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These fast changing developments as well as socio, economic, political and legal implications need to be understood and analyzed with a view 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.

DECODING CORPORATE & COMMERCIAL LAWS IN THE 21ST CENTURY

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NLIU - TRILEGAL SUMMIT ON CORPORATE AND COMMERCIAL LAWS 2018

24 – 25 AUGUST, 2018

TRILEGAL

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A COLLECTION OF ARTICLES AND ESSAYS

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Foreword

Among the diverse activities undertaken by the students of National Law Institute University (NLIU), Bhopal, the NLIU-Trilegal Summit on Corporate and Commercial Laws, 2018, occupies an important phase of development. The post-globalization scenario has seen greater recognition of the importance of corporate and commercial laws in India, with the enactment of newer laws and amendment of existing laws to facilitate domestic and global trade and commerce. The setting up of diverse legal institutions to resolve disputes, promote competition, and check unfair trade practices have added additional inputs to this development. Similarly, issues like consumer protection and corporate social responsibility have also been given their due importance in this scheme of development.

At the same time, India has also witnessed a couple of corporate giants caught in the cobweb for diversion of funds and other irregularities in the course of their business that resulted in the CEOs moving out of India and thereby posing additional jurisdictional issues in their prosecution. This has led not only to economic and commercial implications, but raised a series of political issues as well.

The constantly transforming science and technology have contributed significantly to consumerism and thereby facilitated trade and commerce. Yet, the issues relating to ever increasing cybercrimes of all sorts and data protection have definitely become issues that transcend corporate and commercial laws.

The emergence of Competition Act, 2002; Insolvency and Bankruptcy Code, 2016; Right to Information Act, 2005; Companies Act, 2013; Arbitration and Conciliation Act, 1996 and the like have also facilitated the emergence of commercial arbitration and its practice in India. There is also a constant pressure and demand to calibrate all the domestic

commercial practices with global standards or prescriptions like the UNCITRAL Model. All these developments and many others have raised the bar for the regulatory agencies in India to bridge the gap between India and the world.

These fast changing developments as well as socio, economic, political and legal implications need to be understood and analyzed with a view 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.

I would like to place on record the efforts taken by the Centre for Business and Commercial Laws (CBCL) towards organizing this Summit and congratulate Trilegal and Eastern Book Company for extending their support. I also would like to congratulate Prof. (Dr.) Ghayur Alam for guiding the CBCL at the 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
Director
National Law Institute University, Bhopal

Preface

It is a matter of immense pleasure to write the foreword 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 organizing the NLIU-Trilegal Summit on Corporate and Commercial Laws, 2018.

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.

If the second half of the twentieth century was a period defined by interdisciplinary approach, the twenty-first century ushered in the era of transdisciplinary and interconnected thought. Understanding corporate and commercial laws necessarily entails understanding the cross-currents of technology and market. A modern lawyer cannot deal with commercial matters with just commercial and corporate laws. She has to be well versed in economics, politics and technology at the least. She has to have the ability to learn new things very quickly. She has to understand that this is an era of governance by market. State is withdrawing herself from the rowing wheel and she has to assume this role. At best, the State is reduced to the role of a regulator. Corporate and commercial laws continue to push the frontiers of knowledge. Public law is increasingly

assuming the role of regulatory law. Private law is increasingly acquiring the space of public law.

Building on the above narrative, this book begins with *India and its Unprotected Financial Data* by Ashirbad Nayak and Sridutt Mishra. In this article, the authors seek to demonstrate the inefficacy of Indian laws with regard to technologies like e-wallets, internet banking and other digital payment solutions. They discuss instances wherein sensitive financial data of users were compromised and suggest the adoption of data protection policies in order to combat data and privacy breaches.

Lack of Fair Competition in the Indian Aviation Sector: Whodunit? by Akhil Shandilya and Angelika Awasthi analyses the issues faced by India's aviation industry in light of being oligopolistic in nature. The authors suggest solutions that can be employed to address the issues arising from such alliances that these airlines enter into for mutual benefits.

To Be or Not to Be: Price Discrimination as an Antitrust Issue by Shweta Murarka and Shaurya Aron discusses the advantages of price discrimination and argues that despite the many positive effects of pricing strategies, there is a negative connotation to it, which has proven to be detrimental to some markets. In conclusion, it addresses contrasting arguments, including the assertion that pricing strategies could also be predatory.

CCI's Puerile Extirpation of the Single Economic Entity Doctrine in Aditya Birla Bid Rigging Order by Ahkam Khan and Divyansh Prasad argue that the Competition Commission of India failed to take into consideration the practices in mature jurisdictions such as the US and EU, in its decision. The authors also criticize the order for not being in line with precedents while attempting to draw attention to its implication on the notion of conducting business as a "group".

Director's Faceless Liabilities: Expanding the Realm of Insolvency by Samriddh Bindal and Shriji Pandey, examines the role of directors in companies, post the enforcement of the Insolvency and Bankruptcy Code, 2016. It puts forth that directors can no longer be complacent on the feasibility of businesses and must be able to identify the indications of insolvency to take necessary action. It reiterates that the directors, as

representatives of the firm, must act in a bona fide manner so as to give equal importance to the interests of all stakeholders.

Manoeuvre of Insolvency for MSMEs: A Honey Jinx by Divyanshi Bansal and Shubham Kumar discusses the specific reasons due to which MSMEs are at a greater risk of liquidation than their larger counterparts. In addition, the authors propose suggestions which may be incorporated into the insolvency laws to deter MSMEs from getting liquidated.

Demystifying the Impact of Hybrids: An Undetected Minefield in the Indian Insolvency Landscape by Ishaan Chopra attempts to devise a mechanism in order to identify the nature of such hybrid instruments and to protect the interests of stakeholders. The Privacy Challenge for Fair Competition in the Emerging Digital Economy by Prannv Dhawan and Shubham Agrawal develops a critique of the use of cross-subsidiary unconsented use of personal user data for market dominance. Further, the authors illustrate the need to reinforce the data protection framework proposed by the Justice Srikrishna Committee, while taking the suggestions under the draft of the Indian Privacy Code, 2018, into consideration.

Smart Contracts: The Opportunities and Challenges by Utsav Mitra and Kuruvila M. Jacob discuss what smart contracts are, while comparing them to traditional contracts. The validity of smart contracts within the present legal framework in India is discussed and attention is drawn to the practicality of using these smart contracts in everyday life. The authors conclude that while there are many avenues where these smart contracts may be used, existing laws must be revamped in order to accommodate them.

Arbitrating the Insolvency Code by Sami Ahmed and Rishika Jain discusses the essence of arbitration in the CIRP process of the Insolvency and Bankruptcy Code, 2016. It also sheds light on the intersection of arbitration and insolvency laws in India, with the relevant provisions in this regard. The central idea of the piece is to discuss the role of arbitration laws in concord with insolvency laws.

Integrating Blockchain Securities Settlement with Law and Regulation—Policy Considerations and International Principles by Maygha Vishwanat and Sai Makarandh Prasada deals with blockchain security settlement— from an analysis of interests of the market parties

involved, to outlining the relationship between the current intermediated system and the future holding of securities through a blockchain platform. The author goes on to discuss the legal framework required for such securities, the need for regulation and finally, suggests certain principles that may be adopted in framing such laws.

Competition Concerns in a Digital Economy: Dominance and Market Determination by Saurav Roy and Stephanie Nazareth put forth various competition law concerns that have cropped up due to the emergence of a digital economy, primarily with emphasis on market dominance. The author discusses the evolving concept of relevant market with digitalization and analyses the efficiency of the competition law regime in this aspect.

The Insolvency and Bankruptcy Code Conundrum with the Real Estate (Regulation and Development) Act, 2016 and the Competition Act, 2002 by Arushi Chandak talks about the relationship of the Insolvency and Bankruptcy Code, 2016 with the Real Estate (Regulation and Development) Act, 2016 and the Competition Act, 2002. It analyses the possibility of a conflict, especially since the latter legislations were formulated for specific sectors and impose stringent penalties against defaulters and sometimes, provide more preferable and effective remedies.

Resale Price Maintenance in the Age of Internet Retailing; Towards a More "Economic Approach" by Sumit Singh Bhaduaria considers the role of economics in resale price maintenance and discusses the extent of its relevance to competition law. It details the various features of an e-commerce transaction and the effect these features have on competition, in both, upstream and downstream markets. Furthermore, it describes the law on resale price maintenance and the degree to which the relevant laws in the EU, US, and India are founded on economic principles.

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

Trilegal, our equal partner in this endeavour deserves our special mention and thanks. I was delighted when Mr. Yogesh Pratap Singh from Trilegal and one of my first students wrote to me, "Sir, Thanks to your guidance and the super efforts of the kids at CBCL, we have turned

around the event. More than 100 submissions is quite a result. I take this opportunity to thank and congratulate Trilegal for their efforts. We hope that our partnership will take us to newer heights of excellence. Eastern Book Company (EBC), our new teammate, deserves our thanks and gratitude.

The role of leadership cannot be overemphasized. Prof. (Dr) V. Vijayakumar, who has joined NLIU as the Director in May 2018 is a teacher with more than four decades of teaching and administrative experience. Perhaps, he is the only Director (Vice-Chancellor) of a National Law University having the longest experience of working in a National Law University system. Given his wide and extensive experience, we the members of the NLIU family have a lot of hope and expectations from him. We express our unbounded gratitude to him.

I offer my heartiest congratulations to CBCL, the student body, especially Ms Arshia Verma, Mr Rohan Kohli, Mr Shounak Banerjee and other members, who made this event and book, a success.

—Prof. (Dr.) Ghayur Alam
Chairperson, Centre for Business and Commercial Laws
National Law Institute University, Bhopal

From Trilegal's Desk

India has been witnessing a huge increment in economic growth with tremendous influx of foreign investment. There has been a multilateral shift in the regulatory framework in the recent past, with the processes being streamlined, made easy and facilitative without any unnecessary hurdles—this in turn leading market efficiency, discipline and economies of scale.

With this in mind, the NLIU-Trilegal Summit on Corporate and Commercial Laws 2018 is aimed at providing all stakeholders concerned a better and more cogent insight into general corporate and commercial laws, their working, their defects as well as their prospects.

The Summit has been organised by the Centre for Business and Commercial Laws (CBCL) of National Law Institute University (NLIU), Bhopal in collaboration with Trilegal. CBCL has been collaborating with Trilegal ever since the first edition in 2016 and have been instrumental in taking the Summit to greater heights—with newer partnerships, an expanded format and increased participation. CBCL's vision of fostering research in commercial and business laws is synonymous with Trilegal's efforts in engaging with law schools and encouraging budding lawyers.

The collection of articles and essays generated during the two-day Summit has been incorporated inside a volume, the contents of which continues to be of high quality in providing detailed analysis of all aspects of corporate and commercial laws. Some of the topics covered have become increasingly relevant today and have thrown up interesting challenges for regulators and lawyers. 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. Topics covered include Director liabilities, Trade Associations and Cartels, Arbitration and the Insolvency Code, Insolvency of MSMEs, Lack of Fair Competition in the

Indian Aviation Sector, Impact of Hybrids under the Insolvency Code, etc.

I am extremely grateful to the Director and faculty of NLIU, the editors of this volume, the members of CBCL and Trilegal teams who had been involved in assembling this edition of the Summit in this valuable publication.

—Yogesh Singh
Partner
Trilegal, Gurgaon

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 their articles and essays for the NLIU-Trilegal Summit on Corporate and Commercial Laws, 2018. The Summit was envisioned in 2016 as a one of a kind event between NLIU and Trilegal, aimed at encouraging law students to undertake research in niche corporate matters. This partnership was a culmination of CBCL's vision to promote research in business laws and Trilegal's efforts in recognising merit, engaging with students and fostering research and discussion.

After successful editions of the Summit, the 2018 edition was expanded to include corporate and commercial laws in its ambit. Further, this edition will be the first to feature a counselling and training session taken by partners from Trilegal—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. To add to this, the attractive prizes on offer by Trilegal and EBC made this Summit a must for any ambitious law student looking to explore and make a career in corporate law.

With a record number of hundred-plus submissions, the expanded ambit of the Summit, the enviable prizes on offer and a reputed publication backing it, the Summit is now bigger than ever before. After a comprehensive review process taken by CBCL and Trilegal, we are sure that the final fifteen submissions make for some very interesting discussions when the Summit happens on 24–25 August 2018 at NLIU, Bhopal.

We are grateful to Prof. (Dr) V Vijayakumar for his encouragement and support in organising this Summit. We are indebted to the Chairperson

of CBCL, Prof. (Dr) Ghayur Alam for his constant guidance and valuable inputs at each step. He has been a constant guiding force behind the Summit and we thank him for his mentoring and his leadership in ensuring that the entire exercise achieves a fruitful end.

On a final note, we hope that the success of this Summit, and the future editions in the coming years spurs more and more students to take up academic research in the field of commercial laws, as a stepping stone towards a rewarding and fruitful corporate career!

On Behalf of Team CBCL.

—Arshia Verma
(Convenor, CBCL 2018-19)

—Rohan Kohli
(Co-Convenor, CBCL 2018-19)

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India and Its Unprotected Financial Data

—*Ashirbad Nayak*† *& Sridutt Mishra*‡

ABSTRACT

The advent of technological improvements has reduced financial transactions from cumbersome time-consuming processes to a matter of few clicks and fleeting moments. Internet banking, mobile wallets, e-payment options, and digitalisation of customer information have made financial transactions extremely convenient by eliminating the need for physical monetary transactions. However, on the flip side digitalisation has left financial processes vulnerable to data breaches. Considering the sensitive nature of the data involved, the risks are perilous and pose significant financial hazards to all the parties in the fray.

India has witnessed unfortunate instances of data breaches including credit/debit card data leak, Aadhaar card data leak (which is linked to the bank account of the cardholders), and leakage of financial details of customers from mobile apps. All these instances raise the question of whether Indian laws provide sufficient protection to financial data, and how safe are online financial processes? The authors argue to the contrary on the premise of India being reliant on legal frameworks for data privacy which have failed to keep pace with the times, making it difficult to prevent and address financial data privacy issues.

In this article we take a thorough look at tenements of Indian financial data protection laws, and assess the sweeping reforms required for plugging the loopholes left open after Indian legislations. The authors also assert the utility of General Data Protection Regulation being used as a viable blueprint for creation of a new domestic data privacy policy which is equipped to take on the emerging threats to online banking data.

Keywords: *Data, Privacy, Bank, Finance, Online Transactions*

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INTRODUCTION

Data privacy implies the protection of an individual's data, the means of its collection and its dissemination. Personal data of an individual also ensconces the financial aspects of a person's life including data associated with everyday use, such as credit cards, debit cards and bank account details. Due to its sensitive nature, breach of such data, can cause catastrophic financial damages. Financial institutions are under constant threat of data breaches, considering the lucrative gains to be made from leaks. The risk posed to such data is compounded due to the less than stringent laws present in India. Even the Supreme Court, in the landmark right to privacy judgment, has recognised the growing threat to financial data in India and called for a new data protection system.[1]

Financial data is afforded wider protection in the West, particularly in the European Union (EU), due to the recently effected General Data Protection Regulation (GDPR).[2] As a means of safeguarding data privacy, the GDPR allows citizens much greater control over their sensitive personal data, including the right to access[3], rectify[4] and erase[5] their personal data. In light of these legal advancements abroad, we turn to home, to inspect our domestic laws concerning data privacy. This article analyses the Indian laws concerning financial data privacy, and looks upon their drawbacks, before recommending solutions and the need to adopt a more effective financial data privacy system along the lines of GDPR. The authors also point out the problem involving implementation of legal policies including practical hurdles and the lack of protective systems in finance. But, prior to that, we ask ourselves "how secure is our financial data?"

1. HOW SECURE IS OUR FINANCIAL DATA?

The privacy of our financial data is critically endangered, as the following instances will serve to illustrate.

In September 2016, millions of people across India received text messages from their respective banks asking them to modify the PIN and

1. *K.S. Puttaswamy* v. *Union of India*, (2017) 10 SCC 1, para 309.
2. Regulation (EU) 2016/679 of European Parliament and of the Council of 27-4-2016 on the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation) (hereinafter "GDPR").
3. GDPR Art. 15.
4. *Ibid.*, A. 16.
5. *Ibid.*, A. 17.

login credentials of their bank accounts.[6] The sudden synchronised mass appearance of the messages naturally aroused equal measures of curiosity and apprehension in the general public. The fears were well founded, as a month later it came to light, that the messages were sent out due to compromising of over 32 lakh credit and debit card details (along with their PIN credentials) of customers.[7] The affected cards were issued by major Indian banks such as SBI, HDFC, ICICI, Axis and YES Bank and belonged to Visa and MasterCard platforms, which were till then, presumed to be secure.[8] This was the biggest banking security breach in India's history, and justifiably, led to widespread outrage amongst the people. The situation worsened, with Reserve Bank of India (RBI) having to step in, and publicly admit the breach and issue a call for allaying of fears.[9] In the immediate aftermath, SBI blocked around 6 lakh cards so as to prevent further financial losses.[10]

Data security audit of the incident disclosed that though the actual data leaks had occurred between the months of May and July of the same year due to a malware attack, the banks got wind of it only in September.[11] This incident was an eye-opener, highlighting chinks in the armour of Indian financial data privacy measures.

However, a similar data breach occurred in January 2018. This time, 10,000 debit and credit card details of customers of Punjab National Bank were compromised and made available online.[12] This was a sorry

6. Jawed Anwer, "32 Lakh Bank Cards Hacked: India Needs Data Breach Disclosure Law and Needs it Now", *India Today* (20-10-2016, 3.30 p.m.), <https://www.indiatoday.in/technology/talking-points/story/32-lakh-bank-cards-hacked-india-needs-data-breach-disclosure-law-and-needs-it-now-347578-2016-10-20>.
7. Gopika Gopakumar, "Malware Caused India's Biggest Debit Card Data Breach: Audit Report", Livemint (10-2-2017, 1.54 a.m.), <https://www.livemint.com/Industry/jVF2Aw72woDcBsUGseV0UP/Malware-caused-Indias-biggest-debit-card-fraud-Audit-repor.html>.
8. Saloni Shukla and Pratik Bhakta, "3.2 Million Debit Cards Compromised; SBI, HDFC Bank, ICICI, YES Bank and Axis Worst Hit", *The Economic Times* (20-10-2016, 4.47 p.m.), <https://economictimes.indiatimes.com/industry/banking/finance/banking/3-2-million-debit-cards-compromised-sbi-hdfc-bank-icici-yes-bank-and-axis-worst-hit/articleshow/54945561.cms>.
9. Press Release, "ATM/Debit Card Data Breach", Reserve Bank of India (24-10-2016), <https://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=38392>.
10. IANS, "Cyber Threat: SBI Blocks over 6 Lakh Debit Cards", *India Today* (20-10-2016, 12.13 a.m.), <https://www.indiatoday.in/technology/news/story/cyber-threat-sbi-blocks-over-6-lakh-debit-cards-347524-2016-10-20>.
11. *Supra* note 7.
12. Nilesh Christopher, "PNB Sees Data Breach: 10,000 Credit, Debit Card Details Put on Sale Online for as Little as Rs 300", *The Economic Times* (24-2-2017, 7.57 a.m.), <https://economictimes.indiatimes.com/industry/banking/finance/banking/data-breach-hits-10000-pnb-credit-debit-card-customers-report/articleshow/63032730.cms>.

reminder that even after two years and several RBI data security recommendations and government guidelines, there was still no effective legal framework designed to deal with data privacy issues.

The problem is not just confined to credit and debit cards, even online payment wallets are not immune to data losses. The arrival of electronic means of banking, such as PayPal in 1999, changed the banking sector forever. It provided people the convenience to pay online, for the goods that they bought and services that they used, making the use of paper currency further redundant. The beginnings of the *e-wallets* were shaky but what followed was a digital revolution in the banking sector. With Apple, Android, Samsung all bringing in their *e-wallets*, the industry has grown bigger than ever. In India the digital wallet applications such as PayTm, PhonePe, MobiKwik and others have been growing at a pace faster than ever, trying to replicate the success of similar *e-wallets* of the western world.[13]

Major commercial banks have also released their own online banking and wallet apps to keep up with the market.[14] But these *e-wallet* companies, dealing with millions of users also face the data privacy conundrum. The applications save the credit/debit card details of their users in order to facilitate convenient payments for future transactions, and hence make such sensitive financial information of the users prone to online theft. An Android Trojan virus that attacked over 232 banking applications including SBI, HDFC, Axis Bank among others put the users at risk of exposing their personal information such as net banking customer ID and passwords.[15] Quick Heal, which is one of the biggest security software developer in the world, has also put out an analysis of the Trojan virus, highlighting the vulnerability of Indian banking applications, and listed down a few tips to stay safe from Android Banking Trojans.[16]

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13. Ashutosh Singh, "The Future of Mobile Wallets in India", *The Hindu Business Line* (10-3-2016), <https://www.thehindubusinessline.com/catalyst/the-future-of-mobile-wallets-in-india/article8332085.ece>.
14. "Create your PayGo Wallet", Axis Bank, <https://www.axisbank.com/bank-smart/axis-paygo/create-your-paygo-wallet>; SBI Buddy, State Bank of India <https://www.sbi.co.in/buddy/>; HDFC PayZapp, HDFC Bank <https://www.hdfcbank.com/htdocs/common/PayZapp/index.html>; ICICI Pockets, ICICI Bank <https://www.icicibank.com/Personal-Banking/bank-wallet/pockets/pockets.html>.
15. "Android Malware Targets Bitcoin, Bank Apps, Including SBI, HDFC, Axis Bank: Report", *Business Today* (5-1-2018, 5.28 p.m.), <https://www.businesstoday.in/technology/internet/android-malware-targets-bitcoin-cryptocurrency-banking-apps-sbi-hdfc-axis-bank-adobe-flash-player/story/267409.html>.
16. Bajrang Mane, "Android Banking Trojan Targets 232 Apps Including Apps Offered by Indian Banks", Quick Heal Blog (3-1-2018), <https://blogs.quickheal.com/android-banking-trojan-targets-232-apps-including-indian-banks>.

The mobile application industry too is evidently not safe from data privacy concerns, as demonstrated from the May 2017 data breach from Zomato application, where about 17 million user records were stolen from their database, illustrating that the situation is worse than ever.[17] Alarmingly, lots of people save their account details on Zomato and other applications such as Amazon, Flipkart, Snapdeal and Myntra, etc., for swifter payment, and as the Zomato leaks demonstrated, such data is anything but safe. In September 2017, Equifax, a consumer credit reporting agency, announced a cybersecurity breach, which supposedly occurred between mid-May and July 2017.[18] Equifax is one of the largest sources of consumer commercial data in the USA and faced stinging criticism for their inability to secure its own servers.[19] If Equifax, with relatively stronger security infrastructure, could have a data breach, it would not be a surprise that the Indian applications, having supposedly "secure" databases are also attacked in the near future.

The cyberspace is unsafe when it comes to personal financial information of people, and hackers have found a way to sell the stolen information on the dark web.[20] Linking of financial information on apps further aggravates the risks of data breach. Similarly, the financial details of people are also linked with their Aadhaar, which has recently also been mandated by RBI.[21] Aadhaar, with respect to data privacy, has been controversial since its inception, and on 4th January of this year the data leak reported by *The Tribune* was a blow to the Unique Identification Authority of India (UIDAI).[22] Mere months ago, in November 2017, UIDAI had asserted that Aadhaar data was safe.[23] The 4th January

17. Gunjan Patidar, "Security Notice", Zomato (18-5-2017), <https://www.zomato.com/blog/security-notice>.
18. "2017 Cybersecurity Incident & Important Consumer Information", Equifax, <https://www.equifaxsecurity2017.com/> (last visited 15-7-2018).
19. Dustin Volz and David Shepardson, "Criticism of Equifax Data Breach Response Mounts, Shares Tumble", Reuters (8-9-2017, 6.58 p.m.), <https://www.reuters.com/article/us-equifax-cyber/criticism-of-equifax-data-breach-response-mounts-shares-tumble-idUSKCN-1BJ1NF>.
20. Bloomberg, "Here's What Your Stolen Identity is Selling for on the Dark Web", *The Economic Times* (16-9-2017, 7.41 p.m.), <https://economictimes.indiatimes.com/tech/internet/heres-what-your-stolen-identity-is-selling-for-on-the-dark-web/articleshow/60711482.cms>.
21. "Know Your Customer (KYC) Direction, 2016", Reserve Bank of India (20-4-2018), <https://rbidocs.rbi.org.in/rdocs/notification/PDFs/18MDKYCD8E68EB13629A4A82BE8E06E606C57E57.pdf>.
22. Rachna Khaira, "Rs 500, 10 Minutes, and You Have Access to Billion Aadhaar Details", *The Tribune* (4-1-2018, 2.07 a.m.), <http://www.tribuneindia.com/news/nation/rs-500-10-minutes-and-you-have-access-to-billion-aadhaar-details/523361.html>.
23. Press Trust of India, "Aadhaar Data is Fully Safe, Assures UIDAI", *The Times of India* (20-11-2017, 5.05 p.m.) <https://timesofindia.indiatimes.com/india/

mishap was unfortunately, not an isolated incident where the Aadhaar details of users have been compromised. Two major commercial banks of the country, Andhra Bank and Syndicate Bank witnessed unauthorised withdrawals of Rs 4,20,098 and Rs 1,21,500 respectively from customers' accounts using their Aadhaar details.[24]

At a time when India is taking giant leaps forward towards a more digital and cashless economy, the problem of data privacy breaches is a looming terror. Online security of important personal data, specifically financial data is at a bigger risk than ever. The authors would also like to point out the fact that all the aforementioned instances, the Punjab National Bank data breach, Aadhaar data leak, fraudulent withdrawal of money from banks and the Android Banking Trojan attack, occurred within short intervals of each other in the month of January 2018, suggesting too much of coincidence. And, the failure of authorities and the Government to connect the dots and see this as a possible coordinated cyberattack on the data privacy of the country, is highlighted by the lack of any reports discuss the linkage between these incidents.

Considering the grim scenario surrounding data privacy issues, let us take a look at the domestic laws designed for data privacy.

2. INDIAN LAWS: AN ANALYSIS

Indian laws portray a sorry picture while tackling data privacy issues. Two bills, the Privacy Bill, 2011 and the Data (Privacy and Protection) Bill, 2017, which are designed to overhaul the data privacy system, have been languishing for years while awaiting parliamentary approval. The recommendations of Justice B.N. Srikrishna Committee[25] which proposes guidelines for establishing a new legal framework have yet to be carried out by the Government. India, so far, has no specific data protection legislation.

India still relies on the Information Technology Act, 2000, and an amendment to it in 2008 (hereinafter collectively referred to as "the IT Act"), to tackle all data privacy issues, including those involving financial

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aadhaar-data-is-fully-safe-assures-uidai/articleshow/61725148.cms>.

24. Sunny Verma, "Five More Cases of Aadhaar-Related Frauds at Two PSBs", *The Indian Express* (5-1-2018, 9.23 a.m.), <https://indianexpress.com/article/business/business-others/five-more-cases-of-aadhaar-related-frauds-at-twopsbs-5012083>.
25. "White Paper of the Committee of Experts on a Data Protection Framework for India", Ministry of Electronics and Information Technology, <http://meity.gov.in/writereaddata/files/white_paper_on_data_protection_in_india_171127_final_v2.pdf> (last visited 15-7-2018).

data. The Government also issued two Information Technology Rules in 2011 and 2018 concerning data security. Further, Credit Information Companies (Regulation) Act, 2005 and a string of RBI master circulars and guidelines have been issued to improve data privacy in the banking sector. The relevance of these regulations concerning financial data privacy along with their advantages and drawbacks have been discussed in the following sub-sections.

2.1 Information Technology Act, 2000

The IT Act contains a few provisions concerning data privacy. The Act provides compensation for breach of sensitive data from corporations, and also has provisions for civil[26] and criminal prosecution[27] relating to various offences including hacking[28], and breach of privacy.[29] Personal information, under the Act, is defined as information which can be utilised for identification of a natural person.

The Act, unfortunately, has several shortcomings. It does not define "data breach", leaving it ambiguous as to leakage of how much data can be construed as "data breach". The Act does not provide a definition of "sensitive personal data", but rather leaves it upon the Government to do so. Compensation, under the Act, can be provided only upon satisfaction of certain circumstances. Compensation is awarded only if the corporation does not have any security measures in place leading to data breach and the data breach causes either wrongful loss or wrongful gain. Such a pedantic provision does not consider the quality of security measures in place and does not penalise data breaches which have not caused any losses, leaving its applicability, limited, at best.

The only mandate for security measures to be adopted by the corporations is that they have be to be "reasonable". The Act provides no definition of what constitutes "reasonable". Rather, it relies upon other laws, and allows the parties themselves to decide what constitutes reasonable, and in absence of them both, upon government rules. No laws as of yet prescribe such definitions, thus, if the parties come to a consensus as to what standards they deem to be reasonable, the government rules will not be applicable in that case. Monetarily, the maximum prescribed penalty under the Act for disclosure of data, is only five lakh rupees, which is

26. Information Technology Act, 2000, S. 43.
27. Information Technology Act, *Ibid*., S. 66 etc. .
28. *Ibid*., S. 66 etc.
29. *Ibid*., S. 66 etc.

trivial considering the magnitude of financial data at stake.[30] The deterrence caused by the Act is, thus, minimal.

Since, the Act does not prescribe any security standards to be followed by the financial institutions, therefore there are no preventive measures in place to combat data breaches at the outset. Penalising institutions, after data leaks have actually occurred, as this Act sets out to do, is simply too little too late. The IT Act also faces an uphill task in enforcement of its provisions, as there are no enforcement authorities under the IT Act. Thus, whatever little its provisions, they too remain non-implemented by financial institutions.

Since the IT Act was not formulated while keeping threats to data privacy in mind, but rather to combat an assortment of cybercrimes, it has failed to effectively address data privacy concerns. Therefore, while the technology concerning data privacy and the threats posed to it have evolved, the Act has not been able to catch up with the changing contours, thereby rendering it ineffective for present circumstances. Even the Government recognised this and formulated IT Rules in 2011 to address the issue.

2.2 Information Technology (Reasonable Security Practices and Procedures and Sensitive Personal Data or Information) Rules, 2011

In furtherance of the 2008 Amendment to the IT Act, the IT Rules, 2011 were formulated by the Government, under Section 43-A of the IT Act. The Rules were an improvement over the existing legislations. The new Rules distinguished between personal data and "sensitive personal data" and included financial data under the latter head.[31] It also made it mandatory for corporations collecting, storing, possessing, or even dealing with personal data to have a privacy policy in place.[32] The Rules also require the corporations to obtain written consent of the person whose sensitive data is being collected[33] and disclose the purpose of its collection[34], intended recipient and the name and addresses of the agencies collecting and retaining the information.[35] The Act mandated corporations

30. Information Technology Act, 2000 (21 of 2000), S. 66.
31. Information Technology (Reasonable Security Practices and Procedures and Sensitive Personal Data or Information) Rules, 2011, R. 3(*ii*).
32. *Ibid*., R. 5(1) and so on.
33. *Ibid*., R. 5(1) and so on.
34. *Ibid*., R. 5(1) and so on.
35. *Ibid*., R. 5(1) and so on.

to adhere to security measures[36] and address grievances in a time-bound manner.[37]

In spite of being more progressive than the older Act, the new Rules have some drawbacks, primarily, the Rules will be applicable only in the absence of an agreement between the parties. Correction of errors in personal data can only be done if the corporations deem it as "feasible".[38] Consent of individual is not required to disclose sensitive information if the corporation is directed by a governmental order.[39] The Rules prescribe either international security measures or government approved security codes to be put into place, so far, the Government has not approved any security codes. The Rules do not require corporations to maintain a record of the cybersecurity incidents that have taken place in the past or report such incidents to nodal bodies as Central Emergency Response Team or even inform the customers of data breaches. There is no requirement for corporations to register as data collectors or controllers, leading several corporations to fly under the radar.

2.3 Information Technology (Information Security Practices and Procedures for Protected Systems) Rules, 2018

These were effected recently on 22-5-2018, and concern security of "protected computer systems". The Government itself declares specific computer networks to be "protected".[40] All protected systems shall have a Chief Information Security Officer who shall monitor data privacy threats. All such systems are also to have cybersecurity operation systems to prevent outbreak of emerging cyber threats, and coordinate with National Critical Information Infrastructure Protection Centre for enhancing security measures.

The chief fallacy of this rule is that these added security measures prescribed under this rule, are extended only to organisations such as UIDAI,[41] which are designated as "protected systems", effectively limiting its application to a handful of networks, while major private and public financial systems remain unaffected by these Rules. Yet in spite of

36. *Ibid.*, R. 5(1) and so on.
37. *Ibid.*, R. 5(1) and so on.
38. *Ibid.*, R. 5(1) and so on.
39. *Ibid.*, R. 5(1) and so on.
40. Information Technology Act, 2000 (21 of 2000), S. 70.
41. Aman Sharma, "UIDAI: Illegal Access to Aadhaar Data Can Land You in Jail for Ten Years", *The Economic Times*, (24-12-2015, 5.51 a.m.), <https://economictimes.indiatimes.com/news/politics-and-nation/uidai-illegal-access-to-aadhaar-data-can-land-you-in-jail-for-10-years/articleshow/50304349.cms>.

such designations, there have been data breaches from protected systems in the past, thus, these Rules have their tasks cut out for them.

2.4 Credit Information Companies (Regulation) Act, 2005

Credit Information Companies (hereinafter referred to as "CICs") collect and analyse credit and loan-related information of individuals and provide it to banks and other financial institutions which avail their services. This information is utilised by financial institutions to determine the creditworthiness of the individual. The Credit Information Companies (Regulation) Act, 2005 (hereinafter referred to as "CICRA") mandates CICs to be granted a certificate of registration by the RBI to be functional.[42] We see that these companies undertake an important job of aggregating credit information of individuals, which is sensitive personal data, and hence requires protection from data breaches.

Chapter VI of the CICRA deals with "Information Privacy Principles and Furnishing of Credit Information." The Act imposes a duty on the CICs to ensure the accuracy of the credit information that they collect, and a duty to protect the data from unauthorised access or unauthorised disclosure.[43] The Act also expressly states "privacy principles" with regards to the collection, preservation and usage of the credit data collected.[44] The Act prohibits the CICs, financial institutions or a specific user from giving access to the credit information to any person who is not authorised under the Act.[45]A fine of up to one crore rupees in case of breach of the privacy principles is also enshrined.[46] Even the RBI is empowered to impose penalties up to one lakh rupees, when privacy principles are breached.[47] The fine of one crore rupees is a comparatively high amount and might incentivise the CICs to secure their databases. RBI acting as the supervisory body is another advantage that CICRA as data privacy law has, which is missing in the previously stated laws.

On the other hand, the cognizance of the offence cannot be taken by the court on a complaint by a person whose information has been leaked. The Act specifically mentions that the cognizance will be taken only when a complaint is by an RBI officer.[48] This poses a serious problem as

42. Credit Information Companies (Regulation) Act, 2005 (30 of 2005), (2005), S. 2(*e*).
43. *Ibid*., S. 19 and so on.
44. *Ibid*., S. 19 and so on.
45. *Ibid*., S. 19 and so on.
46. *Ibid*., S. 19 and so on.
47. *Ibid*., S. 19 and so on.
48. *Ibid*., S. 19 and so on.

a person whose information has been leaked cannot seek redressal under this law. Further, the RBI is not suitable as a supervisory body, as its primary function is to regulate and oversee the banking sector, and not to regulate data privacy laws. Giving RBI power to regulate these data privacy provisions with a lack of expertise in the field would again not solve the problem that arose in the first place.

2.5 Reserve Bank of India Guidelines

RBI, in spite of being the regulatory body of the banking sector, has been controlling the data privacy of financial information through various reports, press releases and notifications. It was in 2011 that RBI released the "Working Group on Information Security, Electronic Banking, Technology Risk Management and Cyber Frauds—Implementation of Recommendations" in which it analysed the information security framework. The report recognised that there was no one-size-fits-all guidelines and their implementation should be done by banks according to their nature and scope of activities and their current level of leverage of IT and related controls.[49]

In 2014, the RBI came out with a press release and a charter of customer rights, in this it recognised the right to privacy with respect to financial information as a basic right of customers. In the "Cyber Security Framework in Banks"[50] RBI discussed the abovementioned report and gave guidelines accordingly. The Supreme Court, later on, did declare the right to privacy as a fundamental right and also included financial information in it.[51] The access to the bank's databases is sometimes allowed to third parties for facilitation of some business or operational requirement, but it is not closed on time and hence makes the system vulnerable. RBI fixed responsibility on banks for such incidents.[52] The framework expressly mentioned that banks shall take steps in preserving confidentiality, integrity and availability of the information.[53] The most recent development in the sphere of data privacy, took place on

49. "Working Group on Information Security, Electronic Banking, Technology Risk Management and Cyber Frauds—Implementation of Recommendations", Reserve Bank of India (29-4-2011), <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=6366&Mode=0>.
50. "Cyber Security Framework in Banks", Reserve Bank of India (2-6-2016), <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=10435&Mode=0>.
51. *K.S. Puttaswamy* v. *Union of India*, (2017) 10 SCC 1.
52. "Cyber Security Framework in Banks", Reserve Bank of India (2-6-2016), <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=10435&Mode=0>.
53. *Ibid*.

6-4-2018, when RBI released a notification regarding storage of payment system data. RBI has mandated all system providers to store their entire data, related to their operations of payment systems, in India.[54] RBI has also mentioned in a master circular that mobile banking shall be secure along with ensuring confidentiality, integrity, authenticity and non-repudiability.[55]

The different RBI regulations are a welcome step towards data privacy of financial information. RBI has given guidelines with respect to different aspects of the data privacy, vis-à-vis collection, storage, transmission, transfer and allowing access to the data. As it is only concerned with the financial sector, RBI is proactive with having the banks compliant with these regulations.

On the flipside, as mentioned above, RBI is a regulatory authority and there is an absence of expertise in the field of data privacy regulation. Another problem that is quite evident with these regulations is that they are very scattered and are not covered under one comprehensive guideline. Moreover, the guidelines and regulations enumerated above do not specify any specialised penalties in the event of banks not complying with their provisions.

2.6 Effectiveness

As seen from the preceding analysis, Indian laws have been unable to quell the rising challenges concerning data privacy. Their effectiveness cannot be adequately gauged due to the dearth of cases in this regard, which in itself, might be a result of the law not containing adequate provisions related to data privacy. The law, as it stands right now, is not citizen friendly, and has come under fire from experts who have issued repeated calls for overhauling the system.[56] In fact, two citizen generated draft model bills, the Privacy (Protection) Bill, 2013[57], and the Indian Privacy

54. "Storage of Payment System Data", Reserve Bank of India (6-4-2018), <https://rbi.org.in/Scripts/NotificationUser.aspx?Id=11244&Mode=0>.
55. "Master Circular—Mobile Banking Transactions in India—Operative Guidelines for Banks", Reserve Bank of India (4-12-2014), <https://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=8992>.
56. ET Bureau, "ET View: India Must Enact A Data Protection Law Quickly", *The Economic Times* (25-5-2018, 3.22 p.m.), <https://economictimes.indiatimes.com/opinion/et-view/et-view-india-must-enact-a-data-protection-law-quickly/articleshow/64317696.cms>.
57. "The Privacy (Protection) Bill 2013: A Citizen's Draft", The Centre for Internet and Society, <https://cis-india.org/internet-governance/blog/privacy-protection-bill-2013-citizens-draft> (last visited 14-7-2018).

Code, 2018[58] are much more suitable in dealing with data privacy issues than prevailing IT laws. Absence of a central regulatory authority, lack of implementation mechanisms, no specific protection to financial data, miniscule penalties and no government mandated security framework are some of the drawbacks of Indian laws.

We now contrast Indian laws with GDPR which, is a much more comprehensive and data privacy centric regulation, to witness scopes in which improvements can take place.

3. FINANCIAL ASPECTS OF GDPR

The GDPR came into effect on 25-5-2018, replacing the two-decade old Data Protection Directive. GDPR has resulted in sweeping changes across all corporations, including financial institutions, due to its compliance-oriented nature.

GDPR allows individuals to have a much higher control over their data, including data concerning their economic identity.[59] It establishes an independent supervisory authority in every country[60] which shall supervise domestic corporations. The presence of such an authority is extremely essential to monitor data privacy concerns, address complaints and ensure compliance from corporations. To enhance data security, GDPR mandates data encryption/pseudonymisation[61] which ensures that personal data of the individual is available only on a need-to-know basis.

GDPR is the first legislation to incorporate the right to *erasure*/forgotten[62], making it mandatory for corporations to delete the individual's data upon being requested to do so. This shall prevent data abuse and also ease removal of data, once it has served its purpose of collection.

Unlike earlier, when data breaches would remain unreported to customers for months[63], GDPR requires corporations to issue notifications within 72 hours of becoming aware of a data breach[64] which ensures that customers are kept in loop regarding the safety of their valuable data. Customer's consent has to be explicitly and freely obtained for data pro-

58. "7 Principles of the Indian Privacy Code", Save Our Privacy, <https://saveourprivacy.in/principles> (last visited 14-7-2018).
59. GDPR Art. 4(1).
60. *Ibid.*, A. 4 (21) and so on.
61. *Ibid.*, A. 4 (21) and so on.
62. *Ibid.*, A. 4 (21) and so on.
63. *Supra* Note 7.
64. GDPR Art. 33.

cessing[65], with the entire situation for which consent is obtained, being clearly laid out.[66] Autofill forms have also been done away with.[67] For subsequent sharing with third parties, additional consent of the customer needs to be taken. All this shall prevent hidden policies and ensure that customers know what use their data is being put to.

Every corporation has to appoint a Data Protection Officer (DPO)[68] who shall be responsible for overseeing GDPR compliance, check data privacy standards, and handle customers' grievances, thereby acting as a point of contact between customers and the company. DPO shall help to streamline various facets of data privacy issues being faced by corporations. Periodic data protection impact assessments[69] also have to be undertaken by the companies, which shall help in detecting lapses in their security measures.

Corporations have to address queries related to data privacy issues raised by customers, and provide the customer, the information that they hold about him/her, upon being requested to do so, at their own expense. Even while turning down requests as unreasonable, the corporation has to ensure that reasons for the same have to be noted and conveyed, thereby ensuring that genuine requests are not disposed of unfairly.

Aside from all these stringent obligations, the true beauty of GDPR, lies in its enforcement, which it does by imposing extremely high penalties on corporations in case of data breaches and for failure to comply with its provisions. Threat of penalties, as high as 4% of the company's annual worldwide turnover for non-compliance,[70] have ensured that corporations work round-the-clock for being GDPR compliant and improve data security measures. Since under GDPR, liability is attributed even to third parties, therefore vendors providing IT systems to financial institutions can also be prosecuted for failing to be GDPR compliant.

Due to all these reasons, the GDPR is citizen friendly, and is also helpful in streamlining the process of data collection and regulation. The standardised and uniform approach as adopted by GDPR shall also help companies in increasing their productivity. While GDPR might be applicable to certain Indian institutions owing to them having customers from EU, yet, this applicability does not eliminate the need of having a

65. *Ibid.*, A 7 and so on.
66. *Ibid.*, A 7 and so on.
67. *Ibid.*, A 7 and so on.
68. *Ibid.*, A 7 and so on.
69. *Ibid.*, A 7 and so on.
70. GDPR Art. 83.

domestic data privacy law. Having observed the salient features of GDPR we see that that it can serve as a viable template to base our own domestic legislation on.

4. RECOMMENDATIONS

The authors, after carefully studying the scenario of data privacy of financial information in India and analysing the laws have observed that a well-planned legal structure for data privacy regulations is required in India. In order to resolve this issue, the authors have suggested a few recommendations that would help to make the financial data privacy sector more secure. The suggestions might seem far-fetched, considering the current situation, but only then will the data privacy system be future-proof.

4.1 One comprehensive legislation

The laws relating to financial data privacy in India function in isolation to one another and do not work in a cohesive manner. India requires a new data privacy law which addresses the issues that the current laws are not able to, and it is the view of the authors, that this law can be made on the lines of the recently effected EU GDPR. The legislation should have certain provisions which are not present in the laws currently and hence can help to fill the loopholes.

Primarily, explicit and written consent of the person whose data is being collected, should be obtained, with the purpose of collection being explained in straightforward language. The people whose data is compromised shall be allowed to file complaints with the authority directly, in the event of a data breach. The penalties imposed shall be stringent enough, to create deterrence and ensure the corporations to be compliant. The penalty should not be just for non-compliance with the law but should also be imposed if a breach occurs and steps are not taken to rectify the problem. Mere compliance with the law shall not wash off the liability of the corporations.

To ensure that all the corporations are on an equal footing, the law can impose a penalty which shall be different for different classes of corporations (unlike the GDPR, which does not distinguish size of the corporation while levying the penalty). The penalty will be calculated on the basis of the total annual worldwide turnover of the company. Corporations earning revenue more than a certain limit can be penalised

for a greater percentage of their annual turnover, the larger penalty will also ensure that larger corporations will adhere to the law. Since India has a huge population, a single DPO in a corporation cannot address the queries of the customers, (unlike as provided by in GDPR), therefore there shall be a liaison team comprising of multiple DPOs in every corporation to look into the needs of the customers.

The law should follow a rights-based approach and should consider data breaches as breach of fundamental right to privacy. The customers should be able to access their data whenever they want and consequently should also have a right to get their data erased from the database on request. It should be mandatory for the corporations to erase that data, and if they decline the request, the reasons for the same shall be intimated to the customer. Corporations can turn down requests on legitimate grounds, such as refusal to delete data which is under scrutiny by law enforcement agencies. The customers should also get an opportunity to appeal such decisions, in front of the authority.

The data should be encrypted and stored, which will ensure pseudonymisation of the personal financial data of the customers. This huge overhaul in the whole system will be a painstaking task for the corporations and therefore it shall be mandated to have a data privacy professional in the corporation. For the proper implementation of these laws, a data privacy regulatory authority is necessary, which is the second recommendation by the authors.

4.2 Specific financial data privacy regulatory authority

RBI is the regulatory body in place for the financial sector and has also been regulating the data privacy aspect of the financial information. As pointed out earlier, RBI cannot act as a regulatory authority for data security. Due to the absence of an implementing authority, the provisions of the IT Act could not be enforced, and there was no overseer to check that corporations adhered to sufficient security practices. To prevent recurrence of the same, the creation of an authority is imperative. The authority shall discharge functions in the same manner as bodies like Securities and Exchange Board of India (SEBI) and Insolvency and Bankruptcy Board of India (IBBI) do in their respective fields.

The body shall be solely concerned with protection of financial data. People will have the power to approach it directly and file complaints in events of data breaches. The decisions of the authority will be appealable in courts. Corporations shall be directly answerable to the authority,

and it shall recommend appropriate security and technological measures to be put into place for data security. In the event of non-compliance, the authority will have the power to impose penalties on the corporations. The decisions of the authority will be appealable in the courts. Companies will also have to submit the reports of their data audits to the authority for it to evaluate. Considering the ever-evolving nature of technology, the authority shall comprise of both legal and technological experts, to help it remain abreast with modern trends. The liaison team in corporations will maintain constant correspondence with the authority, with any breaches having to be intimated to the former within a specified time period, of company receiving awareness of the same.

Recognising the fact that small-scale industries might be unaware of the data security threats, the authority can conduct periodic sensitization programs. Adequate time shall be given to the corporations to be regulation compliant.

CONCLUSION

The entire deliberation concerning data privacy laws lead us to the same conclusion, a desperate need for reconfiguration of the legislative framework. As the instances mentioned in the article remind us, the times have changed and so have the threats. India needs to be ready with a legal policy to ward off such threats. GDPR, has already shown us the way forward.

Threats have been manifold and diverse from malware attacks to hacking. The problems have been compounded by lackadaisical attitude of the Government in issuing security measures, and of the corporations in implementing them. An unhealthy mixture of apathy and indifference has pushed concerns of data privacy into the doldrums.

As already demonstrated, Indian laws are not up to the mark and have outlived their usefulness. Unable to address the potent dangers, they are slowly growing obscure. These laws were introduced in an era when internet banking, mobile wallets, debit cards were in their infancy, once financial technology gained traction, the laws lagged behind. An amalgamation of these factors has caused the dire situation in present times. With matters such as Aadhaar, and right to privacy making waves in court, right now is the appropriate time to update our laws. With the Srikrishna Committee, and citizen forums as the Centre for Internet and Society making extensive contributions, considerable brainstorming has already been done in addressing significant issues.

A central data regulatory authority, cohesive data privacy law, compliance provisions, high penalties are essential in establishing an effective data privacy law. It is our only hope that a new day dawns on data privacy scenario, and India is rid of this malicious yet devastating problem.

Lack of Fair Competition in the Indian Aviation Sector: Whodunit?

—*Akhil Shandilya*† *& Angelika Awasthi*‡

ABSTRACT

The Competition Act, 2002 was added to the statute book as a response to the liberalisation of the economy. Thus, the primary objective of competition law is to ensure a level playing field for all players in the relevant market. India is currently considered the third largest domestic civil aviation market in the world. However, it is oligopolistic in nature since 90.5% of the market share vests with only five players in the market. The legislative and regulatory framework that governs the aviation sector comprises of the Act, which is an umbrella legislation to assess the practice adopted by industries in the country and the effect of the same on the competition in India. In the recent case in Express Industry Council of India v. *Jet Airways (India) Ltd., [2018 SCC OnLine CCI 11], the Competition Commission of India penalised three airlines for collusion to inflate prices for cargo transportation by the domestic airlines and thereby contravening the provisions of Section 3 of the Act. This order of the Commission raises a lot of important questions about the competitive environment in which these players operate and the practice adopted by these players to gain an edge in the market. This includes the market access issues and the lack of regulatory framework addressing the competition issues in the sector. The competitive environment is an after-effect of the policy framework within which these airlines compete. Furthermore, airlines frequently enter into alliances, to benefit from joint synergies. This paper thus aims to analyse the institutional issues with respect to the aviation sector and see how these agreements, which are widely accepted as standard industry practice, fit into the overall scheme of the Competition*

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Act in India and goes on to suggest appropriate solutions to remedy the same.

INTRODUCTION

The Statements of Objects and Reasons of the Competition Act, 2002 (hereinafter "the Act") states as follows:

> An Act to provide, keeping in view of the economic development of the country, for the establishment of a Commission to prevent practices having adverse effect on competition, to promote and sustain competition in markets, to protect the interests of consumers and to ensure freedom of trade carried on by other participants in markets, in India, and for matters connected therewith or incidental thereto.[1]

It is amply clear that the Act was added to the statute book as a response to the liberalisation of the economy. Thus, the primary objective of competition law is to ensure a level playing field for all players in the relevant market. The competition law and policy serves the purpose of ensuring consumer welfare by curbing exploitative and anti-competitive practices of the dominant players. An effective competition law regime helps attain efficiencies, which ensure the application of laws, rules, and regulations to ensure market participants compete fairly with each other.[2]

The civil aviation industry in India has emerged as one of the fastest growing industries in the country during the past few years. India is currently considered the third largest domestic civil aviation market in the world.[3] As of 2017, the major players in the market for scheduled domestic airlines, in the decreasing order of their market share were as follows:[4]

1. IndiGo Airlines: 40.1%;
2. Jet Airways: 15.5%;
3. Air India: 13.4%;
4. SpiceJet: 13.0%; and
5. GoAir: 8.5%.

As is evident from the statistics, 90.5% of the market share vests with only five players in the market. Thus, by implication, aviation industry is oligopolistic in nature. Oligopolistic market is characterised by

1. Competition Act, 2002 (12 of 2003).
2. Abir Roy, *Competition Law in India: A Practical Guide* 1 (2016).
3. Indian Aviation Industry, India Brand Equity Foundation (23-6-2018), <https://www.ibef.org/industry/indian-aviation.aspx>.
4. Traffic Reports, Directorate General of Civil Aviation (23-6-2018), <http://dgca.gov.in/reports/Traffic_reports/Traffic_Rep042017.pdf>.

concentration of the market share in a few firms, which exert significant influence over each other. Interdependence is a common incidence in an oligopoly. This can result in diverse outcomes for the market and the consumers. A positive outcome could be in the nature of fierce competition among the firms and thus a lower price and higher consumer satisfaction. But what is often seen is that oligopoly can give rise to restrictive practices adopted by the firms by means of collusion to inflate prices and exploit consumers. This essentially allows the firms to operate like a monopoly. A classic example is of Organisation of the Petroleum Exporting Countries, which is a sovereign cartel exerting profound influence over the oil prices all over the world. Given the oligopolistic nature of the aviation sector, it becomes imperative that a close watch be kept on the activities of the players in the market.

The legislative and regulatory framework that governs the aviation sector comprises of the Act, which is an umbrella legislation to assess the practice adopted by industries and the effect of the same on the competition in India. The policies are formulated by the Ministry of Civil Aviation (hereinafter "MCA/the Ministry") and the major regulators are the following:

1. Airports Authority of India (hereinafter "AAI"), which regulates construction and management of airports;
2. Directorate General of Civil Aviation (hereinafter "DGCA"), which regulates safety and operations of aircrafts;
3. Bureau of Civil Aviation Security, which regulates airport and airline security standards; and
4. Airports Economic Regulatory Authority of India, which regulates tariffs and fees.[5]

In the recent case in *Express Industry Council of India*[6], the Competition Commission of India (hereinafter "the Commission/CCI") penalised three airlines, namely, Jet Airways (India) Ltd., SpiceJet Ltd. and IndiGo Airlines for collusion to inflate prices of fuel surcharge rates for cargo transportation by the domestic airlines and thereby contravening the provisions of Section 3 of the Act. The Commission arrived at this decision after a careful analysis of the market conditions and the corresponding increase in the surcharge. It went on to distinguish price parallelism with

5. The Indian Aviation Sector, Nishith Desai Associates (16-6-2018), <http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research%20Papers/The_Indian_Aviation_Sector.pdf>.
6. *Express Industry Council of India* v. *Jet Airways (India) Ltd.*, 2018 SCC OnLine CCI 11.

collusion in an oligopoly and dealt with the question of how an anti-competitive agreement is evidenced in an investigation.

This order of the Commission raises a lot of important questions about the competitive environment in which these players operate and the practice adopted by these players to gain an edge in the market. This competitive environment is an after-effect of the policy framework within which these airlines compete. This includes the open skies agreements, greenfield airports and the slot allotment policy. Furthermore, airlines frequently enter into alliances, code-share agreements, etc. in the garb of increasing efficiency and benefiting from infrastructural facilities of another airlines and have loyalty programs to ensure that they bind the consumers to their services.

From the standpoint of the players in the market, one may assert that it is often the policy framework put forward by the abovementioned institutions that add hindrance to a fair competition. Be it the complexity of rules or at times the mandate by them, which are outright unserviceable for the airlines. Consequently, these constituents of the market do find themselves stuck between a rock and a hard place.

In the light of the same, this paper aims to analyse the institutional issues with respect to the aviation sector and see how these agreements, which are widely accepted as standard industry practice, fit into the overall scheme of the Act in India.

1. IMPACT OF PUBLIC INSTITUTIONS ON COMPETITION IN THE MARKET

Public institutions and authorities have the onus to cultivate and maintain fairness and equality in the market. The same applies to the ones entrusted with the regulation of the aviation sector. Tremendous power and influence is attached to institutions such as the DGCA, AAI, etc. An error, intentional or unintentional, in terms of policies or their implementation would lead to catastrophic results that may lead to unmatched and unwarranted advantage for a few market players at the cost of others. As a consequence, the objective of achieving fairness in the market competition would be defeated at the very beginning.

The aviation sector has had its fair share of encounters with unfavourable policies. The failure on part of the DGCA[7] to permit an innovator

7. Ranjana Kaul, "The Future of Air Transport from a Developing Country Perspective: India 2014-2019", (2015) 64 ZLW 233, 239.

to demonstrate his six-seater plane, which he had built on his rooftop in Mumbai, is one such instance of the lack of connect between the regulations and their objectives.[8] Deterring innovation and entrepreneurship by red tape could also be seen when concerns regarding the DGCA regulation requiring an applicant of Non-Scheduled Operator Permit (NSOP), importing an aircraft unfamiliar to a DGCA-appointed Flight Operations Inspector (FOI), to bear the costs of training of at least two FOIs amongst other officials.[9] A repercussion of the disconnect from reality and regulator's insensitivity towards the aspiring constituents of the market is that a barrier is fenced on entry to the market. Thereby, when the new entrants are inhibited, the "grandfathers"[10] of the aviation sector would benefit the most.

On the part of the market players, a favourable assertion could be that, since they were bound to follow the mandate of the designated institutions, they could not have altered their practices in any manner that would help promote fair competition. If one rides on this metaphoric train of thought, the blame for poor showing of the aviation sector in terms of fairness and equality would be the failure of these institutions and not the market constituents.

In order to truly understand how consequential these institutions are, one need not look further than policies, namely, open skies agreement and slot allocations at airports.

1.1 Open skies agreement

One of the emerging trends in the global aviation industry other than liberalisation is open skies bilateral agreements.[11] The National Civil Aviation Policy, 2016 (hereinafter "NCAP 2016") envisaged under the "Open Sky ASA"[12] stated that unlimited flights would be allowed to operate to and from major international airports within the Indian

8. Krishna Kumar, "Red Tape Kills Mumbai Pilot's Dream to Build India's First 19-Seater Aircraft", *The Economic Times* (18-6-2018), <https://economictimes.indiatimes.com/industry/transportation/airlines-/-aviation/red-tape-kills-a-pilots-dream-to-build-aircraft/articleshow/61043602.cms>.
9. CAP3100 Air Operator Certification Manual, Directorate General of Civil Aviation, 71 (21-6-2018), <http://dgca.nic.in/manuals/CAP3100AOCManual.pdf>.
10. Grandfather Clause, Investopedia (18-6-2018), <https://www.investopedia.com/terms/g/grandfatherclause.asp>.
11. Ghanshyam Singh, "Aviation Industry: Emerging Legal Challenges" in Ranbir Singh et al (Ed.), *Current Developments in Air and Space Law* (2012) 13.
12. Here, ASA denotes Air Services Agreement.

territory.[13] The MCA, however, reserves the right to notify the list of the airports under the said agreement.[14]

An open skies arrangement allows increase in air transport service between the designated destinations.[15] The said increase, as per noted author Ruwantissa Abeyratne, is irrespective of the market share of the existing airlines. In essence, it promotes competition and allows better connectivity.[16] For instance, the agreement between Canada and the United States of America in 1995 resulted in surge in air traffic and resulted in aggressive competition.[17]

In the recent years, India has entered into open skies agreement with countries such as Japan.[18] The agreement entails the applicability w.r.t. six major Indian airports, namely, New Delhi, Mumbai, Chennai, Kolkata, Hyderabad and Bengaluru.[19] On similar lines, India has entered into such agreements with countries such as Jamaica, Guyana, Czech Republic, Finland, Sri Lanka and Spain.[20]

It is a widely accepted view that arrangements such as open skies allow for greater competition amongst the airlines operating on such routes.[21] However, as mentioned earlier, the Indian Government has adopted a restrictive approach in this regard.[22] The Government has allowed for the open skies agreement to operate in six major airports only[23], which hinders the airlines not operating on such routes to gain from the arrangement.

Allowing for operations through only six airports provides for advantage to those airlines, which have both international and regional

13. National Civil Aviation Policy, 2016, Ministry of Civil Aviation (19-6-2018), <http://www.civilaviation.gov.in/sites/default/files/Final_NCAP_2016_15-06-2016-1.pdf>.
14. *Ibid*.
15. Ruwantissa Abeyratne, "Emergent Trends in Aviation Competition Laws in Europe and North America", (2000) 23(1) World Competition L. Econ. Rev. 146-176.
16. *Ibid*.
17. Sangita Dubey and François Gendron, "The US-Canada Open Skies Agreement: Three Years Later", Government of Canada Publications (22-6-2018), <http://publications.gc.ca/Collection-R/Statcan/87-003-XIE/0039987-003-XIB.pdf>.
18 Circular No. AV.31022/01/2017-CNW, Ministry of Civil Aviation (20-6-2018), <http://civilaviation.gov.in/sites/default/files/August%202017.pdf>.
19. *Ibid*.
20. "India Signs Open Skies Agreement with Six Countries During ICAN 2016", Press Information Bureau (21-6-2018), <http://pib.nic.in/newsite/PrintRelease.aspx?relid=15547>.
21. Ghanshyam Singh, "Aviation Industry: Emerging Legal Challenges" in Ranbir Singh et al (Ed.), *Current Developments in Air and Space Law* (2012) 13.
22. National Civil Aviation Policy, 2016, Ministry of Civil Aviation, 14 (19-6-2018), <http://www.civilaviation.gov.in/sites/default/files/Final_NCAP_2016_15-06-2016-1.pdf>.
23. Circular No. AV.31022/01/2017-CNW, Ministry of Civil Aviation, 2 (20-6-2018), <http://civilaviation.gov.in/sites/default/files/August%202017.pdf>.

connectivity by virtue of the magnitude of their existing operations. At the same time, it inhibits the small players in the market, who would anyway be a less preferable choice due to various factors such as "unfair" slot allocations at airports. Thereby, they shall fail to gain from this arrangement.

1.2 Slot allocation

A slot denotes the permission obtained by a coordinator in order to utilise the infrastructure of a Level 3 airport in planned manner, for the purposes of arrival and departure.[24] With the rise of greenfield airports at Bangalore and Hyderabad, along with leasing of the Mumbai and New Delhi airports to joint venture companies (JVCs), there was a need to revise the slot allocation policy in India. The Ministry recognised the issue and in September 2007, it issued the "Revised Procedure" for slot allocation.[25] On the lines of powers to AAI for its airports, joint venture operators of such airports were given power to periodically analyse, assess, and notify the capacity of their respective airports.[26]

The significance of these slots is paramount. For instance, one of the biggest reasons for potential buyers' interest in acquiring Air India Ltd. stemmed from its vast slot holdings.[27] Air India Ltd. occupies a total of 6282 slots for arrival and departure.[28] On the other hand, the Air India Express occupies 550 of such slots domestically.[29] The preliminary information memorandum submitted to the Ministry mentions the large number of slots available with Air India Ltd. and Air India Express.[30] It asserts that these slots give the duo a significant edge over any new entrant in the market or an airline looking to expand its operations.[31]

24. Worldwide Slot Guidelines, International Air Transport Association, 14 (17-6-2018), <https://www.iata.org/policy/slots/Documents/wsg-8-english.pdf>.
25. *Ibid.*
26. *Ibid.*
27. "Air India's Over 6200 Slots for Flights Could Be A Key Attraction for Bidders", *The Economic Times* (21-6-2018), <https://economictimes.indiatimes.com/industry/transportation/airlines-/-aviation/air-indias-over-6200-slots-for-flights-could-be-a-key-attraction-for-bidders/articleshow/63534783.cms>.
28. Preliminary Information Memorandum for Inviting Expression of Interest for Strategic Disinvestment of Air India Limited, including AI's Shareholding Interest in AIXL and AISATS by Government of India, Ministry of Civil Aviation, Ministry of Civil Aviation, 45 (23-6-2018), <http://www.civilaviation.gov.in/sites/default/files/PRELIMINARY%20INFORMATION%20MEMORANDUM.pdf>.
29. *Id.*, 71.
30. *Id.*, 24.
31. *Ibid.*

Another aspect of the fierce competition pertaining to slot allocations arises, when as per the DGCA guidelines, an airline fails to utilise a slot for a month's time.[32] With IndiGo Airlines facing difficulties with respect to its fleet of Airbus A320neo aircrafts[33], the media outlets have reported that other airlines were quick to claim the "unutilised" slots.[34]

With the rise in number of green airports and change in market players, the need to examine the feasibility and effectiveness of the status quo arises.

A solution to unutilised slots could be secondary trading. This would allow airlines to trade amongst themselves, the allocated slots without the involvement of a regulatory body. The European Union had also proposed the same.[35] In 2012, the Ministry had on an experimental basis proposed auctioning of prime-time slots that were unutilised, despite them being previously allocated.[36] However, it is extremely problematic to accept secondary trading on one hand and auction of slots in general. Alexandre de Juniac, Director General and Chief Executive Officer (CEO) of the International Air Transport Association (IATA) had expressed his disdain for the idea of auctioning slots at Mumbai airport.[37] He asserted that auctions would benefit the bigger entities in the market and would deter smaller players or the new entrants.[38] Selling slots to a new entrant by a pre-existing airline can have grave consequences such as hoarding, which may lead to a surge in the prices. In addition, a foreseeable consequence could be lesser number of slots open to new entrants.[39] Since

32. *See* "use it or lose it principle".
33. Rebuttal on News Item aired by Times Now on 11-2-2018 on PW1100 Engines Fitted on Airbus A320neo Aircraft Operated by M/s Indigo and M/s GoAir, Directorate General of Civil Aviation (20-6-2018), <http://dgca.nic.in/public_notice/PN-A320neo%20engine.pdf>.
34. Aditya Anand, "All Eyes are on Airport Slots", *The Hindu* (21-6-2018), <https://www.thehindu.com/news/national/all-eyes-are-on-airport-slots/article23314380.ece>.
35. Air, European Commission (21-6-2018), <https://ec.europa.eu/transport/modes/air/airports/slots_en>.
36. Auctioning of Departure Slots at Airports, Press Information Bureau (21-6-2018), <http://pib.nic.in/newsite/PrintRelease.aspx?relid=90469>; "Prime-time Flying Slots to be Auctioned: Officials" *The Economic Times* (21-6-2018), <https://economictimes.indiatimes.com/industry/transportation/airlines-/-aviation/prime-time-flying-slots-to-be-auctioned-officials/articleshow/17402280.cms>.
37. Ashwini Phadnis, "IATA Slams Mumbai Airport Plan to Consider Auctioning Slots", *The Hindu Business Line* (22-6-2018), <https://www.thehindubusinessline.com/economy/logistics/iata-slams-mumbai-airport-plan-to-consider-auctioning-slots/article9424497.ece>.
38. *Ibid*.
39. "The Rules on Allocating Take-off and Landing Slots Favour Incumbents", *The Economist*, (22-6-2018), <https://www.economist.com/business/2017/11/16/the-rules-on-allocating-take-off-and-landing-slots-favour-incumbents>.

the civil aviation sector involves large capital infusion at all stages[40], a capital-intensive slot allotment system may not be advisable for a better competition in the market in India.

In the last decade, India has witnessed a sizeable number of airlines ceasing to exist in terms of operations. With big players like Kingfisher Airlines now defunct, and the possibility of others to follow the suit, the slots of such airlines should be returned back to the airport operators.[41] Also, looking at the short span of tourist/peak season for air travel, it would be advisable to return slots not utilised for a total of "21 days in summer and 15 days in winter" to the airport operator.[42] This will ensure the maximum utilisation of the airport infrastructure. In addition, it will prevent any airline from hoarding unutilised slots as well.

1.3 Greenfield airports

The connotation attached to the term "greenfield" pertains to a land, which has not been previously developed, and has uncapped industrial potential.[43] An airport developed on such a land would be referred to as a greenfield airport.

Primarily, the power to establish airports lies with the AAI.[44] However, AAI is also responsible for assisting in the establishment of airports as well.[45] The Greenfield Airports Policy issued by the Ministry provides that under the AAI Act, 1994, the AAI can grant a concession to private entities for the purposes of financing, developing, operating and maintaining an airport.[46] It suggests that for greenfield airports to be developed, the Government of India could allow a private concessionaire to participate in the same.[47] However, this is limited only to the airports managed by AAI. For the rest, an entity referred to as an "Airport Company" may set

40. The Aviation Industry Leaders Report 2018: Navigating the Cycle, KPMG, 31 (23-6-2018), <https://assets.kpmg.com/content/dam/kpmg/ie/pdf/2018/01/ie-aviation-industry-leaders-report-2018.pdf>.
41. Guidelines for Slot Allocation, October 2012, Association of Private Airport Operators, 6 (23-6-2018), <http://www.apaoindia.com/wp-content/uploads/2012/06/APAO-Comments-on-MoCA-Guidelines-for-slot-Allocation-October-2012-06-Dec-2012.pdf>.
42. *Id.*, 3.
43. Greenfield, Merriam-Webster (23-6-2018), <https://www.merriam-webster.com/dictionary/greenfield>.
44. Airports Authority of India Act, 1994 (55 of 1994).
45. *Ibid.*
46. Greenfield Airports Policy, Airports Economic Regulatory Authority of India, 2 (21-6-2018), <http://aera.gov.in/documents/pdf/GREENFIELDAIRPORTPOLICY.pdf>.
47. *Ibid.*

up an airport after being granted a licence by the DGCA.[48] An extension of this allows the Government of India and other State Governments to obtain a similar licence.[49]

The Greenfield Airports Policy suggests that a greenfield airport to be set up by AAI may be "preferably constructed through" a public-private partnership (PPP). In such a case, the land for the airport shall be provided for by AAI.[50]

The Government of India through MCA has granted an "in-principle" approval for the establishment and construction of eighteen greenfield airports.[51] The "in-principle" approval is granted by the Steering Committee set up under the Greenfield Airports Policy, 2008.[52]

The policy explicitly disallows setting up a greenfield airport within an aerial distance of 150 kilometers of an existing airport. However, exceptions may arise in cases where an impact on the pre-existing airport may be done and the proposal to establish a new airport is deemed feasible[53]. The decision with regard to feasibility may be made by the Government of India on a case-to-case basis.[54] Recently, the AAI has recognised as many as three sites for the construction of a second international airport in the vicinity of Bhubaneswar due to the growth in air traffic.[55]

By themselves, greenfield airports are a welcome change. They allow for greater infrastructure availability and result in better services for the consumers. However, there are certain problems that still persist with the same. Problems that have been highlighted with regard to open skies agreement and slot allocation at airports occur in this case as well.

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48. Airports Authority of India Act, 1994 (55 of 1994) (The same shall be done in accordance to the provisions of the Aircraft Act, 1934).
49. *Ibid*.
50. *Supra* note 46 at 3.
51. Construction of Greenfield Airports, Press Information Bureau (24-6-2018), <http://pib.nic.in/newsite/PrintRelease.aspx?relid=168772>.
52. Compendium of Central Government Services and Regulations for Greenfield Airport, Ministry of Civil Aviation, 9 (16-6-2018), <http://civilaviation.gov.in/sites/default/files/moca_001421.pdf>.
53. Moses George, "Public Monopoly to Private Monopoly—A Case Study of Greenfield Airport Privatisation in India", Part I, (2009) 9 Issues Aviation L. & Pol'y 173, 180 (The Greenfield Airports Policy envisages that a second airport should not hamper the traffic at the existing airports).
54. *Supra* note 46 at 7.
55. Jayajit Dash, "AAI Picks Three Sites for Second Greenfield Airport Near Bhubaneswar", *Business Standard* (26-6-2018), <https://www.business-standard.com/article/economy-policy/airport-authority-picks-three-sites-for-second-airport-near-bhubaneswar-118062100889_1.html>.

With India's restrictive approach towards open skies agreement, questions such as whether these greenfield airports will be included into the arrangement under open skies agreement, still pose uncertainty. Failure to include these airports, built in regions with lesser connectivity, without their participation in the arrangement as per open skies agreement would allow for the problems with open skies agreement persistent to occur here as well. For instance, a greenfield airport established in the north-eastern India without it being a participant would serve half the purpose. In essence, it might restrict the choices of consumers, who may prefer to take those services, which connect them to their international destination. This problem becomes grave, when read in light of alliances and loyalty programs adopted by the airlines, as discussed later.

Another problem that has been unaddressed is slot allocation at these airports. There have been no safeguards proposed or adopted to ensure equal opportunity for both newer and pre-existing players to claim slots at these airports. In the long run, this may result in the regional and smaller players to succumb to the mounting pressure of utilising the slots that get their hands on, if any. A consequence of this could possibly be that the airlines, which exercise massive influence in the market, take undue advantage.

2. AN ASSESSMENT OF THE STANDARD INDUSTRY PRACTICE

Aviation industry, by its very nature, is a global industry. It is comprised of a few players that compete for a larger share of the pie. After an analysis of the institutional framework discussed in the last chapter that creates market access issues, it must be seen how the players in the market create an anti-competitive environment. Since there is a fine line between interdependence characterised by price parallelism and collusion between the players in the market, it is incumbent on the Commission to differentiate one from the other.[56]

Section 3(2) of the Act states that an agreement between enterprises, associations, person or association of persons that causes an appreciable adverse effect on the competition within India is void. However, in the aviation sector, certain horizontal agreements are permissible, which are generally accepted as standard industry practice. Back in the year 2003, growth of cooperative alliances was seen as a transformation of the civil

56. *Supra* note 2 at 27..

aviation sector and as an outlet to turn the erstwhile government enterprises into more attractive alliance partners.[57] The justification for these agreements was that it would increase the efficiency in production, supply, distribution, storage, acquisition or control of goods or provision of services.[58]

However, instances of these agreements flouting the antitrust immunity granted to them and entering into the realm of anti-competitive agreements are quite a few.[59] The Commission undertakes a rule of reason analysis, based on the factors mentioned under Section 19(3) of the Act.[60] This provision contains the factors that aid in determining the pro-competitive and anti-competitive effects of an agreement such as creation of barriers to new entrants in the market, driving existing competitors out of the market, accrual of benefits to consumers, to name a few.

Therefore, it is imperative to assess the standard industry practice of forming alliances, which encompass matters of commercial and operational cooperation such as code-share agreements, and loyalty programs to see whether or not they cause an appreciable adverse effect in the market.

2.1 Alliances, code-sharing agreements, and loyalty programs

Since airlines operate in a highly regulated sector, they are precluded by a host of laws and regulations from acquiring control of foreign airlines and carrying domestic traffic in other countries.[61] For instance, it was only through the Consolidated Foreign Direct Investment Policy, 2017 that 100% FDI was allowed in the scheduled air transport service of the aviation sector in India.[62] A solution to this was forming an airline alliance.

An airline alliance is an agreement between two or more airlines to cooperate in terms of destinations, airport lounges, baggage handling at

57. Report of the Committee on a Road Map for the Civil Aviation Sector, Ministry of Civil Aviation, 19 (27-6-2018), <http://civilaviation.gov.in/sites/default/files/moca_000740.pdf>.
58. S. 3, Competition Act, 2002 (12 of 2003).
59. *Hoffmann-La Roche & Co. AG* v. *Commission of the European Communities*, 1979 ECR 461.
60. *Supra* note 2 at 75.
61. Daniel M. Kasper & Darin Lee, "Why Airline Antitrust Immunity Benefits Consumers", Competition Policy International (26-6-2018), <https://www.competitionpolicyinternational.com/assets/0d358061e11f2708ad9d62634c6c40ad/Kasper-SEP-09_1_.pdf>.
62. Consolidated FDI Policy, Department of Industrial Policy and Promotion, 30 (27-6-2018), <http://dipp.nic.in/sites/default/files/CFPC_2017_FINAL_RELEASED_28.8.17.pdf>.

airports, frequent flyer programs, code-share flights, etc., thereby providing a network of seamless connectivity for international passengers.[63] There are three major alliances that dominate the aviation industry, namely, Star Alliance, Oneworld Alliance, and the SkyTeam Alliance. The scope and level of cooperation varies from one alliance to the other.

Code-share agreements are also a way to achieve joint synergies between airlines. These agreements are not specific to alliances; however, they are often a part of the cooperation that they aim to attain. Code-share agreements are best explained as mutual exchange contracts that allow for a flight operated by one carrier, also to be marketed by another carrier, under that other carrier's code and flight number.[64] The carrier that markets and sells the seats of another carrier as its own is known as the marketing carrier, while the carrier operating the flight is known as the operating carrier. It is usually entered into by a smaller airline operating on thinner (often regional) routes using the brand and marketing services of a larger airline.[65]

Furthermore, loyalty programs are offered by the airline industry to incentivise the consumers. An integral part of this is the frequent flyer program under which, participants are rewarded with free travel, service benefits and other privileges.[66]

Airline alliances have long helped the players to grow their operations and revenue by establishing a substantial degree of cooperation, including widened networks, code sharing and cost reductions[67] through fleet rationalisation, expansion, joint marketing, and joint purchasing, etc.[68] Code-share agreements also entail a similar advantage to the airlines. They enhance the presence of an airline in markets where it would otherwise have no profile, and hence facilitate the marketing of its services, allowing its seats to be sold via a marketing carrier that may be much better known in that market.[69] Loyalty programs help the airlines in

63. Vikrant Pachnanda, "Antitrust Issues with Respect to Frequent Flyer Programs and Code-Sharing Agreements that Persist in the Aviation Industry: The Indian Context" Ranbir Singh et al (Ed.), *Current Developments in Air and Space Law* (2012) 142, 143.
64. *Supra* note 5 at 21.
65. "The Future of Aviation—Consultation on Air Transport Policy", The Open University, 34 (28-6-2018), <http://www.open.edu/openlearn/ocw/pluginfile.php/630971/mod_resource/content/1/dft_aviation_pdf_503446.pdf>.
66. Loyalty Programmes in Civil Aviation: An Overview of the Competition Issues concerning Frequent Flyer Programmes, (2005) 1 Eur. Competition J. 375, 375-376.
67. *Supra* Note 63.
68. Current Issues Arising with Airline Alliances, The European Commission (27-6-2018), <http://ec.europa.eu/competition/speeches/text/sp1999678_en.html>.
69. Steer Davies Gleave, Competition Impact of Airline Code-Share Agreements, European Commission, 22 (25-6-2018), <http://ec.europa.eu/competition/sectors/transport/reports/

influencing the behaviour of travellers in such a way that they become more inclined to avail a certain airline's services. Additionally, airline alliances entail obvious benefits for the passengers all over the world such as wider choice of flights, destinations (if the demand is substantial)[70], rewards, and convenient transfers through reduction of travel time.[71]

The direct relationship that a well-connected network of air transportation had with the economy was the reason why legislations all over the world allowed and encouraged them. This is evident from how it was portrayed as a feat of achievement by the Ministry when Air India formally joined the Star Alliance on 11-7-2014 as it allowed the enterprise to offer more itinerary choices to its passengers covering 1269 destinations in 193 countries around the world.[72]

2.2 Antitrust immunity and legislative framework

The abovementioned three major alliances control majority of the market share. However, it is important to note that a sizeable market share does not in itself violate the provisions of the Act. This is because the Act is based on the effect theory and rather focuses on the abuse of the dominant status.[73] There are considerations in place for granting permission to these horizontal agreements.

The legislative framework in India addressing alliances and code-share agreements is the guidelines for grant of permission to operate scheduled international air transport services dated 24-8-2016.[74] According to the guidelines, a domestic code-share agreement with foreign carriers is allowed for Indian carriers if the agreement is within the Air Service Agreement (hereinafter "ASA") framework. Additionally, for international code-share agreements, the designated carriers in India are not required to take an approval from the Ministry. This is, of course, dependent upon the framework of the ASA. The only requirement is that the designated carrier needs to *inform* the Ministry at least 30 days prior

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airlinecodeshare.pdf>.

70. Proposed Domestic Airline Alliances Raise Serious Issues, US General Accounting Office, 6 (27-6-2018), <https://www.gao.gov/archive/1998/rc98215t.pdf>.
71. Current Issues Arising with Airline Alliances, The European Commission (27-6-2018), <http://ec.europa.eu/competition/speeches/text/sp1999678_en.html>.
72. Monthly Summary for the Month of July 2014, Ministry of Civil Aviation (28-6-2018), <http://civilaviation.gov.in/sites/default/files/moca_003337.pdf>.
73. *Supra* Note 2 at 2.
74. Guidelines for Grant of Permission to Indian Air Transport Undertakings for Operation of Scheduled International Air Transport Services, Directorate General of Civil Aviation (27-6-2018), <http://dgca.nic.in/aic/AIC08_2016.pdf>.

to such operation. Prior permission is only required when an Indian carrier intends to join a global alliance.

The NCAP 2016 thus seeks to liberalise the regulatory regime for code-sharing agreements between domestic and foreign airline operators by providing for allowance of code-share agreements between foreign airlines and domestic carriers.[75]

However, more matured jurisdictions such as that of the United States address the issue of antitrust immunity with a more effective regulatory framework. In the United States, airlines must first apply to the Department of Transportation (hereinafter "the DOT") for an antitrust immunity. The authority assesses the application on the ground of public interest. The go-ahead by DOT depends upon factors such as the necessity to meet serious transportation needs and public benefits vis-à-vis the anti-competitive effects of the same. It is important to note that the DOT has to ensure that any reasonable alternative to such alliance formation will not optimally realise the public benefits to approve it. After the satisfaction two-step analysis of adverse impact and public benefit analysis, immunity granted to an alliance which allows them to collude legally on key sensitive issues such as setting fares, agreeing networks and capacity, sharing profits and revenues and selling and marketing jointly to corporate customers.[76]

It is thus evident that a stronger sectorial framework exists, within which the airlines operate. The legislative framework in India, on the other hand, is scattered and seems inadequate. Introduction of antitrust immunity in the country will aid the authorities in exercising a stronger regulatory control over the plethora of horizontal agreements that the airlines enter into.

3. ANALYSIS AND SUGGESTIONS

The primary objective behind liberalisation of the economy was that market forces drive the participants. However, alliances have often proven to be the antithesis of this idea. A former director of a European carrier once stated "there can be little doubt that airline executives see alliances, especially when they involve code sharing and capacity rationalisation,

75. National Civil Aviation Policy, 2016, Ministry of Civil Aviation, 15-16 (27-6-2018), <http://www.civilaviation.gov.in/sites/default/files/Final_NCAP_2016_15-06-2016-2_1.pdf>.
76. Alliances and Codeshares, United States Department of Transportation (26-6-2018), <https://www.transportation.gov/policy/aviation-policy/competition-data-analysis/alliance-codeshares>.

as a way of reducing or limiting competition"[77]. As a result of a close cooperation between the players, it is observed that the airlines are competing less vigorously now. Alliances could create major entry barriers for non-alliance competitors, which would in turn, affect the services offered and the fares charged. Alliances were a response to a closed market and the inhibition of an economy to allow foreign investment in the sector. It conveniently solved the issue of expansion of services globally. However, alliances are majorly operating as a tool to circumvent the law and enter into horizontal agreements with anti-competitive effects on the market.

Alliances cover a wide range of operations and thus call for a careful assessment. Critics have often expressed their reservations about how these alliances function, mainly because they have the potential to significantly reduce competition by virtually having the effect of mergers between the airlines.[78] Antitrust immunity has granted an alliance the potential to be anti-competitive as these airline alliances hold great market power and might be in a position to exercise that power to the exclusion of non-immunised carriers.[79] In some cases, a network of similar agreements is eliminating the competitive process, even if some of such agreements are compatible with the exemptions, the same may not be extended to the set of such agreements.[80]

Thus, the competitive restraints imposed upon the parties, the degree of competition existing prior to the agreements and the impact of the agreement on competition[81] should be analysed. The courts have taken a similar approach wherein they laid emphasis on:

> … weighing up the advantages expected from the implementation of the agreement and the disadvantages which the agreement entails for the final consumer owing to its impact on competition, which takes the form of a balancing exercise carried out in the light of the general interest appraised at community level.[82]

77. Doganis, Rigas, *The Airline Business, Second Edition* (2006) in "Airline Alliances — A Legal Way of Restricting Competition?", Lund University Publications (Ida Hermansson) (25-6-2018), <http://lup.lub.lu.se/luur/download?func=downloadFile&recordOId=8874985&fileOId=8884651>.
78. Current Issues Arising with Airline Alliances, The European Commission (27-6-2018), <http://ec.europa.eu/competition/speeches/text/sp1999678_en.html>.
79. "Competition Watchdogs Probe Airline Alliances", *Financial Times* (27-6-2018), <https://www.ft.com/content/ab6a13d6-2ea1-11de-b7d3-00144feabdc0>.
80. *Metro SB-Großmärkte GmbH & Co. KG* v. *Commission of the European Communities (No. 2)*, 1986 ECR 3021.
81. *Supra* note 2 at 75.
82. *GlaxoSmithKline Services Unlimited* v. *Commission of the European Communities*, 2006 CMLR 1623.

3.1 Clayton test

The DOT in United States uses the *Clayton test* to analyse an alliance. The principles enshrined in the horizontal merger guidelines are much suited to the sector than simply applying the factors in Section 19(3) of the Act. If an alliance has the potential to harness market power i.e. ability to profitably raise prices above competitive levels or reduce the level of competition in areas such as the quality of product or the service, it must not see the light of the day.[83]

3.2 O&D approach

Additionally, the DOT uses the O&D approach to define the relevant market. This is known as the point of origin/point of destination approach, wherein every city pair in the scheduled passenger airline service between a point of origin and a point of destination (either city or airport), generally referred to as routes[84] is considered a separate market from the consumer's viewpoint.[85] Thus, the decision to grant an antitrust immunity to the participants of an alliance depends upon whether or not there are anti-competitive effects on routes in which they compete.

3.3 Concerns regarding loyalty programmes

A peculiar aspect that raises concern over loyalty programs is that the points that accrue from the services availed are valid only for a period of twelve months, after which, they lapse. This acts as a strong influence over the behaviour of the consumers, as it keeps them in a loop. A loyalty program may be considered as abusive if it has tying effects, foreclosure effect, strong loyalty effects, strong exclusivity effects or if they are able to reduce or eliminate effective or potential competition.[86] The Air Traffic Working Group has identified them as potentially serious obstacles to effective competition.[87]

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83. William Gillespie and Oliver M. Richard, "Antitrust Immunity and International Airline Alliances", The United States Department of Justice (28-6-2018), <https://www.justice.gov/atr/antitrust-immunity-and-international-airline-alliances>.
84. *Ibid.*
85. Vikrant Pachnanda, "Antitrust Issues with Respect to Frequent Flyer Programs and Code-Sharing Agreements that Persist in the Aviation Industry: The Indian Context" Ranbir Singh et al (Ed.), *Current Developments in Air and Space Law* (2012) 142,152.
86. Loyalty Programmes in Civil Aviation: An Overview of the Competition Issues concerning Frequent Flyer Programmes, (2005) 1 Eur. Competition J. 375, 392.
87. *Ibid.*, *376*.

In a case of court of first instance, it was held that granting of a rebate by an undertaking in a dominant position in consideration of an undertaking by the customer to take supplies exclusively or almost exclusively from a dominant undertaking is contrary to Article 82 of the treaty of the European Community (EC Treaty).[88] Such a rebate has the effect, through the granting of financial advantages, of preventing customers from obtaining supplies from rival producers.[89]

A much stronger effect is of how everything pans out in consonance. A loyalty program or a frequent flyer program of an alliance allows the consumers to earn bonus points when travelling with any of the partner airlines.[90] It could be used as a means of tapping into the reduced sensitivity of a consumer to price by increasing fares. If an alliance has a large number of destinations to offer to its consumers, it may also result in high switching costs, which would eventually lead to the consumers being bound by the services of the alliance itself. This will have an effect of creating a barrier for newcomers in the same segment, and eventually higher prices for the consumers.

3.4 Airline alliances and mergers: The grey area within

The strongest form of airline alliance involves either unidirectional or cross-equity holdings.[91] Assessing the effect of all of these agreements from a broader perspective shows how it could be a possible abuse of dominance[92] in the market. Strategic alliances only resume the airlines' identity in the eye of the law, but entail close cooperation between two independent airlines such as joint equipment purchasing, insurance and most importantly, cross-equity holdings, which fall short of just an outright merger. In an interesting case of alliance between Alitalia Airlines and KLM Airlines, the European Commission used the parameters of a merger to assess the agreement. The rationale was that agreement entailed such a degree of integration that it was performing the functions

88. Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market insofar as it may affect trade between Member States.
89. *British Airways Plc.* v. *Commission of the European Communities*, Case T-219/99: ECLI:EU:T:2003:343.
90. Loyalty Programmes in Civil Aviation: An Overview of the Competition Issues concerning Frequent Flyer Programmes, (2005) 1 Eur. Competition J. 375, 380-381.
91. Kenneth Button, "Interactions of Global Competition, Airline Strategic Alliances and Air Traffic Safety", George Mason University (29-6-2018), <http://www.gmu.edu/depts/t-app/paper/app-wp2.htm>.
92. S. 4, Competition Act, 2002 (12 of 2003).

of a joint venture such as pricing, capacity, scheduling and revenue management coordination[93] under the merger regulation.

It was observed that the agreement negatively incentivises the members of the alliance to focus on the common interest rather than the individual benefits in the market. The concept of metal neutrality conflicts with the concept inherent in the treaty provisions relating to competition, as the parties substitute cooperation for competition between them. After a series of market tests, it was further observed that the alliance was pro-competitive for the international routes, but did not pass the muster for certain hub-to-hub routes.[94] It was thus remedied by detailed directions for regulation of the operations by the airlines.

This approach should be adopted in India because unlike international alliances, which aid in extending the operations to smaller cities, domestic alliances have the potential to significantly reduce competition to and from small and medium cities.[95] The Commission could choose to exercise a greater level of scrutiny under Section 20 of the Act or just assess the agreements under Section 19(3) depending on the level of integration that the airlines has sought to achieve.

3.5 Suggestions

When sectorial regulation and competition law have the same goal, competition law enforcement may be facilitated in the sense that the competition authority may not have to intervene because the regulation alleviates potential competition problems.[96] The role of the regulatory authorities should be adequately strengthened by introducing sectorial policies such as antitrust immunity in the field of civil aviation. A principal concern is that the grant of immunity eliminates competition between the participants in routes where they offer competing flights, adversely affecting consumers in these routes.[97] Alliances should be restricted from colluding on price and the authorities must ensure that the agreement only

93. Case AT.39964—Air France/KLM/Alitalia/Delta, European Commission, 4 (23-6-2018), <http://ec.europa.eu/competition/antitrust/cases/dec_docs/39964/39964_1755_5.pdf>.
94. Current Issues Arising with Airline Alliances, The European Commission (27-6-2018), <http://ec.europa.eu/competition/speeches/text/sp1999678_en.html>.
95. Proposed Domestic Airline Alliances Raise Serious Issues, US General Accounting Office, 10 (27-6-2018), <https://www.gao.gov/archive/1998/rc98215t.pdf>.
96. Antitrust Enforcement in Regulated Sectors Working Group, International Competition Network, 6 (27-6-2018), <http://www.internationalcompetitionnetwork.org/uploads/library/doc377.pdf>.
97. William Gillespie and Oliver M. Richard, "Antitrust Immunity and International Airline Alliances", The United States Department of Justice (28-6-2018), <https://www.justice.gov/atr/antitrust-immunity-and-international-airline-alliances>.

results in pro-competitive effects. If the members of an alliance retain the independence to determine their price structure, rather than reducing incentive to compete on the routes they both serve, consumer welfare will be ensured. A participant in the alliance may find it profitable to add capacity (by flying larger aircraft or more flights) in that route should it anticipate carrying more passengers as a result of the formation of the alliance.[98] Another usual outcome of code-share agreements is that it might restrict or disincentivise the addition of physical capacity to the routes. If these schemes are adopted by a dominant airline, they may have a strong loyalty-enhancing and exclusionary effect, which will amount to abuse of dominance. All of these factors should also be taken into account while analysing such agreements. The analysis will then be tailored to the dynamics of the industry and will result in increase of efficiencies in the market.

Government policy should reflect changes in the aviation sector such as the development of alliances, code-sharing agreements, and loyalty programs. These horizontal agreements have aided the airlines in having a stronghold in the market by consolidation of operations. Before long, issues in the regional connectivity will also crop up. The government's UDAN-RCS scheme[99] will be a new challenge since the airlines will be competing with railways on the regional routes for the business of price-sensitive passengers. In addition, it would be favourable to have a less restrictive open skies agreement. Such an agreement would cover all/most of the regional domestic airports, and in essence would benefit most, if not all the airlines in the domestic market.[100] This, in turn, shall increase competition in the market. The increase in competition as per the Commission's results in increased innovation along with reduced costs and wider choices to the consumers.[101]

Assessment by the Commission against the background that the interests of consumers are best served by free and fair competition between all airlines in a liberalised market is the need of the hour. A proactive role of authorities such as the Commission and Ministry is strictly called for.

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98. *Ibid.*
99. Ude Desh ka Aam Naagrik: Civil Aviation Ministry's Regional Connectivity Scheme "UDAN", Launched Today, Press Information Bureau (28-6-2018), <http://pib.nic.in/newsite/PrintRelease.aspx?relid=151850>.
100. Vikrant Pachnanda, "Antitrust Issues with Respect to Frequent Flyer Programs and Code-Sharing Agreements that Persist in the Aviation Industry: The Indian Context" Ranbir Singh et al (Ed.), *Current Developments in Air and Space Law* (2012) 142, 144.
101. About CCI, Competition Commission of India (29-6-2018), <https://www.cci.gov.in/about-cci>.

To Be or Not to Be: Price Discrimination as an Antitrust Issue

—*Shweta Murarka & Shaurya Aron*†

ABSTRACT

Economists have studied how price discrimination improves the efficiency of the economy and especially increasing the equity, but it still has a negative connotation to it. It can have pro-competitive effects by enhancing efficiency and ensuring greater market access. Price discrimination allows enterprises to exploit a particular group of customers' willingness to pay. But it also enables them to maximise their quantity of sale if it caters to the demands of the customers with low willingness to pay, and hence, increasing total welfare. This paper looks into the advantages of price discrimination and how the historically suspicious approach towards it is not necessary and has even harmed economies by creating protectionist tendencies. A consequence of price discrimination in a strategic context is that it allows firms to compete separately in each individual market, by intensifying the effort to individualise the purchase offers by making them as specific to the individual as possible. While competition to lower prices may have pro-competitive effects, it can act as a predatory strategy by the incumbents, as they need to only reduce prices for those customers who are more likely to switch over to the rival entrant. In this situation, price discrimination is a less costly form of predatory pricing. Thus, it becomes increasingly important to evaluate whether the general conclusion that price discrimination is always anti-competitive is justified or not.

INTRODUCTION

Prices are the cornerstone of economics, and all features of products like their quantity or quality or customer service, etc. are incorporated in the

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figures of price. Economics starts with the perception of perfect competition, where the price of each good is driven down to its marginal cost because of intense competition. In real markets, however, prices rarely are at marginal costs, because there are always a limited number of sellers and consumers do not have perfect information. This article discusses two related problems arising in imperfect markets: prices set significantly higher than the comparable competitive level by a dominant undertaking and price discrimination, where consumers are charged different prices, not justified by the differences in transporting and selling the goods to them.

Price discrimination, despite its negative connotation, is an essential element of pricing in many markets. For example, the websites of many computer manufacturing firms segment the potential buyers according to their declaration as a student, office use, small enterprise or a large corporation. The price of computers is varied for each type of user. An interesting feature is that the consumers self-select themselves into appropriate groups and enable the supplier to charge them accordingly, even though the products might vary in characteristics depending upon the use. The computer manufacturer sets the prices according to the customer's willingness to pay, or elasticity: the students can afford to pay the lowest prices, while the large firms can pay the highest prices, and thus each segment pays the price determined by its price sensitivity.

A key question this article explores is whether this type of pricing is justified or not? The practice of price discrimination helps the firm to benefit from the differences in the willingness of consumers to pay to earn increased profits and the consumers with low willingness to pay can benefit from lower prices while those with higher willingness to pay can be worse off, relative to the case of uniform prices. It can be thus stated here that there is nothing to conclude that price discrimination is always anti-competitive: its welfare implications are more generally ambiguous. As a rule, if price discrimination leads to an increase in the quantity sold it most likely increases total welfare. It is also likely to be welfare enhancing if the industries exhibit high fixed costs and low marginal costs. Also, banning price discrimination and forcing the firm to charge a uniform price can be detrimental to welfare, if for example the willingness to pay for the consumers varies greatly. Moreover, charging uniform prices may lead some firms to exit the market because of low customer base and lower competition for the existing firms. Such considerations have led economists to be sceptical of claims of "unfairness" in charging different prices, because charging uniform prices can by itself hurt consumers in

the long run by preventing investment in innovative goods and also be unfair by itself.

This article also deals with the approaches towards price discrimination in the US and European Union (EU). Both jurisdictions have historically been critical of price discrimination, and it will be analysed in more detail in US, which has held this position for majority of the 20th century, and only started to appreciate the welfare gains from price discrimination with the advent of Chicago school in the 60s. In EU, Article 82 (now Article 102 of the Treaty on the Functioning of the European Union)[1] has been applied to price discrimination, and since price discrimination connotes fragmented markets, it contradicts their primary goal of single market integration. EU thus had adopted an approach of per se prohibition especially if the firm is dominant, but this is now changing with a growing focus on pro-competitive gains from price discrimination. Both jurisdictions have separated the impacts of price discrimination on consumers and on the rival sellers as primary line and secondary line impacts respectively, but we argue in that a more useful approach would be to calculate the net impacts on total welfare and not go by the market participant which faces harm.

This article proceeds as follows: Sections 2 to 5 are devoted to price discrimination in which the first section (Section 2) explains the economic theory of price discrimination. Section 3 discusses some possible advantages and anti-competitive effects of price discrimination and suggests an antitrust approach towards it. It then moves on to the approaches in US and EU jurisdictions towards price discrimination in Section 4 and Section 5 concludes.

1. BASIC CONCEPT OF PRICE DISCRIMINATION

In legal and common usage, price discrimination is construed as a *price difference*. In this interpretation, which is also shared by the Robinson-Patman Act[2], price differences in the good sold to two different customers or different locations implies price discrimination, but costs of selling are also considered to determine whether a violation has occurred. Thus, if different prices are justified by different costs, it is not taken to be a violation of the Act. This approach in legal terms is based on the principle of

1. Treaty on the Functioning of the European Union. Art. 102.
2. The Robinson-Patman Act of 1936, Pub. L. No. 74-692, 49 Stat. 1526 (codified at 15 USC § 13).

equal treatment, where all consumers are equally treated with the same price charged from all.

Price discrimination is supported by the economic view that goods and services should be distributed to users who will derive the highest value from it. For example, suppose the good can be sold at uniform prices of Rs 100, but there are two consumers who are willing to pay maximum of Rs 50 and Rs 150 respectively for the good. If price discrimination is banned, then the firm charges a uniform price, which can be below Rs 50, or between Rs 50-Rs 100. If price discrimination is allowed, it can be in many forms. An instance of price discrimination here can be that both consumers pay their maximum willingness to pay (also called as their reservation price); as long as the price paid by each consumer is higher than the sellers' costs of selling of the good. This way, both consumers are able to purchase the good contrary to the case where a uniform price was charged (say between Rs 50-Rs 100), in which only the consumer whose maximum willingness to pay was greater than the price charged (the one willing to pay up to Rs 150) would have been able to purchase it. In his book *The Economics of Welfare*, A.C. Pigou[3] divided price discrimination into three categories and examined their effect on consumer and social welfare: first degree, second degree and third-degree price discrimination. Each one of these has been explained now:

1.1 First-Degree Price Discrimination

The example of price discrimination given earlier describes first-degree price discrimination, also called "perfect price discrimination". The supplier charges the exact valuation of each consumer for a certain product in this category of price discrimination. In the example we considered above, since all consumers are paying the maximum amount they are willing to pay, they do not have any consumer surplus left (one the other hand, if the uniform price of Rs 100 is charged, the second consumer would have a consumer surplus of Rs 50 as he can pay Rs 150 but pays only Rs 100). It has been shown in economic theory that this model does not cause any deadweight losses, as the firm is selling, as much the consumers will buy, so there is no reduction in output. This example though illustrates perfect price discrimination, but it is not observed in practice. An example could be a doctor who has been working for a long time in a village, and knows exactly what each person's ability/willingness to pay is for his services.

3. A.C. Pigou, *The Economics of Welfare*, Macmillan, London, 1920.

1.2 Second-Degree Price Discrimination

The consumers are offered a pricing scheme in second-degree price discrimination and these consumers have the incentive to self-select themselves into appropriate groups, according to their willingness to pay. For instance, the seller charges different prices depending upon the quantities purchased. A simple example of this model is two-part tariff, where the consumer pays an initial fee and then a decreasing fee for each extra unit purchased. For example, two consumers pay exactly the same initial fee (say Rs 100) and then they pay the same unit price (Rs 20) for first unit, then each successive unit purchased lowers the price by Re 1 for all the quantities purchased. In other cases, buyers may not pay the same marginal price for each incremental purchase i.e. one consumer pays an incremental price of Rs 10 and other pays Rs 5 for the same quantity and this generates allocative inefficiencies[4]. One other source of inefficiency is that not all consumers can buy sufficient amount of quantity demanded to get past the initial high prices, and thus sometimes goods and services may not be allotted to the user with highest value.

1.3 Third-Degree Price Discrimination

In this model, the seller partitions the markets into sub-markets with their own separate demand schedules for the product and charges each sub-market accordingly. The welfare consequences from following this model are dependent upon the demand elasticity in the different markets and assumptions about whether the demand is linear in prices or not. It has been shown that third-degree price discrimination is poorer in welfare terms compared to even a monopoly, if the monopolist itself choose to discriminate in this fashion.

Examples include senior citizen and kid discounts, "ladies' night" in discotheques and academic journals that charge different prices to individuals and institutions[5].

2. REVENUE GENERATION, WELFARE AND COMPETITION

Economists have studied how price discrimination can be used to improve efficiency in the economy as well equity. It can be shown that

4. Gifford, D.J., and Kudrle, R.T. (2010), "The Law and Economics of Price Discrimination in Modern Economies: Time for Reconciliation?", 43, p. 1241, University of California, Davis Law Review.
5. *Ibid.*, pp 1242.

appropriately designed second and third-degree price discrimination have the ability to make the economy more efficient. It can also be shown that since the poorer consumers can pay less for commodities relative to the well-off consumers, price discrimination increases the equity as people pay closer to their marginal valuations of the product. Hence, it is possible that price discrimination alleviates the concerns about efficiency versus equity and achieves both goals at once. Price discrimination is even applicable as an element of competitive strategy and various results are possible that achieve both, improved efficiency and lower prices for the final consumers.

2.1 Welfare Effects

To study the welfare effects from direct price discrimination, we will study a simple case where customers are divided into two types: the price elastic group and price inelastic group. The standard of comparison is the case of a uniform price for all the consumers.

We can have two opposite effects from direct price discrimination: first, price discrimination increases the price for the inelastic buyers and decreases it for the elastic buyers. This increases the profits of the firm, but may reduce consumer surplus and welfare. If the increase in profit is less than the decrease in consumer surplus, net benefit (or net gains from trade sum of consumer and profits) is negative.

McAfee explains that the net welfare is negative as the consumers are paying different prices, as to maximise the gain from trade it is required to sell the product at same price in all the markets. He notes that,

> …With two different prices, arbitrage would increase the gains from trade, resulting in a common price. Price discrimination represents a rearrangement of output away from high-value buyers and toward buyers with lower values. The absence of price discrimination, which makes every buyer's marginal value equal, creates the distribution of output that maximises welfare. Price discrimination, in contrast, makes Group 1 have a higher price than Group 2 and, thus, reduces the gains from trade. Indeed, by starting at the profit-maximising solution, then permitting free arbitrage by the buyers, a single price would result.[6]

Price discrimination also has an impact on amount. As price discrimination increases the number of consumers because of the product becoming

6. R. Preston McAfee, "Price Discrimination", Issues in Competition Law and Policy 465, p. 481 (ABA Section of Antitrust Law 2008).

cheaper for a section of the consumers, total quantity can either increase or decrease. Since the net impact on welfare is the summation of the two effects, which are moving in opposite direction, McAfee comments, price discrimination can increase welfare on the sole condition that quantity increase is substantial to counter the reduction in welfare.

An important aspect of calculating welfare gains is the improvement in welfare of the price-sensitive group, which are generally poorer. Because they have to pay low prices which may not have been available to them earlier, they are better off, and at the expense of the price-elastic consumers, who in a way subsidise their consumption.

2.2 Fair Pricing

The most common contention against price discrimination with is that the price paid by different buyers for equal quantities should be equal. This idea of fairness indicates that the customer should not be valued for the fixation of price and these two values should be independent. Thus, this notion does not encourage discounts, trade-in, or other forms of benefits indirectly accrued to the buyers from sellers.

Hence, the equal price idea ensures that the high-valuation consumers pay a lower price than if they were being price discriminated against, and have a simpler contract schedule to decide on their purchases, without any sort of haggling with the seller. Similarly, low-valuation buyers pay a higher price than otherwise, or may even be excluded from the market if their valuation is lower than the price charged. Hence, the doctrine emphasises "equal price", when an alternative theory that emphasises "*equal market access*" might provide greater welfare. An equal access doctrine necessarily implies price discrimination as buyers who do not have market access earlier are charged lower prices while those with market access are charged a higher price, perhaps in order to cross-subsidise.

It has been argued above rather than the equal prices doctrine, the equal access doctrine should be followed. Also, microeconomic theory does not address the question of fairness. Instead, it focuses on maximising economic efficiency and separates the question of distribution from it. Equal access is necessarily a distributive assertion, and banning price discrimination tends to create unequal access to markets, as many customers are shut out because of higher uniform prices. Thus, banning price discrimination can harm distributive equality.

2.3 Antitrust and Price Discrimination

Price discrimination is also known as value-based pricing and it is a key feature in pricing goods in many industries.

Price discrimination can only be practised by a firm, which has market power where firms face downward sloping demand curve and this is a key characteristic of almost all the markets today. Some commentators might hastily conclude that the firm thus has market power and use it against the firm in antitrust proceedings. However, serious thought must be given to this conclusion. First, firm may price discriminate because of different costs of providing different versions of a product. For example, providing a multimedia compatible computer might require greater investment in advertising and customer dealing, hence the firm has to charge a slightly higher price for that model. Passing extra costs to the consumer is not price discrimination.

Secondly, large extent of price discrimination does not necessarily imply large degree of market power to the firm. An example to illustrate would be the cellular market. Price discrimination is observed here as there are range of prepaid and post-paid plans for consumers to choose from, and options to customise your own plan and so on. It could be possible that a monopoly would offer a single price for all services, but competition as evidenced by the present, multiple mobile operators have provided consumers with many different plans to choose from, and the firms compete with each other to entice the consumers to switch their operators. Thus, firms do have some market power as they face a downward sloping market demand curve but the conclusion that they have substantial market power requires more proof than just evidence of price discrimination.

Third, price discrimination might imply only short-run market power, but the firm may not hold any market power in the long run. McAfee provides the example of airline industry, which practises price discrimination to such an extent, that two travellers in the same flight and same class might have paid much different prices from each other. However, historical records show that airline profits are generally low in the long run. Hence, price discrimination may not yield substantially higher profits in the long run.

McAfee notes that identifying price discrimination can be difficult. It is so because we need to ensure that price differences are not due to cost differences. McAfee gives the example where:

> … It is often alleged that dry cleaners discriminate against women because the price for cleaning a woman's shirt is higher than the price for cleaning a man's shirt. However, if the cost of cleaning the average woman's shirt is higher than the cost of cleaning the average man's shirt, perhaps because of differences in materials or the nature of the stains, some or all of the price differences may be due to cost differences, even if the stated product—shirt cleaning—is the same.
>
> The problem of identifying price discrimination is exacerbated by dynamic considerations. A given airline sells the same product—a seat on a flight from Los Angeles to New York on 19-1-2008—at many different times. As demand changes, the value of the seat may rise or fall quite dramatically.[7]

2.4 Advantages of Price Discrimination

Gehrig[8] lists some benefits from price discrimination noted in this section:

1. It increases flexibility in pricing. It allows for greater matching between the consumer needs and the products. Since consumers pay their maximum willingness to pay, and can buy a lower quality product according to their budget, consumers can choose the optimal price combination in accordance with their needs. For example, travellers can book flights in advance at a lower price and business travellers need to pay more to book flights in a shorter notice. Electricity availability in peak hours is scarce; hence, use is discouraged by higher tariff rates than otherwise.
2. Compared to charging a uniform price for everybody, price discrimination allows low-valuation users to pay low value and high-valuation users to pay a higher value. If only a uniform price is charged, the many low-valuation users might not be able to purchase the good. Even for high-value users, quantity discounts or decreasing prices for additional units bought allow them to buy higher quantity. This allows a "fair" split of surplus between the consumers and producers; compared to the uniform pricing case where the high-valuation users have too much surplus.

7. *Ibid.*, pp 44.
8. Gehrig, T.P., and Stenbacka, R. (n.d.), "*Price Discrimination, Competition and Antitrust" in The Pros and Cons of Price Discrimination,* Swedish Competition Authority.

2.5 How Should Authorities Deal With Price Discrimination

The appropriate measure of net welfare gains from price discrimination would be the sum of producer and consumer surplus. It may be possible that some consumers are hurt, but firms may gain much more, so net benefits are important. The consumers as well as the sellers share the total surplus: a greater variety of pricing tools prove to be beneficial, while the buyers benefit from an increase in the quantity. The fact that firms benefit is not an unambiguous indicator of anti-competitive effects of price discrimination. Peres, Leitão and Teles[9] note that economists and antitrust authorities (in EU) have disagreed over the appropriate measure of surplus, which is to be considered. This article argues that total surplus, as a sum of consumer and producer surplus is the appropriate measure of welfare gain, because it accounts for the gains to the producers as well. In most scenarios, both producer and consumer surpluses will move in the same direction i.e. practices that decrease (or increase) total surplus also decrease (or increase) consumer surplus. However, in the case of price discrimination, this might not be true. In first-degree price discrimination, firms appropriate all surpluses from consumers, thus their surplus rises, while the consumer surplus falls. But because the firm is now selling to many more consumers who were not able to purchase the product earlier, there is an increase in total surplus as the decrease in consumer surplus is less than the increase in producer surplus. If only consumer surplus is considered, firms will have to charge only the marginal costs, which is not optimal for maximising investment, innovation and long-run welfare. Economists thus maintain that producer surplus should be considered as a component of welfare gains well, since it reflects the dynamic considerations as firms gain from investment and innovation, otherwise all firms will eventually leave the industry or they have to be subsidised. The EU competition law though puts much greater focus on consumer surplus. This leads to the problem of excessive focus on the static framework and ignoring or criticising the actions taken by firms that maximise their long-run welfare—through investments in new technologies. Therefore, as Peres, Leitão and Teles conclude that "if the total welfare standard is not adopted, one should at least consider the objective as that of maximising consumer welfare in the long run", otherwise the authorities might hurt consumers in the long run in attempting to benefit them in the present.

9. Peres, C., Leitão, M., and Teles, G. (n.d.), "Price Discrimination—The Airports Case", <http://www.mlgts.pt/xms/files/Publicacoes/Artigos/561.pdf>.

3. LEGAL TREATMENT OF PRICE DISCRIMINATION IN US AND EU

3.1 Treatment in the US

In the beginning of 21st century, US observed a strict disdain towards price discrimination, both in the matter of public opinion and the policies, which were shaped by it. The first major legislation in US was the Interstate Commerce Act of 1887, which was developed in response to the opinions of farmers who protested against discriminatory prices charged by the Railways. Gifford and Kudrle[10] note that:

> … Even at this early date, a connection between price discrimination and monopoly was part of the public consciousness. From a political point of view, discrimination appeared to document monopoly by presenting a clear benchmark against which to compare exploitatively higher charges.

3.2 Legislature

The Clayton Act[11] was passed in 1914, and prohibited price discrimination where the perceived effect would be to lower competition and/or increase monopoly power. This Act was passed in response to case where firms were accused of predatory pricing: low prices in one market and high prices in another market, to recoup the losses in the former market. Congress addressed this issue again through the Anti-Dumping Act[12] in 1916, Congress passed strict measures that banned firms from selling their products in US at a much cheaper price than what they were charging in their countries. In 1916, the prosecution still had to prove that the firms had predatory intent; this requirement was though waived later. The US Congress thus viewed these practices as unfair.

The anti-dumping and other domestic policies to curb price discrimination followed by the US Congress possibly reduced its welfare over time. This happened because it directly protected the domestic firms from international competition, resulting inadvertently in a protectionist policy. This resulted in the consumers in US having to always pay a higher price, as competition from international firms was absent.

10. *Supra* note 4 at 1261.
11. The Clayton Antitrust Act of 1914, Acts of Parliament, 1914 (US).
12. The Anti-Dumping Act, 1916, Acts of Parliament, 1916 (US).

3.3 Price Discrimination and Article 82(c) of the EC Treaty

The Treaty of Rome or the EEC Treaty 1957 was passed with the purpose of creating a common European market, and contains two articles that deal with price discrimination: Articles 81 and 82 of the Treaty of Rome. Article 81(1)(*d*) is concerned with agreements that "apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage".[13] Article 82 applies similar language that restricts firms enjoying dominant position from using unidentical conditions when trading with different consumers, even if the transactions are equivalent, and thus placing some of them at a competitive disadvantage. Thus, both seek the prohibition of price discrimination by a seller to two different buyers if they are charged different prices, thus hurting the purchaser who pays the higher price.

The EU approach in earlier years is similar to US approach because in designing the EU Treaty, its writers borrowed extensively from the US approach. With the 1970s revolution in US, it is apparent that their approaches have been diverging.

In Europe though, Article 81 is focused on actions that are based on a provable form of agreement or some other concerted action. It then has a limited application as most sales are unilateral actions and outside the scope of Article 81. It thus is narrowly focused on verifiable agreements. It only covers those sales agreements where there exists a contract between firms that mandates discriminatory pricing practices; this limitation thus leaves price discrimination outside the purview of Article 81.

This leaves us with Article 82, which has been the cornerstone of antitrust efforts against price discrimination in EU. Article 82 is concerned with anti-competitive actions of dominant firms, and this is an improvement over the American approach, which has ignored the details about market power of the discriminating sellers. Even the EU though, does not follow a strict definition based approach to market power, and even if a firm that does not have monopoly power can be dominant; large and successful firms are liable for action under Article 82.

An illustration of the case law in EU towards price discrimination is the *Hoffman Roche*[14] case. The Commission condemned the fidelity rebates given to the purchasers by Hoffman Roche as violations of Article 82. Fidelity rebates essentially imply rebates conditioned on the

13. *Supra* note 4 at 1272.
14. *See* ECJ, *Hoffmann-La Roche & Co. AG* v. *Commission of the European Communities*, (Case C-85/76) EU:C:1979:36, 1979 ECR 461, order dated 13-2-1979.

purchaser buying a large portion (or even all) of its requirements from the seller. These are different from volume or quantity rebates, which are rebates conditioned on the buyer purchasing sufficiently large quantity of product for economies of scale to arise, and thus being charged lower prices because of lower average costs.

In this case, the Court was primarily concerned with the effects of fidelity rebates affecting the ability of rival firms from selling to the discriminating firm's buyers. The Court thus appeared to confuse harm to rivals with harm to competition, and misguidedly used the article to protect seller's rivals, even though it should be protecting the seller's customers.

This misguided approach in this case is representative of EU case law in general, which has been concerned with protecting the competitors of the dominant firm. It has deemed practices such as discounts as exclusionary along with fidelity rebates, as they appear to impede rival sellers from selling to the dominant firm's customers. By contrast, quantity rebates have been held as legal, even when provided by the dominant firm. An implicit justification given for quantity is that they allow the parties to benefit from lower unit costs as the volume of transactions increases. Thus, the rebates which are not cost related are more likely to be viewed as exclusionary.

The language in the article is not unambiguous. One of the first conditions that must be met is that transactions should be equivalent. However, equivalence of transactions is quite difficult to prove, as two transactions can be different on a number of counts. For instance, they might have different costs of production and distribution. Then, there is the problem of calculating the exact cost differences and judging that how large should the differences be for them to be non-equivalent. In case of services like airplane travel, even small differences at the time of booking the ticket can have a major impact on price. Lastly, if the Ramsey pricing model is applied and people with different elasticity are charged accordingly, it is unclear whether differences in elasticity can render the transactions as non-equivalent. Thus, there is a lack of clarity on what equivalent transactions imply.

CONCLUSION

It is thus, argued that price discrimination is a useful and necessary component of competition and despite a negative connotation, it can have pro-competitive effects by enhancing efficiency and ensuring greater

market access. Thus, the historically suspicious approach towards it is not necessary and has even harmed economies by creating protectionist tendencies.

The lesson to learn is that discrimination is bad for consumers when it does not lead to an increase in the quantity sold, since it transfers the consumer surplus to the firm without increasing consumption. Thus, price discrimination should necessarily increase the quantity produced. However, we can also look at this from situation where we ban price discrimination: consumer welfare can decrease if the firm then charges a uniform price too high for one set of consumers, as it leads to a reduction in quantity bought which is clearly disadvantageous for the consumers.

Price discrimination is not possible in a perfectly competitive set up, as they face a horizontal demand curve and cannot offer differentiated products. In real markets on the other hand, firms do sell differentiated products and have some control over the price they charge. This discretion can be used for charging different prices for same units sold and other types of discrimination in price or quantity. It does not however imply that the firm will earn more than normal profits: for example, in the airplane industry, which exhibits a form of price discrimination according to the timing of the ticket purchased, long-run profits are not very high. On the other hand, in some markets price discrimination allows entrant firms to capture shares of other firms through selective price discrimination, especially important in markets where there are collusive excess profits with entry barriers.

There is now a growing consensus in US and EU that the fundamental aim of competition policy is improvement in a measure of welfare—either consumer or total surplus. This article has argued that total surplus is a better measure as it captures the gains to the society. Even for price discrimination, it would be useful to evaluate its impacts on such measures than ban it outright just because some consumers or rival firms are adversely affected by it. Total surplus is important because some cases of price discrimination might increase the prices for high-valuation consumers and decrease it for low-valuation consumers, thus making some consumers worse off, but increasing market access for many more.

Price discrimination has a conflating effect on exclusionary strategies, in consonance with other exclusionary strategies like predatory pricing and exclusionary exclusive dealing. Even though price discrimination facilitates the exclusionary effects of other such strategies, it also has non-strategic and efficiency enhancing impacts. Thus, just the presence

of price discrimination does not imply that it will be anti-competitive. To minimise the risk of false positives, authorities must adopt a unified and comprehensive perspective to calculate both the pro and anti-competitive impacts. Lastly, and most importantly, the strategic effects of banning price discrimination must also be considered. In some scenarios, a broad ban on price discrimination can lead to the exercise of market power as the monopolist can keep prices high and exclude several consumers out of the market.

This article has also shown that price discrimination has no relation with fairness concept. Most fairness concepts stipulate that all consumers are charged the same price. While reasonable, it ignores another important concept of equal market access, which can lead to greater consumer and total welfare, even if some consumers are worse off.

Thus, price discrimination is a broad and complex concept, and its impact on welfare can be ambiguous. Simple policies that ban it are likely to impede competition, hurt consumers and innovation. It can thus be suggested that an effects-based approach looking at both the pro and anti-competitive effects of price discrimination and the consequences of banning it should be followed, to comprehensively calculate the efficiency gains from it.

CCI's Puerile Extirpation of the Single Economic Entity Doctrine in Aditya Birla Bid Rigging Order

—*Ahkam Khan*† *& Divyansh Prasad*‡

ABSTRACT

The subject of Section 3 of the Competition Act, 2002 is an enterprise that encapsulates within itself its units, divisions, and subsidiaries. Therefore, any agreement, arrangement or a concerted practice between a company and its subsidiary is not an agreement under the Act. Through its precedents, the Competition Commission of India (CCI) has adopted international best practices and further expanded the concept stating that agreements between group companies also do not amount to an agreement. These entities are together referred to as a "single economic entity".

This article explores the contradicting stand of the CCI with respect to the defence of "single economic entity" in Aditya Birla bid rigging order. The European Union (EU) and the US have evolved certain tests to assess the economic oneness of corporate entities and completely exempt such entities from any liability for concerted practices. The authors challenge the view taken by the CCI in the "Aditya Birla" order, which is in stark contrast to the practices in these mature jurisdictions.

Although the order rightly differentiates bid rigging cases holding that companies cannot defeat the purpose of public procurement under the garb of a single economic entity, it has grossly erred in holding the "group" concept to be entirely alien to the anti-competitive agreements under Section 3. The authors highlight how the order is against not only the Competition

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Appellate Tribunal (COMPAT) precedents, but it also lays down different standards for applicability of the doctrine with reference to merger control and anti-competitive agreements, citing the Aditya Birla/Grasim combination order.

The authors aim to discuss the significance of subsidiaries in a corporate structure and unearth the possible adverse implications of this order on the idea of conducting businesses as a "group". Finally, the authors argue the need for the CCI to reassess their stand on the single economic entity (SEE) doctrine before concluding that the case sets a confusing precedent.

INTRODUCTION

The Competition Act, 2002 "Hereinafter the Act". proscribes any horizontal or vertical arrangement that may have appreciable adverse effects on competition.[1] While the general interdiction flows from Sections 3(1) and (2), the Act discretely lays down specific horizontal and vertical agreements that warrant a check in Sections 3(3) and (4) of the Act respectively. In layman's terms, horizontal agreements are those where the parties operate at the same level of the food chain while vertical agreements are those where the parties ply at different levels. Collusion between such market players could strip the market of freestanding centres of decision-making that antitrust clamours for and could manifest itself in the form of price-fixing, output restriction or market allocation, among other anti-competitive practices. This necessitates the need for competition between them to ensure the fulfilment of the aims and objectives of the Act and hence, the prohibition.[2]

However, the embargo under these sections is not in the form of a blanket ban. For all purposes, Section 3 applies only to agreements between two or more enterprises. An enterprise is not a legal body per se but a fiction for the purposes of the Act that encapsulates a person along with its units, divisions or subsidiaries.[3] Therefore, any agreement, arrangement or a concerted practice between a company and its subsidiary is not an agreement[4] under the Act. The reason for this is simple: common ownership strives for a united interest or profit for both the parent and the subsidiary[5]. This principle essentially leads to the treatment of such

1. The Competition Act, 2002, S. 3.
2. *Ibid*, Preamble and Ibid, S. 2(h) respectively.
3. *Ibid*, Preamble and Ibid, S. 2(h) respectively.
4. *Ibid*, S. 2(b).
5. *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, para 129 (hereinafter "*Vodafone case*").

parent along with its crossly-owned bodies as for antitrust regulations. This rationale has led to the development of the SEE doctrine as well as continuously evolving tests for it in mature jurisdictions like EU and US, which shall be discussed later in the paper.

While separate divisions or units of the same corporation are incapable of conniving amongst themselves and easily determinable as a single non-competing enterprise, the same is not true for different companies in a complex corporate family. Until the 1980s, the common ownership of separate companies that were part of a bigger corporate family was no defence to exclude liability for concerted arrangements under Section 1 of the Sherman Antitrust Act, 1890, in the United States.[6] The agreements between such companies attracted the antitrust liability under this "intra-enterprise conspiracy doctrine" laid down in *United States* v. *Yellow Cab Co.*[7] in 1947. This position only changed through *Copperweld Corpn.* v. *Independence Tube Corpn.*[8] in 1984 when the US Supreme Court recognised the SEE doctrine in the case of wholly-owned subsidiaries.[9] In the EU, the first recognition of the SEE doctrine was in *Béguelin Import Co.* v. *SAGL Import Export*[10] in 1971, which held a parent and a subsidiary to be a part of a single undertaking for the purposes of Article 85(1) of the Treaty establishing the European Economic Community, 1957.

The Indian lawmakers were wary of this and thus, while defining an enterprise, included a person with its "*units, divisions, or subsidiaries*".[11] A subsidiary is a company in which the holding company controls either the composition of Board of Directors or more than one-half of the total share capital (either directly or through one or more of its subsidiaries).[12] However, with the growth of commerce, the structure of corporate holding has undergone a continuous change with businesses evolving into a complex network of wholly and non-wholly-owned subsidiaries. Thus, there was an urgent need to gauge the optimum extent

6. *United States* v. *Yellow Cab Co.*, 1947 SCC OnLine US SC 112 : 91 L Ed 2010 : 332 US 218 (1947) (hereinafter "*Yellow Cab case*"); *Kiefer-Stewart Co.* v. *Joseph E. Seagram & Sons Inc.*, 1951 SCC OnLine US SC 2 : 95 L Ed 219 : 340 US 211 (1951) (hereinafter "*Kiefer case*"); *Perma Life Mufflers Inc.* v. *International Parts Corpn.*, 1968 SCC OnLine US SC 141 : 20 L Ed 2d 982 : 392 US 134, 141 (1968).
7. 1947 SCC OnLine US SC 112: 91 L Ed 2010 : 332 US 218 (1947).
8. 1984 SCC OnLine US SC 147 : 81 L Ed 2d 628 : 467 US 752, 768-69 (1984) (hereinafter "*Copperweld case*").
9. Natasha G. Menell, "The Copperweld Question: Drawing the Line between Corporate Family and Cartel", 101 Cornell L. Rev. 467 (2016).
10. 1971 ECR 949.
11. The Competition Act, 2002, S. 2(*h*).
12. The Companies Act, S. 2(87) (2013).

of control in another company to treat them as a SEE. The CCI's answer was the "group" concept[13]: it held that companies that were part of the same group formed a. SEE for an antitrust liability and any agreement amongst the group companies was not an agreement under the Act.[14]

However, in October 2017, the CCI went against its own precedents and held the "group" concept to be alien to the anti-competitive agreements under Section 3 in *Delhi Jal Board* v. *Grasim Industries Ltd.*[15] This raises serious questions on the scope of SEE doctrine as a defence in India. CCI's tactics of picking cherries from different jurisdictions for long seems compromised through this confusing precedent. Is this case a step back into the pre-1980s era of intra-enterprise conspiracy doctrine?

1. THE SEE DOCTRINE IN INDIA PRE-ADITYA BIRLA

CCI's landmark order on the SEE doctrine, as a defence in the *Lamborghini case*[16], only considered the share capital structure as enough evidence to establish that the two companies formed part of a SEE; and hence, were not liable for an alleged contravention of Section 3. The CCI held that a violation of Section 3 requires an agreement between two enterprises and any internal agreement between parties belonging to the same group shall not amount to an agreement under Section 2(*h*) of the Act because the group companies constitute a single enterprise.[17] Thus, the order amplified the definition of an enterprise under the Act to include not only "*units, divisions, or subsidiaries*" but also companies belonging to the same group under Section 5. The erstwhile COMPAT upheld the CCI's judgment in appeal.[18] However, the COMPAT has categorically stated that the two companies were different enterprises but an SEE nevertheless; thereby, rejecting CCI's expansion of enterprise to include same group companies and instead reading the concept of "group" to Section 3 independently.[19]

13. The Competition Act, 2002, S. 5 Explanation (*b*): Two enterprises are a part of same group if, either directly or indirectly, one of them holds 26% or more of the voting rights in the other, or can appoint 50% or more of the board of the directors in the other, or controls the affairs and management of the other enterprise.
14. *Exclusive Motors (P) Ltd.* v. *Automobili Lamborghini SPA*, 2012 SCC OnLine CCI 69 (hereinafter "*Lamborghini case*").
15. 2017 SCC OnLine CCI 48 (hereinafter "*Aditya Birla case*").
16. *Lamborghini case*, 2012 SCC OnLine CCI 69.
17. *Ibid.*
18. *Exclusive Motors (P) Ltd.* v. *Automobili Lamborghini SPA*, 2014 SCC OnLine Comp AT 1 : (2014) 121 CLA 230, paras 8-11 (hereinafter "*Lamborghini appeal*").
19. *Ibid.*, ¶ 9.

Further applying the group test in *Shamsher Kataria* v. *Honda Siel Cars India Ltd*[20], the CCI held that "an internal agreement/arrangement between an enterprise and its group/parent company is not within the purview of the mischief of Section 3(4) of the Act".

Later, the CCI was faced with this issue in *Assn. of Third Party Administrators* v. *General Insurers' (Public Sector) Assn. of India*[21] where the four public insurance companies argued that they could not have cartelised since each of them formed a part of an SEE along with the Department of Financial Services (hereinafter "DFS"). The CCI explicitly utilised the group test to determine that the companies were not an SEE and further penalised them for cartelisation: "the issue as to whether Government of India and the Public Sector General Insurance Companies constitute a single economic unit would depend upon whether they first qualify as a group as per the provisions of the Act"[22]. The COMPAT upheld the judgment while adopting a slightly different "decisive influence test" since there was neither any cross-holding among the companies nor did the DFS exercise decisive control over them.[23]

The "decisive influence test" is nothing but an extension of the group test (which earlier focussed only on de jure control i.e. the requirement of at least 25% voting rights) that tells us to look beyond only the share capital structure to other prongs of the definition of group under Section 5, like control of affairs and management (de facto control). The insurance companies' argument that they were under the common de facto control of DFS was rejected by the COMPAT for lack of evidence: "On this basis, the Commission holds that the Ministry of Finance did not exercise any de facto or de jure control over OPs' business decision in submitting bids for impugned tenders. As such, OPs cannot be said to constitute a single economic unit"[24].

Therefore, as of December 2016, the successful invocation of SEE as a defence to an alleged Section 3 contravention involved the consideration of de jure or de facto control by one of the enterprises over the other(s). The CCI and the COMPAT categorically held the group test to be the benchmark for assessment. However, the CCI discontinued the test and

20. 2014 SCC OnLine CCI 95.
21. 2016 SCC OnLine CCI 1 (hereinafter "*Insurance case*").
22. *Id.*, para 94.
23. *National Insurance Co. Ltd.* v. *CCI*, 2016 SCC OnLine Comp AT 450. (hereinafter "*Insurance appeal*").
24. *Id.*, supra at 8.

failed to follow the precedents laid down by itself as well as the superior COMPAT in a controversial ruling in October 2017.

2. ADITYA BIRLA[25]: AN ADVENTURIST'S STORY OF A SUPERFLUOUS PROCLAMATION?

On 5-10-2017, the CCI passed a Section 27 order against Grasim Industries Limited (GIL), Aditya Birla Chemicals (India) Limited (ABCIL), and Gujarat Alkalies and Chemicals Limited (GACL) finding them guilty of collusive tendering under Section 3(3)(*d*) of the Act and ordered a penalty amounting to Rs 6.27 crores. This landmark judgment requires a closer critique of the substantial changes that it intends to enforce with regard to the SEE as a defence to anti-competitive agreements.

2.1 Background[26]

The Delhi Jal Board (DJB), a statutory body, used to procure liquid chlorine (LC) and polyaluminium chloride (PAC) for purification of water. In 2013, the DJB informed the CCI about the similar prices quoted by GIL, ABCIL, Kanoria Industries and Chemicals Limited (KICL), and GACL in response to the tender for procurement of PAC under Section 19(1)(*b*) of the Act. Further, the DJB also informed the CCI about the similar prices quoted by these parties except that instead of GACL, Punjab Alkalies and Chemicals Limited (PACL) participated in the procurement process of LC, in a separate reference. The DJB complained that these parties have been negotiating at the same price throughout the tendering process from 2006 to 2012. It alleged that the opposite parties therefore, were acting in contravention of Section 3 by engaging in collusive tendering by quoting similar prices with similar increases/decreases with time. The DG report found that all the parties except KCIL had indulged in collusion during the tendering process and had engaged in bid rigging under Section 3(3)(*d*) of the Act.

2.2 CCI's Examination[27]

CCI observed that the bids submitted by different companies stated increasing prices every year and the price difference among the bids of different companies reduced continuously over the 6-year period. The

25. *Aditya Birla case*, 2017 SCC OnLine CCI 48.
26. *Aditya Birla*, supra at 4-7, 16, 23.
27. *Id.*, ¶ 153-56.

CCI affirmed that the cost of production of PAC varied for different bidders, which counters any contention that the prices quoted were similar due to homogeneity of PAC. Over the years, the cost of production remained constant for GACL but kept on increasing for ABCIL and GIL. CCI also noticed that these companies had been charging DJB more than what they were charging their other customers. Further, CCI analysed the striking fact that despite the plants being in different locations, the demanded prices were quite similar with no variance on extra packaging, transport costs and other factors. The CCI also found that there was an exchange of vital information between GIL and ABCIL throughout the bidding process.

CCI held that LC was different from PAC for reasons aplenty (e.g. its hazardous and toxic nature, its manufacture as a byproduct), which led to different market conditions. Besides the same timing of bids, CCI did not find any evidence of concerted action between the different bidders with regard to LC.[28]

2.3 ABCIL's SEE contention[29]

ABCIL contended that GIL and ABCIL were part of the same group headed by Mr Kumar Mangalam Birla. ABCIL further stated that both the companies had the same decision-making management and directors operated under the same logo and with same customers. The companies also had a common central marketing and procurement team that analysed the tenders and quoted the price in their bids. Relying on the *Lamborghini case*[30] and several precedents from the EU[31] and the US[32], ABCIL submitted that arrangements between entities that are part of the same group are outside the purview of Section 3(3) of the Act and therefore, ABCIL and GIL were not in a capacity to cartelise with each other.

A remarkable argument here was that CCI itself had approved the GIL and ABCIL combination through an order[33] dated 31-10-2015. While approving the combination, the Commission had held that the two par-

28. *Id.*, ¶ 200-03.
29. *Id.*, ¶.113-17.
30. *Lamborghini case*, 2012 SCC OnLine CCI 69.
31. *Viho Europe BV* v. *Commission of the European Communities*, 1996 ECR I-5457 (hereinafter "*Parker case*").
32. *Copperweld Corpn.* v. *Independence Tube Corpn.*, 1984 SCC OnLine US SC 147 : 81 L Ed 2d 628 : 467 US 752 (1984); *American Needle Inc.* v. *National Football League*, 2010 SCC OnLine US SC 52 : 560 US 183 (2010).
33. Aditya Birla/Grasim, Combination Registration No. C-2015/03/256, order dated 31-8-2015 (hereinafter "Aditya Birla Combination").

ties formed part of the same group with common management, logistics, and marketing team and as a result, the parties would never exercise competitive constraints on each other regardless of the propounded combination.[34]

2.4 The judgment[35]

CCI turned down the SEE argument forwarded by ABCIL. While highlighting the importance of competition in public procurement, the CCI held that public procurement is a pious process involving taxpayers' hard-earned money and therefore, any noxious attempt to hijack it should invite an exemplary penalty. In CCI's view, when two entities decide to submit their bids separately, there is a presumption of competition between them and therefore, any attempts to conceal their malevolent intentions through an afterthought facade of SEE would not save them from the clutches of Section 3.

2.5 Inherent defects: The SEE conundrum

While dismissing the SEE contention, the CCI went out of bounds and discarded the applicability of "group" concept to anti-competitive agreements under Section 3 altogether. The CCI held that even if they disregarded the tendering of separate bids by ABCIL and GIL as a reason to treat them as distinct entities, the concept of group had no application to Section 3.[36]

Even otherwise, the Commission observes that the contention of the parties that they form part of a same "group" as defined in Explanation (*b*) to Section 5 of the Act and hence is outside the scope of Section 3 of the Act, is completely misplaced. It is so because the concept of "group" is applicable only in the context of regulation of combinations under Sections 5 and 6 of the Act. This has no application, whatsoever, to the proceedings under Section 3 of the Act.[37]

The judgment patently reeks of judicial adventurism without much thought. Excluding the application of the "group" concept to Section 3 in entirety not only does away with the defence of SEE in India but also impliedly overrules COMPAT's affirmation of CCI's orders in both the

34. *Id.*, paras 11-13.
35. *Aditya Birla case*, 2017 SCC OnLine CCI 48, paras 118-22.
36. *Id.*, para 126.
37. *Ibid.*

Lamborghini appeal[38] and the *Insurance appeal*[39] because they applied the "group" concept to determine the issue of SEE under Section 3. The CCI went even ahead and stated that to extend the application of the "group" concept to Section 3 would require rewriting of the statute.[40]

The CCI rightly differentiated the cases that ABCIL had mentioned for its SEE contention and only relied on *Insurance case*[41] to distinguish the cases of public procurement. However, the *Insurance case* itself had categorically relied on the "group" concept to check whether the four companies formed a SEE as explained in Part III of the paper. Even while comparing the two, the CCI should have examined the factual evidence suggesting that ABCIL and GIL were, in fact, same group companies and hence a SEE; unlike the four insurance companies which neither had any cross-holding nor common ownership or management. Even if we dismiss the factual evidence, CCI's combination order dated 31-10-2015[42] had itself held ABCIL and GIL to be a SEE.[43] The decision very conveniently applied the *Insurance case* in piecemeal without taking into account both the peculiar facts of the case and the consequences of a confusing precedent.

The decision also brings CCI in bad light due to its evident double standards regarding SEE. The question whether the standards for same group companies to qualify as a SEE are different for merger control and different for anti-competitive agreements forms the epicentre of the pandemonium.

"To have differing standards on what constitutes group and single economic entity for the purposes of merger control and abuse of dominance vis-à-vis what constitutes group and single economic entity for the purposes of cartels would create a lot of inconsistency in the market. It sets a very confusing precedent because at the end of the day, clarity and consistency are required when there is a single legislation and here that is the Competition Act", said Nisha Kaur Uberoi.[44]

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38. *Lamborghini appeal*, 2014 SCC OnLine Comp AT 1.
39. *Insurance appeal*, 2016 SCC OnLine Comp AT 450.
40. *Aditya Birla case*, 2017 SCC OnLine CCI 48, para 126.
41. *Insurance case*, 2016 SCC OnLine CCI 1.
42. *Aditya Birla Combination*, Combination Registration No. C-2015/03/256, order dated 31-8-2015.
43. *Ibid*.
44. Payaswini Upadhyay, "Single Economic Entity: Has the Competition Regulator set a Confusing Precedent?", Bloomberg Quint (14-11-2017, 2:41 p.m.), <https://bloombergquint.com/law-and-policy/2017/11/13/single-economic-entity-has-the-competition-regulator-set-a-confusing-precedent>.

The authors believe that though the CCI is right in finding ABCIL and GIL guilty under Section 3(3)(*d*) for bid rigging, the reasoning behind it is dubious and questionable. On the issue of whether or not ABCIL and GIL were a SEE, the CCI should have applied the established "group" test and answered in the affirmative. This would have not caused any confusion concerning the legitimacy of the ABCIL/GIL combination order[45] of 2015. However, the CCI should have still penalised ABCIL and GIL but by carving out an exception in cases of public procurement wherein group companies that formed a SEE would still be treated as distinct competitors under Section 3(3)(*d*) if they submitted separate bids. This would have facilitated the welcome step of separate treatment of public procurement cases in line with international jurisprudence; while the defendant group companies still allowed the SEE defence for all other agreements covered by Section 3 in the future cases. Notwithstanding the aforementioned arguments, the CCI continued the erroneous holding in *D.K. Shrivastava* v. *Daulat Ram Engg. and Services (P) Ltd.*[46] bid rigging order when it affirmed the exclusion of the group concept from the entirety of offences under Section 3.

3. THE YANG IN THE YIN: POSITIVE DIFFERENTIATION OF BID RIGGING CASES

The role of public procurement is unquestionable and it is indispensable to the economy. However, the vigorous competition in this field faces a menace from the behaviour of some market actors who instead of competing with each other, aim to cooperate for their personal interests illegally. It is essential to mention that entities belonging to the same economic group may also submit separate bids in the same tender. This can be particularly harmful to the process due to their knowledge of each other's bidding price in certain cases. Their economic oneness enables an effortless transaction of the information as well as presumes to preclude liability under Article 101. The Aditya Birla case utilises this EU concept of separate treatment of competitors in public procurement process where no defence of SEE is allowed and hence, brings us in tandem with the international best practices with respect to collusive tendering.

45. Aditya Birla Combination, Combination Registration No. C-2015/03/256, order dated 31-8-2015.
46. 2017 SCC OnLine CCI 65 (hereinafter "*Rail Coach Factory case*").

However, in EU, the *Assitur Srl* v. *Camera di Commercio, Industria, Artigianato e Agricoltura di Milano*[47] ruled out the complete obliteration of the SEE doctrine in public procurement. The Court held in favour of providing affiliated undertakings an opportunity to demonstrate that, in their case, "there is no real risk of occurrence of practices capable of jeopardising transparency and distorting competition" and that such undertakings may also enjoy "certain autonomy in the conduct of their commercial policy and their economic activities".[48] At the same time, the Court emphasised on the factual assessment by the authorities of gauging the extent of influence in the respective content of the bids submitted by the undertakings concerned in the same public procurement procedure, which could eventually lead to their disqualification from such a procedure.

Certain regional courts have taken a step forward and have categorically denied the defence of a single economic unit in specific cases of bid rigging in public procurement. The essence of public procurement is the healthy competition among the tenderers and the choice present before the contracting authority to choose the best of them. Therefore, "the entities that took part in the public tendering and submitted commercial tender bids are seen as opponents and the fact that the entities are related by certain shareholders and employees and that these entities can be seen as related companies is not significant in terms of the Competition Law".[49]

4. MATURE JURISDICTIONS ON THE SEE DEFENCE TO AN ANTI-COMPETITIVE AGREEMENT

The decision of the CCI in *Aditya Birla*[50] is in stark contrast to the practices in the European Union and the United States of America. In the European Union, single economic entities have been granted complete exemption from cartelisation offences. However, in cases of public procurement, national jurisdictions have carved an exception to deny these entities an exemption and the burden of proof is on the companies to prove that their bids were distinct and without any intention to distort the process. The position in United States is quite similar and it places emphasis over substance rather than form to determine the applicability

47. Case C-538/07 : order dated 19-5-2009, ECLI:EU:C:2009:317.
48. *Id.*, para 31.
49. *Specialus Montažas and Eksortus* v. *Competition Council, No. A552-2016/2012* (Lithuania). <http://cadmus.eui.eu/bitstream/handle/1814/31771/RSCAS_2014_68.pdf?sequence=1>
50. 2017 SCC OnLine CCI 48.

of the SEE doctrine. Such economic entities are then considered incapable of infringing Section 1 of the Sherman Act.

4.1 The European Union

Article 101 of the Treaty on the Functioning of European Union governs the concerted practices in the European Union. It applies solely to the activities of undertakings and decisions by an association of undertakings, thereby, excluding single economic entities from its purview.

The concept of an undertaking encompasses every entity engaged in an economic activity, regardless of the legal status of the entity.[51] The courts while determining the eligibility of undertakings to violate Article 101 lay immense emphasis on the economic structure. The rationale behind the application of the EU Competition Law to economic entities instead of legal entities is the competitive insignificance of transactions between certain legal entities that may be forming a single economic unit and may be pursuing a "specific long-term economic aim."[52] The test to ascertain whether the companies form an. SEE is a question of degree and varies with the following factors:

(*i*) The parent company's control over the Board of Directors.

(*ii*) The amount of profit taken by the parent.

(*iii*) Compliance with the directions of the parent in matters related to marketing and investment.[53]

However, in matters of partially-owned subsidiaries the test lies in the exercise of "*decisive influence*" over the market policies of the subsidiary. In cases where the subsidiary has no real freedom to determine its course of action and carries out the instructions given to it by the parent company,[54] they form a single economic unit incapable of infringing Article 101. The "Guidelines on the application of Article 101 of the Treaty" specify that the SEE doctrine exempts even to sister companies over which the same parent company exercises decisive influence despite their presence on the same relevant product and geographic markets, quite similar to the group concept in India.[55]

51. *Klaus Höfner* v. *Macrotron GmbH*, 1981 ECR I-1979, para 21.
52. *Akzo Nobel NV* v. *Commission of the European Communities*, 2009 ECR I-8237, para 27.
53. Alison Jones and Brenda Sufrin, *EU Competition Law* 137 (4th Edn. 2011).
54. *Parker case*, 1996 ECR I-5457; *Ahmed Saeed Flugreisen and Silver Line Reisebüro GmbH* v. *Zentrale zur Bekämpfung unlauteren Wettbewerbs eV*, 1989 ECR 803, para 3.
55. Guidelines on the application of Article 101(3) TFEU [formerly Article 81(3) TEC] 2004 Official Journal C 101.

The stand of the EU competition authorities can be further discerned through the *Viho* judgment[56]. Viho had filed a complaint against the distribution policy pursued by Parker, which restricted its subsidiaries distribution to their allocated territories and alleged an infringement of Article 85(1). The Court dismissed the complaint insisting on the economic oneness rather than the legal distinction. It held that "The discrimination at which Article 85(1) is aimed must, therefore, be the result of an agreement, a decision or a concerted practice between separate and autonomous economic entities and not the result of unilateral conduct by a single undertaking."[57] The Court made it clear that Article 85(1) of the Treaty refers only to relations between economic entities, which are capable of competing with one another.

4.2 The United States

Section 1 of the Sherman Act declares illegal, every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations.[58] The essence of this section is concerted or bilateral action. ??Hence, it is widely accepted that the law respects the economic unity of corporations and agreements between its divisions should be immune from antitrust scrutiny.

However, this view came into prominence only in 1984 after the Copperweld decision[59]. The US Supreme Court initially discussed the idea of SEE in 1947 in *Yellow Cab case*[60]. The Court denied complete immunity from Section 1 to such entities and held: "The fact that the corporate defendants, by virtue of affiliation and common ownership constitute a 'vertically integrated enterprise' does not necessarily render inapplicable the prohibitions of the Sherman Act".[61] The Court believed that affiliation in itself could be the means to further the illegal intent of the conspirators of curbing competition. As a result, a rule of reason analysis was to be done while assessing intra-enterprise agreements. These observations by the Hon'ble Supreme Court of United States set forth a proposition of intra-enterprise conspiracy. The intra-enterprise conspiracy doctrine was widely criticised by scholars and was erroneous

56. *Parker case*, 1996 ECR I-5457
57. *Parker case*, 1996 ECR I-5457.
58. Sherman Antitrust Act, 1890, S. 1.
59. 1984 SCC OnLine US SC 147 : 81 L Ed 2d 628 : 467 US 752 (1984).
60. *Yellow Cab case*, 1947 SCC OnLine US SC 112: 91 L Ed 2010 : 332 US 218 (1947).
61. *Ibid*.

on many grounds. It gave rise to a plethora of suits but penalised only a few defendants solely based on intra-enterprise conspiracy doctrine.[62]

For three decades, there was utter confusion and irregularities with respect to this doctrine in the lower courts. There was neither a uniform application of this doctrine nor a comprehensive rebuttal. In 1951, the Court following *Yellow Cab*'s[63] language held that "mere instrumentalities of a single manufacturing-merchandising unit could conspire unlawfully" especially when the defendants "hold themselves out as competitors".[64] Eleven years later in *Sunkist Growers Inc.* v. *Winckler & Smith Citrus Products Co.*[65], the Court disallowed a Section 1 conspiracy claim among three separately incorporated agricultural cooperatives. While absolving the defendants of Section 1 liability the Court laid stress on the economic structure and held that "there was no indication that the use of separate corporations had economic significance in itself or those outsiders considered and dealt with the three entities as independent organisations".[66]

The *Copperweld case*[67] presented an opportunity to the Supreme Court to review and reassess the nocuous consequences of its previous perplexing pronouncements in this regard. The Copperweld judgment was in line with the Yellow Cab critics and it excluded scrutiny of the coordinated behaviour of a parent and its wholly-owned subsidiary from Section 1. The Court placed emphasis on substance over form. The companies may be separate in form but in substance, they are a single enterprise and cannot comprise common plurality, which is essential for a Section 1 violation. The Court also admitted that in no case has the Court considered the merits of the intra-enterprise conspiracy doctrine in depth and its applicability should have been reassessed and scrutinised earlier.

Though it was a welcome change, it failed to determine an extent to which this immunity to antitrust liability would objectively apply. The question of applicability of the per se exemption to subsidiaries which the parent did not completely own was unanswered. The Judges were doubtful about its applicability to hybrid situations and the criteria to find the stopping point of the exemption.[68]

62. Phillip Areeda, Intraenterprise Conspiracy in Decline, 97 Harvard L. Rev. 451 (1983).
63. 1947 SCC OnLine US SC 112: 91 L Ed 2010 : 332 US 218 (1947).
64. *Kiefer case*, 1951 SCC OnLine US SC 2 : 95 L Ed 219 : 340 US 211 (1951).
65. 1962 SCC OnLine US SC 86 : 8 L Ed 2d 305 : 370 US 19 (1962).
66. *Id.*, para 17.
67. 1984 SCC OnLine US SC 147 : 81 L Ed 2d 628 : 467 US 752, 768-69 (1984).
68. *Fraser* v. *Major League Soccer LLC*, 284 F 3d 47 (1st Cir 2002), para 35.

In 2009, the Supreme Court of Appeals of West Virginia endeavoured to look into the cases of non-wholly owned subsidiaries. The Court elaborated on the test of "unity of purpose", which, if established, would eventually foreclose any risk of an anti-competitive conspiracy.[69] The courts, thereby, were expected to examine whether the two entities are so indistinguishably entwined that they have congruent corporate economic goals.

The divergent interpretations led the Supreme Court to clarify its stance in *NFL case*[70]. The Supreme Court had to scrutinise whether the US National Football League formed a SEE to escape antitrust liability. Denying NFL the SEE defence the Supreme Court reaffirmed its stance of examining substance over form and held:

> The relevant inquiry is therefore one of substance, not form, which does not turn on whether the alleged parties to contract, combination, or conspiracy are part of a legally single entity or seem like one firm or multiple firms in any metaphysical sense. The inquiry is whether the agreement in question joins "separate economic actors pursuing separate economic interests", such that it "deprives the marketplace of independent centres of decision-making", and therefore of diversity of entrepreneurial interests and thus of actual or potential competition.[71]

5. CONCLUSION AND SUGGESTIONS

The CCI's observation in *Aditya Birla*[72] is clearly against the international best practices. Absolute negation of the application of the concept of "group" mentioned in Section 5 of the Act to Section 3 will lead to the unwanted consequence of competitive inefficiency at the ground level. Subsidiaries are an essential part of the corporate structure of a company.[73] The activities undertaken by companies have grown multifold nationally and internationally and they depend on their subsidiaries to avoid complexities and for the growth of the company.[74] This order shall uproot the entire concept of running businesses as a group and eventually lead to a denial of the innumerable efficiency benefits of a subsidiary as any exchange of information between such subsidiaries would come

69. *Princeton Insurance Agency Inc.* v. *Erie Insurance Co.*, 690 SE 2d 587 (W Va 2009), p. 15.
70. *American Needle Inc.* v *National Football League*, 2010 SCC OnLine US SC 52 : 560 US 183 (2010).
71. Para 1*(c)*, available at <https://www.supremecourt.gov/opinions/09pdf/08-661.pdf>
72. 2017 SCC OnLine CCI 48.
73. *Vodafone case*, (2012) 6 SCC 613.
74. *Ibid.*, ¶ 256.

under the scanner of the authorities and lead to an investigation by the CCI.

Instead, this interpretation should have been limited to bid rigging in public procurement cases where entities may collude under the garb of SEE to defeat its purpose. CCI should impose a heavy penalty in public procurement cases that involve the taxpayer's money. With respect to other instances of violation of Section 3, the CCI should review, reassess and rectify its order to bring it in accordance with the practices of mature jurisdictions like EU and US.

Further, in public procurement process, the public agencies usually lay down guidelines for a minimum number of qualified bidders required for each tender. This stringent requirement results in instances of proxy bidding by companies through its own subsidiaries or related parties. Mere rejection of the single economic entity defence will not sufficiently hedge the malpractice, as companies shall continue resorting to proxy bidding through its related parties to fulfil the minimum bidder requirement. An example would be the *Nagrik Chetna Manch v. Fortified Security Solutions*[75], where the CCI found that the public procurement agency (Pune Municipal Corporation) failed to detect cartelisation amongst its own tenderers and its glaring acts of commission and omission aided the bidders in cartelisation.[76] Therefore, the Government should endeavour to educate the public agencies and promote reforms in their tender process acting as a vigilante to prevent instances of cartelisation in bid rigging. It should encourage the public agencies to be flexible in their minimum bidders rule and more vigilant while scrutinising the bid documents to uproot this menace. Another positive step in this direction could be the requirement of mandatory disclosure by same group companies in their tender documents, if they take part in the bid as competitors, to exclude the defence of SEE in any related cartelisation litigations in the future before the CCI.

Though this order might be a welcome step for differentiation of public procurement cases, it does not restrict itself to it. This CCI could have refused to inculcate this superfluous holding in the Indian antitrust regime but it even reproduced it in *Rail Coach Factory case*[77] affirming that the group concept was alien to Section 3.[78] Now it is up to the CCI whether it continues this practice or aligns itself with other mature juris-

75. Case No. 50 of 2015, order dated 1-5-2018.
76. *Id.*, para 90.
77. 2017 SCC OnLine CCI 65.
78. *Ibid.*, ¶ 5.2.

dictions given the aforementioned implications of uprooting SEE as a defence for concerted practices amongst the same group companies.

There have been numerous past instances where CCI has made superfluous, naive and inconsistent observations without bearing in mind its implications. One such instance was in *Ramakant Kini* v. *Dr L.H. Hiranandani Hospital*[79], where the CCI passed an order finding a violation of Section 3(1) without coupling it with either of Section 3(3) or Section 3(4) of the Act. This was in contrast to an earlier order where it was of the view that "Section 3(1) of the Act should not be evoked independently."[80] The order failed to present any conclusive reasons for such an inconsistency and glaringly ignored the precedents. Similarly, through its order in the *Aditya Birla case*[81], the CCI has ruled against its own precedent without stating the need or reasons for a deviation from established practices. The CCI, being the competition regulator of the country, should act with more responsibility and maintain a consistent and reasoned approach towards such issues to achieve its objective of promoting and sustaining a fair and competitive environment in the country.

79. Case No. 39 of 2012, para 11, order dated 5-2-2014.
80. *Govind Agarwal* v. *ICICI Bank Ltd.*, 2011 SCC OnLine CCI 42, para 10.
81. 2017 SCC OnLine CCI 48.

Director's Faceless Liabilities: Expanding The Realm of Insolvency

—*Samriddh Bindal*† *& Shriji Pandey*‡

ABSTRACT

A company, being a juristic person can operate through its agents only. The Board of Directors is the most significant part of decision-making body within the company. If the company earns profit it is because of the decisions of directors, it is the directors who have a sense of duty towards the company, they have to set company's strategic aims, ensure essential financial and human resources are at suitable place. With the advent of Insolvency and Bankruptcy Code, 2016, the directors ought to get more serious about the viability of the businesses. The directors must understand the indicators of insolvency and take reformative actions. The directors will have to act in a diligent and bona fide manner at all times so as to balance the interest of all the stakeholders. The directors, apart from this, will have to understand that before the Corporate Insolvency Resolution Process (CIRP) period their duties may change towards the creditors as well. Once the CIR proceedings have started the directors can be held personally liable for their acts as per Insolvency and Bankruptcy Act, 2016.

Through this article the authors have tried to bring forth the developments related to the jurisprudence regarding the liabilities of the directors in the insolvency law. The authors have specifically suggested that a company's insolvency could be adjudged through various indicators and have highlighted various steps that directors can take up to avoid the CIR proceedings. The directors will also have to understand and strike balance between the business decisions for the expansion of assets and for the revival of the company as and when required.

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"Without bankruptcy law, fewer would start enterprises. Bankruptcy law is good both for entrepreneurs who fail and those who succeed."

—Douglas G. Baird

When money is involved, the obligation to check the encouragement of advancing one's own particular advantages to the detriment of another is significant. The law of fiduciary duty predominantly addresses the issues relating to a set of people administrating the money of another. In the corporate framework, the law of fiduciary duty is a well characterized and a precise notion.[1] Adherence to the fiduciary duties while carrying on various transactions and other business-related decisions may often times decide the fate of a company moving down the road to reach bankruptcy as the end point. It is the foremost concern of the insolvency regulating authorities to find a panacea to characterise these duties not only while the company is solvent but even when it is approaching insolvency.

1. FIDUCIARY DUTY OF CARE AND LOYALTY—THE BASIS OF LIABILITY

The directors play several roles for the company, like they manage the company or a particular area of the company. The fiduciary duties of the directors are of utmost importance and can never be neglected. The directors owe duty to shareholders, or conceivably to the company. The fiduciary duties are underpinned by biblical principles[2] and must be understood as rationalising the expectations from a director who works in the interest of the shareholders. Apart from this, the directors have additional core duties, (*a*) a duty of disclosure; and (*b*) duty that has no defined name, the duty of additional consciousness when you sense your company is a takeover target.[3] In *Amalgamated,*[4] the court upheld the *Gantler*[5] case, that officers owe fiduciary duties which are indistinguishable from those directors owe, further said that officers are as well "agents who report to the Board of Directors" and "have a duty to provide the

1. Cory Dean Kandestin, "The Duty to Creditors in Near-Insolvent Firms: Eliminating the "Near-Insolvency" Distinction", Vanderbilt Law Review, 1235 (2007).
2. M. Steel, "The Moral Underpinnings of Delaware's Modern Corporate Fiduciary Duties", Notre Dame Journal of Law Ethics & Public Policy, 26 (2012).
3. Professor Bernard S. Black, "The Principal Fiduciary Duties of Boards of Directors", Stanford Law School (2001).
4. *Amalgamated Bank* v. *Yahoo! Inc.*, 132 A 3d 752 (2016).
5. *Gantler* v. *Stephens*, 965 A 2d 695, 708-09 (2009).

Board of Directors with the information that the directors need to perform their statutory and fiduciary roles".

Directors have ultimate responsibilities for managing the affairs of the company, and work to increase the shareholder's wealth[6]. The forums in order to enforce liability over the director for the breach of its duties have developed two tests, namely, trust fund theory and at risk theory.

(A) *Trust fund theory*: The relation amid a firm and its creditors are same as those which existed between individual creditor and debtor.[7] The so-called trust fund theory was declared for the first time in *Wood* v. *Dummer*.[8] Capital stocks of banks are deemed to be pledge that directors of an insolvent corporation hold the company's assets in trust for benefit of creditors, and fiduciary duties are imposed on directors.[9] The courts of the United States were first to accept the doctrine, but then limited it to mean only that company's property must be applied to the payment of the debts of the corporation before any part of it could be distributed to the stockholders.[10]

"The court's decision focused on determining the point when the duty to creditors is activated. It is noted as a preliminary matter that neither party seriously disputes that when the insolvency exception does arise, it creates fiduciary duties for the directors for the benefit of creditors".[11] These duties of directors arise even when the insolvency was not triggered.[12] Although, the directors owe duty to the shareholders and it is acknowledged that they owe duty to creditors even before insolvency triggers but to what extent, is still unclear.

(B) *At risk theory*: When the company is on the verge of insolvency, shareholders want the directors to implement high-risk strategies to revive the company; in contrast creditors ponder of preserving the value of the estate.[13] The directors owe not only "residue risk bearers" but also fiduciary duties in the vicinity of bankruptcy.[14]

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6. *Dodge* v. *Ford Motors Co.*, 204 Mich 459 (1919).
7. *Catlin* v. *Eagle Bank*, 6 Conn 233 (1826).
8. 30 F Cas 435 (1824).
9. Alan W. Tompkins, "Directors' Duties to Corporate Creditors: Delaware and the Insolvency Exception", SMU Law Review, 169 (1994).
10. *Hollins* v. *Brierfield Coal & Iron Co.*, 1893 SCC OnLine US SC 245 : 37 L Ed 1113 : 150 US 371 (1893).
11. *Geyer* v. *Ingersoll Publications Co.*, 621 A 2d 784 (1992).
12. *Ibid.*, 790.
13. Edward M. Iacobucci, "Directors Duties in Insolvency: Clarifying What is at Stake", (2003) 39 Cdn Bus LJ 398.
14. *Robert Solomon* v. *Credit Lyonnais Bank Nederland NV Pathe Communications Corpn.*, 672 A 2d 35 (1991).

2. "LOOKING BACK" TOWARDS DIRECTOR'S LIABILITIES

Insolvency regimes across the globe prohibit certain nature of acts and transactions subject to avoidance, carried on by a director prior to the commencement of the insolvency procedure. This time period, more so the "relevant time", is used to draw a timeline when the company is facing serious financial crunches, has insufficient funds to pay the outstanding as well as the future matured debts. This timeline begins, as indicated in Insolvency and Bankruptcy Code, 2016 ("IBC") when the director "*knew or ought to have known that there was no reasonable prospect of avoiding the commencement of corporate insolvency resolution*".[15] Generally, the acts wherein parties related to the corporate debtor are involved, the relevant time is relatively brief.

When a corporation is on the verge of inevitable insolvency, this pre-insolvency stage is commonly termed as *twilight zone* or *suspect period*. This time period which has not been defined in any statute yet, is coined by the insolvency industry. The business decisions involving certain transactions like selling and transfer of assets, mergers or getting fresh loans sanctioned when already defaulting in earlier ones are deemed to be crucial for the future concerning not merely the company and the Board of Directors but also the creditors and shareholders, specially when these acts or transactions are in transgression of ordinary standards of behaviour. For instance, the law against wrongful trading practices, operating with a particular level of severity, at any given time in the process of corporate difficulties, gives the directors of sick companies a motivation to cease business operations.[16]

The provision against such practices was introduced in UK in order to make directors answerable for irresponsible trading, as distinct from fraudulent trading[17] as seen in the first reported case of *Produce Mktg. Consortium Ltd., In re*.[18] Section 66 IBC is prohibitive provision against those wrongful or fraudulent transactions concerned with the act of "carrying on a business with the intent to defraud the creditors or for any such fraudulent purpose" when the corporate debtor could clearly see the company moving towards inevitable insolvency. The provision supports the fundamentals of corporate practices and the insolvency proceedings against the lack of due diligence on corporate debtor's part, more specifi-

15. Insolvency and Bankruptcy Code, 2016 (31 of 2016), S. 66.
16. Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (2nd Edn., 2009) 176.
17. L.S. Sealy, *Wrongful Trading*, 48, The Cambridge Law Journal, 375-377 (1989).
18. (1988) 5 BCC 569.

cally the directors of the company, in order to minimize the potential loss of the creditors of the company.

Another such transaction, prejudicial to the insolvency estate or entered into in an effort to defeat the collective rights of creditors[19] are preferential transactions. As the name suggests, involves the transfer of property/assets or an interest thereof of the insolvent company during the relevant time[20] in a manner "beneficial for financial or operational debt or other liabilities owed by the corporate debtor to a creditor or a surety or a guarantor for or on account of an antecedent".[21] It has the effect of putting a creditor in a beneficial position[22] other than what would have been in the event of a distribution of assets accorded by Section 53 of the Code.

If the price received by the debtor as the consequence of a contract with an outsider, is either insignificant or non-existent[23], like a gift, or involving the transfer of assets by the corporate debtor for significantly less consideration[24] and much lower than the market price or true value, occurring within the suspect period, is deemed to be an undervalued transaction. Presupposing that it does not fall within the scope of ordinary course of business of the corporate debtor[25], director's liability clock starts ticking, in case proven to be contrary to the prohibited undervalued transactions. Avoidance criteria for the above such transactions can be objective (one approach emphasis)[26] or subjective (case-specific)[27] under the insolvency laws while it is possible to use both the criteria for specific transactional nature, creating two-tier functionary.

For a distressed company facing financial challenges, a director has a very crucial role to play to avoid insolvency's trailer. The bedrock of the fiduciary duties of the directors, the separation of control and ownership, makes it fundamental to define the liabilities, even before the commencement of the suspect period. It becomes more important considering in fact that the scope of risks taking and experimentation along with the freedom to conduct business in pursuance of personal interests is not

19. UNCITRAL Model Law on Cross-Border Insolvency, S. 15, 30-5-1997.
20. Insolvency and Bankruptcy Code, 2016 (31 of 2016), S. 43(1)(4).
21. *Ibid.*, 15 S. 43 (1) (4) and so on.
22. *Ibid.*, 15 S. 43 (1) (4) and so on.
23. UNCITRAL Model Law on Cross-Border Insolvency, S. 173(*a*), 30-5-1997.
24. *Ibid.*, 15 S. 43 (1) (4) and so on.
25. *Ibid.*, 15 S. 43 (1) (4) and so on.
26. UNCITRAL Model Law on Cross-Border Insolvency, UNCITRAL Model Law as *Supra* Note 19 at S, 157 and so on.
27. UNCITRAL Model Law on Cross-Border Insolvency, UNCITRAL Model Law as *Supra* Note 19 at S, 157 and so on.

controlled by the laws. In some cases, a director may act in a bona fide manner and in good faith towards the interest of the company but the scale to justify it with rationality and due diligence needs to be defined. Insolvency regimes of personal liability for directors, established at law, may again create incentives to manage in a particular way[28] entailing an important role in the avoidance mechanism by evaluating recent developments and resolve the clashes with other coexisting laws. It, therefore, becomes more important for any insolvency regime to draw the circumference of liability and put directors of the company inside it to provide better justice to the insolvency and bankruptcy laws.

3. INDICATORS OF INSOLVENCY

The law is quite clear regarding the duties of directors when the company is solvent as discussed above, but the duties of the directors get muddled up if the same company is nearing insolvency or going through a financial distress. There are many personal interests that may come up in such situation and self-interest may find itself in tension when insolvency is upfront.[29] Consequently, when it is evident that the corporation is close to insolvency, directors working in the interest of shareholders become less and less viable. At that point of time, the shareholders have lost almost all their worth and being a limited liability company they have nothing to lose. This makes them interested in using the other parties' money and investing into high-risk ventures to retain the potential of their shares. At this point a creditor would not prefer such action, as they want that the directors adhering to the principles of maximizing the value of the leftover assets instead of directors taking any other action in the interest of the shareholder leading to the decrease in the worth of the creditors' share. It is in fact clear in common law that after the insolvency is triggered, the directors owe ultimate duty to the creditors.[30]

The Australian case *Australian Securities and Investments Commission* v. *Plymin*[31] was first to make a checklist of indicators of insolvency to decide the extent of liability. The list included continuing losses, absence of alternate finance options, degrading relationships

28. Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (2nd Edn., 2009) 176.
29. Kandestin, Cory Dean, "Duty to Creditors in Near-Insolvent Firms: Eliminating the "Near-Insolvency" Distinction", 60, Vanderbilt Law Review, 1234 (2007).
30. Maurer School of Law, "Fiduciary Duty Owed Creditors by Director of Insolvent Corporation", 25, Indiana Law Journal, (1950).
31. 2003 VSC 123.

with banks and inability to borrow more money. Though it is unsettled whether the duties of the directors must extend towards the creditors when insolvency can be sensed or towards the shareholders. Here again, "at risk doctrine" comes into the picture, which conclusively states that the obligation must be owed towards the creditors because they are the one who suffer the maximum loss and are may be subjected to shareholder opportunism.[32] On the other hand, courts on several occasions have held that there are no duties owed to the creditors, not even to the companies near insolvency.[33]

To understand the duties of the director, we must first understand how the parties, specifically the directors, could assess the suspect period or the twilight period before the insolvency is actually triggered. This would help the directors to not let the control over the company go from their hands, saving themselves from any personal liabilities which may occur when the insolvency is triggered but it could also provide an opportunity to other stakeholders to protect their personal interests and avoid losses. If it is determined or understood that de facto insolvency has been attained, then the directors will have to understand and ensure that there are no payments to be made inconsistent with the due diligence of the company.

Insolvency is generally given a very wide definition[34], therefore it gets difficult to construe the specific financial position that the definition intends to convey for the purpose of suspect period. No single test is conclusive enough to adjudge solvency. It has now become a customary practice to use two major indicators of a company's commercial insolvency to predict insolvency i.e. an inability to meet a demand for a debt which has become due ("cash flow" test) and an excess of liabilities over assets ("balance sheet" test).[35]

The courts have time and again faced difficulty in interpreting and objectifying the specific financial position of the company and declaring it insolvent.[36] *Bell Group Ltd.* v. *Westpac Banking Corpn.*[37] tried to find individual significance of both the tests. It was held that the "cash flow

32. Pamela L.J. Huff & Russell C. Silberglied, "From Production Resources to Peoples Department Stores: A Similar Response by Delaware and Canadian Courts on the Fiduciary Duties of Directors to Creditors of Insolvent Companies", (2007) 2 J. Bus. & Tech. L. 455.
33. *Production Resources Group LLC* v. *NCT Group Inc.*, 863 A 2d 772, 788-89 (2004).
34. UNCITRAL, *Legislative Guide on Insolvency Law* (2005) 05.
35. *Kon Yin Tong* v. *Leow Boon Cher*, 2011 SGHC 228 33, 34.
36. Timbatec Pty Ltd. and the Companies Act, (1974) 1 NSWLR 613.
37. (2008) 225 FLR 1.

test" is appropriate for determining insolvency while that the balance sheet is relevant and significant for judging the ability of a corporation to pay back its debts. Cash flow test has also been regarded as the appropriate test for judging solvency of a firm in Australian Jurisprudence. Furthermore, at various instances it has been found that the balance sheet test can be used as contextual evidence. Thus, it would not be incorrect to say that the solvency tests must be conducted at the time the particular debt is incurred not when the debt is payable. There are four basic solvency applied in bankruptcy and corporate law[38] which are explained below.

(A) *Cash flow test*: This test is also known as the "equitable solvency test". As the name suggests solvency is judged on the basis of the flow of cash of the company. It is considered to be a forward-looking test. Meeting current liabilities is not the only standard that the business must look forward but at least meeting the long-term liabilities must be the adequate goal of any company.[39] Section 101(32)(C) of the Bankruptcy Code of USA uses the cash flow test in determining the meaning of insolvency. The major objective behind this test is to determine if the firm could match its cash resources to its budding obligations and if in the future, the firm will have enough capital to withstand those liabilities. This involves calculating and analyzing the ratio of current assets to the current liabilities of the firm.[40] It analyses the series of projections of future financial performances. It becomes in today's competitive business market because the firm may have to incur some losses on temporary basis in order to become competitive enough not just to sustain but also earn profit on long-term basis as a consequence, the importance of Insolvency Act all the more increases.[41]

The cash flow test to an extent is related to the capital test, where in the capital test it is understood that if the company has a relatively small capital already then it would be difficult for the company itself to withstand and generate enough profits. Companies having less capital will have to go through financial stress more often than companies having adequate capital.[42] A company may have a strong asset base but if it does not have enough cash flowing in its system, it may be wound up as an insolvent firm as it would fail the cash flow test. A creditor is entitled to

38. J.B. Heaton, Solvency Tests, SSRN (10-7-2018, 8.32 p.m.) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=931026>
39. *Pereira* v. *Farace*, 413 F 3d 330, 343 (2nd Cir 2005).
40. *Pereira* v. *Farace*, 413 F 3d 330, 343 (2nd Cir 2005).
41. *Supra* Note 34 at 46.
42. *Morse Tool Inc., In re*, 148 BR 97, 132 (1992).

trigger the insolvency as soon as the debts are not paid or default has occurred, he is not obliged to give the company time for selling its asset and paying the debts from its proceeds.[43]

It is of no doubt that a company is *generally* unable to meet demands to repay its due amount is good evidence that it is the cash flow insolvent[44], that is not a requirement under "general test of cash flow". Failure to pay a single debt suffices. Companies have been wound up if they were unable to discharge a single debt of a particular creditor.[45] Professor Fletcher has often pointed[46] that inability to pay even a single debt which is due and not disputed is itself an evidence of insolvency on which a winding-up order can be made. The UK Supreme Court in *Cheyne Finance Plc, In re (No. 2)*[47] held that the cash flow test is concerned with the present debts along with the debts falling due in near future.

Apart from this, the firm may also have contingent liabilities that may or may not arise in the near future, e.g. corporate guarantee, letters of credit, pending recovery suits, etc. The problem with this test is that if the corporation qualifies the test, then also there are chances that the firm may still go into insolvency. The triggering point of insolvency and bankruptcy in India is "default". Thus the company can still go into liquidation even if it qualifies this test.

(B) *Balance sheet test*: It is said that the true test for insolvency is the balance sheet test.[48] This test is used for identifying the insolvent liquidation for the purposes of assessing directorial liabilities for wrongful trading.[49] A test, where it will be observed that the book value of the firm's assets exceeds the total dues or liabilities is usually conducted on "going concern" basis but can be tried on liquidation basis as well. The UK Supreme Court[50], interpreted the balance sheet test for the first time with regard to Section 123(2) of the Insolvency Act.[51] In this test the court, based on the available evidence, ascertains whether the company has sufficient assets to pay against the liabilities including the prospective

43. *Sunshine Securities (Pte) Ltd., In re*, 1975-1977 SLR 282.
44. *Tweeds Garages Ltd., In re*, 1962 Ch 406 : (1962) 2 WLR 38; *Lyric Club, In re*, (1892) 36 The Solicitors' Journal 801.
45. *Globe New Patent Iron & Steel Co., In re*, (1875) 20 LR Eq 337.
46. Ian F. Fletcher, *The Law of Insolvency* (4th Edn., London: Sweet & Maxwell, 2009) 20-26.
47. 2008 Bus LR 1562.
48. T. Jackson, *The Logic and Limits of Bankruptcy Law* (Harvard University Press, Cambridge, Ma, 1986) 198.
49. Insolvency Act, 1986, UK Act, S. 214.
50. *BNY Corporate Trustee Services Ltd.* v. *Eurosail*, 2013 UKSC 28.
51. Insolvency Act, 1986, UK Act, S. 123(2).

and contingent liabilities. This test is not like an auditing test where the courts would have to ascertain the "point of no return". Whereas, in this test based on the balance of probabilities, the court found that when the debts are payable, the company would be able to withstand even after selling its assets.[52] The problem with this test is that the court often struggles to decide if the value of the assets must be valued as if the firm is a going concern or will liquidate in some time. Although, the worth of the assets and liabilities must be seen keeping in mind the principle of conservatism to more accurately reflect the current market value of the assets and also to protect the interest of the creditors.

The general approach to determine whether to apply the "going concern" principle or value the assets as the firm, is by determining if it will go into liquidation at some point and then value the assets accordingly to that finding.[53] This selection of principle also depends upon the question whether the firm is going to be sold as a going concern or will it be liquidated. However, it may sometimes seem bizarre to value the assets as per the going concern method when the firm is actually going to be liquidated in some time. The answer to this lies in understanding the purpose of the insolvency test i.e. to prevent any undervalued transactions or transfers of the assets. Hence, when the firm is in business then it does not make sense to apply the liquidation values of the assets as it would also be detrimental to the interest of other creditors.

The problem with the balance sheet is that the there is no meticulous definition of "prospective liabilities". Standard accounting practice treats contingent liabilities more subtly.[54] The test can also be difficult where the financial statements are not maintained or are not available as it requires reviewing of books, records and financial data.[55] It is the one test used in identifying insolvent liquidation for the purposes of assessing directorial liabilities for wrongful trading. Since insolvency is the triggering point of the trust fund duty to the creditors, it is difficult to determine the point where the solvency ends and insolvency begins. Therefore, the directors have to perform the duties without even knowing when their obligations will shift towards the creditors, if they have not shifted already[56] which is confusing.

52. *Supra* Note 50.
53. *Brentwood Lexford Partners LLC, In re*, 292 BR 255, 268 (2003).
54. Belcher, *Corporate Rescue*, (Sweet & Maxwell, 1997) 46-47. *A Company (No. 006794 of 1983), In re*, 1986 BCC 261.
55. *Supra* Note 34 at 47.
56. Kandestin, Cory Dean, "Duty to Creditors in Near-Insolvent Firms: Eliminating the "Near-Insolvency" Distinction", 60, Vanderbilt Law Review, 1235 (2007).

(C) *Capital adequacy test*: This test helps in determining whether the company has adequate capital to manage the affairs and earn the profits in the current market. It is largely related to the cash flow test though is less specifically defined in the law. The corporation must have reasonable amount of capital to withstand the fluctuations that may happen anytime in the market, the capital can also be an indicative of the interest and the intention of the owner(s) in the company. The financial projections should be construed in the sense that the other stakeholders have no doubt regarding the viability of the business. This test can also be regarded as part of the cash flow test or the balance sheet test as the capital is of vital importance in both these prior tests.[57]

(D) *Business judgment rule*: "*There exists no cause of action for deepening the insolvency of the corporation and no breach of fiduciary duty without showing bad faith or fraudulent intent*."[58] The business judgment rule is a recourse from the liabilities that the directors of solvent, barely solvent, and insolvent corporations may incur for the decisions if made with due care and in good faith.[59] The rational belief behind the purpose is the protection of the directors for the bona fide decisions made with no personal interest attached and in the best interests of the corporation. In *Lyonnais*[60], it was held that "a troubled company's director should take whatever action he needs to take which is in the best interests of the corporation, irrespective of the preference of an approach that is of greater benefit to their class of the creditors/stakeholders".

The existence of a connection between the elements of the rule and the circumstances under which a director can be excused from liabilities is suggestive that "the appropriate course is the extension of business judgment protection to this category of director".[61] The business judgment rule is what will apply no matter if the firm is undergoing insolvency, is on the lip or nearing insolvency, in the zone of insolvency or insolvent already.[62]

57. J.B. Heaton, Solvency Tests, SSRN (10-7-2018, 8.32 p.m.) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=931026>.
58. *Global Service Group LLC, In re*, 316 BR 451, 460 (2004).
59. *Trenwick America Litigation Trust* v. *Ernst & Young*, 906 A 2d 168, 173, 191 (2006).
60. *Robert Solomon* v. *Credit Lyonnais Bank Nederland NV Pathe Communications Corpn.*, 672 A 2d 35 (1991).
61. Rosemary Langford, "The New Statutory Business Judgment Rule: Should it Apply to the Duty to Prevent Insolvent Trading" (1998) 16 Companies and Securities Law Journal 536.
62. Kelli A. Alces et al, "Twilight in the Zone of Insolvency: Fiduciary Duty and Creditors of Troubled Companies — Theory and Policy, 1 Journal of Business & Technology Law 292, 291-311.

The court in *Harlowe's Nominees*[63] said "directors in whom are vested the right and the duty of deciding where the company's interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts". This rule in a way limits the power of the courts to second-guess the routine business judgment. If it were otherwise and there were laws laid down on what directors ought to do, there would be perverse result affecting ultimately the conduct of the director. Now, after understanding the tests and applying them the author suggests that there are some steps that directors can take to avoid insolvency.

4. OPTIONS TO AVOID INSOLVENCY PROCEEDING

Administration of a company is a hectic task, especially when the company is in financial hardships. Every stakeholder wants their interest to be looked with more gravity than others, making it a difficult instance for the director to manage the affairs of the company.[64] The directors are obliged to take reformative actions to decrease the liability and manage the affairs of the corporation in a way to make sure that the company at any time is not compelled to liquidate. It is also important for the directors to realise that the acts which are detrimental to the interest of the stakeholders can be well within the scope of incurring personal liability to them towards the stakeholders, as explained earlier.

There are a variety of mechanisms that the company could adopt to rescue itself from the financial crunches. These mechanisms are structured, keeping in mind that the existence of company is of paramount importance. The restructuring arrangements are generally associated with corporate financing or insolvency in which there is a high risk and high amount of debt involved. Such discussions regarding restructuring all the more depends upon the framework of other legislation and how easily a nexus can be drawn from those laws into the law of insolvency.[65] It is suggested in the cases where the insolvency can be triggered at any point of time that the directors be proactive as there can be serious consequences of being reactive.

63. *Harlowe's Nominees Pty Ltd.* v. *Woodside (Lakes Entrance) Oil Co. NL*, (1968) 121 CLR 483, 493.
64. Keith Tully, "Company Insolvency Tips for Directors", The Gazette (9-7-2018, 8.57 p.m.) <https://www.thegazette.co.uk/all-notices/content/100009>.
65. Edward I. Altman & Edith Hotchkiss, *Corporate Financial Distress & Bankruptcy*, Vol. 1, 2005.

The insolvency law contains deeming provisions i.e. once the default has taken place, it would be deemed that the debtor is unable to pay the debts in spite of the fact that the decision to liquidate the company or not will be decided during the CIR proceedings. Before any creditor initiates insolvency application in the Tribunal, there are two alternatives whereby the insolvent debtor can avoid an insolvency order being made against him.

(A) The deed arrangement with creditors refers to a specific kind of arrangement; it takes into account of various accounts and affairs of the debtor. It can be broadly classified into two basic methods: (*i*) assignment of the debtor's assets for the benefit of creditors; and (*ii*) an arrangement whereby the debtor agrees to pay his creditors by instalments from earnings.

Voluntary restructuring negotiations are prevalent from some time now. The restructuring process is to be beneficial for the parties, the debtor and the creditor. Legal systems around the globe allow the debtor to enter into contracts intended to restructure the debts create an extra charge by way of hypothecation of assets to create a sense of security for the creditor.[66] The deed can encapsulate a combination of the assignment and composition and in order to give it more teeth, the guarantee of others.

(B) *Individual voluntary agreement*: Mostly the secured creditors enter into such kinds of agreement. Generally, these creditors are given strong preference in insolvency law. The debtor will have to pay the dues of each and every creditor if such application is initiated. Apart from this, the secured creditor will also get the security and may get remaining amount on liquidation left, if any, as per Section 53 IBC. This means that the secured creditor will hardly face major losses if the firm gets liquidated. To avoid such bankruptcy individual voluntary agreement is conceived to provide this choice. In English Insolvency Act such voluntary actions between the creditor and the debtor are sanctioned by the court. The Cork Report also explained the concept by saying that the deceiving creditors must get the benefit over others.[67]

Apart from all this the directors must in order to protect themselves from personal liability must maintain a clear and explicit records of all the meetings. In furtherance to this, the directors must frequently call

66. *Supra* Note 34 at 66..
67. Peter G. Eales, *Insolvency: A Practical Legal Handbook for Managers* (1st Edn., 1996) 30.

upon the meeting of Board of Directors and closely look at the company's finances. There is no explicit obligation by the law that the directors must put their personal savings into the company to protect company from getting into CIR proceedings.

(C) *Outside directors—A monetary mechanism:* The concept of outside director has emerged in response to highly publicized allegations of unchecked managerial abuses[68] across the Board. Though "outside" directors can be described in different ways, the underlying reasoning is the reliance on them as a monitoring mechanism.[69] This concept of monetary mechanism may prove to be useful for a company not only in the times of distress but also to avoid such situation. There are certain criteria that can help in analyzing the effectiveness of the outside director, namely, the length of the time period for which he has served in the company, his qualifications to affect the monitoring management, tenure of the serving Chief Executive Officer (CEO), strength of the Board of Directors and common practices amongst the corporations.[70] These are all duties of the directors; if they are not followed then they are held personally liable. The director has the utmost responsibility to work in the interest of the company, and at this point of time when each and every creditor wants to get back their money back, the creditors can make the directors liable for not performing their duties as prudent man thinks them to do.

5. A NEW WAVE OF PERSONAL LIABILITY

In spite of the presence of standard set of laws accepted predominantly across various regimes, when it comes to fiduciary duties of a company's director, there have been several advanced manifestations which can prove to be ground-breaking addition to the existent liability trend during the ante-insolvency period. These manifestations of futuristic approach to the liability trend are extending the boundaries to include various factors and tentative harms. The developments in Australia with their tax debt arrangement plans and the expansion of environmental liabilities in insolvency law bring new tang to the realm of director's liability.

68. Michael C. Jensen, "The Modern Industrial Revolution, Exit and the Failure of Internal Control Systems", (1993) 48 J. FIN. 831, 864-65.
69. Laura Lin, "Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence", (1995-1996) 90 Nw. U.L. Rev. 900, 898-976.
70. *Ibid.*, 953.

6. ATO AND INSOLVENCY LIABILITY

In 2015, in a case of "insolvent trading", directors of a petroleum company in *Smith* v. *Boné*[71] were held to be personally responsible for the payment made to ATO (Australian Taxation Office) which constituted an unfair preference to the Commissioner of Taxation. This payment which was set aside was a result of an arrangement. Petrolink negotiated with ATO, eight years prior to the liquidation date to assist in cash flow. The obligation on the director to fully compensate the Commissioner for all the losses incurred, including interest[72], in addition to the liability to indemnify ATO for the payment set aside[73] makes this case special. The reason being strict nature of personal accountability of the directors for the payment arrangement made with the executive body which was considered to be done in good faith and in a bona fide manner but lacked due diligence. The court found that the attitude of the accused director to decide the best interest of the creditors fell short to justify the exclusion from liabilities under the Act[74]. One of the prominent cases on the same issue and similar facts is *Water Wheel case*[75] which is a reminder of the risks a director may face personally if debt is incurred by the company while facing insolvency.

A defence against this liability called "good reason" was used in *Commr. of Taxation* v. *Clark*[76] where the director of a small family company relied on it stating that when she was not participating in any managerial activity and remained genuinely in ignorance of her duties, there was a "good reason" for her to not participate in those activities as it was merely an on-paper position as a director. This defence was rejected by the court on the grounds that recognizing complete abdication of director's responsibilities as a "good reason" would create several risks for the company which may undermine the confident of potential creditors in the future.

71. 2015 FCA 319.
72. Corporations Act, 2001 (50 of 2001), Australian Act S. 588F (2001).
73. *Ibid.*, S. 588GFA.
74. Emily Plucknett & Toby Boys, "Lessons from Smith v. Boné: Repayment Arrangements and Risks to Directors", Mondaq (25-5-2015), <http://www.mondaq.com/australia/x/399718/Directors+Officers/Lessons+from+Smith+v+Bon+Repayment+arrangements+and+risks+to+directors>.
75. *Australian Securities and Investments Commission* v. *Plymin*, 2003 VSC 123
76. 2003 NSWCA 91.

7. INTRODUCTION TO THE NEW ENVIRONMENT OF INSOLVENCY

As a consequence of rapid technological advancement and the recent developments in cases of companies affecting environment undergoing insolvency, environment and bankruptcy laws have come face to face with each other. This has highlighted the need to fine-tune the insolvency proceedings and the environmental liabilities in the insolvency procedure which has much recently been seen in Finnish Government of Justice's attempt to solve insolvency-related environmental and efficiency problems and propose necessary legislative changes by setting up Expert Committee of insolvency law specialists[77]. The reason for such legislation reform would be to try to help insolvent estates to clean up the environment pollution created at the first place and in the future streamlined with simplified insolvency procedures. This will help in addressing the issue of liability which in itself is very complex. Notwithstanding the foregoing, it is pertinent to mention that the clashes between environment and insolvency law are not new.

Under Section 85(2) IBC, legal proceedings in respect of any debt are stayed after the admission of the application for commencement of insolvency procedure. But it is uncontroversial in Canada for a debtor, having the benefit of stay of proceedings, to be disallowed to engage in polluting activities against environmental laws[78]. If a company is found to be contaminating the environment through owned land or otherwise, even after issuance of orders to cease such harmful activities, the regulatory body may take actions against the company, possibly the directors of the company, in terms of fines. As a last resort, a regulator exercising its right to seek reimbursement of the relevant costs might have to perform the remediation tasks itself.

Establishing a three-part regulatory monetary test known as *Abitibi test,* by the Supreme Court of Canada in 2012 in *Newfoundland* v. *AbitibiBowater Inc.*[79], the court established that the environmental remediation order will be treated as monetary claim in case the test is sat-

77. HPP Attorneys Ltd., "New Report on Bankruptcy Proceedings and Environmental Liabilities", International Law Office (6-6-2018) <https://www.internationallawoffice.com/Newsletters/Insolvency-Restructuring/Finland/HPP-Attorneys-Ltd/New-report-on-bankruptcy-proceedings-and-environmental-liabilities?utm_source=ILO+Newsletter&utm_medium=email&utm_content=Newsletter+2018-07-06&utm_campaign=Insolvency+%26+Restructuring+Newsletter>.
78. Steven J. Weisz et al., "The Ongoing Clash Between Canadian Environmental and Insolvency Law", 8, Insolvency & Restructuring Int'l, 20, 21-23 (2014).
79. 2012 SCC 67.

isfied. To satisfy the test, presence of a debt, obligation or liability owed to a creditor is necessary and must be incurred prior to the bankruptcy or insolvency. Along with it, there must be a possibility of attaching a monetary value to the debt, obligation or liability.

Subsequently, this test was applied in *Northstar*[80] and *Nortel*[81] cases. In the former case, directors themselves agreed to personally pay for the liabilities and Ministry of the Environment was deemed to be as a creditor. While in the later case, environmental liabilities were stayed as it passed the test and it was considered to be a monetary claim. The reasoning behind both the cases to treat the environmental liabilities as a part of the insolvency claims was to give a new shape to the liability as a director of an insolvent company for causing environmental damages emphasising on the value of protecting the nature.

In Brazil, the same liability is strict and personal based on possession of the area and person obtaining benefit from that area.[82] Therefore, it increases the personal accountability of the directors towards company's involvement in activities hazardous and harmful to the environment.

CONCLUSION

The sense of duties and liabilities of the director increases when the company is in suspect zone. The jurists have explained the twilight period seldom but in the article, several tests have been proposed which can be helpful to overcome the economic distress from the company. In the presence of these visible indicators it is proposed that the directors must take steps to rescue the company from the clashes of financial instability.

Though it is the duty of the director to look and adjudge the financial status of the company through the indicators as mentioned above, the skills of conducting and controlling business activities is what defines the corporate world. Therefore, these increased set of liabilities come face to face with the director's freedom to choose, take risks and make business decisions related to the well-being of the company. It can subvert the skills required in the business domain. It becomes pertinent to find a balance between the independence of the directors to carry on the business and the restrictive approach of the insolvency authorities to avoid certain

80. *Northstar Aerospace Inc., In re*, 2013 ONCA 600.
81. *Nortel Networks Corpn., In re*, 2013 ONCA 599.
82. Roberta Danelon Leonhardt et al, "Expanding Environmental Liability in Insolvency Cases: Risks for Shareholders, Managers and Practitioners under Brazilian Law", 9, Insolvency & Restructuring Int'l, 16, 20-21 (2015).

acts which are likely to cause damage to the other parties whose interests are involved. Surely, in the times of financial crisis, when the company has a good chance of going down the drain, the revival mechanism can be tricky and can risk the future of the company as well. But the risk taking must be calculated and that is where the legislative and regulatory authorities may find a way out of this conflicting situation.

Maneuver of Insolvency for MSMEs: A Honey Jinx

—Divyanshi Bansal[†] *& Shubham Kumar*[‡]

ABSTRACT

The Insolvency & Bankruptcy Code, 2016, defined a structure for resolving insolvency of firms. The Code is a one stop solution for resolving insolvencies through fast-track proceedings and offers an economically viable arrangement. However, the present Code does not take into consideration specific problems of micro, small and medium enterprises (MSMEs) and treats them at par with large corporate entities, causing them undue hardship and becomes a roadblock for successful revival of these firms.

In this study, we examine how MSMEs are different from large corporate entities due to their complex structure and unique problems. After an analysis of the official data of the firms facing insolvency, it can be concluded that more firms are getting into liquidation than resolution, which is contrary to the objective of the Code. The worst sufferer of this is the MSME sector where 70 per cent of the MSMEs are under a threat of forced liquidation.

Further, we have evaluated the specific reasons as to why more liquidation is happening in the MSME sector. Our study concludes by providing suggestions that should be incorporated in the Code which shall help in revival of MSMEs rather than pushing them into liquidation.

Keywords: *MSMEs, Separate Class, Forced Liquidation, MSMEs friendly Code.*

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INTRODUCTION

Economic freedom and economic performance are directly proportional to each other.[1] Markets need the freedom to start, continue and discontinue the business. New firms need to emerge continuously, do their business and exit when they are no more efficient. This ensures a free flow of credit from inefficient users to efficient users. Indian laws provided ease in starting and continuing of business. But when it comes to exiting, the structure of withdrawal was not well defined.

For resolving insolvency of firms in an orderly manner, a committee constituted by Reserve Bank of India (RBI), headed by Shri T. Tiwari was formed.[2] On the recommendation of this committee, Sick Industrial Companies (Special Provision) Act was first enacted in 1985 to provide timely detection of sickness in industrial companies. Thereafter, for debt recovery and rehabilitation of sick companies, the Recovery of Debts Due to Banks and Financial Institution, 1993 and the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 was passed. The problem with these enactments was that they aimed at debt recovery rather than looking at the enterprise as a going concern.[3]

The Government of India, to resolve these defects, set up a high-level committee in the year 1999 headed by V.B. Balakrishna Eradi J.[4] The committee, among others, suggested for repeal of SICA Act, 1985 and adoption of UNCITRAL Model Law as approved by the UNs in Part VII of the Companies Act, 1956. As per the recommendations of the committee, the Companies (Amendment) Act, 2002 was enacted which combined powers of courts, Board of Industrial and Financial Reconstruction (BIFR) and the Company Law Board (CLB) in one specialised body, *i.e.* National Company Law Tribunal (NCLT) in respect of liquidation and structuring of sick companies.

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1. "Freedom to Exit: The Insolvency and Bankruptcy Code, 2016 Builds the Third Pillar of Economic Freedom" (October–December 2016) 1 Quarterly Newsletter of the Insolvency and Bankruptcy Board of India.
2. Report of the Committee to Examine the Legal and Other Difficulties Faced by Banks and Financial Institutions in Rehabilitation of Sick Industrial Undertakings and Suggest Remedial Measures Including Changes in Law, Ministry of Micro, Small and Medium Enterprises, 1984.
3. Anuj Somani, "Insolvency and Bankruptcy Code, 2016 – Beneficial to Secured Creditors and how Ease of Doing Business in India has Improved" KGS Blogs, 08-4-2017, <http://www.kgsomani.com/insolvency-and-bankruptcy-code-2016-beneficial-to-secured-creditors-and-how-ease-of-doing-business-in-india-has-improved/>.
4. Report of the High Level Committee on Law Relating to Insolvency and Winding up of Companies, Ministry of Law, Justice and Company Affairs, 2000.

In 2001, for the first time, N.L. Mitra Committee recommended for separate and consolidated insolvency and bankruptcy laws.[5] In 2005, J.J. Irani Committee suggested a central law to guide the companies, from registration and continuing till the liquidation of a company.[6] In order to ensure consistency with the international standards, the government constituted a Bankruptcy Law Reform Committee (BLRC) under the Chairmanship of T.K. Viswanathan. Hon'ble Finance Minister in his budget speech for 2015–16 stated:

> "Bankruptcy law reform, that brings about legal certainty and speed, has been identified as a key priority for improving the ease of doing business. SICA and BIFR have failed in achieving these objectives. We will bring a comprehensive Bankruptcy Code in fiscal 2015–16, that will meet global standards and provide necessary judicial capacity."[7]

Pursuant to this, on 28 May 2016, the Insolvency and Bankruptcy Code, 2016 came into effect.

The Preamble of the Code seeks to reorganise corporate persons, partnership firms, and individuals in times of financial distress. The NCLT president Mr M.M. Kumar has stated the objective of the Code and said, "The sole objective of the Insolvency and Bankruptcy Code 2016 is to find solutions for stressed assets arisen out of non-performing assets with best of intent as so many things are involved in the process and liquidation perforce would be the last way out which the tribunal would avoid optimally."[8]

In *Prowess International (P) Ltd.* v. *Parker Hannifin India (P) Ltd.*[9], the NCLAT has observed that the object of the Code is the reorganisation of firms and not liquidation. The tribunal said:

> I&B Code, 2016 is an Act relating to reorganization and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximization of the value of assets of such person and to promote entrepreneurship, availability of credit and balance the interest of all the stakeholders including the Government dues. Such being the object of the I&B Code, 2016 if the interest of all stakeholders are balanced and satisfied then to promote entrepreneurship and to ensure that the company continues to function as ongoing concern.[10]

5. Report of The Advisory Group on Bankruptcy Laws, Reserve Bank of India, 2001.
6. Report of the Expert Committee on Company Law, Ministry of Company Affairs, 2005.
7. "Comprehensive 'Bankruptcy Code' proposed", The Hindu,1-3-2015.
8. "IBC's Objective not to Emphasize on Liquidation: NCLT", The Economic Times, 3-1-2018.
9. 2017 SCC OnLine NCLAT 388.
10. *Ibid.*

The Insolvency and Bankruptcy Code, 2016 enacted to strengthen the ease of doing business in India, provides for insolvency framework for corporate entities, partnerships and sole proprietors. The Code acts as an umbrella legislation for all. However, the Code has completely ignored the complexities of MSMEs.

1. STRUCTURE OF MSMES

MSMEs form the backbone of Indian economy and have significantly contributed to the entrepreneurial endeavours. The estimated number of MSMEs is 42.50 million and accounts for 95 per cent of the total industrial units in the country. The sector produces more than 6000 products and accounts for 45 per cent of the total Indian manufacturing output and 40 per cent of the total exports. The current fixed assets of the sector amounts to INR 1, 471, 912. 94 crores.[11] The share of MSMEs in gross domestic product stands at 28.77 per cent and employs around 11.10 crore people.[12]

The MSMEs have been segregated into two categories, manufacturing enterprises[13] and service enterprises.[14] The investment capacity is restricted to INR ten crores and INR five crores respectively. Due to their small size, they have limited working capital and are dependent exclusively on finance from public sector banks. However, banks are unwilling to lend due to their higher risk profile owing to zero collateral or their limited years of operation. Their source of funding ranges from 15 per cent from internal sources, 25 per cent from banks and financial institutions and 10 per cent from capital markets. Around 50 per cent of the funding is funded through alternative funding sources including friends and family, trade credits, etc.[15] The mode of the business in MSMEs is majorly sole-proprietorship based. Ninety five per cent of them are

11. Archana Sinha, "Micro, Small & Medium Industry", Confederation of Indian Industry, <http://www.cii.in/Sectors.aspx?enc=prvePUj2bdMtgTmvPwvisYH+5EnGjyGX-O9hLECvTuNuXK6QP3tp4gPGuPr/xpT2f>, (accessed 8-6-2018).
12. Annual Report, Ministry of Small, Micro and Medium Enterprises, Government of India, 2017–18.
13. The enterprises engaged in the manufacture or production of goods pertaining to any industry specified in the First Schedule to the Industries (Development and Regulation) Act, 1951 or employing plant and machinery in the process of value addition to the final product having a distinct name or character or use.
14. The enterprises engaged in providing or rendering of services and are defined in terms of investment in equipment as per the Micro, Small and Medium Enterprises Development Act, 2006.
15. Vision 2020: Implications for MSMEs, The Federation of Indian Chambers of Commerce and Industry <http://ficci.in/spdocument/20143/Grant-Thornton-FICCI%20MSME.pdf>, (accessed 14-7-2018).

registered as sole-proprietors, while three per cent of them are registered as companies and rest are in the form of partnership or co-operative societies.[16]

One size does not fit all. The Insolvency and Bankruptcy Code, 2016 treats MSMEs at par with large corporate entities, ignoring their complexities. These complexities have been elaborated below:

1.1 MSMEs lack incentives to access the insolvency procedure

MSMEs entrepreneurs are usually not qualified professionals and do not possess enough resources to hire professionals. This leads to a lack of sophistication to identify and react to financial distress.[17] This results in MSMEs losing the value of their assets. Also in many cases, it has been seen, where MSMEs are run by individuals and their families, there is often a social barrier[18] and reputational stigma which discourages MSMEs entrepreneurs from resorting to formal insolvency proceedings. For MSMEs, another disincentive to seek timely remedies under the Insolvency Code is automatic separation of management of the business from the entrepreneur. MSMEs are usually small businesses where the promoter of the business is also engaged in managing the business. The risk of losing their business which is their only source of income makes them reluctant to access the insolvency system.[19] The copious documentation including the legal requirement to file an audited balance sheet and the uncertainties associated with the cost of the proceeding are other barriers for MSME entrepreneur to access the insolvency framework.[20]

1.2 MSMEs creditors' reluctant to initiate insolvency

Under the Insolvency Code, both debtors and creditor have a duty to resolve the business issue and get the firm back on track. However, in cases of MSMEs, these firm possess very limited resource and creditors

16. Annual Report, Ministry of Small, Micro and Medium Enterprises, Government of India, 2017–18.
17. Roberto D'Imperio, "Growing the Global Economy Through SMEs", Edinburgh Group, <http://www.edinburgh-group. org/media/2776/edinburgh_group_research growing_the_global_economy_through_smes.pdf>, (accessed 10-6-2018).
18. Mahesh Uttamchandani and Antonia Menezes, "The Freedom to Fail: Why Small Business Insolvency Regimes are Critical for Emerging Markets, International Corporate Rescue" (2010) 7 (4): 262–68.
19. Report on the Treatment of MSME Insolvency, World Bank Group Insolvency and Creditor/Debtor Regime Task Force, 2017.
20. *Ibid*.

do not expect much return. Where the costs of proceedings outweigh returns, the creditors make a rational decision not to get involved.[21] On the other hand, in large enterprises insolvency cases, their value of assets is high and the creditor's potential chance of recovery of debt is also increased. In such cases, the returns outweigh the costs and so the creditors are more active in the insolvency process.[22] Creditor's passivity often results into a blockade to successful resolution plans, forcing companies into liquidation even where the business was viable. Even the secured creditors are more interested in the enforcement of their security rather than successful revivals.

1.3 MSMEs difficulty in raising finance during insolvency

The Insolvency Code does not provide for easy financial access to MSMEs for post-commencement filing. Raising of interim finance for the firm is difficult since lenders are quite reluctant to lend the sick firms. Banks are facing the problems of rising NPAs. The rescue of viable MSMEs may happen only if the business receives financing. Large corporates have many lines of creditors but when it comes to MSMEs, they are dependent only on one or two creditors to finance their business. Since creditors approval is necessary for raising interim finance, the discretion of Committee of Creditors (CoC) makes it difficult to raise interim finance.

1.4 Overlap of business insolvency law and personal insolvency laws in case of MSMEs

There exists vast heterogeneity in the form of ownership in the MSME sector, 95 per cent of which are owned by sole proprietors. The rest of them are either registered as partnership firms or co-operatives or public or private companies.[23] The purpose of the business insolvency regime is to ensure timely resolution of debt and maximum value realisation by the creditors whereas personal insolvency regime balances the distribution of value to creditors with a basis for the debtor to continue his/her economic life.[24] In large corporate entities, the liability of the directors, promoters and shareholders are limited to their shares. However, when it comes

21. *Ibid*.
22. Andrea Polo, "Secured Creditor Control in Bankruptcy, Costs and Conflict" <http://www.istfin.eco.usi.ch/polo-jmp-200224.pdf>, (accessed 11-6-2018).
23. Annual Report, Ministry of Small, Micro and Medium Enterprises, Government of India, 2017–18.
24. Sumant Batra, "IBC and MSME Insolvency" June 2017, <http://www.insolindia.com/uploads_insol/resources/files/ibc-and-msme-insolvency-1048.pdf>, (accessed 13-6-2018).

to MSMEs, there does not exist any difference between business and the person operating it. The MSME proprietors usually give a personal guarantee against business loans. As a result, during insolvency, where the value of personal assets of the entrepreneur is greater than the value of the business, the creditors would be encouraged to move against the personal assets of the business owner. In such cases, the debtors' personal life comes to a halt and discourages him to undertake any further entrepreneurial activities. Another concern which will arise, after Part III of the Code comes under effect, is that parallel proceedings can be initiated against MSME entrepreneurs, one under personal insolvency regime and another under business insolvency regime.

1.5 Limited information during insolvency

In India, there is no legal requirement for MSMEs to maintain formal books of accounts.[25] One of the main obstacles due to improper account keeping is that the Resolution Professional (RP) cannot provide necessary information to the parties interested in formulating a resolution plan. No account keeping also makes it hard for an MSME to judge whether it is approaching insolvency. For voluntary insolvency proceedings, the Code requires detailed financial records of the debtor. In the absence of improper record keeping, this sector faces a problem in timely filing of insolvency proceedings. On the other hand, large corporations often maintain sophisticated records and are available to all stakeholders. The problem of improper account keeping leads to closure of the business.[26]

1.6 A vicious cycle of insolvency for MSMEs

MSMEs are generally operational creditors to large corporate enterprises. When these large units face insolvency, it affects the business of MSMEs directly. Distressed units delay payments to MSMEs and a cash flow crunch arises. This triggers a cycle of distress events in the MSMEs. MSMEs start delaying payments to its creditors followed by a delay in payment of salaries to employees and further delay in payment of bank loans.[27] Since, in the liquidation process, the operational creditors are

25. Kalainathan Koperunthevy and K. Vijayarani, "Accounting System in Small Scale Enterprises: A Case Study" (2013) 1 (1) Primax International Journal of Commerce and Management Research, 1–8.
26. Rahul Kumawat, "Small Business Accounting: Why it is Essential for SMEs to go for Book Keeping" The Economic Times, 6-2-2017.
27. K.V. Subramanyam, "Insolvency and Bankruptcy Code-2016-A Ray of Hope for Distressed MSMEs in India" SME Advisors, <http://www.smeadvisors.in/

kept down the line after repayment to workers, employees and secured creditors,[28] the operational creditors are not able to realise their debts, and hence MSMEs which are usually operational creditors are pushed into the insolvency process. Therefore, on this basis, the dependency of MSME entrepreneurs on large enterprises is more and accordingly, special provisions for repayment to MSMEs should be incorporated.

Treating everyone equally would in itself be a violation of Article 14 of the Constitution.[29] Article 14 envisages equals to be treated equally and unequals to be treated unequally.[30] Merely because they are small does not mean they are less complex. The Code fails to address the complexities and challenges faced by MSMEs during Corporate Insolvency Resolution Process (CIRP) and treats them at par with large corporate entities when admitted under insolvency proceedings. This has resulted in MSMEs getting forced into liquidation since the existing regime fails to cure their special needs. A report by the *Business Standard* states that nearly 70 per cent of stressed SMEs face liquidation under the existing Code.[31]

2. MSMES AND INSOLVENCY LAWS

On analysis of the preliminary data on insolvency proceedings, a serious issue crops up for consideration. As per the reports of *Financial Express*[32] and *Business Standard*[33], the Code in the initial stage, has failed to achieve its objectives. More firms are going into liquidation. Only a handful of firms have been revived under the Code. The Insolvency and Bankruptcy Board of India (IBBI) chief Mr M.S. Sahoo says that more firms under the Code are going into liquidation.[34] A study of data available will present a clear picture of the issue. As per the data released by the IBBI, in the year 2017, 540 corporates were admitted for resolution. Out of them, only 10 corporates could be restructured and as 148 companies

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insolvency-and-bankruptcy-code-2016-ibc-2016-a-ray-of-hope-for-distressed-smes-in-india> last accessed 17-6-2018.

28. Insolvency and Bankruptcy Code, 2016, S. 53.
29. *Coimbatore District Central Coop. Bank* v. *Employees Assn.*, (2007) 4 SCC 669.
30. Mahendra Pal Singh, *V.N. Shukla's Constitution of India* (13th Edn. 2017).
31. Veena Mani, "Nearly 70% of Stressed SMEs face Liquidation" Business Standards, 30-11-2017.
32. Banikinkar Pattanayak, "Insolvency Law: More Firms Going for Liquidation than Resolution; Over 20 Face Closure", Financial Express, 25-12-2017.
33. Namrata Acharya, "IBC Proceedings: 78 Liquidation Orders, a Handful of Resolutions", Business Standard, 22-4-2018.
34. Ians, "IBC's Objective is to Keep the Firm Alive, Says Bankruptcy Board Chief MS Sahoo", Business Standards, 9-6-2018.

underwent liquidation and the rest of there are under different stages of the CIRP.[35]

S. No.	Name of Corporate Debtor	Whether under BIFR	Date of CIRP Commen-cement	Date of Approval of Resolution	Liquidation Value (Rs in crores)	Realisation by FCs (Rs in crore)	Claim by FCs	Realisation by FCs (%)
1.	Synergies Dooray Automotive limited	Yes	23-1-17	02-8-17	8.17	54.69	972.15	5.63
2.	Chapparia Industries Pvt. Ltd.	Yes	24-2-17	29.-10-17	17.15	20.60	49.75	41.41
3.	Prowess International Pvt. Ltd.	No	20.-4-17	17-10-17	NC	3.42		
4.	Sree Metalik Ltd.	No	30.-1-17	07-11-17	283	607.31	1287.23	7.18
5.	West Bengal Essential Commodities Supply Corp. Ltd.	No	29-5-17	20-11-17	NC	185.84	359.15	51.74
6.	Kamineni Steel & Power India Ltd.	Yes	10.-2-17	27.-11-17	760	600	1508.88	39-76
7.	Shirdi Industries Ltd.	Yes	18-5-17	12-1217	103.05	176.36	673.88	26.16
8.	Hotel Gaudavan Pvt. Ltd.	No	31-3-17	13-12-17	36.12	44.21	70.84	62.41
9.	Nandan Hotels Ltd.	No	17-8-17	14-12-17	NC	1.38	NA	
10.	JEKPL Pvt. Ltd.	No	17-3-17	15-12-17	222.06	162.00	599.00	27.05

This needs further deliberation as to what is the roadblock to successful revivals of defaulting MSMEs under the Act. Some of the causes are highlighted herein:

35. "Resolution: The Soul of IBC", (October–December 2017) 5 Quarterly Newsletter of Insolvency and Bankruptcy Board of India 10 & 11.

1. **No review of resolution plan:** As per Section 31 of the Code, Adjudicating Authority comes into play only after the resolution plan is approved by CoC. If the CoC rejects the plan, the Adjudicating Authority shall have no role to play except to pass an order for liquidation. In *JEKPL (P) Ltd.*[36], it was held that Adjudicating Authority is not expected to substitute the commercial wisdom of Resolution Professional and CoC, nor should it deal with technical complexity and merits of resolution plan unless it is found contrary to express provision of law and goes against the public interest. The Adjudicating Authority has no discretion to examine whether resolution plan is better than liquidation. This discretion can be wrongly exercised by the CoC if there is no check by the Adjudicating Authority regarding the same. David Richards J, in *T&N Ltd., In re*[37], said that creditors are likely to favour liquidation process as it assures them certain money within a specified time frame. Thus, the CoC is more in favour of liquidation as it assures them return of money they have invested in the company in a specified time. It might not be the most profitable deal but has certainty regarding amount they are assured to be given. Since they are the decision-making body as per the Code and until their acts are not in contravention of the Code, the Adjudicating Authority cannot intervene in it.[38] Therefore, the discretion of the creditors as provided in the Code itself leads CoC deciding more for liquidation than the resolution of the company which involves a long process with uncertainty whether it will succeed or not.
2. **A high percentage of majority for approval of resolution plan:** Prior to the Ordinance, 75 per cent voting approval was to decide 100 per cent creditors' stake as well as other stakeholders' stake, for which the statute set out an approval with not less than 75 per cent voting of the CoC.[39] Thus, the fate of a company and all its stakeholders are in the hand of the CoC's discretion which was in itself a little unfair for other stakeholders. Adding to the vulnerability of the other stakeholders, the Ordinance of June 2018 has for certain decisions of the committee, reduced the voting threshold from 75 per cent to 66 per cent including for approval of the resolution

36. *JEKPL (P) Ltd., In re*, CA No. 233 /2017 in CP No. 24/ALD/2017; order dt. 15-12-2017 (NCLT).
37. (2005) 2 BCLC 4882.
38. *Gupta Energy (P) Ltd* v. *Maharashtra Electricity Regulatory Commission,* Appeal No. 16 of 2016 & IA No. 34 of 2016.
39. *Ibid.*

plan.[40] The decision-making will be quick on the reduction of the approval threshold percentage from existing 75 per cent to 66 per cent of CoC. This reduction may support a faster resolution process and may have a greater number of resolution plans, but it could lead to handful of majority lenders with over 51 per cent of debts getting a free hand in determining the fate of the borrower, without regards to the interests of other stakeholders, particularly the operational creditors.[41] Thus, it has further strengthened certain creditors' exercising their discretion and tailor the plan best suited for them to recover their debt from the corporate debtor. Therefore, if they are interested in recovering their dues instead of restructuring the firm, they can exercise their discretion and liquidate the firm.

3. **Difficulty in raising interim finances:** Interim finance is defined under Section 5(15) of the Code and is termed as any "financial debt" which is raised by the Interim Resolution Professional (IRP)/ Resolution Professional (RP) during CIRP to finance the cost of going through CIRP. However, raising of interim finance has not been a cakewalk. Lenders are reluctant to allow interim loans from other creditors as they fear losing charge over the assets. They want, in no case, to risk the recovery of the debt amount. Their ultimate motive is the recovery of debt rather than taking care of the well-being of the corporate debtor. A report by Ernst & Young showed that "despite the priority given to interim finance by the Code, the existing lenders have been extremely reluctant in releasing interim finance."[42] In case there is an external financier who is ready to provide interim finances, it still has to be approved by the CoC which has not been an easy process.[43] Moreover, at present, most lenders are reluctant to fund companies facing bankruptcy proceedings because lenders may lose out if the company goes for liquidation since they are not entitled to receive interest on the loan from the date liquidation of assets is ordered by bankruptcy courts.[44] Another concern while raising interim finance is that the

40. The Insolvency and Bankruptcy Code (Amendment) Ordinance, 2018.
41. Sikha Bansal, "Insolvency and Bankruptcy (Amendment) Ordinance, 2018—Effects & Impacts" [2018] 94 taxmann.com 109 (Article).
42. Abizer Diwanji, "Experiencing the Code: Corporate Insolvency in India" Ernst and Young, August 2017 <https://www.ey.com/Publication/vwLUAssets/ey-IBC-experiencing-the-code/$FILE/ey-ibc-experiencing-the-code.pdf>, (accessed 13-7-2018).
43. *JK Jute Mills Co.* v. *Surendra Trading Co.* (arising out of order dt. 9-3-2017 passed by NCLT, Allahabad Bench in CP No. 19/Ald/2017).
44. Sangita Mehta, "Give Interest to Lenders to Companies under IBC: Panel" Economic Times, 20-3-2018.

non-performing assets of the banks are on a rise. The macro stress test for credit risk indicates that under the baseline macro scenario, the gross non-performing advances ratio may increase to 10.8 per cent by March 2018 and further to 11.1 per cent by September 2018.[45] In such scenario, banks are not ready to provide interim finances.

4. **Delay in the process:** In the case of *JK Jute Mills Co.*[46], it was held that the enterprise value of the firm reduces exponentially with time as prolonged uncertainty about its ownership and control leads to a flight amongst customers, vendors, workers, etc. Thus, the essence of Code is the timeline. The longer the delay, the more likely it is that liquidation will be the only answer. Hence, when delays induce liquidation, there is value destruction.[47] For instance, *firstly*, the Ordinance provides that the corporate debtor can file insolvency commencement petition only if its shareholders pass a special resolution,[48] adding one more layer to the process and resultant delay in insolvency process initiation by the corporate debtor.[49] *Secondly*, prior to the Ordinance, the Adjudicating Authority had no role in effective implementation of the resolution plan. The Ordinance floated in June, 2018 now specifies that the NCLT must ensure that a resolution plan is effectively implemented. A similar provision was present in the Sick Industrial Companies Act, 1985 and it was seen that this resulted in a delay of the resolution process.[50] Further, once the plan has been approved, the resolution applicant must obtain necessary approvals, required by law, within a period of one year from such approval. These instances of delay induces the CoC to opt for liquidation over resolution.
5. **The inadequacy of information utility:** Under the IBC, Information Utility would be the entities that would act as data repositories of financial information which would facilitate the insolvency resolution process in a time bound manner. The Code mandates

45. "Financial Institutions: Soundness and Resilience" (Reserve Bank of India, December 2017) <https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/06FC2_211217392 F55E409 AB4B6B94DBA36D84259F2B.PDF>, (accessed 12-7-2018).
46. *JK Jute Mills Co.* v. *Surendra Trading Co.* (arising out of order dt. 9-3-2017 passed by NCLT, Allahabad Bench in CP No. 19/Ald/2017).
47. *Mobilox Innovations (P) Ltd.*v. *Kirusa Software (P) Ltd.*, [2017] 1 IBJ (JP) 2.
48. The Insolvency and Bankruptcy Code (Amendment) Ordinance, 2018.
49. Sangita Mehta, "Amendment to IBC will Help Small Stakeholders but Delay Resolution" Economic Times, 11-6-2018.
50. Bankruptcy Law Reform Committee, The Report of the Bankruptcy Law Reforms Committee, Vol. I: Rationale and Design (November 2015).

that financial creditors seeking to file an insolvency application is required to furnish a copy of the evidence of the default recorded with the IU.[51] Certain challenges related to IUs stands as follow: *firstly,* without having adequate number of IUs and its infrastructure in place, it is hard for IRP/IPs to gather required information under the Code within the defined timelines, and *secondly*, the IUs regulations prescribe that on receipt of information of default, an IU shall expeditiously undertake the process of authentication and verification of information.[52] At the stage of default, the parties will not cooperate and hence authentication should be ensured at the time of registration itself in order to be effective. However, correction obligations rest with the users only and the IU cannot make any changes unilaterally. In all cases where data correction has been sought a clear mechanism whereby any changes in the data should be made by the IU only after the said change has been certified as correct by both the corporate debtor/individual and the creditor. This is the only way in which the IU shall retain its independence and remain a neutral party in the insolvency proceedings.

6. **No buyback by Assets Reconstruction Companies:** The major problem that is being faced while restructuring the companies, is that the Asset Reconstruction Companies (ARCs) are not interested in the buyback of assets. Therefore, the debt cannot be effectively restructured. This is leading to failure of resolution plans and forcing companies into liquidations. The challenges posed for ARCs are many. *Firstly*, funds available with ARCs are minuscule compared to the vast NPA market. *Secondly*, even if funds are available, the price expectation mismatch between selling bank(s) and buying ARC and an ever elusive consensus on an acceptable valuation framework. *Thirdly,* even if an ARC acquires the NPA of a particular bank, it does not explain how to expeditiously aggregate loans from all other creditors who have complex and deep-rooted inter-creditor issues to achieve threshold level for driving resolution—generally 66 per cent of the debt, though for sale of the asset through SARFAESI is 60 per cent. A more important component in resolution beyond debt aggregation is how to address challenges in resolution including finding fresh money, management and

51. Insolvency and Bankruptcy Board (Information Utilities) Regulations, 2017, R. 8.
52. Satish Pillai, "Information Utility—The Eyes and Ears of the Bankruptcy Code", ICSI Insolvency and Bankruptcy Journal, (2017) 1 IBJ (Art.), <http://www.claonline.in/ICSI_Journal/ICSI_Journal_Sample.pdf>, (accessed 14-7-2015).

> technology to revive the asset. Finally, how to have an exit clause for the investors. The ARCs have to address all these.[53]

In India, every year approximately 80,000 MSMEs are declared sick.[54] The high rate of failure can be attributed to factors like undiversified suppliers and customers, no legal and financial experts to assist in day-to-day business, unmet credit to this sector and lenders charging very high rate of interest and the personal guarantee of the business loan by MSMEs owners. Since, MSMEs are large users of the insolvency system, it becomes necessary to ask whether existing insolvency framework address the need of MSMEs.

3. KEY RECOMMENDATIONS

MSMEs are the cradle of "Make in India" policy of our Hon'ble Prime Minister. They are the storehouse of creative and nascent talent that shall lead India out of poverty and unemployment. To ensure that MSMEs keep running their business, it is necessary that they should have an exit policy suitable to their specific needs. Without successful exits, entrepreneurial talents gets killed. MSMEs fail because of financial distress, debts, lack of technology, human resources, market challenges, recessions, etc.[55] Their revival is necessary so that we do not lose young talent from the market.

In 2010, to study the problem of MSMEs, a task force was set up. The committee realised that MSMEs have unique problems. Limited access to credit, vulnerability to fluctuations in the business environment and a lack of expertise compels MSMEs, otherwise having bright and innovative ideas, to lose their business and drive to the insolvency proceedings. The committee suggested a policy for helping viable enterprises facing temporary issues to continue while allowing the others to close down. The subgroup on exit policy suggested that insolvency of MSMEs be dealt by a *Personal Insolvency Code*. Since MSMEs have complex issues, those issues should be dealt with by a specialised quasi-judicial body which shall analyse the viability and set up time bound closure plans. The subgroups also studied the problem of attachment of personal assets

53. "Assets Reconstruction Companies: The story so far" Price Waterhouse Copper, 12-2-2018, <https://www.pwc.in/publications/2018/asset-reconstruction-companies-in-india-the-story-so-far.html>.
54. SIDBI Report on Small, Micro and Medium Enterprises, Small Industries Development Bank of India (2010).
55. Atisha Singh & Urvashi Shahi, "Exit Options for Distressed Micro, Small and Medium Enterprise in India" (2017) 3 (5) Imperial Journal of Interdisciplinary Research (IJIR).

in case of business failure since an MSMEs entrepreneur usually gives a personal guarantee to loans and suggested for separation of business assets from personal assets.[56] In 2015, another committee was set up to examine the financial structure of MSMEs which suggested in favour of a separate code for a simplified dissolution of MSMEs.[57] The report of the One Man Committee constituted to make recommendations for a National Policy for Micro, Small and Medium Enterprises also accepted the fact that the Insolvency and Bankruptcy Code is too stringent for the MSMEs as a creditor can approach for a small amount of default, the management of the company gets taken over by insolvency experts and the entire staff and labour stands dismissed. The committee observed that the Insolvency Code is applicable to large companies and recommended special provisions for MSMEs such as trying of MSME insolvency cases by special Benches, simplified compliance requirement, etc.[58]

In lights of the abovementioned complexities and suggestions of various the committee, the author proposes for an amendment in the Insolvency and Bankruptcy Code, 2016 by adding a separate chapter that shall deal with exits of MSMEs. The Code shall act as an umbrella legislation for MSMEs incorporated either in form of company or sole proprietorship or partnership.

3.1 Features that shall be incorporated in the chapter dealing with insolvency of MSMEs

1. **Change in the Adjudication Authority:** Under the present Code, the Adjudicating Authority for a corporate person is NCLT[59] and for individual and partnership, Debt Recovery Tribunal (DRT) is proposed as the Adjudicating Authority. Since a large number of MSMEs are sole proprietorship, they fall under the jurisdiction of DRTs. Constituting DRTs as Adjudicating Authorities will further add to the beleaguered status of DRTs.[60] The current DRTs set up across the country have huge pendency of cases and are already

56. Report of Prime Minister's Task Force on Micro, Small and Medium Enterprises, PMO, Government of India, (2010).
57. Report of the Committee set up to Examine the Financial Architecture of the MSME Sector, Ministry of Finance, (2015).
58. Report of the One Man Committee constituted to make Recommendations for a National Policy for Micro, Small and Medium Enterprises, Ministry of Micro, Small and Medium Enterprises, (2017).
59. Insolvency and Bankruptcy Code, 2016, S. 5(1).
60. Report of the Expert Committee on Company Law, Ministry of Company Affairs, 2005.

beset with inadequate infrastructure and staffing.[61] For specialised needs of MSMEs, the author proposes that the Adjudicating Authority for MSMEs be established in every district by the State Government in consultation with their respective High Courts. This shall ensure a timely exit for MSMEs and speedy disposal of cases.

2. **Scheme for rehabilitation of MSMEs:** As we have studied the problems faced in raising interim finances, it is proposed that under the new chapter a provision shall be incorporated wherein Central Government/State Government/RBI can come forward to frame schemes for rehabilitation of sick MSMEs by providing them a one-time package or means of a One Time Settlement Schemes, etc.
3. **Demand notice before initiation of insolvency proceedings:** As per the present Code in case of insolvency of corporate person, a demand notice is to be served by an operational creditor, however, no such demand notice is required to be sent by a financial creditor.[62] In case of insolvency of individuals and partnership, the creditors are required to send 14 days prior notice.[63] Since MSMEs have a longer business cycle and it takes time for them to realise their debts from their creditors, under the new chapter, provisions shall be made for a prior 60-day demand notice before initiating the insolvency process. Such notice shall be served by all types of creditors before the IRP.
4. **Formulation of resolution plan:** Under the present Code, for corporate persons, any person is entitled to submit a resolution plan[64] and the proposed insolvency process of individuals and partnership empower only the debtor to submit a resolution plan.[65] Since most

61. See following website for data published by DRT/DRAT, which mentions that pending matters in April 2016 before DRT are 50,511 matters (for original application pendency) and 19,430 matters (for securitisation application pendency) [Source: <http://drt.gov.in/ Pendency.aspx?page=DRTOAMonthWiseDisposal>], whilst in the same month, the disposal of matters is 796 (for original applications) and 294 (for securitisation applications) [Source: <http://drt.gov.in/OADisposal.aspx?page=DRTOAMonthWiseDisposal>]. Further following news articles: <http://timesofindia.indiatimes.com/business/india-business/Forget-grounding-defaulters-DRTs-ill-equipped-for-recovery/articleshow/51386635.cms>; <http://www.dnaindia.com/money/report-average-annual-loan-recovery-rate-under-debt-recovery-tribunal-estimated-at-25-report-2188028>; <http://articles.economictimes.indiatimes.com/2016-03-10/news/71382272_1_drts-debt-recovery-lakh-crore>; <http://www.thehindubusinessline.com/economy/unsettled-cases-with-debt-recoverytribunals-on-the-rise-economic-survey/article8286181.ece>.
62. Insolvency and Bankruptcy Code, 2016, S. 8.
63. *Ibid*, S. 95.
64. *Ibid*, S. 30.
65. *Ibid*, S. 105.

of the MSMEs are sole proprietorship, they will be regulated by Section 105 wherein the creditors will be barred from submitting a resolution plan. In the new chapter for MSMEs, provisions shall be incorporated where both the creditor and the debtor can present a resolution plan. Since the object of the Code is revival of the firm where the firm is viable, it is often seen that creditors are disinterested in presentation of revival plans and owners of MSMEs often lack technical expertise to draft a revival plan, it will be in the interest of the Code that a provision should be incorporated which will mandate RP to formulate a revival plan if no plan is presented by the debtor or creditor. Such a resolution plan formulated by the RP should be presented to the CoC for their approval to balance their interest and then to the Adjudicating Authority for their final approval.

5. **Management of the enterprise shall not be transferred:** Since the transfer of management of an enterprises to the RP plays a deterrent effect on MSMEs entrepreneur to access the insolvency process, the new chapter should incorporate provisions, whereby the management of the firm does not go out of his hand, instead he shall be in-charge of day-to-day affairs of the firm and the RP shall act as a trustee who shall oversee the affairs of the entrepreneur.
6. **Appellate Authority shall have a final say:** As per the present Code dealing with the insolvency of corporate persons, if a resolution plan gets rejected by CoC, no appeal can be made against their decision. The reasons why the CoC choose to reject a resolution plan have been dealt with above. In such cases even if the firm is viable, it is liquidated. Under the new chapter of the insolvency of MSMEs provisions of appeal against the decision of CoC shall be incorporated and the Appellate Authority shall have a final say in approval of resolution plan even when it is rejected by CoC.
7. **Informal procedures to be adopted:** Formal insolvency procedures involve High Courts and a consequent delay in proceedings. Therefore, an easy mechanism for restructuring such as out of court debt restructuring should be encouraged more as an option in case of MSMEs than formal procedure. Out of court debt restructuring involves changing the composition and/or structure of assets and liabilities of debtors in financial difficulty, and with the objective of promoting efficiency, restoring growth, and minimising the costs associated with the debtor's financial difficulties. They

include measures that restructure the debtor's business (operational restructuring), and measures that restructure the debtor's finances (financial restructuring). In Part III of the IBC, out of court settlement can be allowed by Adjudicating Authority only on request of RP.[66] It cannot be initiated by a debtor or a creditor. Therefore, out of court settlement mechanism like corporate debt restructuring, etc. should be promoted. In addition to this, insolvency professionals must be allowed to give professional advice for out of court debt restructuring for the MSMEs.

8. **Proportionate cost of insolvency resolution process:** As discussed earlier, the insolvency resolution process results in a very high cost which the MSMEs are unable to bear. Therefore, the new chapter in the Code shall ensure regulation of fees charged by the IRP's. The standard should be kept, keeping in view the investment capacity of the enterprise involved in the insolvency proceedings.
9. **Raising the lower threshold in fresh start process:** As per Part III of the Code, the eligibility criteria for a debtor to apply for a fresh start process are too restrictive, such as not having a gross annual income over Rs 60,000; or net asset value of over Rs 20,000; or having a debt above the value of Rs 35,000.[67] These criteria will hardly cover any enterprise in need for the benefits of these provisions. Since, investment in MSMEs can range upto 10 crores, the lower threshold limit should be raised in the new chapter so that more and more firms can avail such benefits.
10. **Fast-track insolvency resolution process for all types of business organisation:** As discussed earlier, delays in the insolvency resolution process leads to a decrease in value of the asset. Presently, the Code contains provisions for fast track proceedings, however, the benefits of this is limited only to corporate persons, as defined under the Companies Act, 2013, or a startup, or an unlisted company with total assets under Rs 10,000,000.[68] These are, hence, not applicable to MSMEs since 95 per cent of them are in the form of sole-proprietorship. The new chapter in the Code should incorporate provisions for timely exits of the MSMEs and speedy disposal of their cases and, therefore, by providing fast-track mechanisms for all types of MSMEs including companies, sole-proprietors, partnerships, etc.

66. *Ibid*, S. 100(2).
67. *Ibid*, S. 80.
68. *Ibid*, Chap. IV, Part II.

CONCLUSION

MSMEs are the "the engine of our economy" and have significantly contributed to the economic growth in the country. It is the backbone of our economy, with the competence to transform our country's landscape from developing to developed. It is one of the biggest employers of workforce, manufactures over 6000 products, and contributes to 40 per cent of our exports. For the development and growth of the economy, it is necessary that sick MSMEs make a timely exit and new firms fills up the vacuum.

For timely exit of all the firms, the Insolvency and Bankruptcy Code, 2016 was enacted. However, the Code does not provide any stimulus for MSMEs and their creditors to access the insolvency process. It ignores their specific needs and treats them at the same pedestal with large corporate houses who are usually borrowers of huge amounts. In contrast to them, MSMEs are small borrowers. Treating two varied classes of entities under the same law, whose problems differ completely, is leading to pushing one of them into forced liquidations. The causes for failure of MSMEs is not identical to those of the large business houses. Therefore, it becomes important that insolvency redressal mechanism for the specific challenges faced by MSMEs should not hinder entrepreneurial endeavours. Provisions of insolvency for MSMEs, therefore, should be distinct from that for the corporates. MSMEs should be treated with a tailor-made mechanism to suit their needs while they face insolvency.

Demystifying the Impact of Hybrid Instruments: An Undetected Minefield in Indian Insolvency Landscape

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ABSTRACT

The capital structures of corporate entities are no longer restricted to pure debt or equity but are increasingly being dominated by hybrid instruments. Formed by a cross of debt and equity features, the duality inherent in such instruments poses a major challenge to the Indian insolvency regimes. Characterisation of a predominantly debt instrument as equity or vice versa can have adverse consequences on the corporate insolvency resolution process or the liquidation mechanism. The Insolvency and Bankruptcy Code, 2016 (Code) does not take cognizance of the complexities that hybrids may pose and fails to appreciate the economic realities behind issue of financial instruments. The Code credulously places reliance upon the form of the instruments and turns a Nelson's eye towards the substance. A corporate debtor can selectively emphasise upon the debt characteristics of a predominantly equity instrument and prejudice the interests of its legitimate creditors. The author endeavours to formulate a mechanism which is capable of discerning the nature of hybrids and protecting the interests of the stakeholders.

The first section explores the concept of financial debt and delves into the concept of the time value of money. The author discusses jurisprudence pertaining to time value of money and its relevance for categorisation of hybrids. The subsequent sections contemplate upon the methodologies employed by credit rating agencies and Indian tribunals. The fifth and the sixth section focuses on a comparative analysis of hybrid discerning mechanisms. The author consistently alleges that the Code

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is not in line with the economic realities of the Indian capital markets and needs to adopt a systematic methodology to filter out fallacious equity claims garbed as debt. Accordingly, the final section suggests introduction of a specific classification mechanism in the Code via introduction of a proviso in Section 53 and Section 18 of the Code.

1. THE CONCEPT OF FINANCIAL DEBT IN THE CODE

This section aims at clarifying the scope of financial debt. Circumscribing such a scope, by appreciating the inherent characteristics of a financial debt, is essential to undertake a detailed analysis of financial instruments in subsequent sections.

Pursuant to Section 7 of the Code, establishing the presence of a financial debt is essential to initiate the Corporate Insolvency Resolution Process (CIRP) before the jurisdictional National Company Law Tribunal (NCLT).[1] Section 5(8) defines financial debt as a debt along with interest which is disbursed against the consideration for the time value of money.[2] The definition of financial debt is followed by certain examples which clarify the scope of financial debt, but are not exhaustive.[3] The examples encompass classic debt arrangements such as loan, cash credits and debentures. The amount due which entails to lease or hire purchase contract which is deemed as financial or capital lease under the Indian Accounting Standards (IAS) has also been accorded the status of financial debt.[4] A combined reading of Section 5(8)(*d*) with IAS 17 portrays that only amounts due under lease agreements whereby risk and benefits incidental to ownership are transferred to the lessee can be classified as financial debt. Additionally, guarantee, indemnity and counter-indemnity obligations with respect to any instrument are encompassed within the ambit of Section 5(8).[5]

Interestingly, amount due against derivative transactions have also been classified as financial debt. Derivatives enable parties to trade specific financial risks—such as interest rate risk, currency, equity and

1. The Insolvency and Bankruptcy Code, 2016, (31 of 2016) S. 7.
2. *Ibid*, S. 5(8).
3. *B.V.S. Lakshmi (Dr)* v. *Geometrix Laser Solutions (P) Ltd.*, Company Appeal (AT) (Insolvency) NCLAT No. 38/2017. [Geometrix.]
4. The Bankruptcy Law Report Committee, "The Report Of The Insolvency Law Committee" (March, 2018), Ministry of Corporate Affairs, <http://www.mca.gov.in/Ministry/pdf/ILRReport2603_03042018.pdf>, (accessed 1-5-2018).
5. The Insolvency and Bankruptcy Code, 2016, S. 5(8).

commodity price risk, and credit risk and have a specified expiry date. The value of a derivative is contingent on time value assigned to it or the expiration period until which speculation opportunity can be[6] or has to be availed.[7] The amount or risk premium payable to the derivative vendor is for the service of providing a speculation opportunity within a specific time frame. Direct relation with time renders risk premium payable as a financial debt.[8]

1.1 Concept of time value of money

The key feature of financial transaction as postulated by Section 5(8) of the Code is its consideration for the time value of money. In accounting terms, the time value of money is the concept that money available at the present time is worth more than the identical sum in the future. There are three economic rationales which explain the decline in future value of money. *Firstly*, individuals prefer present consumption to future consumption.[9] Accordingly, the tradeoff for lower present consumption is higher future consumption. *Secondly*, with monetary inflation over the period of time the purchasing power of a unit currency decreases. *Thirdly*, any uncertainty regarding cash flow in future decreases its relative future value. The financial mechanism for factoring in these considerations is referred to as the discount rate. The discount rate is the consideration at which present and future cash flows are traded off. Each transaction will have a unique time value of money due to difference in the variables in each case. The method employed for factoring in time value of money in a transaction.

$$\mathbf{FV = PV \times [1 + (i / n)]^{(n \times t)}}$$

1. FV = Future value of money
2. PV = Present value of money
3. i = Interest rate
4. n = Number of compounding periods per year
5. t = Number of years

6. Instruments providing an option to exercise the opportunity to buy or sell are referred to as call and put options. See Redhead & Keith, *Financial Derivatives: An Introduction to Futures, Forwards, Options and Swaps* (Prentice-Hall 1997) 205–06.
7. Instruments imposing an obligation to buy or sell are referred to as futures. *See*, Fred D. Arditti, *Derivatives: A Comprehensive Resource for Options, Futures, Interest Rate Swaps, and Mortgage Securities* (Harvard Business School Press 1996) 1122.
8. Dean Pawlowic, "Entitlement to Interest Under the Bankruptcy Code" (1995) 12 Banker. Dev. J. 149, 173 (noting that "the entitlement to receive plan interest is merely a means to provide for present value.").
9. Robert K. Rasmussen, "Creating a Calamity" (2007) 68 Ohio St. L.J. 319, 323.

1.2 Jurisprudential analysis of time value of money

Discerning the time value of money inherent within an instrument is vital to categorise the instrument or a part of its value as a financial debt. The concept of time value of money and its intricacies involving discounting of present value of money to corresponding future value has been discussed in detail in several US Chapter 13 bankruptcy decisions.[10] Chapter 13 plans generally involve a deferred stream of payments and such payments are made in line with the statutorily prescribed discounting process.[11] The discounting seeks to nullify the loss of time value incurred due to delay, and verify that the claim holder receives the equivalent of its present-day substantive entitlement.[12] The landmark Supreme Court decision in *Till* v. *SCS Credit Corp*(*Till*)[13], while examining the parameters to determine the discounting rate, expounded an insightful description of the concept of time value of money. Steven J explained the time value of money as a function of opportunity cost, a premium for expected inflation, and a premium for the risk of default.[14]

By a conjoint reading of the aforementioned dictum and Section 5(8) of the Code, it can be reasonably concluded that the term time value of money as employed in Section 5(8) is contingent upon the variables enunciated in *Till*. In *Nikhil Mehta and Sons (HUF)* v. *AMR Infrastructure Ltd* (*Nikhil Mehta*), the National Company Law Appellate Tribunal (NCLAT), while examining the concept of financial debt held that in case of every financial debt, the inflows and outflows are distanced by time and there is a compensation for time value of money.[15] The time

10. An individual who files for bankruptcy generally faces the decision of filing under Chapter 7 or Chapter 13 of the Code. Claim repayment in Chapter 7 involves the distribution of proceeds from the sale of the debtor's pre-bankruptcy, non-exempt assets. However, claim repayment in Chapter 13 involves the distribution of the debtor's post-bankruptcy income. *See*, Bankruptcy Reform Act, 11 U.S.C. Ss.101-1532 (1978).
11. H.R. REP. NO. 95-595, 430 (1977); 1978 U.S.C.C.A.N. 5963, 6385 (Payments made as per the plan devised under Chapter 13 has to adhere to the statutorily prescribed, "Best interest of the creditor test" which provides that the value of the property to be distributed, as on the effective date of the plan, is not less than the amount that would be paid for such claim if the estate of the debtor were liquidated on such date).
12. *Rake* v. *Wade*, 508 U.S. 464 (1993) : 1993 SCC OnLine US SC 80.
13. *Till* v. *SCS Credit Corp.*, 541 U.S. 465 (2004) : 2004 SCC OnLine US SC 38 [hereinafter "Till"].
14. Till, 474 (Stevens J, plurality opinion) (A debtor's promise of future payments is worth less than an immediate payment of the same total amount because the creditor cannot use the money right away, inflation may cause the value of the dollar to decline before the debtor pays, and there is always some risk of non-payment. The challenge for bankruptcy courts reviewing such repayment schemes, therefore, is to choose an interest rate sufficient to compensate the creditor for these concerns).
15. *Nikhil Mehta and Sons (HUF)* v. *AMR Infrastructure Ltd.*, 2017 SCC OnLine NCLAT 219 [hereinafter "Nikhil"], ¶ 12 (The tribunal relied upon definition of Time Value in

value of money refers to compensation for the variables enunciated in *Till*. Accordingly, it can be deduced that a possibility of quantification of money value associated with a length of time, for any amount disbursed, qualifies such an amount as a financial debt.[16]

The Code, while not elaborating upon the specifics of time value, takes cognizance of this wide meaning of financial debt and the same has also been recognised in *Nikhil Mehta*. NCLAT noted that a forward contract for purchase of goods at a specified future date is essentially a contract for sale of specified goods. However, the amount due pursuant to a forward contract has been assigned the status of a financial debt. The rationale for such a characterisation lies in the compensation for time value associated with forward contracts. The forward purchase contract is employed to hedge against any price variation. The vendor can be prejudiced due to the party defaulting at maturity or unanticipated high inflation over the maturity period. Accordingly, such a contract has time value which is paid for by the vendee.[17]

A commercial effect of borrowing is generated when amount is disbursed against a consideration for time value of money. Section 5(8)(*f*) uses the terminology "commercial effect of borrowing" and acts as a residuary provision to include all instruments that are disbursed against time value.[18] In *Nikhil*, the tribunal undertook a purposive interpretation of Section 5(8)(*f*) and upheld that promise of assured returns to home buyer, elevates the transaction from a mere sale-purchase agreement to a financial transaction having commercial effect of borrowing.[19]

Black's Law Dictionary (9th edn.) where the expression been defined to mean "the price associated with the length of time that an investor must wait until an investment matures or the related income is earned.").

16. Nikhil, ¶16 ("It is true that some time financial transactions seemingly restructured as sale and repurchase. Any repurchase and reverse repo transaction are sometimes used as devices for raising money.").
17. Similarly, NCLAT in *Geometrix* has noted that amount due against any derivative transaction entered into in connection with protection against or benefit from fluctuation in any rate or price has an inherent time value of money and amounts to a financial debt.
18. *Gujarat State Petroleum Corpn. Ltd.* v. *Jodpl (P) Ltd.*, 2018 (1) TMI 125–NCLT Allahabad (giving a purposive interpretation to the term commercial effect of borrowing. In the dispute, the corporate applicant and corporate debtor were engaged in a joint operating agreement. The moot point was whether the amount paid by corporate applicant on behalf of the debtor, towards the development of an exploration block amounted to a financial debt or an operational debt. Though the payment was made for an operational activity by the applicant to the achieve joint objectives of the venture, it was ultimately disbursed on behalf of the corporate debtor and entailed a consideration for time value of money. Accordingly, the transaction had the commercial effect of borrowing.).
19. Nikhil, ¶18; Vinod Kothari & Sikha Bansal, *Law Relating to IBC* (1st edn. Taxman 2016) 112.

The jurisprudence of NCLAT and NCLT, coupled with the examples in Section 5(8) firmly establish the immateriality of nature of instrument to determine the existence of a financial debt. The sole factor for such a determination is existence of consideration for time value of money.[20]

The analysis of time value by NCLAT in *Nikhil* and other similar decisions[21] fails to provide an objective mechanism required for identifying existence of time value in an instrument. The framework prescribed by *Till* can be employed to determine whether the amount was disbursed against time value.[22] While reviewing various financial terms of agreements between parties and the manner of utilisation of the disbursements to determine the presence of financial debt, any term providing for protection against variables enunciated in *Till* should be looked for. Such a contractual element providing for a risk premium might not necessarily be a provision for interest. It can also include arrangements like factoring of discount on payment[23], forfaiting[24], repurchase or a reverse repo transaction.

Having analysed the core characteristics of a financial debt under the Code, author now attempts to examine the nature of hybrid instruments and other complex instruments. As emphasised earlier, the Code does not provide a mechanism for discerning the time value. Characterisation of complex financial instruments, which have a time value garbed in an equity like arrangement, can be a major challenge for NCLT and NCLAT. Acknowledging this challenge NCLAT stated,"It is true that

20. *Geometrix*, ¶29 (showing that there is a debt due which was disbursed against the "consideration for the time value of money", it is not necessary to show that an amount has been disbursed to the "corporate debtor". A person can show that the disbursement has been made against the "consideration for the time value of money" through any instrument.).
21. *Anil Mahindroo* v. *Earth Iconic Infrastructure (P) Ltd.*, 2017 SCC OnLine NCLAT 219 (Stating that home buyers were "financial creditors" due to the assured return scheme in the contract. It was held that such a transaction was in the nature of a loan and constituted a "financial debt" within the Code). Although IBC (Amendment) Ordinance, 2018 has accorded home buyers the status of financial creditors, the competent authority has relied on a case to case basis analysis of terms of contract to endow such a status. E.g., *Col. Vinod Awasthy* v. *AMR Infrastructure Ltd.*, NCLT, Principal Bench, Delhi, CP No. (IB)-10(PB)/2017.
22. Richard A. Posner, Economic Analysis of Law (7th edn., 2007) 194 (identifying the "three main components" of an interest rate as the opportunity cost, the risk premium, and the anticipated inflation rate).
23. Factoring is a financial affair which involves the sale of firm's receivables to another firm or party known as a factor at discounted prices. See, *A.I. Trade Finance, Inc.* v. *Laminaciones de Lesaca*, S.A., 41 F.3d 830 (2d Cir. 1994).
24. Forfaiting simply means relinquishing the right. In this, the exporter renounces his/her right due at a future date, in exchange for instant cash payment, at an agreed discount, to the forfeiter. See, *A.I. Trade Finance, Inc.* v. *Petra Bank*, 989 F.2d 76, 78 (2d Cir.1993).

there are complex financial instruments which may not provide a happy situation to decipher the true nature and meaning of a transaction."

Prior to embarking upon a detailed discussion regarding hybrids' characterisation for insolvency purpose, it is important to discern the nature of a complex financial instrument using the prevailing jurisprudence. In the light of recent judgments regarding the enforcement of fixed price put option clause, it is intriguing to analyse such an instrument. In *NTT Docomo* v. *Tata Sons*, the Delhi High Court upheld that any downside protection against an equity investment, at a predetermined rate, can be claimed by the foreign investor in the form of damages.[25] The enforceability of such option was contentious because Foreign Exchange Regulations prohibit issuance of any equity instrument with attached optionality (call/put options) which provided a fixed rate of return.[26]

The court opined that a contractually stipulated downward protection was not repugnant to FEMA Regulations, which only impose restriction upon assured returns against equity. The amount to be paid by Tata Sons was against a breach of an unqualified obligation to provide the downside protection by selling Docomo's shareholdings at a predetermined price and in no case could such an amount be categorized as delivery of an assured return on equity.

The court's differentiation between assured returns and downward protection, allows a comparative analysis with the treatment of assured returns in *Nikhil*. Such an interpretation is intriguing as the RBI guidelines do not provide a distinction between downside protection and assured returns and impose a blanket prohibition of exit at predetermined rate. Downward protection is effectively an assurance to provide a fixed price which assures that the foreign investor's negative returns will not exceed a particular threshold. In *Nikhil*, NCLAT stated that the promise of the "assured return" makes the applicant analogous to a "financial creditor" or an "investor" that has chosen "committed return

25. See, *NTT Docomo Inc.* v. *Tata Sons Ltd*, 2017 SCC OnLine Del 8078 ¶ 93 Cf.; *Cruz City 1 Mauritius Holdings* v. *Unitech Ltd.*, EX.P.132/2014 & 2017 SCC OnLine Del 7810 (Dealing with the same issues as NTT- Docomo. It was held that if the put option has been provided for a specified limited time and contingent upon certain events than the same cannot be considered as providing the guarantee of assured return at exit. Note that in the instant case, the put option provided to Cruz City was subject to (i) exercise within a specified time; and (ii) failure to commence the Santacruz project within the prescribed period. In the precise words of Bakhru J, This was not an open ended assured exit option as is sought to be contended).
26. A right/option of assured returns can be termed as illegible instruments in accordance with RBI guidelines. *See*, RBI Circular No. RBI/2013-2014/436 A.P. (DIR Series) Circular No. 86 (9-1-2013); Circular dated 14-7-2014 A.P. (DIR Series) Circular No. 3.

plan". The instant at which the unqualified contractual obligation to sell shareholdings at a predetermined price was breached, the shares' predetermined consideration became due and the assurance of a minimum return was reneged. An assured return arrangement, though not a financial transaction, created a commercial effect of borrowing by providing liquidity against shareholdings. Accordingly, the provision for a predetermined return amounts to a finance cost for such a liquidity and represents time value of money against the shareholdings' consideration. Such an interpretation is in line with the SEBI order in *M/s MVL Limited*[27], where it was held that minimum assured return gives the arrangement a form of a "fund mobilisation activity" and the assured return is treated in books as finance cost. This effectively converts the damages against breach of an obligation to provide downside protection into a financial debt, capable of triggering CIRP.

This analysis reflects a possibility of damages against fixed price put options being classified as financial debt. However, mature insolvency law jurisdictions have evolved sophisticated mechanisms to discern the nature of an instrument. The following section analyses such characterizing mechanisms.

2. HYBRID INSTRUMENTS: AN UNCHARTERED TERRITORY FOR THE INDIAN INSOLVENCY REGIME

Hybrid instruments are securities which, by being given specific parameters, possess elements of both debt securities as well as those characteristic of equity.[28] Section 2(19-A), Companies Act defines "hybrid" as to mean "any security[29] which has the character of more than one type of security, including their derivative."[30]

27. In *MVL Ltd.*, 2014 SCC OnLine SEBI 73, SEBI¶123 (Analysing the agreement pertaining to the "assured return scheme" and "buy back scheme").
28. *Black's Law Dictionary* (9th edn., 2009) 126. [Defined hybrid security as follows, "A security with features of a debt instrument (such as a bond) and an equity interest (such as share or stock). An example of a hybrid security is a convertible bond, which can be exchanged for shares in the issuing corporation and is subject to stock-price fluctuations].
29. Companies Act, 2013, [hereinafter Companies Act], S. 2(45-AA); S. 2(45AA) Companies Act defines "securities" as defined in clause (*h*) of S. 2, Securities Contract Regulation Act, 1956 and includes hybrids. S. 2(h) inter alia defines securities to include equity shares, preference shares and debentures.
30. *A Ramaiya, Guide to the Companies Act* (17th edn., 2010)(1971), 209 (shedding light on hybrid securities, and the features that distinguish them from other securities. "The term 'hybrid' is an omnibus term meaning an instrument having embedded features that are economically and substantively different from the features of the host contract. Depending on the context, the word 'hybrid' means a financial instrument having an embedded derivative, or a hybrid between debt and equity.").

A hybrid instrument may have characteristics of debt instruments such as cash flows through maturity similar to interest, a set maturity date and an expected return of amount borrowed. Simultaneously, a hybrid instrument may also have equity features such as voting rights, regular or irregular dividends, no maturity date and lesser priority in liquidation.[31]

Companies gravitate towards hybrid securities because they allow flexibility. The equity characteristics enable the company to enhance its credit worthiness. Simultaneously, debt features help in providing for tax-deductible interest payments.[32] An entity strategically accentuates the equity features or the debt features of the security depending on its financial position and market dynamics.[33] Hybrid instruments include, but are not limited to, compulsorily convertible debentures, redeemable preference shares, optionally convertible redeemable preference shares and un-invoked corporate guarantees.

Absence of clarity regarding the classification mechanism and true nature of a hybrid can lead to a precarious situation in CIRP. For the purpose of liquidation, classification of an instrument provides crucial guidance as to its position in the waterfall. Furthermore, classification of instruments is essential for devising a resolution plan because characterisation of a hybrid as financial debt will impact the composition of committee of creditors. The following section analyses the methodology employed by credit rating agencies for discerning the nature of hybrids and discusses their relevance in the context of Indian insolvency regime.

2.1 The debt-equity conundrum

Credit rating agencies, including Credit Rating Information Services of India Limited (Crisil) and Standard and Poor (S & P), have evolved specialised mechanism to discern the nature debt or equity nature of hybrid securities. Each of these criteria typically involve an assessment of the characteristics of the instrument and the business prospects of the corporation. Accordingly, the instrument is assigned a specific grade which represents its equity content. This comprehensive process is referred to as

31. Ernst and Young, "Financial Instruments", EYGM, <https://www.ey.com/Publication/vwLUAssets/Financial_instruments:_A_summary_of_IFRS9_and_its_effects/$FILE/ey-ifrs-9-financial-instruments.pdf>, (accessed 20-5-2018).
32. *Ibid*, 4.
33. Lucia Cusmano, "New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments", Organization for economic cooperation and development, <https://www.oecd.org/cfe/smes/new-approaches-sme-full-report.pdf>, (accessed 28-5-2018).

assigning equity credit. Following is an analysis of various criteria used to assign the debt or equity value to a hybrid instrument.

2.1.1 *Methodology applied by S & P*

The *Hybrid Capital Handbook* issued by S & P maps out widely accepted methodology to determine the level of equity credit granted to hybrid capital. The hybrid instruments are assigned a part equity and part debt character and placed within a debt-equity continuum.

The agency highlights three characteristics of equity which guide the assessment of hybrid capital.[34]

1. Equity requires no ongoing payment that could lead to default.
2. It has no maturity, no repayment requirement and is expected to remain as a permanent feature of the company's capital structure.
3. It provides a cushion for creditors in case of bankruptcy.

The magnitude of equity inherent in an instrument is contingent upon the aforementioned features. The analysis includes a close attention to the instrument's characteristics but ultimately a holistic approach is taken and the overall effect of the hybrid on issuer's credit profile is evaluated.[35] Several characteristics such as maturity, subordination[36], presence of call options[37], periodic interest increments or coupon

34. Standard & Poor's, *Hybrid Capital Handbook* (2008) 112 [hereinafter "Hybrid Capital Handbook"].
35. *Hybrid Capital Handbook*, 12 ("the security's economic impact is most relevant; its nomenclature is a secondary consideration. A transaction labeled debt for accounting or tax purposes may still be viewed as equity for rating purposes, and vice versa.").
36. Societe Generale, "Debt Capital Markets: Quantifying the impact of sovereign risk on hybrid prices" (2018) 439 [hereinafter, Societe Generale] ("At issuance, hybrid bonds generally pay a fixed rate to investors. If not called after the first call date, the coupon typically becomes floating and may or not step-up depending on the structure of the hybrid. step-ups are incentives for corporates to call the bonds at call dates (or soon after). A company would call a bond if it could refinance it at lower rate than original spread + step-up.").
37. Hybrid Capital Handbook, 79 ["At issuance of the bond, a structure is built in which two main parameters are determined. The first one is the non-callability period, which corresponds to the initial period of the bond during which it cannot be called. After this period, the bond can generally be called at periodic points in time (typically every quarter) at a predetermined price"]; *See*, Morgan Stanley, "Corporate Hybrids Playbook" (2013) 158 ("ArcelorMittal exercised its call option on January 2014 at the price set in hybrid documentation while it was trading at higher levels. The main reason to this decision identified by credit analysts is that the company was not considering replacing this instrument in its capital structure"); *See also*, Josie Cox, "ArcelorMittal Burns Hybrid Bridges with Shock Redemption", (2015) 9 International Financing Review 7, 62.

step-ups[38], interest deferral[39] are analysed to assign equity credit to a security.

The issuers often attempt to garb debt as equity by emphasising upon its permanence in capital structure by stipulating long maturity periods. However, credit rating agencies are cognizant of such attempts to highlight equity features of a debt instrument and equity credit is only assigned after analysing the actual impact of instrument on the issuer's capital structure. Analysis of a hybrid bond is a good example to understand the pragmatic approach undertaken by the rating agencies. If a bond has a perpetual maturity but in 25 years there is a 100 base point step-up in interest rate, then the effective maturity is considered to be 25 years since the probability of redemption in 25 years is extremely high. Hence, perpetual maturity is merely a red herring to gain equity credit for enhanced credit worthiness.

Following an analysis, the securities are placed in a debt-equity continuum. The categories in place are "minimal" (0 per cent), "intermediate" (50 per cent) and high (100 per cent). A hybrid categorised as "intermediate" has 50 per cent of its face value as equity.

Crisil undertakes a substantially similar analysis to assign equity credit to hybrids. Crisil's guide to hybrid capital structure relies on several parameters. Some hybrids, such as participating securities, have two components in their coupon: fixed and variable. A large variable and small fixed component ensures that the amount paid to service the instrument is contingent upon and proportional to entity's performance. Hence, in times of financial constraint, the dividend yield will be low, enabling the company to conserve cash. This feature makes the instrument behave like equity.

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38. Societe Generale, 124 ("Incentives to call that are qualitative, fluctuate, or are otherwise difficult to value will be assessed case by case. Our policy is to view almost every incentive or penalty, when combined with a 100-bps coupon step-up, as problematic, since the coupon step-up is already at the ceiling of the acceptable range for a moderate penalty. Examples could include a loss of favourable accounting treatment, higher cash flows, higher after-tax cost, or loss of peripheral tax benefits.").
39. Crisil also considers deferability of payment obligations. However, the weightage given to deferability is contingent upon trigger for deferring payment. Crisil assesses the equity content by evaluating the likelihood of trigger being activated, in the light of the issuer's business and financial performance. For instance, the trigger for deferral for a highly rated issuer cannot be the diminution of net worth by 80 per cent, for such a trigger is unlikely to be breached. Therefore, to qualify for higher equity content, the triggers need to be such that there is reasonable probability of them being breached. *See*, Crisil, "Treatment of Corporate Hybrids in Credit Ratings", Crisil Ratings, <https://www.crisil.com/Ratings/Brochureware/RR_ASSES/CRISIL-Ratings-research-treatment-corporate-sector-hybrids_2007.pdf>, (accessed 1-6-2018).

At this juncture, it will be useful to undertake a hypothetical assessment of a hybrid to determine its equity credit. Preference shares are definitely the most popular and oldest hybrid securities present in India. Section 53 waterfall provides preference shareholders precedence over equity shareholders. To this extent, the Code appreciates the part debt and part equity character of a security. In light of this unique positioning of preference shares in the liquidation waterfall, it will be interesting to undertake an assessment of equity credit associated with preference shares issued in India.

2.1.2.2 Maturity profile

Preference shares have a fixed residual maturity. In most cases, the tenure is three to five years.[40] Indian markets rarely witness the issue of preference shares having a long residual maturity. In any case, as per Section 55, Companies Act, preference shares cannot be issued with an original maturity of more than 20 years.[41] Thus, the preference shares prevalent in Indian capital market portray debt like short maturity periods. Preference shares also have call options on them which further reduces their effective maturity.

2.1.3.3 Payment

Typically, preference shares in India are non-participating and have a fixed dividend rate. This dividend rate is typically close to the market rate of debt. This further reaffirms dominance of debt like characteristics.

2.1.4.4 Loss absorption capacity

Deferability and non-cumulation are not usually observed in practice, despite large number of these being promoter subscribed. However, if such terms are observed, Crisil and S & P may give some equity benefit.

From the aforementioned analysis, it can be concluded that preference shares issued in India resemble debt. They lack the fundamental equity characteristic of permanence in capital structure due to short residual

40. Crisil, Hybrids' Rating Methodology, "Crisil Ratings", <https://www.crisil.com/Ratings/Brochureware/RR_ASSES/CRISIL-Ratings-research-und-CRISIL-ratings-rating-scales_2013.pdf>, (accessed 9-6-2018).
41. Tenure of preference shares continued as 20 years except for "infrastructural projects". Companies having "infrastructural projects" can issue preference shares for more than 20 years but upto 30 years subject to minimum 10 per cent redemption of such preference shares from 21st year onward or earlier. *See*, Companies Act, S. 55.

maturity period. However, their positioning in the Section 53 liquidation waterfall shows that the legislature sought to assign a greater equity nature to them than they carry in the current Indian capital market. The legislature has relied upon the rationale that preference shareholders obtaining equity in a company whilst making an investment, do so as shareholders, not lenders. However, such a classification turns a Nelson's eye to unique nature each preference share may assume owing to certain specifications in the shareholders agreement. In *Heesh* v. *Baker*[42]("*Heesh*"), the Supreme Court of New South Wales took cognizance of such unique alteration in preference shareholders agreement which give debt like character to amount due against redemption and unpaid dividends.

In this case, the issuer was unable to meet dividend and redemption obligations when due.[43] Following a perusal of the shareholders agreement, the court concluded that the dividends were to be paid at discretion of director. Further, the obligation to redeem, as comprised in the constitution and prospectus as between York and the preference shareholders, was not absolute.[44] It was expressed to be subject to the contractual requirement of profits being available.[45]

However the court noted that there may be some contracts between shareholder and company which impose an "absolute obligation to redeem" (or pay specified dividends), in which case even if that failure was due to an unavailability of a fund for the payment to be made, a breach of contract would give rise to debt. It is interesting to appreciate this dictum in light of the dictum of NCLAT in *Nikhil*. The tribunal noted:

It is *significant to notice that in order to satisfy the requirement of this provision (for qualifying as financial debt), the financial transaction should be in the nature of debt and no equity has been implied by the opening words of Section 5(8) of the IBC. It is true that there are complex financial instruments which may not provide a happy situation to decipher the true nature and meaning of a transaction.*"[46]

42. *Heesh* v. *Baker*, [2008] NSWSC 711. [hereinafter "*Heesh*".]
43. *Heesh*, ¶9 ("Aside from not meeting its obligations to the redeemable preference shareholders, however, issuer was not otherwise insolvent.").
44. *Heesh,* ¶45 (In relation to redemption rights, York could only redeem the shares out of profits or the proceeds of the new issue of shares made for the purposes of the redemption. Further, whilst the prospectus referred to an alternative of a selective buy back of the shares, this was, from York's perspective, optional.).
45. *Federal Commissioner of Taxation* v. *Coppleson*, (1981) 39 ALR 30.
46. *Nikhil*, ¶ 17.

The tribunal's dictum is oxymoronic to the extent that itself recognises the existence of hybrid instruments that may defy the statutorily prescribed absolute requirement of nature of debt to qualify as financial debt. However, unlike *Heesh,* the tribunal did not go to the extent of recognising that even a prima facie equity instrument like preference shares can be deemed to be debt when specific obligations are imposed on the issuer via shareholders agreement. It is vital for the Indian insolvency regime to recognise that a short maturity period, fixed non-deferring dividend payments and a loss absorption capacity can give a consideration paid against acquiring preferential shares a time value and create a commercial effect of borrowing. Recognition of these characteristics can lend the holder a seat in the committee of creditors and in case of liquidation can provide them precedence in preference of payments. Hence, the methodology employed to characterise a hybrid can go a long way in affecting the interests of the party involved in CIRP.

The credit rating agencies perform the task of assigning equity credit with analytical expertise and systematic data collection. However, it is important to study whether judicial authorities have adopted these techniques while determining the nature of a security. The judiciary needs to give a practical effectuation to the duality of hybrid instruments while adjudicating upon their nature. While classification as absolute debt or equity remains a possibility, such blanket characterisation will not always represent the true nature of instrument.

3. INDIAN TRIBUNALS' METHODOLOGY TO DECRYPT HYBRIDS: SUFFICIENT OR PRIMITIVE?

This section analyses the various methodologies employed by Indian tribunals for decrypting the nature of the hybrid. The author also attempts to evaluate whether such methodologies, if applied in evaluating the nature of a hybrid for the purpose of determining its position in the Section 53 waterfall or for adjudicating the validity of a claim to be financial creditor, will be able to protect the interests of the stakeholders in the CIRP.

SEBI, in *issuance of optionally fully convertible debentures by Sahara*[47], ventured into the issue of determining the nature of a hybrid instrument for the purpose of assuming jurisdiction over a dispute. Sahara issued Optionally Fully Convertible Debentures (OFCDs) which

47. In the matter of issuance of optionally fully convertible debentures by Sahara India Real Estate Corpn. Ltd. and Sahara Housing Investment Corpn. Ltd., WTM/KMA/CFD/392/06/2011 SEBI ¶ 111.

were allegedly not adhering to investor safety norms. They argued that SEBI does not have any jurisdiction for adjudicating upon an issue related to such hybrid issues as the term "hybrid" is not included in the definition of "securities", under the SEBI Act.[48] For the purpose of evaluating merit in the argument, SEBI tribunal delved into the nature of OFCDs to determine whether they amount to a security[49] under SEBI Act.

SEBI's first line of OFCDs analysis focussed on terminology and nomenclature of the instrument's name. SEBI stated,"From the nomenclature itself, 'Optionally Fully Convertible Debentures' are 'Debentures', as they indeed are named so. A 'red rose' is as much a 'rose' as any other rose flower."

The analogy, while feasible at the theoretical level, is outrightly amateur. SEBI justifies such an analogy by stating that in both "debentures" and "OFCDs" the issuer "owes" something distinct to the investor, which has to paid back with due consideration. The option allowing the conversion into equity was considered only a mere "peripheral" difference by the tribunal.[50] The tribunal failed to recognise that variables associated with the options can drastically alter the nature of a security.

However, subsequent jurisprudence pertaining to transfer pricing guidelines has churned out systematic hybrid decrypting methodologies. Income Tax Appellate Tribunal (ITAT) in *India Debt Management Private Limited* (IDMPL)[51] delved into the nature of hybrids for the purpose of determining an adequate benchmarking standard. In the given case, IDMPL had characterised the compulsorily convertible debenture[52](CCD) as a pure debt instrument and utilised loan data to benchmark transactions.

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48. *Ibid*, ¶4.
49. SEBI emphasised upon the wide scope of the term "security". See, *Sudhir Shantilal Mehta* v. *Central Bureau of Investigation*, (2009) 8 SCC 1; See also, *Mukesh K. Aggarwala and Co.* v. *Canbank Financial Services Ltd.*, (2010) 6 SCC 178; *Dahiben Umedbhai Patel* v. *Norman James Hamilton*, 1982 SCC OnLine Bom 295.
50. Such a reasoning was derived from Supreme Court's dictum in *Narendra Kumar Maheshwari* v. *Union of India*, 1990 Supp SCC 440. In it was stated that compulsorily convertible debentures are regarded as "equity" and not as a loan or debt. One of the critical considerations adopted by the Hon'ble Supreme Court of India in concluding so, is that, "A compulsorily convertible debenture does not postulate any repayment of the principal. Secondly, Section 81(3) recognizes a 'convertible debenture with an option attached to it' as belonging to the broad family of 'debentures'".
51. *India Debt Management (P) Ltd.* v. *The DICT*, 2015 SCC OnLine ITAT 10024.
52. OECD, "Tranfer Pricing Implications", <https://www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf>. ("The purpose of a benchmarking study is to select comparable transactions by rationally deriving arm's length price based on the financial data of selected comparable. On one side the comparables selected by assesses are rejected in many cases particularly of loss making companies and on the other hand, high margin

ITAT noted that benchmarking of hybrid instruments is contingent upon identification of debt or equity traits. Analysis of features facilitates positioning of the instrument in the debt-equity continuum. Such an analysis involves systematic perusal of the terms and conditions associated with such instrument.

ITAT utilised an amalgamation of Foreign Direct Investment (FDI) regulations and professional quantitative analysis to decrypt the nature of the hybrid.[53] As per the 2014 FDI consolidated circular, only fully and mandatorily convertible debentures are taken as equity and the rest are taken and categorised as external commercial borrowings.[54] ITAT also assigned a significant weightage to Crisil's treatment of CCDs as equity. Additionally, reliance was placed on Indian Accounting Standards which provide for precedence of substance over form and assign an equity nature to CCD. Aforementioned factors conclusively established a dominance of equity characteristics in CCD.

ITAT ruling, in *Cadila Healthcare Limited*[55], involved a dissection of optionally convertible loan agreement in order to decipher the real nature of the hybrid. The Transfer Pricing Officer, relied on the guidance issued by the Reserve Bank of India to characterise the instrument as a loan, which focuses upon the presence of a fixed tenure and non-participation.[56] However, ITAT focussed upon the material impact of the "option

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comparables are cherry picked and applied. Moreover entire methodology of tax payer in selecting comparable is rejected by the tax authorities.") (accessed 15-5-2018).

53. RBI, "Basel II" <https://rbidocs.rbi.org.in/rdocs/content/pdfs/58BS300685FL.pdf>, (accessed 15-5-2018) ("Basel II states that a mandatory convertible debt instrument qualifies as hybrid capital instrument.")
54. RBI/2015-16/96 Master Circular No. 15/2015-16 (Ministry of Commerce and Industry, Government of India, FDI Policy Circular of 2014 stated that that CCDs are not loans and should be reckoned as "capital instruments"). The circular defines "capital" as equity shares; fully, compulsorily and mandatorily convertible preference shares; fully, compulsorily and mandatorily convertible debentures.
55. *Cadila Healthcare Ltd.*, I.T. A. No. 2430/AHD/2012 & CO. No. 242/Ahd/2012. 2013 SCC OnLine ITAT 5245 ("Adjustments in respect of notional interest on such optionally convertible loan cannot be made for making such transaction at arm's length. Since interest is payable on normal loan which is not there in the case of convertible loans which is in the nature of investment/quasi-equity.").
56. Master Circular—Loans and Advances—Statutory and Other Restrictions, RBI/2009-10/69/DBOD No. Dir. BC 13/13.03.00/2009-10. As per the RBI Guidance note following are the features of a loan arrangement, 1) the instrument carried a fixed tenure; 2) no link with the performance of the subsidiary till the point of conversion into equity; 3) no right to participate in the management of the subsidiary just on account of this arrangement; 4) no subordination attached to the loan vis-a-vis other loans; 5) none of the convertible loans has been converted during the present period hence the present arrangement should be treated as a loan; 6) no thin capitalisation issue for subsidiary—hence this should be a loan; 7) objective of securing the loan was to fulfil working capital requirements of the subsidiary and facilitate downstream acquisitions; and 8) the taxpayer could take steps

of converting to equity" on the characterisation of the arrangement and stated:

> The substantive reward for this transaction was not the interest on the amount advanced but rather the opportunity for the taxpayer to own capital in the subsidiary on certain favourable terms. The reward for time value of money in this case was opportunity to subscribe to the capital, unlike in a normal loan transaction where reward is interest.[57]

Accordingly, the arrangement was characterised as quasi capital and not loan. Such pragmatic techniques, if utilised for characterisation of claims for CIRP or liquidation, will effectively protect the interests of the stakeholders against deceptive hybrids.

4. METHODOLOGY EMPLOYED BY AMERICAN BANKRUPTCY COURTS: A JUDICIAL RESOLUTION TO THE DEBT-EQUITY CONUNDRUM?

American and Canadian bankruptcy courts have delved into the nature of hybrid instruments several times for the purpose of solvency analysis.[58]

In *Color Tile Inc.*[59], *re*, the court engaged in analysis of redeemable preferred stock. The court noted that the determination of the debt or equity character is contingent upon the interpretation of the contract

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to recover for non-payment of loan in case the loan is not converted. *See also*, Australian Tax Office, "Thin Capitalization and Inter-corporate Financing" <https://www.transfer-pricing.com/pdf/Australia_Thin%20Capitalisation.pdf>, (accessed 9-6-2018) ("Para 1.37 of the OECD Guidelines, that for the purposes of applying sub-section 136-AD(4) that portion of the debt funding be regarded as quasi equity and that it be costed on an interest-free basis, consistent with its purpose and effect. This is in line with the OECD view that the cost of funding a company's participation is a 'shareholder activity' and that it would not justify a charge to the borrowing company.").

57. The court relied upon the decision in *Soma Textiles & Industries Ltd.* v. *ACIT*, (ITA NO. 472/Ahd/2014). ("As a corollary to this position, in the cases of quasi capital loans or advances, the comparison of the quasi capital loans is not with the commercial borrowings but with the loans or advances which are given in the same or similar situations. In all the decisions of the coordinate benches, wherein references have been made to the advances being in the nature of 'quasi capital', these cases referred to the situations in which (a) advances were made as capital could not subscribed to due to regulatory issues and the advancing of loans was only for the period till the same could be converted into equity, and (b) advances were made for subscribing to the capital but the issuance of shares was delayed, even if not inordinately. Clearly, the advances in such circumstances were materially different than the loan transactions simpliciter and that is what was decisive so far as determination of the arm's length price of such transactions was concerned").
58. Solvency analysis involves examining whether the debts of an entity exceed the fair value of its assets; *See*, Abdullah M, "An Empirical Analysis of Liquidity, Profitability and Solvency of Bangladeshi Banks" (2015) J Bus Fin Aff 4, 157.
59. In *Color Tile*, the trustee sought to avoid and recover as fraudulent transfers payments to purchasers of the debtor's preferred stock made during the year prior to the debtor's bankruptcy. They sought to establish that debtor was insolvent as on date of transfer. The

between the corporation and the security holders and the subsequent financial consequences of an issue. To determine whether the security in this case constituted debt or equity, the court applied the factors traditionally employed to contract interpretation, including the name given to the instrument, the intent of the parties, the presence or absence of a fixed maturity date, the right to enforce payment of principal and interest, the presence or absence of voting rights and the certainty of payment in the event of the corporation's insolvency or liquidation.[60] The stock agreement barred the shareholders' right to redeem the stock if the debtor was in a "substantially leveraged financial position". Additionally, in the case of liquidation, the accrued dividends were endowed a subordinate status to creditors dues in the waterfall of payments. Accordingly, the court took cognizance of the element of uncertainty of payments and gave the preferred stock an equity designation.[61]

In Trace Int'l Holdings Inc.[62], *re*, the court again analysed whether a company's preferred stock issuance should be characterised as a debt instrument and relied upon the criteria laid down in *Color Tile*, *re*. It was noted that a provision in the preferred stock prospectus prohibited redemption of the stock if the company was deemed insolvent. However, this contractual term did not affect the determination of the debt or equity character of the preferred stock because the intention of the parties portrayed otherwise. In subsequent communications, the debtor had acknowledged the unqualified obligation to redeem. Additionally, the contractual term provided for coupon step-ups if the stock was not redeemed on the pre-decided date. The post contract communications

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defendants argued the hybrid security was a debt instrument and the payments were in the form of interest, not dividends made on account of equity.

60. *Bayer Corp.* v. *Masco Tech, Inc.*, (in *AutoStyle Plastics, Inc.*, *re*), 269 F.3d 726 (6th Cir. 2001).
61. Compare with *Brown* v. *Shell Canada, Ltd* [143 B.R. 468, 471 (Bankr. E.D. Tenn. 1992); this case also involved analysis of preferred stock for determining insolvency. The court noted that the preferred stock had many characteristics that made it appear as debt, including a mandatory redemption date, required dividend payments, and additional dividend payments and interest on any unpaid dividends.
62. *Trace Int'l Holdings Inc, re,* 287 B.R. 98 (Bankr. S.D.N.Y. 2002) (emphasising that hybrid securities must be characterised as either debt or equity — they cannot be both). in the *Trace Int'l Holdings*, the court followed *Color Tile* court's analysis by focussing on the stock agreement and whether the dividend payments were intended to be made regardless of the issuer's financial condition, as one would expect from an interest payment on a debt, or whether they were restricted, as one might expect from equity. The court initially noted that a provision in the preferred stock prospectus prohibited redemption of the stock if the company was deemed insolvent. The court disregarded this provision, however, because the parties intended the payments to be made, regardless of the financial condition of *Trace*.

between the parties morphed the nature of the contract and preferred stock was classified as debt. The decision effectively gave intention of the parties, derived from subsequent representations, a precedence over the contractual terms. Such an interpretation rejects a "mechanistic scorecard" and emphasises the importance of decrypting parties' intention.[63]

The landmark judgment of the Canadian Apex Court, in *Canada Deposit Insurance Corp.* v. *Canadian Commercial Bank* (*CDIC*)[64], also provides valuable guidance for the characterisation of hybrids. The court evaluated the debt-equity characteristics of emergency financial assistance arrangement. The arrangement provided that lender will be entitled to warrants, as consideration for financial assistance, allowing them to buy up to 75 per cent common shares of CCB.[65] The court stated,"Characterization should focus on the significant aspects of the investment which work to shape its characterization, rather than those features which are merely incidental and have little effect on the substance of the transaction".[66]

The determination of equity or debt content is contingent upon the substance of a transaction and the intention of the parties to the support agreements.[67] Canadian courts have routinely involved in an analysis of share purchase agreements, conditions attached to shares, articles of incorporation, and the treatment of shares in the financial statements to

63. *Cohen* v. *KB Mezzanine Fund II, LP* (in *SubMicron Systems Corp.*, *re*), 432 F.3d 448 (3d Cir. 2006). (In *SubMicron*, the Third Circuit rejected a factor-based inquiry as a "mechanistic scorecard", opting instead to focus on the parties' intent at the time of the transaction through a common-sense evaluation of the facts and circumstances.)
64. *Canada Deposit Insurance Corp.* v. *Canadian Commercial J.E.,* 92-1742 (SCC) [Hereinafter "*CDIC*"] ¶ 55.
65. The court considered the characterisation of emergency financial assistance provided to the CCB by a group of lending institutions and the federal government (the "participants"). The arrangement provided, inter alia , that the participants would receive, in return for their financial contribution, warrants to buy up to 75 per cent of CCB's common shares.
66. Laying the groundwork for the approach to characterisation that should be taken by the courts, Iacobucci J stated: As in any case involving contractual interpretation, the characterization issue facing this Court must be decided by determining the intention of the parties to the support agreements. This task, perplexing as it sometimes proves to be, depends primarily on the meaning of the words chosen by the parties to reflect their intention. When the words alone are insufficient to reach a conclusion as to the true nature of the agreement, or when outside support for a particular characterization is required a consideration of admissible surrounding circumstances may be appropriate.
67. *See*, e.g., *John Kelley Co.* v. *Comm'r*, 326 U.S. 521, 530 (1946) 1946 SCC OnLine US SC 11. ("There is no one characteristic, not even exclusion from management, which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts."); *J.S. Biritz Constr. Co.* v. *Comm'r*, 387 F.2d 451, 456–57 (8th Cir. 1967) ("These indicia have varying degrees of relevancy, depending on the particular factual situation and are generally not all applicable to any given case.").

analyse the intentions of the parties.[68] Any further ambiguity regarding the nature of the instrument can be resolved by taking into consideration the "surrounding circumstances", which include, but are not limited to, commercial considerations, probability of rights' exercise and likelihood of default. Applying the chalked out criteria, the Apex Court held that financial assistance was in a nature of loan, as the likelihood of warrants being exercised was low.[69]

Unlike SEBI's analysis in *Sahara*, the Canadian and American courts have taken a pragmatic approach while characterising security for insolvency purpose. A similar yet less precise approach has been taken by ITAT in *IDMPL*.[70] However, the contextual and intention based analysis has certain inherent limitation of creating uncertainty in investor relations. The court's analysis is focussed on the parties' intention, the substance of the agreement, and any surrounding circumstances, all of which could change over time. Accordingly, the relationship between the company and investor, and the classification of the investment could also change over time.[71]

5. EXPLORING THE VIABILITY OF EQUITABLE REMEDY OF RE-CHARACTERISATION

The current Section 53 waterfall is based on the common law doctrine of blanket subordination of equity claims.[72] The doctrine has evolved to determine the priority of claims. Equity holders assume a greater

68. *Royal Bank of Canada* v. *Central Capital Corp.*, 61 A.C.W.S. (3d) 18, 132 D.L.R. (4th edn.) 223, 1996 CLB 708 (Ont. C.A.).
69. The court, while analysing the nature of emergency financial assistance, concluded that the words and express terms chosen by the parties portrayed the intention of the parties to enter into a loan arrangement and not an equity investment. Additionally, the low probability of warrants being exercised supported the conclusion that the financial support was in the form of a loan and had precedence in the waterfall of payments during liquidation.
70. See, *Tudor Sales Ltd., re,* 2017 BCSC 119 ("The superficial appearance of transactions arising out of loan documentation is not important. The critical determination concerns the manner in which the transaction or transactions were actually implemented in the circumstances of the surrounding economic reality. A loan to shareholder was categorized as equity as there was no schedule for repayment of advances, and no certain formula to determine interest payable").
71. *See*, David J. Kendall, "Venture Capital Lending: Usury and Fiduciary Duty Concern", (2004) 3 Apr Colo. Law 11,76. ("Special 'bridge loans' are often utilized to provide short-term cash infusions to these companies to keep them on their feet in periods of financial infancy. A debt re-characterization scheme that is impossible to navigate means venture funds will be less willing to extend these bridge loans, for fear that, should the enterprise go bankrupt, those loans will be re-characterized and rendered virtually unrecoverable").
72. 3 *Halsbury's Laws of England* (4th Edn. Butterworths 1980) 315.

participatory risk and are accordingly placed at the bottom of the waterfall.[73] However, as discussed above, the absence of a mechanism to characterise deceptive hybrids often leads to treatment of capital investments as debt. Such an erroneous classification prejudices the claims of creditors and is repugnant to the doctrine of blanket subordination of equity claims. Hence, there exists a need for a sophisticated hybrid decrypting mechanism within the IBC, similar to the methodology adopted by ITAT.

Common law uniformly acknowledges the power of a court to recast a claim asserted by a creditor as an equity interest in an appropriate case. This distinct remedy of re-characterisation of claims emanates from the principles of equity. The American bankruptcy courts have interpreted the equitable powers endowed upon them by Section 105, American Bankruptcy Code to include the power to re-characterise claims.[74] NCLT and NCLAT have also been endowed with similar, if not broader, equitable powers through Rule 11 of the NCLT Rules, 2016[75] and Rule 11 of the NCLAT Rules[76], respectively.[77] Accordingly, the NCLT and the NCLAT can also provide a purposive interpretation to their equitable powers and provide the equitable remedy of debt re-characterisation.

The remedy of debt re-characterisation can have significant consequences on both, the resolution and the liquidation process. The rejection of a claim by the liquidator on the grounds that it represents an equity interest can adversely affect the interests of hybrid security holders, whose instrument predominantly represents debt in issuer's capital structure. Alternatively, the admission of a claim against a hybrid instrument, which is primarily equity in nature but has been garbed as

73. *Canwest Global Communications Corp.*, *re*, (2010), 70 C.B.R. (5th) 1, 191 A.C.W.S. (3d) 378, 2010 ONSC 4209, 2010 CLB 17545 (Ont. S.C.J. [Commercial List]); Jason Harris and Anil Hargovan, "The Intersection Between Shareholders' and Creditors' Rights in Insolvency: An Australian Perspective" (2007) 7 Annual Review of Insolvency Law 67, 89.
74. *Committee of Unsecured Creditors for Dornier Aviation (North America), Inc.*, 453 F.3d 225 (4th Cir. 2006); *Cohen* v. *KB Mezzanine Fund II, LP* (in *SubMicron Systems Corp., re*), 432 F.3d 448 (3d Cir. 2006); *Sender* v. *Bronze Group, Ltd.* (in *Hedged-Invs. Assocs., Inc., re*), 380 F.3d 1292 (10th Cir. 2004); *Bayer Corp.* v. *Masco Tech, Inc.* (in *AutoStyle Plastics, Inc., re*), 269 F.3d 726 (6th Cir. 2001).
75. R. 11, National Company Law Tribunal Rules, 2016 notified via Ministry of Corporate Affairs Circular, G.S.R. 716(E) [hereinafter "NCLT Rules"].
76. R. 11, National Company Law Appellate Tribunal, 2016 notified via Ministry of Corporate Affairs Circular, G.S.R. 717(E) [hereinafter "NCLAT Rules"].
77. S. 105(*a*) provides, "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of the Bankruptcy Code." Similarly NCLT Rules, 2016 and the NCLAT Rules, 2016 provide "inherent powers" to the tribunals to make such orders or give such directions as may be necessary for meeting the ends of justice or to prevent abuse of process of the tribunal.

debt, will prejudice the interests of creditors. Such erroneous inclusion or exclusion by the liquidator can be challenged,[78] and the equitable relief of re-characterisation can be prayed for. Such a relief of equitable re-characterisation will also be beneficial in cases where the resolution professional might erroneously classify a hybrid which is predominantly debt, but has incidental equity like characteristics such as pure equity. Such erroneous interpretation can deny a legitimate financial creditor, whose hybrid carries a substantial time value of money, a seat in the committee of creditors.

NCLT and NCLAT while adjudicating upon debt characterisation need to undertake a contextual interpretation of hybrid agreements and attempt to decrypt the intention of the parties. Principles laid down in *Color Steel* and *CDIC*[79], *re*, can be adhered to while evaluating the nature of hybrids. Additionally, reliance can also be placed upon systematic methodologies churned out by ITAT for characterising hybrids as debt or equity.

6. CODIFICATION OF DEBT RE-CHARACTERISATION IN THE BANKRUPTCY CODE: THE WAY FORWARD

As discussed earlier, a contextual interpretation of hybrid to deduce the intention of parties leads to an uncertainty in the investor-issuer relations. As noted in *Trace Int'l Holdings Inc.*, *re,* subsequent dialogues or representations can amount to a change in intention and can substantially alter the nature of hybrid. A fluid debt re-characterisation scheme will create an inhibition among lenders and lead to stringent terms being incorporated into the arrangement to avoid any possible risk of re-characterisation.

A distinct section of the Code elucidating upon the factors to be considered in a re-characterisation analysis will facilitate the greatest degree of legal clarity and practical utility. The enumeration of specific factors, as stated in *Color Steel*[80], *re*, or *IDMPL*, is pivotal as it will allow the

78. S. 60(5)(*c*), IBC; (5) Notwithstanding anything to the contrary contained in any other law for the time being in force, the National Company Law Tribunal shall have jurisdiction to entertain or dispose of—(c) any question of priorities or any question of law or facts, arising out of or in relation to the insolvency resolution or liquidation proceedings of the corporate debtor or corporate person under this Code.
79. In *Outboard Marine Corp.*, *re,* 50 Collier Bankr. Cas. 2d (MB) 931, 2003 WL 21697357 (N.D. Ill. 2003) and derived from in *Hyperion Enterprises, Inc.*, *re,* 158 B.R. 555, 29 Collier Bankr. Cas. 2d (MB) 1281, 24 U.C.C. Rep. Serv. 2d 670 (D.R.I. 1993).
80. *Cohen* v. *KB Mezzanine Fund II LP*, 432 F.3d 448, 455 n.8 (3d Cir. 2006); *Fairchild Dornier GMBH* v. *Official Comm. of Unsecured*, 453 F.3d 225, 233 (4th Cir. 2006);

issuer to structure the instrument as per the statutory standards and ensure a better evaluation of possible re-characterisation risks.[81] For the purpose of liquidation, a proviso to Section 53 could be inserted, stating the following —

> Provided that characterisation of the claim, for the purpose of endowing subordination or precedence in waterfall prescribed by Section 53(1), shall be contingent upon the following[82];
>
> 1. RBI's guidance for characterisation of an arrangement as loan.[83]
> 2. Equity designations provided in FDI Circular.[84]
> 3. Equity Credit Assigned to the Instrument by the RBI registered credit rating agencies.[85]
> 4. Material consequences on the capital structure. Such consequences are to be evaluated in light of the intention of the issuer as deduced from analysis of share purchase agreements, conditions attached to shares, and the treatment of shares in the financial statements.
> 5. Presence of a fixed maturity date and schedule of payments.

Bayer Corp. v. *MascoTech, Inc.*, 269 F.3d 726, 747–53 (6th Cir. 2001); *Sender* v. *The Bronze Group, Ltd.*, 380 F.3d 1292, 1298 (10th Cir. 2004).

81. Stephen Gill, "Debt-to-Equity re-characterization Is It More than Equitable Subordinations Evil Twin" (2004) 7 AM. Bankr. Inst. J. 29, 45.
82. The list of factors has been compiled from a series of re-characterisation decision. *Roth Steel Tube Co.* v. *Comm'r of Internal Revenue*, 800 F.2d 625, 630 (6th Cir. 1986); *Estate of Mixon* v. *United States*, 464 F.2d 394, 402 (5th Cir. 1972); *Outboard Marine,* 2003 U.S. Dist. LEXIS 12564; in *Hyperion Enterprises*, *re*, 158 B.R. 555 (D.R.I. 1993) See also, *Hillsborough Holdings Corp.* v. *Celotex Corp.*, 176 B.R. 223, 248 (M.D. Fla. 1994).
83. Master Circular—Loans and Advances—Statutory and other Restrictions, RBI/2009-10/69/DBOD No. Dir. BC 13/13.03.00/2009-10 (Para 2.1.3 states, " In terms of the explanation to the Section, 'loans or advances' shall not include any transaction which the Reserve Bank may specify by general or special order as not being a loan or advance for the purpose of this Section. While doing so the RBI shall, keep in view the nature of the transaction, the period within which, and the manner and circumstances in which, any amount due on account of the transaction is likely to be realised, the interest of the depositors and other relevant considerations").
84. Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017, Notification No. FEMA 20(R)/2017-RBI ("Capital Instruments" means equity shares, debentures, preference shares and share warrants issued by an Indian company); author's incorporation of FEMA Notification concerning hybrid discernment is based on ITAT's reliance upon the same in *IDMPL* and *Cadila Healthcare*. The categorisation provides a clear equity or debt designation to certain classes of hybrids and will be a helpful reference while analysing the instruments for insolvency purposes.
85. CARE, Crisil, Fitch India, ICRA, Brickwork Ratings and Smera are RBI registered domestic credit rating agencies. The assessment of equity credit inherent in the instrument in question can be provided to the Adjudicating Authority. *See*, Eligible Credit Rating Agencies, RBI/2014-15/243 DNBS (PD). CC. No. 410/03.10.001/2014-15; author categorically excludes the foreign credit rating agencies. Such an exclusion is in line with the dictum of ITAT in *Idmpl*, where it was noted that "a national scale rating cannot be directly compared with a global scale rating, or even with the national scale rating of a country. This is because the best credit within a country may not be of a similar quality to the best credit globally; the frame of reference would therefore differ, as would the ratings."

6. Security, if any, for the advances.
7. Extent to which the advances were subordinated to the claims of outside creditors.
8. Presence of a sinking fund to provide repayments.
9. Degree of shareholder control.

Notwithstanding the aforementioned primary parameters for discerning the character of instrument, the Adjudicating Authority is empowered to provide individualised relief in exceptional circumstances.

A similar proviso can be inserted in Section 18 and the aforementioned criteria should be adhered to by the interim resolution professional for verifying the status of hybrids issued by the corporate debtor. The hybrids, which have a predominantly debt character and suffice requirements under Section 5(8) shall be characterised as financial debt.

The Indian insolvency regime and its stakeholders have failed to take cognizance of the gargantuan impact the absence of or an ambiguous debt re-characterisation can have on the resolution of stressed assets. In *Neelkanth Township* v. *Urban Infrastructure Trustees Ltd*[86], corporate debtor contended that the claim against the optionally convertible debentures issued by it did not amount to a financial debt. Such an argument hinged on the primary characteristics of the instrument, which was the extremely low interest rate of zero or one percent. It was alleged that optionally convertible debenturess are equity instruments and lack time value of money. However, NCLAT did not delve into equity and debt features of the instruments. Following an approach similar to *Sahara*, the Bench classified the instrument as debt by relying solely on the terminology of the instrument's name. It was noted,"Section 5(8)(*c*) makes it clear that a debenture comes within the meaning of financial debt. Accordingly, optionally convertible debentures are financial debt."

The adoption of such amateur methodologies emphasises the importance of the amendment proposed by the author, and hence, justifies the concerns raised in this paper. With the insolvency regime transforming at a rapid rate, the author hopes that the implications of improper characterisation of hybrids will be understood and dealt with.

86. *Neelkanth Township & Construction (P) Ltd.* v. *Urban Infrastructure Trustees Ltd*, Company Appeal (AT) (Insolvency) No. 44 of 2017, ¶54.

The Privacy Challenge for Fair Competition in the Emerging Digital Economy

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ABSTRACT

The emerging digital technologies and innovations have brought in the fourth industrial revolution. This has transformed personal data of consumers into a factor of production and a tool of market acquisition. The emergence of big corporations in the digital technology sector has led to the infusion of capital resources and financial leverage behind the Big Data analytics and allied processes. While this has efficiency gains in terms of customer experience, inventory management, and smart marketing, it has grave implications on competition in the newly emerging market. This essay attempts to critically analyse recent developments in the law relating to data protection and competition especially with the enforcement of General Data Protection Regulations (GDPR) in the European Union (EU). In addition to the GDPR which has led to significant transformation in the business processes and policies in the multinational conglomerates operating from Europe, the recent decisions by EU's Antitrust Authority in Google case[1] *provides a unique insight into redefining the regulatory response to emerging technologies especially from perspective of ensuring free and fair competition. This focuses on the ability to create unfair market dominance on the basis of disproportionate control over and use of data and misuse of ability as a search engine. It critiques the cross-subsidiary unconsented use of personal user data for market gains and dominance. It further analyses India's engagement with data privacy and its specific intersection with competition*

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1. *Matrimony.com Ltd.* v. *Google LLC*, *re*, 2018 SCC OnLine CCI 1 <https://www.cci.gov.in/sites/default/files/07%20%26%20%2030%20of%202012.pdf>.

regulation from the standpoint of special developmental needs and innovation appetite. While expounding on the right to privacy as per the landmark judgment of K.S. Puttaswamy and the recommendations of Expert Committees on Data Protection, the essay concludes that the data privacy framework proposed by Justice Srikrishna Committee should be strengthened in the light of suggestions under the citizen draft of the Indian Privacy Code, 2018.

1. DIGITAL ECONOMY AND GDPR

Obfuscation and privacy issues have become new age terms as the GDPR came into effect on 25-5-2018 and owing to the popularisation of the Puttaswamy's judgment[2], declared the right to privacy as a fundamental right under Article 21. Due to the technological advancements, the State as well as the sellers, advertisers, search engines and other market players have access to personal data of the data subjects. This brings up privacy issues for the data subjects which is countered by invocation of their right to privacy, thus showing an impact on the power politics between the data subjects and the data processors. The said regulations are said to have an effect on the data privacy law of the EU and other countries including India. Further, these regulations and Big Data have the potential to impact competition law through heterogeneous means. This essay aims to analyse the competition concerns which are raised by Big Data and discusses if the said regulations along with other national laws and regulations provide a viable solution to the competition issues or becomes another draconian law subverting the economic interests of the businesses in an attempt to protect the individual civil liberties.

The exponential growth of the digital economy has enabled the rise of business models based on the collection and processing of "Big Data".[3] Many organisations have tried to define Big Data, however, there is no conclusive definition which covers all its aspects. Big Data is high-volume, high-velocity and/or high-variety information assets that demand cost-effective, innovative forms of information processing that enable enhanced insight, decision-making, and process automation. In simpler

2. *K.S. Puttaswamy* v. *Union of India*, (2017) 10 SCC 1.
3. OECD, Big Data: Bringing Competition Policy to the Digital Era, November 30, 2016, <http://www.oecd.org/competition/big-data-bringing-competition-policy-to-the-digital-era.htm>.

terms, Big Data refers to the collection of data obtained online as well as offline which is processed using personalised algorithms into information which indicates trends, people's preferences and other parameters and indicators which assists businesses and analysts in making better and more informed decisions.

GDPR provides for a change in the power structure by giving rights to individuals and placing obligations on the organisations in order to incentivise the public by making them feel empowered. GDPR is built upon the foundation of some key principles like lawfulness, transparency and accountability, data minimisation, purposefulness, integrity and confidentiality. It has also made space, among other rights, for data subject's consent as well as the right to data portability. This allows the data subjects to have a greater bargaining power with respect to the information they have provided and its use by the organisations. GDPR is designed to place a greater onus on the EU's trading partners in respect of the services provided digitally. India was the 10th largest country for EU exports, and the 9th largest for EU imports in 2017[4], and thereby, data subjects present in the EU would be in a larger proportion which imply a responsibility on the Indian service providers as well.

2. IMPLICATIONS ON A FREE AND FAIR MARKET: EMERGING JURISPRUDENCE

These interdependent characteristics drive both the benefits and potential risks of Big Data from a competition policy perspective.[5] The low costs of storing and processing information and the ease of data collection has resulted in the prevalence of long-term storage of information as well as collection of increasingly minute details concerning an individual which facilitates the creation of his extensive user profile.[6] The public access to this data is questionable as the data in question is the personal data (sometimes, sensitive personal data) of individuals who confide in the particular company/platform to disclose such information; and such data becomes the property of the service company which then processes it either for improving its own services or for getting a competitive advantage. However, the other side of the coin is that when the

4. Eurostat, India- EU International Trade in Goods Statstics, 2018. <http://ec.europa.eu/eurostat/statistics-explained/index.php/India-EU_%E2%80%93_international_trade_in_goods_statistics>.
5. *Supra* Note 3.
6. Joel Reidenberg, "Resolving Conflicting International Data Privacy Rules in Cyberspace" (1999) 52 Stanford Law Review 1315.

company restricts other platforms from accessing such information, the individuals are not able to share the same information (which belongs to them and they have a right over it) with other platforms giving an advantage to a single platform to have such information, thereby leading to dominance and possibly abuse of such dominance.

GDPR is going to affect all those companies wherein the users, or better known as "data subjects" are based in the EU. India, prior to the enactment of the GDPR, took a step ahead in acknowledging the competition concerns which have been popping up with more firms taking advantage of the Big Data. In a judgment of February 2018, Competition Commission of India (hereafter "CCI") had dealt with this matter in one of the findings by the Director General (hereafter "DG") and held Google to be dominant in its relevant market and penalised it for abuse of its dominance. Investigation has revealed that Google integrates vertical search services/options/features in its online general web search services in universal results and commercial units using mechanisms that do not apply in an equivalent manner to non-Google websites/web content. This shows that competition is hampered in the market, impeding innovation, and thus, harming consumers.[7] Further, it was observed by the DG that, "Google does not disclose to the advertisers the details of their quality score[8] or quality scores and bids received from various advertisers for a particular keyword in an auction, even on historical basis." The advertisers may be oblivious to the fact that demotion of their advertisements is due to system faults or possible quality score manipulations, thereby subjecting them to unfair and discriminatory conditions. Investigation revealed that there exists technical feasibility of sharing greater details of quality scores of individual campaigns as well as of historical data. Non-disclosure of adequate information to advertisers renders the entire process opaque and non-transparent and susceptible to manipulation which amounts to imposition of unfair conditions on advertisers in violation of Section 4(2)(*a*)(*i*) of the Act. Google was, thus, found to be abusing its dominant position by not making such details available to its advertisers and following a non-transparent procedure.[9] The quality scores for a particular keyword is based on the number of times it has been entered into the search bar and the quality scores are the processed information

7. *Matrimony.com Ltd.* v. *Google LLC*, *re*, 2018 SCC OnLine CCI 1 <https://www.cci.gov.in/sites/default/files/07%20%26%20%2030%20of%202012.pdf>.
8. Quality score is an estimate of the quality of your ads, keywords, and landing pages. Higher quality ads can lead to lower prices and better ad positions; <https://support.google.com/adwords/answer/140351?hl=en>.
9. *Ibid.*

from the data collected from the search bar. Further, Google restricted the access to such information, taking undue advantage and gave preferences to its own verticals which was held to be anti-competitive in nature as the other advertisers were impervious of the reason for not getting the number of views which it should have.

GDPR provides for data portability by providing clear rights and entitlements to the data subjects over the data they provide. In a way, the said regulations have proposed a property based rights regime with a normative itch for the protection of interests of the data subjects (*i.e.* the consumers). Protection of interests of the consumers is in line with the vision of the Competition Act, 2002. The data subject shall have the right to receive the personal data concerning him or her, which he or she has provided to a controller, in a structured, commonly used and machine-readable format and have the right to transmit that data to another controller without hindrance from the Controller to which the personal data have been provided.[10] It is yet unexplored, however, whether the Indian firms would be bound by GDPR for all their users to ensure equality or the EU users would be given a preferential treatment. Europe is a substantial marketplace for the ITeS, BPO and pharmaceutical industry in India. The size of the IT industry in the top two EU Member States (*i.e.* Germany and France) is estimated to be around 155–220 billion USD.[11] Thus, for the Indian IT industry to keep continuing to do business in Europe, it needs to comply with the GDPR.[12] The GDPR imposes a penalty structure of 20 million EUR or four per cent of global turnover (on the higher side) in cases of non-compliances. But application of foreign laws to domestic transactions may raise sovereignty concerns in the international law arena. GDPR applies to processing of personal data wholly or partly by automated means and to the processing other than by automated means of personal data which form part of a filing system or are intended to form part of a filing system.[13] The regulation applies to the establishment or processor based in the EU and to all those

10. Art. 20, GDPR, <https://gdpr-info.eu/art-20-gdpr/>.
11. Rahul Kumar, India get Ready for EU's New Data Regime, April 25, 2017 <http://www.cioandleader.com/article/2017/05/02/india-gets-ready-eu%E2%80%99s-new-data-regime>; <https://www.pwc.in/consulting/cyber-security/blogs/how-can-indian-organisations-prepare-for-the-gdpr-regime.html>.
12. Sivaram Krishnan, How Can Indian Organisations Prepare for GDPR Regime, 2018 <https://www.pwc.in/consulting/cyber-security/blogs/how-can-indian-organisations-prepare-for-the-gdpr-regime.html>.
13. Art. 2, GDPR.

not established in the EU but processing the data of data subjects based in the EU.[14]

3. DATA EXPLOITATION AND MARKET INFLUENCE

There has been a rising trend of the socio-economic activities being carried out online in reaction to which, the businesses have started preferring such models of operation which include data as an input for taking important decisions. In markets where Big Data is an important asset or input for business success, a concern may arise that the massive accumulation of personal information and intensive use of data analytics may enhance market power, lock-in consumers, and raise barriers to entry.[15] In business, data exploitation promises to create value in a variety of operations, from the optimisation of value chains in global manufacturing and services more efficient use of labour and tailored customer relationships.[16] The reduction in the costs provide a greater incentive to the businesses to rely on Big Data. Such market efficiencies do give rise to the issue of market power, however, as held in the *Google case*, it is a strong indicator of the fact of holding market power but not conclusive proof. Holding market power is not anti-competitive. It is just one of the many factors to determine dominance which is, in itself, not anti-competitive, but an act jeopardising the interests of the other players in the market may be anti-competitive. Competition Act, 2002 is an Act to provide, keeping in view of the economic development of the country, for the establishment of a Commission to prevent practices having adverse effect on competition, to promote and sustain competition in markets, to protect the interests of consumers and to ensure freedom of trade carried on by other participants in markets, in India, and for matters connected therewith or incidental thereto.[17] Section 19(1)(*c*), Competition Act, 2002 (hereinafter called "the Act") provides six factors for determining whether an agreement has an appreciable adverse effect on competition, wherein the first three are anti-competitive in nature and the latter are pro-competitive in nature. In the case of Big Data, it does provide market efficiencies to all the businesses adopting such models creating a pro-competitive environment which marshals metamorphosis of technology and production

14. Art. 3, GDPR.
15. *Supra* Note 3.
16. OECD, Data Driven Innovaton for Growth and Well Being, <http://www.oecd.org/sti/ieconomy/data-driven-innovation.htm>.
17. Preamble, Competition Act, 2002, <https://www.cci.gov.in/sites/default/files/cci_pdf/competitionact2012.pdf>.

of goods and services. It, in effect, provides benefit to the consumers through provision of goods and services fulfilling their requirements as much as possible and making them cost effective as well due to reduced costs of data collection, storage and processing. There are a large number of benefits to be gained by collecting and analysing personal data from individuals. Pooled datasets allow quicker detection of trends and accurate targeting. For instance, in the healthcare sector, by collecting and analysing large data sets of individual's health records and previous hospital visits, healthcare providers could make diagnostic predictions and treatment suggestions.[18] An individual's personal locational data could be used for monitoring traffic and improving driving conditions on the road.[19] Banks can also use Big Data techniques to improve fraud detection[20] and insurers can make the process of applying for insurance easier by using valuable knowledge gleaned from pooled datasets.[21]

In response to these benefits, it may be argued that access to Big Data also allows for a greater scope for the firms to enter into exclusionary practices and collusive agreements both vertically and horizontally (sometimes through mergers). As an effect, there will be a significant gap in the quality of goods and services provided which will consequently have an adverse impact on the interests of the smaller firms who do not have sufficient resources to manage Big Data or those who refuse to enter into tie-ups with the data processing firms.

The concept of appreciable adverse effect on competition is quite nebulous as it is very subjective to decide whether a particular activity or agreement is pro-competition or anti-competition.

The provision of discriminatory access to data, with the intention of providing one company with an unduly competitive advantage over other competitors can be observed, for instance, when a supplier, a platform, or a marketplace operator is vertically integrated in the retail market

18. Clemens Suter-Crazzolara, "Big Data and the Journey to Personalized Medicine", *Forbes* (17-11-2015). Available from <https://www.forbes.com/sites/sap/2015/11/17/big-data-and-the-journey-to-personalizedmedicine/#7865d751b0ee>.
19. Matthew Sparks, "GPS Big Data: Making Cities Safer for Cyclists", *The Telegraph* (9-5-2014). Available from <http://www.telegraph.co.uk/technology/news/10818956/GPS-big-data-making-cities-safer-for-cyclists.html>.
20. 6 Jacomo Corbo et al, "Applying Analytics in Financial Institutions' fight against fraud", McKinsey and Company (April 2017). Available from <https://www.mckinsey.com/business-functions/mckinsey-analytics/ourinsights/applying-analytics-in-financial-institutions-fight-against-fraud>.
21. Information Commissioner's Office (UK), "Big Data, Artificial Intelligence, Machine Learning and Data Protection", Available from <https://ico.org.uk/for-organisations/guide-to-data-protection/big-data/>.

and uses its access to data in the upstream market to obtain an unfair advantage over the other retailers. Even in the absence of vertical relations, a firm may discriminate against access to data with an attempt to exclude a viable competitor.[22] Alternatively, the horizontal firms like the General Web Search Engines may prevent each other by restricting access to information or delaying the release of information or by giving preference to their own verticals. By such practices, the firms with a technical advantage will also get a competitive advantage through behavioural advertising wherein through Big Data, they would be able to easily identify the search trends, people's preferences, etc. and conclude their tastes and preferences. Service providers monetise their online search business through online search advertising. Internet users, who utilise search services, form consideration by providing their attention or "eyeballs" to the search result pages containing links to web content. In addition, they allow the search engines to collect their information for use. By doing so, users facilitate the generation of revenues through sponsored advertisements. On the other hand, by allowing links and content from their webpages to appear in search results, websites enable search engines to maintain and enlarge their internet user base.[23]

4. CONTENTIOUS COLLUSION

Another kind of anti-competitive practice is the collusive conduct, *i.e.* the formation of digital cartels either horizontally or across different services (as in case of WhatsApp and Facebook). Some firms may use similar or identical algorithms for processing of data, or some may agree to share their Big Data with each other or a firm may allow such service at the payment of an exorbitant price. Some bigger platforms like Google are in a better bargaining position to the data subjects which allows space for the former to enter into exclusionary contracts with data processing companies, thereby restricting other platforms from accessing such information. At a more sophisticated level, firms may use Big Data to facilitate (tacit) collusion, either by improving market transparency, or by making actions more interdependent, for instance, by programming immediate retaliations to price falls. Companies may also use artificial intelligence to create profit-maximising algorithms that, through machine learning, may achieve tacit collusion, even in cases where the programmer did not

22. Autorité de la Concurrence and Bundeskartellamt (2016), <https://one.oecd.org/document/DAF/COMP(2016)14/en/pdf>.
23. *Supra* Note 1.

initially foresee such an outcome.[24] It means that the algorithms put these companies in such a position that they may enter into collusive contracts with other companies to the detriment of the interests of consumers as well as other competitors. But such acts are prejudicial to the interests of other players in the market including the other sellers and/or service providers as well as the consumers, as in essence, it derogates the core purpose of the Act.

The soaring number of mergers in the contemporary scenario allows for a greater intrusion into the lives of the data subjects and fundamentally violates the principles of data localisation, data minimisation and proportionality principles. The Big Data is so colossal and processes all the miniscule details of the data subjects that its clear and express purpose gets camouflaged. Mergers, whether horizontal, vertical or conglomerate, have been making unbridled use of this information and thus, have raised serious competition law concerns. Use of Big Data by and through mergers upsurges both price and non-price competition. A case of horizontal mergers is that of Facebook-WhatsApp merger whereby both the consumer communications applications with significant market shares merged in order to exchange their database with each other. A number of respondents to the market investigation stated that they expect the transaction to materially strengthen Facebook's position in the provision of online advertising services as a result of the increased amount of data which will come under Facebook's control.[25] However, due to the existence of other alternative social networking platforms and consumer communications apps, the Commission declared it compatible with internal market and EEA Agreement.[26] Before the CCI, there was a complaint that WhatsApp had increased its customer base from 450 million to 1 billion by sourcing funds from Facebook, and in return, provided details of its users to Facebook by mandatory linking of the WhatsApp accounts to the Facebook accounts. The CCI, however, held that the removal of the subscription fees may be due to the presence of competitors like Hike Messenger which provide communication services without a subscription fees. It must be noted that WhatsApp was an already existing communication services provider and with the entry of the new competitors, it does not face much impact on its business

24. *Supra* note 3.
25. Case M.7217 – Facebook/ WhatsApp Commission decision pursuant to Article 6(1)(b) of Council Regulation No 139/2004. <http://ec.europa.eu/competition/mergers/cases/decisions/m7217_20141003_20310_3962132_EN.pdf>.
26. Agreement on the European Economic Area.

because of the multi-homing behaviour. When users use products/services from two competing product/service providers or avail benefits of network size, it is called multi-homing. The concept of multi-homing has been used extensively in credit cards, banking and telecommunications industry.[27] The Irish Data Protection Authority (DPC) said that it had maintained its insistence that WhatsApp's EU personal data not be shared with Facebook for the management of advertising campaigns and product enhancement purposes until it was satisfied that there was a lawful basis for doing so.[28] Ireland's Data Protection Commissioner, Helen Dixon, told *Reuters* in an interview, "in fact WhatsApp reconfirmed with us recently that moving into GDPR in May, it would continue to observe the pause on processing of data for these purposes", referring to the EU GDPR which from May will require firms to give customers more control over their online information.[29] In another merger of Google and DoubleClick, concerns have been voiced that the new entity could implement a wide range of exclusionary price and non-price strategies. The exclusionary strategies arising from the "conglomerate" dimension of the merger include 1) increasing the price of DoubleClick tools when used by publishers or advertisers with competing ad networks or selectively increasing the price of DoubleClick tools to customers less likely to switch to other ad serving tools suppliers; 2) degrading DoubleClick tools' quality when used with competing ad networks; 3) bundling DoubleClick tools with Google's intermediation services (either through pure or mixed bundling); and finally 4) "tweaking" the ad arbitration mechanism to serve ads in favour of AdSense. The exclusionary strategies arising from the "vertical" dimension of the merger include input foreclosure (that is to say the refusal to sell or raising rivals' costs) in the sale of ad serving tools to advertising networks that compete with AdSense.[30] The theories of harm based on the vertical and conglomerate dimensions of the merger assume that the merged entity would have the ability to foreclose competing networks (through the strategies described) because

27. Monika Mital and Sumit Sarkar, "Multihoming Behavior of Users in Social Networking Websites: A Theoretical Model" (3-4-2012) 24(4) Information Technology & People 378–392. Available from <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2033647>.
28. Reuters, Facebook's EU Regulator Says WhatsApp yet to Resolve Data Sharing Issue, February 28, <https://www.reuters.com/article/us-eu-dataprotection-whatsapp/facebooks-eu-regulator-says-whatsapp-yet-to-resolve-data-sharing-issue-idUSKCN1GC2H8>.
29. *Ibid.*
30. Commission Decision of 11/03/2008 declaring a concentration to be compatible with the common market and the functioning of the EEA Agreement Case No COMP/M.4731 – Google/DoubleClick <http://ec.europa.eu/competition/mergers/cases/decisions/m4731_20080311_20682_en.pdf>.

DoubleClick has significant market power in the supply of ad serving tools, publishers face high switching costs with respect to the ad serving technology. Ad serving tools are an important component of the indirect distribution channel for online advertising and there are strong direct and indirect network effects.[31] However, again due to the existence of various alternatives available and multi-homing, this merger is likely to have less or no significant detrimental effect on competition.

The conglomerate mergers whereby, two subsidiaries of the same parent company merge and use each other's database, encash on the principle of reciprocity. Reciprocity refers to a seller's practice of utilising the volume or potential volume of its purchases to induce others to buy its goods or services.[32] Through merger, the subsidiaries get access to the database of the other subsidiary and its potential volume of purchases also increases. By a simultaneous use of these two, it takes a greater advantage over its competitors. However, the concerns it raises are that it directly violates the principles of data minimisation and proportionality in the sense that the subsidiaries now have access to data more than required which imbalances the proportionality of benefit from the merger. Such sharing of data lacks the consent of the data subjects and even if they are to give their consents, they still do not have an equal bargaining power.

5. PRINCIPLED PROTECTION OF PRIVACY: GDPR AND INDIAN LAW MAKING

Data minimisation, one of the key principles recommended under GDPR, as well as under the data privacy framework proposed by the Justice Sri Krishna Committee, means that data t is processed ought to be minimal and necessary for the purposes for which such data is sought and other compatible purposes beneficial for the data subject. The scope of processing of data becomes significant in light of reports of Aadhaar data breaches by private entities and the use of technological tools by data-driven businesses like Facebook in context of Cambridge Analytica imbroglio. Governments and businesses alike, have access to, and do utilise personal, and even sensitive data, to gauge consumer/citizen behaviour in various spheres. Data minimisation aims to restrict such disproportionate use by limiting the scope of demand of data to the

31. *Ibid.*
32. Howard Adler Jr., "Frontier Issues in Merger Doctrine" (1970) 25 Bus. Lawyer 669; Lawrence G. Goldberg, "The Effect of Conglomerate Mergers on Competition" (1973) 1 The Journal of Law & Economics 16, 137–58, <http://www.jstor.org/stable/724829>.

essential and beneficial minimum. This would be difficult to implement as customer acquisition and marketing strategies of technological giants would need to be completely overhauled. In the era of efficiency, it cannot be expected that data-driven businesses will view privacy as a social good or agree to be held publicly accountable.[33] Under the GDPR, the "destruction, loss, alteration, unauthorised disclosure of, or access to" people's data has to be reported to a country's data protection regulator where it could have a detrimental impact on owners and stakeholders. This can include, but is not limited to, financial loss, confidentiality breaches, damage to reputation and more. The Information Commissioner's Office has to be told about a breach 72 hours after an organisation finds about it and the people it impacts also need to be informed.[34] When the subsidiaries belonging to different fields merge, the principle is violated because unnecessary data also flows in leading to data privacy issues.

Because the subsidiaries have sufficient capital and database now, they are able to manipulate and predate the prices having adverse effect on the competition. In *Reliance Jio case*[35], wherein it started providing 4G LTE services for free for a year using the funds of Reliance Industries Limited led to a case of predatory pricing[36] on the basis of the database of RIL which it had access to. The merger was not found to be anti-competitive because there was no express agreement to the same effect and the facts were not clear. A similar approach is being adopted by the data driven startup industries wherein they create a pool of database which can be used by the other startups and sometimes openly trade their database which does not involve the consent of the data subjects and allow space for them to manipulate prices detrimental to the interests of the consumers, thereby vitiating the purpose of the Act as envisaged in its preamble. In order to ensure that data minimisation becomes a reality, safeguards for the informed and comprehensive consent of the individual on applications creating socio-economic efficiency, must be provided. With rapid globalisation and the concept of global economy emerging, the vast pool of data which exists in the world also calls for data localisation, that is to

33. A. Sinha, "India's Data Protection Framework will Need to Treat Privacy as a Social and Not Just an Individual Good" 53 (18) The Economic and Political Weekly (5-5-2018).
34. Matt Burges, What is GDPR? The Summary Guide to GDPR Compliance in U.K., 2018 <http://www.wired.co.uk/article/what-is-gdpr-uk-eu-legislation-compliance-summary-fines-2018>.
35. *Bharti Airtel Ltd.* v. *Reliance Industries Ltd. and Reliance Jio Incomm Ltd.*, *re*, Case No. 03 of 2017, <https://www.cci.gov.in/sites/default/files/3%20of%202017.pdf>.
36. Predatory pricing means pricing so low that competitors quit rather than compete, permitting the predator to raise prices in the long run; <http://www.oecd.org/competition/abuse/2375661.pdf>.

say that the Big Data should not be shared across borders and should be localised to the area where it is being processed.

There are a couple of legislations dealing with privacy but there is no concrete data protection law in India. Also, the competition law jurisprudence is also an evolving field of law. Puttaswamy's judgment had made it clear that right to privacy is a fundamentally protected right under Article 21 of the Indian Constitution. The right to privacy encapsulates informational privacy, *i.e.* the extent of access to personal information which can be decided by the data subject because the information belongs to him. Like other rights which form part of the fundamental freedoms protected by Part III, including the right to life and personal liberty under Article 21, privacy is not an absolute right. A law which encroaches upon privacy will have to withstand the touchstone of permissible restrictions on fundamental rights. In the context of Article 21, an invasion of privacy must be justified on the basis of a law which stipulates a procedure which is fair, just, and reasonable. The law must also be valid with reference to the encroachment on life and personal liberty under Article 21. An invasion of life or personal liberty must meet the three-fold requirement of 1) legality, which postulates the existence of law; 2 need, defined in terms of a legitimate State aim; and 3) proportionality which ensures a rational nexus between the objects and the means adopted to achieve them.[37] Apart from this, Sections 43-A and 72-A, Information Technology Act, 2000 talks about the compensation to be given in cases of non-implementation and non-maintenance of reasonable standards of security in dealing with sensitive personal data of individuals and about the punishment in cases of disclosure of personal information as a breach of contract or without consent. Such contracts include contracts in the electronic form as well. However, these sections do not impose sufficient liability and does not employ adequate penal measures so as to prevent abuse of Big Data, and thereby hampering of the competition in market. Such protection of data cannot be a blanket protection as it would contradict the purpose of the Competition Act. Such protection should be allowed only to the extent where it does not hamper competition or consumer interests in a market.

For long, our antitrust regimes have been structured around the idea that monopolies are bad and oligopolies are fine. But we know oligopolies have not worked. Although, cost of living and prices have stabilised in the Western world, wages and job growth have flattened. On the

37. *K.S. Puttaswamy* v. *Union of India*, (2017) 10 SCC 1.

contrary, stocks, dividends, executive pay and corporate profits are soaring. A possible resolve can be to take measures to alter how dominance is determined. Such measures may include, *firstly*, using rate of increase in the market share as a metric. Amazon posts a market share growth rate of around five per cent for e-retail and two per cent for overall retail market which signals its monopoly power. *Secondly*, dominance in a given part of an industry should be enough to bring the firm's presence in other parts of the industry under scanner. The reason being once a given part is consolidated, other parts feel the need to consolidate. Like Google uses its dominance in search engine and operating systems to help its maps business and app development business respectively. *Lastly*, attempts to establish an international antitrust regime must be undertaken. Today's firms are not limited to any one country and use their incomes in one country to fund loss-making expansions and acquisitions elsewhere. As such antitrust activities in one nation have consequences elsewhere. For instance, while Grab and Uber might have merged in Singapore, there would be consequences across South East Asia.

6. STRENGTHENING THE CONTOURS OF REGULATION OF DIGITAL ECONOMY: THE INDIAN PRIVACY CODE

K.S. Puttaswamy v. *Union of India*[38] *case* presents the onward march of public understanding towards the value of data privacy. Justice S.K. Kaul's judgment especially points out the transcendental shift brought in by Big Data and its impact on individual dignity. The need for appropriate and comprehensive regulation was underlined emphatically in this judgment. The regulatory framework proposed in the White Paper on data protection by Justice Srikrishna Committee makes exceptions for innovation oriented and socio-economic development centred use of personal data.[39] However, these unclear exceptions for ease of doing business are likely to swallow up the rule. The rule has unalienable fundamental human right to privacy at the very core of it. Hence, the citizen and community led draft called the Indian Privacy Code, 2018 underlines the need for effective procedural safeguards in case of consensual usage of personal information. It also makes unambiguous standards for sharing, deleting, processing and storing Big Data. The underlying principle is that economic efficiency for corporations cannot be attained at the expense

38. (2017) 10 SCC 1.
39. Meity, White Paper on Data Protection framework for India - Public Comments invited, December 18, 2017. <http://meity.gov.in/white-paper-data-protection-framework-india-public-comments-invited>.

of personal dignity. It makes a progressive leap from GDPR by bringing in specific provisions like Section 15 of the said Code that regulates the transmission and processing of data. All Data Controllers are sought to be made responsible to ensure clarity in their notice and communication.[40] They are also sought to be made duty bound to obtain comprehensive, clear and certain consent of the individuals.[41] These propositions and recommendations strengthen the safeguards for fair competition since they prohibit the processes of hegemonic market acquisition utilised by certain conglomerates and corporations to take undue advantage of Big Data analytics. It also narrows the scope of abuse of personal data.

CONCLUSION: TOWARDS A DYNAMIC, FREE AND FAIR DIGITAL ECONOMY

It is imperative for an emerging economy to ensure that the overall processes of business transformation do not adversely impact the fundamentals of a market economy free competition. The changing regulatory framework in the global context and the progressive reform in the Indian context represents a serious effort to safeguard the essential nature of market economy. Once stringent data privacy regulations like Indian Privacy Code, 2018 are swiftly implemented, the scope of unconsented use of user data to create market advantage would significantly reduce. This would, however, not be the ultimate accomplishment for advocates for free competition. The competition regulators like CCI need to upscale and update their regulatory processes, human resources, investigative abilities, and technical expertise in line with the changes that are happening in the larger economic context.

40. The Indian Privacy Code, 2018, S. 6.
41. The Indian Privacy Code, 2018, S.7 <https://saveourprivacy.in/bill>.

Emerging Contemporary Legal Issues in Blockchain Technology Smart Contracts: The Opportunities & Challenges

—*Kuruvila M. Jacob & Utsav Mitra*†

ABSTRACT

Smart contracts have been the topic of much heated debate and discussion recently. Although envisioned around two decades ago, smart contracts only became a reality with the advent of the blockchain technology. This has given rise to several questions regarding the legality and applicability of these self-executing digital contracts. Today, these questions are particularly relevant because of the large commercial transactions that take place every day, involving enormous tracts of data, huge costs, and unnecessary delays by the parties in execution of the terms of the contract. This has led to legal scholars, practitioners and academicians exploring the possibilities of applying smart contracts and replacing traditional contracts.

In this article, the authors have explored the possibilities and challenges associated with smart contracts from a legal perspective. In Part I, the authors have discussed what smart contracts are, and their key characteristics. Part II of this article is a comparison between traditional contracts and smart contracts. Part III of this article deals with the legal issues and hurdles that smart contracts face before they can finally be applied to day-to-day transactions. Part IV of this article tests the validity of smart contracts within the contours of the legal framework in India, and determines whether they can currently be considered as valid contracts in India. Finally, in Part V, the authors have discussed the way forward and have arrived at the conclusion that while there exists several possibilities in applying smart contracts, the existing laws must be revamped to incorporate them.

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PART I: WHAT ARE SMART CONTRACTS?

In today's highly digitised world, commerce and technology go hand in hand. This has resulted in several advances, such as the application of blockchain technology, which is touted to be the next step in the peer to peer economy.[1] Blockchains are basically an open and transparent distributed ledger, organised into smaller blocks containing an encrypted and verifiable database through algorithms and code.[2] They are designed to be resistant to data modification or tampering, and can record the transactions between the parties on a permanent basis. This ensures that the parties will have a lasting account of their transaction and ownership details.[3] Today, several modern applications of blockchain technology already exist, like cryptocurrency, synchronised data storage, and other permanent information sharing mediums like centralised health records, insurance records, Know Your Customer ("KYC") records etc.

A smart contract is also a product of such blockchain technology application where computer programmes can automatically execute the terms of a contract.[4] Here, the parties digitally sign the smart contract using cryptographic security and deploy it onto a distributed ledger, *i.e.* the blockchain.[5] Once the stipulated conditions in the code have been met with, the programme automatically triggers the required action, thereby guaranteeing enforcement of the terms of the contract.[6] Nick Szabo, who is widely credited as the inventor of these modern day smart contracts, defines them as "a set of promises, including protocols within which the parties perform other promises".[7] According to Szabo, it is both an instance of a computer code, and a running software programme which interprets the code, accepts input conditions, and then decides on the outcomes.[8] However, Szabo's definition of smart contract is wide enough to even encompass simple automated transactions such as those of vending

1. Josh Stark, "How Close Are Smart Contracts to Impacting Real-World Law?", COINDESK (14-6-2018, 10:00 a.m.), <http://www.coindesk.com/blockchain-smarts-contracts-real-world-law/>.
2. Price Water Coopers Global Power & Utilities, "Blockchain—an opportunity for energy producers and consumers" (2017) 4.
3. *Ibid.*
4. Oliver Herzfeld, "Smart Contracts may Create Significant Innovation Disruption", *Forbes* (14-6-2018, 11:00 a.m.) <http://www.forbes.com/sites/oliverherzfeld/2016/02/22/smart-contracts-may-create-significantinnovative-disruption/#33451b062702>.
5. Institute of International Finance, "Getting Smart: Contracts on the Blockchain" (2016), <https://www.iif.com/system/files/32370132_smartcontracts_report_may_2016_vf.pdf>.
6. *Ibid.*
7. Nick Szabo, "Smart Contracts: Building Blocks for Digital Markets", *Phonetic Sciences.*
8. *Ibid.*

machines, or automated parking ticket machines. Thus, although there is no universally accepted definition of a smart contract, simply put, a smart contract can be said to be an agreement whose execution is automated by a computer code.[9]

Thus, we can distill the key characteristics of a smart contract, as a contract in digital form, where the contractual clauses are embedded as computer codes in the software, and the performance of the contract is based on self-execution by the computer programme. It is solely for these reasons that advocates of this technology state that digitisation of contractual relationships are the future of large commercial transactions.[10]

Over the course of this article, the authors have discussed in detail what smart contracts are, and how they differ from traditional contracts. The authors have also brought to light and analysed some of the key legal issues which smart contracts are facing today, such as enforceability, dispute resolution, jurisdiction, etc. Finally, the authors have tested the legality of smart contracts against the existing legal framework in India, and have also discussed the way forward for these contracts.

PART II: SMART CONTRACTS VIS-À-VIS TRADITIONAL CONTRACTS

Before we delve further into the legal intricacies revolving around smart contracts, some pertinent questions that might arise are, what are the differences between traditional contracts and smart contracts? Are smart contracts indeed an upgrade from traditional contracts, and what are the foreseeable benefits for the parties who enter into a smart contract? The authors have tried to answer these questions for the benefit of the readers by analysing and discussing both forms of contracting, *i.e.* traditional contracts as well as smart contracts.

The primary difference between traditional contracts and smart contracts is that smart contracts can automatically perform the obligations that have been committed to the agreement without any human intervention whatsoever. This means that once initiated, the execution of the contract becomes irrevocable, unless the outcome on which the contract

9. Alexander Savelyev, "Contract law 2.0: «Smart» Contracts as the Beginning of the End of Classic Contract Law", Higher School of Economics Research Paper No. WP BRP 71/LAW/2016, 7, <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2885241>.
10. Cheng Lim & T. J. Shaw, "Smart Contracts: Bridging the Gap between Expectation and Reality", Oxford Law Faculty Business Law Blog, (17-6-2018, 10:00 a.m.), <https://www.law.ox.ac.uk/business-lawblog/blog/2016/07/smart-contracts-bridging-gap-between-expectation-and-reality>.

is coded itself is based on an unmet condition by either of the parties.[11] Therefore, once the contract is deployed onto the distributed ledger, the computer programme alone controls the execution, hence making it more efficient and economical, with fewer opportunities for error, misunderstanding, delay, or dispute.[12] This is unlike traditional contracts where the parties themselves will execute the terms of the contract and will be prone to human errors, time constraints, financial difficulties, etc. This automatic execution aspect is perhaps the biggest advantage for smart contracts over traditional forms of contracts.

Another important distinction between the two lies in the medium on which the contract is formed. While traditional contracts are usually written down and formed on tangible mediums like paper, smart contracts are data oriented, facilitating computer analysis.[13] Here, the medium will always be the digital space where the terms and conditions of the contract are entered into by an algorithmic code. Moreover, while traditional contracts are concluded between the individual contracting parties who are also in charge of interpreting the clauses and enforcing the terms, smart contracts have an additional party, *i.e.* the computer system where the code has been entered into. This code is in charge of interpreting the contractual clauses on its own, and determining what was promised under what condition,[14] and when exactly to execute the terms. Thus, it is evident that smart contracts are unique from traditional contracts, and can be said to be a sort of an upgrade from traditional contracts because they remove the human involvement entirely, which also effectively increases the efficiency when it comes to the enforcement aspect of the terms in the contract. This will greatly benefit the parties, as it ensures that the transaction is complete, without any delays or additional costs.

Although the opportunities revolving around smart contracts are immense, and there are significant benefits in the terms of cost reduction and security of enforcement, disputes may and will inevitably arise. It is for this reason that we must also analyse the intersection of contract law

11. Norton Rose Fulbright, "Can Smart Contracts be Legally Binding Contracts?" (2016), <http://www.nortonrosefulbright.com/files/r3-and-norton-rose-fulbright-white-paper-full-report-144581.pdf>.
12. Institute of International Finance, "Getting Smart: Contracts on the Blockchain" (2016), <https://www.iif.com/system/files/32370132_smartcontracts_report_may_2016_vf.pdf>.
13. Harry Surden, "Computable Contracts" (2012) 46 U C Davis L Rev 624.
14. Andy Robinson and Tom Hingley, "Smart Contracts: The Next Frontier?", Oxford Law Faculty Business Law Blog, (Jun. 18 10:00 a.m.), <https://www.law.ox.ac.uk/business-law-blog/blog/2016/05/smart-contracts-next-frontier>.

and technology, and determine whether smart contracts can be legally binding, *i.e.* if they are contracts at all. Moreover, while proponents of smart contracts will argue that these forms of contracts will reduce legal disputes between the contracting parties,[15] there exist significant challenges and legal intricacies in replacing human enforced agreements with computer programmes. Take for example, instances where the computer programme is hacked or tampered with, or if some situation arises after the smart contract has been entered into the distributed ledger system and the parties wish to amend their contractual positions. Or worse, imagine a situation where either party is dissatisfied after the computer programme has already executed the contract. Here, the only recourse will be to approach the courts and seek a remedy against an already executed contract and restore the parties back to a position as if the contract had not taken place. Thus, the only way to prevent smart contracts from facilitating illegal or disfavoured conduct is to regulate them.[16]

PART III: THE LEGAL ISSUES INVOLVED

Smart contracts essentially consist of an immutable, unstoppable, and irrefutable computer code that explicitly or implicitly decides what will happen during the existence of the contract based on the terms mutually agreed upon by the parties.[17] These contracts are, therefore, envisioned as potentially eliminating the need for extrinsic enforcement of legal agreements completely, thereby making business transactions cheaper, quicker, and more efficient.[18] However, this characterisation is not entirely true, and before we can successfully utilise smart contracts in today's world, we must analyse and examine the legal issues involved. As "smart" as this new form of contract sounds, they are not without their fair set of difficulties owing to these very inherent characteristics.

In this section of the article, the authors shall deal with some of the key issues involved, and provide the readers with a succinct understanding of the same. Notwithstanding their validity within the Indian legal framework, the authors will highlight some of the seemingly intractable and

15. Don Tapscott & Alex Tapscott, "Blockchain Revolution: How the Technology Behind Bitcoin is Changing Money" (2016) Business, And The World 47, 108.
16. Max Raskin, "The Law and Legality of Smart Contracts" (2017) 1 Geo L Tech Rev 305, 306.
17. Larry D. Wall, "Smart Contracts in a Complex World", Federal Reserve Bank of Atlanta (20-6-2018, 6:00 p.m.), <https://www.frbatlanta.org/cenfis/publications/notesfromthevault/1607>.
18. "Not-So-Clever Contracts", The Economist (Jun. 21,2018, 8:00 PM) https://www.economist.com/business/2016/07/28/not-so-clever-contracts>.

longstanding problems pertaining to smart contracts, such as non-operational clauses, self-enforcement, and dispute resolution issues.

Execution of non-operational clauses

A contract broadly contains operational and non-operational clauses. According to a recent discussion paper released by the International Swaps and Derivatives Association ("ISDA") of the US, "operational clauses" have been understood to mean those clauses that "generally embed some form of conditional logic—*i.e.* upon the occurrence of a specified event, or at a specified time, a deterministic action is required."[19] In order for a code to automatically execute a term, the term must be operational in nature, *i.e.* "if x, then y" or conditional in nature. Thus, this makes operational clauses highly susceptible to being machine-automated[20] in contrast to non-operational clauses which are more difficult to self-execute.

This is so because non-operational clauses are defined as "clauses that do not embed such conditional logic but that, in some respect, relate to the wider legal relationship between the parties."[21] Some examples of these clauses involve choice of law clause, jurisdictional clause, and good faith clauses to name a few. Now, because these non-operational clauses are inherently very subjective in nature, they do not fit the form of "if x, then y"[22] as provided before. This is because such non-operational clauses, albeit defined, makes it difficult and sometimes impossible to interpret and accurately be converted into the "if x, then y" form by a computer programme.[23] For example, let us take the example of a good faith clause between the parties to a smart contract. In this case, although the term good faith has an identifiable legal meaning, its interpretation depends solely on the jurisdiction as well as the facts and circumstances in which it is being interpreted.[24] The primary reason for such interpretation owes to the fact that they are ultimately subjective in nature, and there cannot be a strait jacket formula to determine what conduct is of a good faith nature.

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19. International Swaps and Derivatives Association, "Smart Contracts and Distributed Ledger—A Legal Perspective (2017) 10, <https://www.isda.org/a/6EKDE/smart-contracts-and-distributed-ledger-a-legal-perspective.pdf>.
20. *Ibid*, 12.
21. *Ibid*, 13.
22. Wolfie Zhao, "OTC Trade Group: Blockchain Smart Contracts Could Spark Interpretation Challenges", COINDESK (22-6-2018, 9:00 p.m.), <https://www.coindesk.com/legal-experts-blockchain-smart-contracts-spark-interpretation-challenges/>.
23. International Swaps and Derivatives Association, *supra* at 12.
24. *Ibid*.

Accordingly, the authors are of the opinion that presently smart contracts are not capable of "self-executing" the non-operational terms in a contract due to their inherent subjectivity. Since most commercial contracts in today's world contains both operational and non-operational clauses, it is unlikely that smart contracts will have any utility in such instances, and will be restricted to agreements with only operational clauses.

Self-enforcement

As stated before, the pivotal difference between smart contracts and other agreements is in their self-automated enforcement mechanism. A smart contract "self-executes" the terms of the contract. This translates into self-enforcement as it automatically transfers the consideration or restricts access, such as in cases of non-payment of a loan or a rent[25] without any human intervention. Such an automated enforcement is a pre-emptive form of "enforcement", *i.e. ex ante enforcement*, as it precludes the need to resort to an *ex post enforcement* authority such as the courts or tribunals. This entails that the *ex post enforcement* authorities will be incapable of enforcing a smart contract[26] as the contract can only be executed or enforced if the preconditions have been met. Thus, smart contracts in effect cause a paradigm shift of contract enforcement from ex post authoritative judgment to ex ante automated assessment.[27]

This is particularly problematic when the smart contract is void or voidable. For example, a smart contract entered into by way of coercion,[28] undue influences,[29] fraud,[30] misrepresentation,[31,] or if the contractual terms are against public policy or unconscious or illegal,[32] the smart contract is unenforceable or enforceable at the option of the party aggrieved as per the existing contract regime. However, having said that, the smart contract will nonetheless "self-execute if the conditions therein are met irrespective of the above considerations. Hence, even if a judicial

25. Kwesi D. Atta-Krah, "Preventing a Boom from Turning Bust: Regulators Should Turn Their Attention to Starter Interrupt Devices Before the Subprime Auto Lending Bubble Bursts" (2016) 101 Iowa Law Review 1187.
26. Kevin Werbach & Nicolas Cornell, "Contracts Ex Machina" (2017) 67 Duke Law Journal 313, 332.
27. JIH Hsiao, "'Smart' Contract on the Blockchain-Paradigm Shift for Contract Law? (2017) 14 US China Law Review 685, 690.
28. Indian Contract Act, 1872, S. 15.
29. *Ibid*, S. 16.
30. *Ibid*, S. 17.
31. *Ibid*, S. 18.
32. *Ibid*, S. 23.

entity holds the smart contract to be unenforceable, such a decision cannot undo the result of the already executed agreement.[33]

On the other hand, another impediment with the rigid structure of a smart contract is that it is "tamper-proof"[34] and of a permanent nature, which in the legal sense implies that Section 62, Indian Contract Act will have no application. That is to say, that the parties will not be able to substitute a new contract for it, or rescind, or alter it[35] in the future, if necessary. Thus, a smart contract operates without any scope of intervention of the parties until its pre-defined conditions expire.[36] This is especially problematic because it is practically impossible to shield such contracts from the risk of being affected by coding errors.[37]

Even though one of the fundamental features of a smart contract is "self-enforcement" or "self-execution", this does not absolutely guarantee the performance as coding errors are impossible to discount, and may ultimately result in improper, faulty, or a failure to execute the contract automatically. In such a situation, neither party is at fault as such an error cannot be attributable in cases of a "self-executable" contract. Further, Section 56, Indian Contract Act incorporates the doctrine of frustration which discharges performance in cases of a supervening impossibility of the act agreed to be done.[38] However, the current jurisprudence of the doctrine of frustration does not contemplate an impossibility owing to a technical or a software glitch.

On a related note, albeit coding errors, failure to successfully incorporate the parties' intentions or promises can also result in a fault or improper performance. Thus, the authors are of the opinion that the self-enforcement element of smart contracts are not without inherent faults, and this may pose an immense problem, given that it is the most important characteristic of a smart contract.

33. Kevin Werbach &, Nicolas Cornell, "Contracts Ex Machina" (2017) 67 Duke Law Journal 313, 333.
34. MIK, "Eliza. Smart Contracts: Terminology, Technical Limitations and Real World Complexity" (2017) 9(2) Law, Innovation and Technology 269–300, available at <http://ink.library.smu.edu.sg/sol_research/2341> at p. 10.
35. Indian Contract Act, 1872, S. 62.
36. Eliza Mik, "Smart Contracts: Terminology, Technical Limitations and Real World Complexity" (2017) 9 Law, Innovation and Technology 269, 10.
37. Kenneth A. Bamberger, "Technologies of Compliance: Risk and Regulation in a Digital Age", (2010) 88 Texas Law Rev 669.
38. Indian Contract Act, 1872, S. 56.

Dispute resolution of smart contracts

From the above discussion, it is evident that there also exists a possibility of parties challenging the smart contract before a judicial entity. For example, in a situation wherein *A* has agreed to sell his car to *B* for 1000 Bitcoins, and they enter into a smart contract for the same. The smart contract ensures that upon receipt of payment of the 1000 Bitcoins from *B*, the title of the car gets transferred to *B*. However, let us assume that either *A* refuses to hand over the possession of the car, or the code fails to execute as *A* never had the title to the car in the first place. Thus, in either of these two scenarios, *B*'s rights have been violated and *B* will be forced to take up the matter with the appropriate judicial authority.

Hence, once this dispute arising out of a smart contract reaches the judicial authorities, it will pose several hindrances for the judicial authorities to settle it effectively and immediately. The authors have discussed these issues in three legs, *i.e. firstly*, because of the anonymity of smart contracts, *secondly*, existing uncertainty over jurisdiction and, *lastly*, the evidentiary issues.

Anonymity of smart contracts

The blockchain, or distributed ledger, is open and transparent for all to see. However, the addresses shown on this platform do not necessarily indicate the person to whom the address is associated, as the system is also designed to be anonymous.[39] In the case of a public blockchain, it becomes very difficult to establish the identity of the person involved in a particular smart contract transaction.[40] For example, even though the virtual address of one of the parties might be available on the blockchain, the actual identity of that person may still be concealed.[41] If the authors were to go back to their earlier example, *B* will effectively have no remedy because in order to file an action against *A*, he must be able to identify *A* with absolute certainty.[42] Thus, the authors are of the opinion that the anonymous nature of smart contracts might not necessarily be a good thing during dispute resolution.

39. John Lanchester, "When Bitcoin Grows Up", London Rev. of Books (1-7-2018, 9:57 p.m.), <https://www.1rb.co.uk/v38/nO8/john- anchester/when-bitcoin-grows-up>.
40. Werbach K, *supra* note 49.
41. Savelyev, *supra* at 8.
42. Samuel Bourque, Sara Fung Ling Tsui, "A Lawyer's Introduction to Smart Contracts" (2014) 4 Scientia Nobilitat 13.

Uncertainty over jurisdiction and governing law

In the case of a dispute arising out of a smart contract, another important consideration are the issues pertaining to jurisdiction. According to the Indian Code of Civil Procedure ("CPC"), civil courts shall have jurisdiction to try all suits of a civil nature.[43] Typically, this jurisdiction is determined by "territorial" and "pecuniary" considerations. In the case of smart contracts, it is nearly impossible to determine the territorial jurisdiction in case of a dispute. This is because the transaction is recorded on a distributed ledger which does not have any fixed or tangible location. As such, owing to its global and decentralised nature, it is difficult to identify which jurisdiction's law will govern the contractual issues arising out of a smart contract, as well as which court will have jurisdiction to entertain such a dispute.[44]

Hence, in the authors' opinion, parties entering into a smart contract must have the foresight to overcome such jurisdictional issues by pre-incorporating a jurisdiction and choice of laws clause in it. If this is not done, the parties and the courts will clearly face difficulty in determining the jurisdiction of the dispute.

Evidentiary issues

Since a smart contract is a contract written in computer code, this may pose problems when it comes to adducing and appreciating evidence by the judicial authorities. For instance, it is highly unlikely that ordinary judges in the courts and tribunals would possess the requisite skills to decipher and interpret computer coding directly. Hence, a smart contract will necessarily have to be produced in a common understandable language in order for the judges to review it.[45] Accordingly, the court and tribunals will have to seek the assistance of experts in coding, or smart contract technology, to translate these codes into a common understandable language. This will further lead to unnecessary delays and costs.

Nevertheless, this does not ensure that the problem is solved entirely as the plausibility of a loss of meaning or loss of intention of parties during such translation cannot be ignored. Contracts are based on the founding

43. The Code of Civil Procedure, 1908, S. 9.
44. The Law Society, "Blockchain—The Legal Implications of Distributed Systems" (2017) <https://www.lawsociety.org.uk/support-services/documents/blockchain-legal-implications-law-society-horizon-report/>.
45. Reggie O'Shields, "Smart Contracts: Legal Agreements for the Blockchain" (2017) 21 NC Banking Inst 177, 190.

principle of *consensus ad idem* and unless the common language is an accurate translation of the code, preserving the original intention of the parties, the courts will not be able to rely on the translated language.

The possible alternative to overcome such an issue is for the author of the code to draw up the translation of the code and thereafter, obtain the mutual assent of the parties before the initiation of the smart contract. This would ensure that the intentions of the parties are preserved, and also enable the court to rely on it in order to settle a dispute, if any.

PART IV: AN INDIAN PERSPECTIVE

Although a decade has passed since the inception of blockchains, cryptocurrency and smart contracts, these concepts are still a cause for much confusion and chaos, especially in developing countries such as India. Unfortunately, the abovementioned inherent ambiguities associated with this technology, and the inability to entirely understand their workings, has resulted in an impasse when it comes to the enactment of legislations and regulations governing smart contracts or blockchain technology in general. Nonetheless, the Indian Government has been trying to slowly implement blockchain applications limited to information sharing and maintenance of records, to keep abreast of the changing times. For example, very recently, the State Bank of India ("SBI") has taken the lead in launching "Bank Chain", for the sharing of KYC data among banks, and pharmaceutical companies that use blockchain technology to maintain their records.[46] Similarly, the Reserve Bank of India ("RBI") has recently vide its circular on Prohibition on dealing in Virtual Currencies (VCs), dated 6-4-2018, proscribed entities regulated by RBI to "deal in virtual currencies or provide services for facilitating any person or entity in dealing with or settling virtual currencies".[47] However, what is truly uncomforting is that several Right to Information ("RTI") reports have revealed that the RBI has been issuing circulars without researching and analysing the technology of blockchain and cryptocurrencies.[48] Similarly, the fate of smart contracts has also been left unanswered by the Indian

46. Shritama Bose, "SBI to Deploy Blockchain in Three Functions in FY19", *Financial Express* (2-7-2018, 8:00 p.m.), <https://www.financialexpress.com/industry/sbi-to-deploy-blockchain-in-three-functions-in-fy19/1058852/>.
47. RBI, Circular dated 6-4-2018. RBI/2017-18/154, Prohibition on dealing in Virtual Currencies (VCs), <https://rbi.org.in/Scripts/NotificationUser.aspx?Id=11243&Mode=0>.
48. Aheli Raychaudhuri, "Breaking! In an RTI Reply, RBI Says it has Done No Research on Cryptocurrencies", Crypto News (14-7-2018, 10:00 a.m.), <https://www.crypto-news.in/news/breaking-rti-reply-rbi-says-done-no-research-cryptocurrencies/>.

regulators till now. All this said and done, before we can freely talk about the application of smart contracts in India, we must test them against the existing legal framework and analyse the same. Hence, in this section of the article, the authors have discussed the legal challenges pertaining to the validity of smart contracts in India.

Prima facie, the moniker "smart contracts" itself is quite specious, as the mere inclusion of the word "contract" does not necessarily entail that it is a contract legally. The very basis of contract lies in the legal enforcement of promises between the contracting parties.[49] In India, according to the Indian Contract Act, 1872, a contract is specifically defined as "an agreement enforceable by law"[50] and every contract is required to fulfil the following requisites to be enforceable, *i.e.* offer and acceptance,[51] free consent, lawful consideration and a lawful object.[52] Alongside the Indian Contract Act, a smart contract being an electronic agreement must also fulfil the requisites under the Information Technology Act. The authors believe that essentials such as free consent and lawful object are factors not peculiar to the fundamental characteristics of a smart contract. They are external considerations notwithstanding the nature of the contract, be it smart or traditional.

It is in this light that the authors will attempt to analyse the validity of smart contracts within the Indian legal framework in four phases, viz., offer and acceptance, consideration and requisites of an electronic agreement.

Offer and acceptance

Firstly, in order for a smart contract to be enforceable it must satisfy the requisites of a traditional contract, starting from offer and acceptance. The underlying principle behind offer and acceptance is the concept of "mutual assent" or *consensus ad idem*. Unlike a traditional contract wherein the offer and acceptance are clearly manifested either orally or in a written form, in cases of a smart contracts, the acceptance of the contract is manifested through performance.[53]

As early as 1996, Szabo had drawn a parallel between vending machines and smart contracts. In his example, a vending machine could

49. Charles Fried, "Contract as Promise: A Theory of Contractual Obligation" (1981).
50. Indian Contracts Act, 1872, S. 2(*b*).
51. *Ibid*, S. 3.
52. *Ibid*, S. 10.
53. Max Raskin, "The Law and Legality of Smart Contracts", (2017) 1 Geo L Tech Rev 305, 322.

be considered as the primitive ancestor of smart contracts.[54] This is because in a vending machine or any automatic machine, the display of goods is an offer rather than an invitation to offer, and the acceptance of this offer takes place by inserting the money into the machine to avail the good or service.[55] In the landmark ruling of *Thornton* v. *Shoe Lane Parking Ltd*.[56], the Court of Appeal in the UK, while examining the point of formation of a contract in cases of an automated parking ticket, held:

> the customer pays his money and gets a ticket. He cannot refuse it…he was committed at the very moment when he put his money into the machine. It can be translated into offer and acceptance in this way: the offer is made when the proprietor of the machine holds it out as being ready to receive the money. The acceptance takes place when the customer puts his money into the slot.

Thus, as in the case of a vending machine or any automated machine, the bargain is presented unilaterally[57] in the case of smart contracts. For instance, a smart contract code can be distributed over the ledger as an offer, and a party may accept it through ceding a specific amount of money or virtual currency to the code.[58] This is similar to inserting money in a vending machine, or any other performance as determined by the code.

Consideration

The second important requirement in contract law is "consideration". Consideration has been defined as "an act or abstinence at the desire of the promisor for the promise."[59] In relation to traditional contracts, "consideration" usually refers to the act by the promisor, in return for the transfer of payment. This payment is usually in the form of money, which is defined by economists as "something that serves as a medium of exchange, a unit of accounting and a store of value."[60] Money is legal tender, which is defined as "that thing which must be accepted for discharging contractual obligations for all debts under the civil law of contracts."[61]

54. *Supra* at 5.
55. Elizabeth Macdonald, Ruth Dawn Atkins, Koffman & Macdonald's *Law of Contract* (8th Edn. Oxford University Press 2014).
56. (1971) 2 QB 163 at p. 169 : (1971) 2 WLR 585 (CA).
57. Todd D. Rakoff, "Contracts of Adhesion: An Essay in Reconstruction" (1983) 96 Harv L Rev 1173.
58. *Ibid*.
59. Indian Contracts Act, 1872, S. 2(*d*).
60. N. Gregory Mankiw, *Macroeconomics* (6th Edn. Worth Publishers, New York 2007) 28.
61. Greg Davidson, Paul Davidson, *Economics for a Civilized Society* (1996) 144.

The relation between legal tender and money is quite obvious as "legal tender" can be said to be the money that is recognised by the law of the nation, for discharging all debts. Accordingly, a contractual obligation can only be discharged by a legal tender. However currently, due to the existing technology, payment for smart contracts can only be made in cryptocurrencies, coins, or tokens for smart contracts. These contracts are not capable of transferring fiat money among the parties.[62]

This will certainly pose a problem as the Finance Minister of India very recently stated that "the government does not recognise cryptocurrency as legal tender or coin."[63] Hence, a smart contract executed in India will not involve the legal tender, *i.e.* rupee to discharge the contractual obligation. Therefore, such a contract will be considered void as per Section 24, Indian Contracts Act, and will fail the test of having a valid consideration.

Now, since the Finance Minister made it clear that cryptocurrency will not be accepted as legal tender in India, for the consideration to be valid, it must fall within the scope of "currency". In India, the Foreign Exchange Management Act, 1999 ("FEMA") defines "currency"[64], "foreign currency"[65] and "Indian Currency"[66] to include banknotes, postal notes, postal orders, money orders, cheques, drafts, traveller's cheques, letters of credit, bills of exchange and promissory notes, credit cards or such other similar instruments, as may be notified by the Reserve Bank from time to time.[67] As of date, the RBI has not notified the inclusion of cryptocurrency within the meaning of "currency" or "foreign currency" or "Indian currency" and hence, cryptocurrency cannot be used to discharge any debts or contractual obligations.

Thus, it is evident in light of the Finance Minister's statement as well as in the absence of any RBI notification to this effect that cryptocurrencies are not legal currencies that can be used as valid consideration in smart contracts.

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62. Giulio Prisco, "Smart Contracts for Real Businesses and Banks", Cryptoinsider (5-7-2018, 9:09 p.m.), <https://cryptoinsider.21mil.com/smart-contracts-real-businesses-banks/>.
63. Gwyn D'mello, "Budget 2018: No More Bitcoin in India, As Arun Jaitley Just Killed the Cryptocurrency Dream", *India Times* (8-7-2018, 10:00 a.m.) <https://www.indiatimes.com/technology/news/budget-2018-no-more-bitcoin-in-india-asg-arun-jaitley-just-killed-the-cryptocurrency-dream-338851.html>.
64. Foreign Exchange Management Act, 1999, S. 2(*h*).
65. *Ibid*, S. 2(*m*).
66. *Ibid*, S. 2(*q*).
67. *Ibid*, S. 2(*h*) .

Validity of an electronic agreement

Another aspect that must be analysed is the validity of an electronic contract in the Indian context. Section 10-A, Information and Technology Act, 2000 ("IT Act") provides that in the case of a contract formed wherein "the communication of proposals, the acceptance of proposals, the revocation of proposals and acceptances, as the case may be, are expressed in electronic form or by means of an electronic record, the contract shall be valid."[68] Prima facie, an electronic contract is valid in India owing to the newly inserted Section 10-A, IT Act and this is favourable for the legality of smart contracts. However, there exists a caveat. According to Section 35, IT Act, for an electronic contract to be valid in India, there is a mandatory requirement for the contract to contain an electronic signature by a government designated certifying authority.[69] Moreover, Section 85-B, Indian Evidence Act ("Evidence Act"), clearly provides that an electronic agreement will be considered valid only if it has been authenticated with a digital signature.[70] Since smart contracts are governed by a decentralised network that has no central or government authority validating them, they are only authenticated with the help of a cryptographic key.

This essentially poses two legal hurdles for smart contracts in India. *First*, a smart contract is invalid according to the Information Technology Act for want of governmental authorisation. *Second*, these contracts are inadmissible as evidence in the courts of law in India. Hence, it is evident that smart contracts do not find a place within the framework of the existing regime of contract law in India.

PART V: THE WAY FORWARD AND CONCLUSION

The emergence of smart contracts has the potential to transform contractual relations between parties, and there exists endless possibilities for the use of smart contracts in today's world. However, with the rapid advancements in technology, the law governing them too must catch up. Although in some instances traditional contract law will be the source of interpretation for legal issues that may arise while governing smart contracts, going forward, this too may prove to be inadequate as demonstrated in the previous section. Thus, before smart contracts are fully operational and used for day-to-day commercial transactions, they must

68. Information Technology Act, S. 10-A.
69. *Ibid*, S. 35.
70. Indian Evidence Act, 1872, S. 85-B.

be governed by the same legal standards as applicable to traditional contracts. This means that the legislators must adapt to the changing circumstances and dynamics, and enact statutory and regulatory schemes that accommodate smart contracts within the legal framework. Moreover, in order to address the pressing concerns, existing legislations must also be amended to incorporate rules that will specifically deal with the intricacies of contract formation, jurisdiction, enforceability and the ethical concerns related to smart contracts.[71]

Having said that, while there already exist several legal challenges in its implementation, progressive economies such as that of Japan, have recognised cryptocurrency as legal tender. Infact, the Japanese government is already trying to integrate blockchain into its online systems for accepting government contract bids. Similarly, in the US, the States of Tennessee and Arizona have specifically amended existing legislations to legally recognise smart contracts. In both these States, laws have now incorporated clearly defined terms such as "blockchain", "cryptocurrency" and "smart contract".

Thus, while there still remain legal hurdles and technical issues in adopting smart contracts, the future seems promising. Furthermore, in countries like India, where blockchain technology is slowly gaining acceptance, existing laws must be revamped and made flexible. As discussed above, the authors have identified the legal nuances that exist for smart contracts within the existing paradigm of contract laws in India. Hence, the only solution will be to revamp these old and outdated statutes to accommodate new technology, and this must be done swiftly if India is to keep up with the world.

71. Shields, *supra* at 192.

Arbitrating the Insolvency Code

—*Sami Ahmed & Rishika Jain*†

ABSTRACT

Two comprehensive and integral laws of the corporate arena have recently witnessed a drastic change in the form of a comprehensive amendment. The Insolvency and Bankruptcy Code, 2016 (fully amended as on June 2018) and the Arbitration and Conciliation Act, 1996 (as amended in 2015) has widened the horizons of these two legislations in their own individualistic capacities. However, the very nature of the IB Code, prima facie, appears to have the flair of arbitration in its CIRP process. The aspects of debt restructuring and corporate revamping of an entity involve a series of conciliating efforts of the authority concerned to arrive at ad idem of the stakeholders at large.

Though the IB Code paves a way for the continuation of arbitration proceedings even during the moratorium, if the said proceedings do not involve debt recovery, however, the prevalence of the essence of arbitration in the entire CIRP process has never been discussed and observed.

This paper aims to give a new dimension to the existing arbitration and insolvency laws prevalent in the country. Furthermore, the paper analyses the interplay of these two and discusses the same at length. The paper also throws light on the existing provisions in the said regard and possible inclusive interpretation of the same in light of the aforementioned proposition. Finally, the paper concludes by mediating on the aspects of arbitral awards as a part of restructuring process and settlement of claims under the Insolvency and Bankruptcy Code, 2016 in lieu of the amended Arbitration and Conciliation Act, 1996 and bringing out a new dimension and outlook to these two separate pieces of legislation.

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INTRODUCTION

Insolvency laws and arbitration laws around the world are two sets of different procedures, each having its own purpose, objectives and underlying policy. Apart from the difference in the procedure, the distinct nature of the two laws is probably the reason why the relationship between them is seldom scrutinised in the legal writings and often reduced to the mere statement that the bankruptcy issues are not arbitrable but there are points of interaction between the two laws. The aforementioned statement can be substantiated by the recent judgment where the court has upheld an arbitral tribunal's decision to substitute a disputing party with another entity following a corporate restructuring carried out mid-dispute.[1] Further, it is to be noted that, "legislation on insolvency is a crossroads where all the elements of the Legal system in question meet".[2] Usually, the insolvency laws provide for some limitation on the rights of the debtor and his creditors in order to effectively pursue their basic principles and also it may even limit the rights of third parties. It is pertinent to note that the paper will analyse the interplay of the two laws and discuss the same at length and to address various points of interaction between the two fields of law. In a most simplified manner if we look upon the insolvency laws, it's basic use is to provide a framework for dealing with the competing interests and claims of the relevant stakeholders within a given system. Further, it can be stated that an insolvency law is drafted in a way which is, in a particular legal system, regarded as the most suitable to pursue effectively the underlying policy and the prevailing purpose of the insolvency law, be it the protection of the debtor or securing the interests of the creditors.

It is to be noted that a certain effect of the commencement of restructuring process is that a debtor is deprived of his right to manage and to dispose of the estate which is also evident in the latest IBC, 2016. Almost all the insolvency laws around the world consider for providing such legal effects in the case of bankruptcy liquidation. Moreover, the result of dispossession is that the debtor loses his right to undertake legal actions concerning the property forming part of the estate. The obligations undertaken by the debtor after the bankruptcy order has been made do not bind the estate. It is pertinent to note that the debtor also loses the right to sue and to be sued in the legal proceedings concerning the estate which curbs his rights are relevant only with respect to the

1. *A* v. *B*, (2017) 1 WLR 2030: 2016 EWHC 3003 (Comm).
2. P. Didier, "La Problématique du droit de la faillite internationale/The Problems Surrounding the Law of International Insolvency" (1989) 3 RDAI/IBLJ 201, 203.

estate. Further, after the commencement of liquidation, arbitral proceedings may be, in principle, initiated or continued only by or against the trustee, with respect to the property forming part of the estate. In a similar manner, the arbitration agreements entered into by the debtor before the commencement of the bankruptcy liquidation may be attempted to be invoked against the trustee, and not against the debtor. In the modern era, arbitration laws are the one which generally recognise the right of parties. Moreover, the underlying principle of commercial arbitration has been widely accepted across the globe. The recent amendment in the arbitration laws around the world can be seen as the one which has a limited judicial control. In other words, the role of the judiciary is mainly one of support and assistance to arbitration proceeding throughout the arbitral process, while the supervision and control over arbitration are exceptional and very limited. This is particularly so with respect to arbitrations involving international elements.

As pointed out above, both the laws, *i.e.* arbitration and insolvency are different from each other but the legal basis for using arbitration in insolvency cases rests principally in the UNCITRAL Model Law and the EU Insolvency Regulation. Further, it is possible that, apart from these legal structures, the laws of the relevant countries which will be dealt in the latter part of the paper in a particular case may provide for arbitration in a manner that would permit the use of arbitration in the insolvency context. But there are three scenarios where an international arbitration and international insolvency may interact—1) when arbitration is pending when insolvency case is commenced; 2) when insolvency case has commenced before arbitration cause; 3) when the case deals with rejection of a contract containing an arbitration clause. It is important to note that the Model Law already provides for the use of arbitration in support of an international insolvency case which is quite evident in the language used in Article 27 which provides that the cooperation between courts and administrators referred to in Articles 25 and 26 may include, "approval or implementation by courts of agreements concerning the coordination of proceedings." Further, a much clearer provision would be an addition to Article 27 which would specifically provide that cooperation between courts and administrators may also include the reference of a matter to international arbitration for decision. Throughout the latter part of the paper, the authors will be discussing the need of such a provision that could also authorise an insolvency court to designate the parties to choose the international arbitrators to carry out arbitration authorised by the court.

1. INTERPLAY BETWEEN THE INSOLVENCY AND ARBITRATION LAW

The present era of commercialisation has led to multiple activities and transactions occurring throughout. Nowadays, companies, in a bid to arbitrate the pending suit in their own favour aim to restructure their company, pending suit. Owing to such an activity, the company ends up involving itself in the lanes of legal complexities which results in a judicial dilemma for the courts to deal with. Pertaining to the aforesaid situation is an add-on situation in India, where the process of arbitration is being practiced amidst existing insolvency proceedings initiated under the Insolvency and Bankruptcy Code, 2016 (Hereinafter the Code). The corporate debtors aim to restructure themselves and bring about a sense of settlement to the existing adverse situation. This results in an ultimate compromise on the ends of creditors and provides for a relief to the distressed corporate debtor. Further, under the insolvency code, two instances show an evident prevalence of arbitration at the time of restructuring:

> The very first instance can be pointed out at the initial stage of Corporate Insolvency Resolution Process (CIRP) wherein by virtue of Section 14, moratorium is brought into existence since the date of admission of application. According to the said section, "the initiation of suits or the continuation or pending suits and proceedings including the execution of any judgment, decree or order in any court of law, tribunal, arbitration panel or any authority is prohibited." However, the ambit of the said term "proceedings" is discussed in *Power Grid Corpn. of India Ltd.* v. *Jyoti Structures Ltd.*[3], wherein Yogesh Khanna J categorically explained that the ambit of arbitration proceedings exclude those arbitration matters which do not involve any form of payment of a debt or related transaction.

The underlying principle for the said assertion of the court was that:

> The object of the Code is to provide relief to the corporate debtor through 'standstill' period during which its assets are protected from dissipation or diminishment, and as a corollary, during which it can strengthen its financial position, extending the unexecutability of the award would rather prevent the corporate debtor from recovering money due to it and adding to its financial corpus. Such a consequence would, in fact, be directly contrary to the object of the Code.[4]

3. 2017 SCC OnLine Del 12189.
4. *Ibid.*

However, the fact that the Code is at its nascent stage, puts the entire scope of the said proposition as laid down in the above case under judicial scrutiny and the same is to be dealt over at a broader perspective so as to make it more reliant. Another interplay of arbitration and insolvency can be witnessed at the time of settlement of claims. Under the said Code, the claims are settled in a specific order which has to be duly followed.[5] However, this leaves a scope for the creditors to mediate and reach out on a possible settlement which could be beneficial for all the creditors who otherwise might be rendered barehanded. Further, the ambit of corporate restructuring and arbitration in light of settling suits with the help of an arbitration forum or an Arbitral Tribunal also advances the key cross play of the two distinct yet intermingled fields of law.

Recently NCLAT observed[6] that the language in Part V of Form 5 of the Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016 includes an order of an arbitral panel adjudicating on the default under the heading "Particulars Of Operational Debt [Documents, Records And Evidence Of Default]". On this basis, NCLAT opined that an arbitral award has been specified as a document which can evidence debt and non-payment of the awarded amount amounts to "default" of the debt. NCLAT further opined that under Section 8(2) of the Code while pendency of "arbitration proceedings" has been included as "the existence of dispute", the pendency of an application under Section 34 or Section 37 of the Arbitration and Conciliation Act, 1996 has not been included as "the existence of dispute".[7] Thus, NCLAT made a distinction between pendency of arbitration proceedings, which could imply the existence of a dispute between the parties under the code and pendency of an appeal under Section 37 of the Arbitration and Conciliation Act, 1996. which could imply that there is no existence of a dispute.

Article 8 of the UNCITRAL Model Law states that a court must stay a court action if there is a valid arbitration agreement and the party applies for the stay prior to that party's first court filing on the substance of the dispute. The court may refuse to stay the court proceedings only if the arbitration agreement is null and void, inoperative or incapable of being performed.[8]

5. S. 53, Code.
6. *Annapurna Infrastructure (P) Ltd.* v. *SORIL Infra Resources Ltd.*, 2017 SCC OnLine NCLAT 380. (Hereinafter Annapurna).
7. *Ibid.*
8. David J.A. Boyle, "Interplay between Insolvency and Arbitration Proceedings—A Hong Kong Perspective", (International Arbitration Perspectives on Insolvency - Summer 2010, Mayor Brown) 20–22.

The court's power to stay to uphold arbitration agreements is automatic and does not require an examination of the merits of the case. One exception, however, appears to be when a party opts to file a winding up petition. In such circumstances, recent decisions show that the courts will not stay valid winding up petitions in circumstances where there is also an underlying arbitration agreement. In a recent Hong Kong case, *Sinom (Hong Kong) Ltd., In re*[9], the Court of First Instance confirmed that neither the existence of an arbitration clause nor the commencement of arbitration prevents the court from dealing with a winding up petition. In this scenario, the court will allow the winding up petition to proceed, provided that it is satisfied that the creditor can establish that the sum claimed is due—*i.e.* there is no *bona fide* dispute in relation to the substance of the debt on which the winding up petition is based.[10]

2. ARBITRAL AWARDS AND INTERNATIONAL PERSPECTIVE

By the starting of this century, India looks to become a world-beating economy as it is quite evident in the various reforms which are being initiated in the regulatory landscape and the country, an investment-friendly country. The recent regulatory framework such as IBC, 2016 has been a boost for the investors and a much-needed shot to transform the Indian economy. Even though there were legislations previously which dealt with the aforementioned matters but "the Code" played a major role especially in cases of dispute between the parties on arbitral awards. The term "dispute" defined in Section 5(6), goes on to define that the "dispute" includes a suit or arbitration relating to—(a) the existence of the amount of debt; (b) the quality of goods or service; (c) the breach of a representation or a warranty. An existing "dispute" falling within the above parameters bars the initiation of a CIRP against a corporate debtor and is thus a key remedy available to a corporate debtor under the IBC. Further, an operational creditor when issues a demand notice to a corporate debtor under Section 8 of the Code, he has the opportunity to, within ten days of receipt, bring to the notice of the creditor, the "existence of a dispute" pertaining to the corporate debt, as provided for in Section 8(2)(*a*) of the Code.[11] The phrase "dispute in existence" also

9. HCMP73/2009, order dated 5-8-2009 (Hong Kong).
10. *Ibid.*
11. Nishith Desai Associates, "Arbitral Awards are Valid Records of Default under the Indian Bankruptcy Code (*Annapurna* v. *Soril*)", (LexisNexis 3-10-2017), <http://www.nishithdesai.com/information/news-storage/news-details/article/arbitral-awards-are-valid-records-of-default-under-the-indian-bankruptcy-code-annapurna-v-soril.html>.

assumes significance as it is largely the only legal defence available to a corporate debtor to avoid insolvency or liquidation proceedings initiated by an operational creditor.

Recently in *Annapurna*, the NCLAT held that the arbitral award concludes the disputes between parties and is a valid record of default under the IBC, 2016. Also, the pendency of proceedings for execution of an arbitral award or a judgment and decree does not bar an operational creditor from preferring any petition under the Code. Further, it was also quoted in the judgment that an insolvency resolution process is neither a money suit for recovery nor a suit for execution of any decree or award and is distinct from Section 35, Arbitration and Conciliation Act, 1996 which relates to the execution of an arbitral award. Further, there are many issues raised before the NCLAT are as follows:—

1. After an award made by a tribunal is there "existence of dispute" between the parties?
2. Does the initiation of CIRP under the code entail the pendency of execution proceedings of an award or a judgment?
3. Will the appellants come under the ambit of Section 5(20) read with Section 5(21), the code?

The NCLAT undertook a scrutiny of Section 8(2)(*a*) of the Code to make a distinction between "existence of a dispute' and pendency under Section 34 or 37 of the Arbitration and Conciliation Act, 1996. Further, it considered the fact that in Form 5 of the IB Rules, 2016, the order made by the Arbitral Tribunal is cited as one of the documents required to record an event of default. Moreover, it is observed that non-payment of the award thus amounts to a "default" and to hold that an arbitral award, being a valid record of default, renders irrelevant the pendency of Section 34 or Section 37 petition under the Arbitration and Conciliation Act, 1996, at least in terms of fulfilling the conditions for a complete application under Section 9 of the Code.[12] It is observed by the NCLAT in *Centrotrade Minerals & Metal Inc.* v. *Hindustan Copper Ltd.*[13], that an award has finality attached to a decision on a substantive issue and concluded the dispute as to the specific issue determined in the award and disposes of parties' respective claims. The NCLAT then felt the need to analyse the scheme of the Arbitration and Conciliation Act, 1996 when the award becomes a decree for initiation of CIRP to conclude that once the time

12. *Supra* note 12.
13. (2017) 2 SCC 228.

period for challenging an award expires, or if the challenge is unsuccessful. It is to note that the insolvency resolution process is not a money suit nor a suit for execution of any decree or award which is distinct from Section 35, Arbitration and Conciliation Act, 1996 which relates to the execution of an award. In light of the same, it was held that a CIRP can be initiated for default of debt, as awarded under the Arbitration and Conciliation Act, 1996 even if there is any pending award execution as the same is separate and distinct from a CIRP.

Though the arbitration laws and insolvency laws are poles apart, at certain times, they might interact which the authors already discussed aforementioned. Further, a few years back the Swiss Supreme Court rendered a decision[14] regarding the effects of insolvency proceedings on international arbitrations seated in Switzerland. The aforementioned case is regarding a multi-party arbitration conducted under the ICC Rules with its seat in Geneva. In this case, the insolvent company filed a request to the tribunal seeking a ruling that the arbitration is to be discontinued. Further, the tribunal, after hearing the parties on this matter, rendered an interim award granting the company's request and discontinued the proceeding. Later, the Swiss Supreme Court rejected the request to set aside the interim award and held that the Arbitral Tribunal was correct in discontinuing the proceedings against the insolvent party.

The Swiss Supreme Court decision addresses important choice of law questions concerning the capacity of parties to international arbitration agreements. The decision also raises but does not address, important questions regarding the effects of national legislation which arguably discriminates against arbitration agreements under the New York Convention, 1958. Notably, the Article V.1 of the New York Convention, 1958 provides five grounds on which recognition and enforcement of an arbitration award can be denied—(a) the arbitration agreement is invalid under applicable law or one of the parties is under an incapacity; (b) a party was not given proper notice of the procedure or the appointment of an arbitrator or was otherwise unable to present his or her case; (c) the dispute is not within the terms of the arbitration agreement or was not contemplated by it; (*d*) the composition of the arbitral body or the arbitral procedure was not in accordance with the agreement of the parties (or the law of the country where the arbitration took place); or (e) the award has not become binding or has been set aside or suspended by a competent authority of the country in which (or under the law of which) the award

14. *Vivendi SA* v. *Deutsche Telekom AG*, 4_A428 of 2008, order dated 31-3-2009.

was made. The aforementioned decision also contrasts with a ruling of the English High Court's decision in *Syska* v. *Vivendi Universal SA*[15], which upheld an award which came to a different conclusion in another arbitration seated in England against the same insolvent Polish company. Further, the English court accordingly rejected the request holding that English law rather than Polish law governs the question of the effects of the insolvency proceedings on the arbitration. The court relied upon Article 15 of the EU Insolvency Regulation, 2015 for its decision.

Further, in Germany, the insolvency law does not affect the validity of arbitration clauses the debtor entered into with creditors. However, the administrator is bound by such agreements and cannot set them aside.[16] Therefore, accordingly, the principle is that any creditor can file arbitral proceedings while insolvency proceedings are pending. However, such proceedings should be filed against the insolvency administrator in person, not against the debtor. This should also be reflected in the creditor's statement of claim, as well as in the future arbitral award. Moreover, it is pertinent to observe that for the principles of due process, the tribunal is bound to give the administrator sufficient time to become acquainted with the facts of the case and the status of the arbitral proceedings. The administrator also must be given the opportunity to state a position on any question of fact or law relevant to the case.[17] All the submissions and statements by the debtor's management are not taken into consideration as the debtor can no longer dispose of the assets. If the insolvency administrator is not given the opportunity to defend the case, the award cannot be recognised pursuant to Article V para 1-B of the New York Convention, 1958. Therefore, upon learning that insolvency proceedings have been initiated, the creditor should ask the Arbitral Tribunal to stay the arbitration for a reasonable period of time.

3. CRITICISM

The effective lacunae to the aforesaid interplay can be deduced from the fact that arbitration is a right in *personam* and insolvency proceedings are right in rem. This means that by nature of the execution of rights, arbitration is a private and closely-knit affair. The rights and obligations of the parties concerned to the suit are personal and against each other. On the contrary, the obligations of the corporate debtor which arise out

15. 2009 Bus LR 367 : 2008 EWHC 2155 (Comm).
16. BGH, decision dated 20-11-2003, ref. no. III ZB 24/03; BGHZ 24, 18.
17. Ehricke, ZIP 2006, 1847 (1850); Heidbrink / von der Groeben, ZIP 2006, 265 (269).

of the said proceedings are not personal in nature and are in *rem*, *i.e.* against the whole world. Thus, arbitration secures the confidentiality of the agreements between the parties concerned, insolvency and bankruptcy focus on the due publicity of matters, especially when the company is near liquidation.

The aspect of continuation of pending arbitration proceedings of an insolvent person is yet another grey area to be deeply analysed and pondered over by the experts of law. The complexities of both the laws can further be felt in the cases of cross-border insolvency wherein the parties to the suit might have another clash of opinion for deciding upon the seat of arbitration and the place of conducting insolvency proceedings. It is not necessary that both the seat and place be the same and, thus, it creates yet another blockade for the scholars to decide how to mediate and settle on the said subject-matter. The redundancy of the said interplay can be witnessed especially when the seat of arbitration is to be decided by the Arbitral Tribunal and the insolvency proceedings are to be conducted as per the law. The legalities with regard to the jurisdiction of the same would create havoc for the stakeholders resulting in yet another entanglement of the two laws.

Another aspect of this can be ruled in light of the fact is that arbitration is an expensive affair. An entity which is already under the insolvency and restructuring proceedings is endangered from being liquidated. At such a critical stage, the corporate debtor's desire to participate in the insolvency proceedings are financially impaired. The debtor in such a scenario would seek the path of direct insolvency without getting into the nuances of arbitration. Furthermore, the principal debtor may also be denied to proceed further with arbitration proceedings by the adjudicating authority which is manning the insolvency proceedings already pending in the court of law.

CONCLUSION

The interaction between the two laws can finally be summed to bring in light the existing corporate regime wherein corporate entities in lieu of settling their claims efficaciously resort to arbitration at the time of corporate restructuring. Insolvency proceedings have become a common phenomenon amongst the corporate sector and a crossroad for insolvency laws and arbitration laws in such a scenario undoubtedly aids the overall set up of the system. It is an undeniable fact that a dispute between a debtor and a creditor may also arise in an insolvency proceeding where

an underlying pre-insolvency agreement contains an arbitration clause. In some circumstances, the court may consider an arbitration case to be an appropriate method to liquidate the claim, which is allowed in the insolvency case and the creditor receives its share of the insolvency estate in due course on pro rata basis. If such an arbitration is already in process, the insolvency tribunal may, at its discretion, have the parties complete the arbitration to liquidate the claim for the purposes of the insolvency case. The reference to such a dispute to arbitration, especially in situations of cross-border insolvency; should often be authorised under both insolvency law and arbitration law. However, public policy considerations may be involved and a court may conclude that the issue should not be arbitrated under the circumstances. This aspect is highly discretionary and is to be delved upon as per the merits of the case.

It cannot be denied that arbitration and insolvency are based on opposing principles. Where, on one end, party autonomy rules the sphere of arbitration, insolvency, on the other, establishes a structure which aims at securing the interests of the creditors and equitable distribution of assets out of the debtor's estate. Despite the distinctive nature of the two laws, their intersection cannot be outrightly rejected. This inter legal approach to the corporate sector provides for a better and more satisfactory execution of restructuring and insolvency processes. It must not be forgotten that the insolvency goal of maximum private and public economic benefit is best achieved through cooperation, efficiency, and overall asset maximisation. This vision can successfully be accomplished through the help of arbitral proceedings. Where the stakeholders, arbitrate on the relevant alternatives, with the corporate debtor, it provides for an easy route for all the parties concerned to reach out a settlement which would ensure maximum benefit of maximum people.

Integrating Blockchain Securities Settlement with Law and Regulation—Policy Considerations and International Principles

—Maygha Vishwanat & Sai Makarandh Prasada†

ABSTRACT

The trend of holding and transferring securities has changed to a large extent over the past 100 years. We moved from paper certificates to a dematerialisation system and from there to computerisation and globalisation. This brought about more efficiency and liquidity. However, the law has not kept pace with the growing changes and is now itself an obstacle to efficiency and legal uncertainty. The latest global development in this world, a cryptographic transfer process commonly called "the blockchain", is the most recent efficiency-enhancing change. This paper shows what the new international legal framework could look like, in the light of experience gained from earlier developments.

This paper is organised as follows:

1. *Section 1 gives a basic introduction*
2. *Section 2 analyses the interests of the market participants involved.*
3. *Section 3 outlines the relationship between the current intermediated holding system and the future holding of securities through blockchain platforms.*
4. *Section 4 takes a look at the commercial law framework required for crypto-securities. Section 5 considers regulation and supervision.*
5. *Section 6 contains a set of principles that may be adopted for the purpose of regulating crypto-securities.*

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INTRODUCTION

The current method of holding and transferring securities, by means of intermediation through banks and other financial institutions has led to a patchy international settlement architecture that spans our globe. This settlement architecture is highly complex from an operational point of view. Further, its regulation and supervision is shared amongst all jurisdictions where settlement takes place. And, lastly, the underlying commercial law is inefficient and unable to guarantee legal certainty of holdings and acquisitions throughout, especially in cross-jurisdictional transactions. The most important flaw is probably that commercial law itself is sometimes unable to provide clearly enforceable legal positions for securities holders and collateral takers. Instead, the emphasis in terms of stability and certainty is put on intermediaries who are subject to a detailed set of compliance rules and solvency backstops. Their compliance and their solvency ultimately guarantee the positions of investors and collateral takers.[1]

Blockchain securities settlement is very different from the current intermediated system. There are no securities accounts and no intermediaries. Instead, securities can be transferred directly from the seller to the buyer or from the collateral provider to the collateral taker, respectively. As blockchain securities settlement removes the phenomenon of securities intermediation the relevant laws are now able to get rid of all complications introduced earlier in order to accommodate this holding and transfer model. However, while the commercial law underlying blockchain securities settlement, or "crypto-securities", is in many respects much simpler, it also poses new difficulties. The technical process of settlement through cryptographic processes is so complicated, and there will be several slightly different software platforms for it, that the law will be unable to reflect the details of the acquisition process down to the smallest details. In other words, the law has to cope with the fact that it will have to accommodate the effects of "magical black boxes".

Another feature, the boundary-less transferability through the global internet is a legal challenge, too. In the past, States were unable to agree on a legal framework for cross- jurisdictional securities transfers due to differences in the legal concepts they used to underpin their approaches to securities settlement. In the future, an international accord on the law underlying crypto-securities will be equally complicated to negotiate; however, this time, States benefit from the fact that they will all start

1. CW Mooney, "Property Beyond Negotiability" (1990) 12 Cardozo Law Review 305, 413.

from the same clean sheet. Therefore, an agreement will be, in principle, easier to strike.

Should crypto-securities become mainstream one day (which may take several years from now), being used by retail investors and financial institutions alike, a whole new plethora of additional regulation will be necessary to control the impact of securities held on blockchain platforms on the stability of the financial system. Novel rules regarding the protection of investors might become necessary. Furthermore, the technology has the potential to revolutionise the entire set-up of securities holding, including the staggering investments of pension funds and insurers, and those of institutions that are by definition systemically important. In this regard, global coordination of regulation will be necessary.

1. THE VARIOUS INTERESTS AS GUIDELINES

Law and regulation are there to support market activity and at the same time keep them within our socially permitted boundaries. Therefore, we need to have regard to the interests of market participants and users on the one hand, and to the concerns of States and their societies on the other.

Market participants' interests will not fundamentally change with the transformation of securities settlement from intermediation to blockchain.

1. As transferees of crypto-securities, market participants need to rely on the enforceability of the acquisition, i.e. that they are proof against legal challenges (in addition to the operational safety of acquisition).
2. Further, as transferees, market participants are concerned about settlement risk, i.e. the risk when an asset is transferred that the transferee becomes insolvent before paying.
3. While holding crypto-securities market participants want to be protected against loss and want to enjoy the fruits of their investments, including the exercise of corporate rights (if applicable).
4. Lenders accepting collateral in the form of crypto-securities need to be sure that the collateral arrangement is enforceable should the collateral provider (debtor) default on its obligations.
5. When providing collateral for crypto-securities, market participants need to be sure that the collateral, or its value, will be returned at the end of the arrangement.

6. An unsecured creditor of a holder of crypto-securities needs to be sure that the holder's crypto-securities or rights therein are still enforceable after the opening of insolvency proceedings, i.e. that the rights are available for distribution.
7. An issuer's interest is, typically, to know its investor base (though investors might not necessarily agree with this) and to be able to approach them in the context of corporate actions.

The interests of States and societies are two-fold.

1. First, they are directed at promoting the use of new, efficient technologies to support liquidity and allow for growth. To this end, States have to recognise the potential of new market practices and build a favourable market environment. In the current intermediated securities set-up, the legal and regulatory environment is suboptimal because it was never comprehensively adjusted to the global nature of the securities market. Therefore, forthcoming law and regulation in respect of crypto-securities should be clear and simple enough to support efficiency and liquidity as well as systemic stability and investor protection alike.
2. At the same time, negative externalities of new market practices need to be curbed. There is, first, the clear-cut point that illegal activities need to be avoided. However, more complex but equally, if not more important is the relation of blockchain securities settlement to micro- and macro-prudential regulation. Here, it is important that blockchain securities settlement is not entirely "over the counter" but instead visible to supervisors, not necessarily on an individual basis (an argument well known from the derivatives context).

2. CRYPTO-SECURITIES AND "TRADITIONAL" INTERMEDIATED SECURITIES

Blockchain technology will first serve specific market segments. Even though the technology has the potential to create a system entirely free of intermediation, we will see a patchwork emerging with bits of the new blockchain set-up side by side with the "traditional" intermediated system and probably the even older paper or register-based set-up. Crypto-securities may appear in the market in three different ways.

2.1 Native crypto-securities

In a first scenario, issuers decide to issue shares or bonds directly as crypto-securities. We term these instruments native crypto-securities. They would exist side by side with intermediated securities issues. The relevant legal framework will fundamentally differ and pure crypto-securities and intermediated securities cannot be confounded in legal terms. However, legal uncertainty may arise in the following two scenarios where the market creates intersections between these worlds.

2.2 Trans-crypto-securities

In a second scenario, the issuer moves a pre-existing securities issue fully or partly from the intermediated system to the blockchain environment. I term these instruments trans-crypto-securities. The situation is quite comparable to when securities were moved from the paper and register-based systems into the intermediated environment in the past. The transformation needs interfaces in both operational and legal terms. Disregarding the operational side for the present purpose, the legal interface will need to consist of a rule that has two functions: *first* to make the relevant transformed securities entirely disappear from the intermediated system. *Second*, the securities need to be brought into circulation as crypto-securities.[2]

Both the disappearance and the reappearance need to be legally enforceable, including in insolvency. It must be excluded that rights in transformed securities can still be enforced in the intermediated system. During the transformational process from paper to intermediated securities, many jurisdictions struggled in this regard, keeping the former carrier of the right alive while depriving it of its function, for example, by uselessly storing security certificates in a central depository, a strategy that has the potential to considerably confuse legal analysis. As a consequence, there has always been a residual danger that unsecured creditors try to attach securities at the place of storage of the certificates or at the level of the issuer register, typically by means of court orders.[3]

2. Switzerland has recently introduced a rule catering for the disappearance of bearer securities and their reappearance as pure book-entry securities, *see*, H Kuhn, B Graham-Siegenthaler, L Thévenoz, The Federal Intermediated Securities Act and the Hague Securities Convention, Stämpfli, Berne (2010), 191–211.
3. Geneva Securities Convention, Art. 22.

2.3 Intermediated crypto-securities

In a third scenario, consortia of market players build "crypto-enclaves" in an environment that is generally still intermediated. For instance, a group of banks may set up a settlement mechanism amongst them, using blockchain technology.[4] However, the securities settled in this enclave have been issued as intermediated securities and have not undergone the transformation initiated by the issuer, as described before. Rather, participants in the settlement mechanism create "their own" crypto-securities, which represent securities they are holding themselves in the intermediated system. Here, the danger of mismatch or conflict is considerable, because the intermediated securities are the economic underlying of the crypto-securities. The parallel with the single most problematic trait of the current intermediated holding system is striking: different legal positions ultimately link to the same underlying asset, and the avoidance of conflicts entirely depends on the compliance of the intermediary. If it does not comply and becomes insolvent the acquirers of its crypto-securities would be unprotected.

3. INTERDEPENDENCE BETWEEN CRYPTO-SECURITIES AND COMMERCIAL LAW

An important aspect that needs to be considered is that the introduction of blockchain securities settlement and crypto-securities needs to be accompanied by a national or international reform of commercial law. Commercial law in this sense refers to the required changes in commercial, property and insolvency laws. Failure to bring about this reform will affect States and their economies, including the financial markets as it will lead to uncertainty and opportunity cost because the wide adoption of blockchain technology will be delayed on the ground that it is considered too uncertain in legal terms.

3.1 Why should crypto-securities be a question of state made law?

Blockchain technology is considered to be extremely reliable and transparent. The parties to a transaction acquire and dispose their crypto-securities in a secluded environment. Therefore, fraud and error is highly unlikely, except in the case of "Mt Gox" and "Etherium". This makes

4. GW Peters and E Panayi, "Understanding Modern Banking Ledgers through Blockchain Technologies: Future of Transaction Processing and Smart Contracts on the Internet of Money", Working Paper (18-11-2015), 27–28, available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2692487> (accessed 3-7-2018).

one wonder whether the State should interfere in this IT process of settlement. The fear is that technical outcomes and legal results may sometimes contradict each other which would open the question of whether the law has authority at all in this domain and if it has, whether the legal result can still be put into practice retroactively, because blockchain transactions are generally difficult to reverse.

One might consider that the State must be left out of the scope of the blockchain settlement system as the question of "who owns that" can be left to the IT process itself, or in a case of dispute, to an internal dispute resolution mechanism, with or without human arbitrators. At the first glance, this might seem like a viable solution as this can be compared to arbitration in general. Though the question of opacity shall remain unaddressed, the parties to the crypto-securities transaction can perfectly live with a set-up in which conflicting views and disputes are decided by a process or mechanism built into their respective platforms.

However, this argument misses the interests of those that are affected by the attribution of rights to market participants but are not party to the relevant transactions themselves: these are the general creditors of acquirers and disposers, collateral takers and providers. They will, in many cases, be part of the non-blockchain world, e.g. depositors of a bank, or clients of an insurer. They have never agreed to the dispute resolution mechanism built into the platform but their financial position will be positively or negatively affected by it, should the relevant blockchain user, here the bank or the insurer, become insolvent. This is not to say that the conflict-resolution mechanisms of a platform cannot be relevant. That would be counterproductive because they are considerably more efficient than judicial conflict resolution. The above argument rather suggests that the efficiency of the platform conflict-resolution rules cannot be imposed on third parties without a "bridge". In the world of commercial arbitration such bridges exist, too, notably the recognition of arbitral awards under state law. The issue is, therefore, rather to find the right balance between the State and the built-in rules for acquisition and disposition, including the rules resolving conflicts. The best solution is probably that the state law sets a framework of rules within which a platform has to settle conflicts. This would not necessarily entail any important changes to the concept of blockchain settlement. Rather, the relevant platform rules would be recognised by the law as providing a result that is in the interest of society (legal certainty, efficiency) and therefore sponsored by state law.

3.2 National and international framework for crypto-securities

At the moment there are only rudimentary bits of law dealing with the present question. There are some international benchmarks, such as the Geneva and Hague Securities Conventions (both actually planned as hard law but ultimately not implemented) and diverse UNCITRAL guides and model laws. However, globally there is no harmonisation of commercial law with respect to rights in securities. This is a cause for concern since 40–50% of the dealings in securities involve a cross-jurisdictional element.

Having said that, it is doubtful whether a global blockchain securities settlement could be efficient and safe as long as it is built on a similarly patchy global legal framework. The idea of a "global crypto-securities convention" seems to be utopian, especially considering the experience of the Hague and Geneva Securities Conventions. More promising seems the idea to organise global blockchain securities settlement on the basis of autonomous national laws that are ideally coordinated by a set of global principles, key attributes, or some other type of benchmark.

However, is it at all possible to organise a globally consistent legal framework on the basis of national laws? This involves answering the following question:

Is it possible to clearly identify the law of which State shall apply to the acquisition and disposition of crypto-securities and crypto-securities collateral?

3.2.1 *Determining the governing law for crypto-securities*

One law has to be identified to determine whether an acquisition of crypto-securities is enforceable, and whether the taker of crypto-securities collateral obtains good collateral, etc. (*see*, list of market participants' needs, above). In the past, the classification of the right as tangible or intangible property, claim or any other type of right was key in this regard. However, States might consider introducing tailor-made legal concepts for crypto-securities that classify the rights as sui generis rights or agree that the classification as property, claim or other type of asset is irrelevant. This would increase compatibility amongst jurisdictions in respect of crypto-securities, as their precise understanding of what property, claim and other types of rights entail, differs.

Two traditional methods used to determine the applicable law can be abandoned from the outset: the application of the law of the place of asset

(lex rei sitae), or the law of either the acquirer or the disposer would lead to a myriad of different laws being applicable within the same platform as the crypto-securities and their holders could literally be anywhere. Parties, or the platform, would need to identify the applicable law for each transaction separately. This is operationally difficult and increases risk from the legal point of view. The application of the law of the issuer would not be ideal either. This would lead to a situation where crypto-securities transferred on the same blockchain platform are governed by different laws, depending on which law issuers have chosen for the issue (*lex contractus*, in the case of bonds), or where they are incorporated (*lex societatis*, in the case of shares).

It is paramount that one single law applies throughout each platform. It would not make sense to refer to the place of the source of the blockchain platform per se. As code is delocalised and programming is an unsuitable connecting factor, such an approach leads to uncertainty. The only legally safe method is to rely on a chosen law. Those that set up the blockchain platform make the initial choice, which is subsequently adhered to by any participant joining. However, supervisors should have an interest in, and regulation should set requirements for, that choice. Given the importance in terms of enforceability of acquisition and disposition, especially in insolvency, there should be restrictions, avoiding the choice of the law of offshore jurisdictions.

4. REGULATION OF BLOCKCHAIN PLATFORMS AND CRYPTO-SECURITIES

It is not evident how a totally delocalised platform could be captured by regulation and supervision, and if international laws are necessary to this effect. However, *first*, there are several aspects pertaining to the sphere of financial stability that may require a certain level of regulation and supervision of blockchain-based securities settlement. *Second*, and well known from the Bitcoin context, there is much concern about illegal activity involving any type of crypto-assets in general.

4.1 Regulatory rationales

4.1.1 *Regulating for stability*

Whether crypto-securities settlement would need to be regulated from the point of view of financial system stability may seem to be a somewhat remote issue. Considering bitcoin and other crypto-currencies, they are

not systemically relevant at the moment, despite the fact that they have been around for a couple of years now. However, it cannot be excluded that at some point in the future considerable parts of global securities holdings, including those of pension funds, insurers, and systemically important banks and investment firms, might move from the traditional model of securities holding (which is based on the existence of highly regulated intermediaries) into the blockchain sphere. Therefore, blockchain-based securities holding may become a systemically relevant phenomenon—albeit one that is currently outside any of today's regulatory categories. As intermediaries are largely irrelevant for blockchain holdings, this most important regulatory point of entry will not be available and regulators and supervisors will need to conceive a different method of gaining regulatory grip on the market. Taking inspiration from existing stability-focused regulation, exposures within the market might become a focal point of interest.

Blockchain-based securities settlement is in some ways comparable to the OTC derivatives business, as both exist outside traditional infrastructures such as stock exchanges, settlement systems and clearing houses. However, for purposes of macro-prudential supervision, supervisors will at some point develop an interest in global streams and aggregate holdings, at the latest as soon as blockchain holdings become mainstream. In the OTC derivatives market, these data were unavailable until very recently requirements to report to trade repositories were introduced as a lesson learnt from the financial crisis. In respect of crypto-securities it seems, therefore, appropriate to plan for the introduction of reporting requirements at an earlier stage, i.e. at a time when blockchain settlement is not yet mainstream but still evolving, in order to avoid that technical choices are made now that have the potential to hamper the introduction of such requirements at a later stage.

4.1.2 *Regulation for safety*

In terms of safety, there are two aspects. *First*, in light of the importance of legal certainty, an important aspect of regulation and supervision will be the internal soundness of the platform and its internal rules. As the commercial law will need to refer to a large extent to the platform rules with a view to determining participants' rights, these rules would need to be scrutinised in respect of their completeness, soundness and compatibility with legal principles regarding the acquisition of rights. The most basic, yet most important, of these principles, is the rule of chronology or

"first in time" regarding the acquisition of rights, precluding discriminatory, arbitrary or random attribution of rights. Supervisors will need to verify whether the technical steps leading to an acquisition of crypto-securities or rights therein are not only technically sound but also appropriately aligned with and complemented by the relevant platform rules, and that both are in line with the general legal understanding of how rights are acquired and disposed of. *Second*, considering that at some future point in time considerable holdings might be administered on the basis of blockchain platforms, it is important to ensure operational and institutional continuity of these platforms, in order to make sure that the platform is robust, stable and guaranteed to run in the future. To this end, regulation should require that the owners of a blockchain platform are incorporated, thereby localising them in a specific country and enabling regulation and supervision.

4.1.3 *Regulation preventing illegal activity/anonymity*

The strengths of the blockchain technology must not be misused for illegal activity, such as money laundering, tax evasion and financing of crime. Bitcoin proved to some extent problematic in this regard, as exemplified by the fact that bitcoins could be used to pay for goods and services offered on darknet platforms, such as Silk Road. This characteristic of blockchain technology naturally attracted the lion's share of regulatory and supervisory attention to date, as Bitcoin and other applications did not show any other considerable negative externalities beyond the circle of immediate users. The fundamental element allowing the technology to be used for illegal activity is its anonymity. Bitcoin and most other cryptocurrencies are '"permission-less", i.e. it is possible to adhere to these platforms and transact on them without any prior identity check. Anonymity may be appealing to some; however, it is by no means a necessary characteristic of a functioning blockchain platform. Where aggregate values become larger, anonymity becomes more difficult to justify, as proven by parallel developments in the context of cash: large sums are nowadays increasingly difficult to move around, as regulators restrict the use of cash with a view to avoiding illegal activity. Similarly, securities settlement on blockchain platforms should not be anonymous. Therefore, access to blockchain settlement platforms needs to be controlled ("permissioned"), e.g., by the platform provider.

Apart from the obvious effect of avoiding transactions linked to criminal behaviour there is a second important goal, pertaining to the security

of the platform itself: fraudulent behaviour such as hacking, outperforming, or the use of technical loopholes from inside the circle of users are less likely to happen if the identities of users are known. The introduction of permissioned blockchain-based securities settlement will not meet much resistance: corporations, in particular financial service providers, deal under their clear identities anyway. Therefore, only natural persons intending to use blockchain settlement in the future will show interest in anonymity, for a variety of motives.

4.2 Regulatory capture

Lastly, if States intend to regulate and supervise blockchain-based securities settlement, it is important to consider how "software" could be captured from the regulatory perspective. It is incorporeal, delocalised and may change continuously. However, supervised financial institutions will exist in the future. It is therefore easy to make sure that they only adhere to supervised crypto-securities platforms. Similarly, retail investors might be directed to the supervised part of the crypto-securities world which affords protection only to the clients of regulated and supervised platforms, which is the current practice in many areas of financial regulation.

5. AN ATTEMPT AT FRAMING THE PRINCIPLES FOR REGULATING CRYPTO-SECURITIES

The authors have attempted to develop a framework for the purpose of regulation of crypto-securities.

Principles for a global and Indian legal framework for crypto-securities ("CS")

I. Regulation and supervision of crypto-securities platforms

(a) A CS platform can obtain authorisation from a competent authority, e.g., from the financial supervisor.

(b) Banks, investment firms, pension funds and insurers cannot use unauthorised platforms.

II. Prerequisites for authorisation, and criteria for continued supervision

(a) As a prerequisite for authorisation, a CS platform must be controlled by a platform provider that is incorporated under the law of a State.

(b) The set-up of the CS platform must be operationally sound and designed to provide continuous services.

(*c*) The law of that State is the law governing the platform and the relationship between platform users. The supervisor can approve a different law as platform law, which must be the law of State applying identical standards to CS platforms.

(*d*) Users of the platform must be identified by the platform provider.

(*e*) The operation of the platform must be complemented by a set of internal rules that govern the finality of acquisition and disposition of CS and rights therein.

III. The law applicable to crypto-securities and crypto-securities collateral

The law applicable to transfers of CS (both for the purposes of outright transfer and collateral) and security in CS is the law of the platform.

IV. The relationship between internal platform finality rules and the law

(a) An acquisition of CS or of CS collateral is legally effective as soon as it is final.

(b) The platform rules define the point in time at which an acquisition and the corresponding loss of CS are final (for the purposes of outright transfer or collateral).

(*c*) The platform rules define the point in time at which a security interest in CS is final. A final security interest in CS requires control over the CS by the security taker.

V. Enforceability of CS and security in CS in insolvency

(a) CS and security therein are enforceable in insolvency.

(b) They are only enforceable to the extent the law applicable to the platform allows in cases such as fraud, collusion and undervalue transaction. The platform rules must allow for a reversal upon judicial order to the extent that the acquirer has not disposed of the securities in the meantime.

VI. Legal rules on CS used as financial collateral

(a) CS collateral, encompassing the mechanisms of margining, substitution, rehypothecation and netting, is enforceable in insolvency.

(b) CS collateral is only enforceable to the extent the law applicable to the platform allows in cases such as fraud, collusion and undervalued transactions. The platform rules allow for a reversal upon judicial order to the extent that the acquirer has not disposed of the securities in the meantime.

Apart from this, implementation at a national level is also required.

6. CONCLUSION

In the wake of the markets' constant search for higher liquidity, the legal framework for securities holding, acquisition and disposition has shifted incrementally but fundamentally over time. Originally, when securities were still transferred in certificated or registered form, securities law used to be the overarching determinant defining the rights of holders and acquirers as well as their creditors. With the advent of intermediation, the legal framework became increasingly patchy and dysfunctional, and the conduct of intermediaries gained importance in respect of client asset protection. When, later on, cross-jurisdictional transactions became mainstream, the results provided by the aggregate application of different idiosyncratic laws, became positively confusing, and trust in international securities transactions is now mainly built on tight regulation of intermediaries and on their solvency.

The reason for this retreat of the law is that the international, IT-oriented market practice provides an ideal environment for liquidity but is fundamentally disrupted as a legal environment. This disruption stems mainly from the fact that much of the legal thinking is based on the image of specific, identifiable *erga omnes* rights, whereas the market practice is in reality hostile to that type of asset. Reform efforts have so far been unable to remove that friction because current law and practice have become heavily path-dependent and intimately linked with each other.

Now, blockchain technology is about to be introduced into the world of securities settlement, the relevant parameters will be reshuffled once again. First of all, intermediaries are in principle obsolete and are therefore not a suitable point of entry for the relevant laws and regulations. Secondly, the importance, complexity and convergence of the relevant IT-based processes will increase significantly. Thus, the function of software platforms will become the focal point of the blockchain securities environment. Thirdly, securities will again become specific, identifiable rights, very much comparable to the bearer instruments of the past.

Blockchain technology is based on an extremely fail-proof, complex technical set-up and the role of commercial law is still entirely undefined. Some might even be tempted by the idea to leave the resolution of conflicts between the different users of a software platform to the rules of that platform itself, as the intervention of State-made law might render

the whole set-up less efficient from a market practice point of view. Still, a commercial law framework is indispensable. The significance of acquisitions and dispositions of securities using blockchain technology goes beyond the mere interests of acquirer and disposer as platform users. Unsecured creditors will have a crucial interest in the question of "who owns what" in the event that either the acquirer or the disposer becomes insolvent. The answer must be given by the rules of commercial and insolvency law. Acquisitions and dispositions effected on securities settlement platforms based on blockchain technology therefore need to be subjected to the laws of States.

Legislators would be well-advised to take an interest in the law and regulation underlying blockchain securities settlement at an early stage. The picture of the current global intermediated holding system is a reminder of how disintegrated market practice and law can become. Therefore, instead of being reactive (as they have been in the past), national legislators and international bodies should now take a proactive stance and contribute to the creation of an efficient and legally safe securities settlement environment. Early and determined regulatory and legislative involvement is also important, since only a legally safe environment will appeal to the mainstream parts of the financial industry. Regulated banks, investment firms and pension funds cannot afford to move significant securities holdings into an environment that may be technically sound but which is not safe from the legal and regulatory perspective.

Considering the life-cycle of the current intermediated holding system, which first appeared in the late 19th century, the introduction of blockchain in clearing and settlement appears a once-in-several-generations chance to develop the technical environment of securities settlement in harmony with the law. In that sense, it will be the common effort of legislators, regulators and the financial industry that will be able to unlock the full efficiency and liquidity gains of blockchain technology in securities settlement.

Competition Concerns in a Digital Economy: Dominance and Market Determination

—*Saurav Roy & Stephanie Nazareth*†

ABSTRACT

There has been an upsurge in e-commerce activities in the last decade. India has witnessed a mushrooming of internet platforms, changing consumer preferences, and high demand for e-commerce consumer products. The technological changes and innovative models of such digital economies have thrown open a number of challenges for e-commerce enforcement. It has resulted in a need to draw a line between genuine industry practices and anti-competitive behaviour. It is important for stakeholders and competition authorities to understand whether the current competition regime is capable and well-equipped to deal with antitrust issues. This is most important because the nature of competition concerns, relevance of market definition and nature of network effects involved in digital economies is very different from traditional economies. In this paper, the authors attempt to analyse the issues involved in regulating markets in the digital economy. The paper is divided into four parts. Part I deals with the basics concepts and characteristics of a digital economy. Part II examines the relationship of new digital economies with competition concerns. Part III looks at market definition and dominance in digital economies. In this part, we aim to analyse the issues involved in regulating digital economies and the vast variety of cases decided by competition authorities in India and the European Union. Finally, Part IV provides a critical analysis of the efficiency of the current competition regulations and possible solutions for the competition authorities to use.

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INTRODUCTION

It is evident that across the global economy, the world is experiencing a surge in online economic activity. The world as we know it is shifting from an economy where humans would tend to control means of production and consumption decisions, to one where these same decisions are now mediated by new, digital tools.[1] Digitalisation has revolutionised most markets and brought about a tremendous change in commercial behaviour of stakeholders. Virtually, every business is impacted by technology and is digital in some form or the other. Before we comprehend the impact and implications of technological advancements on competition law, we must understand the characteristics and unique features of digital markets.

Characteristics of a Digital Economy

It is the authors' opinion that there lies a difficulty in providing a uniform definition of digital markets. Even though a myriad of industries are covered under the broad definition of digital markets, they possess similar characteristics. These features ensure the creation of business models which are quite different from those in conventional sectors, as enterprises are forced to make decisions which have an impact on themselves, and the competition between the companies in the online market. Some of these characteristics are mentioned below.

Dynamic and innovative

An integral characteristic of a digital market is that it involves fast-paced and innovation-driven setups. This leads to an environment wherein there is rapid development of new products, or quick improvement of existing ones.[2] This creates a volatile playing field, where market entrants can easily destabilise and threaten the success of incumbents by introducing new products.[3]

Another consequence of these dynamic markets is that competition on innovation takes place not just in the market but for the entire market.

1. "Antitrust Enforcement in the Digital Age" (2017), <https://www.ftc.gov/system/files/documents/public_statements/1253163/georgetown_mko_9-11-17.pdf> (accessed 29-6-2018).
2. "Hearing on Disruptive Innovation" (2015), <http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DAF/COMP(2015)3&docLanguage=En> (accessed 29-6-2018).
3. "Competition Policy: The Challenge of Digital Markets" (2015), <https://www.monopolkommission.de/images/PDF/SG/s68_fulltext_eng.pdf> (accessed 29-6-2018).

As competition is not on the price, enterprises active in the digital arena might be forced to compete for the entire market.[4] This might lead to circumstances wherein products become both leading and standard, rendering the undertaking a market leader and market dominant.

High fixed and low marginal costs

Cost structures of digital markets are characterised by lower marginal costs and higher fixed costs. The normal rule is that effective competition leads prices towards higher short-run marginal costs.[5] However, in digital markets, the opposite is generally the case, as creating a robust digital infrastructure from scratch results in higher costs, whereas the distribution expenditures are comparatively lower.[6]

Two or Multi-Sided Platform Markets

Most digital ventures function as two, or multi-sided businesses. In the case of digital platforms, intermediaries (such as multi-sided platforms) are instrumental to an economic and social interaction between two distinct consumer groups.

The interaction between the two sides with interdependent demand leads to network effects (either direct or indirect). Direct network effects arise when consumers of a product interact with each other.[7] The relative size of the platform and the level of interaction between consumers are directly proportional to each other.[8] Indirect network effects occur when the desirability of a platform increases if the number of service providers increase.[9] Network effects can have a direct and

4. *Microsoft Corp* v. *Commission of the European Communities*, Case T-201/04, order dated 1-9-2007 (European Court of Justice).
5. Phillip Areeda & Donald F Turner, "Predatory Pricing and Related Practices under Section 2 of the Sherman Act", 1975 Harvard Law Review 702.
6. Massimiliano Kadar, "European Union Competition Law in the Digital Era", Zeitschrift für Wettbewerbsrecht (2015), 345 [hereinafter Kadar].
7. Joyce Verhaert, "The Challenges Involved with the Application of Article 102 TFEU to the New Economy: A Case Study of Google", 2014 European Competition Law Review 267.
8. "The Platformization of Digital Markets", (2015), <https://www.iwkoeln.de/fileadmin/publikationen/2015/257401/Digital_Markets_policy_paper_IW_Koeln.pdf> (accessed 6-7-2018).
9. "Challenges for Competition Policy in a Digitalised Economy", (2015), <http://www.europarl.europa.eu/RegData/etudes/STUD/2015/542235/IPOL_STU%282015%29542235_EN.pdf> (accessed 6-7-2018) [hereinafter Challenges for Competition Policy].

beneficial impact on products, making them more valuable to consumer groups.[10]

Winner takes it all

Owing to disruptive innovation, network effects, and soaring initial costs, competition in digital markets is in sharp contrast to competition in traditional markets. The aforementioned elements make it a "winner-takes-it-all" market. This implies that when a particular market player has reached a particular level (called "tipping point" a point at which a business acquires a large number of users that enables it to strengthen its market position), positive reviews from customers ensure that the undertaking gains more and more of a competitive advantage, making it difficult for present or potential rivals from competing with this now dominant undertaking. This makes digital markets susceptible to dominant undertakings which may only be "quasi-monopolistic".[11]

1. CONTEXTUALISING INDIA'S COMPETITION LAW CONCERNS

As mentioned earlier, technology-driven businesses are influenced by high rates of innovation and development, low marginal costs and increasing returns to scale. However, at the same time, such innovations are susceptible to abuse of market power. This is prevalent in markets like the e-commerce market. Since e-commerce is one of the fastest growing and most popular sectors in the global economy, it is prone to market abuse and other competitive restraints. Therefore, due to factors like low marginal costs and increasing returns, a monopoly is created, which affects competition as a whole. Furthermore, in an economy like India where e-commerce companies indulge in practices like cash back offers, deep discounting and exclusive sale agreements, the impact on the competitive environment increases.[12]

Due to the volatile and dynamic nature of this sector, there are no fixed regulations under the Competition Act, 2002 ("**the 2002 Act**") and

10. Francisc Ioanid Toma, "The Challenges of Digital Markets for EU Competition Law: The Case of Android", KU Leuven - Faculty of Law, Students (2017), 11.
11. Joshua Cooper Ramo, "Why 'Network Power' is the Secret of Success for Apple, Facebook and Amazon" *Fortune* (19-7-2016), <http://fortune.com/2016/07/19/21st-century-network-power/ (accessed 8-7-2018).
12. Smriti Parsheera, Ajay Shah & Avirup Bose, *Competition Issues in India's Online Economy*, NIPFP Working Paper Series (2017), 5 [hereinafter Competition Issues in India].

India has had limited exposure to matters in this field. There is no defined text on how to determine competition aspects in an internet-based economy or how to distinguish the geographic or relevant product market in e-commerce. The Competition Commission of India ("**CCI**") is torn between the need to promote innovation, and at the same time, restrain monopolistic growth in the online world.

The 2002 Act governs agreements pertaining to transactions that inhibit healthy competition in the market by abusing its dominant position[13] or by creating an appreciable adverse effect on competition.[14] Dominant position in e-commerce can be abused in a number of ways like predatory pricing, imposing unfair terms, restricting sale or distribution, etc.

There are certain issues that arise in ascertaining an abuse of competition law in the digital economy. *Firstly,* one must ascertain whether e-commerce constitutes a separate market or is part of the traditional offline market.[15] *Secondly,* attention must be paid to the accurate determination of the relevant geographical market. How does one determine the geographical market in an Internet-based business?

A number of cases have come before the CCI on the role of competition law in addressing issues relating to e-commerce. However, till date, the competition authorities have not managed to lay down defined guidelines on the same. In this article, we aim to briefly summarise the current view of competition authorities in India and foreign jurisdictions, relating to competition aspects in digital markets.

1.1 Market definition in digital markets

Defining a relevant market in cases relating to antitrust concerns is imperative, as it helps to facilitate an assessment of market power through identification of a set of products which exercise competitive constraints on relevant undertakings.[16] The need to define the relevant market has been stated by courts across the world, including the European Court of Justice ("**ECJ**") in the *Continental Can*[17] *case*. It has been stated that

13. Competition Act, 2002, S. 4.
14. *Ibid*, S. 3.
15. Competition Issues in India, *supra* at 8.
16. Massimo Motta, Competition Policy: Theory and Practice (Cambridge University Press) (1st Edn., 2004).
17. *Europemballage Corporation and Continental Can Company Inc.* v. *Commission of the European Communities*, Case 6/72 , order dated 21-2-1973 : ECLI:EU:C:1973:22 : 1973 ECR 2015 (European Court of Justice).

market definition is "*the foundation on which an antitrust case or a regulatory intervention is built*."[18] The relevant market encompasses all products which can be sufficiently substituted for the product which is under investigation. There are a few reasons as to why delineating relevant markets in cases of digital business is difficult, namely:

1.2 More than one market is relevant with multi-sided platforms

Competition authorities have struggled with defining a relevant market in cases of multi-sided platforms. Regulators and courts find the distinction between two-sided transaction markets and two-sided non-transaction markets difficult to understand.[19] To complicate matters further, digital firms conduct business by integrating various platforms and then synergise them by linking user data. This opens up the risk of the investigating authority ignoring crucial relationships that the platform in question may possess with other platforms.[20]

1.3 Absence of nominal prices

An important consideration of defining relevant markets arises when zero-priced services such as freeware are being investigated. It is the belief of competition authorities that when there is no price, there is no market. This belief is based on the rationale that the commonly used SSNIP (**S**mall but **S**ignificant and **N**on-Transitory **I**ncrease in **P**rice) test to determine substitutability fails when the products/services are not priced. However, such an approach may be incorrect as the SSNIP test, which is designed to analyse one-sided markets, cannot account for prices being interdependent in markets with multi-sided platforms.

1.4 Fluidity of market boundaries

A definition of a relevant market often tends to be static in nature. This may lead to hesitance on the part of competition authorities to incorporate

18. Lapo Filistrucchi, Damian Gerardin, Eric van Damme & Pauline Affeldt, "Market Definition in Two-Sided Markets: Theory and Practice", 2013 Journal of Competition Law and Economics , 296 [hereinafter Lapo].
19. E.g. Commission decisions *MasterCard* (Case COMP/34.579), *Google/DoubleClick* (Case COMP/M.4731) *Travelport/Worldspan* (Case COMP/M.4523), *GIMD/SOCPRESSE* (Case COMP/M.3420) and *Bloemenveiling Aalsmeer – FloraHolland* (Case NMa/5901), and more.
20. "ChallengesforCompetitionPolicyinaDigitalisedEconomy",(2015),<http://www.europarl.europa.eu/RegData/etudes/STUD/2015/542235/IPOL_STU%282015%29542235_EN.pdf> (accessed 6-7-2018) 54.

such definition into digital markets, which by their very nature are constantly evolving due to the development of innovative business models.

2. DELINEATION OF RELEVANT MARKET

The CCI is bound by the 2002 Act when it makes assessments in relation to the abuse of dominance of an undertaking. The first step in this process is to identify the relevant market. Under the 2002 Act, the concept of relevant market includes the *relevant product market*, i.e. all those products and services which are substitutable with the product being investigated, and the *relevant geographical market*, which refers to an area where the conditions of competition are largely homogenous.[21]

The CCI has been faced with various cases wherein it has had to investigate the activities and market impact of digital businesses. Whether it be dealing with alleged vertical restraints or investigations into abuse of a dominant position, the CCI has questioned whether online platforms serve only as an intermediary/middle-state in the capacity of a service provider for a platform, or whether it is a distributor in the vertical chain.[22]

2.1 Relevant product market

Under the 2002 Act, a relevant product market can be determined by taking into consideration various factors like the physical characteristics of the good, existence of specialised producers, price of goods or services, etc.[23] However, the question that arises before the CCI is whether the same factors can be useful in determining the relevant product market in online markets/e-commerce. Therefore, the moot question is whether online markets must be considered as a separate market or as part of the offline (traditional) market due to differences in price, discounts and shopping experiences. In a majority of these cases, the CCI has clarified that while there are differences that exist between offline (traditional) and online markets, they are essentially distributing the same products and hence cannot be two separate relevant markets.[24]

21. Competition Act, 2002, S. 19(5).
22. "Implications of E-commerce for Competition Policy - Note by India", <https://one.oecd.org/document/DAF/COMP/WD(2018)52/en/pdf> (accessed 5-7-2018) [hereinafter Implication Note].
23. Competition Act, 2002, S. 19(7).
24. Implication Note, *supra* at 3 (accessed 5-7-2018).

In most jurisdictions like the EU, relevant market is determined by the SSNIP Test (**S**mall but **S**ignificant and **N**on-Transitory **I**ncrease in **P**rice). Demand substitution is a competitive constraint that all undertakings are subject to. It is assessed by determining an array of products which may serve as substitutes for the product under investigation. In order to go about this determination, the Notice proposes the SSNIP test.[25] The test determines whether (working with the assumption that the prices of competing products remains the same), a hypothetical monopolist may profitably increase the price of its products by a margin of 5–10%. A set of products is chosen, and the price is progressively increased until the monopolist suffers a loss due to the price increase. This process is continued until this increase in price turns profitable, leading to the discovery of the relevant market.[26]

In India, there is no defined test to determine relevant market but competition authorities have analysed each case on its individual circumstances. The case of *Ashish Ahuja* v. *Snapdeal.com*[27] (hereinafter Ashish Ahuja) involved the sale of SanDisk products by authorised dealers on the Snapdeal platform. The CCI while defining the relevant product market noted that consumers have the option of looking into various factors like shopping experience, price of the product, discounts, etc. before purchasing the final product. For example, in the event there is a rise in price of the product in the online market, consumers may shift their choice of product to the offline market and vice versa. Thus the CCI held that there may be two different channels of distribution (offline and online) of SanDisk products, but there is only one relevant product market.

In another case[28], an informant argued that if a particular commodity (in this case, a book) is exclusively sold on a particular e-commerce platform, it should operate as a separate relevant market, because it is not substitutable with books available in offline stores. This view was dismissed by the CCI, as it was convinced that there could not be a market for a single product only. The CCI noted that consumers have the option to compare prices, features and quality of the product and the online portal is merely a distribution channel.

Similarly, in a case filed by the Real Estate Brokers' Association of India against websites like Magicbricks, etc. the CCI held that as offline

25. *Ibid*, 6.
26. Lapo, *supra* at 305.
27. 2014 SCC OnLine CCI 65.
28. *Mohit Manglani* v. *Flipkart India (P) Ltd.*, Case No. 80 of 2014, order dated 23-4-2014 (CCI) [hereinafter *Mohit Manglani*].

brokers are offering services which are very similar to those being offered by the websites, they form a part of the same relevant market.[29]

The competition authorities have sometimes avoided the question of defining relevant product market in the past. For example, in *Flipkart case*[30], the CCI stated: ".....irrespective of whether we consider e-portal market as a separate relevant product market or as a sub-segment of the market for distribution, none of the Opposite Parties seems to be individually dominant...." This showcases a hesitance on the part of the CCI as to the determination of relevant markets in cases of e-commerce websites.

The CCI has been faced with a plethora of cases in relation to the taxicab aggregator services, offered by companies such as ANI Technologies Private Limited, Uber, and Meru Travel Solutions Private Limited. The CCI has consistently held that the "radio cabs service" is a relevant market in itself, as consumers are unable to substitute these services with other modes of transport. The CCI identified services such as "convenience in terms of time saving, point-to-point pick and drop, pre-booking facility, ease of availability even at obscure places, round the clock availability, predictability in terms of expected waiting/journey time etc." as those which are offered by radio cabs only, and not by other means of transport.[31] With regard to these cases, the CCI has held that the basic nature of services provided by taxicab aggregators is similar to those services which are provided under the traditional business model. The consumer's interests lie in the substitutability of the services provided by one radio cab provider with the services provided by another such provider. The identity of the owner of the car is inconsequential.[32]

In the recent case of *Matrimony.com Ltd.* v. *Google LLC*,[33] the CCI made a distinction between online and offline product market. It determined relevant market on an analysis of price of the products, characteristics, intended use of the product and services provided by Google. This case was regarding Google's dominance in the Search Advertising Market. The Director General ("**DG**") while investigating the case determined the

29. *Confederation of Real Estate Brokers' Assn. of India* v. *Magicbricks.com*, 2016 SCC OnLine CCI 19.
30. *Mohit Manglani*, ¶ 9.
31. *Fast Track Call Cab (P) Ltd.* v. *ANI Technologies (P) Ltd.*, 2017 SCC OnLine CCI 36; *Mega Cabs (P) Ltd.* v. *ANI Technologies (P) Ltd.*, 2016 SCC OnLine CCI 10; *Meru Travel Solutions (P) Ltd.* v. *Uber India Systems (P) Ltd.*, Case No. 81 of 2015, order dated 22-12-2014 (CCI)..
32. Implication Note, *supra* at 4.
33. Case Nos. 7 & 30 of 2012, order dated 8-2-2018 (CCI). [hereinafter *Matrimony.com*].

relevant product market only as "*Online Search Advertising in India*".[34] The DG noted that advertising online is different from offline advertising and they are distinct categories, and although complementary, do not form part of the same relevant product market.[35] Online Search Advertising among other things, consists of features like graphics, texts, email-based marketing, images, social network advertising and mobile applications. This is very different from non-search advertising and is not substitutable with offline advertising. Therefore, it was concluded that the Online Search Advertising market will be a separate relevant product market.

Conversely, courts in the United States of America ("**USA**") have taken a slightly different approach to online advertising. In the case of *America Online Inc.,* the court rejected the proposal to define relevant market as "email advertising". While doing so, the court noted that there are other substitutes for email advertising which exist traditionally like newspapers, billboards, leaflets, etc.[36]

Therefore, assessing relevant product market in online marketplaces is relatively simple due to the ready substitutes that exist in the form of brick-and-mortar businesses. However, relevant product market will tend to differ for digital platforms like social networking websites. These websites are a new concept and do not exist in the traditional brick-and-mortar form.[37] In such cases, courts will tend to give a narrower definition of relevant product market which includes only the internet-based social networking.[38]

Thus, it can be observed that competition authorities regard the interchangeability or substitutability of a product as paramount, when determining the relevant product market.

2.2 Relevant geographic market

Under the 2002 Act, relevant geographic market can be determined by taking into consideration various factors like trade barriers, consumer

34. *Ibid*, 8.
35. *Ibid*, 7.
36. *Am. Online Inc.* v. *GreatDeals.Net*, 49 F Supp 2d 851 (US District Court for the Eastern District of Virginia, 4-5-1999).
37. Jared Kagan, "Bricks, Mortar, and Google: Defning the Relevant Antitrust Market for Internet-Based Companies", (2010) New York Law School Law Review 280, <http://www.nylslawreview.com/wp-content/uploads/sites/16/2013/11/55-1.Kagan_.pdf> [hereinafter Bricks and Mortar].
38. *LiveUniverse Inc.* v. *MySpace Inc.*, CV 06-6994 AHM (RZx), order dated 4-7-2007 (US Dist Ct of Cal).

preferences, local specification requirements, distribution facilities, etc.[39]

The definition of a relevant geographic market relates to a pertinent question which is whether or not consumers can efficiently acquire substitutes. Geographical markets are often defined at a national level, but the evolution of the digital age has led to an increased complexity in determining relevant geographical markets for products. An example of the ever-expanding geographical market in cases of digital services can be gleaned from various African mobile operators offering customers packages wherein domestic prices are charged worldwide, a trend that some European service providers have taken to as well.

Many a time, the definition of a geographical market may be narrow in the offline world, owing to national preferences of consumers, language barriers, or transportation costs. Additionally, the location of the consumer may have bearings on the considerations of local sales networks, which may restrict different prices and conditions, and ultimately, the geographic market itself.[40]

It is pertinent to note that internet markets may be considered global, if a certain product is available only on the internet. Most internet services are globally available, and user preferences around the world are largely similar.[41] However, while determining relevant geographical markets, some courts require a real physical place, which cannot exist without outside boundaries.[42]

The defining of a geographical market takes an interesting turn when online platforms use customers' locations as matching tools.[43] This process, called "geographical segmentation", assists in the distribution of goods and services, and enhances customisation.[44] This phenomenon was utilised by the CCI in the taxicab aggregator cases, to hold that relevant geographical markets were limited to the specific city in question, as the regulatory framework applicable to them differs from one State to

39. Competition Act, 2002, S. 19(6).
40. *Microsoft/Skype,* Case No. COMP/M.6281, order dated 7-10-2011 64, 66 (European Commission).
41. *Ibid.*
42. Jared Kagan, "Bricks, Mortar, and Google: Defning the Relevant Antitrust Market for Internet-Based Companies", (2010) New York Law School Law Review 283, <http://www.nylslawreview.com/wp-content/uploads/sites/16/2013/11/55-1.Kagan_.pdf>.
43. Competition Issues in India, *supra* at 28.
44. "Geolocation Tools and Geographical Market Segmentation", <https://www.ftc.gov/system/files/documents/public_comments/2014/04/00010-89273.pdf> (accessed 6-7-2018).

another, and the scope of operations of these cabs is limited to city limits only.[45]

2.3 Dominance in digital markets

2.3.1 *India*

After the assessment of relevant market under the 2002 Act, another hurdle posed by authorities is how to determine an abuse of dominance in fast-moving technology-driven enterprises.

In the case of *Matrimony.com Ltd.* v. *Google LLC*,[46] the CCI made a few observations regarding assessment of dominance in the digital market. According to the CCI, one must consider the fast-moving innovation and novelty of the products, services of the enterprise, and the nature and extent of network effects.[47] Digital enterprises must not take unfair advantage of their dominant position and thus public intervention in such sectors must be "*targeted and proportionate*"; it must be assessed in a way that allows markets to regulate itself by not restraining innovation.[48]

Competition authorities in the past have acknowledged that the rise of e-commerce and digital markets have benefited consumers and boosted the growth of competition in the market. While deciding whether e-portals abused their dominant position by entering into sale of exclusive products on their websites, the CCI noted that such portals were only a means of distribution which in fact gave consumers an option to make an informed choice by comparing price and quality of goods with offline retail markets.[49] There are several players in the online market that offer similar services, and therefore an abuse of dominance does not arise.[50]

Another issue that arises while assessing dominance is the "market share" of an enterprise. The 2002 Act defines "dominant position" as a position in the relevant market which allows a firm to operate independently of prevailing competitive forces, or affect its competitors or the relevant market in its favour.[51] Section 19(4) of the 2002 Act lays down a few factors for determining the dominance of a firm, such as size, market share, relevance of competitors, resources of the firm, entry barriers, and market structure.

45. Competition Issues in India, *supra* at 27.
46. Case Nos. 7 & 30 of 2012, order dated 8-2-2018 (CCI).
47. *Ibid*, 79.
48. *Ibid*, 197.
49. *Mohit Manglani*, ¶ 9.
50. *Ibid*.
51. Competition Act, 2002, S. 4(2).

Although market share is one of the factors to determine dominance, it does not provide conclusive proof of a firm's dominant position, especially in the online market. With the surge in innovative and high-tech based markets and the "winner-takes-it-all" effect, the best competitor ends up dominating the market. Any competitor can easily gain market share significantly with the introduction of a new product. In the case of *Cisco Systems Inc. and Messagenet SpA*,[52] the court stated that "high market shares are not indicative of market power."

In India too, the Competition Appellate Tribunal ("**COMPAT**") has stated that dominance may mean a "position of strength", but it "does not say that this position of strength necessarily has to come out of market share in statistical terms".[53] The COMPAT urged the CCI to consider a holistic view of the radio cabs market, including factors such as funding, network expansion, discounts, etc. This holistic approach is evidenced from the CCI's orders in the *MakeMyTrip case*, which relates to an acquisition in the travel service related industry, where the CCI took account not just of the combined market share of the parties, but also the presence of competitors in the market. In fact, even in the *Meru*[54] *case* of 2015, the CCI held that "...Market share is but one of the indicators enshrined in Section 19(4) of the Act for assessing dominance, and the same cannot be seen in isolation to give a conclusive finding. Particularly, in case of new economy/hi-tech markets, high market shares, in the early years of introduction of a new technology, may turn out to be ephemeral..."

A hurdle that may present itself in the determination of dominance of a digital business is that the statistics of market shares may not be readily available, making self-reported details unreliable. This leads to situations wherein market shares are calculated with the help of special market reports, as was done in many of the taxi aggregation cases brought before the CCI. In the *Ola*[55] *case* in Bengaluru, the CCI took credence in a public news-based report submitted by the informant which stated that Ola had acquired close to a 69% market share after acquiring another company. The CCI held that even though an elevated market share does not directly indicate a dominant position, the growth that Ola has experienced in the last three to four years evidenced a strong market position.

52. *Cisco Systems Inc.* v. *Messagenet SpA*, Case T-79/12, order dated 11-12-2013, para 69 (Gen. Court [Fourth Chamber]).
53. *Meru Travels Solutions (P) Ltd.* v. *CCI*, 2016 SCC OnLine Comp AT 451.
54. *Meru Travel Solutions (P) Ltd.* v. *Uber India Systems (P) Ltd.*, Case No. 81 of 2015, order dated 22-12-2014 (CCI).
55. *Fast Track Call Cab (P) Ltd.* v. *ANI Technologies (P) Ltd.*, 2015 SCC OnLine CCI 70.

2.3.2 *European Union*

Article 102 of the European Treaty of the Functioning of the European Union ("**TFEU**") deals with abuse of dominant position by an undertaking. It states that "any abuse by one or more undertakings of a dominant position within the internal market or in a substantial part of it shall be prohibited as incompatible with the internal market in so far as it may affect trade between Member States".[56] This provision has been enacted to condemn the activities of dominant undertakings which amount to abusing their position in a market. The concept of dominance can be understood as "a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the market by giving it the power to behave to an appreciable extent independently of its competitors, customers and ultimately its consumers".[57]

While assessing dominance of an undertaking in the digital business, key factors that are taken into consideration are market shares in dynamic markets,[58] profit margins,[59] network effects, product differentiation, and multi-homing.

The concept of abuse was defined by the European Court of Justice ("**ECJ**") as an objective concept relating to the behaviour of an undertaking in a dominant position, which is such as to influence the structure of a market, where, as a result of the very presence of the undertaking in question, the degree of competition is weakened and which, through recourse to methods different from those which condition normal competition in products or services on the basis of the transactions of commercial operators, has the effect of hindering the maintenance of the degree of competition still existing in the market or the growth of that competition.[60]

In 2014, Facebook Inc. ("**Facebook**") sought to acquire WhatsApp Inc. ("**WhatsApp**") by way of a purchase of shares. While analysing the proposed transaction, the European Commission ("**EC**") focused

56. Consolidated Version of the Treaty on the Functioning of the European Union, 2012 OJ C 326/47, Art. 102.
57. *United Brands Company and United Brands Continentaal BV* v. *Commission of the European Communities*, Case 27/76, order dated 14-2-1978 : ECLI:EU:C:1978:22 : 1978 ECR 207 (European Court of Justice).
58. *AKZO Chemie BV* v. *Commission of the European Communities*, Case C-62/86, order dated 3-7-1991 : ECLI:EU:C:1991:286 : 1991 ECR I-3359 (European Court of Justice).
59. *Hoffmann-La Roche & Co. AG* v. *Commission of the European Communities*, Case 85/76, order dated 13-2-1979 : ECLI:EU:C:1979:36 : 1979 ECR 461 (European Court of Justice) [hereinafter *La Roche*].
60. *Ibid*, 541.

its attention on the aspect of consumer communication services, online advertising, and social networking.

In terms of consumer communication, the EC concluded that there existed sufficient competition in the market of applications which can provide consumers with the same services that Facebook Messenger and WhatsApp provide. Such examples include Snapchat, Telegram, iMessage, and Viber.

The EC affirmed that Facebook and WhatsApp were not close competitors in the social networking market, and so a potential merger would not be detrimental to competition law concerns. The EC also elucidated that the primary purpose of WhatsApp was not related to social networking, as it was more focused on providing an option for quick communication to its users.

With regards to the realm of online advertising, the EC identified two possible causes for concern in the deal, i.e. that of Facebook making WhatsApp run advertisements, and using WhatsApp as a source of user data. The EC asserted that even if the merger were to go through, there would be "a sufficient number of other actual and potential competitors who are equally well placed as Facebook to offer targeted advertising".[61] The EC did not find any competition concern with the user data being collected, as the practice of collecting this data is followed by many entities such as LinkedIn, Google, and Amazon.

In conclusion, the EC accepted the proposed transaction and stated that the deal "does not give rise to serious doubts as to its compatibility with the internal market as regards the market for the provision of online advertising services, including its potential sub-segments".[62]

Although the EC did not conclude any anti-competitive implications in the Facebook/WhatsApp merger, in a recent and important case, it fined Google 2.42 billion euros for abusing its dominant position.[63] This was regarding Google's Search Engine, which gave an illegal advantage to its own shopping service. The EC noted that since Google was dominant in general internet search, it abused its dominant position by creating traffic on its own "Google Shopping" product. This traffic indirectly lead to

61. *Facebook/WhatsApp*, Case No. COMP/M. 7217, order dated 3-10-2014, 32 (European Commission).
62. *Ibid*, 34.
63. European Commission Press Release IP/17/1784, Antitrust: Commission fines Google €2.42 billion for abusing dominance as search engine by giving illegal advantage to own comparison shopping service (27-6-2017).

more clicks and more revenue.[64] Google was fined for anti-competitive behaviour as it used its dominance to stifle competition thereby depriving consumers of making an informed choice.[65]

3. ANALYSING THE EFFICACY OF THE EXTANT COMPETITION LAW REGIME

A pertinent question that arises nowadays is—what is the role of competition policy in the digital economy? Is it well-equipped to deal with cases involving high-tech markets and innovative platforms and services? There are different schools of thought in this matter. Some believe that competition authorities should refrain from intervening in the fast-moving digital economy because the immense benefits that arise to consumers from the new digital economy significantly outweigh the competition concerns that may exist in the market, and interference in the natural cycle of these industries may end up "*chilling innovation*."[66] A second group of commentators believe that competition authorities must intervene in matters of antitrust in digital economy, however, the competition framework is not sufficient to deal with these matters and changes must be made to the competition policy.[67]

Richard B. McKenzie while talking about the difference between the old economy and the new, stated:

> The efficacy of antitrust law enforcement has been on trial. The Microsoft case has been the first large-scale antitrust proceedings of the digital age; it has tested the appropriateness of new economic concepts such as 'network effects,' 'tipping,' 'path dependency,' and 'lock-ins' and has forced us to ask whether nineteenth-century antitrust law, combined with twentieth century enforcement norms, are applicable to twenty-first-century problems of business organization.[68]

In the past, competition authorities have not been able to conclusively decide on antitrust cases either because of lack of evidence, or the lack of appropriate tools and tests to understand and determine relevant market and abuse of dominance. The *Google Search Engine case* before the EC and the Federal Trade Commission ("**FTC**") is an example of the above.

64. *Ibid.*
65. *Ibid.*
66. Massimiliano Kadar, "European Union Competition Law in the Digital Era", Zeitschrift für Wettbewerbsrecht (2015), 351.
67. *Ibid.*
68. Anupam Sanghi, *Competition in the Digital Economy: How to assess emerging tech markets?*, (LexisNexis, 2016) 9, <https://competitionindia.files.wordpress.com/2016/02/competition-in-the-digital-economy-3thjan.pdf.>

In 2009, a case was filed before the EC against Google concerning abuse of dominance regarding its Search Engine. However, instead of holding Google liable for anti-competitive behaviour, the EC allowed Google to submit a commitments proposal wherein Google adopted a series of measures to avoid an abuse of dominance situation.[69] The Vice-President of the EC said:

> Without preventing Google from improving its own services, it provides users with real choice between competing services presented in a comparable way; it is then up to them to choose the best alternative. This way, both Google and its rivals will be able and encouraged to innovate and improve their offerings. Turning this proposal into a legally binding obligation for Google would ensure that competitive conditions are both restored quickly and maintained over the next years.

This approach indicates a pro-innovation mindset by the EC.

A similar case was filed in the US before the FTC. However, after 19 months of investigation, the FTC decided not to file the case before the Department of Justice. Instead, it decided to sign an agreement in which Google would voluntarily make some changes that were identified as anti-competitive.[70] The FTC came to such a conclusion due to "*lack of evidence*" and acknowledged the difficulty in probing such cases in e-commerce markets.[71]

The two reasons that could be attributed for the failure of holding Google liable for anti-competitive behaviour are *firstly,* a lack of precise rules regarding the manner in which investigations must be carried out in the internet world (which is significantly different from the physical world).[72] *Secondly*, an ignorance of technical aspects and proper research regarding behaviour in e-commerce markets like the Google Search Engine led to the FTC holding that Google was not anti-competitive.[73]

Even the SSNIP test that features in the guidelines of various jurisdictions,[74] cannot be used effectively in cases of digital businesses, as most platforms that are being investigated are multi-sided in nature.

69. European Commission Press Release IP 14/116, Antitrust: Commission obtains from Google comparable display of specialised search rivals (5-2-2014).
70. Doris Karina Oropeza Mendoza, "Antitrust In The New Economy Case Google Inc. Against Economic Competition On Web.", 2016 Mexican Law Review 100, <https://doi.org/10.1016/j.mexlaw.2016.07.001>.
71. *Ibid*, 100.
72. *Ibid*, 109.
73. *Ibid*.
74. The test features, for example, in the Mexican "Market Definition: Assessment of the Relevant Market in Competition Matters", §2.3 cl. D; in the US "Horizontal Merger Guidelines (2010)", § 4.1.1; in the UK Competition Commission and Office of Fair

Indirect network effects should be considered in the market definition, since groups are linked by external stimuli, and a change in price on one side automatically impacts the other. However, this "feedback loop" is not taken into account by traditional market definition tests, such as the SSNIP test.[75] Thus, the application of the SSNIP test to multi-sided platforms would result in the market being defined too narrowly or too widely, which will be detrimental to the overall assessment.[76] In theory, the SSNIP test is a valid test if the peculiarities of multi-sided platforms are considered and if competition authorities take into account the impact of price considerations on two sides of a digital business. In practice, however, the utility of the SSNIP test has been felt only in markets with one-sided externalities.[77]

In fact, the debate on the application of competition policy in High Innovation Markets came up before the Organisation for Economic Co-operation and Development ("**OECD**") Competition Committee at a round table in 2002. Most of the jurisdictions like the UK, Japan, Australia, Netherlands and the EC were of the opinion that traditional tools of assessing competition can be used in high innovation markets. They regarded a special definition for constituting relevant market as "difficult" and "uncertain".[78] Many countries suggested that a customised and case-by-case approach needs to be taken for such markets. This view was also suggested by India in its note to the OECD Competition Committee meeting on 6–8-6-2018.[79] In this note, India took the view that the digital markets are growing at a fast pace characterised by unique features and therefore intervention in such cases must be cautious, not inhibit competition and must be examined on merits.[80]

However, in India, the CCI fails to give clarity on market definition and cases of abuse of dominance in the digital economy. There is no definite guideline on how market share will be assessed for such high-tech

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Trading "Merger Assessment Guidelines (2010)", § 5.2; or in the Australian Competition and Consumer Commission "Merger Guidelines (2008)", § 4.19–4.22.

75. David S Evans and Richard Schmalensee, "Industrial Organization of Markets with Two-Sided Platforms", 2007 Competition Policy International 457, <http://www.nber.org/papers/w11603.pdf>.
76. David S Evans and Michael Noel, "The Analysis of Mergers That Involve Multisided Platform Businesses", 2008 Journal of Competition Law and Economics 667, <http://www.nber.org/papers/w18783.pdf>.
77. Lapo, *supra* at 329.
78. "Policy Roundtables on Merger Review in Emerging High Innovation Markets 2002", <http://www.oecd.org/competition/mergers/2492253.pdf> (accessed 5-7-2018).
79. Implication Note, *supra* at 5.
80. *Ibid*, 7.

and innovative business models. The CCI often takes an evasive stance and fails to apply global competition and business knowledge to its cases.

Therefore, in a country like India which has not been fully exposed to cases involving e-commerce, competition authorities must take a cue from other jurisdictions and adopt definite set of tests and guidelines to determine antitrust issues. An attempt must be made to understand the economics of online businesses and how to integrate it with traditional markets. India could consider adopting a different approach towards antitrust liability in digital markets. The EU and US have a mechanism that enables enterprises to alter their market structure if identified as potential antitrust claims. The process by the EC is called "commitment decisions" which was adopted by cases like Google Search Engine in 2014 and similarly, adopted by Google in "consent order agreement" before the FTC in the US. This method also saves the need of conducting a full-fledged investigation.

Considering the unique characteristics of digital markets like rapid technological changes, winner-takes-it-all effect and increasing returns; an enterprise is able to acquire quick market share and exponential growth. Dominance must be assessed by taking all these factors into account and authorities must not stick to the limited factors under the 2002 Act. Rather, cases must be decided on an "overall picture" and long-term impact of such digital markets.

CONCLUSION

There is one thing for certain: digital markets are here to stay. The steady growth of e-commerce is both a boon and bane to consumers. In the fast-paced era of technological innovation and evolving marketplaces, an effective competition regime can be characterised as one with quick investigatory tools and decision-making processes. Many a times, the solutions proposed to remedy an antitrust concern in a digital market are obsolete, and hence cannot be implemented. It is necessary for competition regulators to view themselves as consumer champions, and pursue meritorious cases while approaching the relevant economic and legal analysis. Any legislation in the new age economy must be focused on understanding the structure, strategies, and economic effects of such high technology industries. We must remember that the basic essence of competition policy will be applicable to digital businesses as well, and society will only progress when firms obtain profits through innovation, instead of using their capital to restrict entry into these new-age markets.

However, the real question that arises is whether the traditional approach can still be appropriate to assess market dominance in such areas. Competition authorities must not hurry to make decisions, but rather must monitor the industry carefully and understand the market dynamics. Over enforcement could deter investments and healthy competition in the market. However, under enforcement may result in short-term harm and can change market dynamics if there is a significant jump in dominance by an enterprise. Therefore, competition authorities must strive to draw a balance between long term social welfare and the desire to stop anti-competitive strategies that in the long run may drive out traditional markets altogether.

Regulation of Peer-to-Peer Lending

Analysis of the Appositeness of Indian Approach

—*Saumya Agarwal & Ayush Anand*†

ABSTRACT

The last several years have witnessed a tremendous increase in the number of alternate finance systems—systems running parallel to and sometimes complementary to the traditional banking practices. These alternate finance systems came forward as a form of rescue from economic problems and increasingly tighter banking norms. Crowdfunding is one such well-known mode of alternate financing that once captured a majority of the market. Peer-to-peer lending is a kind of financial return crowdfunding and has shown exponential growth rate, attracting participation across the globe starting from 2005 and in India roughly since 2012. Since its advent in India many online platforms took it up and facilitated easier loan facilitation to individuals and small and medium enterprises which faced issues in getting loans through traditional banking system due to reduced economic liquidity. The sector was recently brought under regulation in India by the RBI and a peer-to-peer lending firm was given the status of Non-Banking Financial Corporation (NBFC). The present note aims at analysing the regulatory practices adopted recently by the RBI for NBFC peer-to-peer lending platform through its Master Direction released on October 4, 2017. It addresses the concept of peer-to-peer lending and discusses in detail the journey it has covered since it's advent in India and the salient features of the recent regulations. Further, the note highlights the regulatory practices of United Kingdom, United States of America, China and France, and a critical and comparative examination of the appropriateness of the regulatory framework and guidelines that have come into place in India and the practices of abovementioned countries is made out.

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INTRODUCTION

The financial crisis of 2008 is often said to be the worst economic tragedy since the Great Depression of 1929, due to certain gaps in the existing banking sector such as excessive leverage, inadequate and low-quality capital, and insufficient liquidity buffers, thus exposing the interconnected risk between the financial sector and the real economy. As a response, the Basel Committee on Banking Supervision comprised of central bank and supervisory authority representatives from twenty seven countries including India, agreed upon the new norms known as the "Basel III norms" to combat the weaknesses existing in the sector, to regulate and strengthen the resilience of banks in times of deteriorating economy by strengthening the capital adequacy ratio requirement of banks and also to focus on stress testing and market liquidity risk. With stricter capital requirements than before, the liquidity offered by banks was reduced and small and medium enterprises and individuals faced difficulty in obtaining loans. The resulting vacuum thus created in the lending process was filled by various alternative financial activities, the protagonist of this paper being peer-to-peer lending (hereinafter P2P Lending).

The author through the present discussion aims to delve into the question of appropriateness of the regulatory model incorporated by the Master Directions on P2P Lending issued by the Reserve Bank of India (hereinafter the RBI). The paper has been divided into four parts. Part 1 lays down a general overview of P2P Lending Model. Part 2 discusses upon the journey it embarked in India till now. Part 3 lays down the salient features of the recent regulatory framework. Part 4 analyses upon the moot question of appropriateness of framework by making a comparative analysis.

1. PEER-TO-PEER LENDING MODEL: AN OVERVIEW

1.1 The Concept of Peer-to-Peer Lending

Crowdfunding is an umbrella term that warrants solicitation of funds (small amount) from multiple investors for a specific project, social cause or business venture through a web-based platform or social networking site.[1] Crowdfunding can be divided into four categories: donation crowd

1. Eleanor Kirby and Shane Worner, Crowd-funding: An Infant Industry Growing Fast, Staff Working Paper of the IOSCO Research Department (2014).

funding, reward crowd funding, peer-to-peer lending and equity crowd funding.[2]

P2P lending platform has been defined to mean an intermediary providing the services of loan facilitation via online medium or otherwise, to the participants.[3] It is a virtual marketplace which brings together borrowers and lenders online by providing them with a platform and facilitating smooth business transactions between them. This in turn leads to high returns to lenders and quick funds to borrowers who are either individuals or small businesses. Providing unsecured loans unlike a savings account (traditional finance system), and deciding interest rates are the primary functions of this platform. As on one hand, some P2P platforms arrange loans between individuals, while on the other hand funds are pooled and then lent to small and medium sized businesses.[4]

1.2 Characteristics of Peer-to-Peer Lending

P2P lending is sometimes categorized as an alternate financial service, as it does not clearly fall under any of the three traditional types of financial institutions—deposit takers, investors, insurers.[5]

Alternate finance refers to financial channels, processes, and instruments that have emerged outside of the traditional finance system, such as regulated banks and capital markets. Some examples of alternative financing activities via online market places are reward based equity crowdfunding, peer-to-peer consumer and business lending, reward-based crowdfunding, invoice trading third party payment platforms. Alternative finance instruments includes small and medium enterprise (SME) mini bonds, cryptocurrencies, private placement, community shares and other "shadow banking" mechanisms. It is a deviation from the path of traditional banking or capital market finance by way of a technology-enabled "disintermediation". It means utilisation of third party capital by introducing fundraisers directly with funders.

Typical characteristics of P2P lending are:

1. It is generally conducted for the purpose of profit earning;

2. *Ibid.*
3. "Participant" means a person who has entered into an arrangement with an NBFC-P2P to lend on it or to avail of loan facilitation services provided by it. *See* RBI/DNBR/2017-18/57, Reserve Bank of India, Master Directions—Non-Banking Financial Company—Peer to Peer Lending Platform (Reserve Bank) Directions, (2017) (hereinafter, "RBI Directions").
4. *Supra* at 1. (plz check)
5. Robert E. Wright and Vincenzo Quadrini, *Money and Banking*, Chapter 2: Section 5 (FlatWorld, 2009).

2. Existence of prior relationship between lenders and borrowers or common bond is not necessary;
3. Generally the transactions are facilitated by a P2P lending company;
4. Predominantly, the transactions take place online;
5. Lenders would often choose which borrowers to invest in, provided such a facility is offered by the P2P platform;
6. Under P2P lending, the loans are either secured or unsecured and usually are not protected by government insurance but there can be protection funds like those offered in the UK by Zopa and Ratesetter;
7. For the purpose of debt collection or profit, loans act as securities that can be transferred to others, though not all P2P platforms provide free pricing choices or transfer facilities, and costs can be very high.

2. JOURNEY OF PEER-TO-PEER LENDING PLATFORM IN INDIAN ECONOMY

2.1 Historical Background

P2P lending originated in the United Kingdom in 2005, when Zopa became the first company to offer such loans. Since then, the growth of the model and the number of such platforms has just seen an unprecedented growth. In India, increasing internet penetration led to greater consumer education and made them aware about loans that were documentation-free and could be availed in a relatively shorter time without the usual hassle of dealing with irritant bank managers.[6] P2P initially started off as an unregulated system, RBI first noticed their accelerated growth in its first Bi-monthly Monetary Policy Statement, 2016–17. Soon realising the need to regulate the sector due to its increasing popularity a consultation paper on P2P lending was published on April 28, 2016. Following the consultation paper, on August 24, 2017, the notification was issued by the Department of Non–Banking Regulation, RBI giving all the peer-to-peer lending business platforms status of Non-Banking Financial Corporations (NBFCs) and guidelines as to its operations were released by RBI on October 4, 2017. Faircent has since then, become the first platform to be registered as NBFC-P2P under RBI.

6. LenDen Club, "Have an Insight into the History of P2P Lending in India", (27-7-2018, 8:35 p.m.), <https://www.lendenclub.com/history-p2p-lending-india/>.

2.2 Consultation Paper on P2P Lending by RBI

On seeing the potential benefits and weighing the associated risks posed by P2P lending to the financial system, RBI found it necessary to release the consultation paper to various stakeholders having regard to the current legal and regulatory framework in place both domestically and internationally to regulate the business of financial intermediation. Further, RBI sought an understanding of how different jurisdictions regulate and treat these new online lending platforms.[7]

The consultation paper mentioned the dramatic increase in lending through P2P platforms globally from 2.2 million GBP in 2012 to 4.4 million GBP in 2015 thus reflecting upon the market seizure being shown by the platform.[8] It also discussed in brief the five different P2P lending regulatory models existing in the world—*Exempt market* (unregulated through lack of definition); *Intermediary regulation; Banking regulation; the two-level US model;* and *total prohibition*. India witnessed a lot of P2P lending platforms being involved in business targeted micro finance activities which gave easier credit access to SMEs. The operational business model in India discussed in the consultation paper was a basic model wherein the platforms were technological companies registered under the Companies Act, 2013, acting as a mediator/facilitator between borrowers and lenders, besides providing other additional services like credit assessment and recovery as well. The main focus of the paper was that *whether there is a need for regulating P2P lending in India?* The arguments for and against the proposition were discussed in detail.

Arguments *against* regulating the activity were laid down as:

1. Regulating a blooming sector may lead to labelling it as being credible and thus attracting lenders with low awareness as to the platform's susceptibility to high risk borrowers;
2. Regulating might hamper the growth of the nascent sector as the participants who do not have access to formal financial channels or are denied loans due to reduced liquidity might find these stringent;
2. The platform currently being in its initial stage would not pose an immediate systemic risk or impact on monetary policy transmission mechanism and hence there was no immediate need to regulate it.

7. Reserve Bank of India, Consultation Paper on Peer to Peer Lending, 28-4-2016 (hereinafter "Consultation Paper").
8. Peer2Peer Finance Association, Data, (5-7-2018, 4:55 p.m.), <http://p2pfa.info/data>.

Arguments *for* regulating the activity were laid down as:

1. The alternative forms of finances being promoted by P2P lending pose competition to formal sources of finance due to soft lending rates as a result of lower operational costs which is both a threat to traditional banking finances and a great method of financing SMEs. Thus in both ways regulating the sector will be more competitive and hence, effective;
2. The market being full of scrupulous paths might result in development of unhealthy practises if not regulated;
3. Under Section 45-S of RBI Act, 1934, acceptance of deposits by an individual, unincorporated association of individuals or firms is prohibited if the business falls under any category of clause (*c*) of Section 45-I of RBI Act, 1934. Such infringement is punishable under Section 58-B (5-A) of the RBI Act, 1934. The probability of lenders and borrowers falling within these exclusions and absence of regulations might lead to committing illegality.

After weighing the arguments mentioned above, it was finally proposed to get P2P lending platforms under RBI by classifying them as NBFCs. The regulatory framework proposed, broadly included permitted activity, prudential regulations on capital, governance, business continuity plan (BCP) and customer interface, apart from regulatory reporting.[9]

2.3 Debate on Regulating Financial Innovations: P2P Lending Platforms[10]

The prime areas of discussion in the Consultation Paper were—general rationale for financial regulation, regulations in particular on financial innovations, different approaches employed to deal with financial innovations by the RBI in the past and the challenges that await the path of regulating peer-to-peer lending.

9. *Ibid.*
10. Reserve Bank of India, "Regulating Financial Innovation: P2P Lending Platforms Design Challenges (2017)".

The traditional approach of neo-classical economic theory of unrestricted or *laissez-faire* economic system is shown as being preferred by one set of academics[11] where market failures were seen as not being deep enough to need regulations which itself can have imposition cost.[12] A substantiating argument was that the regulations being imposed reduced competition and favour for only the providers and not the consumers.

The other set of academics argued otherwise and stated that, the private sector if not regulated will in itself produce the least amount of sub-optimal results or market failures,[13] and in the event of market failures, even the most independent private enterprises tend to find shelter under the government's prompt action to rectify the issue

The different approaches followed by the RBI in the past while contemplating upon the regulations of the financial innovation were discussed, *viz*:

1. If the innovation can cause large scale damage: *Ban*;
2. If the damage that can be caused is of a very small magnitude: *Ignore*;
3. If consumers are capable of taking informed decision in this regard: *Watch out and caution*;
4. If it can be beneficial to many consumers: *Regulate passively*;
5. If it can be beneficial to many consumers but has looming consumer protection issues over it: *Regulate actively*.

The final part of the debate pondered upon the need to lightly regulate the sector as consumer protection issues tend to get amplified with time and regulations are necessary to instil trust through stability. This led to issuing of notification by Department of Non-Banking Regulation, RBI on 24 August 2017, classifying platforms carrying out peer-to-peer lending business as NBFC under the powers conferred upon it by sub-clause (*iii*) of clause (*f*) of Section 45-I of the Reserve Bank of India Act, 1934 (2 of 1934) and with the prior approval of the Central Government. Following which on October 4, 2017 the RBI issued directions for NBFC- P2P platforms which provided a framework for the registration and operation of NBFC-P2Ps in India.

11. *Ibid*.
12. David Llewellyn, *The Economic Rationale for Financial Regulation* (1999).
13. Charles Goodhart et al., *Financial Regulation: Why, How and Where Now?* (1998).

3. THE RBI MASTER DIRECTIONS ON NBFC-PEER-TO-PEER LENDING PLATFORMS: SALIENT FEATURES

The RBI Directions has laid down a regulatory framework for the registration and operation of NBFC-P2P lending platforms. The eligibility criteria for registration was laid down wherein the non-banking institution has to necessarily be a company with the certificate of registration and a minimum net owned funds of INR 20 million or an amount higher as prescribed by RBI.[14]

The conditions to be fulfilled for consideration of registration application were also elaborated upon wherein a company incorporated in India with substantive capital structure and Information Technology System. Additionally, the promoters and directors have to satisfy the "fit and proper"[15] criteria.[16]

In case of prospective NBFC-P2Ps, a two-step process has been laid down wherein RBI will be granting an in-principal approval for setting up the platform which will be valid for a period of twelve months from the date it is granted. Within this period the company will be required to set up its technological platform, enter into all legal formalities and show compliance with all conditions of in-principal approval, and then the RBI would issue a certificate of registration as an NBFC-P2P.

In case of existing P2P lending platforms, an application for registration was to be made within three months from the date of issuance of the RBI directions and were allowed to continue operations while the application was under process or till rejected. The scope of activities laid down seems to focus more on the motive of protecting blanket security to participants and development to the sector.

The P2P lending companies are required to maintain a minimum leverage ratio[17] not exceeding 2. There is also a cap of INR one million on aggregate exposure of a lender to all borrowers and on aggregate loans taken by a borrower at any point of time. In addition to this, the maturity of the loans shall not exceed a time period of 36 months and a certificate from the borrower or lender must be obtained stating that all the limits prescribed above are being adhered to.[18]

14. RBI Directions, supra note 3 at 2.
15. RBI Directions, supra note 3 at 8.(plz check)
16. RBI Directions, supra note 3, 3-4 (plz check)
17. Total outside liabilities divided by owned funds.
18. RBI Directions, supra note 3 at 5. (plz check)

For transferring of funds, an escrow account mechanism shall be used by the P2P lending platforms operated by a trustee. Separate escrow accounts must be maintained i.e. one for collections from borrowers and one for funds received from lenders and the banks are supposed to mandatorily promote the trustee. There exists a prohibition on cash transactions and all fund transfers compulsorily have to be made using bank accounts.

Lastly, to become a member of Credit Information Companies (CICs), all NBFC-P2Ps have to share data. They shall also be responsible for updating their databases on a regular basis. These companies are required to publicly disclose requisite information on their websites, while complying with disclosure and transparency norms. Guidelines regulation on change in management or control exceeding 26% in NBFCs now also apply to NBFC-P2P and require prior approval from the RBI. Some other compliance norms include:

1. Appointment of directors has to be in compliance with the "Fit and Proper" criteria (as described in the RBI Directions);
2. The Code of Fair Practices must be put in place and made available on its website;
3. Prescribed returns must be duly submitted;
4. Redressal policy for grievances of participants must be drafted.

4. APPOSITENESS OF THE INDIAN P2P LENDING REGULTORY FRAMEWORK: A COMPARATIVE ANALYSIS

The significance of the RBI Directions lies in the framework of registration and operation it provides through the encompassment of the permitted activity, prudential regulations on capital, governance, business continuity plan and customer interface, apart from regulatory reporting.[19] It is put into place to facilitate regulated growth of the market as well as to protect consumers from the risks and reality of internet-based finance. The debate that follows regulation of financial innovations is to the degree of need; as even-though innovations bring new quality, efficiency, productivity, competitiveness and market share; yet they pose the dangers of untested effects, lack of clarity on long term results and blatant misuse. This part will thus critically examine the appositeness of India's regulatory approach from a comparative perspective.

19. *Supra* at 8. (plz check)

4.1 UK: Special License and Minimum Capital Requirements[20]

The model adopted by the online lending platforms in UK for carrying out business is a client-segregated account, where third party holds the client funds – making the UK P2P platforms nothing more than matchmakers.[21] The regulatory framework currently in place was adopted in 2014 when the Policy Statement 14/4 was published by Financial Conduct Authority (FCA).[22] Consequent to this for entering into online lending market full authorization from FCA is needed[23] and while granting certain parameters would be taken into consideration, viz., planned activities and related risks, budget, resource (capital, system, human), a website to demonstrate user interface. The disclosure requirement needed on the part of the platform is to allow full access to the information related to borrowers for the calculation of risk by lenders.[24] A minimum capital requirement for lending platforms is GBP 20,000 in legal capital.[25] Other regulatory requirements include, rules to be followed while the platform holds funds of clients, dispute resolution rules, reporting requirements and plan to continue existing loans in case of platform crash. The FCA has the power to intervene in case it senses any irregularities to protect consumers and also supervises platforms in monitoring websites, reviewing monthly management information and while engaging with senior management.[26] A self-regulatory body called "Peer-to-Peer Finance Associations" also exists in UK apart from FCA, but is more in the nature of a market lobby.

4.2 US: Burdensome Securities Regulatory Process

Unlike UK, US does not lay down any restriction of business model on online lending platforms and US platforms are not pure information intermediaries. The notary model is followed by the two main platforms

20. Robin Hui Huang, Online P2P and Regulatory Responses in China: Opportunities and Challenges, Working Paper No. 21, Centre for Financial Regulation and Economic Development (2017).
21. Patrick Jenkins, "US Peer-to-Peer Lending Model has Parallels with Subprime Crisis: Credit Quality of Some Loans is Triggering Concerns" (*Financial Times*, 30-5-2016).
22. The FCA's Regulatory Approach to Crowdfunding over the Internet, and the Promotion of Non-readily Realisable Securities by Other Media: Feedback to CP13/13 and Final Rules.
23. FCA, "A Review of the Regulatory Regime for Crowdfunding and the Promotion of Non-readily Realisable Securities by Other Media", February 2015, para 44.
24. *Id.*, para 49.
25. The FCA's Regulatory Approach to Crowdfunding over the Internet, and the Promotion of Non-readily Realisable Securities by Other Media: Feedback to CP13/13 and Final Rules (March 2014), para 12.3.
26. *Ibid.*

where the loans are originated by the partner bank and the platform issues payment dependent notes to lenders.[27] Though being one of the leading countries in this sector the regulatory framework followed by US is quite complex as it is governed by both State and Central rules. The State level approach differs from State to State ranging from complete ban, to allowance of elicitation of borrowers and sophisticated lenders by platform to allowing it according to the criteria of Securities and Exchange Commission. In US, it is necessary to get the loans/notes registered with SEC as it is "*unlawful to sell securities without an approved registration statement and prospectus*."[28] The registration requirements are very burdensome, as it requires more than thirty two pieces of information in addition to last three years' accounting records of the company's business.

4.3 France: A Success Story

The P2P Consumer Lending model is by far the largest model reflected in the French alternative finance data set. French P2P Business Lending is right behind P2P consumer lending and has now become the second largest model.

Until now, France has demonstrated a significant growth and has been a leader in setting European expectations for *FinTech* focused regulation. With a forthcoming scheme on the horizon aiming at harmonization, it is quite useful to understand how existing platforms perceive the present regulatory and supervisory frameworks.

In France, crowdfunding associations work with regulators in order to maintain the proportionality principle in the regulation. The rules that regulate the French platforms, are largely based on regulations framed when the business-customer relationship was not dematerialized. Application of new solutions enabling crowdfunding platforms in conducting their businesses in a more efficient manner must be promoted. These include solutions relating to know-your-customer (funded companies and investors), data security, ease of payment, source and traceability of funds, digital identification, etc. At the same time, factors like a tax system that discourages risk-taking and investment in non-listed companies, prohibition to advertising, ban on advertising, are some

27. United States Government Accountability Office, Person-to-Person Lending: New Regulatory Challenges Could Emerge as the Industry Grows, July 2011, 13.
28. Paul Slattery, "Square Pegs in a Round Hole: SEC Regulation of Online Peer-to-Peer Lending and the CFPB Alternative" (2013) 30(1) YJR 233, 255.

factors that obstruct the development of alternative finance activities like peer-to-peer lending. Nonetheless, the finance sector is favourable to a customary statute for crowdfunding in order to build a growth-oriented environment and also to facilitate direct application of regulations at the European level.

4.4 China: A Matter of Balance

At a fundamental level, China's regulatory outlook with respect to online lending is consistent with its gradualist style of economic reform which functions with trial and error basis at its root. In the interest of providing sufficient room for the expanding internet finance, in the beginning China went ahead with a laissez faire approach towards it. It's quite surprising as China's financial regulations have been traditionally characterized by repression and conservatism. For instance, the Chinese online lending platforms are only required to register themselves with the local authorities and are required to have general telecommunication license which can be easily procured. There exist no substantive requirements such as that of minimum capital or that of a special financial services license. All of this resulted in creation of a large vacuum for online lending platforms such as P2P lending, leading to the "wild west" quality of the existing online lending market.

China's new regulatory regime is intended to uplift the online lending industry and facilitate healthy development to provide an alternative source of finance for innovation and entrepreneurship. To start with, Chinese online lending platforms are required to perform the role of purely informational intermediaries and appoint third-party custodians to keep client funds. This means that the online lending platforms in China are supposed to adopt on the client segregated account model. From a comparative perspective, it follows the UK approach, and differs from the US practice. Is this the correct choice? The Chinese answer may be positive to that. While the restrictions present imposed on the business model may impede the development of the market, it is indispensable to achieve China's goal of controlling financial systemic risks and protecting investors. In the US where the notary model is used, in recent times some high-profile scandals in the online lending market have come to the surface in turn attracting widespread attention.

It is against this background that in the year 2016, Chinese Interim Measures on Online Lending was promulgated as an effort to guard the market against any such kind of frauds and scams. Further details

were fleshed out by the three important implementing rules, namely, the 2016 Guideline on Online Lending Registration, the 2016 Standard on Information Disclosure and the 2017 Guideline on Custodian Business. Together, within a short span of time, they have developed into a relatively complete regulatory regime for online lending in China, putting an end to the previous situation of lawlessness which resulted in an unchecked and order-less growth of the underlying market. In general, this is a sign of positive development and has been welcomed by the market.

4.5 Scrutinising the Indian Scenario

The presence of P2P lending in India is relatively new as compared to other countries; however the growth trajectory of *Fintech* has seen a good amount of rise after demonetization as the deposits in bank ran low and gross NPAs in bank rose resulting in traditional lending processes coming to a stand-still, majorly affecting SMEs and individuals. The report by NASSCOM and KPMG, laid down that the transaction amount of Fintech sector of India was around $33 billion in 2016 and is estimated to reach $73 billion by 2020 at a compound annual growth rate of 22%.[29]

Every sector in its infant stage prefers to operate in a new market and experiment it without having compliance with any stringent regulations. P2P lending operated for around five years after its advent in India in 2012 without any regulations. However, after much deliberation in October, 2017 it was regulated as an NBFC by RBI as discussed in detail in the previous pages.

After a thorough examination of the Indian scenario it can be rightfully inferred that the general mind-set of the people prevalent in the economy is that individual prefer not to risk advancing loans to unregulated platforms for fears of credibility against traditional banking system and prefer to approach the banks for deposits and investments. Thus, regulating this industry can prove as one of the major milestones in the context of current state of affair of India's credit market since these regulations will definitely increase participation of both borrowers and investors in long run.

The business model followed by India is a client segregated account model where the platform works purely as informational intermediaries. The new regulations are well balanced and that is why are likely to

29. "P2P Lending—Present Status and Future Growth in India", (9-6-2018, 9:50 p.m.), <https://www.epaylater.in/blog/p2p-lending-space-india-current-status-and-future-growth/>.

appeal to both borrowers and lenders as they can approach the regulators in case they seek help in case any platform fails to discharge its duties or is unable to honor the rights of investors and borrowers. As now all the transactions are bound to be routed through escrow accounts managed by trustees the transactions including disbursals and EMIs will be more convenient and a lot faster. This model as followed in UK and China has received a positive response in both countries, and is expected to be welcomed warmly in India as well. While these restriction may seem to decelerate the development but is essential in achieving the goal of protecting investors and containing the risks it poses.

The notary model followed by the US requires greater and heightened investor education which India will take years to achieve. Additionally, the greater risk in the US model is something alien to India's conservative market sentiments.

One of the major reasons of the current lending problems in India were due to the high number of bad loans on the balance sheet of banks resulting into a very low appetite of lending towards borrowers with no credit behavior track record. The new regulations lay down that a common platform to share credit behavior of borrowers will be present thus rectifying the existing issue.

Creating a niche sector may also become a possible option for the players. Depending on the knowledge and growth oriented strategies of the platform, it may certainly be able to earmark the different classes of borrowers it intends to target.

India has specific regulations related to reporting and disclosure requirements which are also provided in the framework of UK and US unlike China. The regulations lay down disclosure requirements which make it necessary for the platforms to reveal the performance and composition of loan profile. Thus, while making claims about their performance to lure participants, the platform will be obligated to state the truth. This will lead to transparency and would increase participation with increased credit analysis, which is necessary in current state of demonetization and burdened NPAs. The lending limit for borrowers and investment limit for lenders (as discussed previously) is also prescribed which should be welcomed as it will clearly help in controlling the risks of online lending, particularly default risk and systemic risk.

The regulations thus prove to be prophylactic and were a much needed step which should be welcomed as it will help the sector to grow in a more regulated manner which will be beneficial in a long run.

5. CONCLUSION

Although the traditional banking system is still the preferred destination for Indian investors and borrowers, criticisms regarding its efficiency and reliability are on a rise. The ever increasing amount of NPAs in the system poses a great threat to the economy and has become a major factor for launching a search operation to look for viable options in the form of alternative financing activities. The foregoing discussion made it possible to bring the concept of P2P lending market to the limelight and to discuss its future prospects now that it has become a well-regulated activity. Though, it is an underdog in the financial services sector, its global success it has proved as its litmus test. Globally, it has been there for almost a decade now, but its presence in India is relatively new. After allowing it to enjoy a regulation free run and allowing it to experiment in the dynamic environment of Indian financial system, the Indian Government found the best possible time to legitimize it, by bringing it under a regulatory framework which also made possible its continuous evaluation.

In essence, the significance of the new regulatory framework lies in the legitimization of this process through a system of registration, well prescribed lending limits, disclosure norms and obligation that is structured in a manner to achieve two primary objectives, namely facilitating a healthy growth of the online lending market and protecting the financial interests of the consumers. There may be instances when these two objectives may be consistent with each other, while on other occasions they may show a drastic contrast. Hence, there existed a challenge of finding the best possible combination of regulations that can strike a balance between the two regulatory objectives. After a thorough analysis, it appears that the regulatory bodies were able to hit the bull's eye as an economy which was facing an economic standstill as the aftermath of demonetization, was desperately looking for an alternate to the traditional banking system.

The Indian experience of this step would definitely be able to contribute significantly to the central question of all international debates. On paper it seems to be quite promising but it should be given a reasonable time to experiment itself in the market.

ESSAYS

Resale Price Maintenance in the Age of Internet Retailing: Towards A More "Economic Approach"

—*Sumit Singh Bhaduaria*†

ABSTRACT

This paper studies the recent debate between law and economics of resale price maintenance particularly exacerbated with the growth of internet as a distribution channel. The growth of e-commerce has a significant impact on the retail competition featuring the emergence of new business models particularly modeled on deep discounting. The present economic literature identified that these changing market realities has rendered many dual distribution and multi-distributional channel inefficient in different market situation. A price discounting by an online retailer a greater impact, in comparison with bricks and mortar retail discounting, the effective retail distribution of manufacturer products. To correct such distribution inefficiencies, the use of vertical restraint, particularly resale price maintenance is becoming increasingly popular. This paper studies the economics of resale price maintenance in e-commerce market and advocates an 'economic approach' for treatment of resale price maintenance. This paper covers the legal treatment of resale price maintenance particularly highlighting the extend of law on the subject as founded on economic principals in three jurisdictions – EU, U.S. & India. Further, this paper argues that businesses have substantially less discretion to use resale price maintenance in certain jurisdictions. While the Indian jurisprudence on resale price maintenance is still at nascent stage, the paper highlights and suggest that an economic approach in consistency with the law of U.S. is more appropriate.

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INTRODUCTION

Resale price maintenance (RPM) is a field of competition law which witnessed the greatest tussle between law and economics in almost all jurisdictions. It is a field which has seen continuous disagreements on the extent and role of economics in shaping the rules of competition law.

Traditionally, RPM agreements have been strictly constructed by competition authorities across jurisdictions. In many jurisdictions, vertical price fixing is considered equivalent to horizontal price fixing which is a *per se* violation of law. The recent market development has stirred the debate over the current treatment of RPM in almost all the jurisdictions. In particular, the extent of retail competition affected by the growth of internet retailing has significantly contributed to this debate. It has changed the way in which the vertical restraint, particularly RPM was perceived in the traditional market. The economics literature on RPM has identified many pro-competitive effects of RPM in these changing market dynamics. However, the law on the subject continues to ignore these market realities. This paper studies the economics of RPM in the e-commerce market and highlights the importance of economics in competition policy. It further captures the law of RPM and its treatment under EU, US and India and argues for an "economic approach" in dealing with the subject of RPM.

The second chapter of the paper identifies the main features of an e-commerce transaction. It further describes how these features affect competition in both upstream as well as downstream markets. The third chapter studies the economics of RPM. It describes both pro-competitive as well as anti-competitive explanations supported by economics, in particular, to its application in response to internet retailing. Chapter four of the paper surveys the legal treatment of RPM and identifies the extent to which the law of RPM is founded on these economic principles in each of the jurisdiction, viz. EU, US and India. The fifth chapter concludes the paper.

1. COMPETITION AND INTERNET RETAILING

Over the last decade, e-commerce has shown phenomenal growth and is shaping the economic development across the nations. Today, internet has become the most common distributional channel for most of the industries product including electronics, information technology, cloths,

cosmetics, etc.[1] The rise in e-commerce transaction features has many competitive advantages such as increase in number of market players, accessibility to wide set of consumers, therefore, dual distribution and multi-channel distributional strategies have become a common practice for distributors.[2] However, at the same time, co-existence of these retail channels raises many competition issues which require rethinking of the policy towards RPM.

1.1 Competitive advantage of internet retailing

The growth of internet retailing has brought many competitive advantages which influence the policy, the vertical restraint on the distribution of the products.

First, e-commerce brings transparency in the prices of the products. In addition to it, the lower search cost, increased convenience allows a consumer to have wide available choices.[3] Further, easy availability of information about quality and offers over the internet allows a customer to make better choices. Cumulatively, it increases the pricing pressure on the producers and distributors of the goods, thereby insulating intra-brand as well as inter-brand price competition in the market.[4]

Second, internet retailing significantly reduces distributional costs for manufacturer and distributors and increases their ability to stock and market products to large number of customers.[5] Internet allows manufacturers to reach directly to the consumers by adopting dual distribution policies, thereby eliminating the cost of distribution incurred in traditional market. The low cost of structure over internet allows manufacturer and retailers to give significant discount, thereby enhancing the demand of product.[6]

Third, internet retailing has increased the emergence of new market players. The technological innovation and research has further allowed the emergence of different kinds of business models. The low cost

1. Reuben Arnold, et al., "Resale Price Maintenance and Dual Distribution", Cornerstone, <https://www.cornerstone.com/Publications/Articles/Resale-Maintenance-and-Dual-Distribution>.
2. *Ibid.*
3. Melody Y. Kiang & Robert T. Chi, "A Framework for Analyzing the Potential Benefits of Internet Marketing" (2010) 2 (4) J. Electronic Com. Res.
4. OECD, "Vertical Restraint for Online Sales", (2013), <http://www.oecd.org/competition/VerticalRestraintsForOnlineSales2013.pdf>.
5. Ethan Lieber & Chad Syverson, Online vs. Offline Competition, Oxford Handbook of the Digital Economy (2011) 14.
6. *Ibid*, 17.

associated with setting up an online business facilitates entry in the market.[7] There are three broad business models which have emerged, "pure internet business", "bricks and clicks" and sales via "third party platforms" such as e-commerce platform, price comparison website.[8] The success and failure of these businesses depends on the level of advertising, technologies and web-design in order to gain a competitive advantage in the market.[9] These businesses cumulatively create a competitive environment where the structure of the market and flow of information directly benefits the consumers.[10]

Overall these three factors contributed in increasing the competitiveness of both upstream as well as downstream markets. The increased outreach due to internet retailing expands manufacturer output and intensifies inter-brand competition in the market. The most desired impact is on the welfare of the consumers in terms of lower prices and access to wide information available.

1.2 Competitive disadvantage of internet retailing

The co-existence of online and offline distribution channel raises many competition concerns both at horizontal and vertical level. On the horizontal level, price transparency over internet may facilitate collusion. While on the vertical level, the co-existence of online and offline distribution channel creates possibilities of free-riding by one type of channel over the other. The low cost of structurer for distribution of goods over the internet allows retailers to give significant discount which further intensifies probabilities of consumer free-riding.

The problem of free-rider is more likely to occur in the markets where there is significant online retailing. Some authors has gone to the extent of saying that even absent free-riding, online discounting have potential to disrupt efficient retail distribution of the products.[11] The distribution inefficiency created as a result of the problem of free-rider necessitates imposition of vertical restraint particularly RPM. Despite its efficiency

7. OECD, "Vertical Restraint for Online Sales", (2013), <http://www.oecd.org/competition/VerticalRestraintsForOnlineSales2013.pdf>.
8. *Ibid.*
9. Bundeskartellamt, "Vertical Restraints in the Internet Economy"—Background Paper, Meeting of the Working Group on Competition Law, <http://www.bundeskartellamt.de/SharedDocs/Publikation/EN/Diskussions_Hintergrundpapiere/Vertical%20Restraints%20in%20the%20Internet%20Economy.pdf?__blob=publicationFile&v=2>.
10. *Ibid.*
11. Pinar Akman & D. Daniel Sokol, "Online RPM and MFN under Antitrust Law and Economics", (2017) 2 Rev. Indus. Org. 14.

generating motives and sufficient economic justification, competition authorities across the world have ignored the pro-competitive effect of RPM. The changing dynamics of new market economy poses a peculiar challenge to competition regulators; thus, it is important to take into account the disruptive technology advancement and innovation while formulating competition policy.

2. ECONOMICS OF RESALE PRICE MAINTENANCE

This chapter shall attempt to elicit the economic foundation of a decision to impose RPM. The question assumes significant importance for an economist because policy of resale price maintenance is against the economic interest of a manufacturer. Fixing the retail margins increases the manufacturer cost of doing business because manufacturer buys retail services at a cost equal to retail margin.[12] The lesser the retail margin, the more it is beneficial to manufacturers as it lowers the prices and increases the demand of a manufacturer product.[13] RPM would increase the prices which, other things being equal, will lower the demand of a manufacturer product.[14]

In these circumstances, the pertinent question that arises is why would a manufacturer eliminate the price competition by fixing the retail margins of the retailers. The answer to the question lies in the analysis of whether restraint is being used in anti-competitive ways. Economics advances two theories by which RPM can be used anti-competitively which shall be analyzed in subsequent chapter. However, if the anti-competitive theories do not apply, the manufacturer's decision is always founded on pro-competitive economic rationale. This chapter begins with explaining anti-competitive theories of RPM. The second part shall explain the economics of pro-competitive justification for using RPM particularly when it is imposed in response to internet retailing.

2.1 Anti-competitive explanations

RPM is often condemned as a tool to facilitate collusion in the market. In this regard, two theories are prominent. *First*, that it facilitates horizontal

12. See, *Continental T.V.* v. *GTE Sylvania*, 433 US 36 (1977).
13. Alison Jones & Brenda Sufrin, EU Competition Law: Text, Cases, and Materials (6th Edn. 2015) 123.
14. Phillip E. Areeda and Herbert Hovenkamp, Antitrust Law-An Analysis of Antitrust Principles and Their Application (Wolters Kluwer 2018) (1978).

collusion among manufacturer; *Second*, that it facilitates retailers cartel when it is motivated by dominant retailer or a group of retailers.

2.1.1 *Manufacturer cartel*

The proponents of this theory argue that RPM is used as an anti-competitive tool to facilitate cartel among manufacturers. The explanation of this theory found its existence on two premises: *first,* collusion by monitoring wholesale prices is difficult for manufacturers as these prices are often undisclosed or they are part of a complicated contract.[15] Further, there is higher probability of cheating by an individual manufacturer.[16] *Second,* collusion by monitoring retail prices without imposing vertical restraint is also difficult, due to the variation between wholesale prices and retail prices charged in different locations.[17]

RPM reduces the ability of retailers to lower the prices; thus, eliminates the possibility of cheating by an individual manufacturer by undercutting the wholesale prices.[18] For these reasons, retail price fixing appears to be most effective strategy to monitor the manufacturer cartel. However, RPM as a collusion facilitating tool operates only when almost all manufacturers engage in fixing retail prices; otherwise, a single manufacturer use of RPM does not show any anti-competitive harm.[19] Lester Telser famously used this theory to explain the vertical price arrangement by GE and Washington in the market for large lamps.[20]

However, economics on the subject does not support the use of RPM particularly when imposed to control internet retailing.[21] Because monitoring of internet prices is easier than traditional brick and mortar prices, the use of RPM as a tool to facilitate collusion in e-commerce market makes little economic sense.

15. Bruno Jullien & PatrickRey, "Resale Price Maintenance and Collusion", (2007) 38 Rand J. Econ. 985.
16. *Ibid*, 989.
17. Lester G. Telser, "Why Should Manufacturers Want Fair Trade?", (1960) 3 J. L. & Econ. 86.
18. *See*, Hoon Bang & YangsooJin, "Brand-Specificity of Pre-sale Services and Inter-brand Competition with Resale Price Maintenance" (2015) 43 Int'l Rev. L. & Econ. 9.
19. James R. Silkenat, "Reviewed Work: The Antitrust Paradox: A Policy at War with Itself by Robert H. Bork" (1978) 127 U.Pennsylvania L. Rev. 279.
20. *Supra* note 17
21. *See,* Edward Iacobucci & Ralph A. Winter, "Selective Distribution and Internet Sales; An Economic Perspective" (2016) 81 Antitrust L. J. 48.

2.1.2 *Retailers cartel*

According to this theory, the RPM is anti-competitive when it is imposed not at the instance of manufacturer but compelled by the group of colluding retailers.[22] The retailers wishing to collude face two potential difficulties: *first,* there is likelihood of cheating; *second,* direct cartel at retail level face the threat to be caught by competition authorities very likely. The fixation of retail price by coercing manufacturers seems to eliminate these potential problems by allowing cartel members to effectively monitor price-cutting retailers.[23] The cheating on cartel becomes unlikely as retailers face direct threat of cutting supplies from manufacturer. Further, the retailers are saved from engaging directly in horizontal price fixing.[24]

The growth of internet as a distribution channel increased the likelihood of bricks and mortar retailers demand to protect their retail margin. Often these demands are pro-competitively motivated as uncontrolled internet discounting reduces bricks and mortar retailer's incentive to actively promote the manufacturer products.[25] In such circumstances, continuous communication between manufacturer and distributors regarding pricing and marketing strategy does not *ipso facto* suggests collusive activities.[26] Thus, a genuine demand to protect retail margins must be distinguished from coercion by retailers which require analysis of market power in terms of large market share.

2.2 Pro-competitive explanations

If the anti-competitive theories do not apply, explanations to RPM by an individual manufacturer lie in distributional efficiency.[27] It is not disputed that RPM increases the prices of the products which, if other things are equal, reduces the total demand of product.[28] Thus, when a manufacturer adopts RPM, it implies that "other things are not equal". The starting point to understand this lies in the fact that demand of the product does not depend on prices alone. By fixing the retail prices, manufacturers make "investment" in buying retailing services which result

22. Robert Bork & Ward S. Bowman, "The Crisis in Antitrust" (1965) 65 Colum. L. Rev. 363.
23. *Ibid,* 369.
24. Frank Mathewson & Ralph Winter, "The Law and Economics of Resale Price Maintenance" (1998) 13 Rev. Indus. Org. 58.
25. Phillip E. Areeda and Herbert Hovenkamp, Antitrust Law-An Analysis of Antitrust Principles and Their Application, (Wolters Kluwer 2018) (1978).
26. *Monsanto* v. *Spray-Rite Service Corpn.*, 465 U.S. 752, 762 (1984).
27. Robert Bork, The Antitrust Paradox: A Policy at War with Itself, Free Press, 1993.
28. Massimo Motta, Competition Policy, Theory and Practice, Cambridge University Press, 2004, 78.

in incremental sales, thereby increasing overall demand of the product.[29] There are different variations of this pro-competitive justification. The subsequent sub-chapter shall analyse these pro-competitive explanations of RPM particularly when it is imposed in response to significant online discounting.

2.2.1 *Free-riding on services*

The first variation of pro-competitive justification for RPM is the problem of free rider on retailer promotional services. This problem occurs when discounting retailer free rides on the pre-sale services such as product demonstration, advertising, sales staff provided by a full-service retailer.[30] According to this explanation, promotional services such as product demonstration, sales person assistance, advertisement and sales staff, knowledgeable salespersons has a demand enhancing effect on the sales of the product.[31] The problem of free-riding arises when a low services discount retailer benefits from the increased sales, thereby free rides on the investment made by a full-services retailer in providing these demand enhancing services. Consequently, full-services retailer either reduces the investment in promotional services or drops the distribution of manufacturer's product. RPM eliminate the ability to discount retailers to free-ride on the promotional services, thereby allowing a full-services retailer to rip the benefits of its own investment.

The policy of RPM fixing by limiting price competition among the distributors aimed at increasing the competition on the non-price factors required for the sales of the product such as product demonstration, product knowledge, shelf display, sales promotion, advertisement, etc. The guaranteed retail margin on the resale of a product compensates a full-services retailer to provide services desired by manufacture as well as consumers and induces other retailers to compete on non-price factors. This reduces the incentive for the consumer to obtain the sales services from a full-service retailer and later buy it from discount retailers.

The growth of internet as a distribution channel has increased the potential for engaging in free-riding on retail services. The internet retailers have inherently low cost of structure which enable retailer to

29. Simon Bishop & Mike Walker, The Economics of EC Competition Law: Concepts, Application and Measurement (3rd Edn. Sweet & Maxwell 2007).
30. Mart Kneepkens, "Resale Price Maintenance: Economics Call for a More Balanced Approach" (2007) 28 (12) Eur. Competition L. Rev. 659.
31. *Supra* note 17..

provide heavy discount as compared to brick and mortar retailers.[32] The ease and convenience of shopping over internet increases the potential of consumer to avail the brick and mortar retail services and buy the product online at a discounted price. The policy of RPM to control free-riding between online and offline retailers finds support both in law as well as economics.[33]

The critics argue against use of the RPM to control online discounting by citing the empirical evidence of "reverse" free-riding.[34] These empirical evidences show that consumer first researches online before buying a product from brick and mortar retail services and these type of free-riding occur more frequently.[35] However, both free-ridings are separate market distortion and the existence of one would not exacerbate or mitigate the other free-riding. The use of RPM to solve the problem of free-riding would not exacerbate or mitigate the existence of "reverse free-riding".[36] Thus, existence of "reverse free-riding" does not mitigate the pernicious effect of consumer free-riding on online retailers.

2.2.2 *Protection of retail distribution in the absence of free-riding*

The RPM can be used pro-competitively to bring distribution efficiency even when there is no consumer free-riding. The economics of this pro-competitive rationale lies in the assumption that a retailer's decision to actively promote a product by prominently displaying it or increasing sales person assistance brings distribution efficiency resulting in incremental sales, thereby increase in the profit of manufacturer.[37] To achieve this efficiency in market, it is necessary for manufacturer to compensate retailers to actively engage in promotional services.

It is posit that manufacturer cannot merely rely on retail competition for consumer for providing promotional services on its product primarily for two fundamental economic reasons: *first,* that a retailer decision to actively promote a particular brand would not led a consumer shift to

32. *Supra* note 11.
33. *See,* Dennis W. Carlton & Judith A. Chevalier, "Free Riding and Sales Strategies for the Internet" (2008) 49 J. Indus. Econ. 449.
34. Marina Lao, "Resale Price Maintenance: The Internet Phenomenon and Free Rider Issue" (2010) 55 The Antitrust Bulletin 473.
35. Gregory Gundlach, Joseph P. Cannon & Kenneth C. Manning, "Free Riding and Resale Price Maintenance: Insights from Marketing Research and Practice" (2010) 55(2) The Antitrust Bulletin 389.
36. Benjamin Klein, "Resale Price Maintenance of Online Retailing" in Roger D. Blair et al (Ed.), Oxford Handbook of International Antitrust Economics, Vol. 2 (2014).
37. Benjamin Klein, "Competitive Resale Price Maintenance in the Absence of Free-Riding" (2009) 76 Antitrust L. J. 439.

another retailer. It will led marginal consumers who are influenced by promotion to buy promoted product while other intramarginal consumer may choose to buy product of their preference; *second,* marginal consumer who are influenced by the promotion do not pay for the services.[38] For these reasons, retailers possess substantial discretion on promotion of a particular brand which has positive influence on the demand of the product.

In these circumstances, retail price maintenance is the most effective way to compensate retailers for providing promotional services, thereby maintaining effective retail distribution. As minimum expected return is *sine qua non* for actively promoting a brand that results in incremental sales. Absent RPM, a price discounting retailer would reduce the expected return even when he is not free-riding and providing similar services.[39] Therefore, retailer price discounting has an effect of disrupting an effective retail distribution system, thereby reducing the desired number and type of retailers even when there is no free-riding.

The growth of internet as a distributional channel has further increased the likelihood of use of RPM to protect the effective retail distribution. The discounting by online retailer has more pernicious effect on manufacturer retail distribution system than discounting by bricks and mortar retailer primarily for two reasons: *first*, that the ability of online retailer to discount is significantly higher; *second,* inter-retailer demand effect as a result of significant online discounting is larger.[40] These reasons suggest that online price discounting has greater potential to undercut retailer expected margin to provide promotional services.[41] In such circumstance, RPM is the most effective tool to create distribution efficiency.

3. LEGAL ASSESSMENT

The previous chapter has surveyed the economic literature on the subject and it is shown that RPM has pro-competitive welfare enhancing effect in many circumstances. The immediate policy implications of these findings suggest that competition authorities must construe such agreement with a more economic approach. This chapter shall analyse and compare the current legal standard of assessing the resale price agreement in India, EU, and US. Further, the chapter shall review the policy implications in

38. Benjamin Klein, "The Evolving Law and Economics of Resale Price Maintenance" (2014) 57 J. L. & Econ 169.
39. *Ibid.*
40. Klein, *supra* note 36.
41. *Ibid.*

each of the jurisdiction considering the economic rationales of the RPM agreement.

3.1 United States

3.1.1 *Legal framework*

In US, the framework to access vertical restraints and the approach to antitrust is primarily developed by the jurisprudence of case laws owing to its peculiarity of common law system. The definition of vertical agreements is interpreted under Section 1, Sherman Act, 1890 which declares every contracts, combinations, or conspiracy in restraint of trade to be unlawful.[42] The statutory language of §1 of Sherman Act is so wide that if literal interpretation is undertaken, it virtually prohibits almost all contracts that restrain trade.[43] However, US courts have interpreted the statute to prohibit only those vertical restraints which are "unreasonably restrictive" of competition.[44]

The law on vertical price restraint in US has evolved from *per se* illegality to *rule of reason* and it continues to develop.[45] In a landmark antitrust ruling, in *Leegin Creative Leather Products Inc.* v. *PSKS Inc.*,[46] the US Supreme Court overruled the century old *per se* illegality of vertical price restraints in favour of *rule of reason* analysis. In contrast to the EU, the *rule of reason* standard of US is more generous in recognizing pro-competitive impact. The approach is founded on prior influence of Chicago School of thoughts which believes that it is better to remove the anti-competitive practice than to make a false conviction.[47]

Under the current *rule of reason* standard in the US, heavy burden lies upon the plaintiff to demonstrate that the alleged vertical price restraints significantly and adversely affect the competition in the market. The defendant may present pro-competitive rationale of the alleged practice. The ultimate conclusion of the court would be based on overall effect on the inter-brand competition in the market. The demonstration of market power of the entity is also an important consideration required to be

42. Sherman Antitrust Act, 15 USC S. 1 (1890).
43. See, *Board of Trade of Chicago* v. *United States*, 246 US 231, 138 (1918).
44. See, *State Oil Co.* v. *Khan*, 522 US 3, 10 (1997); *Texaco Inc.* v. *Dagher*, 547 US 231, 138 (1918).
45. See, *Miles Medical Co.* v. *John D Park & Sons*, 220 US 373 (1911); *State Oil Co.* v. *Khan*, 522 US 3 (1997); *Leegin Creative Leather Products Inc.* v. *PSKS*, 551 US 877 (2007).
46. 551 US 877 (2007).
47. Julia Wahl, Siska Troost & Caroline Buts, "The Internet: Just Another Distribution Channel? EU and US Competition Policy Approaches to E-Commerce", ECONRSA, <https://econrsa.org/system/files/workshops/papers/2015/buts.pdf>.

proved by the plaintiff without which alleged conduct has no plausible anti-competitive effect.[48]

Unlike EU, US *rule of reason* approach is flexible and relies less on legal presumptions. Even the "soft legislations" such as EU Vertical Guidelines received strong condemnation and are deemed unnecessary.[49] The standards of *rule of reason* are so stringent that some commentators have described it as equivalent to *de facto illegality*.[50] Hon'ble Richard Posner J has famously described it as "in practice… no more than a euphemism for non-liability."[51] Even empirical research confirmed this conclusion.[52]

3.1.2 *Treatment of e-commerce*

While both the jurisdictions agreed on the competitive effect of e-commerce on the prices, choices and the business strategies, they both arrived at different policy regime for treatment of vertical restraints on e-commerce. In contrast to EU competition policy, US competition regime does not deem it necessary to devise specific analytical framework or rules to deal with vertical restraints in e-commerce.

There are two primary reasons for it; ***first***, pro-competitive or anti-competitive effect of a particular vertical restraint does not depend upon the extent of online sales in the market. The extent of e-commerce may alter the significance of certain factors such as free-riding of traditional offline retailers or market power as a result of network effect. However, it cannot provide any guidance on competitive effects of any vertical restraint. ***Second,*** even if there is a relationship between e-commerce and conditions under which a vertical restraint may be anti-competitive or pro-competitive, the current *rule of reason* standards are flexible enough to adapt to the new challenges by e-commerce.[53]

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48. *Leegin Creative Leather Products Inc.* v. *PSKS*, 551 U.S. 877 (2007); See also, *Jacob* v. *Tempur-Pedic*, 2010 WL 488086 (11th Cir. 2010); *Spahr* v. *Leegin Creative Leather*, 2008 WL 391464 (E.D. Tenn. 2008).
49. Robert Pitofsky, Former Chairman, Fed. Trade Comm'n, "Vertical Restraints and Vertical Aspects of Mergers—A US Perspective", Speech before the 24th Annual Conference on International Antitrust Law and Policy at the Fordham Corporate Law Institute, (16-17 October 1997).
50. Douglas H. Ginsburg, "Vertical Restraints: De Facto Legality under Rule of Reason" (1991) 60 Antitrust L.J. 495, 521.
51. Richard A. Posner, "The Rule of Reason and Economic Approach: Reflection on the Sylvania Decision" (1977) 54 U. Chi. L. Rev. 1, 14.
52. *See,* Michael A. Carrier, "The Rule of Reason: An Empirical Update for the 21st Century" (2009) 16 Geo. Mason L. Rev. 827, 829.
53. Antitrust Modernization Commission, Report and Recommendation, 2-4-2007 <https://govinfo.library.unt.edu/amc/report_recommendation/amc_final_report.pdf>.

The approach may seem plausible owing to predominant role of economic analysis and anti-competitive effects on markets to determining the legality of the practice. Unlike EU competition policy, there are no limited types of legally accepted pro-competitive rationale recognised under the US competition law. The legality of a vertical restraint depends on its effect on the market which is determined on the basis of well-founded economic principle. Thus, having regards to the *rule of reason* standards, the evolutionary nature of US antitrust law is acceptable to the wide range of pro-competitive rationales as specified in the previous chapter. Consequently, businesses have greater leeway to use RPM to protect their bricks and mortar distributional network.

The absence of special consideration dynamic nature of internet retailing while declaring vertical price restriction under *rule of reason* analysis by *Leegin* was much criticised primarily for the reasons that the growth of e-commerce businesses are primarily modeled on giving heavy discounts.[54] Further, the current *rule of reason* standards would virtually make it impossible for plaintiff to challenge the vertical price restriction.[55] Thus, it is argued that increased adoption of RPM on e-commerce would threaten the growth of internet as a distribution channel.

However, case laws relating to RPM on e-commerce after *Leegin* demonstrated that RPM may not be defendable in all circumstances.[56] In *Babyage.com, Inc* v. *Toys "R" Us, Inc.*[57,] the manufacturer, Toys "R" is restricting its retailers not to sell its products below the fixed prices. Earlier, the manufacturer was also found pressuring suppliers not to sell the products to online retailers on discount. On a complaint by small retailer, the Federal Trade Commission (FTC) did hold that the vertical price restraint restrict competition from large warehouses as well as e-retailers, but the fact that restriction was related to e-commerce was not given much significance.

54. *See*, Erich M. Fabricius, "The Death of Discount Online Retailing? Resale Price Maintenance after *Leegin* v. *PSKS*" (2007) 9 N.C. J. Law & Tech. 1; Daniel B. Nixa, "Note: Internet Retailers and Intertype Competition: How the Supreme Court's Incomplete Analysis in *Leegin* v. *PSKS* Leaves Lower Courts Improperly Equipped to Consider Modern Resale Price Maintenance Agreements Winter" (2009) 11 Vand. J. Ent. & Tech. L. 461.
55. Harv. L. Rev. Ass'n, "Leegin's Unexplored 'Change in Circumstance': The Internet and Resale Price Maintenance" (2008) 121 Harv. L. Rev. 1600; See also, *Bell Atlantic Corpn.* v. *Twombly*, 550 US 544 (2007) (The court laid down rules for strict pleading requirement).
56. *Supra* note 47.
57. 558 F. Supp. 2d 575 (E.D. PA. 2008).

In another case, *McDonough* v. *Toys "R" Us, Inc.*[58], the dominant retailer Toys "R" was found coercing manufacturer to adopt resale price restriction owing to the increasing competition in e-commerce. In this case, the court did take into account the special characteristic of e-commerce while granting certification. These two case laws demonstrate equal treatment of online and offline retailing under US jurisprudence and assure from the fear over drastic implication of *rule of reason* standards for the treatment of vertical restraint.[59]

3.2 European Union

3.2.1 *Legal framework*

In the EU, the legal framework to assess the vertical restraint is structured on and heavily relies on legal presumptions.[60] All agreements, including vertical agreement, are primarily governed under Article 101 of the Treaty of Functioning of European Union (TEFU) which prohibits agreements or practices that affect, by object or effect, trade between Member States and appreciably restrict or distort competition within the internal market.[61] Article 101(3) further provides individual exemption if the agreements brings efficiencies to outweigh anti-competitive effects of the agreement.[62]

In contrast to the US, the European approach to access vertical restraint has been characterised as a "structural rule of reason" analysis.[63] In this regard, Vertical Agreements Block Exemption Regulation (VABER) assumes significant importance. Article 1 of VABER creates "safe harbours", providing exemption to those agreements where the market share of both the supplier and the buyer is below 30 per cent.[64] However, this exemption is subject to the condition that the agreement or practice is not contained under hardcore restriction.[65] Hardcore restrictions are legally

58. 638 F. Supp. 2d 461 (E.D. PA. 2009)
59. *Supra* note 47.
60. Gabriele Accardo, "Vertical Antitrust Enforcement: Transatlantic Perspectives on Restrictions of Online Distribution under EU and U.S. Competition Laws" (2012) 12 TTLF Working Paper 49.
61. Consolidated Version of the Treaty on the Functioning of the European Union, Art. 101, 5-9-2008, 2008 O.J. (C 115) [Art. 101, TFEU].
62. Art. 101(3), TFEU.
63. *See*, Doris Hildebrand, "Economic Analyses of Vertical Agreements—A Self-Assessment" (2005) 17 Int'l Competition Law Series.
64. Petit Nicolas and Henry David, "Vertical Restraints under EU Competition Law: Conceptual Foundations and Practical Framework", <https://ssrn.com/abstract=1724891>.
65. European Commission Regulation 330/210 of 20-4-2010 on the Application of Article 101(3) to Categories of Vertical Agreements and Concerted Practices, 2010 O.J. (L 102) 1 (EU) [hereinafter "VABER"].

presumed to adversely affect the market; however, the presumption is rebuttable.[66]

RPM is considered as hardcore restriction under VABER; thus, presumed to be prohibited under Article 101(1) of TEFU irrespective of the market share of the enterprise. However, it could claim individual exemption if it brings efficiency within the meaning of Article 101(3) of TEFU. Thus, unlike US, where burden lies upon the plaintiff to show anti-competitive effects of RPM; the legal presumption in EU required the proof of efficiency to claim exemption under Article 101(3). In this regard, vertical restraints provide a framework for assessing competitive effects on market.[67]

3.2.2 *Treatment of e-commerce*

In EU, restriction on internet sales is highly regulated primarily for the added policy reason, separate from antitrust consideration, to create a single integrated European market.[68] Further, e-commerce is regarded as an important instrument to achieve single internal market in consonance with the objective of EU competition law.[69] Thus, certain restrictions on internet sales are considered hardcore restrictions under vertical guidelines,[70] for which individual exemption are available under Article 101(3) of the treaty.

The EC Guidelines eliminate all those practices which hinder the extent and promotion of e-commerce. However, guidelines also recognise the problems arising out of significant online discounting. In this regard, the guidelines legitimise certain restrictions to control online retailing. In particular, a manufacturer may prevent "pure plays" of internet retailing by mandating offline retailers to sell certain amount of products.[71] However, he cannot restrict the amount of internet sales by offline retailers.[72]

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66. *See*, Article 101(3) TFEU.
67. Commission Guidelines on Vertical Restraints, 2010 O.J. (C 130) ¶ 47–48, [hereinafter "Vertical Guidelines"].
68. José Manuel Barroso & Mario Monti, "A New Strategy for the Single Market: At the Service of Europe's Economy and Society" Report to the President of the European Commission, 44–45 (9-5-2010), <http://ec.europa.eu/commission_2010-2014/president/news/pressreleases/pdf/20100510_1_en.pdf>.
69. Interview with Dr Alexander Italianer, Director General for Competition, European Commission, in the Antitrust Source (April 2011).
70. Vertical Guidelines, ¶ 52–56.
71. *Ibid*, ¶ 52(*c*).
72. *Ibid*, ¶ 54.

Further, it is impermissible for a manufacturer to compensate offline retailers by lowering wholesale prices or increasing wholesale price for online retailers.[73] The underlying rationale for these rules is founded on the condition that a manufacturer does not engage in any practices which involve a reduction in online retailer's incentive to give discounts. The EC competition law recognised discounting is the prime mover of e-commerce business. However, an important question arises whether the manufacturer possess this extent of autonomy, as in the US, to use RPM to control online retailing.

The EC vertical guidelines recognised the possibility of free-riding between online and offline sales; thus, use of RPM in such circumstances is recognised as primary pro-competitive justification.[74] The use of RPM is further narrowed down to "experience or complex products" which requires demonstration of "point of sale" services by offline retailers.[75] Thus, the use of RPM is limited only to provide compensation for "point of sale" services for technological complex products or product involving brand name image. The use of RPM is not permissible to control online discounting for safeguarding the effective retail distribution network of manufacturers.

The EC vertical guidelines do not recognise the disruptive effect of significant online discounting on the retail distribution network of a manufacturer which is necessary to create incremental sales absent free-riding.[76] Thus, unlike US where the manufacturer in number of circumstances can pro-competitively use RPM by restricting online discounting, EU competition law restricts their ability to use it in only extreme circumstances.

3.3 India

The growth of the Indian competition law jurisprudence is still at a nascent stage with the Indian competition regulator still in the process of developing an analytical approach towards the intricacies of the economics of vertical restraints. The analytical approach developed through judicial pronouncements is still at odds with the economic foundation of antitrust reasoning.[77] Till date, India has a very little substantive jurisprudence

73. *Ibid*, ¶ 52(*d*).
74. *Ibid*, ¶ 56.
75. *Ibid*, ¶ 225.
76. Ralph A. Winter, "Vertical Control and Price Versus Non-price Competition" (1993) 108 Q.J. Econ. 61.
77. *See*, Shilpi Bhattacharya, "India's Competition Jurisprudence: In need of a More Economic Approach?" (2018) 4 L. & Pol'y Brief.

on vertical restraint and its economic foundation.[78] Further, the existing jurisprudence on the subject lacks sufficient analytical approach in consonance with the economic foundation of law.[79] This subchapter shall review the Indian legal framework to access the vertical agreement, in particular, RPM, and recommends lessons to be learned from most mature jurisdictions.

3.3.1 *Legal framework*

In India, vertical agreements are governed under Section 3(4), Competition Act, 2002 which prohibits such agreement only if it causes Appreciable Adverse Effect on Competition (AAEC) in the market.[80] The AAEC is not defined; however, it is determined on the basis of six factors mentioned under Section 19(3) of the Act.[81] Thus, the analysis is based upon r*ule of reason* approach whereby the Competition Commission of India (CCI) balances the pro-competitive and anti-competitive impact of an agreement on the basis of the factors mentioned under Section 19(3) of the Act.

The *rule of reason* approach under Indian competition law is quite uncertain owing to the lack of statutory guidance to evaluate the different kinds of vertical agreements.[82] Further, the commission is not equipped with the statutory guidance over role of market power, market definition and possible adverse effects on market.[83] Although, recent jurisprudence of vertical agreement has adopted market power as a screen to access AAEC,[84] the lack of guidance over market definition culminates legal uncertainties over its role under Section 3 of the Act[85], which is subsequently clarified by the Apex Court.[86]

78. *Ibid*.
79. Tilottama Raychaudhuri, "Vertical Restraint in Competition Law: The Need to Strike Balance between Regulation and Competition" (2011) 4 NUJS L. Rev.
80. Competition Act, 2002, S. 3(4).
81. *Ibid*, S. 19(3).
82. Tilottama Raychaudhuri, "Vertical Restraint in Competition Law: The Need to Strike Balance between Regulation and Competition" (2011) 4 NUJS L. Rev.
83. *Ibid*.
84. See, *Ghanshyam Dass Vij* v. *Bajaj Corpn. Ltd*., 2015 SCC OnLine CCI 174 (CCI relied on *de minimis* doctrine of EC Vertical Guidelines to rule that below 30 per cent market share does not indicate market power). See also, *Vishal Pandey* v. *Honda Motorcycle and Scooter India (P) Ltd*., 2018 SCC OnLine CCI 15.
85. *See*, Nidhi S. Prakash, "Is a Relevant Market Mandatory to be Delineated in Cartelization Cases?" Mondaq (30-11-2017), <http://www.mondaq.com/india/x/651564/Cartels+Monopolies/Is+A+Relevant+Market+Mandatory+To+Be+Delineated+In+Cartelization+Cases>.
86. Sagardeep Rathi, Anisha Chand & Akash Karmakar, "SC Clarifies: Delineation of Relevant Market Not Mandatory for All Allegations of Anti-Competitive

The Act defined RPM agreement to include any agreement to sell goods on a condition that the prices to be charged on the resale by the purchaser shall be the prices stipulated by the seller unless it is clearly stated that prices lower than those may be charged.[87] The Act specifically prohibits those agreements which restrict the ability of retailers to charge lower than stipulated prices; thus, the Act only prohibits maintaining minimum resale prices. The setting up of maximum retail prices does not raise competition concern under the Act.[88]

3.3.2 *India's jurisprudence on RPM*

The CCI has examined the issue of RPM several times.[89] The CCI's decision in *FX Enterprise* v. *Hyundai Motors*[90] is the only case where the RPM agreement was found violative of Section 3(4) of the Act. This case is illustrative of CCI's economic approach to deal with such an agreement. Further, there is no substantive jurisprudence on RPM in e-commerce market. However, pending cases, such as *M/s Jasper Infotech (P) Ltd.* v. *Kaff Appliances*[91], involves dispute over discount restriction on sales made through e-commerce platform. This case presents an opportunity for CCI to re-examine its approach to deal with the growing market realities.

In the *Hyundai case*, the policy of setting of maximum retail price (MRP) and discount restrictions was challenged to be violative of Section 3(4) of the Act. The CCI examined the agreement exclusively on three anti-competitive effects which are: 1) that the alleged agreement facilitate collusion in both upstream as well as downstream market; 2) that it reduces intra-brand and inter-brand price competition; 3) that it reduces intra-brand price competition, thereby increasing price for the consumer. The CCI failed to even recognise the pro-competitive rational let alone balancing it with anti-competitive effect.

Agreeements, MONDAQ (9-7-2018), <http://www.mondaq.com/india/x/716946/Cartels+Monopolies/SC+Clarifies+Delineation+Of+Relevant+Market+Not+Mandatory+For+All+Allegations+Of+AntiCompetitive+Agreements>.

87. Competition Act, 2002, S. 3(4).
88. Avaantika Kakkar & Kirthi Srinivas, "Resale Price Maintenance under the Competition Act – Old Wine in a New Bottle?" (2016) Competition L. Rep. 177.
89. *Amit Auto Agencies* v. *King Kaveri Trading Co.*, 2013 SCC OnLine CCI 68. *Shubham Sanitary wares* v. *HSIL Ltd.*, Case No. 09 of 2015, 5-2-2014 (CCI); *ESYS Information Technology* v. *Intel Corpn.*, 2014 SCC OnLine CCI 10; *Jasper Infotech (P) Ltd.* v. *Kaff Appliances (India) (P) Ltd.*, 2014 SCC OnLine CCI 150; *Prime Mag. Subscription Services (P) Ltd.* v. *Wiley India (P) Ltd.*, 2016 SCC OnLine CCI 32.
90. *Fx Enterprise Solutions India (P) Ltd.* v. *Hyundai Motor India Ltd.*, 2017 SCC OnLine CCI 26.
91. *Jasper Infotech (P) Ltd.* v. *Kaff Appliances (India) (P) Ltd.*, 2014 SCC OnLine CCI 150.

The anti-competitive issues examined lack of sufficient economic analysis to prove the necessary effect on the market. The CCI found the agreement to be facilitating collusion in downstream markets primarily because it was enforced at the instance of the distributors. The existence of this anti-competitive explanation operates only when there is proof to the effect that certain dominant retailers pressurising the adoption of RPM, otherwise manufacturer has no incentive to increase retail margin by fixing prices. Similarly, existence of upstream collusion arises only in a situation where all the market players adopt RPM, otherwise non-participants may take away the sales by reducing the prices. However, CCI has failed to conduct such economic analysis and bring such a situation under the scanner.

Further, CCI held that the agreement reduces intra-brand price competition, thereby result in higher prices. Every vertical price restriction reduces intra-brand price competition and result in higher prices which *ipso facto* does not show any anti-competitive harm.[92] The pricing effect of RPM has more welfare effect in consistence with the pro-competitive theories of RPM. However, CCI failed to recognise the pro-competitive rationale for RPM in the form of improved distribution efficiency by maintaining the financial health of the distributors.

Such an approach would have drastic implications upon the interpretation of the pending cases before the commission primarily on those cases which are dealing with the growing market reality where with the emergence of internet retailing; RPM has been sought by many manufacturers to maintain positive product competitiveness in the market.

CONCLUSION

In a nutshell, the competition authorities must recognise the greater role of economics in the competition law analysis. Traditional modes of distribution of goods are outdated and are replaced by new and efficient form of distribution system which challenged the static competition law rules governing the resale price agreement. The growth of internet as a distribution channel has featured many pro-competitive effects on market. However, its features also affect the retail competition in a negative way. The stiff competition over internet is also vulnerable to distributional inefficiency. These changing dynamics of the market has increased the frequency of vertical restraint imposed by manufacturer to correct

92. *Leegin Creative Leather Products, Inc.* v. *PSKS*, 551 U.S. 877 (2007).

distribution inefficiency, thereby maintaining the overall competitiveness of the market. However, the law on the subject is tailored to correct the market failure observed in traditional market setting. The economic development of the subject provides sufficient guidance to identify and correct the failure arising in dynamic market setting. In these circumstances, the competition regulators across the world have greater role in perceiving these realities and correct the failure appropriately.

The Insolvency and Bankruptcy Code Conundrum with the Real Estate (Regulation and Development) Act, 2016 and the Competition Act, 2002

—*Arushi Chandak*†

ABSTRACT

The Insolvency and Bankruptcy Code, 2016 has been a laudable attempt by the Government of India to consolidate the existing fragmented insolvency and bankruptcy regime in India. In its last year of functioning, it has yielded several noteworthy results, however it remains mired with several different controversies, two of which have been sought to be discussed. These relate to the conflict of the Insolvency and Bankruptcy Code, 2016 with the Real Estate (Regulation and Development) Act, 2016 and the Competition Act, 2002 respectively. The recent ordinance dated 6-6-2018, recognised home buyers as financial creditors under the Insolvency and Bankruptcy Code, 2016, allowing them to initiate corporate insolvency resolution process of the defaulting company. However, this has created an issue with regards to the most suitable remedy for such home buyer. The Real Estate (Regulation and Development) Act, 2016 is a specialised legislation for the real estate sector and provides home buyers with remedies for the kind of issues that the Insolvency and Bankruptcy Code, 2016 now seeks to be an antidote to. There has also been much talk regarding resolutions plans under the Insolvency and Bankruptcy Code, 2016 in respect of approvals required for the proposed transactions by the Competition Commission of India under the Competition Act, 2002. There appears to be a dichotomy between the non-obstante clause under the Insolvency and Bankruptcy Code, 2016 and the

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requirement of the resolution plan to be compliant with all laws as on date. This paper seeks to delve into these questions and propose suggestions to put these issues to rest.

INTRODUCTION

The Insolvency and Bankruptcy Code, 2016 ("**the Code**") was promulgated by the Central Government in an attempt to consolidate the existing fragmented insolvency and bankruptcy regime in India. The presence of multiple judicial forums that dealt with bankruptcy disputes led to uncertainty regarding jurisdiction. The Code accordingly provides a specialised forum to oversee all insolvency and liquidation proceedings for individuals, small and medium sized enterprises and corporates. By empowering all classes of creditors to trigger a resolution process in the event of non-payment of a valid claim, it marks a paradigm shift from the previously existing "debtor in possession" to a "creditor in control" regime.

Another key issue that the Code seeks to resolve is the long timelines involved in insolvency proceedings in India. According to the World Bank's Ease of Doing Business Report[1], it takes more than four years on an average to resolve insolvency in India. A person on the ground would confirm that it takes much more time than that. The Code seeks to limit that to a maximum of 270 days[2], including any extension possible to facilitate faster debt recovery.

In the last year of its functioning, the Code has been mired with different controversies that has resulted in one removal of difficulties order[3], two amendment ordinances[4], and one amending Act.[5] The most recent ordinance, dated 6-6-2018[6], inter alia, recognised home buyers as financial creditors under the Code, which has created uproar for apparent conflicts with the Real Estate (Regulation and Development) Act, 2016 ("**RERA**"), a specialised statute to protect the interests of home buyers. The present paper seeks to evaluate this conundrum and attempts to analyse which would be the better suited legislative remedy for a home buyer. Furthermore, there have been concerns with regard to the need for

1. World Bank, 2018. Doing Business 2018: Reforming to Create Jobs. Washington, DC: World Bank. DOI: 10.1596/978-1-4648-1146-3.
2. Code, S. 12.
3. Insolvency and Bankruptcy Code (Removal of Difficulties) Order, 2017.
4. Insolvency and Bankruptcy Code (Amendment) Ordinance, 2017; Insolvency and Bankruptcy Code (Amendment) Ordinance, 2018.
5. Insolvency and Bankruptcy Code (Amendment) Act, 2018.
6. Insolvency and Bankruptcy Code (Amendment) Ordinance, 2018.

review and approval of insolvency resolution plans by the Competition Commission of India ("**CCI**") under the Competition Act, 2002 ("**Act**") to ensure that no appreciable adverse effect occurs on competition. Given the stringent timelines under the Code, that are in direct conflict with those under the Act and the adverse effect rejection of resolutions due to non-compliance with existing laws would have on the corporate debtor, this paper also seeks to resolve these antitrust concerns.

1. STATUS OF HOME BUYERS

Under the Code, the maintainability of applications for initiating corporate insolvency resolution process ("**CIRP**") chiefly depends on the applicant first satisfying the National Company Law Tribunal ("**NCLT**") that it falls within the definition of "Financial Creditor" or "Operational Creditor".[7] Prior to the amendment, home buyers were neither covered under the definition of a financial creditor or an operational creditor, which had the following implications:[8]

(*a*) inability to initiate CIRP against a defaulting debtor company;

(*b*) inability to participate in the CIRP;

(*c*) uncertainty over their status as a creditor, whether secured or unsecured, at the time of liquidation; and

(*d*) inability to continue with civil remedies for recovery of their dues after initiation of CIRP.

The status of home buyers has resultantly been the subject-matter of several litigations. The Principal Bench of the NCLT in *Vinod Awasthy* v. *AMR Infrastructure Ltd.*[9] ruled that a flat purchaser could not be considered an operational creditor. A similar view was also expressed in *Pawan Dubey* v. *J.B.K. Developers (P) Ltd.*[10], and *Mukesh Kumar* v. *AMR Infrastructure Ltd.*[11] However, the National Company Law Appellate Tribunal in *Nikhil Mehta* v. *AMR Infrastructure Ltd.*,[12] held home buyers to be financial creditors if the Company agrees to give a periodic assured return to the home buyer. Taking note of this anomaly, the Supreme Court passed an order in the insolvency proceedings of Jaypee Infratech Limited, directing parent company Jaiprakash

7. Code, S. 12.
8. *Chitra Sharma* v. *Union of India*, 2017 SCC OnLine SC 1650.
9. CP No. (IB)-10(PB)/2017, decided on 22.2.2017 (NCLT).
10. 2017 SCC OnLine NCLT 520 : (2017) 4 BC 56.
11. 2017 SCC OnLine NCLT 515 : (2017) 139 CLA 166.
12. 2017 SCC OnLine NCLAT 377 : (2017) 141 CLA 281.

Associates Limited to deposit INR 2000 crores to protect the interests of home buyers.[13]

On 6-6-2018, the President of India promulgated the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2018 ("**Ordinance**") incorporating the key recommendations of the Insolvency Law Reform Committee's ("**ILRC**") report published on 3-4-2018 ("**Report**"). One of the most significant recommendations of the ILRC was the inclusion of home buyers within the ambit of financial creditors to provide them a say in insolvency proceedings of developers and builders.[14] Home buyers would therefore have due representation in the Committee of Creditors ("**CoC**"). Accordingly, the Ordinance expanded the definition of financial debt under Section 5(8) of the Code to include any amount raised from an allottee under a real estate project, being an amount having the commercial effect of a borrowing, fall within the purview of Section 5(8)(f). Apart from giving them the opportunity to initiate corporate insolvency resolution process under Section 7 and being on the CoC under Section 24, it now also provides them a place in the liquidation waterfall under Section 53 and the guarantee of receiving at least the liquidation value under the resolution plan.

However, subsequent to the promulgation of the Ordinance, several industry players have argued that the Ordinance has whittled down the power of the Real Estate Regulatory Authority ("**Authority**") and deemed the RERA redundant.[15] The RERA is a specific sectoral law that offers protection to home buyers, inter alia, in the following manner:

(*a*) imposing mandatory registration of projects with the Authority;[16]

(*b*) compulsorily depositing of 75 per cent of the amount realised in a separate account;[17]

(*c*) imposing the condition of withdrawing from the account in proportion to the degree of project completion;[18] and

(*d*) prescribing penalties for non-compliance with RERA.[19]

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13. *Chitra Sharma* v. *Union of India*, 2017 SCC OnLine SC 1650.
14. Report of the Insolvency Law Committee (2018), pp 15.
15. ASSOCHAM, "IBC, RERA Pitted Against Each Other; Need Reconciliation: ASSOCHAM" (2018), <http://assocham.org/newsdetail.php?id=6803>; Press Trust of India, "New IBC Ordinance Whittles Down Rera Powers: MahaRera" (2018), <https://www.business-standard.com/article/pti-stories/new-ibc-ordinance-whittles-down-rera-powers-maharera-118061700288_1.html>.
16. Real Estate (Regulation and Development) Act, 2016, S. 9.
17. Real Estate (Regulation and Development) Act, 2016, S. 4(2)(l)(D).
18. Real Estate (Regulation and Development) Act, 2016, S. 4(2)(l)(D).
19. Real Estate (Regulation and Development) Act, 2016, Ch. XIII.

In essence, RERA imposes a duty on promoters and backs such an obligation with preventive and penal provisions. RERA also prescribes that in the event of failure to give possession of the apartment, the home buyer is to be given the choice to withdraw from the project and the promoter is liable to repay the amount received.[20] In case of non-withdrawal, promoter shall pay interest for every month of delay till the date of handing over the possession.[21]

On the other hand, the Code has now propelled home buyers up the ladder of precedence in recovery proceedings. The money paid by home buyers having the commercial effect of a borrowing, allows them to be part of the CoC which has the power to appoint the resolution professional and approve resolution plans. This will ensure that their interests are also protected and they have voting rights in proportion to the financial debts owed to them.

However, the Ordinance creates an apparent conflict between the two statutes and both include sections stating that provisions of the statute are to have an overriding effect in case of any inconsistency with any other law for the time being in force.[22] The Code being the later statute would ordinarily prevail in cases of conflict. It is however pertinent to note that both the Code and RERA provide home buyers with different remedies, ruling out the possibility of a conflict. As noted earlier, RERA seeks to create a transparent real estate regime to ensure statutorily defined rights, obligations and interests of stakeholders are protected. The Code only comes into play when there is an insolvency or liquidation situation, in context of distribution of proceeds from sale of assets of the company. However, since the Code deals with only a specific scenario in an otherwise RERA governed entity, it may be argued that the Authority should have the exclusive power to deal with such scenarios.

Having said that, there exists a conundrum regarding which statute provides a more suitable and appropriate remedy to home buyers. While the Code now allows a home buyer to initiate CIRP against a defaulting developer and they are now entitled to a piece of the pie if the company is liquidated,[23] the question that arises is where they would fall in the liquidation waterfall. While it may be argued that they could fall within the

20. Real Estate (Regulation and Development) Act, 2016, S. 18(1).
21. Real Estate (Regulation and Development) Act, 2016, S. 18(1).
22. Insolvency and Bankruptcy Code, 2016; S. 89, Real Estate (Regulation and Development) Act, 2016, S. 238.
23. Insolvency and Bankruptcy Code, 2016, S. 53.

ambit of Section 3(30) of the Code; secured creditor since Section 3(31) defines security interest to include title or interest or a claim to property. Regulation 21 of the Insolvency and Bankruptcy Board of India (Liquidation Process) Regulations, 2016 that elucidates upon the proving of a security interest, lays down as under:

The existence of a security interest may be proved by a secured creditor on the basis of—

(*a*) the records available in an information utility, if any;

(*b*) certificate of registration of charge issued by the Registrar of Companies; or

(*c*) proof of registration of charge with the Central Registry of Securitisation Asset Reconstruction and Security Interest of India.

Therefore, proving a security interest under this regulation would be extremely arduous for a home buyer. In this regard, if they were considered an unsecured creditor, they would be given their due under Section 53(d) of the Code under the liquidation waterfall. Realistically speaking, during the liquidation of a defaulting company, the unsecured creditor, i.e. the home buyer, would receive very little, if at all, after the dues to secured creditors, workmen, employees and the Government have been paid.

Furthermore, the Code prescribes no guarantee that a home buyer receives at the very minimum a refund of the amount paid by him, or any interest payable for delays, neither does it provide an option for a home buyer to receive the flat or apartment that is the bone of contention in the scenario. With more and more cases resulting in financial creditors taking large haircuts on money due, the remedy under the Code would not be prudent for the home buyer.[24] Therefore, in the interest of the home buyer, RERA, that is a consumer-centric legislation especially formulated for the real estate sector and imposes stringent norms and penalties against errant builders, provides more effective and preferable remedies. Accordingly, in the first instance, home buyers should approach the NCLT under the Code only when the promoter fails to remedy the default under RERA.[25]

24. *Synergies-Dooray Automotive Ltd.* v. *Edelweiss Asset Reconstruction Co. Ltd.* , (2018) 143 CLA 306; *Shirdi Industries Ltd., In re*, 2018 SCC OnLine NCLT 499.
25. Sanjay Vijayakumar, "Rera Vs Ibc: Two Laws That Now Ring Fence Homebuyers" (2018), <https://www.thehindu.com/business/rera-vs-ibc-two-laws-thatnow-ring-fence-homebuyers/article24305859.ece>.

2. APPROVAL OF RESOLUTION PLANS BY THE CCI

Under the Code, the acquisition of a corporate debtor begins with the submission of a resolution plan to the resolution professional by the resolution applicant, followed by the approval of such resolution plan by the CoC and finally by the NCLT. Two of the most crucial aspects of the CIRP relate to the adoption of a resolution plan itself and the time periods prescribed. If an approved resolution plan is not filed with the NCLT within the prescribed timeline, the company would be required to undergo mandatory liquidation.[26]

In this regard, a key issue that has arisen in recent times has been the prior notification and approval of a resolution plan under Section 6 of the Act. Section 6 requires all combinations; mergers, acquisitions or amalgamations, that satisfy certain financial thresholds and are not otherwise exempt, to be notified to and approved by the CCI before coming into effect. It may be pertinent to note at this juncture that at present there exists no statutory pronouncement on this issue in the Code that specifically requires or does not require approval of the CCI for a resolution plan.

There appears to be a dichotomy between Section 238 and Section 30(2)(e) of the Code. While the former seems to suggest that resolution plans under the Code would not require approvals from the CCI since in instances of conflict, the Code assumes primacy, the latter, requires a resolution plan to not contravene any of the provisions of the law in force. In view of Section 30(2)(*e*) of the Code, it would be reasonable to assume that this would include no violations of the Act.

It may be argued that CCI approval must be taken for transactions since the transaction or series of transactions contemplated under the resolution plan may have adverse effect on competition in the market. Accordingly, the power of the CCI to make appropriate modifications or stall such transactions must not be abrogated under any circumstances. Keeping this in mind, recently JSW Steel and Vedanta received approval from the CCI for acquiring the insolvent entities Monnet Ispat and Energy and Electrosteel Steels Ltd. respectively.[27]

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26. Insolvency and Bankruptcy Code, 2016, S. 33.
27. Approval of the Competition Commission of India given to the proposed combination with regard to the resolution plan in respect of the corporate insolvency resolution process of Monnet Ispat and Energy Limited, JSWSL: SEC: MUM:SE: 2018-19 (2018), <https://www.bseindia.com/xml-data/corpfiling/AttachLive/793ed357-b74b-4699-9993-16ea781f8ef2.pdf>; Vedanta Limited acquisition of Electrosteel Steels Limited approved by Competition Commission of India, VEDL/Sec./SE/18-19/32 (2018), <https://www.

That being said, there exist several issues that plague this approval process. *First*, when does the requirement for notification and approval of a resolution plan arise. *Second*, how should the timelines prescribed under the Code be vis-à-vis the timelines under the Act and *third*, what happens in the event that the resolution plan is rejected or stalled by the CCI.

Under Section 6 of the Act, the notification process is triggered and the process to assess the impact on competition, can be commenced only upon:

(*a*) the execution of a binding agreement or document, in case of an acquisition;

(*b*) issuance of board resolutions approving a merger or an acquisition.

The Act prescribes that such a filing has to be made within 30 days of any of the above events.[28] However, unlike conventional mergers and acquisitions, insolvencies under the Code are a multi-step process involving bid filing, negotiations and acceptance by the CoC, and it remains elusive as to which step would constitute the trigger event. This may be understood in context of the recent insolvency proceedings of Binani Cements Limited.[29] Here, Rajputana Properties Private Limited and UltraTech Cement Limited had filed their resolution plans with the CCI for its approval even before the submission of the same to the NCLT, and in the case of the former, even before the approval of the CoC.

It is also important to note that filings made prior to the execution of a binding agreement would be construed as premature,[30] but what would be considered as a binding agreement in context of resolution plans under the Code remains elusive. Would the submission of resolution plan, prior to the approval of the CoC be enough to trigger the notification to the CCI, or would only a resolution plan approved by the CoC be considered a trigger? Considering that multiple resolution plans are submitted, and only one is to succeed, would the filing prior to approval by the CoC be considered premature?

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bseindia.com/xml-data/corpfiling/AttachHis/88d71df4-70b6-4f4e-a3a8-ccdcc844436e.pdf>.

28. Competition Act, 2002, S. 6(2).
29. Payaswini Upadhyay, "IBC: In The Binani Cement's Insolvency Case Has The CCI Muddied The Waters For Approval Filings?" (2018), <https://www.bloombergquint.com/law-and-policy/2018/03/14/ibc-in-the-binani-cements-insolvency-case-has-the-cci-muddied-the-waters-for-approval-filings>.
30. Combination Registration No. C-2012/07/69, Competition Commission of India (2012), <https://www.cci.gov.in/sites/default/files/C-2012-07-69.pdf>.

Precedents in this regard, such as notification by Vedanta Limited[31], *Rajputana Properties (P) Ltd., In re*[32], and JSW Steel[33], prior to approval by the CoC would suggest otherwise. Had the CCI held the aforementioned view, it would have held those notices to be premature and invalid. It could therefore be safely assumed that the CCI considers a resolution plan filed by a resolution applicant as a "binding document" for the purposes of filing notice.

In the interest of all the stakeholders, it would accordingly be advisable that the approval from the CCI is sought as early as possible, i.e. when the bid is submitted. Such an approval would help resolve the antitrust and bankruptcy law conundrum and ensure that bids that would have an appreciable adverse effect on competition be excluded from the purview of approval from the CoC. This is even more relevant considering the stringent timelines provided under the Code for the insolvency process. Another possible solution would be to either construe the bid as an agreement within the meaning of Section 6 of the Act, or by making the signing of a letter of intent mandatory, once the bid is accepted.

Another area of concern is conflicting timelines under the Code and the Act. The Code prescribes an outer limit of 270 days within which the entire insolvency resolution process has to be completed.[34] However, the Act allows the CCI to take up to 210 days[35] to approve, disapprove or approve the transaction subject to remedies. In order to reconcile this difference, an expedited review process for resolution plans be prescribed to ensure that the process may be completed within the 270 days limit under the Code. It is pertinent to note that the CCI has being able to clear proposals in an expedited manner in the case of Rajputana Properties Private Limited. This would be in the interest of stakeholders since the Code lays down mandatory liquidation of the corporate debtor for failure to abide by the timeline.[36]

31. Vedanta Limited acquisition of Electrosteel Steels Limited approved by Competition Commission of India, VEDL/Sec./SE/18-19/32 (2018), <https://www.bseindia.com/xml-data/corpfiling/AttachHis/88d71df4-70b6-4f4e-a3a8-ccdcc844436e.pdf>.
32. 2018 SCC OnLine CCI 30.
33. Approval of the Competition Commission of India given to the proposed combination with regard to the resolution plan in respect of the corporate insolvency resolution process of Monnet Ispat and Energy Limited, JSWSL: SEC: MUM:SE: 2018-19 (2018), <https://www.bseindia.com/xml-data/corpfiling/AttachLive/793ed357-b74b-4699-9993-16ea781f8ef2.pdf>.
34. Insolvency and Bankruptcy Code, 2016, S. 12.
35. Competition Act, 2002, S. 6(2A).
36. Insolvency and Bankruptcy Code, 2016, S. 33.

Last, there is also an issue regarding what happens in the event that the CCI rejects or stalls the bid by concluding that the resolution plan, if effected, will have an appreciable adverse effect on competition? This is also relevant in context of Section 30(2)(e) of the Code that requires resolution plans to be compliant with all laws in force; non-conformity with the same being a ground for rejection by the NCLT.[37] In the event of such a rejection, would the clock under the Code restart or would it lead to commencement of liquidation, an option not preferred by stakeholders? To resolve this, it would be advisable that CCI approval is sought as soon as possible to limit the chances of mandatory liquidation. This could possibly be a panacea to the potentially significant risk of derailment of the process envisaged under the Code.

37. Insolvency and Bankruptcy Code, 2016, S. 31.