ibid*, ¶6.3.
98. Aisshwarya Tiwari, "India: Lobby Groups Ask the RBI to include Crypto, ICOs in Regulatory Sandbox", (26-7-2019, 7:22 PM), <https://btcmanager.com/india-lobby-groups-ask-the-rbi-to-include-crypto-icos-in-regulatory-sandbox/?q=/india-lobby-groups-ask-the-rbi-to-include-crypto-icos-in-regulatory-sandbox/&q=/india-lobby-groups-ask-the-rbi-to-include-crypto-icos-in-regulatory-sandbox/&q=/india-lobby-groups-ask-the-rbi-to-include-crypto-icos-in-regulatory-sandbox/&nonamp=1>.
99. OECD, "Initial Coin Offerings for SME Financing", (26-7-2019, 7:22 PM), <https://www.oecd.org/finance/initial-coin-offerings-for-sme-financing.htm>.

prevent them from unnecessary risk and unforeseen losses. For example, Thailand recognises that retail investors play a key role in development and success of ICOs; however, in order to limit their potential losses has imposed a limit of 300,000 baht per project.[100] Russia has imposed a similar limit of 50,000 roubles within one issue.[101]

The authors are of the opinion that the approach taken by Russia and Thailand in this regard can prove to be very useful in the Indian context where investor awareness about ICOs is still at a nascent stage.

Disclosure and Prospectus Requirements

ICOs were developed with an aim, easier and quicker access to funding which implicitly also meant surpassing bulky documentation requirements required in traditional funding. Moreover, fundamental principles to ICOs were Autonomous Virtual Organisations and Pseudonymity[102] and putting disclosure and prospectus requirements is antithetical to the concept of ICOs as they were developed to tap opportunity of unregulated cyberspace. However, there have been enough precedents as to the fraudulent dealings[103] of ICOs. Majority of ICOs are issued by the companies without any developed business[104] and thus vulnerable to theft leading to a substantial liability.[105] This leads us to the requirement of disclosure and prospectus. However, regulators should understand need for lenient regulations such that to provide with necessary impetus.

Against this backdrop, regulators see an immense challenge in balancing the interests of the investors such that also maintaining positive regulatory environment for the ICOs. However, some jurisdictions have come up with the disclosure requirements such that to limit risks of losses

100. Securities and Exchange Commission, "Public Consultation Document, Regulatory approach on Initial Coin Offering (ICO)", Aor Tor Ngor. 34/2560 dated October 2017.
101. Article 3.1, Draft Law No. 419059-7 on Digital Financial Assets.
102. Nate Crosser, "Initial Coin Offerings as Investment Contracts: Are Blockchain Utility Tokens Securities", 67 U. Kan. L. Rev. 379 (2018).
103. US *Securities and Exchange Commission Press Release 2018-23*, SEC Charges Former Bitcoin-Denominated Exchange and Operator with Fraud, (26-7-2019, 7:43 PM), <https://www.investor.gov/additional-resources/newsalerts/press-releases/sec-charges-fonner-bitcoin-denominated-exchange> [<https://perma.cc/L543-FVRQ>].
104. Ernst and Young, "EY Research: Initial Coin Offerings (ICOS)", (26-7-2019, 7:42 PM) <http://www.ey.com/Publication/vwLUAssets/ey-research-initial-coin-offerings-icos/$-File/ey-research-initial-coin-offerings-icos.pdf> [<http://perma.cc/8PSD-VFRB>].
105. Report of Investigation Pursuant to Section 21(A) of the Securities Exchange Act of 1934: The DAO, 2017 WL 7184670, at 9-10.

faced by investors although reducing the requirement to an extent. Russia has come up with comprehensive disclosure requirements for issuers and investors such that of regulations require the public offer to issue tokens to contain information about the issuer and its beneficiary; full name of the issuer of tokens and its beneficiary; location of the permanent executive body of the issuer and its beneficiary; the official website of the issuer in the Internet Information And Telecommunications Network, information on validator, location of the permanent executive body, official website - telecommunication network "Internet"; and information about the person engaged in depository activities. In Switzerland, if the token has characteristics of a security, a prospectus requirement under the Swiss Code of Obligations[106] is invoked. There is, however, also a need of certain exemptions to prospectus requirements required as ICOs still in development stage. Singapore provides us with a ripe example of exemptions that can be provided as to if the size of the offer is small[107], tokens offered as private placements[108] or offered exclusively to institutional or accredited investors solely.[109]

Therefore, the authors are of opinion that the prospectus should be an intermix of technological and financial information considering the complicated nature of ICOs meanwhile exemptions should be provided to ICOs with small offer amount such that to democratise fund raising.

VI. CONCLUSION

Investment bank JP Morgan's CEO Jamie Dimon once in 2017 stated that cryptocurrencies will be wiped out in just a matter of time from the financial system. The same organisation within one year in 2018 released a report exploring the future and current value of tokens and blockchain within the financial industry, changing its stance. This anecdote captures the meteoric rise of ICOs and involvement of technology in finance around the world. Acknowledge ICOs or see them making their own way out, but with success of ICOs like that of Drivezy in recent times one thing which is clear is that the future of ICOs appear to be promising.

106. Guidelines, Enquiries regarding the regulatory framework for initial coin offerings (ICOs), *Finma* dated 2-16-2018.
107. The size of the offer is not more than 5 million SGD within any 12 month period.
108. Offered to no more than 50 persons within a period of 12 months.
109. Monetary Authority of Singapore, A Guide to Digital Token Offerings, ¶2.7.

But with novel opportunities come novel threat. ICOs operate in a legal vacuum right now close to anarchy. Jurisdictions across the globe have been attempting to regulate ICOs from the threats of fraud, money laundering and duping of innocent investors. This provides India with a golden opportunity to draft a regulation hand picking up the tested systems across the globe and incorporating them to provide safe space for innovation meanwhile balancing the rights of investors.

Although India has self-standing regulations for regulating ICOs as funds, it being a security is a contentious issue and needs a clear definition accommodating ICOs. Further, utility tokens need to be freshly regulated with lack of regulatory response from India in this segment. But a question that still remains is whether SEBI is technologically equipped to regulate ICOs?

Sailing the Rough Waters: A Study of Duties of Directors and Creditor Protection under Companies Act, 2013

—*N Raghav Harini*†

ABSTRACT

The modern approach to the duties of directors, in which directors owe a duty to both shareholders and non-shareholders, has been embraced by Common Law countries and other legal systems. The judicial trend for almost four decades has expressly recognised the extension of directorial duty towards creditors. The duty finds its roots in the concept of limited liability and stakeholder approach. This article argues that it is justified in reorienting the duties of directors towards creditors. Section 166 of Companies Act, 2013, states that the duties of directors does not expressly mention the inclusion of creditors as one of the constituencies to which the duties are owed. In light of the same, the article examines the relationship between Common Law principles and codified law, and the scheme of the Section to import these rules. The article also studies the two models of duties, enlightened shareholder value model and pluralist model to understand whether an independent duty exists towards non-shareholders. Finally, the article raises three questions to trigger the duty towards creditors. These questions study various objective standards - balance sheet, cash flow tests, and substance versus form argument and subjective elements - knowledge and surrounding circumstances.

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I. INTRODUCTION

Creditor protection is not a spontaneous emergence of law. It is indispensable for capitalist development and to sustain the wealth of a country. Traditionally, there are three types of creditor protection; debtor control, credit contracts, and insolvency procedures.[1] The first two models are self-serving. The legal system of a country not only has the burden to set up efficient recovery and revival laws but also needs to ensure that there are sufficient norms to ensure that the creditors' interests are protected by the company and their agents.[2] Research has shown that with acceleration in the credit protection norms and judicial enforcement, credit constraints are loosened significantly.[3]

When creditor protection is pursued from the agency paradigm, the question of whether the directorial duties need a reorientation towards creditor protection has to be addressed. The judicial trend across the world tends to suggest that the directors need to consider the interests of creditors as a part of their directorial duties[4], with occasional digressions.[5] Firstly, the article explores the question of why the interests of the creditors have to be addressed under the agency paradigm. Secondly, the article pursues the directorial duties under the Companies Act, 2013. Finally, the article identifies the gunpoint at which the duty towards creditors ought to be triggered.

II. WHY SHOULD CREDITORS CONCERNS BE GIVEN IMPORTANCE?

One of the important consequences of incorporation of the company is the separate legal existence of a company and its members. Although a

1. Simon Deakin, Viviana Mollica and Prabirjit Sarkar, "Varieties of Creditor Protection: Insolvency Law Reform and Credit Expansion in Developed Market Economies", 15 Socio-Economic Law Review, 359 (Apr. 2017).
2. *Ibid*.
3. Daniela Maresch, Annalisa Ferrando and Andrea Moro, "Creditor Protection, Judicial Enforcement and Credit Access",(European Central Bank, Working Paper Series No. 1829, July 2015).
4. *Liquidator of West Mercia Safetywear Ltd* v. *Dodd*, [1988] 4 BCC 30 ("Liquidator of West Mercia"); *Facia Footwear Ltd* v. *Hinchliffe*, [1998] 1 BCLC 218; In the United States, In Re: STN Enterprises, 779 F.2d 901 (2nd Circular, 1985); *Credit Lyonnais Bank Nederland NV* v. *Pathe Communications Corporation* (Delaware Court of Chancery, 30-12-1991) ("Credit Lyonnais Bank").
5. *Yukong Lines Ltd of Korea* v. *Rendsburg Investments Corporation*, [1998] BCC 870.

company is mindless automation which requires the hands and the brains of its members and various agents[6], the company and its members are separate legal entities in the eyes of law. Although joint-stock companies were common earlier, it was only in the late 19th century that the legal consequences of incorporation were recognised.[7] The concept of limited liability is a concomitant of separate legal personality of the company. The members of the company are not liable for the debts of the company since the company is a separate legal personality from its promoters, members, and shareholders. A creditor's claim is restricted only to the satisfaction of the assets of the corporation and not of the members. Therefore, the legislative recognition of separate legal personality seems lopsided to the creditors.

In the commercial world, the creditors deploy various self-serving strategies (as mentioned in the introduction) to protect themselves from the downside risks of the company's ventures. Financial institutions may also appoint a person as a nominee director on the board of directors, subject to the articles of association.[8] However, these self-serving mechanisms involve a substantial amount of money and a relative bargaining power and non-institutionalised creditors may not be able to resort to them. Therefore the need for the director to acknowledge and value the interests of creditors becomes pertinent.

Consider a 'going concern', where the company decides to take up a risky project. In such a case the creditors of the company would not be concerned with the risky project as much as the shareholders. This is because if the company ends up in liquidation, the creditors would receive their debts. Shareholders, on the other hand, would be concerned about the risk-return matrix of the venture, since they would be the receivers of the profits. However, when a company is nearing insolvency or in the zone of insolvency, the tables seem to turn. The creditors tend to be the real bearers of risk of the company while the shareholders gamble their chances at reviving the company's health or making more profits for themselves. Directors as nominees of the shareholders are incentivised to pursue ventures that are favourable to shareholders while externalising the risk to the creditors.

6. *Stone and Rolls* v. *Moore Stephens*, [2009] 1 AC 1391, P.139.
7. *Saloman* v. *Saloman and Co.*, [1897] AC 22, HL.
8. S.161(3), Companies Act, 2013 ,(18 of 2013), Acts of Parliament,2013 (India).

Another argument in favour of the extension of directorial duties towards the creditors is the stakeholder theory. Under this theory the company is identified as a nexus of contracts. It postulates that the shareholders are not the only ones in the company to bear the brunt of the board decisions or the directorial inefficiencies.[9] The non-shareholding constituencies like employees, suppliers, and creditors have significant contributions to the growth of the company. Although most of these constituencies are contractually protected, it might not be adequate at all times, as mentioned before, due to various reasons. From this perspective, directors should not be viewed as agents of the company merely serving the shareholders but should serve multifarious non-shareholding entities of the company as well.

Thus the regulatory regime cast a duty on the directors to appreciate the risks that a creditor bears when the financial times are not great and shift the focal length of duties.[10]

III. COMPANIES ACT, 2013.

Section 166 of Companies Act, 2013 (hereinafter the Section) provides for directorial duties. The section reads as follows–

166. Duties of directors

(1) Subject to the provisions of this Act, a director of a company shall act in accordance with the articles of the company.

(2) A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, and the community and for the protection of environment.

(3) A director of a company shall exercise his duties with due and reasonable care, skill and diligence and shall exercise independent judgment.

(4) A director of a company shall not involve in a situation in which he may have a direct or indirect interest that conflicts, or possibly may conflict, with the interest of the company.

9. Ernest Lim, A Critique of Corporate Attribution: "Directing Mind and Will" and Corporate Objectives, Journal of Business Law (2013).
10. Liquidator of West Mercia, *supra* note 4, at 33; *Multinational Gas and Petrochemical Co.* v. *Multinational Gas and Petrochemical Services Ltd.*, [1983] 3 WLR 492; *Kinsela* v. *Russell Kinsela Pty Ltd.* [1986] 4 NSWLR 722.

(5) A director of a company shall not achieve or attempt to achieve any undue gain or advantage either to himself or to his relatives, partners, or associates and if such director is found guilty of making any undue gain, he shall be liable to pay an amount equal to that gain to the company.

(6) A director of a company shall not assign his office and any assignment so made shall be void.

(7) If a director of the company contravenes the provisions of this section such director shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

On a cursory perusal, it is obvious that the Section does not expressly state that the directors owe a duty towards creditors. Thus, reorientation of directorial duties towards creditors requires analysis in the light of, the scheme of the Act.

As already mentioned in the introduction, judicial systems across the world have recognised the duty of directors to protect the creditors who form a significant part of the company to prevent any sort of abuse towards the creditors. Common Law system suggests the existence of this duty both expressly and implicitly.[11] To import this Common Law principle within the realm of statutorily recognised duties under the Section, not only the scheme of the Act has to be examined but also the interplay between the two broad sources of law: the statutory law and the common law.

These two sources share a symbiotic yet complicated relationship.[12] There seems to be no legal complications when these sources are aligned. However, when a specific statute does not expressly provide for a right or an obligation, but the same has its origin and its sanction from the roots of Common Law, the discussion on importation or rejection of Common Law principles becomes relevant. The Companies Act, 2013 calls for this discussion, given the non-inclusion or non-exclusion of creditors under the Section.

A statute may exclude or confirm the operation of the Common Law upon a subject or employ as an integer for its operation, a term or

11. *Lonrho Ltd* v. *Shell Petroleum Co. Ltd.*, (1982) AC 173: [1980] 1 WLR 627; In Re: *Horsley and Weight Ltd.* [1982] Ch 442: (1982) 3 WLR 431; *Winkworth* v. *Edward Baron Development Co. Ltd.,* [1986] 1 WLR 1512.
12. Adam Pomerenke, Statute and Common Law, Address Before the TC Beirne School of Law, The University of Queensland (17-8-2017), in Current Legal Issues Seminar Series.

expression with the content given to it by the Common Law from time to time.[13] A Common Law principle may be imported if it is not inconsistent with the principles contained in the codified law.[14] This requires analysis of the construction of the Act and whether the importation is truly justified or merely a matter of convenience.

The Companies Act, 2013 had codified the duties of the director for the first time. The crux of codifying law is "*to be exhaustive on the matters in respect of which it declares the law and it is not in the province of a Judge to disregard or go outside the letter of the enactment according to its true construction*."[15] Therefore deference to the legislative wisdom is paramount in importing Common Law principles within statutory laws. It may be argued that since the Act does not expressly provide for the inclusion of creditors under the Section, it is beyond the power of courts to include them.

As observed previously, the Companies Act, 1956 did not have a corresponding provision to the Section. Although there is hardly any case which discusses the duties of a director under the erstwhile regime, the non-existence of the legislative provision would have made the resort to the Common Law principle indisputable. Section 465 of the Act (which is yet to be notified) discusses the operation of law that will remain in force with the enactment of the Companies Act, 2013. Section 465 (2)(c) states that any principle or rule of law that was a part of the repealed enactments shall not be affected, notwithstanding the repeal contemplated under subsection (1) of the same section. If and when this provision is officially operative, the importation of Common Law principle would be uncomplicated.

The Section is an embodiment of the stakeholder approach of the Company Law as argued in part II. It recognises that directorial duties must be extended to various sections such as employees, community, and environment in addition to shareholders. It can be argued that since the Section does not expressly prohibit the retreat to the common law principle of inclusion of creditor interests, the recognition of duty is consistent

13. *Aid/Watch Incorporated* v. *Commissioner of Taxation*, (2010) 241 CLR 539, P.18.
14. *Stovin* v. *Wise*, [1996] 3 WLR 388.
15. Joseph Peter v. State of Goa, Daman and Diu, (1977) 3 SCC 280: AIR 1977 SC 1812, 1814.

with its scheme. However, it is important for the words of it to bear an interpretation to confirm this view.

Although the justification for the inclusion of creditors in the directors' duties is convincing, Section 166 as it stands does not permit such an importation. Notwithstanding the fact that such importation is not coherent with the construction of the words of law, the next question is whether such duties of directors are independent or not.

Umakanth Varottil observes that the Companies Act, 2013 is not a legal transplant of the contemporaneous legislations across the world but is an autochthonous adoption of necessary provisions.[16] Section 166 draws its inspiration from Section 172 of UK's Companies Act, 2006. It is pertinent to consider the history of these legislations.

The Companies Act, 2006 is not a hasty legislation but a carefully deliberated work that entailed comprehensive discussions and debates on various facets of corporate governance. The Company Law Review[17] evaluated two different models of directorial duties, before the legislative drafting. The first model is the enlightened shareholder value (ESV model). Under this model, a company is viewed as a vehicle to maximise shareholders' wealth which ultimately results in the protection of interests of non-shareholding parties as well. The director does not owe any exclusive duty to the non-shareholders. The second model is the pluralist model. Unlike the first model, under the second model directorial duties are owed to every entity associated with the company, shareholding or otherwise. Pluralist model places both shareholders and non-shareholders on the same pedestal, thereby invoking an inference of exclusive and independent duty towards non-shareholders.[18] The legislative document suggests that the UK had chosen the ESV model[19], while India has embraced the pluralist form[20].

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16. Umakanth Varottil, "The Evolution of Corporate Law in Post-Colonial India: From Transplant to Autochthony" (NUS Law, Working Paper No. 2015/001, January 2015).
17. Department of Trade and Industry, *Modern Company Law for a Competitive Economy: Completing the Structure: a Consultation Document*, Company Law Review Steering Group, P. 3.51 (2000).
18. Mihir Naniwadekar and Umakanth Varottil, "The Stakeholder Approach Towards Directors' Duties Under Indian Company Law: A Comparative Analysis", (NUS Law, Working Paper No. 2016/006, August 2016).
19. *Supra* note17.
20. Twenty-first Report, Standing Committee on Finance (2009-2010) (15th Lok Sabha), The Companies Bill, 2009 (Ministry of Corporate Affairs), Lok Sabha Secretariat, New Delhi,

The obvious consequences of the second model are two fold. The first question is whether the model contemplates the consideration of interests of all stakeholders, irrespective of the financial health of the company (resource allocation, reorientation of duties are sub-issues of this broader question). The academic circle is of the view that the pluralist model is not sustainable in the long run since it leads to a conflict of interests apart from lack of resources to recognise the independent duty towards other stakeholders.[21] The courts also seemed sceptical about the existence of exclusive duty towards the director.[22] The second problem is the divorce between recognition of duties and enforcement of the same. Although the statute recognises the existence of duties, it does not provide an enforcement mechanism. This paradox in the duty-enforcement paradigm seems to suggest that the pluralist model is fallacious.

IV. WHAT'S THE TRIGGER FOR THE DUTY

Consider another instance: A transaction is carried out after boardroom deliberations and approvals. However, it has come to the knowledge of creditors that the transaction has put the creditors' interests at risk. The creditors, therefore, decide to sue the director(s) responsible for putting the company at a perilous situation.

To decide whether the director can be sued under these circumstances, several questions have to be raised. This part of the article attempts to decode the same. The following questions have been raised in light of the illustration:

1. When can creditors sue the directors?
2. Can all creditors sue?
3. Should the transaction be evaluated as a matter of substance or as form? Is the state of mind of the directors involved relevant?

1. When can creditors sue the directors?

The incidence of this duty does not arise at all times; their interests need not be given utmost emphasis at all times. The proposition emanates

31-8-2010.

21. S*upra* note 18; *supra* note 9.
22. *Spies* v. *The Queen*, [2000] HCA 43: 201 CLR 603.

from the fact that the consideration of creditors' interests at all times might be counterproductive. A company which is financially sound and which has been paying the dues to the creditors has no necessity to consider the interests of the creditors since, even if the venture fails, the creditors would be settled. This view has been ratified by the Delaware Court in the case of *Credit Lyonnais Bank Nederland, N.V.* v. *Pathe Communications Corporation*.[23] The Court held that when the company is solvent, the actual risk bearers are the shareholders and thus there is no necessity for consideration of creditors' interests. If the creditors are given certain veto rights while the company is healthy, the creditors might be interested in low-risk ventures, which might not be in the best interests of the company. When this argument is pursued under the two models of directorial duties, the fallacy under the pluralist model is noticeable even more. The pluralist model recognises the existence of exclusive duty towards creditors and other non-shareholders and thus the question of whether the protection of their interests at all times needs to be considered arises. But such a consideration, as observed above, would not be in the best interests of the company.

Since consideration of creditors' interests at all times is not in the best interest of the company, there needs to be a gunpoint at which the duty is triggered. Therefore, insolvency or doubtful insolvency, as the metric to trigger the duty is applied. Balance sheet test and cash flow test are widely used as two broad tests to ascertain whether a company is in insolvency or verging on insolvency (and therefore trigger the duty). Simply put, the balance sheet test reviews the assets and liabilities of an organisation and the cash flow test reflects the cash inflow and outflow of the company at a particular point of time.

In the case of *Yukong Lines Ltd of Korea* v. *Rendsburg Investments Corporation*[24], the balance sheet test was applied to decide whether the director had breached his duty. Similarly in the case of *Geyer* v. *Ingersoll Publications Co.*[25] the balance sheet test was applied. Australian jurisdiction had relied on the cash flow test[26] but later adopted a fact-sensitive

23. Credit Lyonnais Bank, *supra* note 4.
24. *Supra* note 5.
25. *Geyer* v. *Ingersoll Publications Co.*, 621 A. 2d 784.
26. *Bank of Australasia* v. *Hall*, (1907) 4 CLR 1514, 1527 (Austl).

approach in determining insolvency[27]. UK insolvency laws have transitioned in the same manner.[28]

The United Kingdom Supreme Court in the case of *BNY Corporate Trustee Services Limited* v. *Eurosail*[29] studied these two tests in a copious detail. In this case Eurosail, a special purpose entity was set up by Lehman Brothers to purchase mortgages against the issue of loan notes. After Lehman Brothers' Chapter 11 bankruptcy, the note holders believed that Eurosail would not be able to make any repayments, although the majority of the debt was due only in the year 2045. The Court had to consider the long-standing tests in determining the status of the company's financial health.

Lord Walker observed that although cash flow test is relevant in most of the cases. When there is a need to examine the financial health of the company in future there is a need to resort to the balance sheet test. He argues,

> *"The express reference to assets and liabilities is in my view a practical recognition that once the court has to move beyond the reasonably near future (the length of which depends, again, on all the circumstances) any attempt to apply a cash-flow test will become completely speculative, and a comparison of present assets with present and future liabilities (discounted for contingencies and deferment) becomes the only sensible test."*[30]

He also refers to Lord Neuberger's words that aptly capture the problem with a blind reliance on balance sheet test.

> *"More generally, I find it hard to discern any conceivable policy reason why a company should be at risk of being wound up simply because the aggregate value (however calculated) of its liabilities exceeds that of its assets. Many companies in that position are successful and creditworthy, and cannot in any way be characterised as 'unable to pay [their] debts'. Such a mechanistic, even artificial, reason for permitting a creditor to present a petition to wind up a company could, in my view, only be justified if the words of section 123(2) compelled that conclusion, and in my opinion they do not."*

27. *Taylor* v. *Australia and New Zealand Banking Group Ltd.*, [1988] 6 ACLC 808, 811 (Austl.).
28. Purpoint, In re, [1991] BCLC491; Rod Gunner Organisation, In re, [2004] 2 BCLC110; Cheyne Finance plc., In re, [2007] EWHC 2402 (Ch).
29. *BNY Corporate Trustee Services Limited* v. *Eurosail,* (2013) Bus LR 715: [2013] UKSC 28.
30. *Ibid*, at 37.

It may be inferred from the paragraph above that the application of these tests without consideration to surrounding circumstances would be arbitrary and mechanic and may sometimes lead to different results. For example, in a post-enforcement legal regime, there might be instability in the market dynamics or hindrances in certain industries. Currency movements, volatility in stock markets, late-maturing period of assets are certain factors that influence the asset and liability components of the financial statements. Blind application of these tests could affect the interests of the company since it is common for the business to oscillate in the health spectrum. Thus it is only fair when the surrounding circumstances and subjective elements are accounted for while determining the insolvency of the company.

2. Can all creditors sue?

If a suit can be initiated against directors for breach of their duty towards creditors, the next question is what kinds of creditors can sue. The courts have recognised that directors of a company owe duties towards creditors. However, they are under no obligation to prioritise the interests of potential creditors when entering transactions, even when there is a recognised risk of insolvency.[31] The UK Supreme Court in the *Eurosail* case observed that the petitions by prospective or contingent creditors cannot file a suit; however, if another creditor sued the debtor, the claims of prospective or contingent creditors could be admitted on proof.[32]

3. Should the transaction be evaluated as a matter of substance or as form? Is the state of mind of the directors involved relevant?

"*Whether or not the transaction is a distribution to shareholders does not depend exclusively on what the parties choose to call it. The court looks at the substance rather than the outward appearance*" are the words of Lord Hoffmann J in the case of *Aveling Barford* v. *Perion Ltd.*[33] These words imply that a transaction has to be evaluated as a matter of substance, i.e. based on the economic repercussions and accounting treatment rather than outwardly appearance or label. The *Aveling Barford*

31. *Henry George Dickinson* v. *Nal Realisations (Staffordshire) Ltd.*, [2017] EWHC 28 (Ch): [2018] 1 BCLC 623
32. *Supra* note 29, at p. 27, 32.
33. [1989] BCLC 626, 631.

case was one of the first cases that extensively discussed the substance versus form argument in light of unlawful distribution. Such an evaluation of a transaction not only aids in understanding the accounting treatment (which would affect the cash flow and balance sheet status) but it is also pertinent in understanding the role of the director and her state of mind.

The question of characterisation of the transaction, as Sir Owen Dixon CJ terms it in *Davis Investments Pty Ltd* v. *Commissioner of Stamp Duties*[34] and Lord Walker in *Progress Property Company Ltd.* v. *Moorgarth Group Ltd.*[35] is not a strait-jacket approach. In *Progress Property*, it was held that the substance of the transaction called for an investigation of all the relevant facts including the state of mind of the human beings involved[36], rather than objective or constricted approach. The case goes on to clarify when the subjective mind frame of such human beings have to be considered. Lord Walker observes that the state of mind of the controlling shareholder must not be a mitigating factor but when the factual matrix demands examination into surrounding circumstances such as market analysis, terms of negotiation, etc. such subjective criteria must be given due consideration. In this case, the appellant company Progress Property Company Ltd (PPC) sold its shares in a wholly-owned subsidiary YMS Properties Ltd to the respondent Moorgarth Group Ltd. (Moorgarth). The primary contention of the appellant was that the transaction was grossly undervalued. PPC contended that it was worth more than £4 million but that it was sold for as little as £63,225.72. The contention was challenged on the ground that Mr. Moore, the director of PPC and Moorgarth had genuinely believed that there existed indemnity and counter-indemnity but in reality, they did not. Lord Mance dismissed the case of PPC on three grounds. Firstly, he agreed with Lord Walker that the courts must look at the essence of the transaction and not the presentation of the parties. Secondly, he observed that the issue of re-characterisation of the transaction does not arise on the ground that the director had taken short-sighted or imprudent decisions. Thirdly, PPC argued that Mr. Moore ought to have known that the

34. NSW (New South Wales), (1958) 100 CLR 392, 406.
35. (2010) UKSC 55: [2011] 2 All ER 432.
36. *Ibid.*, at p. 27.

indemnity and counter-indemnity did not exist, as a director of both PPC and Moorgarth. Lord Mance dismissed this argument as well.

Knowledge is considered as an important criterion in determining the breach of duty of directors towards the creditors.[37] Lord Walker further observed that the discussion on knowledge might be redundant in certain cases like *Progress Property*, while it would be very pertinent to engage on it in cases like *Aveling Barford*.[38] Courts have appreciated an interesting tangent of the knowledge persuasion, the argument of ought-to-have-known, as well.[39] This argument posits that since the proof of knowledge is high or sometimes impossible, the introduction of an element of objectivity that the director ought to have known that the company was insolvent or was doubtfully insolvent would be an equitable standard. The academic circle is of the view that it might be just to adopt the ought-to-have-known standard since it might not be easy to establish the existence of knowledge all the times.[40]

But going back to Lord Walker's premise that knowledge might be irrelevant in certain cases, does not necessarily mean that the significance of the knowledge of directors can be compromised while evaluating their liability or the nature of the transaction. Directors as agents of the company have a responsibility to keep themselves updated on the functioning of the company, industrial practices and trends. They cannot be exonerated of their liability if they were oblivious to such practices. On the other hand, pursuing the doctrine of equitable fraud in which fraud comes into existence by an aggregate of its effect on the affected parties without any consideration to the subjective frame of mind of the directors[41] would not be fair either. It creates absolute liability on the directors which might affect their decision-making capabilities. They might not be willing to take decisions which they believe might entail risks. Therefore,

37. Liquidator of West Mercia, *supra* note 4, at 33.
38. *Supra* note 33 at P. 42, 44. He observed that a challenge to an undervalue transaction does not necessarily depend on grounds of knowledge of the director or by establishing the fault of the director.
39. Keay Andrew, "The Director's Duty to Take into Account the Interests of Company Creditors: When Is It Triggered?", MelbULawRev. 315 (2001).
40. *Ibid*.
41. *Armitage* v. *Nurse*, (1998) Ch 241: [1997] EWCA Civ 1279; *National Funds Assurance Co*., In re, (1878) 10 Ch.D. 118; *Welham* v. *Director of Public Prosecutions*, [1961] AC 103: (1960) 2 WLR 669.

the element of knowledge has to be appraised while deciding their culpability or evaluating the transaction.

V. CONCLUSION

The rationale (the limited liability argument and stakeholder approach) for extending the duties of directors towards creditors is compelling. Various jurisdictions have appreciated and acknowledged the same. However, Section 166 as it stands today does not permit the importation of this duty. There is also a necessity to clarify whether the duty is independent or parallel with the duty towards shareholders. It is only through a legislative exercise or court's interpretation that these questions can be answered.

There are two problems in the state of the law of duties towards creditors. Firstly, the subjective elements such as knowledge and circumstances are required to be compounded with these tests. However, there are legal constraints in either identifying those elements or establishing them. Secondly, there is no established standard for triggering this duty. Referring to a plethora of cases and treatise has only proved the above.

In a bid to appreciate the creditors' concerns and therefore to protect them, it is submitted that the apposite standard to trigger the duty, is when the director has a reasonable expectation that the company's solvency might be jeopardised. This test implies that the trigger is couched on the satisfaction of the director involved. Therefore, it is also submitted that the surrounding circumstances and elements, which involve the state of mind such as due diligence, knowledge, and intention be taken into consideration.

Equity Crowdfunding in India: Present Perspectives and Prospects

—Ayush Wadhi[†] *and Swati Shekhar*[‡]

ABSTRACT

"Fundraising is the gentle art of teaching the joy of giving"
—Henry Rosso

The Indian capital market is majorly dominated by traditional means of raising funds such as issuing of equity shares through IPOs, to funding through angel investors and venture capitals. The advent of technology gave birth to a symbiotic relationship between the traditional economy and its digital counterpart. One of the hallmark developments in raising funds by small enterprises, is to raise small quantum of amounts from a large number of people through online platforms that crystallised in the form of Crowdfunding. The principle of Crowdfunding is "wisdom of the crowd" which implies that the crowd has certain amount of wisdom and knows what could be a good investment for them. Besides obtaining funds through the masses it also proves to be an alternative to obtaining funds through angel investors and venture capitalists, making the exercise of raising capital for Start-ups in a much less strenuous fashion. This paper studies the genesis of finding a need to build a robust framework to recognise Crowdfunding route in India through the Consultation Paper on Crowdfunding in India released by the Securities and Exchange Board of India (SEBI) and critically analysing it in regard to the position of Equity Crowdfunding in India, in the backdrop of its benefits and risks, coupled with study of various jurisdictions in regard of Crowdfunding regimes. Moreover, the paper also explores recent trends of equity Crowdfunding and

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the probable future prospects. The leitmotif of the paper is to analyse the proposed recommendations by SEBI as opposed to the recent trend of preferring Alternative Investment Funding for Crowdfunding ventures and propose suggestions to a future regulatory paradigm where equity Crowdfunding, in its very essence could exist in India.

A. INTRODUCTION

The recovery of financial crisis in the last decade saw the rise in stricter lending policies in traditional market players that lend funds coupled with elaborate documentation discouraging borrowing in an economy with booming growth in the number of start-ups which consequently result in untimely disbursement of funds making it an impediment for small businesses to avail credit[1]. The route of obtaining finances in the form of Venture Capital, Angel Investments are strenuous to obtain as the latter prefer to favour investments specifically of large quantum. Thus many start-ups lose out on getting a prospective idea into the market due to insufficiency of funds. As small business owners have unique needs, traditional banking sources fail to address them. Thus a large number of start-ups and small enterprises turn to alternative sources of funding to meet their ends[2].

Crowdfunding is one such alternative source of funding that provides a practicable answer to small businesses and start-ups in raising funds. Crowd funding, is, as its name indicates, funding from the crowd-raising small amounts of money from a large number of investors. Unlike typical business financing, which comes primarily from wealthy individuals and institutional investors, Crowdfunding raises money from the general public.[3] Crowdfunding model can be of two types: equity and non-equity based model. Non-equity Crowdfunding is when people donate money online or purchase products or experiences in exchange for contributions

1. EY. What is the status quo? The future of financial banking: Minds made for redefining financial services. (14-7-2019. 2:53 AM) <https://www.ey.com/Publication/vwLUAssets/EY-The-future-of-SME-banking/$FILE/EY-The-future-of-SME-banking.pdf>.
2. *Ibid.*
3. Bradford, Steven C. 2012. "Crowdfunding and the Federal Securities Law." Columbia Business Law Review, 1-150.

to a project. The donation model falls within the ambit of non-equity type of Crowdfunding wherein contributors donate for charitable causes and receive nothing in return, Milan is one such Crowdfunding platform that works on the above said model in India.[4] The reward model also follows non-equity type of Crowdfunding that offers something to the investor in return for the contribution, but does not offer interest or a part of the earnings of the business. The reward could be small, such as a key chain, or it could be something with a little more cachet, such as the investor's name on the credits of a movie.[5] On the other hand, equity Crowdfunding allows people to become shareholders in a company, in equity Crowdfunding, companies sell ownership stakes online in the form of equity or debt[6]. Thus as investors are receiving equity in exchange for their funds and are thus purchasing securities thus attracts security regulations.[7] As this deals with funds invested in a company in exchange for equity it has called for stringent regulations by governing authorities', i.e. SEBI in the Indian scenario. Whereas, the peer to peer lending model is based on extending loans to small businesses, with an expectation of repayment where the business owner does not part with any part of his enterprise, becomes pertinent to note that the success of interplay between Crowdfunding and Fintech have opened new financial channels and give the customer a much simplified management of their activities, with the consequent cancellation of unnecessary management costs.[8]

In the light of the background of the brief explanation as provided hereinabove the paper seeks to critically analyse the status quo of Crowdfunding in India emphasising specially on equity based Crowdfunding: its future and challenges in India.

4. Terms and Conditions, FAQS (14-7-2019. 2:43 AM), <https://milaap.org/about-us/terms-and-conditions>.
5. *Ibid*, at 3.
6. *Ibid*, at 4.
7. Ibrahim, Darian M., "Equity Crowdfunding: A Market for Lemons?190" *Minnesota Law Review* (2015).
8. Paolo Pietro Biancone, Silvana Secinaro, Mohamad Kamal, Crowdfunding and Fintech: business model sharia compliant 1-10, European Journal of Islamic Finance.

B. MERITS AND RISKS ASSOCIATED WITH CROWDFUNDING:

To evaluate Crowdfunding it is essential to take into consideration the pros and cons to strike the right amount of balance in it. As Crowdfunding would broadly fall under the regulations framed by the securities board of a country it is pertinent to lay down such rules that cater to protecting investors from the associated risks of failure, fraud attached to it and assisting small businesses to raise capital in a manner that is economically viable. In this section the article attempts to lay down the merits and risks of Crowdfunding that regulatory authorities seek to balance.

Merits of Crowdfunding:

One of the basic points Crowdfunding seeks to establish is to bridge the gap of access to funds by small-medium enterprises or start-ups by employing technology and using social media by Crowdfunding platforms. This mitigates the spatial gap between the entrepreneur and the investors. It acts as a medium to accelerate investments by promoting the idea to multiple prospective investors online which proves to be more efficient that traditional borrowing from family and friends.[9] It solves the problem arising out of traditional sources of investing that are set at high rates of interest, small businesses often find it difficult to generate a steady cash flow to repay them, also lack of liquidity of assets to provide as a security - restricts the access to various forms of lending; by providing capital at a comparatively lower cost.[10] The benefits derived are threefold serving the interests of investors, entrepreneurs of the business and the intermediary platform. Investors get to engage themselves with the start-ups far beyond geographical boundaries, gain early access to non-pecuniary products along with partaking equity of the business whereas platforms also get to function on a revenue model by charging fees on successful projects, linking capital with ideas and help in increasing credibility of the same.[11] Crowdfunding essentially fosters the growth

9. Loreta Valanciene, Sima Jegeleviciute: "Valuation of Crowdfunding: Benefits and drawbacks" 44 Kansas University of Technology, Lithiuania (2013).
10. Armour, J. and Enrique, L. (2018), "The Promise and Perils of Crowdfunding: Between Corporate Finance and Consumer Contracts." The Modern Law Review, 81: 51-84. (16-7-2019, 11:57 PM) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3035247>
11. Agrawal, Ajay A., et al. 2013. "Some Simple Economics of Crowdfunding. National Bureau of Economic Research Working Paper" 19133, 1-46, (17-7-2019, 12:19 AM),

of the economy with the rise in emerging companies. Although it may be argued that Venture Capitalists and Angel investors contribute more to the running of the business as they have more expertise in specific areas, it must be noted that Crowdfunding is not expected to do away with the above forms of raising funds but to provide access to capital for small businesses who cannot afford the abovementioned, it seeks to connect investors who have less money to invest in small businesses that intend to raise capital both being the factors VC's and Angel investors do not touch. Thus, Crowdfunding helps small businesses to raise low cost capital by investors with the financial resources that are untouched and not superfluous in quantum.

Risks related to Crowdfunding:

The rate of failure of Crowdfunding campaign ranges from 69 per cent to 89 per cent contingent on the platform.[12] There are numerous risks associated with Crowdfunding both from the perspective of the investors as well as the entrepreneurs who seek to raise capital. Crowdfunding is essentially internet-based, which means that the money can be raised from people around the world and this could create problems pertaining to compliance of Local Laws of the countries. Moreover, the process being internet based, there is a higher risk of ascertainment of credibility of the investors as the meetings take place virtually.[13] Additionally, there is always a potential risk of a cyber- attack on the occasion that the platforms lack technical abilities for securing the data. Such an attack could involve "data theft, destruction or manipulation; identity theft; monetary theft as well as the disruption of IT services."[14] Furthermore, there is always a risk of default and in such cases there may be no recourse available to the investors. The premise of Crowdfunding is investing in a future possibility and this possibility carries with it a high risk of failure which

<https://www.nber.org/papers/w19133.pdf>.

12. Catherine Clifford: "Less than a Third of Crowdfunding Campaigns reach their goals", accessible at: <https://www.entrepreneur.com/article/269663>
13. *Supra* 10.
14. R. Tendulkar, "Cyber-crime, securities markets and systemic risk", IOSCO Research Department Staff Working Paper, July 2013. Found at: <https://www.iosco.org/research/pdf/swp/Cyber-Crime-Securities-Markets-and-Systemic-Risk.pdf> (accessed: 7-7-2019), 20:52 (Page 11)

may cause losses to the equity investors.[15] Another risk is that of illiquidity associated with equity Crowdfunding wherein there is no secondary market available for these securities to be traded.[16] The risk related to the entrepreneur is that their ideas, which are put up for Crowdfunding may be stolen by larger corporations or better funded investors in case the entrepreneurs lacks the knowledge for protection of the idea.[17] Thus, these are the risks that an investor and/or an entrepreneur might have to bear through the process of raising funds by the means of Crowdfunding.

Now that we have a fair idea as to the merits and risks of Crowdfunding, let us dive into a brief overview of the Crowdfunding regimes across various jurisdictions around the world.

C. JURISDICTIONAL ANALYSIS OF CROWDFUNDING:

USA

In the United States of America, on 5 April 2012, the Jump Our Business Start-ups Act, 2012 (hereinafter "JOBS Act") was introduced in order to facilitate small businesses to sell their securities to the public through the power of internet[18] by making amendments to the then existing Securities Laws,[19] but these regulations came into effect on 16 May 2016. The statutory requirements concerning Crowdfunding exemptions are primarily stated in Section 4(a)(6) and 4-A of the Securities Act, 1933.[20] Furthermore, all the transactions which take place are to be conducted by SEC-registered intermediaries, which either may be a registered broker or a "funding portal".[21] It is pertinent to mention that Title III of the JOBS Act (cited as the "Crowdfund Act.") eliminated the mandatory registration requirement and enabled the raising of funds without issue of prospectus. Moreover, the Act imposes a cap on the amount of funds which can be raised in a particular year through the process

15. Consultation Paper on Crowdfunding in India: SEBI Press Release PR 62/2014(17/06/14): (17-7-2019, 01:23 pm), <https://www.sebi.gov.in/sebi_data/attachdocs/1403005615257.pdf>
16. IOSCO Staff Working Paper - Crowd-funding: An Infant Industry Growing Fast , 2014
17. *Supra* 16
18. W.M. Cunningham, *The JOBS Act: Crowdfunding Guide to Small Businesses and Start-ups* (2nd edn. 2016).
19. Jumpstart Our Business Start-ups Act, Pub.L. 112–106, S. 302 – 305 (2012).
20. Securities Act, 15 USC S. 77d(a)(6), 77d-1 (1933).
21. Jumpstart Our Business Start-ups Act, Pub.L. 112–106, S. 302 (2012).

of Crowdfunding (amount not to exceed USD 1 million in a 12-month period).[22] Some other provisions include disclosure of documents, filing of the annual report with the regulating authority and prohibition on the funding portals to provide investment advice or making recommendations to the investors.

Italy

Italy was one of the foremost countries to come up with a Crowdfunding regulation[23] in the year 2013. But, the rules so made were too restrictive in nature which hampered the market of equity Crowdfunding to grow.[24] The regulation was initially meant only for "innovative start-ups" but later, the scope was expanded by allowing "innovative SMEs" to raise funds through Crowdfunding. Some important provisions of the regulation include registration of the online portals with CONSOB[25] which then is entrusted with the assigned task of shareholder protection, declaration of integrity and professional requirements for the controlling shareholders and persons performing managerial and supervisory functions[26] and maintenance of confidentiality of information obtained from the investors by the portal manager.[27] The platforms are entrusted with the duty to inform the non-sophisticated investors of the risks involved in making investments via equity Crowdfunding and also to examine the reliability of the claims made by the entrepreneurs who seek to raise funds through Crowdfunding.

New Zealand

In New Zealand, the Financial Markets Conduct Act, 2013 contains provisions to facilitate both peer-to-peer lending as well as equity Crowdfunding. The regulations made thereunder contain detailed eligibility criteria for the peer-to-peer lending and Crowdfunding service.[28]

22. *Ibid*.
23. Regulation on "the collection of risk capital via online portals", CONSOB Regulation No. 18592 (2013)
24. European Crowdfunding Network, Italy opens up equity Crowdfunding to all kinds of SMEs (23-7-2019, 7:37 PM), <https://eurocrowd.org/2016/12/13/italy-opens-equity-Crowdfunding-kind-smes/>.
25. *Supra* 26, Art 4-7.
26. *Ibid* at Art. 8-10.
27. *Ibid* at Art. 19
28. Financial Market Conduct Regulations, Reg. 186-187 (2014).

The companies are allowed to raise capital without issuing prospectus, up to the limit of USD 2 million from 20 investors in a 12-month period.[29] Moreover, it is pertinent to mention that the cost of Crowdfunding in New Zealand is lesser as compared to the US owing to the exemptions from the disclosure and registration obligations to the Crowdfunding companies.[30]

China

The scenario of Crowdfunding in China is highly dynamic and in is undergoing rapid change.[31] The reason for this rapid growth can be attributed to the lack of governing regulations which in turn leads to the setting up and initiation of the operations swiftly.[32] Crowdfunding in China, due to the legal uncertainty has been sculpted into "sale-oriented." What this means is that the investors buy the product before it has been produced and this happens at advanced stages of production.[33] This helps in shifting the risk from the investors to the entrepreneurs and as a result, the portals that use this model charge a comparatively lower fee. Similar to the international Crowdfunding platforms, the investors in China likewise need to accept a standard service contract while they open an account with the portal and this contract emphasises on the intermediate role played by the portal between the investors as well as the entrepreneurs.[34]

Australia

Crowdfunding in Australia is governed by a recent legislation, i.e. Corporations Amendment (Crowd-sourced Funding) Act, 2017, which has made certain amendments to the Corporations Act, 2001 in

29. Financial Market Conduct Act, Schedule 1, Part 1 (2013).
30. Andrew A. Shwartz, Equity Crowdfunding in New Zealand (24-7-2019, 01:38 pm), <https://www.law.ox.ac.uk/business-law-blog/blog/2018/10/equity-Crowdfunding-new-zealand>.
31. Andrea S. Funk, *Crowdfunding in China: A new institutional Economics approach,* 150 (2019).
32. Zaiyu Huang, Candy Lim Chiu, Sha Mo and Rob Marjerison, "The nature of Crowdfunding in China: initial evidence", APJIE 300, 305 (2018).
33. Julien Legrand, "E-commerce and Crowdfunding: Why are they the same in China" (24-7-2019, 08:39 pm), <https://yaleglobal.yale.edu/content/e-commerce-and-Crowdfunding-why-are-they-same-china>.
34. Jing Li, "Equity Crowdfunding in China: Current Practices and Important Legal Issues," The Asian Business Lawyer 59, 71 (2016).

order to facilitate Crowdfunding.[35] In order to engage in equity-based Crowdfunding activities, companies need to meet a certain criteria, which is that the company seeking to raise funds must have at least two directors, the place of business of the company must be Australia, the consolidated gross assets or annual income must not exceed $25 million and the company must raise funds only through an approved intermediary. Additionally, the company is allowed to raise funds to the tune of USD 5 million in a 12-month period through crowd-sourced funding and the cap on the investor investment is USD 10,000 per annum. [36]

D. CROWDFUNDING IN INDIA: PERSPECTIVES AND PROSPECTS:

1. The Sahara Case: Implications of Crowdfunding:

Before we get into the intricacies of the Crowdfunding regime in India, let us analyse the case *Sahara India Real Estate Ltd.* v. *Securities and Exchange Board of India* [37], wherein the perception of Crowdfunding was for the first time explored.

The Sahara Group of Companies (hereinafter "Sahara Group") controlled two unlisted companies namely Sahara India Real Estate Corporation Limited (hereinafter "SIRECL") and Sahara Housing Investment Corporation Limited (hereinafter "SHICL") out of which, at an EGM of SIRECL, a special resolution[38] was passed which sought to raise capital by issuing unsecured OFCDs by means of a private placement. The details of offer were included in the Red Herring Prospectus, which in opinion of the Sahara Group was to be filed with the Registrar of Companies[39] and it clearly stated that only those persons to whom the Information Memorandum (IM) was circulated[40] and/or persons associated or affiliated with the Sahara Group were eligible to invest in the OFCDs. The RHP also cited that the Sahara Group had no intention

35. Corporations Amendment (Crowd-sourced Funding) act, 2017, Act No. 17 of 2017 (Australia).
36. Australian Securities and Investment Commission, Crowd-sourced Funding (25-7-2019, 1:20 pm), <https://asic.gov.au/regulatory-resources/financial-services/crowd-sourced-funding/>.
37. (2013) 1 SCC 1 (India).
38. Section 81 (1A), Companies Act, 1956 (1 of 1956), Acts of Parliament (India).
39. Section 60, Companies Act, 1956 (1 of 1956), Acts of Parliament (India).
40. Section 60-B, Companies Act, 1956 (1 of 1956), Acts of Parliament (India).

to list the given securities on any recognised stock exchange and consequently, they were of the opinion that the RHP would have to be filed with the ROC and not with the Securities and Exchange Board of India (hereinafter "SEBI").

The actual tussle began when another company belonging to the Sahara Group, i.e. Sahara Prime City Limited (SPCL) had submitted a Draft Red Herring Prospectus (DRHP) to SEBI in order to raise funds through an initial public offering (IPO). As a disclosure obligation, SPCL, in its DHRP had to reveal the fundraising information of companies controlled by the Sahara Group. Post publication of the draft, SEBI invited comments and objections on the draft from public.[41] There were several objections and complaints raised by the public regarding the fundraising by two companies namely SIRECL and SHICL, who had raised funds by issuing OFCDs to a large number of people for a considerably long amount of time, which was omitted in the DHRP of SPCL.

As a result, SEBI sought clarifications from Sahara Group, but they refused to respond. The contention of Sahara Group was that the as cited in the RHP, the companies were not meant to be listed on any stock exchange and thus, SEBI could not seek information for the same reason.[42] However, due to its concerns over investor protection, SEBI ordered an investigation to examine whether there has been any contravention of regulations or directions issued by the board by a person in relation to securities market.[43] After the investigation, SEBI concluded that the IM was issued through 1 million agents and over 2900 branch offices to more than 30 million persons inviting them to subscribe to the OFCDs and for this reason, it amounted to a public invitation and hence, would fall under the jurisdiction of SEBI and ordered the repayment of the entire sum of money to the investors with an interest rate of 15 per cent. Sahara group filed an appeal to the Securities Appellate Tribunal against the impugned order, but this appeal was dismissed and the Sahara Group preferred an appeal to the Hon'ble Supreme Court of India.[44]

41. Regulation 9, Securities and Exchange Board of India (Issue of Capital and Disclosure Regulations), No.SEBI/LAD-NRO/GN/2018/31, 2009 (India).
42. Section 55-A, Companies Act, 1956, (1 of 1956), Acts of Parliament (India).
43. Section 11-C, Securities and Exchange Board Act, 1992, (15 of 1992), Acts of Parliament (India).
44. Section 15-Z, Securities and Exchange Board Act, 1992, (15 of 1992), Acts of Parliament (India).

The bone of contention was whether the OFCDs offered by the companies fall under the purview of "private placement" or a public offer. Sahara Group accentuated that the RHP expressly stated that the offer was open only to the persons to whom the IM was circulated and/or the persons who were associated/affiliated with the Group. Moreover, none of the securities were listed on any recognised stock exchange. The Supreme Court appraised Section 67 of the Act[45] which dealt with the issue of debentures to public. The Court put emphasis on the proviso of Section 67(3) which states that the offer made to 50 or more persons would be treated as a public offer and par the scope of this section. On this point, the Court held that as the OFCDs were issued to the general public and hence it does not fall under the purview of private placement.

The court further held that the provisions of Section 60-B(9)[46] would be attracted because the offer was made to the public through the IMand hence, the prospectus must be filed with SEBI. Finally, the Court after ascertaining that the impugned offer was a "public offer" held that the provisions of Section 73[47] would be attracted which contained provisions for mandatory listing of the securities on the stock exchanges. In the end, the offer made by SIRECL and SHICL was considered to be public offers and they were ordered to refund the sum of money collected via the RHP along with 15 per cent interest to SEBI.

As a repercussion of the Sahara Case, it was felt necessary to segregate the jurisdiction of SEBI and RoC and this could be achieved by clearly describing the constituents of a "private placement" and a "public offer". To achieve this, a change was introduced in the Companies Bill, 2011 wherein Section 42 was to be the provision to govern private placements, which could be made to 50 persons (except qualified institutional buyers and the employees) at a time, and 200 persons in one financial year. For answering the situation of demarcation between a public offer and private placement, there is a provision made wherein it is clearly stated when the company, whether listed or unlisted, offers to allot securities to a number of people exceeding the prescribed limit, it will be deemed to be a public offer.[48] Hence, in this way, certain provisions were made in

45. Section 67, Companies Act, 1956 (1 of 1956), Acts of Parliament (India).
46. Section 69-B(9), Companies Act, 1956 (1 of 1956), Acts of Parliament (India).
47. Section 73, Companies Act, 1956 (1 of 1956), Acts of Parliament (India).
48. Explanation I, Section 42(2), Companies Act, 2013 (18 of 2013), Acts of Parliament (India).

order to prevent further frauds from occurring and to protect the investors, which is of prime importance.

2. SEBI Consultation Paper on Crowdfunding in India

a. The present regulatory paradigm in India

Presently, the Companies Act, 2013 and the SEBI Act 1992 primarily provide a framework on businesses raising funds. However before the existence of the 2013 Amendment, the erstwhile act provided for a lengthy procedure for a company to issue securities to the public like issuing a prospectus, listing and registering securities on stock exchange that consumed considerable amount of time rendering the process to in turn prove expensive to small businesses. On the other hand private placement of securities under Section 67 of the 1956 Act, required the number of offerees to be restricted to not more than 49 persons. [49]

It was only after the 2013 Amendment, Section 42 was introduced that fixed the number of offerees to whom private placement offers were made to 50, exceeding which such an offer would be deemed as a public offer under Chapter III –Part 1 of the 2013 Act. As per the latest amendment rules on Section 42 of the 2013 Act, an offer to subscribe to private placement cannot be made to more than 200 persons.[50] The limit does not count within its scope offers made to the qualified institutional buyers, or to employees of the company under a scheme of employees stock option[51] SEBI has also instituted a platform to enable Small Enterprises and Start-ups to raise funds through SME Segment of Exchanges, Institutional Trading Platform (ITP), Category I- SME Fund under AIF Regulations wherein companies having post-issue face value capital not more than 10 Crore Rupees shall list only in SME platform.[52] Also a company, having post issue face value capital between 10 Crore to 25 Crore Rupees have an option to list themselves on this platform.[53]

Moving forward after noting the present legal structure in place to raise funds for small businesses and start-ups, the Consultation paper

49. Section 67, Companies Act, 1956 (1 of 1956), Acts of Parliament (India).
50. Rule 2(2) Companies (Prospectus and Allotment of Securities) Second Amendment Rules, GSR 752(E), 2018. (India)
51. *Ibid*.
52. *Supra* 18.
53. *Ibid* at 18.

seeks to place a mechanism that looks after Crowdfunding in India as an additional route to raise capital for such enterprises and leaning to strike a balance between investor protection and access to capital markets by providing sufficient protection for investors on one hand and avoiding strenuous regulations for the issuers on the other.[54] The key points mentioned therein can be understood as follows:

I. Nature of Investors:

The consultation paper expressly states that as retail investors in India are not suited for investing in securities that involve high amount of risk, only Accredited Investors may be participants of Crowdfunding in India except those retail investors who have sound knowledge of investing in high risk securities guided by investment manager and avail services of portfolio management.[55] Additionally they are required to have:

(*i*) minimum income of 10 Lakh Rupees,

(*ii*) have filed Income Tax Return for at least three financial years, and

(*iii*) would not invest an amount greater than 60,000 Rupees and less than 10 per cent of their net worth through Crowdfunding platforms.

II. Investment Limits:

Further SEBI proposed a cap for Crowdfunding offering to be made to not more than 200 persons that excludes qualified institutional buyers (QIB) or to the employees of a company. Parallel to this a similar rule is laid down in the Companies (Prospectus and Allotment of Securities) Rules, 2014, restricting the number of offerees in case of a private placement offer. A minimum offer value per person has been set at 20,000 Rupees as given under the Companies (Prospectus and Allotment of Securities) Rules, 2014 and thus it is proposed as follows:

Person	*Investment Limit Recommended*
QIB	Purchase five times the minimum offer value and Should hold minimum of 5% of issued securities.
Company	Purchase four times the minimum offer value
HNI	Purchase three times the minimum offer value

54. *Ibid* at 29.
55. *Supra* 18.

III. A) Disclosures: For issuers in the light of raising funds

The cornerstone of making Crowdfunding a success in the Indian capital market is to have legitimate disclosures by the issuer of securities seeking to raise funds through the Crowdfunding platforms by submitting a private placement offer letter (PPOL). A few of the contents as listed by SEBI under this PPOL is namely information related to name and registered address, business plan of the venture for which funds are proposed to be raised and proposed usage of the funds obtained and valuation of securities. The PPOL would be then circulated by the Crowdfunding platform to the Accredited Investors registered with its forum. Additionally, a report prepared depicting the future estimation of sales and growth ought to be a part of the disclosures due to the lack of performance history available of such small businesses and start-ups. Disclosures are also mandated by SEBI in the consultation paper in lieu of using the funds obtained through Crowdfunding, namely ongoing disclosures, audited financial statements, performance since the past disclosures made, channeling the funds in accordance with the purpose of issue of such securities.

B) Disclosures: For platforms raising funds

The main onus of the Crowdfunding platform in lieu of raising funds is to mitigate the risks attached to it and ensure high credibility of such transactions. This could be achieved through screening of issuers and conducting primary due diligence, verifying the presence of a disclaimer that spells out the risks attached to the investment, and also conduct due diligence of the investors to ensure they meet the requirements as specified by SEBI.

b. Critical analysis of the Consultation Paper:

Although SEBI has tried borrowing from various jurisdictions to build a regime that is conducive to legitimise the functioning of Crowdfunding in India, it nevertheless leaves room for some loopholes. The first of all being, participation of investors in the process of raising funds is solely restricted to Accredited Investors not exceeding 200 offerees of which retail investors need to have sound knowledge on investment along with high capital to bare the losses that arise out of such investments[56]. The

56. *Ibid* at 8.

number of such retail investors are handpicked as compared to the retail investors that form a majority in the market, itself eliminates unsophisticated investors and thus removes the crowd from Crowdfunding defeating the very objective. [57] This leads to the further challenge of whether Accredited Investors with ample resources and market know-how would prefer investing in start-ups and small businesses in small amounts over other forms of investments in raising funds, such as venture capital and angel funding?

Although the minimum offer value of 20,000 Rupees has been waived off by Companies (Prospectus and Allotment of Securities) Second Amendment Rules, the stipulated requirements of QIB's, Companies and HNI collectively must own 50 per cent of the securities, unless this requirement is met, the issuer does not see the light of raising funds through Crowdfunding causing it to fail in the nascent stages.

The scope of the SEBI consultation paper limits itself to unlisted public companies. The process to comply with this provision rather proves burdensome for start-ups and small businesses having dearth of capital may not find it viable to start off as a public company. Many small businesses and start-ups begin as Private Limited Companies, One Person Company, Limited Liability Partnership and thus including such business models becomes important.[58]

As specified under the disclosures, it is mandatory for the Crowdfunding platform to conduct basic due diligence and screening process of the issuer. As Crowdfunding in India is open to only Accredited Investors equipped with sophisticated financial advisors having a grip over the market, conduct a detailed due diligence of the business seeking to raise funds through this platform. It poses an open threat to the efficacy of the Crowdfunding website, deteriorates credibility of the platform and imposes burden on the enterprise seeking to raise these funds. [59]

The consultation paper touches very slight aspects of transfer of securities traded through Crowdfunding platform that states transfer of

57. Darian M. Ibrahim, "Crowdfunding Without the Crowd," 95 NCL Rev. 1481 (2017), <https://scholarship.law.unc.edu/nclr/vol95/iss5/6/>.
58. Stuti Shah, Equity Crowdfunding in India: Towards a Regulatory Framework, 4 RMFLR (2017) 168
59. Majumdar, Arjya, Regulating Equity Crowdfunding in India - A Response to SEBI's Consultation Paper (22-6-2015 (26-7-2019, 11:58 AM) <http://dx.doi.org/10.2139/ssrn.2621488>

securities could be through a buyback in accordance to the Companies Act, 2013 or transfer to any other Accredited Investor/family member/friend/relative or any other investor. It fails to define who fall under the categories abovementioned. The cascading effect of this provision leads to the formation of an ambiguous unregulated secondary market in regard to equity Crowdfunding. The paper also remains silent on providing clarifications on cross border Crowdfunding. However the paper sends out a strong message that as provided under Section 42 of Companies Act, 2013 Crowdfunding platforms would follow the Private Placement Procedure from approaching the platform with a PPOL to issuing securities to the Accredited Investors.

E. RECENT TRENDS OF EQUITY CROWDFUNDING AND ITS FUTURE PROSPECTS

In India, under the current paradigm there is grey area as to the legality of Crowdfunding on account of absence of laws. But, SEBI has a clear stance on equity Crowdfunding and has declared it illegal under a Caution Press Release[60] wherein, it is mentioned it has come to the notice of SEBI that fundraising activities on unauthorised online platforms (such as websites and other internet based online portals) are occurring by way of Private Placement in contravention to the provisions of the Securities Contract (Regulation) Act, 1956 and the Companies Act, 2013. Hence, issue of securities through these unrecognised online portals in India is illegal.

As a repercussion to the aforementioned press release, SEBI sent show cause notices to numerous Crowdfunding platforms functioning in India seeking information about the legitimacy of the fund raising procedure of the platforms.[61] Subsequently, SEBI sent notices to these platforms for not abiding by the provisions of private placement and hence the firms lined up to be registered with SEBI as Alternate Investment Funds (AIF).

60. *SEBI Cautions Investors, Securities and Exchange Board of India*, PR No. 137/2016, (26-7-2019 02:33 am), <https://www.sebi.gov.in/media/press-releases/aug-2016/sebi-cautions-investors_33094.html>.
61. Anirudh Laskar, "SEBI wants Crowdfunding bodies to warn investors" (26-7-2019, 02:55 am), <http://www.nishithdesai.com/fileadmin/user_upload/pdfs/NDA%20In%20The%20Media/Quotes/170908_Q_Sebi-wants-disclaimer-for-Crowdfunding_01.pdf>.

It is pertinent to mention that bringing the Crowdfunding platforms under the purview of AIF would mean that they would be governed by the provisions of SEBI (Alternate Investment Fund) Regulations, 2012 (hereinafter "AIF Regulations) and this will restrict the scope of Crowdfunding to a great extent. The very essence of Crowdfunding is "wisdom of the crowd", but due to it being governed by AIF Regulations, Only an investor having minimum net tangible assets worth of 2 Crore Rupees is eligible to invest. The minimum amount of investment to be made by the investor is 1 Crore Rupees [62] (except the employees or directors of funds), and the minimum amount to be invested in a scheme is 20 Crore Rupees[63] Moreover, the maximum number of investors is capped at one thousand[64] (and if the AIF is a company, the provisions of Companies Act, 2013 are to be applied). Therefore, considering the aforementioned provisions, it can be deducted that the very essence of Crowdfunding is being deteriorated as the stringent regulations of AIF will govern the regime Crowdfunding in India.

F. RECOMMENDATIONS FOR A PROSPECTIVE REGIME OF EQUITY CROWDFUNDING IN INDIA.

In the end, this paper would like to explore some probable regulatory possibilities in form of suggestions so that Equity Crowdfunding, in its very essence could exist in India. To build a robust structure to regulate Crowdfunding in India, the regulations have to be in such a manner that it strikes a perfect balance between investor protection and widening the scope of capital markets for the purpose of raising funds. In the light of the above discussion, the recommendations made in the SEBI consultation paper are a better alternative than channelising crowd funding through AIF regulations. Although the SEBI consultation paper is holistic in nature, the authors seek to make some recommendations to make Crowdfunding future proof, such as; the scope of Accredited Investors should be widened and there should be an increase in the limit of offerees against issuing securities with differential voting rights to include the

62. Regulation 10(c), SEBI (Alternate Investment Fund) Regulations, 2012, LAD-NRO/GN/2012-13/04/11262, 2012 (India).
63. Regulation 10(b), SEBI (Alternate Investment Fund) Regulations, 2012, LAD-NRO/GN/2012-13/04/11262, 2012 (India).
64. Regulation 10(f), SEBI (Alternate Investment Fund) Regulations, 2012, LAD-NRO/GN/2012-13/04/11262, 2012 (India).

'crowd' in crowd funding, eliminate minimum investment limit in regard to QIB, HNI, Company so as to facilitate the transaction in the absence of such minimum requirements, make way for more express clarifications in regard of transfer of securities so that investors are insulated to the threat posed by illiquidity. Prime importance must be given in making crowd funding a concept of all or nothing i.e. keeping execution of the business plan at a standstill unless the set targeted funds have been achieved. Further, disclosure and reporting obligations must be standardised so as to regulate the cost of Crowdfunding. Hence, in conclusion, the existence of a Crowdfunding in the very essence that it is supposed to exist is still a long way due to the stringent provisions and absence of a regulatory framework in India, but its future is full of opportunities.

Social Stock Exchanges: A Small Step in Regulation, a Giant Leap for Impact Investment

—*Tanya Vinod Nair*†

ABSTRACT

Social finance, also known as impact investment, is the form of investing that combines financial and social or environmental returns. The impact investment sector in India is steadily growing, with the funding in 2016 alone reaching USD 1.1 billion. However, social enterprises still in India still struggle to obtain adequate capital. To combat this and bring about financial inclusion in the country, the creation of a social stock exchange was proposed in the 2019-20 Union Budget. A social stock exchange is a platform for impact investors to engage with social businesses and voluntary organisations and invest in them. Presently, social stock exchanges are operational in a number of countries such as Singapore, Canada, South Africa, Brazil, Jamaica, etc. Social stock exchanges differ from their conventional counterparts on various grounds, such as disclosure requirements, regulation of investors, etc. This paper seeks to provide an understanding of the concept of social stock exchanges and to analyse its role in the regulation of the social finance sector in India. It will also attempt to suggest some legislative changes to make the current capital markets regime in India ready for a social stock exchange. India's impact investment environment is currently controlled only by the laws applicable to conventional investments, in spite of the unalike natures of typical financing and social finance. It is therefore now hoped that the proposed social stock exchange will help create a standardised mechanism for impact investment transactions, reduce deal costs for the investees and lessen their dependence on foreign contributions.

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On July 5, the Finance Minister Ms Nirmala Sitharaman presented the Union Budget for the financial year 2019-20, and introduced a slew of structural reforms, focusing mainly on the infrastructure, education and transport sectors.

One of the initiatives is the creation of a social stock exchange—an electronic fund raising platform for social enterprises and voluntary organisations to raise capital by issuing equity, debt or even mutual fund-like units[1]. The purpose behind this, as per the Finance Minister, is to bring the capital markets closer to the general public and to meet the Government's goals on financial inclusion and inclusive growth[2]. This proposed exchange will be regulated by the Securities and Exchange Board of India (SEBI)[3]. This initiative is considered to be highly beneficial in further opening up the social finance sector in India.

SOCIAL FINANCING IN INDIA - A CONTEMPORARY MOVE FOR INCLUSIVITY IN ECONOMIC GROWTH

Social finance, or impact investing, aims at resolving social problems by harnessing the power of the market to address pressing global social challenges—to do well financially by doing social good[4]. With social finance, impact investors put their capital behind ventures (known as "social businesses") that profitably cater to the poorer, more vulnerable people in the society. These businesses provide access to critical goods and services, such as financial services, healthcare, affordable housing and quality employment to the economically and socially disadvantaged—people excluded from ordinary markets because conventional businesses view them as being too costly or risky to service or employ. The Global Impact Investing Network, an association working to expedite the development of the impact investing industry, has provided the following definition for impact investments:

> "Impact investments are investments made into companies, organisations and funds with the intention to generate social and environmental impact

1. Nirmala Sitharaman, Budget Speech, Ministry of Finance, Government of India, (20-7-2019, 9:13 AM), <https://www.indiabudget.gov.in/budgetspeech.php>.
2. *Ibid.*
3. *Ibid.*
4. Sarah Dadush, Regulating Social Finance: Can Social Stock Exchanges Meet the Challenge?, 37 U. Pa. J. Int'l L. 139, 143 (2015).

alongside a financial return. Impact investments can be made in both emerging and developed markets, and target a range of returns from below rate to market rate, depending on the circumstances."

According to a report by Brookings India, the impact investing sector in India attracted over USD 5.2 billion between 2010 and 2016, with over USD 1.1 billion invested in 2016 alone.[5] These numbers show that impact investing is slowly coming up as a new asset class in Indian investing, as investors are gradually moving towards investment options that provide them with social and environmental returns along with the financial benefits. Presently, impact investors use several equity and debt instruments, including social impact bonds, development impact bonds and outcome funds to generate investment. Social impact bonds are result-based contracts between private investors who invest in social programs, service providing social enterprises (for example, NGOs) and an outcome payer, usually the Government, which will repay the investors, and also provide them with additional returns if the program is successful in achieving its intended outcomes; development impact bonds, are essentially the same as social impact bonds, but where the outcome payer is a private entity[6]. Similarly, outcome funds provide capital only when positive social outcomes are confirmed[7] to provide capital to social businesses.

In spite of this, the same report showed that 57% of the social enterprises surveyed recognised access to capital as their foremost obstacle to growth. This clearly means that governments, social enterprises and impact investors need to now shift their focus on effective resource mobilisation, outcome-based incentives for investees, and bringing more private capital in the hands of institutional as well as retail investors into the hands of the social impact sector.

For this purpose, the Government has proposed the creation of a social stock exchange, an electronic platform to facilitate impact investment in

5. Shamika Ravi, Emily Gustafsson-Wright, Prerna Sharma, Izzy Boggild-Jones, "The Promise of Impact Investing in India", The Brookings Institution, (20-7-2019, 9:42 AM), <https://www.brookings.edu/wp-content/uploads/2019/07/The-promise-of-impact-investing-in-India.pdf>.
6. "How Development Impact Bonds work, and when to use them", The Dalberg Group, (20-7-2019, 12:23 PM), <https://www.dalberg.com/our-ideas/how-development-impact-bonds-work-and-when-use-them>.
7. "Fundraising Essentials: Outcome Funding", FundsforNGOS, LLC. (20-7-2019 3:22 PM) <https://www.fundsforngos.org/featured-articles/fundraising-essentials-outcome-funding/>.

social enterprises, which will operate on the lines of a conventional stock exchange. Social enterprises seeking to increase their funding and step up their ventures can engage with investors who are looking for opportunities that will offer them financial returns along with an affirmative societal influence.

This essay attempts to understand the concept of social stock exchanges and how they are different from conventional stock exchanges as well as analyse its possible regulatory function in the presently under-regulated social finance sector. Additionally, it will also endeavour to make some suggestions on what legislative changes are required in the present Indian capital markets regime to make it better suited for a social stock exchange.

WHAT ARE SOCIAL STOCK EXCHANGES?

A social stock exchange can be understood as a platform to connect "businesses that deliver social and environmental value with investors seeking both a social and a financial return."[8] Its primary purpose is to act as a facilitator between impact investors and social enterprises. Just like a typical stock exchange, a social stock exchange also acts in a regulatory capacity, by necessitating listed social enterprises to comply with its rules and regulations to maintain their listing. For example, social businesses can be expected to furnish the exchange with their annual reports prepared in the manner set out by the social stock exchange. However, unlike regular stock exchanges, social stock exchanges demand not only information pertaining to the listed entity's financial status, but also its social performance.

Additionally, social stock exchanges create and assess innovative instruments to set aside social organisations and impact investors from their traditional equivalents, institute systems to regulate social finance transactions and also seek to improve the relationship between impact investors, listed social entities as well as their beneficiaries.[9]

Some of the advantages of social stock exchanges are:

8. *Supra* at 4.
9. *Supra* at 4.

1. Social stock exchanges provide impact investors and investee companies with access to a market especially meant for investment opportunities that combine financial and social returns.
2. By creating a standardised set of procedures for social impact investment transactions, social stock exchanges help reduce transaction costs for impact investors. On the other hand, one may argue that listing on a social stock exchange will require a social business to incur high costs, but here it must be kept in mind that listing will eventually benefit these enterprises by providing them with greater accessibility and availability, better public outreach and a more diverse set of investors.
3. Listing on a social stock exchange will also give social ventures a seal of quality, as they will have to go through extensive due diligence in order to get listed and also adhere to strict governance and disclosure norms to maintain the listing. This will increase impact investors' confidence in them.
4. A social stock exchange will create an environment of transparency in the social finance sector and will help impact investors make more informed decisions.
5. Social stock exchanges can be vital in regulating the social finance sector, which currently does not have its own legislation in India and is regulated by the Securities Laws applicable on the instruments used in impact investment transactions.

SOCIAL STOCK EXCHANGES FROM AROUND THE WORLD - POTENTIAL LEARNINGS FOR INDIA

Presently, social stock exchanges are operated in a number of countries, like Brazil, South Africa, the UK, Singapore, Canada, Jamaica, etc. Some of them are further discussed below:

1. The Social Stock Exchange (SSX), United Kingdom

   The SSX's mission is "to create an efficient, universally accessible buyers' and sellers' marketplace where impact investors and social impact businesses of all sizes can achieve a greater impact

either through capital allocation or capital raising."[10] Further it aims to "bridge the gap between the increasing desire of businesses to make a difference alongside making a profit and those investors who share this vision and have the means to enable it to be fulfilled."[11]

An interesting feature of the SSX is that it does not operate as a proper trading platform, but more accurately as a source of information for investors to learn about impact investing opportunities. It requires a listed social enterprise to also be listed on a traditional stock exchange as for public trading and trade in securities permitted by that exchange.

2. The Social Venture Connection (SVX), Canada

The SVX started in 2013, with a mission to create a "market for good" in the form of "a local, impact-first platform connecting impact ventures, funds, and investors in order to catalyse new debt and equity investment capital for local ventures that have demonstrable social and/or environmental impact."[12] Just like the SSX, the SVX is not a full-fledged stock exchange. It only acts as "a private investment platform built to connect impact ventures, funds and investors."[13] It is open only to accredited investors and has no secondary market for the securities issued by its listed entities.

The SVX also imposes substantial obligations on these sophisticated investors by way of an Investors Agreement, in order to attract stakeholders who are equally committed to the financial as well as social aspects of their investments. This Investors Agreement also gives SVX the right to penalise investors[14]. However, the contract does not clarify instances in which the exchange may take such a measure. This is a trait not commonly found in conventional stock exchanges, but it does require additional clarification.

10. Our Mission, Social Stock Exchange, (20-7-2019, 5:54PM) <http://socialstockexchange.com/our-mission-history/>.
11. *Ibid.*
12. Adam Spence, Tristina Sinopoli, SVX: Invest for impact: Case Study, Social Venture Exchange, (Jul. 21 11:43AM), <http://s3.amazonaws.com/svx.production/cms/files/files/000/000/007/MaRS_SVX_Case_Study-original.pdf>.
13. *Supra* at 4.
14. SVX Listing Agreement, Social Venture Exchange, (20-7-2019 7:40 PM), <https://svx.ca/en/terms-of-use>.

One more noteworthy characteristic of the SSX is the restriction on the amount of investment in a transaction, which depends on know-your-client and sustainability requirements. By putting this cap on the financial returns an investor can obtain, the exchange can ensure that the investor's main focus is the social return[15].

3. The Impact Exchange (IX), Singapore

The IX was launched in 2013 as "the world's first social stock exchange dedicated to connecting impact enterprises with capital that reflects values".[16] It allows listing of common equity, preference shares or bonds of for-profit businesses; bonds issued by not-for-profit impact entities and shares or units of social investment funds.[17] It is a joint initiative between the Stock Exchange of Mauritius (SEM) and the Impact Investment Exchange Asia (IIX).

The most remarkable highlight of the IX is its prerequisite to appoint an Authorised Impact Representative (AIR) "to support it through the listing process and ensure compliance with its listing requirements (a Nominated Impact Advisor) as well as to verify impact reports at the end of each financial year (an Impact Verification Agent)."[18] According to the exchange, the AIR will help ease the listing process for interested organisations and also provide for the impartial authentication of the issuer's social and environmental impact.[19]

HOW ARE SOCIAL STOCK EXCHANGES DIFFERENT FROM REGULAR STOCK EXCHANGES?

Social stock exchanges, as the name itself suggests, are stock exchanges created to specifically cater to investors and investee looking for investment opportunities that combine financial and social returns.

15. *Supra* at 4.
16. Impact Exchange, Impact Exchange, (Jul. 20, 9:03 PM), <https://iixglobal.com/impact-exchange/>.
17. Impact Exchange Board Listing Guide, Impact Exchange, (Jul. 20, 9:03 PM), <https://iixglobal.com/wp-content/uploads/2017/04/Impact_Exchange_Listing_Guide-2017-1.pdf>.
18. *Ibid.*
19. *Ibid.*

1. Stakeholder Protection: A unique distinction between social stock exchanges and conventional stock exchanges is that in the more popular traditional exchanges, the only stakeholders protected by the exchange are investors. On the other hand, social stock exchanges also have the duty to look out for the beneficiaries of their listed entities.

   According to Sarah Dadush, Professor of Law, Rutgers Law School, beneficiaries as stakeholders of a social stock exchange are equally important as the investors or the listed bodies, lest they be left behind by the promise of social as well as financial returns that social finance is based on[20]. Especially since social finance seeks to bridge the gap caused by a lack of governmental and philanthropic contributions, the vulnerable section it ultimately serves has become more dependent on the money it brings to social enterprises and voluntary organisations working for them. In this light, it is important for the social stock exchange to keep check and balance mechanisms in place to prevent their listed entities from losing sight of their social objectives for the allure of bigger investments.
2. Investor Regulation: While a traditional stock exchanges punishes an investor for flouting clauses of Listing Agreement, SEBI Act or other capital market guidelines, social stock exchanges add fresh responsibilities on investors. For example, Canada's Social Venture Connection (SVX), protects its listed entities from investors not concerned with their social objectives, by asking potential investors to enter into an investor agreement to regulate their conduct. It also maintains the right to ban an investor for not meeting promised social goals, thereby going beyond purely financial regulations.[21]
3. Disclosure Norms: The disclosure requirements typically put in place by social stock exchanges are also not like the ones demanded by typical stock exchanges, as most stock exchanges expect social ventures interested in listing to furnish their financial information as well as reports stating their social or environmental impact. In fact, the IX, which operates in Mauritius, has made it compulsory for listed entities to have an Authorised Impact Representative

20. *Supra* at 4.
21. *Supra* at 14.

(AIR) as mentioned earlier.[22] This AIR also act as an Impact Verification Agent (IVA) who validates the listed entity's impact reports at the end of every financial year. All AIRs, IVAs and NIAs (Nominated Impact Advisor, who help the social enterprises with the listing process) must be authorised by the exchange[23].

4. Audit Scope and Impact: According to the Listing Guide published by the Impact Exchange, the IVA "may be viewed as an external, independent social impact auditor with a specific expertise in the assessment of the social and environmental impact and returns on investment generated by impact entities."[24] An issuer's appointed IVA will assist it in satisfying its market transparency requirements and ongoing impact reporting obligations."[25]

ROLE OF SOCIAL STOCK EXCHANGES IN REGULATION OF THE SOCIAL FINANCE SECTOR IN INDIA

At the moment, the social finance sector in India does not have any laws for its control. Its organisational structures, operations and most importantly investments, are all governed by the legislations governing traditional for-profit businesses.

There is no legal distinction between social businesses and conventional businesses, in spite of the fact that the main objectives of these types of organisations are vastly different. Similarly, their stakeholders, challenges, etc. are also not the same.

Some of the major issues faced by social enterprises in India are[26]–

1. Heavy reliance on foreign aid which is also tough to obtain.
2. Mission drift in for-profit enterprises.
3. Tax incentives.

It is believed that the advent of a social stock exchange will help mitigate some of these problems. For example, one of the key intentions of the

22. *Supra* at 16.
23. *Ibid*.
24. *Ibid*.
25. Ibid.
26. Anirudh Gaurang, Barkha Jain, "Understanding the Financial Challenges faced by Indian Social Enterprises", National Stock Exchange, (22-7-2019 01:12 AM), <https://www.nseindia.com/research/content/RP_17Oct2014.pdf>.

proposal of the exchange was to reduce Indian social enterprises' reliance on foreign contributions.[27] The social stock exchange will bring forth more impact investment opportunities for retail and institutional investors alike, which will help the organisations move away from foreign aid.

The problem of "mission drift" refers to a number of ways in which social enterprises can move away from their goal to help the vulnerable, to the sole motive of more profit. "In pursuit of more profit, a business may be inclined to target relatively better-off customers, raise prices to take advantage of the lack of competition often encountered in underserved markets, or take cash out of the business rather than reinvest in innovation to enable even broader customer reach."[28]

The Indian social impact sector also faces the hindrance of a mission drift, and unfortunately there is no protection against this in Indian law[29]. However, other social stock exchanges around the world have successfully implemented procedures to prevent this. For example, the SVX in Canada has eligibility criteria for investors and also presses significant responsibilities on the investors[30]. Most importantly, the exchange has also put in place a limit on the deal size between investors and investees[31]. This can help the SVX put a limit on the maximum financial returns an impact investor can obtain in a particular transaction. On the other hand, since the listed entity's ability to garner funds is also capped, the upper limit on returns can prevent misuse of limited funds and help keep commercial pressures to reap excessive returns from the market at bay.

In the current Indian tax regime, only donations made up to a certain amount in specified organisations and funds are eligible for tax deductions under Sections 80G and 80GGA of the Income Tax Act, 1961. It is suggested that this benefit should be extended to investment in securities issued at the social stock exchange, in order to make impact investment through the exchange more lucrative.

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27. "Social stock exchange idea highlights India's move away from foreign aid", The Guardian, (22-7-2019 09:00AM), <https://www.theguardian.com/global-development/2019/jul/09/india-social-stock-exchange-could-revolutionise-ethical-impact-businesses-aid-nirmala-sitharaman>.
28. *Supra* at 4.
29. *Supra* at 25.
30. *Supra* at 14.
31. *Supra* at 4.

PREPARING THE CURRENT INDIAN CAPITAL MARKETS REGIME FOR A SOCIAL STOCK EXCHANGE

The present regulatory environment in Indian capital markets does not provide for any laws specific to social enterprises. In fact, it does not contain anything to oblige listed companies to disclose their social or environmental impact either. In this section, we aim to discuss some legislative changes required in the present laws to better suit the needs of the proposed social stock exchange.

1. Bringing about cost effectiveness: One of the primary objectives of the social stock exchange is to reduce transaction costs for its listed entities by creating a standardised procedure for impact investment transactions. For this purpose, let us look at the processes adopted in conventional stock exchanges. For example, to make an Initial Public Offer (IPO), the company seeking a listing must comply with the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements), 2018 (ICDR Regulations) the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements), 2015, (LODR Regulations) the Listing Agreement with the relevant stock exchange, etc.

   The ICDR regulations list out the eligibility criteria for a company seeking to make a public issue or a rights placement. In the case of a public issue of securities, the company is required to engage multiple intermediaries such as merchant bankers, custodians, credit rating agencies, underwriters, etc. This makes the process very costly. However, as explained earlier, social enterprises usually do not have enough funds to make out this IPO. Hence, it is suggested that the Securities and Exchange Board of India (SEBI) amend the ICDR Regulations, LODR Regulations, the Companies Act, 2013 and all other relevant laws to create a separate, cost-effective route for entities listed in the social stock exchange to issue securities.

2. Preventing misuse of funds: A central function of social stock exchanges is to "help social businesses commercialise their financing so that they can scale up operations and break their dependency on grant funding.:"[32] This is not as necessary in a conventional

32. *Supra* at 4.

stock exchange, because there the listed entities often operate on a larger scale that traditional listed companies. Although in the case of social businesses and voluntary organisations, such assistance can go a long way to prevent misuse of funds, as well as the problem of mission drift.

For this purpose, SEBI can look at the Singaporean IX for inspiration. The IX, as a part of its listing procedure, asks entities to appoint an Authorised Impact Representative, who will act as a Nominated Impact Advisor (an intermediary who will assist the issuer with the listing process), and an Impact Verification Agent, who will verify the issuer's impact reports at the end of each financial year.[33]

The Impact Verification Agent, who is essentially a social auditor, is entrusted with the following functions:[34]

i. Perform a rigorous analysis and review of the issuer's recorded impact information

ii. Provide a signed independent analysis of the issuer's recorded impact information by evaluating the impact of the issuer against the projected social and/or environmental objectives and indicators.

3. Creation of a separate rating system : In conventional stock exchanges, issuers making public issues of shares must necessarily obtain a credit rating from a SEBI-registered credit rating agency, as per the ICDR Regulations. However, if this rule is extended to the planned social stock exchange, then such a credit rating will prove to be futile because it measures financial returns only. On the other hand, we now know that a social enterprises' key feature is that it focuses on financial as well as social or environmental results. Therefore, it is recommended that SEBI either adopt a globally well-known method of impact measurement or create a new one for the social stock exchange.

The Impact Reporting and Investment Standards (IRIS) is a standard system that "provides standard social, environmental,

33. *Supra* at 17.
34. *Ibid.*

and financial performance indicators for defining, tracking and reporting the performance of investment capital.[35]"

IRIS is a set of standardised metrics which can be used to compute and describe the social, environmental and financial performance of organisations and businesses receiving impact investment capital.[36] Similar to International Financial Reporting Standards or the Generally Accepted Accounting Principles, IRIS can be integrated into most approaches to impact reporting and data management platforms.[37] IRIS metrics can also be easily integrated into custom impact measurement systems used by investors across the field.[38] The Global Impact Investing Network has managed IRIS since 2009.[39] Before 2009, it was jointly administered by The Rockefeller Foundation, Acumen and B Lab.

Another equally popular method of social impact measurement is the Global Impact Investing Rating System. GIIRS is a wide-ranging and transparent scheme for measuring the social and environmental impact of developed and emerging market companies and funds. It seeks to spark the impact investment industry by providing a tool that is intended to change investor behavior and unlock sidelined investment capital through comparable and verified social and environmental performance data on high impact funds and companies seeking investment capital.[40] GIIRS Ratings & Analytics allows entrepreneurs, companies and fund managers to better serve their customers, workers, and communities by raising capital from mission-aligned investors based on the social and environmental impact of their underlying businesses or portfolio companies.[41]

35. Impact Reporting and Investment Standards – IRIS, The International Trade Centre, (23-7-2019, 7:33 PM), <http://www.forumdecomercio.org/WorkArea/DownloadAsset.aspx?id=58642>.
36. Sarah Gelfand, "Why IRIS?", Stanford Social Innovation Review, (23-7-2019, 7:35 PM), <https://ssir.org/articles/entry/why_iris>.
37. *Ibid*.
38. *Ibid*.
39. *Ibid*.
40. Beth Richardson, "Sparking Impact Investing through GIIRS", Stanford Social Innovation Review, (24-7-2019 09:00AM), <https://ssir.org/articles/entry/sparking_impact_investing_through_giirs>.
41. *Ibid*.

Therefore, we see that there are certain changes required in India's securities laws for them to be made right for a social stock exchange. As at the time of writing only the proposal for the social stock exchange has been released, it will be interesting to see how it changes the regulatory environment in India.

CONCLUSION

The social stock exchange, introduced in the 2019-20 Union Budget, is expected to be a major boost to India's impact investment environment, which has been plagued by a lack of funding. This deficiency severely affects social enterprises and voluntary organisations working to provide affordable housing, healthcare, etc. to the vulnerable sections of society. With the help of a social stock exchange, these ventures can attract more funds from domestic investors on a transparent and centrally regulated platform. The social stock exchange model is currently operational in many countries including Singapore, the UK and Canada. The exchanges there have adopted innovative measures to protect their impact investors, listed organisations as well as the beneficiaries of those social ventures. Additionally, the proposed social stock exchange is also a giant step towards the regulation of impact investment in India. However, a major challenge is that the existing laws regulating capital markets in India are not suitable for a social stock exchange. Hence, it is suggested that appropriate changes be introduced to ensure the smooth creation and operation of a social stock exchange in India.

To Enforce, or Not to Enforce: The Impacts of Ipso Facto Clauses on Indian Insolvency

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ABSTRACT

Ipso Facto Clauses are defined as clauses which make contracts determinable on insolvency. These clauses give complete discretion to the contractor to terminate the contract upon the insolvency of the other party. This creates an uneven balance of power within a contract and makes the process of insolvency resolution difficult. This article examines the response of foreign jurisdictions to such clauses, with the most recent being Australia completely putting a stay on their enforcement. The current position in United States of America as well as United Kingdom is examined. The authors have then linked this analysis back to the Indian context and analysed how ipso facto clauses make the achievement of the main purpose of the Insolvency and Bankruptcy Code, 2016 [IBC] difficult and can push companies further away from successful resolution. These clauses make running the corporate debtor as a going concern nearly impossible as they allow suppliers to stop the supply of material, no matter how crucial it may be to the running of the corporate debtor, without any notice. The authors have explained how these clauses can be disastrous to all stakeholders in the resolution process. However, the authors have also noted that there is a marked insufficiency in the safeguards provided to suppliers in the IBC and have suggested the possibility of including a scheme which provides better protection to suppliers to incentivise them to continue supplies to an entity undergoing the insolvency process. This shall ensure that the corporate debtor has a greater chance at resolution.

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I. INTRODUCTION

Freedom to contract is an integral part of any contractual law regime. Under Classical Contract Law, parties are free to enter into any form of contract with each other with minimum interference of the court. Then, they are strictly bound by the contract even if such a contract is disadvantageous to any party.[1] The principle of sanctity of contract is described as a thread which runs through contract from beginning to end, enjoining the courts to be ever vigilant in ensuring that established and new doctrines do not become an easy exit from bad bargains.[2] The freedom and sanctity of a contract are necessary instruments of *laissez faire* and it is the duty of courts to foster the one and to vindicate the other.[3] The classical principle of contracts states that public policy requires that men of full age and competency should have utmost liberty of contracting and that their contracts entered into freely and voluntarily must be upheld by the Courts of Justice.[4] This principle postulates that the most elaborate form of social organisation is possible when contracts are freely made and effectively sanctioned.[5]

However, in modern times, this principle is largely modified and impacted by a number of considerations. The terms of a contract are no longer sacrosanct and in fact are open to judicial scrutiny. One instance of this is in case of unfair terms in consumer contracts[6] or terms which are imposed in standard form contracts.[7] Here, owing to unequal bargaining powers, the courts look into the terms imposed in a contract and often interpret them in favour of the weaker party. There has been significant departure from the concept of freedom of contract also by means of enacting legislation which prohibits certain kinds of contracts.[8] Here, while parties are still free to enter into any form or kind of agreement, if prohibited by law, then the agreement cannot be enforced under law.

1. Robert Duxbury, Contract Law 2 (Sweet & Maxwell, 2013).
2. Adams et al., *Understanding Contract Law* 197 (Oxford-Clarendon Press, 1979).
3. Michael Furmston, Cheshire's Law of Contract 21 (Oxford, 2007).
4. *Printing and Numerical Registering Co.* v. *Sampson,* 1873 P 177: [LR] 19 Eq 462.
5. Kessler et al., *Contracts, Cases and Materials* 4 (2nd edn., 1970).
6. *Emaar MGF Land Ltd* v. *Aftab Singh*, (2018 SCC OnLine SC 2771) offers such an example. Herein, an arbitration clause was held to not limit the right of a consumer to approach the Consumer Dispute Redressal Commission.
7. *Suisse Atlantique Société d' Armement Maritime SA* v. *N.V. Rotterdamsche Kolen Centrale*, (1967) 1 AC 361: (1966) 2 WLR 944.
8. An example of this would be Section 14 of the Transfer of Property Act, 1882 in India which prohibits transfers for perpetuity.

One form of clauses over which there may be limited bargaining power are *ipso facto* or determinable clauses in insolvency. *Ipso Facto* clauses can be defined as clauses which make a contract terminate automatically upon the insolvency of another party. In various jurisdictions, both courts as well as legislatures have been reluctant to enforce these kinds of clauses for the reason that they impact the debtor adversely. On the ground of equity and securing the ultimate goal of resolution in insolvency, these clauses have been prohibited in several countries. This article examines the debate around these clauses in foreign jurisdictions and possible interpretations of the same in the Indian regime. It seeks to evaluate the best position that Indian Courts and legislators can take with regard to these clauses, and whether the classical principle of freedom of contract upheld by Indian Courts should be given away to prohibit these clauses in the interest of meaningful resolution.

II. IPSO FACTO CLAUSES IN FOREIGN JURISDICTIONS

The subject of ipso facto clauses has been subject to debate in numerous jurisdictions. The conflict between such clauses and the concept of freedom of contract is not new. In recent times however, the drastic effects of these clauses are being better understood and there has been legislation in a number of countries pertaining to them. Before proceeding to understand them in the Indian context, the authors shall give a brief insight into these global changes.

Australia

In Australia, new laws with respect to the *ipso facto* clauses came into effect from the 1 July 2018 after a lot of debate and discussions. The proponents of the same were of the opinion that the clauses are extremely useful as they provide the parties privy to the contract with the opportunity to rescind the same in case the threat of insolvency looms on the other party. However, at the same time, they were widely criticised for diminishing the chances of revival of an insolvent or potentially-insolvent party.[9]

9. David Walter, Maria O'Brien, Adam Jeffrey, *Australia : Ipso facto Clause Reforms,* LEXOLOGY (23-7-2019, 10.30 pm) <https://www.lexology.com/library/detail.aspx?g=17899438-ddfb-436f-8d19-bf8b075b79fc>.

The Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017[10] or the Amending Act intends to apply a 'stay' on the enforcement of such clauses by making the same mandatory and applicable on any party's right to rescind, amend or modify the contract when the other party enters into any form of arrangement or any voluntary administration or any insolvency and restructuring process. This howsoever, will not affect the rights of the party to terminate the contract in situations like non-performance of the terms of contract, so on and so forth.

As far as the duration of such a stay is concerned, the stay would be effective depending upon the type of insolvency which is occurring. There are a few exceptions to the ipso facto stay as well, aimed at delineating the ambit of the same. They can be broadly classified into two categories, namely – excluded types of contract and excluded types of contractual rights[11]. The excluded types of contract are mentioned in the "Corporate Regulations 2001",[12] in the form of additional provisions. They can be categorised into the following:

1. Debt and Equity Capital Markets – arrangements made for issuing or sale of securities, promissory notes or syndicated loans, covered bonds
2. Other Financing Agreements – securities financing, margin lending facilities, flawed asset arrangements, contracts under which the priority of security interests change
3. Mergers and Acquisitions – The agreements dealing with business sale and share sale
4. Government and Public Sector – Comprises of government permits, approvals, contracts with respect to Australia's National Security and other contracts related to carrying out essential or critical works for the Government
5. Securitisation, Project Finance and Construction – arrangements that involve securitisation or a public-private partnership

10. Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act, 2017.
11. Patrick Lowden, Andrew Rich, Daniel Stathis, Rowena White, *Australia's New Ipso Facto Regime : Are Your Rights Affected?*, Herbert Smith Freehills (26-7-2019, 10.30 pm) <https://www.herbertsmithfreehills.com/latest-thinking/australia%E2%80%99s-new-ipso-facto-regime-is-now-live-are-your-contractual-rights-affected>.
12. Kelly O'Dwyer, Corporations Amendment (Stay on Enforcing Certain Rights) Regulations, 2018.

6. Derivatives, Netting, Clearing and Payments –This includes derivatives, some close-out and netting arrangements and arrangements with respect to the RTGS system
7. Other – This includes a variety of contracts like agreements for managing financial investments, agreements for the commercial charter of the various international ships, agreement for the keeping of the source code or passwords or related material and contracts entered or renewed on or after 1 July 2018 but before the closing date of 1 July 2023, as a result of a novation or variation of a contract entered into before 1 July 2018.

As far as the "Excluded Types of Contractual Right" are concerned, they have been mentioned in the Declaration of the Amendment[13] and relate prima facie to the financial contracts and agreements. Some of the broad categorisations can be:

1. Termination of rights in a standstill or forbearance agreement
2. Rights of novation
3. Rights of assignments
4. Rights with respect to set-off and netting
5. Rights to indemnities for the charges, expenses, liabilities or the losses arising out of the preservation or enforcement of rights
6. Rights of the secured creditor to appoint a receiver or other controller to any asset
7. Certain step-in rights
8. Enforcement Rights (which includes acceleration rights, rights to exchange currencies or rights to crystallise a security interest) for the purpose of enforcing the right of a secured creditor to appoint a receiver or other controller to any asset, where another receiver or controller has been appointed

United States of America

The Courts of law, in general do not enforce the ipso facto clauses as applying the same would mean that the debtor or the party going

13. Kelly O'Dwyer, Corporations (Stay on Enforcing Certain Rights) Declaration, 2018, Federal Register of Legislation.

through the insolvency process would never be able to continue with the already existing contracts. This would also hamper the performance of the contract, which otherwise could have been easily performed, thus undermining the public policy which aims at the rehabilitation of the debtor.[14] Therefore the general rules and practice, shields the debtors by going against the enforceability of such clauses.

As far as the statutory backing for the same is concerned, Section 365(e)[15] of Title 11 of the United States Code states:

> (1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on-
>
> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
>
> (B) the commencement of a case under this title; or
>
> (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement

A plain reading of the above-mentioned section would imply that the section disallows the non-debtor to take advantage of the financial condition of the debtor and denying any rights to him. Talking about the case laws, *Peaches Records and Tapes Inc., In re*[16], the Nehi Record Distributing Company leased some of the commercial properties from the non-debtor party and also entered into a sublease agreement with Peaches Records and Tapes. The lease and sublease agreements had a provision for re-entry for non-debtors, if the lessee or the guarantor becomes insolvent or enter into any debtor proceedings.

Both of them filed petitions under Chapter 11 and their petition was consolidated, and the non-debtors challenged Section 365(e). They raised the argument that the bankruptcy filing by Nehi, the guarantor, was a proper ground for termination. The Court applied and refused to apply the ipso facto provision.

14. *Southern Pacific Funding Corpn., In re*, 268 F 3d 712 at 716 (9th Cir 2001).
15. United States Code § 365(*e*).
16. 51 BR 583 (9th Cir BAP 1985).

In *Mirant Corpn.* v *Mirant Corpn.*[17], Mirant filed for bankruptcy and thereby BPA wanted to terminate the contract with respect to future power purchasing but the same was agreed to be invalid under Section 365(e). But however they contended that Section 365(c)[18], pertaining to executory contracts, would make the ipso facto clauses enforceable if the contract is of such a nature that it would excuse the non-debtor party from accepting performance from any trustee or assignee.

The court held that determination and applicability of Section 365 is decided with the materials and record at hand and should not be abstract or hypothetical. The court was of the opinion that it would led the court deciding on these matters, without the entire circumstances are presented before the court.

This was further affirmed in the *Footstar*[19] case, where the court through Judge Hardin went into the differentiation between the actual test and the hypothetical test and held that the real test should be given more importance and thereby Footstar was allowed to assume the agreements it had with Kmart, which were suspended by the later when Footstar filed for bankruptcy.

Aerobox Composite Structures LLC, In re[20], the licensing agreement between Aerobox and Tubus Bauer contained the ipso facto clause, terminating the contract in case of bankruptcy of Aerobox. The court held that the test given in Footstar is good in law but at the same time, the exception under Section 365(c)(1), should be kept in mind and the non-debtor should not be forced to accept performance from any other entity other than with whom he or she has originally contracted.

In addition to that there are certain other provisions, which the courts have used in order to secure the position of the debtors from time to time. One such provision is Section 541 of the US Code. The same provides that the "bankruptcy estate", is created whenever a bankruptcy petition is filed and this estate has a separate legal existence and is defined as comprising of all the debtor's legal and equitable interests in the property, on the bankruptcy petition's filing date. The courts have included

17. 440 F 3d 238 (5th Cir 2006).
18. United States Code § 365(*c*).
19. *Footstar Inc., In re*, 323 BR 566 (Bankr SDNY 2005).
20. 373 BR 135, (Bankr DNM 2007).

the debtor's contractual rights and contracts with any of the creditors, suppliers, customers in the same.[21]

In addition to that, *Thorpe Insulation Co., In re*[22], the court observed that the debtor cannot waive the protection of the Bankruptcy code and doing the same would undermine the public policy and the creditors would force the debtors in future, would routinely make their debtors waive off such rights. In the given case, Thorpe had created a statutorily authorised trust after negotiating with his insurers, for paying damages to individuals having claims against him and they also assigned their contribution and indemnity rights against "Continental" to Thorpe, in return for which, Thorpe filed for bankruptcy. Continental argued that the same violated the settlement agreement, but however the court ruled in favour of Thorpe.

Another landmark case for the same would be *Lehman Bros. Holdings Inc., In re*[23]. wherein LBSF was a party to some swap agreements and it purchased credit protection from the "issuers", who then issued notes in favour of the note holders. Both of them were backed by collateral.

The Swap Agreement provided that LBSF would enjoy priority status over the note holders, if the collateral was liquidated, unless LBSF filed for going through Bankruptcy proceedings. However, if there was a default on the part of LBSF, then the note holders were to be paid first. Sometime later, LBHI, which was an indirect parent of LBSF filed for the bankruptcy proceedings and the trustees liquidated the collateral and distributed it to the note holders first.

It was after this that LBSF filed for bankruptcy and it contended that the priority provisions are ipso facto clauses and hence unenforceable. The court however held that, LBSF was involved in two completely different transactions – Type 1 and Type 2. Type 1 transactions provided for LBSF's right to priority unless it defaulted and the second type, did not fix any type of priority. In the second situation, LBSF did not enjoy any special right and the provisions of the same did not modify or end any right under the contract. So thereby, the same were held not to be

21. *Plunkett, In re,* 23 BR 392, (Bankr ED Wis 1982).
22. 671 F 3d 1011 (9th Cir 2012).
23. 533 BR 476, (Bankr SDNY 2016).

ispo facto clauses. However, the Type 1 clauses were held to be ipso facto clauses, as they terminated a certain and a fixed right of the contract.

In addition to the above discussion, there are a few exceptions to certain situations, in which the ipso facto clauses would become applicable. Exception to the same is discussed in Section 365(e)(2)[24], which prescribes for two situations. Firstly, they may be enforced if the "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or an assignee of such contract" and secondly, "is a contract to make a loan or extend other debt financing or financial accommodations" for the advantage of the debtor or in case of "issuing of security to the debtor." These agreements can be terminated in case of insolvency and bankruptcy proceedings. The contracts dealing with personal services were also held to fall within the exception.[25]

United Kingdom and Singapore

Prior to 2018, the English Law allowed the parties to rely on the ipso facto clause, primarily due to the fact that the English Courts have always upheld the freedom to contract and it was regarded as one of the most fundamental principles of justice. UK's Insolvency regime is considered to be one of the finest insolvency regimes in the world and that is the reason many countries like Singapore, etc. used to look at the treatment of ipso facto clauses by the UK legal system and thereby did not introduce the restriction on the ipso facto clauses even after conducting the review process in the year 2017, which led to the implementation of the Singapore Restructuring Law, with effect from 23 May 2017[26].

However, in August 2018, the Government of the United Kingdom proposed a reform[27] in the form of prohibition on the suppliers who used to enforce the termination clauses on the ground of the party entering into the insolvency procedure. Under the current regime, there exists

24. United States Code § 365(*e*)(2).
25. In re, Health Plan of Redwoods, 284 BR 408 (Bankr ND Cal 2002).
26. Chris Mcleod, *Singapore's Restrictions on Ipso facto*, LEXOLOGY (24-7-2019, 10.30 pm), <https://www.lexology.com/library/detail.aspx?g=4d40d932-2ac4-45dd-abf4-76853aa7331a>.
27. Department for Business, Energy & Industrial Strategy, Insolvency and Corporate Governance Government Response (2018).

a provision of "essential supplies" with respect to the companies that have entered into restructuring arrangements but however this proposal, instead of adopting into the existing regime would provide for a new regime altogether.

These proposals are aimed to be incorporated because it was felt that the essential supplies do not provide a substantial assistance to the businesses while they were going through restructuring. As far as the technical details of the same are concerned, they have not been disclosed - as to how would the clauses would be treated – will they be void or just unenforceable. In addition to this, how the Government would counter the significant concern of curtailment of the freedom available to contract would also be interesting to look out for. However, the proponent of the same, are of the opinion that it is a reasonable interference with the freedom to contract and regulations like this are important in order to have better financing avenues and commercial environment[28].

UK has also proposed a new set of regulations called The Business Contract Terms (Assignment of Receivables) Regulations, 2018[29] which restricts the provisions that prohibit the assignment of certain receivables, the intention for the same being broadening the financial access. These regulations aim to provide more relief to the borrower, in the cases wherein he assigns the receivables to the lending institution, which the lender could use, in case he fails to repay the loan.

This shows that there is a change in the perspective assigned with respect to the freedom to contract and certain restrictions are considered to be reasonable for ensuring a better economy and legal framework.

It can be said that having the ipso facto clauses' restrictions would make the UK system similar to that followed in the USA. Apart from countries like USA and Canada, even Singapore, which used to follow the English system closely, implemented restrictions on the ipso facto clauses, in the form of Insolvency, Restructuring and Dissolution Act,

28. Jat Bains, Simon Beale, Paul Keddie, Jamie Macpherson, *Blunting the effect of Ipso Facto Clauses,* MACFARLANES (26-7-2019, 10.34 pm), <https://www.macfarlanes.com/what-we-think/in-depth/2018/blunting-the-effect-of-ipso-facto-clauses-a-reasonable-interference-with-freedom-of-contract/>.
29. Business Contract Terms (Assignment of Receivables) Regulations, 2018, Draft Statutory Instruments.

2018 in November, 2018[30]. Section 440(1)[31] and Section 440(3) of the same restricts the non-defaulting party from modifying the contractual obligations in case of a distressed company or in case of any proceedings with respect to the distressed companies.

However, the legislature has provided the scope for exceptions to, like the US and has included contracts like contract in the form of a licence, permit or approval that is issued by the Government or any other statutory body or contracts likely to affect the national interest or the economic interest and a commercial charter of ship, which are precisely similar to the exceptions provided by the US.

III. THE SITUATION IN INDIA

This article has focussed on identifying jurisprudence in varied countries in the sphere of determinable clauses and their interpretations. Coming to the Indian Jurisdiction, we first focus our attention on the way determinable clauses have been looked at and interpreted in India. We then focus on the IBC as a special legislation and discuss how determinable clauses would go against the very principles on which IBC is based. We proceed with examining how the safeguards within Indian Law for suppliers supplying their goods to a company undergoing a CIRP. We examine the insufficiency of these safeguards which motivates suppliers to protect their interests by way of inserting ipso facto clauses in their supply contracts. Then, the authors analyse the possible impacts of enforcement of these clauses within the Indian insolvency regime.

1.1 Determinable Clauses in the Indian Jurisdiction

The law with reference to the performance of contracts in India is found under the Specific Relief Act which excludes determinable contracts from its ambit.[32] A contract which is drafted such that it is by its nature revocable cannot be specifically enforced.[33] If the defendant is by way of an

30. Paul Apathy, Emmanuel Chua, *Singapore Unveils New 'Omnibus' Insolvency, Restructuring and Dissolution Bill,* Herbert Smith Freehills (24-7-2019, 10.45 pm), <https://www.herbertsmithfreehills.com/latest-thinking/singapore-unveils-new-omnibus-insolvency-restructuring-and-dissolution-bill>.
31. Insolvency, Restructuring and Dissolution Act, 2018, S. 440.
32. The Specific Relief Act, S. 14(1)(*c*), No. 47, Acts of Parliament, 1963 (India).
33. *Her Highness Maharani Shantidevi P. Gaikwad* v. *Savjibhai Haribhai Patel*, (2001) 5 SCC 101: AIR 2001 SC 1462.

express clause in the contract entitled to revoke the contract, the same cannot be specifically enforced.[34] It is possible that a contract may allow the other party to terminate the contract without any reason and without any notice. In this situation as well, the opposite party cannot compel performance of the contract.[35] This shows that the Indian law gives primacy to the plain terms of the contract and if parties have voluntarily entered into a contract which is determinable in nature, they cannot go back and violate the provisions of the same contract. The only place wherein contracts determinable on insolvency are disallowed is the Transfer of Property Act which expressly prohibits entering into contracts for the transfer of any kind of property in which an interest is determinable on insolvency.[36] However, for this to apply an interest of some kind has to be created under the contract in the property, but this is not what happens in supply agreements drafted for sale of goods, which are rather covered under the Sale of Goods Act.[37] In such a sale, no contingent interest is being created in moveable goods and the Transfer of Property Act only covers a case in which a condition of solvency in attached to the retention of interest in the property.

The subject of ipso facto clauses has only been subjected to limited judicial interpretation in India. The Delhi High Court encountered a situation wherein a contract was terminated by a supplier on the ground of the apparent insolvency of the other party. The court stated that the nature of such an agreement is such that it is a private commercial transaction which can be terminated at any time without assigning any particular reason. The specific performance of such a contract could not be claimed.[38] However, when the terms of a contract explicitly required the company to whom supplies were being made to be insolvent and supplies were terminated merely because of the threat of insolvency, the court did grant an interim injunction directing the supplier to make supply of services.[39]

34. Mulla, *The Indian Contract and Specific Relief Acts* 1098 (14th edn., 1939).
35. *Dharam Veer* v. *Union of India*, 1988 SCC OnLine Del 175: AIR 1989 Del 227.
36. The Transfer of Property Act, S. 12, No. 4, Acts of Parliament, 1882 (India) (hereinafter "TPA").
37. The Sale of Goods Act, S. 2(7), No. 3, Acts of Parliament, 1930 (India).
38. *Rajasthan Breweries Ltd.* v. *Stroh Brewery Co.*, 2000 SCC OnLine Del: AIR 2000 Del 450.
39. *Lindsay International Pvt. Ltd.* v. *Laxmi Niwas Mittal*, 2017 SCC OnLine Cal 270: (2017) 3 Cal LT 214.

However, when a clause gives a clear right on termination on insolvency, Indian Courts have accepted arguments related to freedom of contract to allow the termination of these contracts upon insolvency. Therefore, the court has not interfered with such contracts on the grounds of equity or fairness and has let such clauses be operated as they are.

1.2 The Corporate Insolvency Process in India -The Concept of a Going Concern

To understand the effect that these clauses would have on insolvency resolution in India, the authors will first give a background of the key principles governing the Insolvency and Bankruptcy Code. What makes the jurisprudence under the Insolvency and Bankruptcy Code incomparable to any other decisions regarding *determinable on insolvency* clauses is that the IBC postulates a completely different procedure for insolvency than any other legislation. It is a self-contained code[40], guided by its own principles and approaches. Therefore, the interpretation of determinable clauses in context of the IBC must be in light of the spirit of the legislation. No person can be allowed to subvert the spirit or the guiding principles of a legislation. In a given situation, the interpretation which is more in line with the mischief sought to be prevented by enacting such legislation should be preferred.[41]

The major concept underlying the process of corporate insolvency resolution in India is that of a *going* concern. There is a clear statutory mandate on part of both the interim resolution professional[42] and the resolution professional[43] to run the business as a going concern once the process of insolvency resolution begins. "Going concern" means all the assets, tangibles or intangibles and resources needed to continue to operate independently a business activity which may be whole or a part of the business of the corporate debtor without values being assigned to the individual asset or resource.[44] This concept originates from accounting and means that a company is to be treated as if it stays in business

40. *Innoventive Industries Ltd.* v. *ICICI Bank*, (2018) 1 SCC 407.
41. *District Mining Officer* v. *TISCO*, (2001) 7 SCC 358.
42. Insolvency and Bankruptcy Code, 2016 (31 of 2016), S. 11, Acts of Parliament, 2016 (India) (hereinafter "IBC 2016").
43. IBC 2016 *supra* note 42, S. 25.
44. Insolvency and Bankruptcy Board of India, Agenda for Liquidation Process Regulations (21-7-2018, 12.50 pm) <https://ibbi.gov.in/Agenda_03_26062018.pdf>.

without any intention of winding up or ending its operations.[45] In this situation, the lifetime of an enterprise is expected to be till perpetuity.[46]

Under the IBC, the concept of going concern becomes important from varied perspectives, that of the resolution professional, of the creditors, of the resolution applicant and of its employees and those who depend on the Corporate Debtor. It is usually felt that as a Corporate Debtor consists of numerous workmen and employees who depend on it for their daily bread, if a resolution applicant can continue the same as a going concern, every effort must be made to ensure the same.[47] A resolution applicant who submits a resolution plan must demonstrate how the company will be continued as a going concern since a resolution plan is not a mere sale of the company.[48]

From the viewpoint of creditors as well the concept of a going concern is relevant. It was pointed out in the Bankruptcy Laws Reform Committee report that a good realisation can generally be obtained if the firm is sold as a going concern. The report also mentioned that the present Indian mechanisms for debt recovery did not provide for such mechanisms previously and this is a novelty of the IBC.[49] The entire purpose of resolution under the IBC is to preserve and maximise enterprise value, which is why the resolution professional is to keep the business running as a going concern until the CoC approves a resolution plan which ensures that the business keeps going on forever.[50]

From the perspective of the resolution professional or professionals, as the case may be, this means that they have the right to discontinue overly burdensome contracts and file applications with the Adjudicating Authority for avoidance of vulnerable transactions.[51] Anything which prevents the functioning of the company can be restricted by the Resolution Professional, while he has a duty to ensure that the business of the

45. Stuart Warner, *The Finance Book* 45 (Financial Times Publishing, 2017).
46. Deepak Panda, Enterprise Value of Firms in Insolvency, IBBI-IGIDR Reforms Conference 6 (2018) (hereinafter "Panda").
47. *Arcelormittal India (P) Ltd.* v. *Satish Kumar Gupta*, (2019) 2 SCC 1.
48. *Binani Industries Ltd.* v. *Bank of Baroda*, (2018) SCC OnLine NCLAT 521.
49. Dr T.K. Vishwanathan, Bankruptcy Law Reforms Committee, The report of the Bankruptcy Law Reforms Committee (2015) (hereinafter "BLRC Report").
50. M.S. Sahoo, "Balancing the Interests of Stakeholders", Insolvency and Bankruptcy News 3 (2017).
51. M.S. Sahoo, "Our Bankruptcy Code is World-Class", *Indian Business line* 4 (2019).

company continues. Therefore, from every perspective, the concept of going concern is central to the corporate insolvency resolution process in India.

The judiciary has also been proactive in ensuring that there are sufficient funds available to run the corporate debtor as a going concern. When banks refuse to allow for withdrawal for funds to pay for electricity of the premises and the payment of salaries of workers, the Tribunal held that this violated the principle of going concern. Therefore, the Tribunal ordered for allowing the withdrawal of these funds.[52] At the time of admission of each CIRP, a direction is given to the resolution professionals by the Tribunal that the business must be run as a *going concern*. In fact, a company which is a corporate debtor is never allowed to enter into a phase of stagnancy. Even if the resolution applicant delays the implementation of his/her resolution plan in the phase before it is implemented, responsibility is vested in the resolution professional to keep the corporate debtor running.[53]

Therefore, it becomes clear that a continued business enterprise is a clear focus of the IBC. Interim Finance can also be raised by the Resolution Professional to meet this goal.[54] In a Code dedicated to ensure continued business, it seems abnormal that ipso facto clauses would be given any favour. These clauses are heavily tilted in favour of the suppliers to ensure that timely payments are made to them and they do not have to keep supplying to a company whose financial condition is dismal. However, if this was allowed, almost all suppliers would import such clauses into their supply agreements and since these contracts would all automatically terminate upon insolvency, continuing business operations would be a problem. The Resolution Professional would then have to look to find new suppliers, which could create stagnancy in the business in the meantime. From each perspective, this is problematic.

From the perspective of the resolution applicant, the turnaround process of a stagnant enterprise would be tougher. From the perspective of the creditors, enterprise value will erode.[55] From the perspective of employees, since the company will stop making any kind of supply, their

52. *Edelweiss Reconstruction Limited* v. *Reid & Taylor*, C.P. (IB)382(MB)/2018.
53. *Ramkumar SV* v. *Ingen Capital Group LLC*, 2018 SCC OnLine NCLT 4256.
54. IBC 2016, *supra* note 42, S. 25.
55. Panda, *supra* note 46.

salaries as well as employment by itself would be threatened. From the perspective of the Resolution Professional, it will become a lot tougher to preserve and protect the corporate debtor, as necessary as a duty. Continuance of contracts is the key to ensure that the business lasts for perpetuity. Therefore, if suppliers were allowed to automatically terminate their contracts with the corporate debtor, this would conflict with a key principle of the IBC.

1.3 Suppliers under the IBC

An argument made in favour of ipso facto clause is that they help to protect the interests of suppliers who make supply of goods to companies which turn insolvent. Such companies are not likely to be able to pay for the goods supplied and therefore, the suppliers automatically terminate their contracts with the company. This helps to ensure that the inventory of the supplier is preserved. A contract with a company which is undergoing a CIRP is likely to turn onerous and therefore suppliers prefer to have clauses in their contracts which give them the right to terminate such a contract.

The Code however prohibits this in situations where suppliers are supplying essential services.[56] These suppliers cannot terminate their agreements and must mandatorily continue the supply of essential services even during the CIRP. There is sufficient safeguard within the Code for suppliers who continue the supply of essential goods to the corporate debtor even when the CIRP is in motion. The suppliers of such goods receive priority payouts under the IBC. The payments to these suppliers from a part of insolvency resolution costs. [57] Any resolution plan submitted must account for these costs at the outset and on a priority basis.[58] It is the duty of the Resolution Professional to examine each submitted plan and ensure that the plan complies with this requirement. In case the Resolution Professional fails in this duty, a supplier can approach the NCLT.[59] Then the NCLT may ask for the modification of a plan to include this requirement.[60] However, the problem with this safeguard

56. IBC 2016, *supra* note 42, S. 14(3).
57. IBC 2016, *supra* note 42, S. 5(13).
58. IBC 2016, *supra* note 42, S. 30(2).
59. IBC 2016, *supra* note 42, S. 60.
60. *Sunil Jain* v. *Punjab National Bank*, Company Appeal (AT) (Insolvency) No. 156 of 2018. Not found

is the limited scope of the term essential services. This term includes electricity, water, telecommunication services and information technology services.[61] There has been a recommendation for extension of this terminology, but the same has not been acted upon.[62]

There exists a major lacuna in the term essential services as it does not cover those goods which are inputs to the direct outputs produced by the corporate debtor.[63] This means that a supplier of sugarcane to a sugar factory is not an essential supplier although the raw material is extremely essential for the running of the factory.

For payments to be made to such suppliers of ordinary goods, limited aspects of the situation are covered indirectly under the heading of insolvency resolution process costs. Those costs which are under *insolvency resolution process costs* also have to receive priority payouts[64], as previously explained. These include the costs incurred by the resolution professional in running the business as a going concern.[65] However, this is also limited in the sense that it applies only to the costs incurred by the RP himself. There may be costs incurred on the company's account in paying for the suppliers or there may be situations where there are continuing defaults on part of the company undergoing CIRP in paying to suppliers who continue their supplies to such a company. These situations are not covered by this provision.

As the payments made to suppliers who continue to supply non-essential goods are nowhere assured within the IBC until these are costs actually incurred by the Resolution Professional, there is nothing which prevents the corporate debtor from defaulting on these payments. The suppliers who have performed their end of the contract do not have an opportunity to actually sue the company owing to the moratorium in place.[66] In case these defaults happen after the last date for submission of claims, these suppliers can also not file their claims as operational

61. Regn. 32, Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016, Gazette of India, part III, S. 4 (30-11-2016).
62. Shri Injeti Srinivas, Insolvency Law Committee, Report of the Insolvency Law Committee 5 (2018).
63. Regn. 32, Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016, Gazette of India, part III, S. 4 (30-11-2016).
64. IBC 2016 *supra* note 42, S. 30(6).
65. IBC 2016, *supra* note 42, S. 5(13).
66. IBC 2016, *supra* note 42, S. 14.

creditors.[67] There might be long-term contracts for which payments are to happen at defined periods. If these payments are not made and the last date also passes, the suppliers are left without any recourse. The only way in which they can recover their debt is by filing a suit against the resolution professional and getting tied up in litigation. As these suppliers also do not fall under the heading of operational creditors, the resolution applicant may also ignore them if they do not fall under the category of *insolvency resolution process costs*, as described earlier.

Given the uncertainty of payments to be made to suppliers, in order to safeguard their interests, suppliers may be motivated to insert clauses which make their contracts determinable on insolvency. This gives an easy exit to suppliers who do not want to be involved in the CIRP of the corporate debtor or do not have litigious tendencies. Prior to the enactment of the IBC, Insolvency in India was governed under the Provincial Towns Insolvency Act and the Presidency Towns Insolvency Act. Both of these were silent on determinable contracts. But the Provincial Towns Insolvency Act did protect bona fide transactions entered into with the insolvent and insolvency does not have the effect of invalidating the same.[68] There are no such safeguards provided for within the IBC. Therefore, suppliers are incentivised to put in their own safeguards in form of determinable clauses in their contracts.

1.4 The Holistic Impact of Ipso Facto Clauses on Insolvency in India

As previously explained, a key aspect of Indian Insolvency is the concept of a going concern which runs as a central theme throughout the IBC. The idea that a company shall run for perpetuity requires the support of various stakeholders. Extensive powers have been granted to the Resolution Professional and the interim Resolution Professional to ensure that the business of the corporate debtor can be preserved and managed.[69] The protection and preservation of value of the corporate debtor is an important part of the duties of the Resolution Professional and the law requires

67. "Last date", as provided for in Regn. 6(2)(*c*) of the CIRP Regulations refers to a date within 14 days of appointment of the resolution professional.
68. Presidency-Towns Insolvency Act, 1909, S. 55, Acts of Parliament (1909).
69. IBC 2016, *supra* note 42, S. 20.

every endeavour to be made to ensure continued business enterprise.[70] In a situation where a supplier has an ipso facto clause in his contract which makes the same determinable on insolvency, it is not possible to compel performance on part of the supplier.

Holistically, this makes the job of running the corporate debtor as a going concern much tougher. If the key material contracts terminate upon insolvency, it will be extremely tough for the Resolution Professional to enter into new contracts with suppliers. Although the Resolution Professional has this power[71], it will be difficult to enter into such contracts at a short notice when the corporate debtor is already undergoing CIRP. Unwilling suppliers can force the corporate debtor into even worse situations, which will impact all the stakeholders who stand to benefit when the business is being run as a going concern. Creditors will stand to benefit less as enterprise value will erode, and resolution applicants will be unwilling to pay high amounts in resolution plans for a business which is non functional. The main principle behind the IBC, which is resolution will prove to be much more difficult.

Till date, the Indian Courts have not had to grapple with such a situation where they have had to deal with such a clause in a matter related to insolvency. The NCLT has been faced with such a clause in a matter of liquidation.[72] In this matter, the tribunal emphasised extensively on the aspect of *freedom of contract* and interpreted the clause as it is. It stated that since the clause itself provided for the power of revocation, the contract could be revoked by the supplier on the event of insolvency.

However, the authors do not believe that such a decision can be imported into the CIRP as well. This is because in the event of failure of the resolution process, the cardinal principle of the CIRP which is the concept of "going concern" is not carried into the liquidation process. At the stage of liquidation, it is certain that there will be dissolution of the corporate identity.[73] Therefore, continuation of contracts does not hold much significance. On the contrary, in case of CIRP, resolution is at the heart of the process and the continuation of business is a key part in this. So, if contracts were allowed to be automatically terminated in

70. IBC 2016, *supra* note 42, S. 25.
71. IBC 2016, *supra* note 42, S. 25(2).
72. In the matter of VNR Infrastructure, C.P. No. 12/10/HDB/2017.
73. IBC 2016, *supra* note 42, S. 54.

the beginning of CIRP, the same could serve as a serious impediment to resolution.

IV. RECOMMENDATIONS

The main purpose of enactment of IBC is to ensure that there can be quick resolution of a corporate debtor. When a firm is protected as a going concern, the overall societal costs go down and there is less destruction of value.[74] It is sufficiently clear that the protection of an enterprise is crucial to the success of IBC, and therefore, the authors have made certain recommendations with respect to ensuring the same.

Firstly, ipso facto clauses can be made invalid under the Insolvency and Bankruptcy Code, 2016. This can be done by way of a direct mandate disallowing any action on these clauses. At the same time, this cannot be done in isolation. Ipso Facto Clauses are used by supplier companies to protect themselves therefore there must be some form of protection provided to them if such clauses are completely removed. One way of doing this is by enlarging the definition of essential services under the IBC. Currently, similar to UK, India also follows a system of providing a limited list of services which qualify as essential services. However, this list is objective and does not recognise the fact that different services may be essential for different sectors. If the main goal is to run the corporate debtor as if it is to run for perpetuity, it is also necessary that it must possess the raw materials necessary to conduct its business, which would be different for different businesses and must be accordingly allowed to be determined by the resolution professional and Committee of Creditors on a case-to-case basis. On the contrary, it could also be stated, as recommended by the Insolvency Law Committee that applications for continuation of other services can be made to the NCLT.[75] It is not possible practically to give an exhaustive list of supplies which are essential; however, anything crucial to running the business must be included within the list and given the same protection as an essential supply.

Secondly, another form of ensuring protection to suppliers is to provide for a mechanism by which these suppliers can seek a personal guarantee

74. BLRC Report, *supra* note 26.
75. Shri Injeti Srinivas, Insolvency Law Committee, Report of the Insolvency Law Committee 35 (2018).

from the insolvency professional that payment for the services provided will be made. Such a provision was added in UK recently by way of The Insolvency (Protection of Essential Supplies) Order, 2015 which allows a supplier to stop his supply in cases where he has not received such a personal guarantee or he is allowed to do so by the Court or the insolvency practitioner or payments are not made within 28 days.[76] By statutorily granting the right to terminate, it is ensured that suppliers do not exercise termination rights arbitrarily. This is also a possibility under the IBC.

The authors believe that ipso facto clauses go against the main principles of the IBC and therefore should not be enforced by courts of law. At the insolvency stage, depriving the company of its key raw materials could have drastic consequences for the future prospects of resolution. However, it is insufficient to merely ban these clauses. In order to create a holistic enabling atmosphere for purposes of resolution, the cooperation of suppliers to a business is quintessential. Adopting some changes to provide suppliers with safeguards could be the way to make them partners in the resolution process, rather than making them potential litigants.

76. Government of UK, The Insolvency (Protection of Essential Supplies) Order 2015, Guidance for Insolvency Practitioners and Suppliers (Jul. 12. 3.50 pm) <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/465979/Continuity_of_essential_supplies-_guidance_to_insolvency_practitioners_and_suppliers.pdf>.

Assessing the Feasibility of Pre-Packaged Administration in Corporate Insolvency Proceedings in India – Is it the Need of The Hour?

— *Tushar Kumar*†

ABSTRACT

Recently, the Government of India had reconstituted the Insolvency Law Committee to examine the viability of introducing pre-packaged insolvency under the Insolvency and Bankruptcy Code, 2016 ("IBC"). Pre-packaged insolvency essentially pertains to an arrangement under which sale of some or all of the assets of the corporate debtor is negotiated with the purchaser, prior to the initiation of the formal insolvency process and then the arrangement is filed in the court to have a binding effect. It comes with the benefits of speeding up the insolvency process, reducing the involvement of courts and minimal or no impact on the goodwill of the corporate debtor through confidentiality of arrangements.

However, the author vehemently disagrees with the incorporation of the pre-packaged insolvency into IBC on various fronts. Firstly, the said tool, as is evidenced from its implementation across jurisdictions has a tendency to unduly discriminate and widen the gap between secured and unsecured creditors in a resolution process as the pre-packed insolvency arrangement will occur between the corporate debtor and the most significant creditors, disregarding the junior or unsecured creditors in the process. Secondly, the possibility of sale of the corporate debtor to a resolution applicant which is a related or connected party cannot be totally ruled out, which will further jeopardise the intent of Section 29A of IBC, enlisting

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the conditions for ineligibility of resolution applicant. Thirdly, it is too early to import the pre-pack provisions into IBC, which has completed only three years of its implementation, as the pre-pack procedure has been incorporated in other jurisdictions only after a considerable time has lapsed, post the enactment of an insolvency law. The author feels that the legislature instead of incorporating pre-packaged insolvency, should continue with its vigilant efforts to curb the loopholes in the existing law through amendments.

INTRODUCTION

In March, 2019 the Ministry of Corporate Affairs (hereinafter referred to as "**MCA**"), in pursuance of re-constituting the Insolvency Law Committee under MCA Secretary Injeti Srinivas, had sought comments from the concerned stakeholders on the viability of introducing *Pre-Packaged Insolvency*[1] in the current framework under the Insolvency and Bankruptcy Code, 2016 (hereinafter referred to as "IBC"). The proposal is intended to complement or aid the current insolvency process under IBC, rather replacing it altogether,[2] which is in consonance with the existing pre-pack mechanisms across jurisdictions. *Pre-Packaged Insolvency* or *Pre-Packaged Administration* in insolvency proceedings essentially pertains to an arrangement under which sale of some or all of the assets of the corporate debtor (an enterprise which is about to enter insolvency proceedings) is negotiated with the purchaser, prior to the initiation of the formal insolvency process post which the arrangement is filed in the court to have a binding effect on the relevant stakeholders.[3] Since all the negotiations and creditors' approval in some cases, is

1. Pre-Packaged Insolvency Resolution: Government Seeks Stakeholder Comments (17-4-2019), <https://www.financialexpress.com/economy/pre-packaged-insolvency-resolution-govt-seeks-stakeholder-comments/1550354/>; IBC Timeline Adherence Soon: Injeti Srinivas, Corporate Affairs Secretary (13-5-2019), <//economictimes.indiatimes.com/articleshow/69298163.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst>.
2. Pre-Packaged Bankruptcy Scheme to Speed Up Insolvency Resolutions Pre-IBC (27-11-2018), <https://www.financialexpress.com/industry/pre-packaged-bankruptcy-scheme-to-speed-up-insolvency-resolutions-pre-ibc/1394887/>.
3. Pre-Packaged Insolvency Resolutions: The Way Forward, Ernst & Young, Society of Insolvency Practitioners of India, 9-3-2019; Association of Business Recovery Professionals, UK.

finalised before filing any petition in courts,[4] it ends up saving time in the insolvency procedure (liquidation or resolution) of a corporate debtor. Further, the confidentiality or the secrecy of the process, prior to the involvement of the courts helps to preserve the goodwill of the corporate debtor[5] as neither the issue of insolvency of the corporate debtor becomes public[6] nor there is open solicitation of buyers from the market.[7]

However, the author firmly believes that in addition to the inefficient consequences associated with the implementation of pre-packaged insolvency across jurisdictions, incorporation of pre-packaged structure in the Indian insolvency framework would thwart the legislative intent and the objective of the IBC. This essay has been further divided into four parts.

Part I deals with how the pre-packaged insolvency process would skew the emphasis of a resolution process under IBC towards disregarding the rights of unsecured creditors and unduly widening the gap between financial and operational creditors, a consequence which not only goes against the mandate of IBC but also against judicial precedents in India.

Part II focuses on the possible conflict of the pre-packaged administration with Section 29-A of IBC as the purchasers, in such a transaction, can be related or connected to the corporate debtor which will allow them to buy the business at a discounted value, thereby jeopardising the rescue of the business.

Part III talks about the premature incorporation of pre-packaged insolvency into IBC as only three years have passed since its enactment and the procedures should be allowed to shape smoothly under the current framework.

Part IV concludes the essay by emphasising that the theoretical benefits of pre-pack do not coincide with its implementation and lauding the effort of Indian Government to optimise the functioning of IBC through necessary amendments and the overall impact that the IBC has had on the

4. *Corporate Insolvency Law: Perspectives and Principles,* by Vanessa Finch, 2nd edn., 2009, Cambridge University Press, 454; M. Plevin, R. Ebert and L. Epley, "Pre-Packaged Asbestos Bankruptcies: A Flawed Solution" (2002) 44 South Texas L Rev. 883, 888.
5. Mark Hyde; Iain White, Pre-Pack Administrations: Unwrapped, 3 Law & Fin. Mkt. Rev. 134, 138 (2009).
6. Insolvency and Bankruptcy Code, 2016, S. 15.
7. *Ibid*, S. 30.

Indian economy, which could be possibly neutralised with the untimely implementation of pre-pack administration in Indian insolvency.

PRE-PACK TRAMPLING THE RIGHTS OF UNSECURED AND OPERATIONAL CREDITORS IN A RESOLUTION PROCESS UNDER IBC?

The Bankruptcy Law Reforms Committee, responsible for recommending the enactment and the initial draft of IBC, in its 2015 report[8] had stated that the objective of IBC is to preserve the rights of *all stakeholders* in a bankruptcy processand satisfy the liabilities of all those creditors who are not even a part of the negotiation process.[9] Maximisation of economic value[10] of the corporate debtor will only be achieved when the least possible haircut to various classes of creditors is ensured and not just secured creditors.[11] Although, IBC distinguishes *financial creditors*[12] (providing money for working capital) from *operational creditors*[13] (credit related to goods and services of the corporate debtor) concerning rights such as initiation of insolvency process or participation on committee of creditors, it has been supplemented with adequate safeguards for operational creditors in a resolution process, like priority of payment over financial creditors[14] and the right to obtain at least the amount that they would have otherwise obtained in liquidation proceedings.[15] Additionally, the resolution process under IBC does not discriminate between secured and unsecured creditors,[16] in terms of priority of payment or anything else. Keeping the same in mind, it is pertinent to analyse the pre-packaged administration in India in terms of the effect it will have on the various classes of creditors in a resolution process.

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8. The Report of the Bankruptcy Law Reforms Committee (November 2015), <https://dea.gov.in/sites/default/files/BLRCReportVol1_04112015.pdf>; *Innoventive Industries Ltd.* v. *ICICI Bank*, (2018) 1 SCC 407.
9. Report of the Insolvency Law Committee (March 2018), <http://www.mca.gov.in/Ministry/pdf/ReportInsolvencyLawCommittee_12042019.pdf>.
10. *Id.*, p. 11.
11. Think of Unsecured Creditors, Too, FE Bureau, *Financial Express* (2-4-2018), <https://www.financialexpress.com/opinion/think-of-unsecured-creditors-too/1117965/> .
12. Insolvency and Bankruptcy Code,2016 . (31 of 2016), S. 5(7).
13. *Ibid*, S. 5(20).
14. Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016, Regn. 38(1).
15. Insolvency and Bankruptcy Code, 2016 (31 of 2016), S. 30(2)(*b*).
16. *Ibid*, S. 30.

Pre-Packaged administration has been incorporated in insolvency laws of many jurisdictions around the world, like UK,[17] US,[18] Netherlands,[19] Germany.[20] Even though the mechanism of pre-pack varies from country to country, it essentially permits negotiations between the corporate debtor, the prospective purchaser and the creditors, before the initiation of formal insolvency proceedings. Generally, the initiation of these negotiations can be done by the corporate debtor or the creditors,[21] resulting in a proposal which is further filed in court to have a binding effect on stakeholders. However, the viability of the proposals resulting from these negotiations and the acceptance from creditors thereof are significant contentious issues which have to be examined from the implementation of pre-pack across countries.

In UK's pre-packaged administration (or pre-pack sale) procedure, the directors of the relevant enterprise appoint an Insolvency Practitioner (IP) to evaluate its financial position, who, if decides, that a pre-pack sale is the best option, would then carry negotiations with the prospective buyers and post the negotiations, the sale is executed by the IP shortly, on or after his appointment as the administrator.[22]

UK's pre-pack is infamously known as sub-rosa debt restructuring[23] because the administrator can go ahead with a pre-pack sale if he thinks fit, without taking the creditors' approval,[24] due to which the rights of several creditors (including unsecured) are severely impaired. In *DKLL Solicitors case,*[25] the pre-pack sale of the business of DKLL Solicitors was approved by the administrator and eventually by the court, despite the fact that the major creditor of the business had objected to such sale.

17. Insolvency Act, 1986, Schedule B1 (as amended by Enterprise Act, 2002).
18. Bankruptcy Code, 1978, S. 1126(*b*).
19. Dutch Bankruptcy Act, 1893 (proposed through the Bill of 2014).
20. Insolvency Code, 1994 (amended in 2012 by Act for the Further Facilitation of the Reorganisation of Companies)
21. Barbara Tomczyk; PrzemyslawWierzbicki, Pre-Pack under Polish Law, 11 Insolvency & Restructuring Int'l 42, 44 (2017).
22. UK Pre-Packs Endorsed…but "Clean-Up" recommended, by Glen Flannery, Eurofenix, Autumn 2014; *Pre- Packaged Insolvency Resolutions: The Way Forward*, Ernst & Young, Society of Insolvency Practitioners of India, March, 2019.
23. Anthony Wijaya, "Pre-Pack Administration Sale: A Case of Sub Rosa Debt Restructuring" (2016) 25 Int'l Insolvency Rev. 119.
24. *In re*, *Transbus International Ltd.,* (2004) 1 WLR 2654; Mark Hyde; Iain White, Pre-Pack Administrations: Unwrapped 3 Law & Finmkt Rev 134, 138 (2009).
25. *DKLL Solicitors* v. *Revenue and Customs Commrs.*, 2007 EWHC 2067.

Further, in *Re Bluebrook*,[26] the court unfairly sanctioned a pre-pack scheme between the corporate debtor and senior lenders, without any payment to subordinated lenders (creditors below the senior lenders in order of priority) aggregating to 119 million pounds, as according to the valuation of the corporate debtor accepted by the court, the assets were not sufficient to pay subordinated lenders, as opposed to the valuation report submitted by subordinated lenders which showed that the assets were sufficient to pay their debt. Notwithstanding the disputed valuation in the UK[27], it is a serious concern that pre-pack has been often used as an orchestrating attempt by the administrator, the corporate debtor and the senior creditors to convert debt into equity of a newly formed shell company and push the unsecured or junior creditors out of the restructuring process.[28] Even though the administrator (former Insolvency Practitioner) is required to make a disclosure explaining the viability of the proposal,[29] it does not give rights to the junior creditors to object the sale which has already been completed,[30] but only challenge the conduct of the administrator who, if found guilty, would only be subject to a disciplinary action by the regulatory authority.[31]

On the other hand, the Dutch Bankruptcy Act, 1893 does not explicitly provide for a pre-packaged insolvency, although the Continuity of Enterprises Act –is being proposed to provide a statutory basis for

26. *In re*, *Bluebrook Ltd*., 2009 EWHC 2114.
27. Jennifer Payne, *Schemes of Arrangement: Theory, Structure and Operation*, (Cambridge University Press, 2014), p. 385; *IMO Car Wash: What It Means for Restructuring*, Slaughter and May Financing Briefing, August 2009, https://www.slaughterandmay.com/media/847944/financing_briefing_imo_car_wash_what_it_means_for_restructurings_aug_2009.pdf.
28. *In re*, *Transbus International Ltd*., (2004) 1 WLR 2654; "*A Preliminary Analysis of Pre-Packaged Administrations*", by Sandra Frisby, Report to The Association of Business Recovery Professionals, August 2007, p. 34; Jennifer Payne, *Schemes of Arrangement: Theory, Structure and Operation*, (Cambridge University Press, 2014), p. 385.
29. Statement of Insolvency Practice 16 (E&W), Pre-Packaged Sales in Administrations (Association of Business Recovery Professionals) [9], https://www.cms-lawnow.com/ealerts/2009/01/new-statement-of-insolvency-practice-16-ew-and-revised-insolvency-code-of-ethics?cc_lang=en.
30. Anthony Wijaya, "Pre-Pack Administration Sale: A Case of Sub Rosa Debt Restructuring" (2016) 25 Int'l Insolvency Rev 119, p. 133; Mark Hyde and Iain White, 'Pre-Pack Administrations: Unwrapped' (2009) 3 LAW & FINMKT REV 134, p. 137.
31. Phoenix Operations in the Pre-Packaged Administration: A Rescue for the Company or a Trap for the Creditors?, Queen Mary, University of London, Dissertation in Commercial and Corporate Law, 7-8-2013.

pre-pack sale in the Netherlands.[32] Even then, pre-packaged insolvency has been accepted by the Dutch courts as a measure of restructuring.[33] It usually involves a request to the court for the appointment of a silent trustee, who enters into discussions with relevant stakeholders resulting in a proposal which is given effect in the formal bankruptcy proceedings.[34] However, the problematic part is that the relevant stakeholders are usually secured or preferential or senior creditors,[35] along with the prospective buyers and the corporate debtor. In the first pre-pack case in 2009, involving restructuring of Schoeller Arca Systems group ("SAS"),[36] the Dutch Court approved a scheme, which had been put together by the senior creditors, management of the corporate debtor and the buyer, despite the fact that it had been objected to by the subordinated bridge lenders. The major restructurings of viable businesses in the Netherlands, through pre-pack have been negotiated by the secured creditors (mostly senior bank debt) and the debtor.[37] It is because of this lack of transparency that the Dutch pre-pack has received heightened criticism over the years.[38] It would therefore, not be unsafe to conclude that the pre-packaged insolvency is likely to disregard or exclude the small or unsecured creditors in a restructuring transaction, which further has a potential to discourage such form of unsecured lending in an economy.

It is worthwhile to reiterate the fact that IBC is aimed at satisfying the interests of all stakeholders, rather than trampling the rights of any class of creditors, as is the case with pre-pack. Even though *financial creditors* enjoy some privilege over *operational creditors,* the same has been supplemented with statutory safeguards for operational creditors either in

32. Bo Xie, *Comparative Insolvency Law: The Pre-pack Approach in Corporate Rescue*, (Edward Elgar Publishing, 2016), p. 252.
33. B. Rumora-Scheltema*et al.*, "Dutch Pre-pack Alternatives on the Rise" <http://www.lexology.com/library/detail.aspx?g=a04ba290-dbf2-428a-bb2a-32ce2b0716aa> (last visited on 24-7-2019).
34. *Ibid.*
35. Bo Xie, *Comparative Insolvency Law: The Pre-Pack Approach in Corporate Rescue*, (Edward Elgar Publishing, 2016), p. 251.
36. Clifford Chance Client Brief, 'The Way Forward where Value Breaks in the Junior Debt – a Ruling from the Dutch Courts' (Client briefing, September 2009) <http://www.cliffordchance.com/content/dam/cliffordchance/PDF/value_breaking_in_the_junior_debt.pdf>, accessed on 20-7-2019.
37. Insolvency Review Edition 6, Netherlands, By Lucas P Kortmann & AbslemOurhris, available at <https://thelawreviews.co.uk/edition/the-insolvency-review-edition-6/1175159/netherlands>, accessed on 24-7-2019.
38. *Ibid.*

the code or rules.[39] Further, IBC does not discriminate between secured and unsecured creditors in a corporate resolution process.[40] The priority accorded to secured creditors in a liquidation process[41] is justified as it happens only after the secured lender has relinquished the security to the liquidation estate, which can then be sold to receive proceeds.[42] Since no form of relinquishment happens in case of a resolution process, the corporate applicant has the liberty to prepare the plan in accordance with Section 30, the benefits of which are shared equally between secured and unsecured creditors in a class (financial/operational creditors). Recently, a resolution plan was re-written by an Appellate Court to grant equal rights to secured and unsecured creditors within the financial and operational creditors, as the order of priority, specified in Section 53, does not apply to resolution proceedings in IBC.[43]

The incorporation of pre-pack into IBC will have adverse implications on the corporate resolution process, not only in the form of unfair priority of secured over unsecured creditors, but also impairment of rights of the operational creditors as most operational creditors, as observed by the Supreme Court, are unsecured creditors.[44]

PRE-PACK: CONTRAVENING SECTION 29A OF IBC?

One of the significant reasons, attributable to the fallout and the resulting criticism of pre-packaged administration in UK insolvency, is the *connected party sales*[45] entered into by the administrator, a phenomenon also known as *phoenixism*.[46] This stems from the fact that the administrator, usually appointed by the controlling party of the corporate debtor, is given unbridled powers to arrange pre-pack sales. The connected party, being either the directors or any shareholder or promoter of the corporate debtor, often makes use of the sensitive information pertaining to the enterprise and forms a shell company to buy-out the assets of the

39. Refer to citations 14 and 15.
40. Insolvency and Bankruptcy Code, 2016 (31 of 2016), S. 30.
41. *Ibid*, S. 53.
42. *Ibid*, S. 52(1)(*a*).
43. *Standard Chartered Bank* v. *Satish Kumar Gupta*, 2019 SCC OnLine NCLAT 388.
44. *Swiss Ribbons (P) Ltd.* v. *Union of India*, (2019) 4 SCC 17.
45. Insolvency Act, 1986, Ss. 249 and 435 (UK)
46. Lorraine Conway, *Corporate Insolvency: Consultations on Reform*, Briefing Paper, Number CBP8291, 9-7-2018, <http://researchbriefings.files.parliament.uk/documents/CBP-8291/CBP-8291.pdf> (last visited on 26-7-2019).

corporate debtor at low costs,[47] which does not remotely come close to maximizing the economic value of a distressed enterprise. Despite the safeguards available against phoenixism in the UK Insolvency Act,[48] the connected party sales are on the rise.[49]

Presently, in Indian insolvency context, the issue is addressed by Section 29-A of IBC which pertains to the ineligibility of the resolution applicant (bidding for the debtor enterprise) who, even though seemingly intends to buyout the dying business is not considered eligible for the same. The Finance Minister, while talking about the intent behind inserting Section 29-A stated that people on account of whom the insolvency of the corporate debtor had been put in question, would try to apply and buy back the corporate debtor at a discounted value, which has never been the object of IBC.[50] Additionally, IBC prohibits not only such people who are mentioned in the ineligibility list of Section 29-A, but also people who are acting jointly or in concert with such people, thereby making the ambit of the section even wider.

Keeping the attitude of the lawmakers and the judiciary in mind, it is impractical to imagine a scenario in which pre-packaged insolvency is inserted into IBC, a jurisdiction which vehemently prohibits connected party sales. Since the procedure emphasises on "pre", i.e. before involving courts, the regulation of such sales become even more difficult. Lack of effective regulation is the entire reason why there was a rise in connected party sales in UK post the Enterprise Act of 2002,[51] which started the administration styled pre-pack in insolvency in UK. The only way to make the pre-pack sales devoid of connected party sales is by assistance of court, like in USA pre-packaged administration under the Chapter 11.[52] However, judicial oversight in pre-pack would allow the challenge to such transactions, even before the conclusion of the sale, which will eradicate the essence of pre-packed insolvency of reducing time and

47. *Ve Vegas Investors IV LLC* v. *Shinners*, 2018 EWHC 186.
48. Insolvency Act, 1986, Ss. 216 and 217 (UK).
49. The Insolvency Service, 2013 Annual Review of Insolvency Practitioner Regulation (April 2014), 10; Companies Abusing Insolvency Pre-Packs, Independent Panel Says, by Josephine Cumbo, *Financial Times*, 25-11-2018, available at <https://www.ft.com/content/0fee6146-f0bb-11e8-ae55-df4bf40f9d0d>, accessed on 26-07-2019.
50. *Swiss Ribbons (P) Ltd.* v. *Union of India*, (2019) 4 SCC 17.
51. *Corporate Insolvency Law: Perspectives and Principles,* by Vanessa Finch, 2nd edn., 2009, Cambridge University Press, 461.
52. The Bankruptcy Code, 1978, S. 1126(*b*) (US).

involvement of courts. It is because of this reason that the pre-pack even though having benefits theoretically, has never been used frequently in practice in America.[53]

TOO EARLY FOR PRE-PACK INTO IBC?

Pre-packaged insolvency is not a tool which has been noticed in insolvency regimes of various jurisdictions since times immemorial but a tool which has evolved consistently with practice and use around the world.[54] It is because of the fact that procedures and practices have been allowed to smoothly develop under insolvency law for a considerable period of time, post which if there is an observed pattern of frequent pre-packs, the legislators have tried to give it due recognition by amending the then existing law and giving it a statutory recognition.[55] The reason attributable to the rise in the consistent practice of pre-pack can either be a foreign jurisdiction influence or the urge to have minimal court interference. Either way, the mechanism of pre-pack varies from country to country, considering the past domestic insolvency practices[56] and the corporate structures.[57] The introduction of pre-packaged insolvency in UK happened through the Enterprise Act of 2002[58] which amended the initial Insolvency Law enacted way back in 1986. Similarly, the current US Bankruptcy Code of 1978 underwent changes, owing to the emergence of frequent pre-pack administration after 27 years in 2005 through the Bankruptcy Abuse Prevention and Consumer Protection Act.[59] Dutch

53. S. Takagi, Recent Developments of Restructuring Schemes and Practices in the US, the UK, Germany and France: Comparative Study (International Insolvency Institute Publication) <https://www.iiiglobal.org/sites/default/files/recentdevelopmentsfrestructuringschemesand_practiceskadomaecheck.pdf> 30-1-2016; Bo Xie, *Comparative Insolvency Law: The Pre-Pack Approach in Corporate Rescue*, (Edward Elgar Publishing, 2016), p. 194.
54. Bo Xie, *Comparative Insolvency Law: The Pre-Pack Approach in Corporate Rescue*, (Edward Elgar Publishing, 2016), p. 36.
55. Insolvency Review Edition 6, Netherlands, By Lucas P Kortmann&AbslemOurhris, available at <https://thelawreviews.co.uk/edition/the-insolvency-review-edition-6/1175159/netherlands>, accessed on 24-7-2019.
56. Mark Wellard; Peter Walton, "A Comparative Analysis of Anglo-Australian Pre-Packs: Can the Means be Made to Justify the Ends", 21 Int'l Insolvency Rev. 143, 182 (2012).
57. The Rise of the "Pre-Pack": Corporate Restructuring in the UK and Proposals for Reform, by John Armour, RP Austin and Fady JG Aoun, Restructuring Companies in Troubled Times: Director and Creditor Perspectives, 43-78. (Sydney: Ross Parsons Centre, 2012), <http://ssrn.com/abstract=2093134>, (last visited on 24-7-2019).
58. *Ibid.*, p. 3.
59. Bo Xie, *Comparative Insolvency Law: The Pre-Pack Approach in Corporate Rescue*, (Edward Elgar Publishing, 2016), p. 193.

legislators, witnessing frequent pre-packs in insolvency are currently thinking of introducing pre-pack insolvency procedures through a Bill[60] into the Dutch Bankruptcy Code enacted way back in 1893.

As far as Indian insolvency is concerned, IBC is the first comprehensive insolvency law[61] providing a detailed procedure of not just liquidation but also rescue or resolution of an enterprise. Being enacted in the year 2016, IBC has just completed three years of its implementation.[62] As stated by the Chief of Insolvency and Bankruptcy Board of India,[63] the insolvency procedures and systems should be allowed to develop properly under the current law, before thinking about the proposal to implement pre-packs. The incorporation of pre-pack would bring about various instrumental changes, for instance variations in the rights of creditors or approval procedures, which would be too early for the recently enacted IBC. Notwithstanding the vigilant effort of the Government to identify loopholes and come out with amendments, the inclusion of pre-pack would be a big fundamental change, amongst other amendments, to the insolvency law, which has a potential to result in lack of investor confidence.[64]

CONCLUSION

The Bankruptcy Law Reforms Committee, in its report, had stated that under pre-IBC Laws, debt enforcement rights were available for secured creditors only and so there is a need for a law where rights for all creditors are preserved. The reform has been reflected in the post IBC scenario where almost 49% of the cases for insolvency have been initiated

60. Continuity of Enterprises Act – I, 2014; Insolvency Review Edition 6, Netherlands, By Lucas P Kortmann&AbslemOurhris, available at <https://thelawreviews.co.uk/edition/the-insolvency-review-edition-6/1175159/netherlands>, accessed on 24-7-2019.
61. A year later, the Insolvency and Bankruptcy Code is still evolving, by Jayshree P. Upadhyay and Alekh Archana, <https://www.livemint.com/Industry/X3wAbf9I3Um8xTDUdbeHaL/A-year-later-the-Insolvency-and-Bankruptcy-Code-is-still-ev.html>, accessed on 20-7-2019.
62. With IBC about to be 3, A Look at the Hits & Misses and the Road Ahead, by Joel Rebello and Atmadip Ray, <//economictimes.indiatimes.com/articleshow/69017429.cms?from=mdr&utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst>, accessed on 24-7-2019.
63. Systems, Practices need to Develop before Allowing Pre-Packs: IBBI chief, By K.R. Srivats, <https://www.thehindubusinessline.com/economy/systems-practices-need-to-develop-before-allowing-pre-packs-ibbi-chief/article23686891.ece>, accessed on 20-7-2019.
64. The Bad Bank Theory, by Anand Adhikari, <https://www.businesstoday.in/magazine/cover-story/the-bad-bank-theory/story/281017.html>, accessed on 20-7-2019.

by operational creditors.[65] Further, even though there is distinction of rights between financial creditors and operational creditors in IBC, the percentage of haircuts has been nearly been the same for both the classes of creditors.[66] The reformation of the insolvency regime is also manifested in India's jump in the rank of Ease of Doing Business List from 130 in 2016 to 77 in 2018. In such a case, incorporation of a measure like pre-packaged administration, which has faced intense criticism for its lack of transparency and ineffectiveness around the world, would not only derail the progress of India's insolvency reform but push it back into pre-IBC era, where effective regulation would be absent and unsecured creditors' rights would be disregarded. It is worthwhile to mention that IBC presently prescribes for a procedure pertaining to withdrawal of application,[67] post the initiation of proceedings, which allows the parties to enter into settlement, but the same can be done only after taking approval of 90% of members of committee of creditors.The high threshold has been set so that the interests of almost all creditors are taken into account and backdoor negotiations are avoided.

The author is of the opinion that the legislature, instead of implementing premature measures like pre-packaged administration in Indian insolvency at this stage, should continue with its vigilant effort of identifying loopholes in the implementation of IBC and bringing out timely amendments to the law.This will not only help to clarify the insolvency governance framework, but also instill confidence in foreign and domestic investors to invest in distressed assets in India.

65. Haircuts for Operational Creditors in Line with that for Financial Creditors, available at <//economictimes.indiatimes.com/articleshow/69855784.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst, accessed on 26-07-2019>.
66. *Ibid*.
67. Insolvency and Bankruptcy Code, 2016 (No. 31 of 2016), S. 12A.

Institutionalising Whistle-blower Mechanism in Insider Trading Regime: Overhauling Evidence and Enforcement Challenges

—*Shubham Gupta*†

ABSTRACT

In the aftermath of the recent episodes of insider trading cases of Sun Pharma, Infosys, NSE, ICICI, the capital market regulator has adopted an interventionist approach. SEBI has introduced the amendment laying down the requirement of whistle-blower policy to be instituted in the Insider Trading regime to overcome the evidentiary challenges. Deputising whistle-blower mechanism would not clout in detecting insider trading cases, that have not been discovered by the investigation by SEBI, but will also shape the compliance culture in the companies. Thus, a protective shield with proper bounties must be bestowed to an insider (whistle-blower) who unveils the ongoing fraud in the company. Also, whistle-blower, who has the duty to disclose must not be equated and should not be given a protective shield.

Admittedly, the whistle-blower mechanism is also handcuffed with certain challenges to implement such as frivolous litigation, resources constraints and proper legal policy. Therefore, to effectively introduce a whistle-blower mechanism, the whole legal regime must be reviewed through the angles of social enforcement and behaviour studies. In this essay, social behaviours have been vastly studied vis-a-vis legal implications. Thus, it is believed that the efficiency of whistle-blower mechanism is directly proportional to the efficiency of other corporate governance institutions. Interaction of corporate governance institution will allure more complaints. However, in India, the history supports the highest unreliability of corporate governance institutions and

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therefore creates a suffocating space to exist for whistle-blower mechanism. Nonetheless, if an agency creates a favourable environment to respond to queries of whistle-blower mechanism in its early days, the sound will be reporting.

INTRODUCTION

Over recent years, whistle-blowing has been fashionable in detecting finance frauds. Whistle-blowing who has traditionally seen with frowned eyes on, because of organisational dissent enjoys a distinct rise in popularity. The regulator and the agency consider whistle-blower as an integral part of a regulatory mechanism that helps in better monitoring of misconduct or fraud in the management because the employee has more complete knowledge regarding the inner working of the companies.[1] In Insider trading, due to evidentiary challenges, a whistle-blower mechanism may be boaster to effective enforcement by collecting or disclosing relevant misconduct or fraud.

Whistle-blowing and insider trading, both are vested with the same type of rights deriving out of the same intellectual property – valuable information. This information can be said to beneficial on account the employees are acquainted with management or transaction happening in the company. Also, the regulator may leverage out this information to track the source of Unpublished Price Sensitive Information.

According to Section 12 of the SEBI Act,[2] "[t]o *protect the interests of investors in securities and to promote the development of and regulate the securities market, which makes it imperative for SEBI to employ all legitimate means to detect and initiate action against insider trading at the earliest to instill confidence among investors and ensure the integrity of the securities markets in line with the mandate conferred upon it*." The capital market regulator SEBI, in its 2019 Prohibition of Insider Trading (PIT) Regulations simulates a formalised version of

1. Richard E. Moberly, "Sarbanes-Oxley's Structural Model to Encourage Corporate Whistleblowers", 2006 BYU L. Rev. 1107, 1180 (2006).
2. The Securities and Exchange Board of India Act, 1992 (4-1-1992), S. 12.

whistle-blower policy in the company. As per the amendment,[3] every listed company has to formulate a whistle-blower policy bestowing anti-relation protection, method of disclosing information, and channels through which the internal reporting can be done. The recently released discussion paper on the informant mechanism or whistle-blower mechanism lays down the procedural and substantive law aspects with regard to insider trading case. Not only did they agreed to share hand with whistle-blower but also benefit by introducing bounty mechanism.

The need to institutionalise a whistle-blower mechanism becomes an underlying assumption that insider information that may be revealed by whistle-blower will help in discovering the source of leakage of UPSI and to respond to evidentiary challenges. The recent example of insider trading of SunPharma, NSE, Infosys, ICICI, etc. has been made out of whistle-blower complaints. SEBI's believe that evidentiary challenges could be best to meet out from internal mechanism only. However, there are many legal challenges to implement an effective informant mechanism like the efficiency of corporate governance institutions, the credibility of information and frivolous litigation.

WHISTLE-BLOWING – ALTRUISM OR SELF-INTERESTED?

Inside trading is not particularly distinct from whistle-blowing, because both aim to get the money out of it. It could not be said that the motive for whistle-blower is pure. Most cases that have been reported in the history of whistle-blower has been due to organisation dissent or retaliation in the company. It is noted that disgruntled employee is more likely to blow the whistle.[4] Thus, heroic images that conjure up as concerned citizen are motivated up by self-interest, whereas, insider trade is shaped towards gaining profit out of confidential information, which is not publicly available. Both activities require a pre-existing relationship with the company. In insider trading, the person who traded must be an insider under the purview of PIT Regulations. An insider may be the one who

3. Securities and Exchange Board of India (Prohibition of Insider Trading) (Amendment) Regulations, 2018, Gazette of India, Part III Section 4 (31-1-2018), Regulation 9 (A).
4. William De Maria, Department of Business Law and Taxation, *The Victorian Whistleblower Protection Act: Patting the Paws of Corruption*, 13 (3-5-2002).

possess UPSI or a connected person.[5] Usually, insider trading happens on account of leakage of UPSI from top-level management of the company, whereas whistle-blowing stipulates the same sort of relationship where the employee is aware of the irregularities in the company. Also, the functional basis for both the activity, be it reporting or trading, is a secret valuable information which is not available in general. Besides, in insider trading, the insider does not need to convince anyone, whereas, in whistle-blowing, the report has to be convinced to regulators, analysts and other corporate governance institution.

Fettering the chain of activities, whistle-blower and insider do share common characteristics[6].

1. Functional dependence on confidential information that is not publicly available – thus, they are informational intermediaries.
2. They are in a pre-existing contractual or quasi-contractual relationship with the source of information.

However, the main difference that distinguishes their action into benevolent or malignant is that whistle-blower speaks whereas an insider trades on this information. Economic impact and moral significance may be a different and distinct image for whistle-blowers and insiders in the market. Since, the actions create different consequences, thereto, a different treatment.

THE ROLE OF WHISTLE-BLOWER IN DETECTING INSIDER TRADING CASES

Deputising private individuals to aid government agencies is not a new practice. Whistle-blowing challenges institutional authority, prerogative, and discretion. This may be called an institutional or democratic reform that implied in whistle-blowing laws.[7] It is impossible to monitor the trades of the friends or relatives of an insider and therefore anyone possessing UPSI would be deemed to an insider and would be liable for

5. Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015, Gazette of India, Part III Section 4 (15-1-2015), Regulation 2(1)(n).
6. Jonathan Macey, "Getting the Word Out About Fraud: A Theoretical Analysis of Whistleblowing and Insider Trading", 105 Mich. L. Rev. 1899 (2007).
7. Law Commission of India: Report on the Public Interest Disclosure and Protection of Informers, 33 Commw. L. Bull. 505, 513 (2007).

insider trading violation, if traded while in possession. However, in spite of these measures, trading on inside information does exist; however, the degree to which inside information is leaked and the amount of trading on this inside information is unknown.[8]

From the case of Bradley Birkenfeld,[9] a private banker who was awarded a staggering amount of USD 104 million in Enron case, that triggered reforms in whistle-blowing reporting, whistle-blowing has kicked investigation and detection, where it would have been extremely difficult to detect the secretive nature of corporate and securities fraud. It becomes difficult to detect the case, especially where the outsiders do not have access to internal files and evidence. Thus, the people involved in an internal process or transaction become an auxiliary hand to detect the fraud in the securities of the company. It is stated that detection through internal governance is more than any specific factor.[10] The detection of fraud occurs through the complex web of market actors that complement each other.[11] Getting the word out of the insiders would help in detecting white-collar crimes like Insider Trading and Money Laundering.

In Insider trading cases, the role of whistle-blower becomes pertinent due to evidentiary challenges. Recurring amendments to PIT Regulations manifest a challenge to existing enforcement regime. Despite the updated PIT regulations, the amendments appear to be an experimental approach towards effective detection and evidentiary challenges. This is because the chain of shared UPSI remains untracked for many reasons. The inflow of UPSI to other insiders, which is not a part of the transaction and outsiders becomes extremely difficult from an evidentiary perspective. Thus, an insider who is aware of a misconduct in the big corporation the source of leakage may become an elixir to collect potential evidence. The design of sound reporting and regular followup may eliminate the chances of spoiling the potential evidence. Therefore to grapple with

8. Arthur J. Keown and John M. Pinkerton, Merger Announcements and Insider Trading Activity: An Empirical Investigation, 36 J. of Fin. 855, 867 (Sept. 1981).
9. Orly Lobel, "Linking Prevention, Detection, and Whistle-blowing: Principles for Designing Effective Reporting Systems", 54 S. Tex. L. Rev. 37, 52 (2013).
10. Vanessa Castellina, "The New Financial Incentives and Expanded Anti-Retaliation Protections for Whistleblowers Created by Section 922 of the Dodd-Frank Act: Actual Progress or Just Politics", 6 Brook. J. Corp. Fin. & Com. L. 187, 210 (2011).
11. *Ibid.*

enforcement and investigation challenges the recent amendment[12] endures a whistle-blower mechanism and encourages insiders to share information to the government regarding inconsistencies in the company.

The whistle-blower policy serves a dual purpose. It instils the ethical code of conduct in the company and also helps in detection of the fraud case. A robust whistle-blower protective mechanism will anchor robust corporate governance and internal compliance as the fear of impression of reporting would revolve in the mind of fraudsters.[13] It would intrigue companies to invest in internal compliance to adopt proper functioning. However, the whistle-blower mechanism in PIT regulations may face several legal challenges because it is socio-ethical enforcement. Also, the regulator responsiveness would be a pre-eminent factor for sound reporting. The more efficient system and incentive to report to the regulator, the more chances of getting the information about insider trading .

Further, the trend of increasing high-disgorgement case, the agency must respond to whistle-blower complaint and must protect their interest in case of genuine reporting and award them with proper money. In US, after the disparaging experience of frauds like Enron, WorldCom, Tyco, the US expanded the horizon of anti-retaliation in Sarbanes-Oxley Act to give protection who spoke out the fraud persisting in the company.[14] However, many studies have suggested that mere anti-retaliation provision will not induce informants to come forward, because of extreme repercussions. There is evidence that companies' corporate culture instils fear of reporting improper or illegal behaviour.[15] Whistle-blower's description of how his life changed after reporting misconduct: "I didn't just lose my job, I lost my house and then I lost my family."[16] Thus, the studies have suggested the monetary incentive with extant compliance mechanism will leverage out more complaints in the long term.[17] Thus,

12. Securities and Exchange Board of India (Prohibition of Insider Trading) (Amendment) Regulations, 2018, Gazette of India, Part III Section 4 (31-12-2018), Regulation 9 (A).
13. Orly Lobel, "Linking Prevention, Detection, and Whistle-blowing: Principles for Designing Effective Reporting Systems", 54 S. Tex. L. Rev. 37, 52 (2013),
14. Christopher Wiener, "Blowing the Whistle on Van Asdale: Analysis and Recommendations", 62 Hastings L.J. 531, 558 (2010).
15. Stephen M. Kohn, *The New Whistleblower's Handbook: A Step-by-Step Guide to Doing What's Right and Protecting Yourself* 19 (2011).
16. Nancy M. Modesitt, "Why Whistleblowers Lose: An Empirical and Qualitative Analysis of State Court Cases", 62 U. Kan. L. Rev. 165, 194 (2013).
17. Iskra Miralem, Comment, "The SEC's Whistleblower Program and its Effect on Internal Compliance Programs", 62 Case W. Res. L. Rev. 329, 332 (2011).

in India where not a high frequency of disgorgement occurs like the US, the detection becomes an unconquered task. Still, the whistle-blower will act as supplementary information in front of agency information, because hidden information could be provided only by insiders.[18] The agency may gather evidence from the aggressive trading pattern, but the hidden information will always be of paramount importance. Hence, a whistle-blower plays a pivot role in insider trading cases.

KIND OF INFORMATION THAT QUALIFIES WHISTLE-BLOWER INFORMATION

The proposed policy establishes an office independent of the investigation department to determine the qualitative assessment of the information provided by the whistle-blower. The office will act as an intersection with the whistle-blower and the SEBI. But, the determination has been left to the discretion of the office subject to the qualification of material information. No meritorious proof had to be administered. Thus, how the question arises in dispute, what indicators or factors constitute material information? How the seriousness of the complaint should be taken?

Thus, in the questionable domain, the cost-benefit analysis of the information must be evaluated and thereafter a full-fledged investigation must be launched. The cost-benefit analysis may be dependent on four varied factors[19]—

1. *the seriousness of the facts alleged in the complaint and the potential consequences of a failure to investigate extensively;*
2. *whether the complaint fits into a situation where complaints are frequent and risks are known to be typical;*
3. *if there is a delay in making the complaint and whether the facts alleged are still relevant; and*
4. *the completeness and accuracy of the disclosures made. Initial procedures such as limited interviews, random testing and limited electronic searches could be applied before launching a full-fledged investigation*

18. David Cooper, "Blowing the Whistle on Consumer Financial Abuse", 163 Univ. of Pennsyl. L. Rev., 557, 588 (Jan. 2015).
19. Aditya Vikram Bhat et al., *ICLG: Corporate Investigations 2019 – India,* <https://www.azbpartners.com/bank/iclg-corporate-investigations-2019-india/>. Not found

PRIMA FACIE CASE

In order to claim bounties or protection under whistle-blower laws, the person must be able to establish prima facie cases. As such, the current proposed regime does not contemplate any threshold to file a complaint and any burden of proof, therefore systematic ingredients must be laid down by SEBI. As held in the case of *Priest* v. *Baldwin Associates,*[20] every whistle-blower protection law requires that the employees establish following elements:

1. To claim relief under whistle-blower policy for anti-retaliation, the person who discloses the information must be an employee of the company.
2. The person who has been charged with the misconduct or discrimination against the employee [whistle-blower] should be an employer that also includes independent contractors, lawyers and auditors.
3. The whistle-blower must have been engaged in "protected activity" and SEBI or internal whistle-blower policy of the company must define the protected activity. In the protected activity, the threshold of purloining the documents, theft, etc must be strictly mentioned, so that no provision could be circumvented by the employer to retaliate against the whistle-blower at the later stage.

This threshold specifies that the internal policy of the company would help in adjudication of the cases with respect to the information released. If the employee is able to prove causation of misconduct with termination from the job, then he may be able to get relief under the law. Moreover, Section 24-B of the SEBI Act empowers SEBI to grant immunity to any person.[21] The power under this section has not been used yet, but this may help in creating a protective mechanism for whistle-blower policy

EXISTING LEGAL REGIME

According to SEBI PIT Regulation amendment, the listed companies need to form a whistle-blower policy to report instances of the leak of UPSI.[22]

20. DOL Case No. 84-ERA-30, 204, 206.
21. The Securities and Exchange Board of India Act, 1992 (4-1-1992), S. 24B.
22. Securities and Exchange Board of India (Prohibition of Insider Trading) (Amendment) Regulations, 2018, Gazette of India, Part III Section 4(31-12-2018), Regulation 9 (A).

Responsibility has also been placed on the boards and audit committees to ensure compliance and verify the systems and controls implemented by the entity.[23] Further, the capital market regulator SEBI released a discussion paper on 10June 2019 leveraging the whistle-blower policy mechanism for active reporting to detect the cases of insider trading.[24] This discussion paper was released with the notion that mere regulator watch is not efficient in prosecuting insider trading case. Thus, an insightful outlook of other methods of detection like whistle-blower or informant mechanism needs to incorporate SEBI (PIT) Regulations.

The discussion paper lays down the aspects of the whistle-blower policy. It stipulates that an informant who wants to report the ongoing fraud must fill the voluntary information disclosure norm where the information can be reported. He must also disclose the source of information, i.e. to the effect that information has not been gained out from regulators. This paper also manifests a bounty mechanism for disclosing the information, provided that information must be material or capable of bursting out the fraud.

DOWNSIDES OF THE PROPOSED MECHANISM

The materiality of information

The policy which has been simulated by SEBI expects only the material information to be investigated for potential of insider trading case, for eradicating out frivolous litigation. However, the determination of materiality clause has not been mentioned and as per proposed policy, no office which is responsible for determining the threshold of information has been established. Thus, it would be quintessential to further clarify on the threshold of the material clause, and if so, who should be responsible for the same. This is also questionable whether the enforcement department of SEBI must be bestowed with the power of materiality clause or should a separate mediating office be linked with these two entities.

23. Securities and Exchange Board of India (Prohibition of Insider Trading) (Amendment) Regulations, 2018, Gazette of India, Part III Section 4 (31-12-2018), Regulation 9 (A).
24. Discussion Paper on amendment to the SEBI (Prohibition of Insider Trading) Regulations, 2015 to provision for an informant mechanism, (10-6-2019), <https://www.sebi.gov.in/reports/reports/jun-2019/discussion-paper-on-amendment-to-the-sebi-prohibition-of-insider-trading-regulations-2015-to-provision-for-an-informant-mechanism_43237.html>.

No tracking system

The best efficiency of whistle-blower mechanism depends on interactions with the regulator.[25] Lack of follow-up from whistle-blower by the regulator may lead to spoiling of evidence and credibility of the information.[26] Thus, a proposed policy falls on the tracking system, on the progress of investigation that has been processed. It has witnessed that only follow-up from whistle-blowers may fruit the best evidence in the court to prosecute insider trading cases.

No small cause cases

Whistle-blower policy incentivise the informant by providing bounty rewards. However, the threshold which has been leveraged in case of attracting whistle-blower policy must be minimum disgorgement of INR 5 Crore that must turn to be successful. This is disturbing, because in India, insiders usually trade in small amount, and thus, itself slash out the majority of cases which could have been detected under the purview of SEBI (PIT) Regulations.

Anonymity

Anonymity is one of the fundamental principles of whistle-blower mechanism.[27] The proposed legal regime states that anonymity of whistle-blower shall be maintained. The policy enunciates that an anonymous complaint may also be filed through an attorney. However, it restricts the anonymity clause, subject to the requirement of evidence during enforcement proceedings. Therefore an attorney is the one who may be compelled to disclose the whistle-blower identity which is subject to an attorney-client privilege under Section 126 of the Indian Evidence Act.

Thus, the proposed legal regime has been introduced with serious implementation challenges.

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25. Robert Vaughn, *The Successes and Failures of Whistleblower Laws* 168 (2012).
26. David Cooper, "Blowing the Whistle on Consumer Financial Abuse", 163 Univ. of Pennsyl. L. Rev., 557, 588 (Jan. 2015).
27. Whistle blowing Effective means to combat economic crime, PWC (July 2012), <https://www.pwc.in/assets/pdfs/services/forensic-services/whistleblowing-aneffectivemeanstocombateconomiccrime.pdf>.

LEGAL CHALLENGES TO IMPLEMENT

1. **Short selling and trading pattern:** According to the Efficient Market Hypothesis,[28] the change in the prices of securities or the share market is the result of all publicly available information. Thus, an insider who wants to trade while in the possession of UPSI necessarily lead to exposure of fraud or revelation of UPSI in the market. In other words, if the information of insider is found to be unreliable or unworthy, there would be change in the prices of the securities of that company, such trading pattern can be observed from the surveillance department at the Stock Exchange. That, the fastest detector of the all uncanny trades happening on the Stock Exchanges. Therefore, a whistle-blower, who may be triggered by the self interest may not carry significant worth that detection form trading pattern. Because trades that lack information content will not affect prices, insiders cannot profit merely by selling; they must also reveal information for prices to adjust.
2. **Internal reporting:** According to the definition of whistle-blower, a whistle-blower is an employee who reports employer's illegality to governmental or enforcement agency.[29] If a whistle-blower who wishes to report to top-level senior management internally, it would not receive any protection under the whistle-blower policy. In case of Enron,[30] the whistle-blower, Sherron Watkins reported the illegality or misconduct of the company to the top-level executive who later was convicted of the same charges. Thus, the policy advisors believe that reporting misconduct to persons who themselves are involved in the picture would effectuate the whistle-blower policy in the enforcement mechanism. It would also make corporation invest in corporate governance or compliance mechanism.
3. **Frivolous litigation:** The regulator has prescribed a bounty mechanism in the informant scheme.[31] In other words, to incentivise free reporting with evidence, the whistle-blower would be awarded a

28. Arthur J. Keown and John M. Pinkerton, "Merger Announcements and Insider Trading Activity: An Empirical Investigation", 36 J. of Fin. 855, 867 (Sept. 1981).
29. Whistleblower, *Black's Law dictionary* (7th edn., 1999).
30. Geoffrey Christopher Rapp, "Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers", 87 B.U. L. Rev. 91, 136 (2007).
31. Discussion Paper on amendment to the SEBI (Prohibition of Insider Trading) Regulations, 2015 to provision for an informant mechanism, (10-6-2019), <https://www.sebi.gov.in/

huge amount of money if the information that is disclosed by him reasonably establishes the case of insider trading. Involvement of money may allure frivolous litigation, which in turn, would increase the investigation and enforcement cost.

4. **Corporate governance and whistle-blowing:-** The mechanism of insider trading and whistle-blowing depends on how each of these activities correspond to or interact with other institutions of corporate governance and informational gatekeepers.[32] The efficiency of whistle-blowing depends on the institutions of corporate governance.[33] Once the information is tendered to enforcement agency or other institutions of corporate governance, the entity, or the regulator needs to get convinced about the credibility of the information before the actions taken in furtherance.[34]

In light of these shortcomings, the corporate governance institution fails to stand on the check of reliability. Also, it is tendency or the social behaviour, the people are less inclined to believe who is a disgruntled employee or self-interested individual. It is noted that bureaucrats are less likely to believe whistle-blower information because consequences are quite dismal.[35] If the information turns out to be false or dubious, then consequences maybe a blunder. In Dirks case, when the whistle-blower disclosed the information of mismanagement to SEC and other institutions, nobody paid heed to information of whistle-blower and side-lined stating "that is a ridiculous story". Thus, increasing the efficiency of corporate governance institution becomes primary importance.

FIXING THE CRACK IN INSULATION

1. **Intuitive appeal:** Whistle-blowing is an intuitive appeal. Since the resources are limited and government agencies can monitor only limited entities effectively, it would be difficult to initiate an investigation on incomplete information. The whistle-blower who is

reports/reports/jun-2019/discussion-paper-on-amendment-to-the-sebi-prohibition-of-insider-trading-regulations-2015-to-provision-for-an-informant-mechanism_43237.html>.

32. Jonathan Macey, "Getting the Word Out About Fraud: A Theoretical Analysis of Whistleblowing and Insider Trading", 105 Mich. L. Rev. 1899, 1920 (2007).
33. *Ibid*.
34. *Ibidd*, at 1922.
35. *Ibid*.

well-acquainted with the inner workings of the company may have a detailed or hidden information of the mismanagement and must be carrying a key evidence to effectuate prosecution Thus, even the other mechanisms of detection like short-selling, buying future stock, etc; a whistle-blower mechanism will always act as supplement to enforcement agency's information and foster an efficient enforcement mechanism. Even if the fraud has been exposed to SEBI, then also, the whistle-blower mechanism would add value by arranging the systematic nature of mismanagement and preserving the evidence.

Moreover, in India, most recipients of UPSI who believe it to be true trade on a limited or short number of securities, which could not have been easy to detect from the trading pattern would have vanished in the humungous trading on the stock exchanges.[36] There may be several reasons that can be advanced for such trading. In this case, whistle-blower's information may be productive in detecting insider trading.

2. **Agency responsiveness**: The fear of frivolous litigation or case, on the underlying assumption that a bounty mechanism will trigger many false complaints. However, the phenomenon of frivolous litigation depends upon the agency responsiveness.[37] It has been noted that if the agency is confident about the review process; then they are least concerned about the frivolous litigation and can easily weed out the frivolous complaints. Thus, the office of the informant must cultivate its reputation for responsiveness in the early days in the market and should be ready to handle an increase in information volume.
3. **Shaping the compliance culture**: It is assumed that the employer fears that there is no incentive in investing in compliances culture, as an employee who observes fraud would directly report to the enforcement agency, and hardly there are any chances of internal

36. Sandeep Parekh, Insider Trading—The Optical Illusion of Failure, (12-11-2012), <http://spparekh.blogspot.com/2012/11/insider-trading-optical-illusion-of.html>.
37. Geoffrey Christopher Rapp, "Mutiny by the Bounties? The Attempt to Reform Wall Street by the New Whistleblower Provisions of the Dodd-Frank Act", 2012 BYU L. Rev. 73, 123.

improvements.[38] However, I believe, rather this would trigger the companies to indulge in compliances behaviour, because if attractive investment in internal compliances derives from the need of building employee confidence in those programs. Moreover, whistle-blowing is more efficient than private actions as it would provide an early opportunity to lessen the effect on corporate well-being.

4. **No Minimum requirement of disgorgement:** SEBI should depart from the minimum requirement of disgorgement of INR 5 Crore because it tends to ignore the majority of the cases which can be discovered or for which the whistle-blower information could be tendered. Rather SEBI, being an agency-centric model, must exercise discretion over whether to pursue the information.[39] Once, the office of informant believes that information may lead to an inconsequential result, the SEBI's enforcement department may stop the investigation. On the contrary, if the information seems important and fraud-findings facts are involved the office of the informant must decide in its own application of mind to reward the whistle-blower. Besides, the minimum cap of 10% of the disgorgement amount must be there and above that depends on the impact or seriousness of the information provided.
5. **Anonymity:** The whistle-blower mechanism is dependent upon three pillars that are job protection, incentives, and confidentiality of identity. If personal anonymity is not maintained or his attorney has been compelled to disclosed identity on enforcement proceeding, such would halt the progressive outcomes of whistle-blower mechanism and hindered the free reporting of complaints.

CONCLUSION

Since decades, insider has been challenging to prosecute due to evidentiary issues. This is so, because of the flow of UPSI from insiders to outsiders, who may be relatives and closely connected to insiders become extremely difficult to monitor, owing to failure to gather evidence as

38. Patrick Gnazzo & Joseph Murphy, "Summary: An Insider Perspective on Whistleblower Programs" in *For Whom the Whistle Blows: Advancing Corporate Compliance and Integrity Efforts in the Era of Dodd-Frank* 10, 10 [Michael D. Greenberg (ed.), 2011].
39. David Cooper, "Blowing the Whistle on Consumer Financial Abuse", 163 Univ. of Pennsyl. L. Rev., 557, 588 (Jan. 2015).

to leakage of information. Also, the scope of a connected person, who would be deemed insider is unclear and dubious, as to the extent of the relationship. There are several factors which can be leveraged as the potential of trading in the securities market. Thus, it becomes impossible to monitor the trade of the friends or relatives of an insider. Also, this became difficult to detect owing to an unknown source of leakage of information. Therefore, the detection and investigation became the major challenges to prosecute insider trading case. Also, in India, unlike the US, people trade only in short terms and mixed with a daily dealer in the market. Whereas in the US, big hedge funds or private equity funds deliberately deal in with securities, which is apparent to get notice of. Thus, it becomes difficult to get the deliberate intention of trading from a share-trading pattern.

Therefore, SEBI introduced a whistle-blower mechanism to be instituted and must be formulated by the companies to report cases of fraud. Therefore, a recent intervention proposing a whistle-blower or informant mechanism to gather evidence for investigating crimes became an important policy. The whistle-blower will offer large monetary rewards on the actionable claim. This whistle-blower mechanism not only discloses the fraud being committed in the company but also shapes the compliances culture in the companies. Corporate governance is a core to insider trading as well as whistle-blowing. Thus, it would ensure that companies are careful about the transaction being taken and also the involvement of intermediaries. Thus, the role of whistle-blower may foster a new usher in Insider trading regulation.

Further, the issues of whistle-blowing are omnibus, due to efficient detection mechanism already being pursued by the SEBI. Informants, computer monitoring of stock transactions, and reporting of unusual activity by self-regulatory organisations or market professionals are the usual ways in which insider trading cases come to light. But, a whistle-blower mechanism has different informational advantages as it fosters the hidden information which could have been discovered by SEBI and also, helps in preserving the evidence. Therefore, a certain outlook like removing the requirement of material information, anonymity concerns, and agency responsiveness may perfectly correspond to effective blower mechanism.

ESSAYS

An Optimal Liability Solution for Independent Directors

—*Sarath Ninan Mathew*†

ABSTRACT

Presently, India does not differentiate between Executive Directors and independent Directors in terms of attributing liability. This essay challenges the equal-liability framework. First, it is advocated that independent directors must have objectively greater liability protections than given in status quo. Second, from a relative plane, it is sought to be established that independent directors must have significantly lesser exposure to liability in comparison to executive directors.

In proving these, the paper dwells into the theoretical construct behind imposing liability. The paper balances the concerns arising from the Fiduciary Model of liability with concerns highlighted in the Resource Dependence Theory. Hitherto, the Indian legal system has been looking solely at the Fiduciary Model, thereby ignoring certain key harms that the Resource Dependence Theory highlights.

After considering the theoretical framework behind liability, the Essay develops various prescriptive norms that aim to ensure accountability while causing the least amount of dis-incentivisation possible. Dis-incentivisation in this regard refers to meritorious people feeling disinclined to take up the role of independent directors when faced with an archaic liability framework. Ultimately, the compromise advocated in the essay will serve the interests of all stakeholders better than status quo. The Company, as well as people transacting with the company such as depositors, creditors etcetera, will benefit from an increased talent pool of independent Directors which result from the adoption of the model suggested by this paper.

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INTRODUCTION

Mandatory independent Directors are a relatively new conception in India.[1] Consequently, most provisions of the Companies Act, 2013 dealing with the liability of Directors do not differentiate between managerial Directors and independent Directors.[2]

While Section 149(12) does speak specifically about the liability of independent Directors, the grounds mentioned therein are in effect parallel to liability norms governing executive directors. It uses the words, "*only in respect of acts of omission or commission by a company which had occurred with his knowledge, attributable through board processes, and with his consent or connivance or where he had not acted diligently*".[3] The standard is evidently that of mere constructive knowledge, not intention or even actual knowledge; this represents the most minimum level of attribution. There is no relatively lesser standard of attribution that can be envisaged for executive directors. Thus, while Section 149(12) does seem to apply only to independent directors, it falls short of drawing a distinct liability paradigm. Further, the idea of equal liability for all directors, regardless of the functions carried out by them, has already been explicitly recognised by High Courts.[4]

This paper seeks to critically analyse the above-mentioned liability framework. In pursuance of this, the paper first tries to analyse the competing interests involved when imposing liability on Directors, from a theoretical perspective. Secondly, the position of independent Directors is considered specifically in this balance of interests. The finding of the paper is that independent Directors ought to be subject to a far relaxed liability regime than seen in *status quo*.

THEORETICAL ANALYSIS OF A DIRECTOR'S LIABILITY

Director liability can be broadly divided into two categories – liability to the company, and liability to the public at large.[5] At a conceptual level, these are totally distinct kinds of liabilities. The motivation behind

1. Companies Act, 2013 (18 of 2013), India Code, S.149(4) (2018).
2. *Ibid*, Ss. 166(7), 178(8), 184 (4).
3. *Ibid*, S.149(12).
4. *Madhavan Nambiar* v. *Registrar of Companies*, 2001 SCC Online 938, 14 (Mad).
5. Elena Gilardi, "Liabilities of Directors and Shareholders of a Company Limited by Shares under Italian Law", Bus. JUS Blog, S. 1.1 (18-10-2012), <https://

liability to the company is the much touted "fiduciary" relationship between the Director and the company.[6] The rationale for liability to public, on the other hand, is based on the concept of piercing the corporate veil.[7] Considering the doctrinal difference in these liabilities, they are analysed in a compartmentalised form in this paper.

1) Directors' liability to the company

The predominant theoretical framework used for rationalising Director liability, specifically in the Indian context, is the doctrine of fiduciary relationship.[8] This rule seeks to solve the agency problems inherent in the Director-company relationship. The standard agency problems inherent in all forms of agency are those arising from conflict of interest, and sub-optimal performance.[9] To combat these problems, the model of fiduciary liability imposes two corresponding categories of duties on agents – duty of loyalty and duty of care.[10] Duty of loyalty requires agents to act solely in the best interests of the principal even when doing so would result in a loss to the agent.[11] On the other hand, duty of care requires the agent to undertake a minimum threshold of diligence when acting on behalf of the principal.[12]

A bare reading of the text of the Companies Act, 2013 shows that, in India, the fiduciary model is the major framework, if not the sole one, for determining a Director's duties and liabilities. Section 166 of the Act,

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www.businessjus.com/wp-content/uploads/2014/05/Liabilities-of-directors-and-shareholders-of-a-company-limited-by-shares-under-Italian-Law.pdf>.

6. Rhoads, C. Brewster, "Personal Liability of Directors for Corporate Mismanagement", 65(2) Univ. Pa. L. Rev. & Am. L. Reg. 128, 128 (1916), <https://www.jstor.org/stable/3313956> (last visited 24-7-2019); "Relation of Shareholders and Creditors of a Corporation to Its Directors", 3(7) Colum. L. Rev.482, 482 (1903), <https://www.jstor.org/stable/1109482> (last visited 24-7-2019).
7. B. C., Liability of a Corporation to Third Parties for Acts of Promoters before Incorporation, 8(7) Va. L. Rev. 525, 525 (1922), <http://www.jstor.org/stable/1064096> (last visited 24-7-2019).
8. *Sangramsinh P. Gaekwad* v. *Shantadevi P. Gaekwad*, (2005) 11 SCC 314, 42 (India).
9. Kathleen M. Eisenhardt, "Agency Theory: An Assessment and Review", 14(1) Acad. Mgmt. Rev.57, 58 (1989), <http://www.jstor.org/stable/258191> (last visited 24-7-2019).
10. Robert H. Sitkoff, "The Economic Structure of Fiduciary Law", 91 Bos. Univ. L. Rev. 1041,1043 (2011), <https://dx.doi.org/10.2139/ssrn.1782999> (last visited 24-7-2019).
11. Harry S. Pangas, The Past, Present, and Future Roles of the Key Players in *Aspatore Books* ch.2, 5 (2007), <https://us.evershedssutherland.com/portalresource/lookup/poid/Z1tOl9NPluKPtDNIqLMRV56Pab6TfzcRXncKbDtRr9tObDdEua3Cro!/fileUpload.name=/PangasBookChapter.pdf> (last visited 24-7-2019).
12. *Ibid.*

which lays down the principal duties of Directors, can neatly be divided into duties of care and duties of loyalty. Sub-sections (1), (2), (3), and (6) impose the following duties on a Director–

1. Act in accordance with the Articles of the Company.
2. Act in good faith keeping in mind the objects of the company and the best interests of the various shareholders and stakeholders associated with the company.
3. Exercise reasonable skill, care, and independent judgment.
4. A bar on assigning her office to any other person.

Sub-sections (4) and (5) of Section 166 impose the following duties–

1. A bar on entering into any situation which would lead her to have a conflict with the interests of the company.
2. A bar on making or attempting to make undue gains to himself directly or indirectly by using her position as a Director.

The first set of duties is a clear reference to duties of care. These provisions lay down certain base thresholds which attempt to reduce the probability of a sub-optimal performance from a Director. The latter set of duties belongs to the category of duties of loyalty as the provisions make reservations against conflicts of interests. Apart from Section166, we find a plethora of provisions in the Companies Act wherein duties along the nature of duty of care / duty of loyalty are imposed on the Director. The various instances of requirement for shareholder approval for important decisions of the company are illustrations of duty of care.[13] The abundant disclosure obligations imposed for a variety of transactions represent duty of loyalty.[14]

Liability is the corollary to duty. Since fiduciary relationship is a basis for importing duties, it is also a framework within which Director liability can be understood. Fiduciary model is in fact the predominant method in India for determining Director liability.[15] The fiduciary model undoubtedly has the advantage of solving the standard problems of

13. Companies Act, 2013 (18 of 2013), India Code, Ss 186(3), 192(1), 196(3)(a), 203(2), 271(1)(b).
14. *Ibid*, Ss. 102(4), 167(1)(d), 184(1), 189(2), 191(1)(b)(iv).
15. *Sangramsinh P. Gaekwad* v. *Shantadevi P. Gaekwad*, (2005) 11 SCC 314, 42.

agency.[16] However, Directors are specialised agents. Not every person can efficiently manage the affairs of a company.[17] The fiduciary model of corporate governance does not take into account this reality of a limited talent pool. Under the fiduciary model, Directors are exposed to the risk of high personal liability for perceived negligent decisions.[18] The business judgment rule (analysed in detail subsequently), a defence to Director liability, has been considerably watered down by case laws.[19] These operate as active deterrents for talented Directors from taking up the mantle.

Professor Marylin R. Kaplan analyses the looming Director availability crisis and a sub optimal risk averse corporate governance scenario which arises from the blanket application of the fiduciary model.[20] She advocates viewing Director liability from a Resource Dependence Theory (Hereinafter, "RDT") perspective.[21] RDT is an attempt to understand the behaviour of a company as responses to its dependence on external resources. Under this paradigm, decisions taken by the company should be understood as attempts to modify the environment around it with the objective of maximising the resources available to it.[22] Applying RDT to corporate governance requires treating Directors as an important external resource rather than focusing on them solely as agents of the company.

Professor Marylin does not analyse what a balance between the fiduciary model and RDT would entail. While exact rules in this regard are a policy consideration beyond the scope of this paper, certain generalisations can be envisaged. First, RDT need not be considered while considering violations of duty of loyalty. Breach of duties of loyalty arises from an explicit and dishonest positive act undertaken by the Director. The shortage of pool of Directors which is the crux of RDT is not activated

16. Sitkoff, *supra* note 10.
17. Bill Snyder, "Is your CEO Irreplaceable?", Stanford Graduate School of Business (6-10-2017), <https://www.gsb.stanford.edu/insights/your-ceo-irreplaceable>.
18. *Official Liquidator* v. *P.A. Tandolkar*, (1973) 1 SCC 602: AIR 1973 SC 1104 (India); *Dorchester Finance Co Ltd* v *Stebbings,* 1989 BCLC 498, at 502,503; *Smith* v. *Van Gorkom,* 488 A 2d 858: 46 ALR 4th 821 (Del 1985), 66, 68.
19. Marilyn R. Kaplan and J. Richard Harrison, "Defusing the Director Liability Crisis: The Strategic Management of Legal Threats", 4(3) Org. Sci. 412, 419 (1993), <https://doi.org/10.1287/orsc.4.3.412> (last visited 24-7-2019).
20. *Ibid*, 416.
21. *Ibid*.
22. Jeffrey Pfeffer and Gerald R. Salancik, *The External Control of Organisations: A Resource Dependence Perspective*, at xi (2003).

in the case of duty of loyalty. As long as a director knows she will not act dishonestly, she need not fear liability arising out of breaching duty of loyalty.

With respect to duty of care, the balance lies in following the business judgment rule strictly. The business judgment rule states that if a directorial decision is one which could have been taken as a matter of business policy, then the Director should not be prosecuted.[23] While, this statement is admittedly vague,[24] the tendency in Indian courts has been to interpret business judgment rule as gross negligence as opposed to simple negligence.[25] The difference between gross negligence and ordinary negligence is a tangible one and should be regarded as forming the correct balance between protecting the company from sub-optimal performance while still retaining a pool of talented Directors.

2) Director's liability to third parties

Treatment of a company as a legal entity separate from the shareholders who constitute it, or the Directors who manage it, is a concept that goes to the core of company law.[26] Arguably, companies were envisaged solely for the purpose of the reduction in risk that comes about as a result of viewing the entity as distinct.[27] The principle of corporate veil that is inherent in each company was recognized as early as the 1890s in *Salomon* v. *Salomon and Inc*.[28]

Though the principle of corporate veil is so intrinsic to the concept of companies, subsequent case laws allow piercing the veil and imposing liability on the persons actually responsible for the loss caused, in exceptional circumstances. Instances which have led to the lifting of corporate

23. *Dodge* v. *Ford Motor Co.*, 204 Mich 459: 3 ALR 413.
24. Bayless Manning, The Business Judgment Rule in Overview, 45 Ohio St. L. J.615, 619 (1984), <http://heinonline.org/hol-cgi-bin/get_pdf.cgi?handle=hein.journals/ohslj45&section=29> (last visited 24-7-2019).
25. *Official Liquidator* v. *P.A. Tandolkar*, (1973) 1 SCC 602: AIR 1973 SC 1104 (India); *Ionic Metalliks* v. *UoI*, 2014 SCC Online Guj 10066, at 40-41 (Guj.); *National Bank of Upper India, Lucknow* v. *Dina Nath Sapru*, 1926 SCC Online Oudh CC 81, ¶¶ 7-8 (Oudh C.C.).
26. *Shiromani Gurudwara Prabandhak Committee* v. *Shri Som Nath Dass*, (2000) 4 SCC 146: AIR 2000 SC 1421 (India); *In re* Kondoli Tea Co. Ltd., ILR 13 (Cal) 43 (1886).
27. But see Arthur W. Machen, Jr., "Corporate Personality", 24(4) Harv. L. Rev. 253, 265 (1911), <http://www.jstor.org/stable/1324056> (last visited 24-7-2019).
28. *Salomon* v. *Salomon and Inc*, (1897) A.C. 22: [1896] UKHL 1.

veil include evasion of tax,[29] evasion of liability from welfare legislation,[30] and transactions with enemy nations during war.[31] However, such a list is not exhaustive; lifting the corporate veil is a question of fact and the decision depends on a case to case basis.[32]

Since case laws do not give a general principle for veil lifting, one might think of visiting the statutory provisions next. Most provisions within the Companies Act, 2013 that affix liability on Directors are in the context of liability to shareholders / prospective shareholders.[33] There are only few provisions which deal with the liability of Directors to third parties.[34] Section 447 is the major provision in this regard. It envisages criminal liability for Directors and consists of huge fines to be paid by the Director personally. A bare reading of the text of Section 447 shows that the intent to defraud is a pre-requisite for affixing liability on Directors.

A few salient features come to the forefront from the above analysis–

1. The judiciary has not laid down definitive rules for determining the circumstances wherein the corporate veil can be pierced.
2. The judiciary has accepted that the veil should not be discarded causally so as to not offend the core premises of company law.
3. The statutory mechanisms clearly state that intent to deceive is a pre requisite for fixing liability.
4. Additional liability, regardless of whether it is to shareholders or third parties, has the same consequence under an RDT paradigm which is reduction in the pool of available Directors.

Based on the above premises, the paper argues for the creation of a norm that lifting of corporate veil ought to be restricted strictly to only those cases where it can be shown that the Directors had an intention to deceive. Further, the liability should not be on the entire board, but

29. *In re* Sir Dinshaw Manekji Petit, 1926 SCC Online Bom 33, at 26, 35 (Bom.).
30. *The Workmen Employed in Associated Rubber Industries Limited, Bhavnagar* v. *The Associated Rubber Industries Ltd., Bhavnagar*, (1985) 4 SCC 114: AIR 1986 SC 1, at 117 ¶ 4; *Kapila Hingorani* v. *State of Bihar*, 2003(6) SCC 1, at 19-20.
31. *Daimler Co. Ltd.* v. *Continental Tyre and Rubber Co.*, [1916] 2 A.C. 307 (HL) 311; *Connors Bros.* v. *Connors*, 1938 SCC Online Can SC 41: (1940) 4 All E.R. 179.
32. A. T. W., and C. O. H, "Corporations: 'Disregarding the Corporate Entity'", 8(6) Cal. L. Rev.435, 436 (1920), <http://www.jstor.org/stable/3474663> (Last visited 24-7-2019).
33. Companies Act, (18 of 2013), India Code, Ss 26, 34, 35, 36(a), 36(b), 42(10).
34. *Ibid*, Ss 36(c), 37, 447, 448.

rather individuals who can be proved to have been dishonest. This interpretation does justice to the statutory intent as well as policy considerations arising out of RDT.

The following list provides a summary of the policy prescriptions advocated by this paper with respect to Director liability–

1. Liability to the company arising from a breach of duty of loyalty should be punished with no reservations.
2. Liability to the company arising from a breach of duty of care should be punished cautiously and the business judgment rule should be applied strictly.
3. Liability to third parties should be regarded as a sparse exception and should be allowed only when it can be shown that the impugned Director(s) had an intention to deceive.

LIABILITY FOR INDEPENDENT DIRECTORS

In the previous section, the paper has considered various scenarios and attempted to formulate rules which place an optimal amount of liability on the Director. It is admitted that while doing so, there has been a consistent advocacy for adoption of a much more liberal view of liabilities than in *status quo*. The rationale behind this is predominantly the consideration of RDT in the context of Directors, which is conventionally not undertaken for corporate governance in India. The liberal principles of liability evolved in the previous section, while debatable in the context of executive Directors, is necessarily to be applied for independent Directors.

Independent Directors are functionally required to act as a check against arbitrary exercise of power as well as negligence of Executive Directors.[35] This functionality is curtailed when an independent Director has any financial interest in the company directly or indirectly. To guard against these, there is a general prohibition on the independent Director being a related party to the company, or any promoter/director of the company.[36] Additionally, an independent Director cannot own shares

35. *Ibid*, Schedule IV, Clause II.
36. *Ibid*, S. 149(6)(b).

in her company;[37] neither can she be paid extra-ordinary compensation amounts which might colour her independence.[38]

These characteristics constitute tangible differences that independent Directors have in comparison to Executive Directors. While there does exist a limit on directorial compensation for Executive Directors, it is much higher in comparison to that of independent Directors.[39] Further, there is no bar on Executive Directors from owning shares of the company in which she is working.[40] In fact, companies give stock options to directors as an incentive to compensate, retain, and attract them.[41] These material differences have to be juxtaposed in the analysis undertaken in the previous section to envisage a model for determining liability of independent Directors.

As far as fiduciary duties are considered in isolation, independent Directors are no different from Executive Directors. Independent Directors are also agents of the company. Even though their functions are different from Executive Directors, the differences do not eliminate, or even affect, the classical agency problems. While the statute limits avenues for conflicts of interests by placing certain conflicts as disqualifying factors for independent Directors, this does not guarantee that conflicts may not occur subsequent to appointment. Sub-optimal performance is a risk that runs in all agency relationships and one cannot see any factor that saves independent Directors from this vice.

However, taking into account RDT gives a strong argument for adopting a liberal liability paradigm for independent Directors. In RDT, we find a huge impact arising from the differences between independent Directors and Executive Directors. Independent Directors, as an external resource, are even more valuable than Executive Directors.[42] They have to be competent enough to exercise supervision over the actions of Executive Directors. Additionally, it is extremely difficult to incentivise

37. *Ibid*,.S. 149(9).
38. *Ibid*, S. 197(1)(ii).
39. *Cf.ibid*, S. 197(1)(i*) with ibid*, S. 197(1)(ii).
40. *See* Charles Hall Davis, Should a Director of a Corporation Be a Stockholder? , 1(5) Va. L. Reg.321 (1915), <https://www.jstor.org/stable/i246056> (last visited 24-7-2019).
41. Eelke M. Heemskerk, Decline of the Corporate Community: Network Dynamics of the Dutch Business Elite, 16 (2007), <http://www.jstor.org/stable/j.ctt46not1.5> (last visited 24-7-2019).
42. Kaplan, *supra* note 19, at 415.

independent Directors to compensate for any risk that they have to take. This is because of the statutory ban on large compensation packages[43] and stock options for them.[44]

Further, the ground realities of contemporary Indian corporate governance suggest that governance for most companies is structured in such a way that there is a large information asymmetry between independent Directors and Executive Directors.[45] This means that independent Directors have a practical difficulty in exercising diligence above certain levels. Prospective independent Directors are aware about this information asymmetry. Equal liability combined with lesser compensation and the lack of tools to perform their functions substantially reduces the talent pool of independent directors.

In light of the above reasons, independent Directors' liability has to be lower in comparison to executive directors'. This paper argues that the threshold for imposing liability on independent Directors should be solely that of intention. Liability should be imposed on an independent Director only if it can be shown that she had the intention to cause a loss to the company, gain an undue benefit, or cause a loss to any third party. Even keeping gross negligence as the standard is sub-optimal considering the limited returns that independent directors receive in comparison to executive directors.

The liability regime captured in the above paragraph does not make it impossible or even difficult for companies to function. Independent Directors are in most cases well respected members of the society for whom reputation is a prized possession.[46] In the wake of sub-optimal performance, the company is still free to take punitive measures steps that could extend to dismissing the Director. The reputational loss caused from such steps are active deterrents to sooth the classical problems of agency.[47] Additional forms of deterrence, apart from its utilitarian prob-

43. Companies Act, 2013 (18 of 2013), India Code, S. 197(1)(ii).
44. *Ibid*, S.149(9).
45. Securities and Exchange Board of India, Report submitted by the Committee on Corporate Governance, 34 (2017), <http://www.nfcg.in/KOTAKCOMMITTEREPORT.pdf> (last visited 24-7-2019).
46. Wei Jiang *et al*, Reputation Concerns of Independent Directors: Evidence from Individual Director Voting, 29(3) Rev. Fin. Stud.655, 659 (2016), <https://academic.oup.com/rfs/issue/29/3> (last visited 24-7-2019).
47. Ramon Casadesus-Masanell and Daniel F. Spulber, "Agency Revisited", 39 (Harvard Business School Working Paper No. 10-082, 2010), <https://www.hbs.edu/faculty/

lems premised on RDT, are also morally unfair considering the limit in compensation provided to independent Directors.

Further, keeping intent to defraud as the trigger point for liability complements the standard this paper advocated for Director liability to third parties. Thus, the norm for independent Director liability, regardless of whom it is owed to, ought to be that of intent to deceive.

CONCLUSION

The standard of liability for independent Directors that this paper advocates is "intention to commit a wrong". This standard takes into account the harms suffered by companies on deterring enterprising persons from joining the board. Only a person who seeks to be dishonest will be deterred in the intention oriented standard. Further, especially in the case of independent Directors, this does not lead to a decline in solving the standard agency problems as reputational loss in itself can act as sufficient deterrence for independent Directors.

In most developed countries, including the United States of America, there exist varied insurance mechanisms for protecting Directors from frivolous law suits.[48] These include Director and Officer (D&O) Insurance, direct indemnification by the company, individual insurance by the company itself, and companies aggregating as a group to give insurance facility to Directors.[49] In India, even standard D&O insurance schemes are only entering the market and are in a nascent stage.[50]

Taking into account the very limited compensation that independent Directors receive, policy makers in India should seriously consider mandating all companies (or atleast a subset thereof, like listed companies) to subscribe to standard D&O insurance for their independent Directors.[51]

Publication%20Files/10-082.pdf> (last visited 24-7-2019).

48. Bernard S. Black, Brian R. Cheffins and Michael Klausner, "Outside Director Liability: A Policy Analysis", 162(1) J. Inst. & Theoretical Econ. 5, 14 (2006), <https://www.jstor.org/stable/40752553> (last visited 24-7-2019).
49. *Ibid*, 11,12.
50. Vyapak Desai and Ashish Kabra, "Global Litigator: Director and Officer Liability in India", 41(4) Litig. 17, 19 (2015), <https://www.jstor.org/stable/26401860> (last visited 24-7-2019).
51. *See* Eddy Wymeersch, "European Company Law and Corporate Governance: Quo Vadis? – Closing Remarks", 69(4) Rabel J. Comp. & Int'l. Priv. L. 787, 793 (2005), <https://www.jstor.org/stable/27878559> (last visited 24-7-2019).

This was strenuously advocated by the Kotak Committee Report as well.[52] It is unfortunate that the legislators deemed it unnecessary to accept this recommendation in the 2018 amendment to the SEBI (Listing and Obligation Disclosure Requirements) Regulation, 2015.[53]

It is imperative that the discourse in India shifts from analysing liability solely in the context of agency problems. Liability has to also be acknowledged as a form of disincentive for independent Directors. Such a balanced conception of liability will be advantageous to all stakeholders in the corporate regulatory framework.

52. Securities and Exchange Board of India, *supra* note 45, at 30-31.
53. Securities and exchange Board of India (Listing Obligations and Disclosure Requirements) (Amendment) Regulations, 2018, , pt. III S. 4 (9-5-2018).

Issuance and Listing of Shares with DVR: Evaluating a "Make in India" Initiative from the Lens of Corporate Governance and Shareholder Democracy

—*Aadhya Kancharla*†

ABSTRACT

Amidst growing concerns of dated regulations being a hindrance to startups wishing to list on the Indian exchanges, SEBI in an unprecedented move last month implemented a comprehensive framework to allow new age technology startups to issue shares with superior voting rights to their promoters. This move was in line with other recent measures taken by the capital markets regulator to encourage startups to list locally, including rebranding the Institutional Trading Platform to "Innovators Growth Platform" by easing listing norms in order for startups to raise funds through IPOs. These changes did not appear out of the blue, as the Indian fascination with enabling technology startups to achieve "unicorn" status as well as ensuring that the existing unicorns go public in Indian markets stems from the 2016 Startup India Action Plan that acts as a limb of the "Make in India" initiative.

The aim of this essay is to unwrap the shiny packaging of the "modern" reform of allowing promoters to retain control of their companies by means of superior voting rights in exchange for lesser cash flow rights. While this proposal was put forward by stating the importance of this provision in order for these asset-light startups to raise adequate funds to achieve unicorn status and also acting as a defense against hostile takeover bids, it is important for us to examine the effectiveness of this new amendment in justifying violation of shareholder democracy as

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well as the fundamental principle of corporate governance- "one share, one vote". The author undertakes this by determining whether the "coat-tail provisions" serve as effective checks and balances and a final conclusion is made upon analysis of empirical studies and corporate governance practices in different markets while also judging India's capacity to deal with this new provision.

EXAMINING THE NEED FOR A DUAL CLASS STRUCTURE

The debate over shares with differential voting rights, or as they are known in other countries, dual class shares, is not one that is new to India. While the Company Law Board in 2009 had rejected the argument that superior voting rights were a form of oppression[1], SEBI (Securities and Exchange Board of India) had subsequently banned listed companies from issuing shares with superior rights as to dividend or voting rights.[2] This move was upon taking cognizance of the deeper issues of corporate governance including the oppression of minority shareholders and entrenchment of management in the hands of family-owned businesses. Why then, with India still ranking third on the Credit Suisse Study of countries with the highest number of family owned companies[3] and promoters owning more than 45% shareholding in listed companies[4], is our capital markets regulator departing not only from its previous actions but from the Western markets that it often models its behavior on?[5] The explanation for this lies in the changes the Modi led government has been bent on making in order to attract foreign investment and bring the Indian economy in line with that of the US and China, and coming up with these hybrid instruments that promote growth as well as act as a takeover defense seems to be one of them. The dichotomy of investors' concerns of this move impacting India's reputation at protecting minority

1. *Anand Pershad Jaiswal* v. *Jagatjit Industries Ltd.*, (2010)1 Comp LJ 509
2. SEBI circular no. SEBI/CFD/DIL/LA/2/2009/21/7 dated 21-7-2009
3. Eugene Klerk et al., The CS Family 1000 in 2018, 10 (September, 2018), <https://www.credit-suisse.com/media/assets/corporate/docs/about-us/research/publications/the-cs-family-1000-in-2018.pdf>.
4. Mithun Varkey, Tipping the Balance, India Business Law Journal (18-6-2019), <https://www.vantageasia.com/sebi-differentiated-voting-rights/>.
5. Following issues raised by institutional investors, FTSE Russell and S&P Dow Jones market indices limited the listing of multiclass entities on their benchmark equity indexes.

investors' interests versus building a path for asset-light startups to leap-frog their value to multi-billion dollars is one that needs to be addressed without romanticising this decision.

This decision by SEBI was, in a strange coincidence, announced on the day when the founders of FundsIndia.com exited their firm due to the dominance of private equity investors[6]. In an era where businesses in India are evolving from MNCs and State-owned corporations to companies led by first-generation entrepreneurs[7], it is important that the regulatory environment is conducive for startups to go for IPOs—in order to maximise shareholder value and to showcase that their company is heading in the right direction. This is especially pertinent if we wish to move from the trend of Internet startups founders exiting their companies, tempted by the financial security that comes from giving up their control. The cash-out mentality of startup founders[8] needs to change in order for Indian startups to achieve long-term growth and find a place in the global economy, and this could be done by preventing "startup deaths" of the companies that have been built upon the dreams of innovators. Even if one argues that the success of a company cannot be ensured by preventing change in control, the dual class structure offers an optimal solution for the problems faced in startup financing. A class of shares with superior voting rights to the promoters would ensure that founders do not lose control of their business after multiple rounds of private equity funding.

While venture debt financing is cheaper than equity when structured appropriately and does not come at the cost of takeovers or acquisition of the startups, the business model of tech startups is one that comprises of intangible assets such as data and algorithms as opposed to machinery and land through which debt is raised.

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6. Sanjay Vijayakumar, PE Investors oust FundsIndia.com founders, *The Hindu* (26-6-2019), <https://www.thehindu.com/business/pe-investors-oust-fundsindiacom-founders/article28159307.ece>.
7. RSM India, Indian Business and Investment Environment, A Guide to Doing Business in India, 6(October, 2016), <https://www.rsm.global/india/sites/default/files/media/RSM%20India/doing_business_in_india_-_23_may_2017.pdf>.
8. Shelley Singh, Venkat Ananth, Here's why the cash-out mentality is becoming popular with startup founders, *The Economic Times* (January, 2019), <https://economictimes.indiatimes.com/small-biz/startups/features/heres-why-the-cash-out-mentality-is-becoming-popular-with-startup-founders/articleshow/67331976.cms?from=mdr>.

Issuing shares with lower voting rights is permitted for private companies under the current regulatory framework[9] and while tech startups prefer setting up private companies to avoid the pressures of the market, they still tend to go for public listings in order to provide their investors with an exit strategy. SEBI has recognised that easy access to private capital could mean reduced IPO activity and has specifically targeted startups belonging to the knowledge-based technology sector through its definition of who can list on the "Innovators Growth Platform"[10].

Although it seems that this move would address the regulatory bottlenecks that deter pre-revenue startups from IPOs and would build a stronger ecosystem that encourages tapping public markets for generating revenue, the underlying effects of this new system run much deeper than increased IPO activity. We need to consider that most private equity investors are prevented by their charters from investing in companies that offer them inferior voting rights as they wish to have a say in the managerial decisions of companies in order to guarantee returns on their investments. Furthermore, institutional investors who serve as a connection between shareholders and the companies in which they invest have raised concerns of valuation discounts and violation of the principles of corporate governance. It is important to address the concerns of these stakeholders and analyse the strength of the checks and balance system put in place by SEBI.

EVALUATING CONCERNS OF CORPORATE GOVERNANCE AND MARKET VALUATIONS

The criticisms to the new framework largely stem from responses to SEBI's Consultation Paper by organisations representing the interests of Institutional Investors.[11] The Council of Institutional Investors was founded to protect long-term investors against inequitable voting structures and a study published by the Investor Responsibility Research Centre and Institutional Shareholder Services revealed that companies with dual class shares have undesirable economic results in the long

9. Companies Act, 2013 S. 43(a)(ii).
10. SEBI (ICDR)(Second Amendment) Regulations, 2019, Clause V(i)(1).
11. See generally, Asian Corporate Governance Association, Re: Consultation Paper on Issuance of shares with Differential Voting Rights, <http://www.acga-asia.org/pdf/20190507-acga-letter-to-sebi-on-dvr>.

run[12]. While it is apparent that Institutional Investors act as effective intermediaries for shareholders to make informed use of their rights and exercise ownership functions, it is important to differentiate between legitimate concerns of violation of corporate governance practices and "group-think mentality".

Traditionally, it has been accepted that the separation of stock ownership and voting control in a public company leads to agency costs and bad governance. The belief is that controlling shareholders can take decisions that they will not have to bear the economic costs of due to greater cash flow rights lying in the hands of minority shareholders. However, it is important to look at the trend of change in capital markets, at least in the US, wherein the problem lies in "separation of ownership from ownership"[13] with institutional investors controlling the shares of most public companies. Considering that they are intermediaries who do not own the capital they buy shares with, instances of proxy contests arise. Even in India, proxy voters had almost ousted Deepak Parekh from the Board of HDFC[14] and superior rights (SR) shares offer protection to promoters against control contests. Yet, from a corporate governance perspective, which is ultimately important for the reputation of doing business in our country, the critical voices of institutional investors cannot be excluded. The main concerns put forward by these organisations are two-fold: firstly, that shares with lower voting rights trade at a lesser value and hence would not even benefit short-term investors and secondly, that promoting shares with differential voting rights would reflect badly on India's corporate governance practices.

In lieu of addressing the first concern, it is an unfortunate consequence that the "financialisation" of Indian corporate governance markets[15] has

12. Lukomnik, J. and S. Quinn. "Controlled Companies in the Standard & Poor's 1500: A Ten Year Performance and Risk Review". Investor Responsibility Research Centre Institute and Institutional Shareholder Services (2012).
13. David J. Berger, Wilson Sonsini Goodrich and Rosati, "What's the Problem with Dual Class Stock? A Brief Response to Professors Bebchuk and Kastiel", Harvard law forum on Corporate governance and Financial Regulation (17-4-2019), <https://corpgov.law.harvard.edu/2019/04/17/whats-the-problem-with-dual-class-stock-a-brief-response-to-professors-bebchuk-and-kastiel/#3>.
14. Ashok Banerjee, "Shares with Differential Voting Rights", Indian Finance Association (2019), <http://indiafa.org/shares-with-differential-voting-rights/>.
15. Sunanda Sen, Zico DasGupta, "Financialization and Corporate Investments: The Indian Case", Levy Economics Institute Working Paper Collection (January, 2015) <http://www.levyinstitute.org/pubs/wp_828.pdf>, *See also*, David Berger, Wilson Sonsini Goodrich &

led to public companies using shareholder value as a metric of how well they are doing. There is evidence to correlate greater shareholder value with better corporate governance practices which corresponds to better market returns[16] but how important is the market value of shares in achieving long term results for startups?

In accepting dual class share structures, there is a tradeoff between the entrepreneurs' pursuit of their vision and investors' needs for reducing agency costs[17] and an efficient market would ensure a mutually optimal arrangement between investors and issuers once the barrier of asymmetric information taken down. However, some scholars argue that even if promoters' vision produce high corporate value within the initial time period of public listing, his business decisions grow inefficient later on and this imposes increased management agency costs on the shareholders.[18] It can thus be established that the reason for previously issued shares with fractional voting rights in India trading at nearly 50% discount is due to the perpetuity of inferior voting rights and the risk of governance costs that short-term investors are unwilling to undertake. While shareholder democracy is an important tool to protect the reputation of our markets, the narrow focus on only immediate economic returns instead of long term growth and health that could lead to higher corporate profits could be detrimental to the success of these startups. "Hedge fund activism" that has been promoted by organisations such as the OECD in the belief that this would strengthen corporate governance practices has led to private equity investors being resistant to charters that contain anti-takeover provisions[19] and empirical studies have proven that the value of voting rights for shareholders is significant only during

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Rosati, *Why Dual-Class Stock: A Brief Response to Commissioners Jackson and Stein,* Harvard law forum on Corporate governance and Financial Regulation (22-2-2018).

16. Lester Picker, The Effect of Corporate Governance on Shareholder Value, The National Bureau of Economic Research (2019), <https://www.nber.org/digest/may11/w16574.html>.
17. Zohar Goshen, Assaf Hamdani, Corporate Control and Idiosyncratic Vision. The Yale Law Journal (2016). 125(3): 560–795.
18. Andrew William Winden, "Sunrise, Sunset: An Empirical and Theoretical Assessment of Dual-Class Stock Structures", Colombia Business Law Review (2018), 894.
19. The OECD Steering Group on Corporate Governance, The role of private pools of capital in Corporate Governance: Summary and Main findings about the role of Private Equity firms and "Activist" Hedge Funds, Corporate Affairs Division, Directorate for Financial and Enterprise Affairs Organisation for Economic Co-operation and Development (May, 2007), <http://www.oecd.org/corporate/ca/corporategovernanceprinciples/38672168.pdf>.

change of control events[20]. This flies in the face of entrepreneurs who arguably know how to successfully execute their dreams of building unicorn-status startups.

The voting premium is lesser for countries with better legal protection for minority shareholders and hence in order to quell investors' concerns it is important to examine the strength of the corporate governance system in India.

EXAMINING THE ENFORCEMENT ENVIRONMENT AND SEBI'S SYSTEM OF SAFEGUARDS

The ability of promoters in India to use the control given to them to execute their vision would have to be balanced against efforts to diminish governance risks in order to ensure the success of DVR (Differential Voting Rights) structures in India. In recent times, India has prioritised strengthening the corporate governance system and this has manifested in establishing a position of No. 7 out of 190 countries in the protection of minority interests in the World Bank's Doing Business Report. While it is true that the recent strong enforcement action taken against Sun Pharmaceuticals, Yes Bank etc. along with guidelines issued by the Ministry of Corporate Affairs for Responsible Business Conduct[21] might result in investors placing more faith in India's corporate governance, proper awareness needs to be spread regarding the system of safeguards available to investors. The framework published by SEBI takes into account the Kotak Committee's recommendations[22] on preventing mismanagement of control by the promoters but further safeguards to ensure an airtight system of protecting minority shareholders are warranted to be discussed.

SEBI in its consultation paper has brought its regulations at par with the Companies Act, 2013. However, the pre-condition of having a consistent track record of distributable profits has been removed as this provision would be limited to new age technology startups as defined

20. Aswath Damodaran, "The Value of Control: Implications for Control Premia, Minority Discounts and Voting Share Differentials", Damodaran on Valuation (Second Edition, 2008).
21. Amita Gupta Katragadda, UK Sinha, Opinion: The quiet transformation of corporate governance, *LiveMint* (10-05-2019) <https://www.livemint.com/opinion/columns/the-quiet-transformation-of-corporate-governance-1557392837251.html>.
22. *See* Report of the Committee on Corporate Governance (5-10-2017).

in the Innovators' Growth Platform[23] the collective net worth of whose promoter group should not be more than Rs. 500 crores. Furthermore, SEBI has issued certain "coat-tail provisions"[24] in order to prevent managerial entrenchment. These including preventing further issue of superior rights shares post-listing, SR shares having the same face value as ordinary equity shares with distinction between the two arising only matters of voting on resolutions, restriction on creation of third party interests over shares,[25] a maximum cap of 75% of total voting rights on the voting rights of the promoters and a maximum voting differential of 10:1. In addition to these, the following amendments/ provisions are recommended to be included within these coat-tail provisions—

1. A specified time limit until which shares with superior voting rights can be issued before an IPO in order to ensure that the shares are not misused by promoters post a large investment being made by private investors. The Corporate Governance Code does not apply to unlisted companies and this leaves the minority shareholders virtually unprotected.
2. The provision that the sunset clause of five years can be extended by a shareholders' resolution (even though superior voting rights do not extend to matters of appointment of directors, extension of sunset time period etc.) should not be allowed as in many cases there could be influence of control over the majority voting shareholder over other shareholders and even the Board of Directors, despite appointment of Independent Directors.
3. Event- based triggers such as the death of promoters or termination of employment of directors needs to be considered by the SEBI and ideally the SR shares should be extinguished with the removal of its holder.

23. *Supra* note 11.
24. "Coat-tail" provisions had been imposed by the Toronto Stock Exchange for classes of shares with differential voting rights in order to wipe away private benefits of control and essentially mean provisions that bring voting rights of the controlling shareholders on par with those of the other shareholders in certain cases.
25. Preventing promoters from pledging SR shares is in line with SEBI tightening rules of pledging shares by promoter group entities- the definition of pledged shares has been expanded and in cases where the pledging of a promoter exceeds 50 per cent of his shareholding she will have to cite reasons for the same.

From the lens of corporate governance, SEBI has placed checks by mandating that half of the board must comprise of independent directors, the audit committee should only have independent directors and making amendments to the definition of "related parties" to include the promoter group as well as requiring the board to make bi-annual disclosures of related party transactions to the stock exchanges as well as framing a corporate governance policy.[26] However, the question of efficiency of enforcement of these meticulous regulations needs to be answered. With India ranking 163 out of 190 countries in World Bank's Ease of Doing Business Report in Enforcement of Contracts, barriers such as the Business Judgment Rule[27] and the lack of execution of class action suits coupled with the strength of the corporate lobby, it might seem that SEBI is biting off more than it can chew.

Ultimately, the success of DVR structures for startups-even if short lived, depends on how investors engage with companies that employ this mechanism. Perhaps the model adopted by Singapore and Hong Kong could be followed—enhanced measures have been taken by constituting a corporate governance committee comprised entirely of independent directors that make recommendations to the Board and act as a mediator of conflicts of interest between the company and its shareholders. However, the effectiveness of this in situations of defined control is yet to be judged and ultimately the confidence of investors has to be achieved, which could be done by adding additional disclosure requirements. The terms of offer should clearly state the vision of the promoters and how they intend to enhance corporate value and if they could provide for protection against agency costs to public shareholders while also making them accountable in case they influence management.[28]

If investors are secure and are convinced that the founders have the ability to execute unique and compelling business strategies, they would be willing to give up their control rights. DVR structures could be more

26. Cyril Amarchand Mangaldas, "Corporate Governance: On April 1, New Rules of The Game for India Inc.", Bloomberg Quint Opinion (16-3-2019) https://www.bloombergquint.com/law-and-policy/corporate-governance-on-april-1-new-rules-of-the-game-for-india-inc.
27. The Courts' presumption that the directors of the company acted in good faith would prevent looking into whether there was influence by the directors on shareholders' decisions.
28. Vidhi Centre for Legal Policy, A Response to the SEBI Consultation Paper on Issuance and Listing of Shares with Differential Voting Rights (May, 2019).

beneficial to them than issuing preference shares as there would be no limitations on the dividends they would be entitled to receive.

SEBI has not underestimated the significance of this move in laying out a safety net to protect the interests of the stakeholders and either ways, this new structure would speak volumes of the strength of corporate governance in India. If executed efficiently, this could be the answer that startup founders have been searching for and could put India on the map of global innovation.

Commodum Ex Injuria Sua Nemo Habere Debet: Conflict between Sections 29A of IBC & 230 of Companies Act, 2013

—*Arjun Gaur*†

ABSTRACT

Section 29A of the Insolvency and Bankruptcy Code was introduced with the objective of preventing recalcitrant promoters from gaining control of a corporate debtor against which insolvency resolution process has been initiated. The policy underlying Section 29A in respect of the resolution process is also the fulcrum of the proviso to Section 35(1)(f) of the Code, which prohibits the sale of the assets of the corporate debtor during its liquidation. The recent amendments to the Liquidation Process Regulations seek to create inroads into the hitherto irreversibility of the liquidation process under the Code by explicitly allowing a company in liquidation to enter into a compromise or arrangement under Section 230 of the Companies Act, 2013. What the amendment fails to clarify is whether a person, who is ineligible to submit a resolution plan under Section 29A, and consequently prohibited from purchasing the assets of the corporate debtor during liquidation is also prevented from proposing a scheme of compromise or arrangement under Section 230 of the Companies Act. The essay endeavours to argue that the correct interpretation of Section 29A of the Code vis-a-vis Section 230 of the Companies Act 2013 is that an ineligible resolution applicant under the former Section should not be allowed to propose a compromise or arrangement under the latter. An opposing interpretation would fall foul of the object and purpose of the introduction of Section 29A in the Insolvency and Bankruptcy Code and will lead to an incongruous situation wherein a person can bid neither for the company during its resolution nor for its

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assets during liquidation, but can gain control of the company by entering into a compromise or arrangement with the company's creditors and/or members during the liquidation stage.

On 25 July 2019, the Insolvency and Bankruptcy Board of India [hereinafter, "IBBI"] issued a notification amending the IBBI (Liquidation Process) Regulations, 2016 [hereinafter, the "LP Regulations"].[1] The amendments are primarily aimed at streamlining the liquidation process under the Insolvency and Bankruptcy Code, 2016 [hereinafter, the "Code" or the "IBC"] in order to maximise the value of the assets and reduce the time taken. One such amendment has been the insertion of a Regulation 2B, which enables a corporate debtor in liquidation to enter into a compromise or arrangement [hereinafter, "compromise/arrangement"] under Section 230 of the Companies Act, 2013 [hereinafter, "CA 2013"] within 90 days of the order of liquidation passed under subsections (1) and (4) of Section 33 of the Code.

The prelude to the amendments to the LP Regulations was a series of NCLAT liquidation orders, vide which the liquidators were directed to "take steps under Section 230" with the objective of rehabilitating the corporate debtor;[2] and a "Discussion Paper on Corporate Liquidation Process" released by the IBBI [hereinafter, the "Discussion Paper"], which took note of the aforementioned orders of the NCLAT and analysed the viability of a scheme of compromise/arrangement under Section 230 of

1. Insolvency and Bankruptcy Board of India, Insolvency and Bankruptcy Board of India (Liquidation Process) (Amendment) Regulations, 2019, Notification No. IBBI/2019-20/GN/REG047, available at https://ibbi.gov.in/webadmin/pdf/whatsnew/2019/Jul/Liquidation%20Regulations%2025072019%20final%20English_2019-07-25%20 20:13:32.pdf [hereinafter, "LP Amendment Regulations 2019"].
2. *S.C. Sekaran* v. *Amit Gupta*, Company Appeal (AT) (Insolvency) No. 495 and 496 of 2018; *Y. Shivram Prasad* v. *S. Dhanapal*, 2019 SCC OnLine NCLAT 172; *North East Centre for Technology Application and Reach* v. *Sri Vari Metal Works Pvt. Ltd.*, 2019 SCC OnLine NCLAT 160; *Hindustan Paper Corporation Officers and Supervisor Association* v. *Hindustan Paper Corporation Ltd.*, 2019 SCC OnLine NCLAT 207; *Concept Management Consulting Ltd.* v. *Anand Chandra Swain*, 2019 SCC OnLine NCLAT 232; *R. Vijaykumar* v. *Kasi Viswanathan*, 2019 SCC OnLine NCLAT 227; *M. Palanisamy* v. *Senthil Papers and Boards Pvt. Ltd.*, 2019 SCC OnLine NCLAT 260; *Superna Dhawan* v. *Bharti Defence and Infrastructure Ltd.*, 2019 SCC OnLine NCLAT 270; *Sh. D.R. Balakrishna Raja* v. *Indian Bank*, 2019 SCC OnLine NCLAT 322; *C. Mahendra International Ltd.* v. *Naren Sheth,* 2019 SCC OnLine NCLAT 332.

CA 2013 after the passing of an order for liquidation.[3] A key issue which finds mention in the Discussion Paper,[4] but is absent from the recent amendments to the LP Regulations is whether persons ineligible under Section 29A of the IBC should be allowed to enter into a compromise/arrangement with the creditors and/or members of the corporate debtor after it has been ordered to be liquidated. The discrepancy lies in the fact that while Sections 29A and 35 (1)(f) of the Code prohibit certain persons from submitting a resolution plan and bidding for the assets of a corporate debtor in liquidation respectively, there is no such express prohibition with respect to the persons who can enter into compromise/arrangement under Section 230 of CA 2013. Consequently, a promoter of a company can propose to enter into a scheme of compromise/arrangement under Section 230 of CA 2013.[5]

This essay proposes, contrary to the view taken by the IBBI in its Discussion Paper, that the correct reading of Sections 29A and 35(1)(f) of IBC along with Section 230 of CA 2013 would yield the following result: that an ineligible person under Section 29A of the Code cannot enter into a compromise/arrangement with the creditors and/or members of the corporate debtor in liquidation. A conflicting interpretation of Section 230 vis-a-vis Section 29A of IBC, apart from being absurd, would militate against the mandate of the latter section and the intention of the Parliament in inserting Section 29A by the IBC (Amendment) Bill, 2017.

BACKGROUND

In accordance with the recommendations of the Bankruptcy Law Reforms Committee's Report, the Code follows a rescue-approach. This implies that whenever a corporate debtor fails to meet its payment obligations, the first step is to resolve its distress situation by following the Corporate

3. Insolvency and Bankruptcy Board of India, Discussion Paper on Corporate Liquidation Process along with Draft Regulations, 27-4-2019, available at <https://ibbi.gov.in/webadmin/pdf/whatsnew/2019/Apr/Discussion%20paper%20LIQUIDATION_2019-04-27%2020:52:25.pdf>.
4. *Ibid,* at ¶ 3.3.3.
5. *Rasiklal S. Mardia* v. *Amar Dye Chem Ltd.* (In Liquidation), 2019 SCC Online NCLAT 243; Company Appeal (AT) No. 337 of 2018.

Insolvency Resolution Process [hereinafter, "CIRP"] and inviting "resolution plans". During this period, the corporate debtor shall be managed by a Resolution Professional acting on the directions of the Committee of Creditors [hereinafter, the "CoC"]. However, if the resolution fails, the corporate debtor shall have to be liquidated in accordance with the provisions of the IBC.

Additionally, Section 230 of CA 2013 allows a company to enter into a compromise/arrangement with its creditors or members or any class of them on an application filed in this regard before the NCLT by the company itself, any of its members (including the promoters[6]), its creditors, or the liquidator (in case the company has been ordered to be liquidated). While CA 2013 does not define "compromise" and "arrangement", the Courts have judicially interpreted these terms in accordance with Section 391 of the Companies Act, 1956 [hereinafter, "CA 1956"], which was the analogous provision under the erstwhile company law. In this regard, "compromise is an expression which implies the existence of a dispute such as relating to rights, which it seeks to settle, but the word "arrangement" is a term of very wide import and its meaning is not to be limited to something analogous to a compromise."[7] As such, compromise and arrangement include all modes of reorganising the share capital,[8] schemes of corporate debt restructuring,[9] alteration of preferential or other special rights attached to shares and so on and so forth.

Section 230 requires the convening of "class" meetings on a direction from the NCLT, i.e. meeting of the class of persons (creditors or members or both) affected by the scheme of compromise/arrangement,[10] and having a "commonality of interest".[11] In the class meetings, the proposed scheme of compromise/arrangement will have to be approved by a majority of persons, representing three-fourth in value of persons belonging to the group. After the approval of the relevant "classes", the NCLT will sanction the scheme on being satisfied of the statutory compliances, as

6. *Ibid.*
7. A. Ramaiya, *Guide to the Companies Act* 3688 [Arvind P. Datar et al. (eds.), 18th edn. 2014].
8. Companies Act, 2013, S. 230 (1) Explanation.
9. Companies Act, 2013, S. 230 (2)(c).
10. *Jaypee Cement Ltd., In re*, 2004 SCC OnLine All 2053: (2004) 122 Comp Cas 854.
11. *Maneckchowk and Ahmedabad Manufacturing Co. Ltd. In re*, 1969 SCC Online Guj 22: (1970) 40 Comp Cas 819 (Guj).

well as of the fact that the scheme is *bona fide*, just, fair, reasonable, and not contrary to public policy or any provisions of the law.[12]

A scheme of compromise/arrangement under Section 230 can also be proposed in case of a company in winding up and can, therefore, take the company out of winding up and set it on the course of revival.[13] The Courts, acting in terms of Section 391 of CA 1956, have leaned in favour of the revival of the company rather than closing it down.[14] However, the Court may also decline to sanction the scheme of revival when it appears that the scheme is merely "an eyewash" for the purpose of forestalling the winding-up of the company.[15] But, once the scheme of compromise/arrangement has been sanctioned by the requisite majority and approved by the Tribunal, it becomes binding on the company, its members, its creditors, and the liquidator (if the company is in winding up).[16]

IS SECTION 230 OF CA 2013 SUBJECT TO SECTION 29A OF IBC?

In light of the above discussion, the question that arises for consideration is: whether Section 230 of CA 2013should be subject to Section 29A of the IBC? In this regard, it is pertinent to briefly take note of the persons who have been enumerated under Section 29A of the Code. From a bird's-eye perspective, Section 29A includes an undischarged insolvent; a wilful defaulter; a person whose account or the account of a corporate debtor under the management or control of such person, has been declared as non-performing asset; a person disqualified to act as a director under CA 2013; a person prohibited by the SEBI from trading in securities. The aforementioned persons, along with any other person "acting jointly or in concert with such person", are not eligible to submit a resolution plan

12. *Miheer H. Mafatlal* v. *Mafatlal Industries Ltd.*, (1997) 1 SCC 579: AIR 1997 SC 506.
13. *Vasant Investment Corpn. Ltd., In re*, 1978 SCC OnLine Bom 151: (1982) 52 Comp Cas 139; *Bengal National Textile Mills Ltd. In re*, 1983 SCC OnLine Cal 163: (1986) 59 Comp Cas 956 (Cal); *Rajdhani Grains and Jaggery Exchange Ltd. In re,* 1981 SCC OnLine Del 112: (1983) 54 Comp Cas 166 (Del).
14. *Alembic Chemical Works Ltd. In re*, 1986 SCC OnLine Guj 143: (1988) 64 Comp Cas 186 (Guj); *Wearwell Cycle Co. Ltd. In re,* 1993 SCC OnLine Del 348: (1998) 94 Comp Cas 723 (Del).
15. *BIFR* v. *CMD*, *APS Star Industries Ltd.*, 2008 SCC OnLine Guj 410: (2009) 152 Comp Cas 302 (Guj).
16. *Navjivan Mills Co. Ltd. In re*, 1970 SCC OnLine Guj 42: (1972) 42 Comp Cas 265 (Guj); *Naokhila Loan Co. Ltd. In re*, 1947 SCC OnLine Cal 92: (1946-47) 51 CWN 791 (Cal).

under the IBC. In the same vein, the proviso to Section 35(1)(*f*) of the Code prohibits the liquidator from selling the "immovable and movable property or actionable claims of the corporate debtor in liquidation to any person who is not eligible to be a resolution applicant."

The subservience of Section 230 of CA 2013 to Section 29A of the IBC is premised on two key factors: *first*, the IBC will override the provisions of the CA 2013 by virtue of the non-obstante clause in the Code; and *secondly*, Section 29A is a mandatory provision as opposed to Section 230, which is merely an enabling provision.

Section 238 of the Code prescribes that the provisions of the IBC shall override "anything inconsistent therewith contained in any other law" in force in India. A plain reading of the non-obstante clause contained in Section 238 makes it evident that the provisions of the IBC shall have an overriding effect "only if there is anything inconsistent contained in any other law or instrument having effect by virtue of any other law."[17] By virtue of Section 238, the provisions of the IBC will override the provisions of CA 2013 to the extent of any inconsistency between the two.[18] However, in order to completely understand the effects of a non-obstante clause, the Court has to interpret such clause in the context in which it appears, and take into account not just the plain language of the clause, but also the intention of the legislature in enacting the clause, the legislative policy behind the enactment and the object and purpose sought to be achieved.[19]

Section 29A was not present in the Code when it was originally enacted in 2016. It was first inserted by the IBC (Amendment) Ordinance, 2017 in order to rectify "a loophole in the Act which allowed a back-door entry to erstwhile managements in the CIRP."[20] Subsequently, a modified version of Section 29A was introduced by the IBC (Amendment) Bill, 2017 in the Lok Sabha. The following excerpt from the Statement of Objects and Reasons of the Bill is apposite for the present purpose:

17. *Central Bank of India* v. *State of Kerala*, (2009) 4 SCC 94, at 116.
18. *PSL Ltd.* v. *PSL Ltd.*, 2018 SCC OnLine Bom 36, at 23-27.
19. *Yakub Abdul Razak Memon* v. *State of Maharashtra*, (2013) 13 SCC 1, 645-647; *Geeta* v. *State of Uttar Pradesh*, (2010) 13 SCC 678, 685-687; *Central Bank of India* v. *State of Kerala*, (2009) 4 SCC 94, 130-135.
20. *Chitra Sharma* v. *Union of India*, 2018 SCC OnLine SC 874, at 32.

> "2. ... *Concerns have been raised that persons who, with their misconduct contributed to defaults of companies or are otherwise undesirable, may misuse this situation due to lack of prohibition or restrictions to participate in the resolution or liquidation process, and gain or regain control of the corporate debtor. This may undermine the processes laid down in the Code as the unscrupulous person would be seen to be rewarded at the expense of creditors.*"[21] [emphasis supplied]

The object behind the introduction of Section 29A was that the persons who were responsible for the distress situation of the corporate debtor should not be allowed to regain control of the company by proposing a resolution plan. A perusal of the other clauses of Section 29A lends further credence to the observation that errant promoters, in general, are sought to be kept out of the management of the corporate debtor.[22] This policy of the legislature, which permeates Section 29A, also permeates Section 35 (1)(f) when it applies not merely to resolution applicants, but also to liquidation.[23] The intention of the legislature to restrict certain persons from entering or re-entering the management of the corporate debtor is not, therefore, restricted to the stage of CIRP, but extends to the liquidation process, as is also evident from the Statement of Objects and Reasons of the IBC (Amendment) Bill, 2017 reproduced above. Giving a purposive interpretation to Section 29A, the Supreme Court has taken into account "reasonably proximate facts" occurring even prior to the submission of the resolution plan while deciding the question of eligibility of a resolution applicant under Section 29A (c).[24] This is an illustration of the approach taken by the Supreme Court in giving a wide interpretation to Section 29A in accordance with its objectives.

Coming to the question at hand, when the Adjudicating Authority under the Code, i.e. the NCLT, passes an order of liquidation, the liquidator is tasked with selling the immovable and movable property and actionable claims of the corporate debtor.[25] The liquidator can sell

21. The Insolvency and Bankruptcy Code (Amendment) Bill, 2017, Lok Sabha Bill No. 280 of 2017, available at <https://ibbi.gov.in/webadmin/pdf/whatsnew/2017/Dec/280_2017_LS_Eng_2017-12-28%2020:06:07.pdf>.
22. Insolvency and Bankruptcy Code, 2016, S. 29A.
23. *Arcelor Mittal (India) (P) Ltd.* v. *Satish Kumar Gupta*, (2019) 2 SCC 1, at 69.
24. *Ibid*, at109.
25. S. 35 (1)(f), Insolvency and Bankruptcy Code, 2016.

these assets on a standalone basis, in a slump sale, collectively (in sets), or in parcels, or can even sell the corporate debtor or its business as a going concern.[26] But the proviso to Section 35 (1)(f) of IBC, which was introduced by the IBC (Amendment) Act, 2018, explicitly prohibits the liquidator from selling these assets to the persons ineligible under Section 29A. In the absence of such a proviso, the persons disqualified under Section 29A would either have benefitted from the purchase of the assets of the corporate debtor at the liquidation value (which tends to go down with time)[27], or would have gained control of the corporate debtor or its business if it would have been sold as a going concern. Similarly, if persons ineligible under Section 29A are allowed to propose compromise/arrangement (under Section 230 of CA 2013 read with the newly-introduced Regulation 2-B of the LP Regulations) with the company, its members, or its creditors, after an order of liquidation, such ineligible persons will be able to hold the reins of the corporate debtor at the expense of the creditors and other members. This is because while the creditors would be forced to take huge haircuts in order to revive the corporate debtor, the recalcitrant promoters, who might even have been responsible for the sickness of the company in the first place, would be able to retain control of the enterprise. Therefore, allowing ineligible persons under Section 29A to enter into compromise/arrangement with the creditors and/or members after a liquidation order would enable the overt circumvention of the clear provisions of Sections 29A and 35 (1)(f), and the betrayal of the intention and the object of the IBC (Amendment) Act, 2018.

Cases of proposed revival schemes under Section 391 of CA 1956 were fraught with instances of delaying tactics employed by recalcitrant promoters who were reluctant to surrender control of the sick company.[28] The doors to such inordinate delays, caused at the instance of the promoters are proposed to be kept shut by keeping ineligible persons under Section 29A out of the scope of Section 230 of CA 2013 and even though the courts have wide discretion in refusing to sanction a scheme of compromise/arrangement where the management had been involved

26. Insolvency and Bankruptcy Board of India (Liquidation Process) Regulations, 2016, Regulation 32.
27. The Report of the Bankruptcy Law Reforms Committee, November 2015, at Pg. 15, available at <https://ibbi.gov.in/uploads/resources/BLRCReportVol1_04112015.pdf>.
28. *In Re: Saroj G. Paddor*, [1996] 22 CLA 200 (Bom).

in misconduct in relation to the affairs of the company,[29] an outright disqualification of persons enumerated in Section 29A will not only avoid delays during the liquidation process (because a considerable time is lost in getting the compromise/arrangement sanctioned), but will also better serve the purpose with which the Code was enacted. This is especially in view of the fact that notwithstanding the newly proposed timeline of 90 days,[30] applicable to a company in liquidation, for completing the process under Section 230 of CA 2013 and the now reduced upper-limit of one year within which the liquidation process has to be completed,[31] several promoters have the ability to game the system, as became evident in the Essar Steel case.[32]

Moreover, Section 230 of CA 2013 is merely an enabling provision that allows a company to enter into a scheme of compromise/arrangement on being approved by the requisite majority (majority in number representing three-fourths in value), and getting sanction from the NCLT after complying with the statutory procedure. On the other hand, Section 29A and the proviso to Section 35 (1)(f) are mandatory provisions because the ineligibility attaches automatically to a person mentioned in Section 29A. As such, no amount of CoC approval (even if all the members of the CoC agree) can remove the disqualification. The only exceptions to Section 29A are either mentioned in the Section itself,[33] or are carved out at other relevant places (e.g. Section 240-A of the Code restricts the application of clauses (c) and (h) of Section 29A to micro, small and medium enterprises). Therefore, the argument that 75 percent super majority will act as a check against the acceptance of a compromise/arrangement by errant promoters is fallacious, because the mandatory ineligibility under Section 29A cannot be overcome by a vote in favour of the scheme by the creditors and/or the members of the company.

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29. A Ramaiya, *Guide to the Companies Act,* 3724, 3732 (Arvind P. Datar et al. eds., 18th edn. 2014).
30. Regulation 2B (1), Insolvency and Bankruptcy Board of India (Liquidation Process) Regulations, 2016.
31. Regulation 12, LP Amendment Regulations 2019.
32. Apoorva Mandhani, Why the Essar Steel Case Pushed Modi Govt to Give More Teeth to Bankruptcy Code, *The Print*, 19-7-2019, available at <https://theprint.in/economy/why-the-essar-steel-case-pushed-modi-govt-to-give-more-teeth-to-bankruptcy-code/264862/>.
33. Insolvency and Bankruptcy Code, 2016, S. 29A (c) *proviso*; Insolvency and Bankruptcy Code, 2016, S. 29A (d) *proviso*.

CONCLUSION

It is beyond any dispute that the paramount objective of the Code is to "ensure revival and continuation of the corporate debtor";[34] and as such, the liquidator can sell the business as a going concern or strive to enter into compromise/arrangement with the creditors and/or members on behalf of the company. But, since an erstwhile promoter of the corporate debtor has no vested right to bid for its assets during liquidation,[35] an interpretation which allows such recalcitrant promoter to regain control of the company by entering into a compromise/arrangement with the creditors and/or members would undermine the salutary object and purpose of the Code.[36] Furthermore, the NCLAT's reliance on the Supreme Court judgment in *Meghal Homes (P) Ltd. v. Shree Niwas Girni K.K. Samiti*[37] in the recent orders[38] passed with respect to Section 230 of CA 2013 is also misplaced insofar as the Supreme Court judgment relates to a point of time when there were no restrictions on who could purchase the assets of the corporate debtor at the time of its liquidation.

Interestingly, an interpretation which makes Section 230 of CA 2013 subject to Section 29A of the Code is also supported by the recent amendment to the IBC introduced in the Rajya Sabha.[39] The proposed amendment to cap the duration of the CIRP at 330 days (including the time spent in litigation) is a manifestation of the intention of the Government that resolution or revival *at any cost* is not the objective of the Code. The objective is to strike a balance between resolution and liquidation.[40] If revival is not possible, liquidation is the only option available. This is in line with the Parliament's altered approach of leaning in favour of the public interest contained in the recovery of public monies owed to banks and financial institutions over the revival of sick industrial companies.[41] *Ergo*,

34. *Swiss Ribbons (P) Ltd.* v. *Union of India*, (2019) 4 SCC 17, at 12.
35. *Ibid*, at 69.
36. *Chitra Sharma* v. *Union of India*, 2018 SCC OnLine SC 874, at 31.
37. *Meghal Homes (P) Ltd.* v. *Shree Niwas Girni K.K. Samiti*, (2007) 7 SCC 753.
38. *Supra* note 2.
39. Insolvency and Bankruptcy Code (Amendment) Bill, 2019, Rajya Sabha Bill No. XXVI of 2019, available at <https://ibbi.gov.in/uploads/whatsnew/bill>.
40. Ministry of Corporate Affairs, Report of the Expert Committee on Company Law 2005, Pg. xv, available at <https://ibbi.gov.in/uploads/resources/May%202005,%20J.%20J.%20Irani%20Report%20of%20the%20Expert%20Committee%20on%20Company%20Law.pdf>.
41. *Madras Petrochem Ltd.* v. *Board for Industrial and Financial Reconstruction*, (2016) 4 SCC 1, at 43.

even if a scheme of compromise/arrangement envisaged by Section 230 is taken to be the last shot at the revival of the corporate debtor, it should not be extended to such an extent that it frustrates the clear mandate of Section 29A, which is to keep the errant promoters out and prevent them from regaining control of an already ailing enterprise. An opposing conclusion would amount to serious inroads into Section 29A and would dilute its purpose.[42] As for the authority competent to decide the eligibility of a person under Section 29A in respect of a proposed scheme of compromise/arrangement under CA 2013, the liquidator, since he possesses quasi-judicial powers under the Code,[43] should be empowered to determine the question.

42. Dipak Mondal, Defaulting Promoters Getting "Backdoor" Entry to Regain Companies under IBC, *Business Today*, 19-4-19, available at <https://www.businesstoday.in/current/economy-politics/defaulting-promoters-getting-backdoor-entry-to-regain-companies-under-ibc/story/338638.html>.
43. *Swiss Ribbons (P) Ltd.* v. *Union of India*, (2019) 4 SCC 17, at 60.

Rejection of Claims by Resolution Professional: Scope and Remedies

—*Aman Vasavada*†

ABSTRACT

This essay reviews the scope of a resolution professional to reject the claim of a creditor in the Corporate Insolvency Resolution Process. Further, it appraises the various remedies that may be available to a creditor whose claim has been rejected by the resolution professional at the stage of verification. Under the Insolvency and Bankruptcy Code, 2016, one of the first tasks of the interim resolution professional is the verification of claims made by the creditors of the corporate debtor. Rejection of the creditor's claim at this stage excludes the creditor from the insolvency process and jeopardises its chances at making any recovery. The written law is ambiguous on the scope and nature of the power of the resolution professional to reject claims. This essay argues, in the light of the recent judicial reasoning, that a resolution professional merely has the administrative discretion to reject claims within the prescribed rules of proof. The essay then explains how an application to the NCLT under Section 60(5) of the Insolvency and Bankruptcy Code, is the only direct remedy for getting a rejected claim admitted. Ancillary remedies, namely, challenging the resolution plan, initiating disciplinary proceedings and post-moratorium actions against the revived entity have also been appraised.

1. INTRODUCTION

The Corporate Insolvency Resolution Process under the Insolvency and Bankruptcy Code, 2016 is dotted with several phases and timelines. After

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the application for initiation is admitted, the NCLT declares a moratorium, appoints an Interim Resolution Professional ("IRP") and makes a public announcement of the commencement of insolvency proceedings. This announcement serves as an invitation to all creditors of the Corporate Debtor to file their claims with the IRP. Collation of claims by the IRP right at this nascent stage of the corporate insolvency resolution process ("CIRP") is in furtherance of several functions. It will help the IRP constitute the committee of creditors, ascertain the financial situation of the corporate debtor and prepare the information memorandum for formulating a resolution plan.[1]

But can an IRP or subsequently a Resolution Professional ("RP")[2] reject the claim of a particular creditor? The precise duty of the IRP at this stage is veiled with ambiguity and this confusion could have drastic consequences especially for lenders. The Insolvency and Bankruptcy Code, 2016 ("the Code") finds itself in a determinative phase wherein its fledgling jurisprudence has to cope with its burgeoning relevance. Clarity on interpretative and anomalous issues in the functioning of the Code is hence imperative. In pursuance thereof, this paper attempts to understand the scope for rejection of claims by a resolution professional and explores the remedies available to an aggrieved creditor to get its claim admitted. In its concluding remarks, the paper raises the possibilities of a smoother verification process.

2. SCOPE OF REJECTION OF CLAIMS BY RP

Section 18 of the Code imposes a duty upon the RP only to "receive and collate all the claims".[3] Section 15 states that she is "responsible for receiving claims".[4] The Code neither clarifies her ability to reject claims, nor does it delineate the scope within which such power could be exercised. We thus have to look at the Regulations governing CIRP.[5]

1. Insolvency and Bankruptcy Code (31 of 2016) ("IBC"), Secs. 21, 29.
2. In this paper, usage of the word "RP" may mean to include IRPs as well, as the case may be.
3. IBC, Sec. 18.
4. IBC, Sec. 15.
5. IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 ("CIRP Regulations").

2.1. The RP's Right to Reject: Enabling Provisions?

Part IV of the CIRP Regulations deals with the proof of claims. It prescribes various documents through which creditors could prove their claims,[6] empowers the RP to summon evidence as she deems fit to substantiate the claims[7] and finally imposes a duty upon her to verify claims within seven days of receipt.[8] Beyond her duty to "receive" and "collate" claims, she now has to "verify" them.

Hence, non-submission of proofs could entitle the RP to reject a creditor's claim. But this may only confer an administrative power on the RP, and not the right to reject claims on merits. Further, Regulations 14(1) and (2) seem to convey that even if there is insufficient proof of the claim, the RP is required to make the best estimate based on the information available and include it.[9] This seems to indicate that there is no right to reject. However, an equally valid argument can be made that she has to actively apply her mind to the proofs received and accept only those claims that satisfy her as having been sufficiently proved – an act of adjudication. While this last proposition can be argued, it is submitted that expecting adjudication by RP at this stage is unfeasible.

It is hard to expect an RP with no judicial training to adjudicate complicated debts in seven days. The alternative solution of reducing the standard of proof for conclusively proving a disputed claim is also unwise, considering so much can be at stake. In any case, RPs are not competent to adjudicate upon various issues of facts and law that could arise out of a disputed claim. It seems absurd, thus, to grant adjudicatory powers to an RP.

This submission is bolstered when we compare the powers of the RP with those of the Liquidator under the Code itself. The Liquidator also has to "consolidate" and "verify" claims much in the same way as the RP does.[10] However, the Liquidator has to undertake the additional step of "admission or rejection" of claims for which it has to record reasons for rejection and an appeal procedure against such rejection is expressly

6. CIRP Regulations, Reg. 7-12.
7. CIRP Regulations, Reg. 10.
8. CIRP Regulations, Reg. 13(1).
9. CIRP Regulations, Reg. 14.
10. IBC, Secs. 38-39.

provided for.[11] The absence of this extra step in the provisions dealing with the powers of the RP is a clear indicator that the legislative intent was to grant an adjudicatory function upon the Liquidator while granting a purely administrative discretion to the RP. As we shall see in the next part, courts too, seem to agree with the proposition that an RP cannot adjudicate upon claims.

2.2. Understanding Judicial Attempts at Delineation

A "claim"[12] includes a right to payment even if it is disputed.[13] Hence, the RP has to collate and verify *all*[14] claims, even if disputed. However, verification may not always be possible. In *Grasim Industries* v. *Tecpro Systems*,[15] the NCLT upheld the IRP's right to reject claims that are not verifiable in the debtor's books, noting that allowing a disputed claim would defeat purpose of moratorium and hamper the time-bound process. This clarifies that the RP is certainly vested with some power to reject a claim. Hence, it only remains to conclude whether the RP's discretion is administrative or adjudicatory in nature.

In *Swiss Ribbons* v. *Union of India*,[16] it was urged that disputed claims should be raised at the stage of verification with the RP, as opposed to the stage of commencement of insolvency proceedings. The logic was that these disputes cannot be resolved without going into documentary evidence that is anyway submitted as proof of claims under Section 18. However, the Supreme Court rejected this argument by holding that claims can be disputed at the stage of initiation itself.[17] It further held that RPs have no adjudicatory powers, thereby concluding the debate over the nature of an RP's power. The Supreme Court definitively held that:

> "It is clear from a reading of the Code as well as the Regulations that the resolution professional has no adjudicatory powers…the resolution professional is given administrative as opposed to quasi-judicial powers."[18]

11. IBC, Secs. 40, 42.
12. IBC, Sec. 3(6).
13. *Innoventive Industries Ltd* v. *ICICI Bank*, (2018) 1 SCC 407,.
14. IBC, Sec. 18(2).
15. *Grasim Industries and Edelweiss ARC* v. *Tecpro Systems*, C.A. No. (IB) 197 (PB)/2017 .
16. *Swiss Ribbons Pvt Ltd* v. *Union of India*, 2019 SCC Online SC 73, Para 4.
17. *Ibid*, Para 24.
18. *Ibid*, Para 59.

When BHEL's massive claim was rejected by Monnet Ispat's RP, the NCLAT simply relied upon *Swiss Ribbons* and the RP was directed to re-examine the claim based on the accounts and BHEL's evidence.[19]

2.3. Apparent Scope of Rejection

Doubts can still exist because, as discussed above, the Regulations focus on words like "proof" and "verification" that impart a very adjudicatory flavour. In fact, it was argued very recently before the NCLAT, while relying upon the above decision in *BHEL*'s case, that the RP had no jurisdiction to reject a claim.[20] The NCLAT refused to go into the question based on the facts of the case,[21] but it is submitted that had it done so, it is unlikely that it would have deviated from *Swiss Ribbons*' position. While *Swiss Ribbons* and *BHEL* restrict the RP's powers, they still allow functional administrative discretion subject to judicial review by the NCLT. The UNCITRAL also recommends that while verification of claims could involve assessments of legitimacy, at no point should an insolvency professional substitute the court in its functions.[22] Hence, a reasonable answer to the first question raised by this paper regarding the scope of rejection by a resolution professional can be concluded by stating that a resolution professional can exercise administrative discretion and not quasi-judicial powers, while verifying claims. In doing so, she can reject a claim only in accordance with the prescribed regulations for non-submission of proofs.

3. REMEDIES

Rejection of claims can have injurious implications. Financial creditors lose their seat in the Committee of Creditors ("CoC") and their chances at recovery. Operational creditors get excluded from the resolution plan, losing their claim to the promised[23] minimum sum not less than the liquidation value. To make matters worse, Section 31 makes the NCLT-approved resolution plan binding upon everyone, including "creditors"

19. *Navneet Kumar Gupta* v. *BHEL*, (2019) SCC Online NCLAT 114.
20. *Bank of Baroda* v. *Bijay Mumuria*, (2019) Case No. 229/2019 (NCLAT).
21. *Ibid*.
22. UNCITRAL, Legislative Guide on Insolvency Law 178 (2005).
23. IBC, Sec. 30(2)(b).

and "other stakeholders involved in the resolution plan",[24] arguably affecting these rejected creditors. The Insolvency and Bankruptcy Board of India ("IBBI") has also clarified that creditors whose claims haven't yet been admitted cannot be treated as a dissenting creditor and have no say in the resolution process.[25] The position of a rejected creditor at this stage seems unenviable.

A remedy against rejection is thus crucial. However, the only remedy to actually get rejected claims admitted seems to lie in an application to the NCLT under Section 60 of the Code. A subsequent remedy may lie under Section 61 wherein the NCLT order approving a resolution plan is challenged. Pursuing the claim after the moratorium ceases is also an option deserving consideration. Finally, seeking removal of the IRP at the stage of filing of claims might bolster a creditor's case.

3.1 Getting the Claim Admitted

Under Section 60(5) of the IBC, the NCLT can hear any claims against a corporate debtor, any questions of priority or any questions of fact or law regarding the CIRP. In the absence of the NCLT's inherent powers,[26] Section 60 serves as a residuary and is the only direct remedy at the stage of verification.

In *Swiss Ribbons*, the Supreme Court ruled that set off and counter claim can be "considered at the stage of filing of proof of claims during the resolution process by the resolution professional, his decision being subject to challenge before the Adjudicating Authority under Section 60."[27] There is no reason to not extend this reasoning to primary claims. Separately, it explained that the provision enables NCLT to even set aside CoC decisions, if the rejection is arbitrary.[28] Similar oversight over RP's arbitrariness is an obvious inference. It can look at whether the RP rejected the claim based on extraneous considerations beyond her prescribed framework for discretion, and can direct admission or reconsideration. Additionally, incorrect categorisation of the creditor into a

24. IBC, Sec. 31.
25. IBBI, Voting in the Committee of Creditors, Circular No IBBI/CIRP/018/2018 (14-9-2018).
26. *Lokhandwala Kataria Construction Pvt Ltd* v. *Nisus Finance & Investment Manager LLP*, 2017 SCC Online NCLAT 406; Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016.
27. *Swiss Ribbons Pvt Ltd* v *Union of India*, 2019 SCC Online SC 73, para 35.
28. *Ibid*, para 54.

class (eg. financial or operational) by the RP during verification can also be challenged under Section 60.[29]

It is worth discussing whether the CoC supervises the RP instead of the NCLT, thereby removing the need to directly invoke Section 60(5)? At the stage of submission of resolutions plans, the RP is mandated[30] to rely upon the CoC's wisdom in approving or rejecting a plan. However, it is impractical to defer verification of claims to the CoC. First, there are likely to be many more claims as compared to resolution plans and more importantly, the CoC is not even in existence yet at the stage of verification to decide upon them. A possible solution would be to adopt a system wherein the CoC is constituted from the undisputed claims and then the disputed claims are laid before the CoC. However, even this would fail as CoC members will likely reject all disputed claims in order to maximise their own recovered value. It would be hard to hold the CoC accountable for self-serving bias when the policy and design of the Code is so creditor-friendly.

Hence, the only supervisor over the RP at this stage is the NCLT. Asking the NCLT to adjudicate upon every claim on merits could nip the efficacy of CIRP at the bud itself. However, it is still feasible for the NCLT to prima facie peruse a disputed claim, following which it simply directs the RP to reconsider the claims. In cases where it appears that the RP has been unable to verify a claim or has rejected it, applications under s 60(5) have been made seeking directions to the RP to include the applicants in the CoC and these claims have been adjudicated even at the appellate level in time enough for the directions to be successfully made.[31] Inefficient as it may seem, adjudication on merits in such exceptional cases can also not be ruled out from the scope of Section 60(5).

With the NCLT as the solitary supervisor over the RP at this stage and with sufficient precedent regarding the scope and ambit of Section 60(5) an application thereunder is the best hope for a disgruntled creditor seeking to get its claim admitted after rejection by the RP.

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29. Ashish Makhija, *Insolvency and Bankruptcy Code of India*, 736 (2018).
30. *ArcelorMittal India Pvt Ltd* v. *Satish Kumar Gupta*, (2019) 2 SCC 1, para 77.
31. *Export Import Bank of India* v. *Resolution Professional, JEKPL*, 2018 SCC Online NCLAT 7; *With Axis Bank Limited* v. *Edu Smart Services Private Limited*, 2017 SCC Online NCLAT 1811.

3.2 Further Remedies

3.2.1 *Challenging the Resolution Plan*

The claim of a rejected creditor will likely never find its place in a resolution plan. After such a resolution plan is approved by the NCLT via an order under Section 31, an appeal can be filed against it under Section 61(3) on grounds including material irregularity in exercise of the powers by the RP.[32] Being an appeal before the NCLAT, this has to be filed within 30 days of the NCLT's order approving the resolution plan. "any person aggrieved" can file this appeal,[33] and adverse decisions taken by the RP can be objected at this stage, seeking necessary corrections,[34] which could include amending the resolution plan to account for these claims.

3.2.2 *Proceeding against the RP*

Challenging a disputed claim under Section 60(5) can defeat the purpose of the moratorium. The NCLT may be reluctant to adjudicate upon disputed claims and derail the time-bound CIRP process. Hence, initiating parallel proceedings before the IBBI challenging independence and impartiality of the RP could help convince the NCLT to take up the cause of the aggrieved creditor. Any person[35] aggrieved by an RP's functioning can move to IBBI for an investigation.[36] Upon investigation and after a show-cause hearing[37], a Disciplinary Committee constituted by the IBBI could order for the removal, suspension or cancellation of the RP's registration.[38] Penalties under Section 70(2) for non-compliance with the statute could also be leviable.[39]

To facilitate the above procedure, one has to prove certain violations by the IRP. The wrongful rejection of the claim could itself be argued as

32. IBC, Sec. 61(3)(ii).
33. IBC, Sec. 61(1).
34. *Speculum Plast Pvt Ltd* v. *PTC Techno Pvt Ltd*, 2018 SCC Online NCLAT 872, Para 72.
35. IBBI (Grievance and Complaints Handling Procedure) Regulations, 2017, Reg 2(h) allows only "stakeholders" to file such a complaint But Reg 2(j) defines "stakeholder" to include a creditor as well as any other person having an interest in the insolvency, thereby making locus standi consistent with s 217's wording of "any person aggrieved".
36. IBC, Sec. 218-219 r/w IBBI (Insolvency Professional) Regulations 2016, Reg 11.
37. *Ibid*, Sec. 219.
38. *Ibid*, Sec. 220(2).
39. *Ibid*, Sec. 70(2).

a violation, if the circumstances are suspicious. Compliance with their Code of Conduct is mandatory[40] and her rejection might be considered as a breach of independence and impartiality.[41] Acting in connivance with applicants/debtors to not consider a claim[42] and partiality during verification[43] can successfully attract Section 220(2). A Disciplinary Committee has noted: "(He), as IRP did not consider the claim of the claimant. He did not even respond to him...As RP, he did neither consider the claim nor respond to the complainant. He utterly disregarded his statutory duty."[44] Hence, these proceedings could serve to strengthen a rejected creditor's remedy under Section 60(5).

3.2.3 *Post-Moratorium Action*

Section 31 makes the NCLT-approved resolution plan binding upon "creditors" and "other stakeholders involved in the resolution plan".[45] It could be argued that rejected creditors are included within these persons and hence, bound by the resolution plan. If rejected creditors are mentioned in the resolution plan, it could imply that their claim has been dealt with as unsuccessful and they can no longer re-agitate the claim after the moratorium ends.

However, it is submitted that rejection of claims by the RP is not an adjudicatory function and hence, it cannot amount to a conclusive decision on the rights of a creditor. Hence, the creditor could pursue his unextinguished rights in civil proceedings against the revived entity[46] after the moratorium ends. The NCLAT has, after declaring a rejection by the RP as wrongful, clarified that if the resolution plan is approved and the resolution applicant takes over management of the corporate

40. *Ibid*, Sec. 208(2).
41. IBBI (Insolvency Professional) Regulations, 2016, Sch l, paras 5-9; IBBI, Disclosures by Insolvency Professionals and other Professionals appointed by Insolvency Professionals conducting Resolution Processes Circular No. IP/005/2018 (January 2018), Para 9.
42. In the matter of Mr Rakesh Wadhwa, (2018) IBBI/DC/05/2018 (IBBI Disciplinary Committee).
43. In the matter of Mr Mukesh Mohan, (2018) IBBI/DC/07/2018 (IBBI Disciplinary Committee).
44. In the matter of Mr. Dhaivat Anjaria, (2018) IBBI/Ref-Disc.Comm./02/2018 (IBBI Disciplinary Committee).
45. IBC, Sec. 31.
46. It is worth noting that if the CIRP fails and the corporate debtor slumps into liquidation, then fresh claims can be filed by the previously rejected creditor and the Liquidator has the power to adjudicate upon them under Section 40 of the Code.

debtor, the rights of the aggrieved creditor will not cease simply because it cannot be raised at this stage.[47]

4. CONCLUDING REMARKS

To summarise the findings of this essay, it is submitted that as things stand, the RP has the power to reject claims based on her administrative discretion. This discretion should be exercised within the rules of proof laid down in the Code and the Regulations and her decision of admission or rejection can be challenged before the NCLT under Section 60(5) within the prescribed time. Further remedies may be available to the creditor but they could derail the time-bound process and hence may not be readily deployable.

The questions addressed by this paper assume significance due to the dubious nature of the verification process that could potentially exclude genuine creditors from the process due to lack of proof or due to arbitrary action by the RP. Looking forward, verification of claims can certainly be made smoother. If Information Utilities become prevalent as envisaged by the Code, they should soon provide IRPs with undisputed, complete and instant information.[48] This would likely take away all discretion from the RP and render the verification process largely automatic.

UNCITRAL's Legislative Guide on Insolvency Law[49] presents another solution to the verification dilemma with the automatic-approval route wherein all claims are automatically admitted, subject to challenge by an objector. This would reduce role of RP and can be made viable in India if the NCLT is empowered to hear such challenges by objectors, backed by heavy penalties for false challenges. The UNCITAL Guide also suggests a system of provisional admission of disputed claims.[50] In the Indian set-up, such a system would allow the NCLT to adjudicate upon the disputed claims, while the RP continues the CIRP process unhindered, treating all claims as provisionally admitted. The NCLT can refrain from deciding upon approval of resolution plan or from ordering liquidation until all provisionally admitted claims are disposed of by it.

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47. *Andhra Bank* v. *F. M. Hammerle Textile Ltd*, 2018 SCC Online NCLAT 222.
48. Bankruptcy Law Reforms Committee, Report of the Bankruptcy Law Reforms Committee- Volume I: Rationale and Design (2015), Executive Summary.
49. UNCITRAL, Legislative Guide on Insolvency Law, 249-264 (2005).
50. *Ibid*.

However, even the UNCITRAL Guide cautions lawmakers that irrespective of the method of verification of claims and irrespective of where a nation's insolvency code lies on the debtor-versus-creditor-friendliness spectrum, all rejections of claims by insolvency professionals should be made challengeable at once.[51] This essay finds that the present law in India, if clarified desirably, would permit such a system of instant challenge under Section 60(5), proving to be an effective check on the discretion of the RP. Nevertheless, neither this remedy, nor the further remedies discussed in the preceding part are necessarily time-efficient and in line with the spirit of the Code. An impetus to Information Utilities is hence, imperative, along with a consideration of the alternative models could help boost the efficacy of the Code.

51. *Ibid*, 178 (2005).

ARTICLES & ESSAYS

The fast changing developments in the economic landscape of India along with socio - political and legal implication, requires alanysis with the aim to provide solutions to the emerging issues in an informed manner. The law schools certainly can provide the platform for teaching and research in these areas of law by employing transdisciplinary approach in their curriculum. NLIU has taken and shall continue to take up diverse academic programmes and actions, and the NLIU-Trilegal Summit is one among them. This Summit seeks to bring the academic experts with the practitioners to chalk out the future course of actions that would certainly contribute to the field of corporate and commercial laws.