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Alternative Investment Funds in India: Unlocking Sophisticated Investment

Sai Krishna Bharathan and Ganesh Rao[1]

Alternative Investment Funds are increasingly becoming fundamental to capital raising activities in the Indian economy by tapping into an asset class of high net worth individuals, financial institutions and other investors who are comfortable with understanding multifaceted investments. This paper examines the evolving regulatory framework around such pooling investment vehicles and concludes with important future considerations for the holistic development of Alternative Investment Funds in the Indian market.

I. Introduction

An enterprise requires access to an adequate amount of stable, long-term capital as well as to advisors who can assist it in improving governance processes and in expanding production and services. However, due to the limited risk appetite of traditional sources of finance such as banks, there is a requirement for alternative sources of 'patient' capital. Pooled investment

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vehicles, that is, vehicles that collect funds from investors and invest such monies in accordance with a specified investment policy (instead of the investor buying securities directly), step in to fulfil the capital need of enterprises. Such pooled investment vehicles include mutual funds, pension funds, employee gratuity trusts, and alternative investment funds.

Alternative investment funds ('**AIFs**') are vehicles set up in India for pooling of funds on a private placement basis. They are primarily regulated by the SEBI (Alternative Investment Funds) Regulations, 2012 ('**AIF Regulations**') issued by the Securities and Exchange Board of India ('**SEBI**'), and accordingly AIFs do not include funds covered under the SEBI (Mutual Funds) Regulations, 1996, SEBI (Collective Investment Schemes) Regulations, 1999 or any other regulations issued by SEBI for regulating fund management activities. Further, AIFs do not cover (i) holding companies[2], (ii) trusts set up for employee stock options, (iii) family trusts for relatives, (iv) employee welfare or gratuity trusts, (v) special purpose vehicles not established by fund managers (for instance, securitization trusts), (vi) funds managed by securitization or reconstruction companies, or (vii) pooled vehicles which are directly regulated by other Indian regulators, such as pension funds.

As of March 31, 2017, AIFs have invested in excess of INR 350 billion, which represents rapid growth of approximately 92.5% due to INR 168 billion invested during the previous year.[3] Amounts committed for investment through AIFs, that is, the maximum potential amount for investment in India, is currently around INR 843 billion. These investments are not only being made across Indian industries, including sectors critical for the nation's socio-economic development, but are also being received by start-ups to mature enterprises. AIFs are increasingly considered as an attractive investment vehicle for foreign and non-resident Indian investors, reflected in the fact that a substantial share of these investments originates as foreign direct investment ('**FDI**') from India-focused offshore funds or foreign investors.[4] Given the increasingly important role played by AIFs in the Indian economy, this paper examines the legal framework in India around AIFs and notes key concerns for further consideration by various stakeholders.

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[2] As defined under Section 2(46) of the Companies Act, 2013.

[3] Securities and Exchange Board of India, *Data relating to activities of Alternative Investment Funds (AIFs)*, Securities and Exchange Board of India (2017), http://www.sebi.gov.in/statistics/1392982252002.html (last visited October 1, 2017).

[4] Securities and Exchange Board of India, *Concept Paper on Proposed Alternative Investment Funds Regulation for Public Comments*, Securities and Exchange Board of India (2011), http://www.sebi.gov.in/reports/reports/aug-2011/concept-paper-on-proposed-alternative-investment-funds-regulation_20484.html (last visited July 6, 2017).

A. Prior legal framework

Incremental steps towards the facilitation and regulation of AIFs were initiated over four decades ago. In 1973, the Committee on Development of Small and Medium Entrepreneurs, under the chairmanship of the late R.S. Bhatt, recommended the promotion of venture capital financing in India to meet the gap in funding requirements faced by start-up companies, especially those based on innovative technologies.[5] This was followed by the Industrial Finance Corporation of India sponsoring the creation of the Risk Capital Foundation in 1975 to supplement promoters' equity by encouraging professionals and technology advocates to promote new industries[6] and the Industrial Credit and Investment Corporation of India allocating funds for providing assistance to emerging high-risk technologies in 1984.[7] In 1987, the Indian government introduced a cess on all knowhow payments to create a venture capital fund ('**VCF**') administered by the Industrial Development Bank of India.[8]

The first meaningful step towards encouraging venture capital financing, however, was taken by the Indian government in 1988 when it issued restrictive guidelines for the establishment and functioning of VCFs, which were to be implemented by the Ministry of Finance's erstwhile Controller of Capital Issues ('**CoCI**').[9] Among other things, these guidelines limited the setting up of VCFs to banks and financial institutions.

Upon the liberalization of the Indian economy in 1991, CoCI was abolished and the SEBI was created. In 1996, SEBI issued the SEBI (Venture Capital Funds) Regulations, 1996 ('**VCF Regulations**') for administering the activities of domestic venture capital funds. At this time, though regulatory approvals required for foreign investment in most sectors were gradually being relaxed, legal mechanisms for monitoring foreign venture capital and private equity investors were absent. Accordingly, when in 2000 SEBI was made the nodal regulator for venture capital funds,[10] SEBI undertook significant reforms including the notification of the SEBI (Foreign Venture Capital Investors) Regulations, 2000, which was applicable to offshore funds,

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5 T. Satyanarayana Chary, *VC funding: Nothing ventured, nothing gained*, HINDU BUSINESS LINE (2004), http://www.thehindubusinessline.com/2004/03/30/stories/2004033000240900.htm (last visited July 5, 2017).

6 *Id.*

7 Industrial Credit and Investment Corporation of India, *1984-1985 Annual Report* 12 (1985).

8 Chary, *supra* note 5.

9 Kartik Ganapathy & Rajesh Pathania, *Legal and regulatory aspects for private equity and venture capital in India*, 63 FINANCIER WORLDWIDE 9, 10-11 (2008).

10 Chary, *supra* note 5.

enabling foreign venture capital and private equity investors to register with SEBI.

The VCF Regulations defines a VCF as a fund established in the form of a trust or a company or a body corporate registered under the VCF Regulations having a dedicated pool of capital raised and invested in accordance with the VCF Regulations. The VCF Regulations specifies that VCFs must invest at least two-thirds of their investible funds in unlisted equity shares or equity linked investments of a 'venture capital undertaking.' A venture capital undertaking is defined as a domestic company whose shares are unlisted and which is not engaged in activities or sectors listed by SEBI after the approval of the Indian government. The remaining one-third of the VCF's investible funds could also only be invested in one or more of five specific ways.[11]

The Income-Tax Act, 1961 was amended to grant VCFs a statutory tax pass-through status. That is, the income of a VCF was exempted from tax, but the income distributed by it to its investors was chargeable to income-tax in the hands of the investors of the VCF as if the investments made by the VCF were made directly by such investors of the VCF.[12] The single level of taxation provided simplicity and certainty in VCF taxation matters (though subsequent amendments did away with this pass-through status for VCFs).

B. Necessary reforms

As VCFs were aimed towards well-informed and relatively experienced investors, SEBI had historically sought to facilitate, rather than dictate, the growth of a venture capital industry with a relatively 'light touch' approach. However, financial crises in western countries highlighted vulnerabilities in certain fund strategies and their ability to magnify risks through the financial system. Therefore, at the time the AIF Regulations were introduced, private pools of capital were being subjected to regulation across jurisdictions

[11] Regulation 12(d)(ii) of the VCF Regulations states that 33.33% of a VCF's investible funds must be invested in: (a) subscription to initial public offer of a venture capital undertaking whose shares are proposed to be listed; (b) debt or debt instrument of a venture capital undertaking in which the VCF has already made an investment by way of equity; (c) preferential allotment of equity shares of a listed company subject to lock in period of one year; (d) the equity shares or equity linked instruments of a financially weak company (that is, a company, which has at the end of the previous financial year accumulated losses, which has resulted in erosion of more than 50% but less than 100% of its net-worth as at the beginning of the previous financial year) or a sick industrial company whose shares are listed; and (e) special purpose vehicles which are created by a VCF for the purpose of facilitating or promoting investment in accordance with the VCF Regulations.

[12] INCOME-TAX ACT, 1961, No. 43, Acts of Parliament, 1961 (India), sections 115U and 10(23FB).

due to their increasing importance in the financial ecosystem, along with the belief among regulators that they needed to have a better picture of the overall risks posed by such funds.[13]

In its *Concept Paper on Proposed Alternative Investment Funds Regulation for Public Comments*[14], SEBI highlighted that while it had framed the VCF Regulations to encourage funding of entrepreneurs' early stage companies, the VCF Regulations were instead increasingly used for many other funds such as private equity and private investment in public equity and real estate funds, leading to investment restrictions originally contemplated for VCFs being applied to these funds. Further, as registration under the VCF Regulations was not mandatory, there was a lacunae in the regulation of pooling investment vehicles. Therefore, SEBI stated that the regulatory framework governing domestic pooling vehicles needed to be overhauled in order to, among other things, promote start-ups and early stage companies, permit investments in secondary markets, and utilize investment restrictions and concessions from such restrictions to incentivize beneficial economic behaviour. As this necessitated recognizing alternative investment funds as a distinct asset class, SEBI introduced the AIF Regulations which, among other things, made registration mandatory for VCFs and other domestic pooling investment vehicles which may have otherwise been covered by the VCF Regulations.

Importantly, SEBI adopted a practical grandfathering approach which provides that funds already registered under the VCF Regulations would continue to be governed by the VCF Regulations. However, new funds and existing unregistered funds would need to be registered under the AIF Regulations.

C. Further steps

In 2015, SEBI constituted the Alternative Investment Policy Advisory Committee ('**AIPAC**'), a standing committee under the chairmanship of Mr. N.R. Narayana Murthy for advising SEBI on initiatives to strengthen the alternative investment ecosystem in India and to bring to attention obstacles in the development of the industry. AIPAC released two reports, one on January 20, 2016 and another on December 1, 2016. Certain recommendations from the first AIPAC report were adopted in the annual budget tabled

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[13] Nishith Desai Associates, *Fund Structuring & Operations: Global, Regulatory and Tax Developments impacting India focused funds*, Nishith Desai Associates (2017), http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research%20Papers/Fund_Structuring___Operations.pdf (last visited on July 7, 2017).

[14] Securities and Exchange Board of India, *supra* note 4.

by the Union Finance Minister for the financial year 2016-17. While the first AIPAC report concentrated on structural reforms and future practices for AIFs,[15] the second AIPAC report concentrated on performance indicators,[16] such as more detailed disclosures in the offer documents released by the AIF, stricter reporting norms, incentivizing domestic investment in AIFs, and standardization of industry benchmarks. As the AIPAC interacts with industry professionals, the AIPAC reports are a positive step towards discourse between the regulator and the practitioners. However, the recommendations in the AIPAC reports are yet to translate into widespread changes, some of which are discussed in further detail later on in this chapter.

II. Structural Overview

An AIF is defined under the AIF Regulations to mean a fund established or incorporated in India as a trust, company, limited liability partnership (**'LLP'**) or a body corporate which is a privately pooled investment vehicle with Indian or foreign investors. Given that applicable laws impose significantly lesser administrative, disclosure and other compliance requirements upon trusts, as against companies or LLPs, trusts are the preferred mode for setting up AIFs. It should be noted however that unlike a company or an LLP, a trust does not have a separate legal personality. It is the trustees who are the owners of the trust property which vests with them, and the beneficiaries of the trust have beneficial interest in the trust.

The AIF Regulations require that an AIF have a sponsor and a manager. A sponsor means any person or persons who set up the AIF and includes promoter in case of a company and designated partner in case of an LLP.[17] A manager refers to any person or entity appointed by the AIF to manage its investments.[18] The manager and the sponsor may be the same.

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[15] Alternative Investment Policy Advisory Committee, *The Alternative Investment Policy Advisory Committee Report*, Securities and Exchange Board of India (2016), http://www.sebi.gov.in/sebi_data/attachdocs/1453278327759.pdf (last visited July 6, 2017).

[16] Alternative Investment Policy Advisory Committee, *The Alternative Investment Policy Advisory Committee Second Report*, Securities and Exchange Board of India (2016), http://www.sebi.gov.in/sebi_data/attachdocs/1480591844782.pdf (last visited July 6, 2017).

[17] SEBI (Alternative Investment Funds) Regulations, 2012, No. LAD-NRO/GN/2012-13/04/11262, Circular issued by Securities and Exchange Board of India, 2012 (India), regulation 2(1)(w).

[18] *Id*, regulation 2(1)(q).

A. Categorisation

The AIF Regulations bucket AIFs into three specific categories in order to appropriately determine the different investment criteria, restrictions and regulatory concessions under the AIF Regulations. An AIF has to be registered under one of the three categories. Only AIFs that have not made any investments under the category in which they were originally registered, are permitted to apply to SEBI for a change in their categorisation.[19] If an AIF applying to SEBI for a change in categorisation has received commitments prior to its application, such an AIF is under a duty to inform investors that it is seeking a change in its categorisation, and provide the investors with an option to withdraw from the AIF without any penalty.

Category I AIFs: Such AIFs invest in start–up or early stage ventures or sectors considered socially or economically more desirable. Therefore, they are subjected to greater regulation but enjoy greater benefits as well. The sub-categories of category I AIFs are venture capital funds, small and medium sized enterprise ('**SME**') funds, infrastructure funds, social venture funds and angel funds. Such AIFs are close ended, that is, they are required to have a limited tenure. They must have a minimum tenure of three years. Category I AIFs can invest a maximum of 25% of their investible funds in a single company.[20]

Category II AIFs: Such AIFs are effectively the miscellaneous category of AIFs. They are not permitted to employ any leverage or borrowing other than to meet day to day needs and as such do not get any special benefits. Like category I AIFs, category II AIFs are close ended and are required to have a minimum tenure of three years. Category II AIFs can invest a maximum of 25% of their investible funds in a single company.[21] Various types of funds such as real estate funds, private equity funds, funds investing only in debt securities and funds for distressed assets are typically registered as category II AIFs.

Category III AIFs: Category III AIFs are interested in fetching short term returns, and therefore may make riskier investments (for instance, hedge funds). Such AIFs employ diverse or complex trading strategies, such as investments in listed and unlisted derivatives, and may employ leverage. This category of AIFs may be open ended or closed ended, that is, they are not

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[19] *Application for change in category of the Alternative Investment Fund*, 2013, No. CIR/IMD/DF/12/2013, Circular issued by Securities and Exchange Board of India, 2013 (India).

[20] SEBI, *supra* note 17, regulation 15(1)(c).

[21] SEBI, *supra* note 17, regulation 15(1)(c).

required to have a specified tenure.[22] Category III AIFs can invest a maximum of 10% of their investible funds in a single company.[23]

B. Investors

Under the AIF Regulations, domestic as well as foreign investors can invest in AIFs by way of subscription to 'units' of AIFs. No scheme of an AIF may have more than 1,000 investors,[24] and for angel funds, the cap on investors is reduced to 200.[25] The value of units of an AIF or the rights assigned to the holders of units of AIFs are primarily driven by contract, specifically the 'contribution agreement' (which in case of an LLP, includes the LLP Agreement, and in case of a company, includes a subscription and shareholders agreement) entered into by the AIF and the investor.

Under the AIF Regulations, the total amount of funds committed by investors to the AIF by way of a written contract, that is the contribution agreement, is termed as the corpus.[26] The 'investible funds' of the AIF, that is, the funds which may be invested by the AIF's investment manager, are calculated after subtracting the estimated expenditure for administration and management of the fund from the corpus of the AIF.[27] In commercial parlance, and reflected without explanation in the AIF Regulations, the 'commitment' of an investor towards an AIF is distinct from its 'contribution'. The 'commitment' is the amount pledged by the investor towards the corpus of the AIF under the terms of the contribution agreement. Typically, 'contribution' is the amount actually drawn down by the investment manager from the investor's commitment towards the corpus of the AIF under the contribution agreement. The minimum commitment amount for an investor is INR 10 million;[28] however, for employees or directors of either the AIF or its investment manager, or an investor in an angel fund, the minimum commitment amount is INR 2.5 million.[29]

Notably, the investment manager or sponsor of the AIF is required to invest funds in the AIF by way of their 'skin in the game'. For category I

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[22] The leverage of a category III AIF shall not exceed two times the net asset valuation of the fund. *See: Operational, Prudential and Reporting Norms for Alternative Investment Funds (AIFs)*, 2013, No. CIR/IMD/DF/10/2013, Circular issued by Securities and Exchange Board of India, 2013 (India).

[23] SEBI, *supra* note 17, regulation 15(1)(d).

[24] SEBI, *supra* note 17, regulation 10(f).

[25] SEBI, *supra* note 17, regulation 19E(4).

[26] SEBI, *supra* note 17, regulation 2(1)(h).

[27] SEBI, *supra* note 17, regulation 2(1)(p).

[28] SEBI, *supra* note 17, regulation 10(c).

[29] SEBI, *supra* note 17, regulations 10(c) and 19D(3).

and II AIFs, the investment manager or sponsor is required to invest INR 50 million or 2.5% of the corpus of the AIF, whichever is lower. For category III AIFs, the required threshold is the lower of INR 100 million or 5% of the corpus of the AIF.[30] For an angel fund, the threshold reduces to the lower of INR 5 million or 2.5% of the corpus of the angel fund.[31] The interest of the investment manager or sponsor in the AIF must be disclosed upfront to investors of the AIFs. Pursuant to the 'investment management agreement', the investment manager would normally be entitled to an amount paid annually/quarterly from the contributions made to the AIF for meeting the operating and other expenses of managing the AIF borne by the manager. The minimum investment requirement of the manager in the AIF under the AIF Regulations cannot be set off against its management fees.[32]

Domestic Investors: Certain domestic investors such as banks, insurance companies and pension companies are governed by restrictions imposed by their respective regulators. For instance, banks can invest in only Category I AIFs and cannot hold more than 10% of the unit capital of a category I AIF.[33] Similarly, while pension funds and insurance companies can invest in category I and category II AIFs, the Pension Fund Regulatory and Development Authority and the Insurance Regulatory and Development Authority of India have prescribed detailed norms for such investments in AIFs.[34]

Foreign Investors: Pursuant to amendments made by the Reserve Bank of India ("**RBI**") to foreign investment regulations, a person resident outside India can now invest in units of AIFs without seeking any governmental or RBI approval.[35] Investment by AIFs in domestic entities will however be considered as foreign investment if the sponsor and/or the investment manager of such AIFs are not Indian 'owned and controlled',[36] irrespective of the

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[30] SEBI, *supra* note 17, regulation 10(d).

[31] SEBI, *supra* note 17, regulation 19G(2).

[32] SEBI, *supra* note 17, regulation 10(d).

[33] *Master Direction – Reserve Bank of India (Financial Services provided by Banks) Directions*, 2016, No. Master Direction/DBR.FSD.No.101/24.01.041/2015-16, Master Direction issued by Reserve Bank of India, 2016 (India), regulation 5(a)(v)(b).

[34] *Investment in 'Alternative Investment Funds (AIF)'*, 2016, No. PFRDA/2016/8/PFM/02, Circular issued by Pension Fund Regulatory and Development Authority, 2016 (India); *The Investments* – Master Circular on IRDAI (Investment) Regulations, 2016 (updated as of May 2017).

[35] Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) (Eleventh Amendment) Regulations, 2015, No. FEMA 355/2015-RB, Notification issued by Reserve Bank of India, 2015 (India).

[36] A company is considered as owned by resident Indian citizens if more than 50% of the capital in it is beneficially owned by resident Indian citizens and/or Indian companies, which are ultimately owned and controlled by resident Indian citizens. *See*: Consolidated FDI Policy, 2016, No. 5(1)/2016-FC-1, Notification issued by Department of Industrial Policy & Promotion, Ministry of Commerce & Industry, 2016 (India), clause 2.1.31.

amount of foreign investments in AIFs. Therefore, if an AIF is Indian owned and controlled, then investments made by such an AIF would not attract sectoral caps or other restrictions under Indian foreign investment norms. Further, investments by non-resident Indians are deemed to be domestic investments at par with investments made by resident Indians.[37] A foreign venture capital investor can only invest in a category I AIF.[38]

C. Administrative process

Key documents that are required in an AIF structure, whether under law or commercial practice, are as follows:

Constitutive Document of the AIF: This can be a trust deed (for a trust), LLP agreement (for a LLP) and memorandum of association, articles of association and shareholders agreement (for a company). The constitutive document(s) should specify the various functions and responsibilities to be discharged by the trustee, designated partners or board of directors, as the case may be. Certain other items should be kept in mind, for instance, the formula for computing the beneficial interest of the investors in an AIF, in some instances, may be required to establish whether the trust is determinate in nature, and whether it is entitled to a pass through for tax purposes. Therefore, from an income-tax perspective, such formula should be specified in the AIF's constitutive document.

Private Placement Memorandum: As an AIF can only raise capital commitments through private placement, it is required to issue a private placement memorandum (or information memorandum). The AIF Regulations require that such private placement memorandum shall contain all material information about the AIF as may be necessary for the investor to take an informed decision on whether to invest in the AIF. By way of examples, the following are required to be included in the private placement memorandum: information about the investment manager and its key members, investment strategy, fees and expenses proposed to be charged, the distribution waterfall, tenure, terms of redemption, risk factors, conflict of interest and processes to identify and address them, manner of winding up of the

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[37] FOREIGN EXCHANGE MANAGEMENT (TRANSFER OR ISSUE OF SECURITY BY A PERSON RESIDENT OUTSIDE INDIA) (SECOND AMENDMENT) REGULATIONS, 2016, No. FEMA.362/2016-RB, Notification issued by Reserve Bank of India, 2016 (India).

[38] FOREIGN EXCHANGE MANAGEMENT (TRANSFER OR ISSUE OF SECURITY BY A PERSON RESIDENT OUTSIDE INDIA) (THIRD AMENDMENT) REGULATIONS, 2016, No. FEMA.363/2016-RB, Notification issued by Reserve Bank of India, 2016 (India).

AIF, and disciplinary history of the AIF, sponsor, investment manager and their key managerial personnel and affiliates.[39]

Investment Management Agreement: The powers and duties of the trustee, board of directors or designated partners, as the case may be, are delegated to the manager of the AIF through this agreement.

Contribution Agreement: This is a tri-partite agreement between the trustee (or board of directors for companies or designated partners for LLPs), investment manager of the AIF and the investor, setting out in detail, the commercial understanding regarding the investor's investment in the AIF.

The AIF Regulations prescribe the process for registration of AIFs, the norms for disclosure and transparency as well as specify certain restrictions on investments. Therefore, the key documents detailed above should be drafted keeping in mind that AIFs are subject to such regulatory conditions or restrictions.

Corpus: The corpus of each scheme is required to be at least INR 200 million,[40] except for angel funds where it is INR 100 million.[41] While category III AIFs are required to appoint a SEBI registered custodian regardless of the size of the corpus of the AIF, category I and II AIFs are required to appoint a custodian only if the corpus exceeds INR 5 billion.[42]

Winding up: The AIF Regulations provide that an AIF shall be wound up in the following cases: (a) when the tenure of the AIF or all schemes launched by the AIF, as mentioned in its 'placement memorandum' (discussed below) is over; (b) 75% of the investor by value of their investment in the AIF determine by way of a resolution at a meeting that the AIF be wound up; (c) if the AIF is a trust, if it is the opinion of the trustees of the AIF that the AIF be wound up; and (d) if SEBI so directs in the interests of investors.[43] Within one year of the investors and SEBI being intimated by the trustees, board of directors, or designated partners, as the case may be, the AIF will be fully liquidated and the proceeds accruing to investors of the AIF have to be distributed to them after satisfying all liabilities.[44]

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[39] SEBI, *supra* note 17, regulation 11(2).
[40] SEBI, *supra* note 17, regulation 10(b).
[41] SEBI, *supra* note 17, regulation 19D(2).
[42] SEBI, *supra* note 17, regulation 20(2).
[43] SEBI, *supra* note 17, regulation 29(1).
[44] SEBI, *supra* note 17, regulation 29(7).

Disclosure: In accordance with a SEBI circular,[45] AIFs are required to submit regular reports to SEBI providing details of the investments of the AIFs. Category I and II AIFs and category III AIFs which do not undertake leverage are required to submit such reports on a quarterly basis. Category III AIFs which undertake leverage are required to submit reports to SEBI on a monthly basis. Further, at end of each financial year, the investment manager of an AIF is required to prepare a 'compliance test report' on the AIF's compliance with the AIF Regulations and circulars issued thereunder in a specified format, and submit it to the trustee and sponsor of the AIF. In case the trustee or the sponsor observes any violation of the AIF Regulations or circulars issued thereunder by SEBI, the same shall be intimated to SEBI as soon as possible.[46] Separately, an AIF is required to make specific disclosures to its investors including on conflict of interest, fees, risk management, investment valuations etc.[47]

Valuation: Category I and II AIFs are required to appoint an independent valuer to carry out a valuation of their investments once every 6 months (extendable to 1 year with the approval of 75% of the AIF's investors, by value of their investments).[48] Category III AIFs are required to ensure that their net asset value is independently calculated and disclosed to their investor every 3 months (when the category III AIF has a fixed tenure) or every 1 month (when the category III AIF does not have a fixed tenure).[49]

Alterations: The AIF Regulations provide that the fund strategy of an AIF cannot be materially modified without the approval of at least two-thirds of its investors, by value of their investments.[50] Similarly, a change in the placement memorandum of an AIF, which would significantly influence the decision of an investor to continue being invested in the AIF, is required to be followed up by providing an exit option to investors along with a period of one month for indicating their dissent, unless such changes (with certain exceptions) have been approved by 75% of the AIF's investors, by value of their investment.[51]

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45 *Operational, Prudential and Reporting Norms for Alternative Investment Funds (AIFs)*, *supra* note 22.

46 *Guidelines on disclosures, reporting and clarifications under AIF Regulations*, 2014, No. CIR/IMD/DF/14/2014, Circular issued by Securities and Exchange Board of India, 2014 (India).

47 SEBI, *supra* note 17, chapter IV.

48 SEBI, *supra* note 17, regulation 23(2).

49 SEBI, *supra* note 17, regulation 23(3).

50 SEBI, *supra* note 17, regulation 9(2).

51 *Guidelines on disclosures, reporting and clarifications under AIF Regulations*, *supra* note 46.

Listing: The units of an AIF may be listed on a SEBI recognized stock exchange, after the AIF has finalized its corpus and would not be conducting further draw down of contributions from investors, with a minimum tradable lot of INR 10 million. However, it is important to note that SEBI has yet to put in place a regulatory regime for listing and trading of AIF units.

Further, in order to receive registration as an AIF under the AIF Regulations, there are specific documentation requirements. While the documentation and information provided hereafter is from the perspective of an AIF established as a trust, the requirements would not significantly vary for LLPs or companies.

An application for registration has to be made in Form A prescribed under the AIF Regulations. It should be noted that in the event the constitutive document of the AIF, such as the trust deed, has not been registered, the AIF Regulations provide flexibility for an in-principle approval. If only an in-principle approval is sought, the unregistered document, such as the draft trust deed, is sufficient for SEBI filing. The registered trust deed would be required to be submitted within 6 months from the receipt of such in-principle approval from SEBI.

The AIF application is required to be accompanied by a cover letter specifying whether the AIF: (a) is registered with the SEBI as a venture capital fund; (b) has been undertaking the activities of an AIF prior to the application; and/or (c) is making the application for registration of a new fund and accordingly, the details of the AIF, the trustee, the sponsor, the manager, and proposed investments are to be provided.[52]

D. Preferred structures

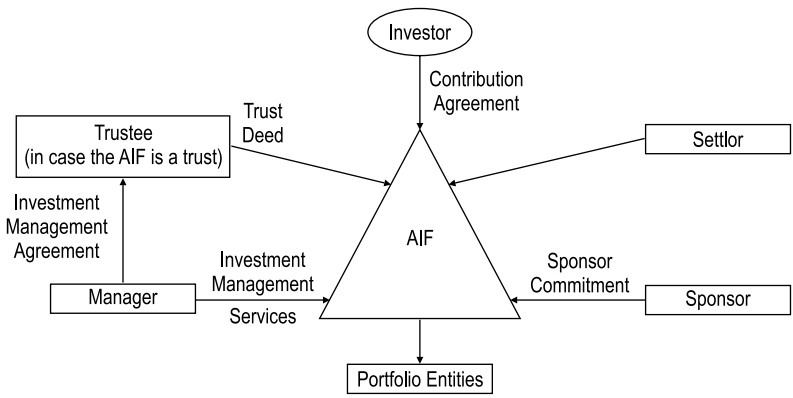
As stated above, due to administrative ease, Indian AIFs are generally registered as trusts. Other factors to be accounted for when finalizing the AIF structure would be the cost of incorporation, tax implications, marketing and promotion restrictions and jurisdictions of target investors, the last of which has grown in importance with the liberalization of foreign investment regulations allowing offshore investors to invest in AIFs.

As of June 30, 2016, category II AIFs constituted around 55% of AIFs in India while category III AIFs constituted around 13% of AIFs in India. While India has accorded a tax pass-through status to category I and category II AIFs registered with SEBI - with a requirement to subject any income

[52] SEBI, *supra* note 17, first Schedule, Form A.

credited or paid by the AIFs to a withholding tax of 10% for resident investors and as per the applicable rates for non-resident investors[53] - such tax pass-through status has still not been accorded to category III AIFs.

A schematic representation of a typical AIF structure, established as a trust is provided below:



Indian resident investors prefer a domestic fund structure as they are not allowed to make investments in offshore vehicles which in turn invest in Indian entities.

For administrative ease and other factors, offshore investors are typically pooled in jurisdictions which have Bilateral Investment Promotion and Protection Agreements or other such agreements with India, which may provide investors access to an efficient dispute resolution framework and other rights and reliefs.[54] Consequently, foreign investment into AIFs follows either of two approaches:

Unified Investment Structure: Commitments from both domestic and offshore investors are pooled into a domestic AIF. Usually, the foreign investor will pool their investment in a fund set up in an appropriate jurisdiction abroad ('**offshore fund**'), which in turn invests in the domestic AIF. As foreign investment in an AIF does not require governmental approval, this structure has received a boost in recent years and is a preferred structure where the substantive management and control of the fund rests in India.

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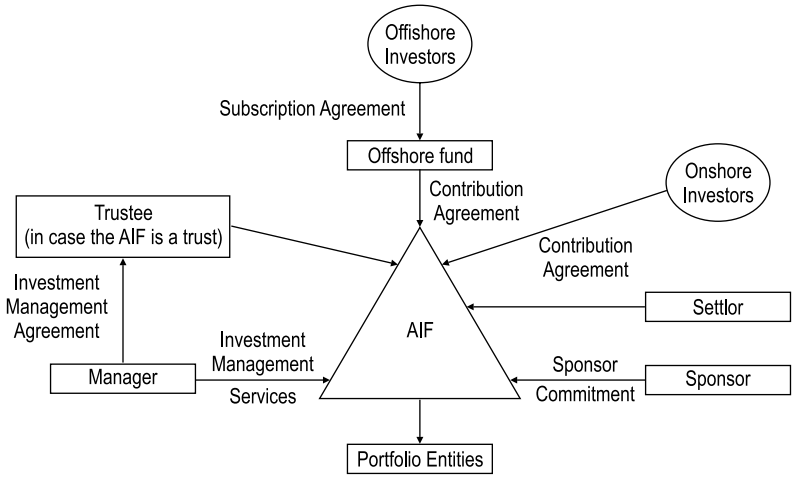
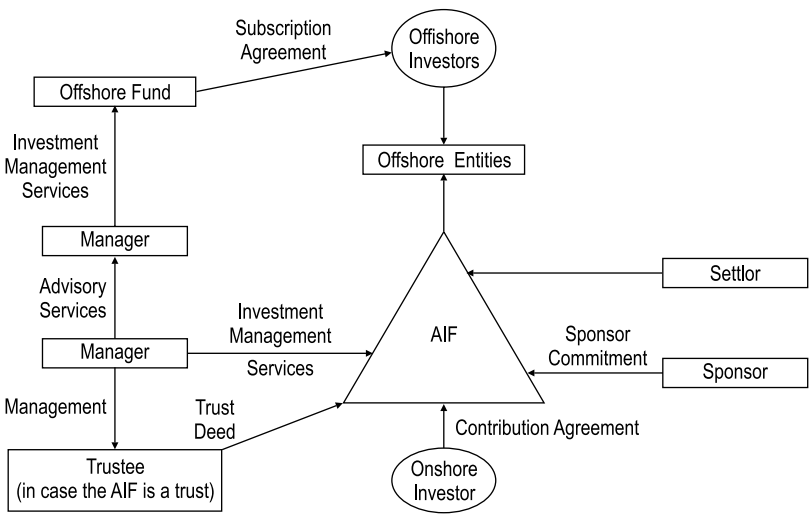
[53] INCOME-TAX ACT, 1961, No. 43, Acts of Parliament, 1961 (India), section 194(LBB).

[54] Mauritius is the primary source for overseas investment into Indian corporates, accounting for about 35% of total foreign inflows into India. Further, India saw about USD 52.99 billion of inflows from Singapore from April 2000 to December 2016, making it the second largest investor in India after Mauritius, accounting for 16% of total FDI received by India. *See*: Nishith Desai Associates, *supra* note 13.



***Co-investment/Parallel Investment Structure*:** As the name suggests, in this structure, separate pools of capital are raised for domestic and offshore investors, by establishing a domestic AIF and an offshore fund both of which simultaneously make investments in Indian entities. The domestic AIF and the offshore fund usually have separate management structures.



E. Risk management

The parameters laid down by the AIF Regulations for effective management of an AIF are not exhaustive, and concentrate on investor protection. For

instance, mandating a minimum commitment and restricting the number of investors to ensure that only a certain class of investors with assumed experience in wealth creation can invest in AIFs, and requiring that the investment manager or sponsor provide a minimum commitment to the AIF so that those accountable for the investments of the AIF have alignment of interests with investors and have an incentive to perform.

As incentive structures for effective management of the fund and protection of investor interests have evolved through commercial practice, the extent of Indian regulatory oversight under the AIF Regulations is not exhaustive.

Investment Committee and Advisory Board: To allay investor concerns, it is becoming increasingly common for AIFs to set up an investment committee authorized to ratify or reject the decision of the investment manager in respect of the various investment and/or divestment proposals of the AIF, and monitor the performance of the AIF on a continuing basis. Such investment committee is usually comprised of senior representatives of the investment manager and may also include independent experts. Separately, sophisticated investors have often insisted upon the formation of an advisory board to the AIF comprised of members not associated with the investment manager or sponsor, who examine and have the power to approve, or reject, a number of matters, including transactions that could involve a potential conflict of interest.

Management Fee and Carried Interest: As stated in part B above, pursuant to the investment management agreement, the investment manager would be entitled to a management fee which is meant to cover the expenses borne by the investment manager in managing the AIF. Such management fee usually bears no correlation to the performance of the investments made by the AIF. The management fee is usually calculated as a percentage of the commitments or contribution of investors to the AIF, but the specific formula varies from AIF to AIF. Similarly, as the expenses of the AIF are usually borne from the contributions made by the investors, investors may express apprehension about the kind of expenses charged to the AIF. Certain investors may insist on placing a cap on expenses, taking into account the investment strategy of the AIF. In addition to the fees, sponsors or managers are usually entitled to performance fees which are based on the performance of the AIF. Commercially, the concept of such performance fees or 'carried interest', has evolved significantly. 'Carried interest', or 'carry', is simply a share of the profits of the investors in an AIF that are paid to the sponsor or the manager, as an incentive for good performance and as a method to align their interests with that of the investors. However, carried interest is usually

not paid until investors have received a specified percentage of return – usually expressed in internal rate of return or 'IRR' terms - on their investments, also known as 'hurdle' or 'preferred return', thereby providing a further incentive to ensure prudent risk taking behaviour.

III. Issues for Consideration

The data in the table below is captured from the figure released by SEBI on the basis of disclosures made by AIFs registered with SEBI.[55] The data shows that as of June 30, 2017, AIFs regulated by SEBI have invested nearly INR 393 billion. Over half of this amount is in the form of investments by category II AIFs. As of date, over 300 AIFs have been established under the AIF Regulations.

(All figures in INR billion)

Category	**Commitments raised**	**Funds raised**	**Investments made**
Category I			
Infrastructure Fund	68.2959	42.6038	35.7822
Social Venture Fund	10.3512	5.8951	4.9651
Venture Capital Fund	142.4042	32.9848	22.1924
SME Fund	2.0783	1.7512	0.2847
Category I Total	223.1296	83.2349	63.2244
Category II	580.6349	275.0792	221.7745
Category III	156.4453	122.9796	108.0834
Grand Total	960.2098	481.2937	393.0823

On the basis of the data available and the observations made so far in this article, a few issues are raised for further consideration.

Unlocking category III AIFs: Tax pass-through status should be accorded to Category III AIFs to ensure that the potential of such AIFs is harnessed. As AIFs are pooling vehicles established to enable investors to diversify their investments by investing across different asset classes and using different investment strategies, the income that ought to be taxed is the income of the investors and not that of the AIF. The basis for identifying the taxpayer in an AIF should not be different for different categories of AIFs. Category III AIFs can bring about certain economic benefits which should be strongly considered by policy makers.

[55] Securities and Exchange Board of India, *supra* note 2.

First, category III AIFs are attractive to large institutional investors with a capacity for absorbing risk. However, as category III AIFs typically start their corpus with the proprietary capital of the investment manager or sponsor, there is an alignment of interest between them and the investors. Globally, hedge funds attract sovereign wealth funds, pension funds, endowments and others institutions who are generally considered to be prudent investors.[56]

Second, as category III AIFs are interested in short term returns, and high-risk high-reward investments, it is in their interest that the quality of governance in their portfolio companies is efficient and effective. Therefore, their strategies include activist investment strategies which aim to improve the quality of corporate governance and improvements in the operational performance of their portfolio companies.[57]

Introduction of accredited investor test: Currently, there is no scientific mechanism to identify investors who are sophisticated enough to understand and accept complex investment products. SEBI mandates a minimum commitment size to identify such sophisticated investors. However, this may be insufficient. SEBI has already laid down a test for determining an angel investor under the AIF Regulations; using the same concept, an accredited investor test could be formulated and made applicable to other categories of AIFs. This is a concept adopted in several mature jurisdictions with clear-cut criteria on the basis of which an investor will qualify as an accredited investor. The determination of an accredited investor may be based on past tax assessments to gain an idea of the person's net worth and annual cash flows. If such a test is introduced, SEBI may consider reducing the minimum ticket size for investing in AIFs to promote diversification of assets and attract a larger pool of investors.

Strengthening fiduciary principles: The second report of the AIPAC has mentioned the United States Employee Retirement Income Security Act of 1974 ('**ERISA**') as providing an effective five pronged test for determining the duties of a fiduciary. SEBI may consider incorporating a specific set of guidelines for the fiduciary duties of investment managers based on this test to provide greater clarity to all stakeholders. Each investment should be judged on its own merit and the test should be applied separately to each investment. The test under the ERISA is as follows:

(a) fiduciaries must avoid conflicts of interest when managing assets;

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[56] Alternative Investment Policy Advisory Committee, *supra* note 16.
[57] Alternative Investment Policy Advisory Committee, *supra* note 16.

(b) fiduciaries must discharge their duties for the exclusive purpose of providing benefits or fulfilling reasonable expenses, and must not receive excessive compensation;

(c) fiduciaries must discharge their duties like a prudent expert, that is with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like chapter with like aims;

(d) fiduciaries must diversify investments to minimize risk of losses, unless it is prudent to not do so; and

(e) fiduciaries must behave in accordance with law.

IV. Conclusion

AIFs are significant sources of capital for Indian investee entities and therefore, play a major role in our economy. Recognising this, Indian regulatory authorities are gradually expanding the investor pool for investments in AIFs and expanding the investment universe of AIFs, in terms of the tools that AIFs can invest in. Commercial practices should continually be strengthened to manage risks inherent in AIF investments while ensuring the capital allocation and capital raising in the Indian economy can meet its full potential. Regulations on AIFs interact with the numerous other continually shifting and dynamic regulations in the Indian legal landscape and greater coordination is required among the different regulators to not just ensure clarity in the legal framework, but that the intent of one regulator is not defeated by the other regulator's policies. At the same time, the international regulatory and tax environment is also undergoing changes. A greater number of AIFs tailored to meet the demands of specific investors will continue to be set up. It will be up to business practices determined by investment managers and investors, and the legal framework created by regulators to define whether AIFs can be a force for unlocking Indian economic growth.

An Overview of Contract Labour Related Laws in India

Mr. Manishi Pathak[*]

The principal legislation governing the employment and regulation of contract labour in establishments is The Contract Labour (Regulation and Abolition) Act, 1970 (**"CLRA"**). Given the growing market practice of employing contract labour, especially with the advent of the information technology industry, involvement of contract labour has been a controversial subject in India. Despite the complexity revolving around the employment of contract labour in India, the arrangement has become significant and a growing form of employment across sectors / industries. This has been due to the various associated advantages, ranging from comparatively lower wages to flexibility in terminating the relationship, etc.

The present article provides an overview of the various aspects pertaining to engagement of contract labour in India. This article aims to provide

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a limited insight into the relevant laws, obligations of a contractor and/or employer, and various prominent issues that have taken the centre stage from time to time. The purpose of this article is to provide an overview regarding the contract labour regime existing in India as per the Central (Federal) laws and does not cover any State specific requirements, except as already discussed herein.

I. BACKGROUND

Contract Labour has been a significant and continuously growing form of employment in which a Company engages the service of employees belonging to a third party, i.e., a contractor. As alluded to above, factors like cost effectiveness, higher productivity, flexibility in employment, facilitation for focusing on core competencies, *etc.*, constitute a few of the advantages that have encouraged the employment of contract labour.

There has been a gradual increase in the employment of contract labourers in India, which is reflected in the following data:[1]

Year	No. of Contract Labourers
2013-14	1967747
2014-15	1903170
2015-16	2092673

Given the increase in the engagement of contract labour, the Chief Labour Commissioner expressed his concern stating that "*The increasing trend of hiring employees on contract, both in the corporate set-up and the government, is a matter of concern especially since there is a difference in salaries between permanent employees and contract labour.*"[2]

II. CONTRACT LABOURERS AND PROTECTION ACCORDED TO THEM

Owing to the lack of bargaining power and the fact that their rights are not at par with regular employees, various statutory rights/comforts have

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1 Ministry of Labour and Employment, *Press Information Bureau – Violation of Contract Labour* (April 10th, 2017, 5:43 PM), *available at* http://pib.nic.in/newsite/pmreleases.aspx?mincode=21 (Last visited on July 1, 2017).

2 A.K. Nayak, *High contract labour a matter of concern*, THE TIMES OF INDIA (May 19, 2017), *available at* http://timesofindia.indiatimes.com/city/goa/high-contract-labour-a-matter-of-concern/articleshow/58742054.cms (Last visited on July 14, 2017)

been extended to contract labourers. Different legislations accord different benefits, which aim at providing certain statutory guarantees to a contract labourer. In addition to the efforts of the Legislature, such benefits have also been recognized in various judicial pronouncements.

In *BHEL Workers Assn.* v. *Union of India*[3], it was held that contract labourers are entitled to the same wages, holidays, hours of work and conditions of service as enjoyed by workmen directly employed by the principal employer of the establishment, in the same or similar kind of work. On the particular facts of this case, it was held that the working conditions and procedure for recovery of wages applicable to them was to be at par with what applied to workers employed by the principal employer under the appropriate Industrial and Labour Laws.

The relationship between an establishment/employer (referred to as the 'principal employer' under the CLRA) who engages contract labour and the person who provides the same, under a contract for supply of manpower, (referred to as the 'contractor' under the CLRA) is generally referred to as a 'contract labour arrangement'. The workers provided by a 'contractor' to perform work of a 'principal employer' are referred to as 'contract labour'.

III. CLRA and Its Role

A. Objective

The CLRA was enacted in 1970. Its preamble highlights its twofold objective, i.e., abolition of contract labour under certain circumstances, and regulation of employment of contract labour. The object of the CLRA has been highlighted by judicial pronouncement as follows:

> "The Act was passed to prevent the exploitation of contract labour and also to introduce better conditions of work. The Act provides for regulation and abolition of contract labour. The underlying policy of the Act is to abolish contract labour, wherever possible and practicable, and where it cannot be abolished altogether, the policy of the Act is that the working conditions of the contract labour should be so regulated as to ensure payment of wages and provision of essential amenities. That is why the Act provides for regulated conditions of work and contemplates progressive abolition."[4]

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[3] BHEL Workers Assn. v. Union of India, (1985) 1 SCC 630.
[4] Gammon India Ltd. v. Union of India, (1974) 1 SCC 596.

In *Sirpur Paper Mills Ltd.* v. *Commr. of Labour*,[5] the court confirmed this objective, and held that the CLRA was brought into existence to regulate the supply of the labour force and to prevent the exploitation of labourers. Provisions were made for the protection of rights of contract labour and both the labour contractor and the principal employer were made responsible.

Therefore, the key purposes behind the CLRA can be summed up as:

(i) Affording security to contract workers;

(ii) Affording equal working conditions and benefits to contract workers at par with regular workers; and

(iii) Preventing the exploitation of contract workers.

B. Applicability

CLRA applies[6] to

(i) Every establishment engaging twenty or more workers on contract basis;

(ii) Every contractor deploying twenty or more workers at the principal employer's establishment.

C. Participants in a Contract Labour Arrangement

Contract labour, contractor and principal employer together constitute a contract labour arrangement under the CLRA.

- Contract Labour: A workman employed in or in connection with the work of an establishment by or through a contractor.[7]
- Contractor: A person who undertakes to produce a given result for the establishment through contract labour or who supplies contract labour for any work of an establishment.[8]
- Principal Employer: The definition of principal employer is an inclusive one. The principal employer in the following establishments is as follows:

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5 Sirpur Paper Mills Ltd. v. Commr. of Labour, 2010 SCC OnLine AP 658 : 2011 LLR 250.

6 It is important to note that in states such as Maharashtra (2016 Amendment) and Rajasthan (2014 Amendment), the applicability threshold is fifty (50) or more workmen.

7 Section 2(1)(b), Contract Labour (Regulation and Abolition) Act, 1970.

8 Section 2(1)(c) , Contract Labour (Regulation and Abolition) Act, 1970.

(i) Office / department of the government or a local authority: Head of such establishment.

(ii) Factory: Owner or Occupier of the factory.

(iii) Mine: Owner or Agent of the mine.

Other establishment: Person responsible for the supervision and control of the establishment.[9]

D. Benefits

The CLRA, being the fundamental legislation pertaining to contract labourers, provides for certain benefits to them, including, *inter alia*, canteens, restrooms, drinking water, latrines and urinals, washing facilities, first-aid facilities, and timely payment of wages. The CLRA has demarcated these obligations to be performed by the principal employer and contractor, respectively.[10]

E. Illustration - Key Compliances[11]

Principal Employer	**Contractor**
Licensing	
1. Registration of establishment. 2. Issue Form V with the objective of ensuring that a contractor obtains a valid license.	1. Obtaining licence.
Payment of Wages	
1. Primary responsibility of ensuring presence of a representative while the contractor is disbursing wages to contract labour. 2. Ultimate responsibility for payment of wages to contract labour in the event of default on part of the contractor. However, the amounts can be recovered from the contractor.	1. Primary responsibility for payment of wages to contract labour employed.
Provision of Facilities	

[9] Section 2(1)(g), Contract Labour (Regulation and Abolition) Act, 1970.

[10] Chapter V (Section 16 – Section 21), Contract Labour (Regulation and Abolition) Act, 1970.

[11] *Ibid.*

1. Ultimate responsibility for provision of certain facilities (canteen, rest-rooms, first aid facilities, etc.) to contract labour, in the event of failure on part of the contractor. However, the cost towards such facilities may be recovered from the contractor.	1. Primary responsibility for provision of certain facilities (canteen, rest-rooms, first aid facilities, etc.) to contract labour.

Therefore, the CLRA puts the primary onus on the contractor for undertaking certain statutory compliances / obligations concerning the contract labour, with the rider that in case the contractor fails to do so, the obligation would fall on the principal employer.[12] This position was further confirmed by the Supreme Court in *People's Union for Democratic Rights* v. *Union of India*,[13] wherein it was held that if a contractor fails to fulfil its duties under the Act, then the principal employer shall be under an obligation to provide all amenities and benefits prescribed under the law to contract labour deployed at its establishment.

In addition to the protection extended by CLRA, benefits also accrue to contract labour from other statutes as discussed herein.

IV. EMPLOYEES' PROVIDENT FUNDS AND MISCELLANEOUS PROVISIONS ACT, 1952 ("EPF ACT")

Applicability: The EPF Act applies to every scheduled establishment, which is a factory, employing twenty or more workers, and such other establishments, employing twenty or more workers, which the appropriate government may, by notification, specify.[14] Further, Section 2(f)(i) of the EPF Act recognises contract workers as employees since the definition of 'employee' includes any person employed by or through a contractor in or in connection with the work of the establishment.[15]

Benefits: The EPF Act provides for certain provident fund benefits to the employees and in accordance with the EPF Scheme, the EPF Act makes it the responsibility of the principal employer to pay contributions for the contract

[12] Section 20, Contract Labour (Regulation and Abolition) Act, 1970.
[13] People's Union for Democratic Rights v. Union of India, (1982) 3 SCC 235.
[14] Section 1(3), Employees' Provident Funds and Miscellaneous Provisions Act, 1952.
[15] Section 2(f)(i), Employees' Provident Funds and Miscellaneous Provisions Act, 1952.

labour employed through the contractor[16] which he can subsequently recover from the contractor.[17]

V. EMPLOYEES' STATE INSURANCE ACT, 1948 ("ESI ACT")

Applicability: The ESI Act is applicable to all factories (including factories belonging to the Government) and any other establishment to which the appropriate government may, by giving one month's notice by notification, extend the provisions of the Act.[18] Since State governments are also the appropriate governments with regard to extension of the ESI Act to establishments in their jurisdiction, notifications have been issued by almost each State government (exceptions being Manipur, Sikkim, Arunachal Pradesh and Mizoram) extending the provisions of ESI Act to other establishments in their respective States. The general trend in these notifications has been to extend the ESI Act to other establishments employing 20 or more persons. However, in states such as Delhi, Karnataka, etc., the ESI Act has been extended to notified establishments employing 10 or more persons.

Section 2(9)(iii) of the ESI Act recognises contract workers as employees as the definition of 'employee' includes a person whose services are temporarily lent or let on hire to the principal employer by the person with whom the person whose services are so lent or let on hire has entered into a contract of service.[19]

Benefits: The ESI Act makes the principal employer liable to pay contributions in respect of contract labour in the first instance,[20] which can subsequently be recovered from the immediate employer, i.e., the contractor.[21]

VI. EMPLOYEES' COMPENSATION ACT, 1923 ("EC ACT")

Applicability: The EC Act applies to railway servants; master, seaman or other members of the crew of a ship; a captain or other member of the crew of an aircraft; person recruited as driver, helper, mechanic, cleaner or in any other capacity in connection with a motor vehicle; person recruited for work

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16 Section 6, Employees' Provident Funds and Miscellaneous Provisions Act, 1952 r/w para 30 of Employees' Provident Fund Scheme.
17 Section 8A, Employees' Provident Funds and Miscellaneous Provisions Act, 1952.
18 Sections 1(4) and 1(5), Employees' State Insurance Act, 1948.
19 Section 2(9)(iii), Employees' State Insurance Act, 1948.
20 Section 40, Employees' State Insurance Act, 1948.
21 Section 41, Employees' State Insurance Act, 1948.

abroad by a company and such persons employed in the capacity specified under Schedule II of the EC Act.[22]

Benefits: Subject to applicability of the EC Act, the liability of principal employer and the contractor for paying compensation has been fixed in the execution of the work by a contract labour.[23] The principal employer is responsible for payment of compensation, and for personal injury caused by an accident arising out of and in course of employment, to contract labour.[24] However, the principal employer is entitled to be indemnified by the contractor for such amount.[25] The above position has been upheld by various Courts in India.[26]

It is important to note that the ESI Act provides that an employee covered thereunder will not be entitled to claim benefits (compensation or damages) under the EC Act.[27]

VII. Factories Act, 1948

Applicability: The Factories Act is applicable to every factory where 10 or more workers are working with the aid of power, or 20 or more workers are working without the aid of power. Section 2(l) of the Factories Act, 1948 defines a 'worker' to include persons employed, directly or by or through any agency (including a contractor). In other words, the definition does not discriminate between person employed directly by the principal employer and a person employed by or through a contractor, provided all the conditions provided in the definition are fulfilled.

Benefits: There are several health, safety and welfare measures prescribed under the Factories Act, 1948, which must be provided by the 'occupier' (as defined under the Factories Act) to each worker employed at a factory. Also, the workers shall also be entitled to benefits relating to overtime, compensatory leave, leave with wages, etc.

Despite the benefits conferred upon the contract labour under various legislations, there are certain legislations which do not confer any obligation on the principal employer, concerning contract labour, such as Payment of Gratuity Act, 1972 and Payment of Bonus Act, 1965. Additionally, since

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[22] Section 2(dd), Employees' Compensation Act, 1923.
[23] Section 12, Employees' Compensation Act, 1923.
[24] *Ibid.*
[25] *Supra* note 23.
[26] Sarjerao Unkar Jadhav v. Gurinder Singh, 1990 SCC OnLine Bom 36 : (1991) 62 FLR 315.
[27] Section 53, Employees' State Insurance Act, 1948.

contract labour is engaged for specific period and for a particular job, the provisions of the Industrial Disputes Act (Section 25F in this case) are not attracted and do not lay any obligation on principal employer concerning contract labour.[28] However, since the contractor is the immediate employer of the contract labour, payment of retrenchment compensation to such contract labour is the responsibility of the contractor (when the contractor terminates such a person). It has been held that the contractor shall make provisions for retrenchment compensation and such other requirements that he is statutorily required to observe as applicable to workmen in the canteen/ catering establishment.[29]

The claim for regularization, in case of a sham arrangement, can also be filed against the principal employer, under the Industrial Disputes Act, 1947 by a worker who has completed 240 days of service and completes all necessary aspects relating to such a claim. This aspect has been discussed at length under the head of Chapter E.1. below and particularly in of *International Airport Authority of India* v. *International Air Cargo Workers' Union*.[30]

A. Prohibition of Contract Labour

The system of contract labour has been discussed by the Supreme Court in the decision of *Sankar Mukherjee* v. *Union of India*,[31] wherein it was held as follows:

> "It is surprising that more than forty years after the independence the practice of employing labour through contractors by big companies including public sector companies is still being accepted as a normal feature of labour-employment. There is no security of service to the workmen and their wages are far below than that of the regular workmen of the company. This Court has disapproved the system of contract labour holding it to be 'archaic', 'primitive' and of 'baneful nature'. The system, which is nothing but an improved version of bonded-labour, is sought to be abolished by the Act. The Act is an important piece of social legislation for the welfare of labourers and has to be liberally construed."

The primary purpose behind the enactment of CLRA was the abolition of contract labour altogether in certain situations. Section 10 of CLRA

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[28] Nuclear Fuel Complex v. K. Penta Reddy, 2002 SCC OnLine AP 123 : (2002) 2 ALT 553.
[29] SRF Ltd. v. Govt. of T.N., 1995 SCC OnLine Mad 48 : (1996) 73 FLR 1354.
[30] International Airport Authority of India v. International Air Cargo Workers' Union, (2009) 13 SCC 374.
[31] Sankar Mukherjee v. Union of India, 1990 Supp SCC 668.

gives effect to this objective. According to sub-section (1) of Section 10, "*the appropriate government may, after consultation with the Central Board or, as the case may be, a State Board, prohibit, by notification in the Official Gazette, employment of contract labour in any process, operation or other work in any establishment*."[32]

Sub-section (2) contains several circumstances and factors which an appropriate government (Central or State) shall take into account before issuing a notification under sub-section (1), which include:

- work is incidental to, or necessary for the industry or occupation that is carried on in an establishment;
- work is of perennial nature;
- work is done ordinarily through regular workmen;
- work is sufficient to employ considerable number of whole-time workmen.[33]

As per the information available, the Central Government has issued 88 Notifications under Section 10 of the CLRA abolishing employment of contract labour in specified establishments / businesses in consultation with the Central Advisory Contract Labour Board.[34] The trend in these notifications demonstrates that the grounds prescribed under sub-section (2) of Section 10 have been kept in mind.

It is pertinent to note that Andhra Pradesh has imposed a blanket prohibition on employment of contract labour in core activities. In addition to this, there are several other States that have issued notifications for prohibition on employment of contract labour in either certain specific establishments or specific activities.

1. Sham Arrangements

In certain circumstances, the nature of relationship between the principal employer and contract labour is such that, *prima facie*, it may appear to be a legitimate contract labour arrangement but in fact, is merely an arrangement to deprive those workers from the benefits that they would have been entitled to, had they been appointed in the capacity of regular employees. Such an arrangement has been termed a "sham arrangement" by the Courts. In such

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[32] Section 10(1), Contract Labour (Regulation and Abolition) Act, 1970.
[33] Section 10(2), Contract Labour (Regulation and Abolition) Act, 1970.
[34] Ministry of Labour and Employment, *Annual Report*, Government of India, New Delhi, 2016-17.

circumstances, courts have pierced the veil to determine the true nature of engagement and role of employees. For example, In the landmark judgment of *SAIL* v. *National Union Waterfront Workers*,[35] (**"SAIL Judgment"**) it was held:

> "On issuance of prohibition notification under Section 10(1) of the CLRA prohibiting employment of contract labour or otherwise, in an industrial dispute brought before it by any contract labour in regard to conditions of service, the industrial adjudicator will have to consider the question whether the contractor has been interposed either on the ground of having undertaken to produce any given result for the establishment or for supply of contract labour for work of the establishment under a genuine contract or is a mere ruse/camouflage to evade compliance of various beneficial legislations so as to deprive the workers of the benefit thereunder. If the contract is not found to be genuine but a mere camouflage, the so-called contract labour will have to be treated as employees of the principal employer who shall be directed to regularize the services of the contract labour in the concerned establishment."

2. Contract Labour and Nature of Relationship

Courts have found the existence of a "sham arrangement", where an "employer-employee" relationship exists between the principal employer and the contract labour. In *Workmen of Nilgiri Coop. Mktg. Society Ltd.* v. *State of T.N.*,[36] the Supreme Court held that the question in each case has to be answered having regard to the facts involved. It was held that no single test - be it the control test, be it the organization or any other test - has been held to be the determinative factor while establishing the jural relationship of an employer and employee. The Court held that several factors that would have a bearing on the issue, are:

(a) who is appointing authority;

(b) who is the pay master;

(c) who can dismiss;

(d) how long alternative service lasts;

(e) the extent of control and supervision;

(f) the nature of the job, e.g. whether, it is professional or skilled work;

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[35] SAIL v. National Union Waterfront Workers, (2001) 7 SCC 1 : 2001 SCC (L&S) 1121.

[36] Workmen of Nilgiri Coop. Mktg. Society Ltd. v. State of T.N., (2004) 3 SCC 514.

(g) nature of establishment;

(h) the right to reject.

In an earlier case, *Hussainbhai* v. *Alath Factory Thezhilali Union*,[37] it had been held as follows:

> "Where a worker or group of workers labour to produce goods or services and these goods or services are for the business of another, that other is, in fact, the employer. He has economic control over the workers' subsistence, skill, and continued employment. If he, for any reason, chokes off, the worker is, virtually, laid off. The presence of intermediate contractors with whom alone the workers have immediate or direct relationship ex contractu is of no consequence when, on lifting the veil or looking at the conspectus of factors governing employment, we discern the naked truth, though Sniped in different perfect paper arrangement, that the real employer is the Management, not the immediate contractor"

The tests for the determination of an employer and employee relationship in context of contract labour were also laid down in the decision of *National Airport Authority* v. *Bangalore Airport Service Coop. Society*,[38] the excerpt of which is as follows:

> "In order to determine whether the applicants were the workmen of the appellants and thus there was the relationship of employer and employee between the appellants and the applicants, both the Single Judge and the Labour Court should have considered, firstly, whether there was a contract of employment between the appellants and applicants. Secondly, whether the porterage service was incidental or integral part of the functions of the airport authorities."

B. Debate on the Absorption of Contract Labourers

There has been a controversy as to whether contract labourers are to be treated as direct employees of the establishment in the event that there is any notification abolishing contract labour in respect of that work or that establishment or in case the arrangement providing for employment of contract labour is sham or not genuine, or other such circumstances.

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[37] Hussainbhai v. Alath Factory Thezhilali Union, (1978) 4 SCC 257.

[38] National Airport Authority v. Bangalore Airport Service Coop. Society, 1991 SCC OnLine Kar 273 : (1991) 2 Kant LJ 287.

It may be relevant to mention that neither section 10 nor any other provision of the CLRA provides that the contract labour will automatically become employees of the principal employer, on issuance of prohibition notification by the appropriate government. In other words, the CLRA is silent on the aspect pertaining to automatic absorption of contract labour pursuant to issuance of prohibition notification by an appropriate government under section 10 of CLRA. In view of the foregoing, the issue of absorption has been examined by various courts in India and has been a subject matter of divergent opinions, few of which have been discussed herein below (E.1 and E.2).

The Hon'ble Supreme Court of India in *Air India*[39] held that on or after issuance of a notification under Section 10 of CLRA, the contract worker will be automatically absorbed by the principal employer. However, the constitution bench in SAIL Judgment (as briefly discussed below) set aside the judgment of *Air India* by holding that on issuance of prohibition notification under section 10 of CLRA where the employment of contract labour is prohibited, the proper authority to assess and examine the dispute would be the Industrial Tribunal. However, on abolition of contract worker under Section 10 of CLRA, if any dispute is raised by the contract labour for regularization, the Industrial Adjudicator would have to consider the question whether the contractor had been engaged either to produce any given result for the establishment or for supply of contract labour for work of the establishment under a genuine contract or it is was a mere ruse or camouflage to evade compliance of various beneficial legislations so as to deprive the workers of benefit thereunder.

Consequently, in view of the SAIL Judgment, the legal position prevailing as of date of writing is that mere issuance of prohibition notification by the appropriate government does not imply automatic absorption of the contract labour.

1. Judicial Precedents against Absorption

Following the SAIL Judgment, there have been a catena of judgments holding against the regularization of contract labourers as employees.

In *Haldia Refinery Canteen Employees Union* v. *Indian Oil Corpn. Ltd.*,[40] it was held that it has nothing to do with either the appointment or taking disciplinary action or dismissal or removal from service of the

[39] Air India Statutory Corpn. v. United Labour Union, (1997) 9 SCC 377 : AIR 1997 SC 645.
[40] Haldia Refinery Canteen Employees Union v. Indian Oil Corpn. Ltd., (2005) 5 SCC 51.

workmen working in the canteen. Merely for the fact that the management exercises such control does not mean that the employees working in the canteen are the employees of the management. Such supervisory control is being exercised by the management to ensure that the workers employed are well qualified and capable of rendering proper service to the employees of the management.

Further, in *International Airport Authority of India* v. *International Air Cargo Workers' Union*,[41] it was held that the principal employer only controls and directs the work to be done by contract labour, when such labour is assigned / allotted / sent to him. But it is the contractor as employer, who chooses whether the worker is to be assigned / allotted to the principal employer or used otherwise. In short, the worker is the employee of the contractor and thus, the ultimate supervision and control lies with the contractor as he decides where the employee will work and how long he will work for and subject to what conditions, *etc*. When the contractor assigns / sends the worker to work under the principal employer the worker works under the supervision and secondary control of the principal employer. The primary control rests with the contractor.

The true position regarding absorption of contract labourers has been laid down in the SAIL Judgment[42] as below:

> "An analysis of the cases, discussed above, shows that they fall in three classes: (i) where contract labour is engaged in or in connection with the work of an establishment and employment of contract labour is prohibited either because the industrial adjudicator/court ordered abolition of contract labour or because the appropriate Government issued notification under Section 10 of the CLRA, no automatic absorption of the contract labour working in the establishment was ordered; (ii) where the contract was found to be a sham and nominal, rather a camouflage, in which case the contract labour working in the establishment of the principal employer were held, in fact and in reality, the employees of the principal employer himself. Indeed, such cases do not relate to abolition of contract labour but present instances wherein the Court pierced the veil and declared the correct position as a fact at the stage after employment of contract labour stood prohibited; (iii) where in discharge of a statutory obligation of maintaining a canteen in an establishment the principal employer availed the

[41] *Supra* note 30.
[42] *Supra* note 35.

> services of a contractor the courts have held that the contract labour would indeed be the employees of the principal employer."

From a reading of the points relating to classes (i) and (ii) (in the SAIL Judgement), it is amply clear that such cases would not mean that the contract labour should be absorbed as regular employees.

There can be no direction for absorption even in the event where the principal employer engages contract workers after a notification, under Section 10 of CLRA, has been confirmed again in the SAIL Judgment[43] where it has been held that the Courts cannot read in some unspecified remedy (i.e., absorption) in Section 10 or substitute for penal consequences specified in Sections 23 and 25 of CLRA.

2. Judicial Precedents in favour of Absorption

In *Bengal Nagpur Cotton Mills* v. *Bharat Lal*,[44] the Supreme Court held as follows:

> "It is now well settled that if the industrial adjudicator finds that the contract between the principal employer and the contractor to be a sham, nominal or merely a camouflage to deny employment benefits to the employee and that there was in fact a direct employment, it can grant relief to the employee by holding that the workman is the direct employee of the principal employer. Two of the well-recognised tests to find out whether the contract labourers are the direct employees of the principal employer are: (i) whether the principal employer pays the salary instead of the contractor; and (ii) whether the principal, employer controls and supervises the work of the employee."

In this case, the Industrial Court answered both questions in the affirmative and as a consequence held that the first Respondent is a direct employee of the Appellant.

Further, in the decision of *Bhilwara Dugdh Utpadak Sahakari Samiti Ltd.* v. *Vinod Kumar Sharma*,[45] while holding that the workers were employees of the company and not the contractor, the Supreme Court held as follows:

> "Labour statutes were meant to protect the employees/workmen because it was realised that the employers and the employees are

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[43] *Supra* note 35.
[44] Bengal Nagpur Cotton Mills v. Bharat Lal, (2011) 1 SCC 635.
[45] Bhilwara Dugdh Utpadak Sahakari Samiti Ltd. v. Vinod Kumar Sharma, (2011) 15 SCC 209.

> not on an equal bargaining position. Hence, protection of employees was required so that they may not be exploited. However, this new technique of subterfuge has been adopted by some employers in recent years in order to deny the rights of the workmen under various labour statutes by showing that the concerned workmen are not their employees but are the employees/workmen of a contractor, or that they are merely daily wage or short term or casual employees when in fact they are doing the work of regular employees. This Court cannot countenance such practices any more. Globalization/liberalization in the name of growth cannot be at the human cost of exploitation of workers."

VIII. CONCLUSION

Despite the consequences, the practice of employing contract labour is quite prevalent in India, spread across several industries, and in different occupations, including skilled, semi-skilled and unskilled work. It might appear that the institution of contract labour is an attempt to circumvent the labour laws. However, there has been a gradual shift towards efficient management of contract labour including payment of benefits at par with regular employees today (in certain circumstances). While contract labour largely may not receive the same security and dignity of labour as regular workmen, the demand for it is still growing. Therefore, in the wake of these circumstances, there is a need to bring in changes in the law which will ensure that the rights of contract labour can be better protected. The aftermath of the SAIL Judgment[46] has made the judicial stand on contract labour absolutely unambiguous. It is now clear that neither Section 10 of the CLRA nor any other provision in the CLRA expressly or by necessary implication provides for automatic absorption of contract labour on issuing a notification by the appropriate Government under sub-section (1) of Section 10 prohibiting employment of contract labour in any process or operation or other work in any establishment. The principal employer cannot be required to absorb contract labour working in the concerned establishment.

The role of contract labour has to be seen in the context of a growing trend towards unbundling the production process into parts and outsourcing supply of the same to different producing units. This practice has mostly increased with the growth of information technology. If such outsourcing leads to a greater specialisation in the production of these services, with resulting gains in efficiency and reduced costs, it could stimulate a larger total

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[46] *Supra* note 35.

demand for these services and, therefore, create employment.[47] Therefore, the system of contract labour is a necessary evil which requires to be regulated to protect the interests of such contract labourers, in particular and the industry, in general. In the current day and age, while steps have been taken to protect the interests of persons (contract labour), the interest of the industry also requires consideration. It is also important to provide opportunities of employment to people, as controlling or discouraging practices may lead to loss of employment opportunities.

[47] Raj Kapila & Uma Kapila, *Planning Commission Reports on Labour and Employment*, 204 (2002).

Rethinking the (Limited) Responsibility of Multinational Enterprises

Régis Bismuth[*]

The widespread use of limited liability entities in corporate groups as well as the strict standards applied by courts for piercing the corporate veil have been two major obstacles to the emergence of a liability regime for multinational enterprises. In light of these difficulties, a "corporate social responsibility" (CSR) discipline of "responsibilisation" of parent companies has emerged through the recognition of a duty of care in relation to the activities of their subsidiaries. However, this discipline presents significant shortcomings which should lead us to critically question the regime of limited liability by highlighting that it was an accident of history that has led to an asymmetry between the circulation of rights and the fragmentation of liabilities throughout the corporate group. It is against this background that we propose a new way of solving the issue of corporate group responsibility.

Juxtaposing the words "enterprises" and "responsibility" might cause some awkwardness. Legal responsibility requires the existence of a legal subject to which a wrongful act can be attributed. Multinational enterprises are not

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de plano legal subjects. It is indeed necessary to draw a distinction between, on one hand, an enterprise which actually takes decisions as an economic structure and, on the other hand, corporations into which the enterprise has been fragmented, which, formally take decisions as distinct legal entities. As underlined by Jean-Philippe Robé, an *enterprise*, as "a unique organization coordinated by a single management team exists in reality, although it does not exist as such in the legal system".[1] Without going as far as considering that the "responsibility of enterprises" is an oxymoron, it is possible to identify a kind of hiatus or discontinuity between these two notions through which a form of legal irresponsibility can take root.[2] It is indeed within this gap between form and substance that legal engineering to optimize the circulation of assets throughout the enterprise – generally composed of limited liability companies – while allowing for compartmentalization of liabilities has taken place. This potential for legal engineering is amplified in the case of multinational enterprises (MNEs) since the characteristics of different legal orders can be more easily exploited to optimize the circulation of rights and the segmentation of obligations.[3]

It is therefore necessary to comprehend lucidly the ways through which the legal organization of enterprises (mostly through parent companies and subsidiaries) constitutes an obstacle to imputing responsibility on multinationals. This paper studies situations where the liability for tortuous acts of the parent is sought for acts attributable to the subsidiaries located abroad. Imputing responsibility on the parent company may be sought for different motives: legal (greater confidence in the legal system of the State where the parent is located), financial (if the subsidiary is not solvent) or strategic (a claim lodged against the parent company could affect its reputation and facilitate an off-court settlement).

Disputes of this nature generally raise two key difficulties. The first, that will be at the centre of analysis, is related to the link between the parent and the behaviour of the subsidiary. The liability of the former can be incurred

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1 Jean-Philippe Robé, *Globalization and Constitutionalization of the World Power System*, *in* Multinationals and the Constitutionalization of the World Power System 14, (Jean-Philippe Robé, Antoine Lyon-Caen & Stéphane Vernac (eds.), Routledge, 2016); *see also*, Jean-Philippe Robé, Le temps du monde de l'entreprise – Globalisation et mutation du système juridique 90 (Dalloz, 2015).

2 Juliette Tricot, *Personne(s) morale(s) et personne(s) physique(s) : Comment renouveler l'approche personnaliste ? Réflexions à partir du droit pénal*, *in* La RSE Saisie Par le Droit – Perspectives Interne et Internationale 173, (Kathia Martin-Chenut & René de Quenaudon (eds.), Pedone, 2016).

3 Gwynne Skinner, *Rethinking Limited Liability of Parent Corporations for Foreign Subsidiaries' Violations of International Human Rights Law*, 72 Washington and Lee Law Review 1769 (2015).

either by way of attribution of the contentious conduct (by lifting the corporate veil) or due to a failure to fulfil a duty of care concerning the activities of the subsidiary. The second arises from the obstacles to the jurisdiction of domestic courts of the host State of the parent company. Indeed, the claim usually concerns facts occurring abroad and involving a legal entity not having string ties with the forum. From an international law perspective, States enjoy a great flexibility since they neither oblige nor preclude them from exercising their jurisdiction in such situations. Besides, the Ruggie's "Guiding Principles on Business and Human Rights" adopted by the Human Rights Council simply indicate that "as part of their duty to protect against business-related human rights abuse, States must take appropriate steps to ensure, through judicial means, that when such abuses occur within their territory and/or jurisdiction those affected have access to effective remedy".[4] There is no such thing as an obligation for States to exercise extraterritorial jurisdiction for human rights abuses perpetrated abroad. The issue of jurisdiction has already been dealt with in many studies[5] and does not require to be further explored within the framework of this article. The root of the problem lies more in the characterization and conceptualization of the link between the parent company and its subsidiary. Our proposal is to develop a framework that would eventually solve all issues concerning the jurisdiction of domestic courts.

Limited liability and the problem associated with lifting the corporate veil constitute two major obstacles to affixing responsibility on multinational enterprises. A study of the litigation through which the (*ex post*) liability of the parent is sought for acts committed by the subsidiary shows that the criteria implemented for lifting the corporate veil are particularly restrictive (A). Given these difficulties, a new form of (*ex ante*) "responsabilisation" of parent companies has emerged and intends to promote corporate social responsibility (CSR). The emerging duty of care of parent companies concerning the activities of their subsidiaries also has some significant shortcomings (B). These obstacles and shortcomings should lead us to critically rethink the legal regime of limited liability. A short historical analysis shows that the emergence of limited liability is more an accident of history and has eventually generated imprudent and risky behaviour from corporations[6] as

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[4] Guiding Principles on Business and Human Rights: Implementing the United Nations "Protect, Respect and Remedy" Framework, Principle 25, A/HRC/17/31 (21 March, 2011).

[5] For instance, see, Claire Bright, L'accès à la justice civile en cas de violations des droits de l'homme par des entreprises multinationals (2013) (Unpublished Ph.D. thesis, European University Institute) (on file with the author).

[6] Paddy Ireland, *Limited Liability, Shareholder Rights and the Problem of Corporate Irresponsibility*, 34 CAMBRIDGE JOURNAL OF ECONOMICS 837, 845 (2010) (noting that

well as an opportunity for them to better protect their rights and fragment their liabilities (C). Drawing on this, we propose a new way of conceiving enterprise responsibility (D).

I. The Fortress of Corporate Veil (Ex Post Responsibility)

Holding parent companies liable for acts committed by their subsidiaries can be envisaged first, through an approach where the acts of the subsidiaries are directly attributed to the parent. This possibility has been recognized only following very strict standards of attribution to the extent that it calls into question the principle of separate legal personality and *per extensionem* the rule of limited liability (when the liabilities of the subsidiary exceeds the amount of the original investment of the parent company). Two fundamental institutions of corporate law are thus at stake when the responsibility of the parent is envisaged, which explains the strict standards of attribution that have been implemented. We will limit ourselves to some general remarks, notwithstanding the fact that they do not reflect all the nuances and subtleties of the issue[7].

Different regimes of corporate veil piercing (or any other doctrine leading to an equivalent result in substance) are applicable depending on the domestic legal systems in place.[8] In France, we usually refer to the notions of "*abus de la personnalité morale*" ("abuse of legal personality") or of "*transparence de la personnalité morale*" ("transparency of legal personality"). In common law systems, notions of "instrumentality", "alter-ego", "agent", "dummy" or "cover" are used. One of the most emblematic cases of corporate veil piercing, where the acts of a subsidiary were attributed to the parent company is perhaps the *Amoco Cadiz* case in which a US federal court observed that the parent "exercised such control over its subsidiaries

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the no-obligation, no-responsibility, no-liability nature of corporate shares permits their owners or their institutional representatives to enjoy income rights without needing to worry about how the dividends are generated. They are not legally responsible for corporate malfeasance, and in the event of failure only their initial investments are at risk).

[7] Jennifer A. Zerk, Multinationals and Corporate Social Responsibility – Limitations and Opportunities in International Law 215 (Cambridge University Press, 2006); Marguerite Kocher, Emmanuel Leroux & Pedro Nicoli, *Groupe d'entreprises* , *in* La RSE Saisie Par le Droit – Perspectives Interne et Internationale 151 (Kathia Martin-Chenut & René de Quenaudon (eds.), Pedone, 2016).

[8] For a cross-cutting study, see Karen Vandekerckhove, Piercing the Corporate Veil 86 (Kluwer, 2007); Stephen M. Bainbridge & M. Todd Henderson, Limited Liability – A Legal and Economic Analysis 86 (Edward Elgar, 2016).

AIOC and Transport that those entities would be considered to be mere instrumentalities".[9]

Without having the intention to list exhaustively the criteria applied by domestic courts, it is important to note that the sole existence of constant intra-group relations is not sufficient to lift the corporate veil. It is necessary to gather evidence showing the absence of separation of business activities, continuous interferences in the business of the subsidiary, the existence of common executives and directors in the two entities, a chronic undercapitalization of the subsidiary due to a siphoning off of the profits of the subsidiary, etc. Legislative authorities have already adopted some special rules of attribution in order to facilitate corporate veil piercing in certain cases. For instance, Article L512-17 of the French environmental Code imposes on the parent, the duty to compensate environmental damages that cannot be covered by the subsidiary whenever it is established that a misconduct from the parent lead to the subsidiary's lack of assets.

In the field of European Union (EU) competition law, standards of attribution are less stringent and consecrate a genuine responsibility of corporate groups. Besides, it is important to note that EU disciplines regarding anti-competitive practices (Treaty on the Functioning of the EU, articles 101 and 102) apply to "undertakings" and it was thus, necessary for the Court of Justice of the EU to define this notion.[10] Such standards facilitate the work of the EU Commission when it comes to collecting fines from insolvent subsidiaries or imposing larger fines since they are based on the turnover of the whole corporate group.[11] Attributing the liability to the parent company neither requires to be proved that it played any role, active or passive, in the infringement nor that it had been made with its knowledge. It suffices to attest that the parent can exert decisive influence on the conduct of its subsidiary. Besides, the Court of Justice of the EU (CJEU) considers the fact that when 100% of the shares in a subsidiary are held by its parent, it generates a rebuttable presumption (but irrebuttable in practice) that the latter exerts decisive influence over the former.[12] It is also noteworthy to mention some arguments that have been raised by parent companies to attest the autonomous conduct of their subsidiaries. Some of them are indeed similar to those raised in transnational litigation targeting multinational corporations of human rights or environmental abuses. When the parent alleges

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[9] Oil Spill by the "Amoco Cadiz" off the Coast of France on March 10, 1978, In re, MDL docket no. 3, 76 ND III. 1984, American Maritime Cases, 2123-2199. See also, Vandekerckhove, *supra* note 8, at 85.

[10] WALTER FRENZ, HANDBOOK OF EU COMPETITION LAW 202 (Springer, 2016).

[11] EC Treaty arts. 81-82 (as in effect December, 2002) (now TFEU articles 101 and 102).

[12] Case C-97/08, *Akzo Nobel NV e.a. v. Commission*, 2009 E.C.J.

that it does not play any role in the commercial policy of the subsidiary, the European courts hold that in large corporate groups, "the division of tasks constitutes a common practice".[13] They have also noted that the implementation of a "philosophy of maximal delegation of functions to subsidiaries does not constitute an evidence likely to prove their autonomous conduct".[14]

Therefore, there exists a significant asymmetry between the loose conditions under which the corporate veil can be lifted in competition cases and the more stringent ones for other types of litigation. EU competition law also shows that there is no insurmountable obstacle (stemming for instance from corporate law principles) to implementing a different standard of attribution of the conduct of the subsidiary to the parent when it comes to human rights or environmental litigation – unless we consider that market competition is an overriding objective deserving special protection. Recent evolutions of corporate social responsibility have nonetheless shown that the more radical solutions implemented in EU competition law have not been a source of inspiration. It is within this framework that it is necessary to show that the current promotion of an *ex ante* "responsibilisation" of corporations through a "duty of care" owed by the parent company has important shortcomings.

II. The Mirages of the Emerging Duty of Care (Ex Ante "Responsabilisation")

The difficulties surrounding corporate veil piercing through an attribution of the acts of the subsidiaries to the parent have left gaps in holding multinationals accountable. It is for this reason that emerging disciplines of corporate social responsibility have focused on the obligations of the parent company – among which, its duty of care in relation to the activities of its subsidiaries.[15] This duty is based on the idea that the parent has an obligation to be interested in the activities of its subsidiaries regardless of whether they enjoy wide management autonomy. The rationale for the duty of care of the parent is both to prevent harmful conduct as well as to fix a point (the parent) to which responsibility may be assigned.

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[13] Arkema SA v. Commission, TEU, 30 September, 2009, T-168/05 80.

[14] Legris Industries SA v. Commission, TEU, 24 March 2011, T-376/06 53. (a "*philosophie de délégation maximale aux filiales ne constitue pas un élément de preuve susceptible de démontrer l'autonomie de ces dernières*").

[15] Nicolas Cuzacq, *Le devoir de vigilance des sociétés mères et des donneurs d'ordre*, *in* La RSE Saisie Par le Droit – Perspectives Interne et Internationale 453 (Kathia Martin-Chenut & René de Quenaudon (eds.), Pedone, 2016).

Before being enshrined in domestic legislation, the duty of care of parent companies had already been recognized in some precedents, such as in *Chandler v. Cape*. A claim was brought before British courts against the parent company following the contraction of asbestosis by an employee of a subsidiary. The issue at stake was not about piercing the corporate veil but rather to determine what the obligations of the parent company towards the employees of its subsidiaries was. In 2012, the Court of Appeal held that the parent company had a direct duty of care concerning the health and safety of such employees, but only under strict conditions: the parent company and its subsidiary had similar businesses and the parent company had superior knowledge of the risks involved by such activities (knew, or ought to have known) and it knew or ought to have foreseen that the subsidiary or its employees would eventually rely on using that superior knowledge. It is also noteworthy to mention that at the time of that litigation, the subsidiary entity had been dissolved, thereby implying a risk of denial of justice.[16]

While applied by domestic courts under stringent criteria, this "duty of care" has become, these past years, the new credo of CSR, being sometimes enshrined under a different label such as the "due diligence" obligation.[17] It has progressively – yet timidly – been incorporated in domestic statutes. It is the case of the UK Bribery Act of 2010 which introduced an obligation to develop "adequate procedures" of due diligence to prevent bribery.[18] The obligations of corporations (designated as "commercial organisations") are vaguely worded in this piece of legislation. Besides, the Act indicates that "the Secretary of State must publish guidance about procedures that relevant commercial organisations can put in place to prevent persons associated with them from bribing".[19] It was eventually done in 2011.[20] A similar due diligence obligation has been incorporated in the recent French anti-bribery statute adopted in 2016 but implementation measures have not yet been adopted.[21]

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16 Chandler v. Cape Plc., (2012) 1 WLR 3111 : 2012 EWCA Civ 525 at 80.

17 Guiding Principles on Business and Human Rights (Implementing the United Nations "Protect, Respect and Remedy" Framework), Endorsed by the UN Human Rights Council in its resolution 17/4 of 16 June 2011, Principle No. 17 (noting that "in order to identify, prevent, mitigate and account for how they address their adverse human rights impacts, business enterprises should carry out human rights due diligence").

18 Obligation stemming from Section 7 of the UK Bribery Act titled "failure of commercial organisations to prevent bribery".

19 UK Bribery Act, Section 9(1).

20 The Bribery Act 2010 – Guidance about procedures which relevant commercial organisations can put into place to prevent persons associated with them from bribing (section 9 of the Bribery Act 2010), March 2011, https://www.justice.gov.uk/downloads/legislation/bribery-act-2010-guidance.pdf.

21 Loi 2016-1691 of 9 December 2016 relative à la transparence, à la lutte contre la corruption et à la modernisation de la vie économique.

On a much larger scale, the French Parliament adopted in March 2017 a new Statute – kept in limbo for a considerable time – implementing a general duty of care (*devoir de vigilance*) of companies with respect to the activities of their subsidiaries and suppliers.[22] This statute imposes on companies of a certain size an obligation to establish, publish and implement a "vigilance plan" which includes reasonable measures aimed at identifying and preventing serious breaches to human rights and adverse impacts on health and on the environment stemming from the activities that a company controls, directly or indirectly, through subsidiaries or suppliers with whom it has an established commercial relationship.[23] If the company fails to meet its obligations of vigilance, the statute provides that it will have to compensate for the harm which the proper fulfilment of its obligations would have avoided.[24] While the claimant would still have to prove a causal link between the fault of the company and the damage they have suffered, the new system aims at circumventing legal obstacles arising out the principle of separate legal personality and the stringent standards applicable to corporate veil piercing.

While some felt that the new statute would eventually affect the competitiveness of French corporations[25], it has some weaknesses that could potentially diminish its effectiveness. Of course, the implementation of the vigilance plan increases the accountability and awareness of corporations but such a plan could be designed so as to optimize the protection of the parent. It is important to note the considerable uncertainty surrounding some notions listed in the statute. It indicates that the "vigilance plan" must incorporate "risk mapping" (*cartographie des risques*), "assessment procedures" (*procedures d'évaluation*) of subsidiaries and suppliers, "risk mitigation" tools, and a "warning mechanism" (*mécanisme d'alerte*").[26] Implementation measures will probably clarify these requirements but this must not overshadow the fact that this new scheme will generate legal-managerial engineering, driven by audit and consulting firms, to conceive vigilance plans that would eventually shield the parent company from liability. The statute indeed specifies that it is a failure to comply with requirements relating to the vigilance plan that could eventually lead to an obligation to compensate the harm suffered. This is particularly blatant if we look at the

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[22] Loi 2017-399 of 27 March 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre.

[23] Code de commerce [C. com.] [Commercial Code] art. L225-102-4-I.

[24] Code de commerce [C. com.] [Commercial Code] art. L225-102-5-I.

[25] *See* for instance during the travaux préparatoires, Rapport fait au nom de la Commission mixte paritaire chargée de proposer un texte sur les dispositions restant en discussion de la proposition de loi relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre, AN n° 4184, Sénat n° 99, 2 November 2016. See also, Nicolas Cuzacq, *supra* note 15, at 453.

[26] Code de commerce [C. com.] [Commercial Code] art. L225-102-4-I.

parliamentary discussion. An MP stressed that the statute has not implemented an "obligation of result" but rather a "best effort obligation". He also pointed out that "if an accident occurs, which could unfortunately happen, the corporation would have to prove that it took precautionary measures, for instance to prevent the cascade of subcontractors from being to opaque, and this will be sufficient to escape liability".[27] The UK Bribery Act includes a provision which perfectly illustrates this philosophy by underlining that "*it is a defence for (a commercial organisation) to prove that (it) had in place adequate procedures designed to prevent persons associated with (it) from undertaking such conduct*".[28] We could also anticipate exculpatory synergies stemming from a loose duty of care coupled with the common law doctrine of the "business judgment rule" which – provocatively put – can be described as the "managerial margin of appreciation" pursuant to which it is not the province of courts to assess the economic or strategic opportunity of executives' decisions taken in good faith.

As a consequence, when it comes to the responsibility of multinational corporations, the fortress of corporate veil (except in competition law matters) is to be superseded by the managerial shield of duty of care. On a side note, one can be surprised that the standard of responsibilisation and of responsibility implemented under such frameworks are similar for the activities of subsidiaries and of suppliers. It is clear that the influence exerted over suppliers can be as significant as that exerted over subsidiaries. To that extent, the obligation to control suppliers is a useful step forward. Would it be necessary, however, to consider that the position of subsidiaries is specific since they belong to the capital structure of the enterprise and that their acts, as a result, should be deemed to be attributable to the parent?

III. Limited Liability as an Accident of History

A historical analysis of the evolution of corporate law shows that the current situation giving full effect to limited liability and limiting the possibility of a genuine enterprise liability eventually constitutes an anomaly. Indeed, History shows that three key ruptures occurred in the nineteenth century: the first concerns the changing nature of joint stock companies (1), the second deals with the incidental emergence of corporate groups (2) and the third

[27] Declaration of MP Dominique Raimbourg. See, Rapport fait au nom de la Commission mixte paritaire, *supra* note 25 ("si un accident se produit, ce qui peut malheureusement arriver, l'entreprise devra montrer qu'elle avait mis en œuvre des mesures et pris des précautions, par exemple pour éviter que la cascade de sous-traitants ne soit trop opaque, et cela suffira ä dégager sa responsabilitë").

[28] UK Bribery Act, section 7(2).

concerns the extending scope of the limited liability of legal persons (3). On those distinct aspects, the writings of Jean-Philippe Robé[29], Paddy Ireland[30], Phillip Blumberg[31] as well as Stephen Bainbridge and Todd Henderson[32] have been extremely influential.

A. The Changing Nature of Joint Stock Companies

First, it should be recalled that the creation of the first joint stock companies was not originally a right accessible to anyone but rather a privilege granted by the State for the implementation of projects of general interest (building bridges, exploitation of mines, etc.). Robé explains that, in the vision of liberal society that prevailed after the French Revolution, there can be no recognition of any form of authority of intermediate bodies interposing themselves between the State and the individual. Besides, this led to the adoption of the "Loi Le Chapelier" of 1791 which banned all types of guilds and to a rising suspicion *vis-à-vis* corporations.[33] Following the former "companies" which needed to be recognized pursuant to a Royal charter in the seventeenth and eighteenth centuries, the first joint stock companies were only incorporated in France after an authorization granted by the government. The process was particularly long and costly[34] and archives shows that the "public interest" objective of the entity was scrupulously scrutinized.[35] While procedures were different in the US and the UK at that time, the "public interest" criterion remained the same. Some authors also underline that the limited liability granted to those entities fulfilling public objectives derives from the principle of absolute sovereign immunity which was then prevalent.[36] The stringent procedures governing the creation of corporations were aimed at regulating institutions which were regarded as "necessary but dangerous".[37] Limited liability was deemed necessary for economic initiative but was potentially a source of negative externalities and moral hazard.[38]

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29 Robé, *supra* note 1.
30 Ireland, *supra* note 6, at 837.
31 PHILLIP I. BLUMBERG, THE MULTINATIONAL CHALLENGE TO CORPORATION LAW – THE SEARCH FOR A NEW CORPORATE PERSONALITY (Oxford University Press, 1993).
32 Stephen M. Bainbridge & Todd Henderson, *supra* note 8.
33 Robé, *supra* note 1, at 84.
34 ANNE LEFEBVRE-TEILLARD, LA SOCIÉTÉ ANONYME AU XIXE SIÈCLE – DU CODE DE COMMERCE À LA LOI DE 1867 : HISTOIRE D'UN INSTRUMENT JURIDIQUE DU DÉVELOPPEMENT CAPITALISTE 21 (PUF, 1985).
35 Robé, *supra* note 1, at 86.
36 Stephen M. Bainbridge & Todd Henderson, *supra* note 8, at 25.
37 Anne Lefebvre-Teillard, *supra* note 34, at 22.
38 Anne Lefebvre-Teillard, *supra* note 34, at 22. See also, Paddy Ireland, *supra* note 6, at 844.

However, by mid-nineteenth century, most of those requirements were progressively dismantled in the US due to regulatory competition between federated states wishing to be more economically attractive. A similar evolution was observable in Europe after the main occidental powers adhered to economic liberalism.[39] This has resulted, for instance in France, in the law of 24 July 1867 which abolished the condition of prior governmental authorization, thereby, shifting corporations into a private law framework.[40] This evolution constituted a historic turning point that has allowed the constitution of private powers and, as a consequence, the coalition of affected stakeholders.[41] It is not a coincidence that at the same time, in 1864, France adopted the "Loi Ollivier" abolishing the criminal offense of coalition and subsequently in 1884, the "Loi Waldeck Rousseau" recognizing trade union freedom.

B. The Incidental Emergence of Corporate Groups

Until the end of the nineteenth century, particularly in the US, only individuals had the possibility of holding corporate shares. It was prohibited for corporations unless a specific authorization was granted by Statute. Those restrictions were progressively dismantled following several reforms adopted by the state of New Jersey in 1888, 1889 and 1893.[42] The states of New York, Delaware and Maine followed this lead as they wished to preserve the fiscal resources resulting from incorporation of businesses. This led to the formation of large corporate groups which "replaced trusts as the preferred technique for achieving corporate concentration".[43]

It is also not a coincidence that at the same time competition law emerged in the US with the adoption of the Sherman Act of 1890 and the creation of the Federal Trade Commission in 1914. Besides, in 1910, US President Taft proposed the Congress adopt a prohibition of intercorporate ownership of stock but the initiative was eventually unsuccessful[44].

C. The Extending Scope of Limited Liability

The possibility of constituting large corporate groups coupled with the device of limited liability increased the opportunities for legal engineering. It is noteworthy to mention that between the end of the nineteenth century and

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[39] Robé, *supra* note 1, at 88-90.
[40] Anne Lefebvre-Teillard, *supra* note 37, at 417.
[41] Robé, *supra* note 1, at 101.
[42] Blumberg, *supra* note 31, at 56.
[43] Blumberg, *supra* note 31, at 56.
[44] Blumberg, *supra* note 31, at 58.

the beginning of the twentieth, the legal regime of limited liability evolved in a way that was very favourable to corporations. Initially, a distinction existed between contractual liability and liability for torts.[45] Before discussing this evolution it is necessary to present the underlying issues at stake.

Those contracting with a limited liability entity have the possibility of assessing and eventually accepting the risks stemming from that limitation. However, third persons who suffer on account of the prejudice caused by a limited liability entity have not consented to such limitation. It is therefore possible to question the legitimacy of its effectiveness against third-parties.[46] The question is, whether, it is legitimate that the parent company can benefit from the profits generated by some subsidiaries while circumscribing the losses of others exceeding their contributions. This could induce enterprises to lodge hazardous activities in specific subsidiaries.[47]

The effectiveness of limited liability against third-parties can be regarded as an anomaly. Besides, there had been a debate before US courts as to whether limited liability of shareholders for *debts* should extend to its *liabilities* within the framework of tort claims. The solution depended on how the corporate laws of federated states were drafted. For instance, Californian law made a distinction between responsibility for contractual debts (with limited liability) and torts (no limited liability) until the 1930s.[48] But for the great majority of state legislation, only a reference was made to the limited liability of shareholders for *debts*. The US Supreme Court, following the position of New York courts, considered in *Chase* v. *Curtis* in 1885 that, if no clear distinction existed in state legislation, limited liability shall apply to the responsibility for both debts and torts.[49] Thus, when it concerns tortious liability, corporations have also benefited from the advantages stemming from the corporate veil.

Each of these three evolutions is of a certain importance but they are absolutely fundamental when taken as a whole. They have indeed enabled the development of a legal engineering aimed at the optimization of corporate structures relying greatly on limited liability and the principle of separate legal personality. This historical and critical reinterpretation of corporate

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[45] Gwynne Skinner, *supra* note 3, at 1792.

[46] Pierrick Le Goff, Faut-Il Supprimer Les Sociétés À Risque Limité? Apport Et Critique De L'analyse Économique Américaine Du Droit Des Sociétés, Revue Internationale De Droit Comparé 598-599 (1999).

[47] Henry Hansmann & Reinier Kraakman, *Toward Unlimited Liability for Corporate Torts*, 100 Yale Law Journal 1881 (1991).

[48] Stephen M. Bainbridge & Todd Henderson, *supra* note 8, at 40-42.

[49] Chase v. Curtis, 1885 SCC OnLine US SC 62 : 28 L Ed 1038 : 113 US 452 (1885). Gwynne Skinner, *supra* note 3, at 1793-1794.

law should prompt us to rethink the issue of enterprise responsibility from a different angle.

IV. RETHINKING ENTERPRISE RESPONSIBILITY

Corporations generate wealth but are also externality-producing devices.[50] Wealth can move almost freely throughout the corporate structure for instance, the payment of taxes at the group level or the transfer of dividends. However, when it comes to address the negatives externalities generated by the subsidiaries, the parent company is shielded from liability. It is therefore necessary to redress this asymmetry in order to align the rights and obligations of multinationals.

A. An Analogy with State Responsibility

Given the commonalities with regard to the structures of corporations and of states, one option would be to follow the rules of State responsibility concerning the attribution of an internationally wrongful act to a state. One of the key principles with respect to the attribution of conduct is the irrelevance of the State's internal legal structure: whatever is the horizontal or vertical separation of powers within the State, the conduct of one of its organs is deemed one of its own[51], regardless of its level of independence, even in cases of *ultra vires* acts, "if it exceeds its authority or contravenes instructions".[52] It is also noteworthy to mention the case of persons or entities not within the structure of a State but whose conducts are attributable to the state if they are "in fact acting on the instructions of, or under the direction or control of, that State in carrying out the conduct" (*de facto organs*).[53]

A parallel can be drawn with corporations: they have the possibility of choosing to carry out their activities in-house or through subsidiaries, subcontractors or suppliers. In that respect, three things ought to be pointed out. First, when a corporation decides to subsidiarise activities, those activities are carried out within the same economic structure. The possible offences or torts committed by the subsidiary should therefore be attributable to the parent, even in case of *ultra vires* acts, namely if the subsidiary does not respect the vigilance plan implemented by the parent. In that sense a subsidiary can

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[50] Robé, *supra* note 1, at 393.

[51] Articles of the International Law Commission (ILC) on the Responsibility of States for Internationally Wrongful Acts, Article 4(1); JAMES CRAWFORD, STATE RESPONSIBILITY – THE GENERAL PART 116 (Cambridge University Press, 2013).

[52] *Ibid.*, Article 7. See also, James Crawford, *supra* note 51, at 136.

[53] *Ibid.*, Article 8. See also, James Crawford, *supra* note 51, at 141.

be regarded as an organ of the enterprise just like a political subdivision of a State is one of its organs under international law. Second, when the activities are outsourced or subcontracted to a different entity, a distinction must be drawn between two different situations. If a decisive economic influence is exerted over the supplier or subcontractor, it is a situation of *de facto* control over the external entity and, consequently, its behaviour should be attributed to the client company. This was the approach of the US federal Court in *Doe v. Nestle* in which it was held that the client company exerted "their control over the cocoa market" and that they "continue to supply money, equipment, and training to Ivorian farmers, knowing that these provisions will facilitate the use of forced child labour"[54]. Third, even if the client company does not exert a decisive influence over the supplier or subcontractor, the former owes a duty of care with regard to the activities of the latter and should therefore cut its economic ties with the latter if it "knew, or ought to have known" that the supplier or subcontractor was involved in serious breaches of human rights, environmental regulations or anti-bribery laws. Interestingly, when adopted in domestic legislation, the duty of care (or of vigilance) applies to the corporation in the same way for subsidiaries, suppliers or subcontractors with whom it has an established commercial relationship while our position is that it should apply only with regard to suppliers or subcontractors over which the corporation does not exercise a decisive influence. The applicable standard envisaged in the recent French legislation – which was supposed to be revolutionary – does not jibe with the economic reality of business organizations.

Our historical and critical reinterpretation of the evolution of corporate law shows that limited liability was an accident of history stemming from a regulatory race to the bottom[55] and that it was both legitimate and economically appropriate for the parent to bear the responsibility for the conduct of its subsidiaries. A comparison with the international responsibility of states leads to the same inference. Besides, when a State cannot raise its domestic legal structure as defence (the contentious act was committed by a province enjoying a status of independence in the federal State) for a violation of international law (for instance international human rights), it would be incongruous if a parent company could do so.

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[54] Doe v. Nestle, No. 10-56739, D.C. No. 2:05-CV-05133- SVW-JTL (9th Cir Sep. 4, 2014).

[55] Karen Vandekerckhove, *supra* note 8, at 9 (noting with regard to limited liability "its possibly historically accidental nature and (…) its alleged lack of economic justification").

B. One Conceivable Proposal

The question to be determined is, what would be the optimal strategy to ensure the emergence of a new principle of attribution of the subsidiary's conduct to the parent – taking into account that such a principle may appear as revolutionary and even shocking.[56] A first option could be to abolish limited liability in domestic corporate laws or, on a less radical approach, to limit the responsibility in proportion to equity participation when it comes to tortuous liability.[57] This proposal seems inconceivable since it would require a coordinated and harmonized legislative intervention of several states (and of federated states in a federal context such as in the US) on a matter for which resistance will be encountered.[58] This would also raise several insoluble conflict of laws issues.[59] A second option would be to envisage an international treaty including a list of substantive obligations for multinational corporations (for instance those of the OECD Guidelines for Multinational Enterprises) as well as a regime of strict liability that would be borne by the parent for any violation of the substantive obligations committed by one of the subsidiaries. Claims could be brought before international (for instance the model of the International Criminal Court) or domestic courts. In the latter case, the strict liability imposed on the parent would prevail over domestic rules of limited liability and of distinct legal personality. This second option has the advantage of piercing the corporate veil only for the substantive obligations listed in the treaty. Such a project is, however, not realistic and politically feasible. Keeping in mind the resistance to soft law instruments that deal with corporate social responsibility, there would obviously be no international consensus on such a treaty.

The ultimate option has the merit of being possibly experimented in the long run. It would rest on codes of conduct or other types of unilateral commitments adopted by corporations within the framework of their CSR strategy. While such undertakings are usually exploited as public relations tools[60], the outreach would be different if the parent company accepts to (1) bear the liability stemming from the conduct of any entity included in

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[56] Pierrick Le Goff, *supra* note 46 , at 595.

[57] Henry Hansmann & Reinier Kraakman, *supra* note 47, at 18.

[58] Karen Vandekerckhove, *supra* note 8, at 9 (underlining that "it would seem unthinkable today to deny the benefit of limited liability to multinational groups whose organization is entirely based on this rule. Limited liability has become a fact of international corporate life").

[59] Pierrick Le Goff, *supra* note 46, at 605.

[60] Kathia Martin-Chenut & Juliette Tricot, *La loyauté des engagements : La RSE prise au mot par le droit*, *in* LA RSE SAISIE PAR LE DROIT – PERSPECTIVES INTERNE ET INTERNATIONALE 363 (Kathia Martin-Chenut & René de Quenaudon (eds.), Pedone, 2016).

the group's accounting consolidation scope (thus, including subsidiaries) and (2) consent to the jurisdiction of the domestic courts of states where it is incorporated or where the group conducts business activities. Some general comments can be made regarding those three elements.

First, there is no insurmountable obstacle to impute the responsibility on the parent for the conduct of its subsidiaries. This has already been implemented in the US within the framework of anti-corruption procedures based on the Foreign Corrupt Practices Act (FCPA). For instance, the Alstom case involved several violations committed by different subsidiaries (Alstom Network Schweiz, Alstom Power, Alstom Grid). Eventually, it is the parent company Alstom S.A. which accepted through a guilty plea to pay the financial penalty of $ 772 millions for all infringements.[61] Agreements concluded between US authorities and its subsidiaries specify that they are not liable to fines "because Alstom S.A., the parent company of the Company, pursuant to a separate plea agreement, has agreed to pay a fine of $772,290,000 relating to the same underlying conduct".[62] The agreement concluded between US authorities and Alstom S.A. also indicates that the latter and its subsidiaries shall not accept any reimbursement or compensation, from any source and that the fine shall not be subject to tax deduction.[63] This example clearly shows that the consent of the parent company can constitute the source of attribution of liability.

Second, the group's accounting consolidation scope seems to be the more relevant criterion in order to determine the scope of application *ratione personae* and identify entities whose contentious conduct is eventually attributable to the parent. Three arguments can be raised. In the first place, there are international standards on that matter adopted by the International Accounting Standard Board (IASB) specifying different forms of corporate control in order to determine what constitutes a "single economic entity".[64] Additionally, when corporations advocate for a recognition of the "group interest"[65] in order to justify the legality of intra-group transactions that are detrimental to the subsidiaries but beneficial from a group perspective, they

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[61] United States of America v. Alstom SA, Plea Agreement, US District Court of Connecticut, 22 December 2014, https://www.justice.gov/file/189331/download.

[62] United States of America v. Alstom Grid, Inc., Deferred Prosecution Agreement, US District Court of Connecticut, 22 December 2014, https://www.justice.gov/file/189296/download.

[63] United States of America v. Alstom SA, *supra* note 61, at 18.

[64] The standard IFRS 10 titled "Consolidated Financial Statements" has been incorporated in EU law through regulation 1254/2012 adopting certain international accounting standard (Official Journal of the EEU, 29 December 2012, L360/1).

[65] On this notion, see, Charley Hannoun, Le Droit Et Les Groupes De Sociétés 83 (LGDJ, 1991).

also rely on the criterion of accounting consolidation scope.[66] Finally, it is through the accounting consolidation scope that corporate groups present themselves to a large categories of actors (shareholders, financial institutions, financial regulatory authorities, etc.). This criterion has therefore the advantage of being both objective and consistent with how the group perceives itself as an economic entity.

Third, the parent's consent to the jurisdiction of domestic courts of states where it is incorporated and where the group conducts business activities can solve all private international difficulties related to the issue of jurisdiction. It is particularly the case when the contentious behaviour occurs in a country different from the place of incorporation of the parent. Moreover, by recognizing the jurisdiction of the domestic courts where the group conducts business activities (a criterion existing in the French new anti-bribery statute)[67], the risks of regulatory arbitrage concerning the localization of the parent company are offset.

In a more prospective sense, it is also possible to envisage the framework under which such a commitment could be undertaken. The corporation's unilateral consent has the advantage of necessitating neither a modification of domestic corporate laws nor for states to accept an international binding instrument. It can be built onto one or several existing CSR international instruments, like the OECD Guidelines for Multinational Enterprises or the UN Human Rights Council Guiding Principles on Business and Human Rights. A possible strategy rests on the idea that a corporate group cannot claim compliance with the said instrument without unilaterally consenting, first, to bear the liability stemming from the conduct of any entity included in the group's accounting consolidation scope and, second, to the jurisdiction of domestic courts in the aforementioned way. In this regard, the reputational dimension of CSR could constitute a useful leverage to ensure the widest possible dissemination of this discipline initially, with the more virtuous multinationals or at least those those wishing to appear as such.

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[66] As pointed out by a recent report on that matter, "out of simplicity and uniformity among the Member States, the definition of the group should be based on the accounting consolidation exercise, which is a concept that is already harmonised at the EU level through European directives. Thus, a company is included within the consolidation scope if an exclusive control, a joint control or a notable influence is exercised by the parent company" (Anne Outin-Adam & Didier Martin, *Towards Recognition of the Group Interest in the European Union*, Report from the "Club des Juristes" 22, June 2015, http://www.leclubdesjuristes.com/wp-content/uploads/2015/06/CDJ_Rapports_Group-interest_UK_June-2015_web.pdf). See also, YANN QUEINNEC & WILLIAM BOURDON, RÉGULER LES ENTREPRISES TRANSNATIONALES – 46 PROPOSITIONS, FORUM POUR UNE NOUVELLE GOUVERNANCE MONDIALE 20 (2010,).

[67] Article 21 of Loi 2016-1691 of 9 December 2016 relative à la transparence, à la lutte contre la corruption et à la modernisation de la vie économique.

This new mechanism would rely exclusively on the unilateral consent of corporations and therefore can be gradually implemented. It has the advantage of simplicity and would be an effective alternative to the emerging duty of care for which one may dread that it is just a new occasion to make a new form of legal engineering prevail – similar to the one that has been deployed to take advantage of limited liability. Paved with good intentions, this duty of care has probably improved corporate groups practices. However, it overshadows the need for a radical upheaval of the historical accident of limited liability in order to better address contemporary challenges implied by the activities of multinationals. Such a (r)evolution is in line with the natural course of history. The history we are going through as well as the one we have inherited.

A Critical Analysis of the Relationship between Corporate ownership and governance*

Pratiek Sparsh Samantara and Kemi Gupta

Most Indian companies display a concentrated stock-ownership pattern, that is, the shares of companies are concentrated in only a few hands – and typically, controlled by families. However, our modern corporate governance pattern follows the Anglo-Saxon approach, which was developed to regulate companies with more dispersed ownership of shares. In such a scenario, it would be useful to probe into a) whether there is any correlation between a particular model of corporate governance and profitability; and b) whether the Anglo-Saxon model of dispersed stock-ownership is the more 'evolved' and better option.

The authors seek to answer these questions by demonstrating the theoretical underpinnings, and economic rationale behind corporate ownership structures and governance practices. Specifically, assumptions about 'The Modern Corporation' in the pre-eminent Berle-Means hypothesis are revisited, and

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the theories of Natural Progression and Path Dependence critiqued in tracing the evolution of governance structures. These structures are manifested today in two broad categories – Insider, and Outsider systems. The authors compare laws and policies from either of the two systems in studying their respective benefits and shortcomings.

Finally, the Indian model of corporate governance is scrutinized in underscoring the fact that transplantation of Anglo-Saxon governance systems leads to inconsistencies. It is forwarded that systems of corporate governance must be derived keeping in mind the concentrated-ownership structure of Indian companies, and certain positive measures appurtenant to this context – like the Independent Directors provision in the Companies Act, 2013 – must be crafted more rigorously to ensure protection of minority shareholders.

I. INTRODUCTION

The highly influential Cadbury Committee Report[1] had defined corporate governance as a "*system by which companies are directed and controlled*". This paper attempts to deconstruct systems of corporate governance to establish a very important aspect that has led to their current form: patterns of ownership. In this study of the history and evolution of corporate structures, various questions arise. Is there one efficient model of ownership? Concomitantly, can governance practices from such a model be transplanted in jurisdictions that exhibit an entirely different ownership pattern? The latter question is not as far-fetched as it may sound, and the Indian framework bears testimony to that fact.[2] In attempting to answer these questions, one is compelled to analyze the systems of governance that exist in various countries, their economic rationale, and sustainability in other climates.

In this vein, **Section B** of the paper scrutinizes the first major academic work related to the topic: *The Modern Corporation and Private Property* by Professors Adolf Berle and Gardiner Means. **Section C** delineates the theories on the evolution of ownership structures. **Section D** describes the frameworks of corporate governance subsisting in countries that may be broadly divided into the two categories of 'insider' and 'outsider' economies based on ownership and control. Finally, **Section E** dissects the Indian model and comments on its suitability.

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[1] FINANCIAL REPORTING COUNCIL, REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE (1992).

[2] Refer to Section E of this paper.

II. THE BERLE-MEANS CORPORATION

The Modern Corporation and Private Property was a seminal work of authorship in the subject of corporate law that laid the empirical foundations for theorization on corporate structures. Studying businesses in America, Professors Adolf Berle and Gardiner Means arrived at the thesis that the emergence of corporate ownership had resulted in a flux in the very understanding of private property. A corporation is not owned by shareholders in the same sense that say, a bicycle or a house is. The shareholders are the owners, but they exercise control over the corporation only through the board of directors. Thus, there is a separation of ownership and control. The concern that the Professors shared was that the owners of the company are becoming increasingly passive (shareholder apathy), and control over the firm is being exercised more and more by the management (leading to problems of agency). Challenging conventional assumptions of investments and rewards, they found that the structure is such that the capital is held by 'innumerable individuals', while the control is surrendered to a 'unified direction'. To quote Carl Furstenburg,

> "Shareholders are stupid and impertinent - stupid because they give their money to somebody else without any effective control over what this person is doing with it - impertinent because they ask for a dividend as a reward for their stupidity."

Put another way, the size of investments and the decision-making powers of owners (especially the latter) have been lowered to such levels that rather than have a claim over the profits of her investment, the owner has become the mere 'recipient of the wages of capital'. More worryingly, corporate law has ensured that production in a society is 'not governed by blind economic forces', but is held at ransom by a few powerful individuals in control of giant and widespread enterprises. The book was published in 1932, but many of its findings and suggestions are relevant even today. Many corporate-law theorists have argued for the very justification of corporate governance[3], and a specific type of corporate governance[4], based on the Berle and Means hypothesis.

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[3] Jensen, Michael C. and Meckling, William H., *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, J.F.E., Jul. 1976; Michael C. Jensen, *A Theory Of The Firm: Governance, Residual Claims And Organizational Forms*, J.F.E., May. 1999.

[4] John Armour and Jeffrey N. Gordon, The Berle-Means Corporation in the 21st Century (UPENN, Working Paper, 2008).

However, it has been subject to re-interpretation and criticism over the years. For example, authors have raised doubts about the universality of dispersed ownership, and consequently aimed to debunk the transformative powers of 'managerial capitalism'.[5] Other theorists have challenged the preponderance of economic grounds for the success of the 'Berle-Means corporation', seeking to explain the same as a political accident.[6] A few works have sought to highlight the distinctions between the 'Berle-Means corporation' and the companies existing today – primarily in terms of their set-up of management.[7] They allude to the presence of CEOs on company boards, termed as inside directors; and claim that while Berle and Means had conflated this category with that of outside directors[8], the two should be distinguished as management (officers) and board respectively. It was observed that the officers exercised the real power in a company, and the outside directors were mere 'rubber stamps'.[9]

However, the growth of a class of professional directors who sat on the boards of a number of companies was seen by many as a reaffirmation of the Berle and Means hypothesis that a small group of individuals have been handed the reins to the entire financial system. Modern theorists term the effect as 'interlocking'. This created a centralized network of inter-related firms.

The existence of a certain structure of corporate ownership enjoins the legal systems of countries to come up with corrective measures for associative problems that might emerge. For example, as has been detailed above, a diffused ownership structure creates agency problems and shareholder apathy. One aim of corporate governance frameworks in this regard would thus be to ensure adequate flow of information between the management and shareholders. Tools that are to be applied here cannot be utilized universally, as they are specific to the structure. Hence, it is important to identify if there is an ideal structure of corporate ownership that all legal systems should strive for, and conjointly, its governance mechanisms that should be applied. To explore these propositions further, one must study the two theories that delineate the evolution of corporate structures.

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[5] Julian Franks and Colin Mayer, *Capital Markets and Corporate Control: A Study of France, Germany and the UK*, E.P., Apr. 1990.

[6] Armour and Gordon, *supra* note 4, at 7.

[7] Mark S. Mizruchi, *Berle and Means Revisited: The Governance and Power of Large U.S. Corporation*, T.A.S., Oct. 2004.

[8] Defined as '*directors whose primary affiliations are with other firms*'.

[9] Mizruchi, *supra* note 7, at 17.

III. THEORIES ON EVOLUTION OF CORPORATE STRUCTURES

A. The theory of natural progression

Professors Berle and Means were proponents of this theory[10], which stated that economies of scale gradually produce large companies.[11] In order to effectively handle companies of such magnitude, it is natural that the risk taken by promoters is distributed among new investors. Essentially, growing companies have a natural incentive to transform into dispersed structures.[12] The criticism of this theory would lie in the fact that it works only as a thought experiment. If applied practically, it would imply that concentration of ownership is a primitive structure that would evolve into dispersion of risk. It excludes considerations of very developed nations that largely have corporations with concentrated ownership and arguments that that very fact is what leads to their development.[13]

Alternatively, there are studies that show a positive correlation between widely-held stock ownership and profitability.[14] The rationales for both arguments deserve consideration. If a few shareholders own a massive chunk of a company's stock, it gives them great incentive to elaborately monitor the company and leads to better control over managerial decisions. This may work in the favour of the minority shareholders – when the company's performance is bettered; or may militate against them – when the controlling shareholders oppress and mismanage. On the other hand, a diffused ownership structure leads to diversification of risk, which allows companies to invest in multiple avenues, thus increasing stability.[15] Furthermore, some works also endorse the notion that placing more control in the hands of the management leads to an enhanced firm performance due to an incentive effect.[16] On the other hand, Professors Lens has hypothesized through an

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[10] ADOLF BERLE and GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[11] It is sought to be clarified that while the Professors Berle and Means did argue that the theory of natural progression is empirical reality, they rejected dispersion of ownership as a model structure and stated that it leads to adverse corporate performance.

[12] Jeremy Grant and Thomas Kirchmaier, Corporate Ownership Structure and Performance in Europe (CEC, Discussion Paper No. 0631 2005) referring to Demsetz, H. and B. Villalonga, *Ownership Structure and Corporate Performance*, J.C.F., Jun. 2001.

[13] Barry D. Baysinger, Rita D. Kosnik and Thomas A. Turk, *Effects of Board and Ownership Structure on Corporate R&D Strategy*, A.M.J., Mar. 1991, at 205-214.

[14] Grant and Kirchmaier, *supra* note 12.

[15] *Id.*

[16] Jensen and Meckling, *Agency Theory and Ownership Structure - Estimating the Effect of Ownership Structure on Firm Performance*, A.U.S.E., Jun. 2012.

economic analysis that there is no observable pattern between ownership structures and profitability.[17]

A key criticism of the aforementioned theory is that it ignores the effects of endogenous or exogenous influences that might mould a financial system to be structured in a certain manner. This may include the role of the state, financial institutions, and various economic or sociological factors. As Professors Zingales and Rajan have stated:

> "financial systems do not .... emerge simply as a result of their superiority in a particular environment. The power of vested interest distorts the process of evolution."[18]

A number of studies chart out the evolution of structures against political or legal events that finally shape a majority of corporations. Thus, it is argued that political events in the late 19th and early 20th centuries led to greater regulatory restraints over large financial institutions, impeding the accumulation of capital which lowered concentrated stakes.[19] Other theories postulate that the degree of ownership concentration depends on the legal protections offered to minority shareholders.[20] Taking into account externalities and offering a reductive view of the inherent nature of corporations helps one arrive at the more nuanced idea of path dependence.

B. The theory of Path Dependence

Professors Bebchuk and Roe, one of the most influential exponents of this theory, argued that a convergence of industrialized nations' corporate governance systems into the Anglo-Saxon model was unlikely to happen; and in the process, raised serious concerns about the economic efficiency of the said model.[21] They identified two forms of path-dependence:

a) Structure-driven – the initial organizational set-up affects emergent companies. This is because of the 'rent-seeking' activities of some individuals, i.e., the persons who benefit under the current system would impede changes to the same. Thus, due to such activities, the

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[17] Harold Demsetz and Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, J.P.E., Dec. 1985, 1155-1177.

[18] Rajan R. and L. Zingales, *Banks and Markets: The Changing Character of European Finance* (NBER, Working Paper No. 9595, 2003).

[19] Markus *Brendt, Global Differences in Corporate Governance Systems Theory and Implications for Reforms* (HLED, Discussion Paper No. 303, 2000).

[20] *Id.*

[21] Schmidt, Reinhard H., *Path Dependence, Corporate Governance and Complementarity* (Department of Finance, Goethe University Frankfurt am Main, Working Paper No. 27, 2002).

structures of some companies will be resistant to change, even if the rules around them are modified.[22]

b) Rule-driven – the original laws, regulations and guidelines etc. affect emergent rules. Again, persons benefiting from the existing system will form interest groups to lobby to the policymaker and ensure that he/she caters to their demands. Thus, the legal rules aiding such structures will be perpetuated, and no overhaul of the model will be allowed.[23]

These rationales apply equally to concentrated as well as dispersed models of ownership. The conclusion that the Professors reach is that a convergence of corporate governance systems is unlikely, as it would be in actors' rational interests to perpetuate divergent systems. As a counterpoint to the first theory conjecturing structures in motion, path-dependence speculates that they remain in a state of inertia.

Having presented both sides of the debate, it would now be appropriate to inspect the two frameworks of corporate governance that emerge as a direct consequence of either kinds of share ownership.

IV. Models of Corporate Governance

A. The Insider Model

This model is found in a number of European countries including Italy, France, Germany, Sweden, and some East Asian countries – primarily, Japan and North Korea.[24] These jurisdictions possess a high concentration of ownership in companies. Typically, wealthy families or the state are the most powerful block-holders. A survey of German companies also finds banks and other important institutional investors to be controlling large stakes.[25] As mentioned above, such block-holders are incentivized to exercise rigorous control over the activities of the firm.[26] However, this does not preclude agency costs – which may arise between majority and minority shareholders as well. It is for this reason that such models also include measures to ensure the flow of information between participants.

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[22] *Id.*

[23] *Id.*

[24] Andrei Shleifer and Robert W. Vishny, *A Survey of Corporate Governance*, J.O.F., Jun. 1997, at 737-783.

[25] Roger M. Barker, *Insiders, Outsiders, and Change in European Corporate Governance*, Paper presented at the Council for European Studies Conference, Chicago, 2006.

[26] Gilson, Ronald J. and Gordon, Jeffrey N., *Controlling Shareholders* (Columbia Law and Economics, Working Paper No. 228, 2003).

In Germany, banks exercise significant proxy voting power through the concept of *Depotstimmrechte*.[27] A few banking conglomerates therefore exercise up to 95% of the voting rights in some companies, single-handedly controlling their direction.[28] The role of the stock market and public shareholding in general is diminutive: the amount of stakes owned by the general public is four times lesser than that in America.[29] In Japan, the system of cross-shareholdings dominates the market. A few major businesses hold most of the shares in all companies, leading to control of being locked up in a few players' hands.[30] This structure births systemic risk and anti-trust concerns.[31]

Some studies[32] argue that the state in Insider economies will be unwilling to enforce contracts impartially or use arms-length contracting due to the lobbying of a few powerful block-holders.[33] It is a fact that companies in such jurisdictions are less capable of amassing the amount of capital that is possible in, say, the USA. They depend on profits and bank-debts for the same. This fact also reasonably explains the evolution of some financial systems into Insider economies. In period immediately following the Great War, most of continental Europe suffered from 'capital immobility.'[34] Only a few resourced individuals and institutions were able to keep companies afloat or invest in them to register growth. Consequently, the governance frameworks that were developed lacked sufficient measures for protection of minority shareholders.[35] As a corollary to this idea, it has also been observed that countries with civil law systems, and especially those with a history of French colonial rule, tend to have lesser protections afforded to minority shareholders.[36] Examples in this regard include Mexico and Venezuela.[37] Alternatively, countries influenced by common law (like India) fare better on this count.[38]

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[27] Alberto Onetti, Alessia Pisoni, *Ownership And Control In Germany: Do Cross-Shareholdings Reflect Bank Control On Large Companies?,* C.O.C., Summer 2009, at 54-77.

[28] *Id.*

[29] *Id.*

[30] Kurt Schussler, *Japan Cross-Shareholdings May Unwind Under New Governance Code*, Bloomberg News (Jun. 1, 2005, 4:45 AM), http://www.bloomberg.com/news/articles/2015-05-31/japan-cross-shareholdings-may-unwind-under-new-governance-code.

[31] David Flath, *Keiretsu Shareholding Ties: Antitrust Issues,* C.E.P., Jan. 1994, at 24 to 36.

[32] Dr. Calin Valsan, Comparative Corporate Governance: A Global Perspective, Bishop's University, http://www3.ubishops.ca/faculty/cvalsan/corporategovernance/textmorecomparativecg.pdf.

[33] *Id.*

[34] Barker, *supra* note 25.

[35] Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, *Investor Protection and Corporate Governance*, J.F.E., 2000, at 3-27.

[36] *Id.*

[37] *Id.*

[38] Refer to Section D.

Works by Raghuram Rajan and Luigi Zingales have suggested that insider companies will resist changes that allow dispersion of stock till they derive large-scale benefits from their holdings.[39] If the market underperforms for an extended period and the controlling block-holders don't receive adequate benefits, then they will be incentivized to diversify their risk and allow the inflow of public capital and dilution of their control.[40] However, this is an extreme scenario. Multiple studies have confirmed that controlling block-holders value the private benefits of control far more than financial returns.[41] These private benefits manifest themselves in terms of self-dealing transactions, tunneling, and nepotism.[42]

Insider systems are also termed as 'relations-based governance' as they rely heavily on trust, reputation-building and honourable actions. A key example is Japan, wherein a great premium is placed on building personal relationships and dealing by a code of honour.[43] This is in direct contrast to the following framework of rules-based governance.

B. The Outsider Model

Found in Anglo-American economies, this model operates on companies with dispersed stock ownership. Most of the issues that a corporate governance system would wrangle with here involve creating adequate mechanisms to reduce agency problems between ownership and management – since there is a clear line of distinction in those domains, as the Berle-Means thesis had proved. Such problems typically relate to the difficulties of monitoring in a dispersed ownership structure. The management is seen as having different motives than the owners, meaning that it is impossible to observe managers' actions without costs being incurred.[44] Additionally, the shareholders holding smaller stakes are not sufficiently incentivized to concern themselves with decision-making and hence lose out on control.

A 2006 research paper found that companies' ownership structure is predominantly composed of portfolio-oriented investors who hold about 3% of the stakes each. The same study forwards how control over the firm is

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[39] Rajan and Zingales, *supra* note 18.

[40] This is known as rent-seeking behavior, and is a cause for path-dependence.

[41] Alexander Dyck and Luigi Zingales, *Private Benefits of Control: An International Comparison* (NBER, Working Paper No. 8711, 2002).

[42] Zohar Goshen and Assaf Hamdani, *Concentrated Ownership Revisited: The Idiosyncratic Value Of Corporate Control*, SSRN Elec. J., Apr. 2013.

[43] *Supra* note 32.

[44] Tuomas Laiho, *Agency Problems and Ownership Structure - Estimating the effect of ownership structure on firm performance*, A.U.S.E., 2011.

effected "*through 'exit', rather than 'voice'*"[45] Thus, a majority of the stakeholders are not concerned with traditional hierarchical control over their property, but sell off their stakes. This is in contrast to the insider system where the private benefits of control outweigh financial returns; here, shareholders would be incentivized to sacrifice control in exchange for liquidity and diversification.[46]

Outsider systems, are also denoted as rules-based contracting or arms-length contracting systems. The onus is placed on the state to develop institutions and regulatory bodies that enforce contracts and resolve disputes. In such systems, the nature of interactions is purely transactional, as it is believed that a strong institutional setup would enable the market to allocate resources correctly. External control measures are the key highlight, as it is presumed that managers would have opportunistic tendencies and would take decisions that ensure private benefits to themselves, prejudicing shareholders. These measures may include a legally enforced mandatory board or shareholders' meeting, or a mandatory auditors' report. Most rules are geared towards the objective of transparency and disclosure. Additionally, what prevents managers from acting in their self-interest is not the rigorous control exercised by insiders, but pressures from outside – be it from the market (takeovers etc.) or the law.

Outsider systems with diffused ownership tend to have more publicly listed firms. As a case in point, the proportion of listed companies in America is far more than that in continental Europe.[47]

It must be noted that even within an outsider system, essential differences in the framework of corporate governance can arise depending on the nature of shareholders, i.e., whether most of the shareholders belong to the institutional or retail categories. Retail investors in USA far outnumber those in UK, which has a higher proportion of institutional investors.[48] As a result, the courts in USA are aggressive when it comes to enforcement of the private actions launched by shareholders. An empirical study by John Armour[49] found that directors in American companies have a 1/250 chance

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[45] Barker, s*upra* note 25.

[46] Goshen and Hamdani, *supra* note 42.

[47] Luca Enriques and Paolo Volpin, *Corporate Governance Reforms in Continental Europe*, J.E.P., Winter. 2007, at 117-140.

[48] Vasiliki Stergiou, The Complex Relationship Of Concentrated Ownership Structures And Corporate Governance (2011), (unpublished thesis, The London School of Economics and Political Science) (on file with the London School of Economics and Political Science Library system).

[49] John Armour, Bernard S. Black, Brian R. Cheffins and Richard Nolan, *Private Enforcement of Corporate Law: An Empirical Comparison of the US and UK* (University of Texas

of being subject to a lawsuit relating to their fiduciary duties to shareholders. In contrast, the odds in UK stand at 1/10,000. Studies have also confirmed that the mechanisms in USA are generally more mandatory-law-based, while those in UK are based on governance. This is because of the difference between the nature of investors. Retail investors have very little incentive to affect managerial decisions by themselves, and instead require the support of the law. On the other hand, institutional investors are more incentivized, experienced and sophisticated. Thus, while statutes in USA prescribe extended liability regimes, the UK system focuses on periodic disclosure to allow shareholders the chance to make an informed decision on when to use appropriate internal-governance strategies.[50] As stated in *Caparo Industries Plc.* v. *Dickman*,[51]

> "[T]he purpose of annual accounts, so far as [shareholders] are concerned, is to enable them to question the past management of the company, to exercise their voting rights, if so advised, and to influence future policy and management."

The UK regime, apart from having less onerous disclosure requirements,[52] enables shareholders to exercise a more influential role in controlling the board of directors. As an example, all that is required to remove a director at any point of time in UK is a simple majority.[53] In USA, however, a staggered system is followed, meaning that only a certain proportion of the board can be removed from service at an AGM, and it usually takes a number of years before the control of extant directors is entirely wrested.[54]

V. ANALYZING THE INDIAN MODEL

The Corporate ownership structure in India is of an Insider-economy. Both ownership and control are closely held by an identifiable and cohesive group of 'insiders' who have a long-term stable relationship with the company, and generally act in concert to monitor corporate management. A majority of businesses in India ranging from roadside *kirana* stores to small and medium sized enterprises and large conglomerates are in the dominant control of families contributing to almost two-thirds of India's GDP, 90 per cent of the

School of Law, Working Paper No. 89, 2007).

[50] Brendt, *supra* note 19.

[51] (1990) 2 AC 605 : (1990) 2 WLR 358.

[52] *Id.*

[53] Companies Act, §168(1) (2006).

[54] Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participant* (NBER, Working Paper No. 8974, 2002).

total industrial output, 79 per cent of organized private sector employment and about 27 per cent of the overall employment in the country.[55] Data available for the period from 2001 to 2013 shows that promoter shareholding in India was close to 70 per cent in Public Sector Undertakings, 40 to 60 per cent in Indian Business Groups and Private Indian companies and about 50 per cent in companies listed on the Bombay Stock Exchange.[56] A 2014 study found also that the median stake held by promoter groups in India has risen to 56.24% in 2011, from 42.9% in 2001, thus confirming that concentrated ownership is the norm in India.[57] The ownership pattern in these family influenced firms represents a class of long term investors (shareholders running for multiple generations) mostly in control of senior management positions with a poorly diversified portfolio.[58]

Concentrated shareholding, especially in cases of family owned and controlled entities often leads to stability and long-term sustainability offering more efficient and cost-effective management. The motivation and determination to grab opportunities and convert them into profits is rarely as effective in non-family business structures.[59] The ones in control are directly concerned about personal wealth creation and preservation, the brand of their family names, family reputation and goodwill, owing to which the elements of self-discipline and self-governance are often higher.[60]

However, in family run businesses with concentrated shareholding patterns, 'shareholder value' depends on the expectations and priorities which are relevant to the family shareholders rather than to the other minority shareholders.[61] Given the sole objective of personal wealth creation, such

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[55] Christophe Bernard, *Family-owned businesses- The backbone of India's economy*, KPMG (Oct. 25, 2013), http://www.kpmgfamilybusiness.com/family-owned-businesses-backbone-indias-economy/.

[56] Arunima Haldar, S.V.D. Nageswara Rao, *Corporate Governance in India*, 12 C.O.C. 289, 291 (2014)

The Data used in the study was collected from the Prowess database of Centre for Monitoring Indian Economy during the financial year 2008 to 2011.

[57] Vincent Tawiah, Sakshi Sharma, M. Benjamin, Anil Chandok, Maniriho Arsonval, *Who Owns Indian Companies? A Decade Of Shareholding Patterns Of Automobile And It Industry*, IOSR-J.B.M., Oct. 2014, at 51-60. In 2013, the shareholding of promoters fell to 51.6%.

[58] Palanisamy Saravanan, *Corporate Governance Characteristics and Company Performance of Family Owned and Non-Family Owned Businesses in India*, G.L.H., Mar. 2009, at 39-54.

[59] N. Balasubramanian and R.V. Anand, *Ownership Trends in Corporate India 2001-2011: Evidence and Implications* (IIM Bangalore, Working Paper No. 419, 2001-2011).

[60] Rajesh Narain Gupta, *Understanding Family Business in India*, Family Business United, http://www.familybusinessunited.com/opinions/perspectives/understanding-family-business-in-india-perspective/.

[61] Deborah A. DeMott, *Guests at the Table?: Independent Directors in Family- Influenced Public Companies*, J.C.L., 2008, at 819-863.

extensive control often offers enormous potential to the controller to expropriate profits and personally benefit at the cost of the absentee minority shareholders.

A. Evolution of Corporate Governance in India

The Indian framework of corporate governance embodies an approach of transplantation of laws and codes from UK and USA (following the outsider model)[62] Until the advent of liberalization in 1991, the Indian corporate law framework was drawn largely from statutory enactments in UK.[63] Thereafter, corporate governance norms were transplanted from USA.[64] The approach to governance from 1947 to 1991 was highly restrictive due to the Industries (Development and Regulation) Act of 1951, and various sector-specific legislations that led to a 'license raj'. A socialist ideology formed the backbone of most laws, and corporate laws were no exception.[65] Additionally, the Monopolies and Restrictive Trade Practices Act of 1969 and Foreign Exchange Regulation Act of 1973 prevented the entry of new capital, leading to a highly concentrated ownership structure where a few families and conglomerates controlled most of the available capital.[66] Structural and rule-driven path dependency ensured that this structure prevails even today.

Post-1991, the influence of Delaware-based law led to several amendments that eased a number of restrictive laws.[67] The supersession of Securities and Exchange Board of India (SEBI)[68] over the Controller of Capital Issues (CCI) translated to a disclosure-based regime that resulted in a manifold increase of public offerings of securities.[69] Additionally, most of the provisions of the latest Clause 49 of the SEBI listing agreement mirror the Sarbanes-Oxley Act, and other mandatory provisions prescribed by the regulator clearly find their inspiration from Outsider economies.[70]

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[62] Umakanth Varottil, *The Evolution Of Corporate Law In Post-Colonial India: From Transplant To Autochthony* (LSE, Working Paper No. 001, 2015).

[63] Varottil, *supra* note 62. Examples include the English Companies Act of 1948.

[64] *Id*. Examples include the Sarbanes Oxley Act of 2002.

[65] *Id*. Examples would include the practice of designating private companies as '**deemed public companies**' under the Companies Act, 1956 so as to enable greater state regulation. Companies (Amendment) Act, 1960 introduced Section 43A into the Companies Act, 1956 that dealt with deemed public companies. Additionally, schemes of arrangement were to be allowed only if they weren't averse to '**public interest**': Companies Act, 1956, § 394, proviso, as amended by the Companies (Amendment) Act, 1965.

[66] Varottil, *supra* note 62, at 1, 6.

[67] Varottil, *supra* note 62. Examples include the provisions on purchase of stock options, and those allowing the buy-back of shares. Further, the concept of 'deemed public companies' was deleted by the Companies (Amendment) Act, 2000.

[68] Rakesh Agrawal v. SEBI, 2003 SCC OnLine SAT 38 : (2004) 1 Comp LJ 193.

[69] Chakrabarti, Rajesh and Yadav, Pradeep K. and Megginson, William L., *Corporate Governance in India*, J.A.C.F., Mar. 2008, at 59-72.

[70] *Id*.

Agency problems relating to separation of ownership and control are commonly associated with economies having dispersed ownership pattern. In India, therefore, where the norm is that of concentrated ownership in the hands of promoters, Anglo-Saxon governance patterns cannot be adopted blindly.

B. Analyzing the Role of Independent Directors

The role and functions of the Board change drastically depending on the type of corporation. While Anglo-Saxon Boards usually follow vertical governance (working on behalf of the shareholders), boards in family-owned corporations focus on horizontal governance which entails balancing the interests of different shareholders. Therefore concentrated ownership structures require a trustworthy board that protects the interests of the minority. This void is often filled by the appointment of an Independent Director on the Board who maintains a rigorous oversight over the decisions taken by the corporation. The office of an independent director particularly draws attention in an insider model as they heighten accountability and serve as a link between the non-family (minority) shareholders and the board by providing alternate perspectives. Further, they also help ensure that the Board's focus remains on the corporation's business irrespective of the frictions that may arise within the founding family.[71] It is through them that objectivity and rational perspective can be brought on board.

In India, the newly enacted Companies Act of 2013 imposes a specific obligation on listed companies to have at least one third of the total number of directors as independent directors[72] and the Act for the first time, defines the term "Independent Directors". To ensure complete independence, any promoter of the company or its holding, subsidiary or associate company or anyone related to them or anyone who has or had a pecuniary relationship with the company during the two immediately preceding financial years or current financial year has been excluded from the appointment of an independent director.[73]

Although Indian regulators have become more focused towards making corporate governance stronger, the ground reality presents a contradictory picture. Promoters have been found to utilize their personal network to search and appoint these directors. It was found that around 25 per cent of Indian companies had 'name-sake' Independent Directors who were found

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[71] *Id.*
[72] Companies Act, s. 149 (2013).
[73] *Id.*

to be relatives of the owners, about 65 per cent of companies did not have independent directors driving the board meeting agenda, 92 per cent of companies were found to be functioning without a lead independent director.[74] Further, although the Act recommends separating the offices of the Chairperson and CEO and the Managing Director, 68 per cent of companies were found to be evading this rule. As far as the appointment of woman directors is concerned, the seat was found to be occupied mostly by immediate family members- wives or daughters who had no active control over the proceedings of the Board.[75]

SEBI places a cap on an individual to be an independent director on the board of not more than seven listed companies simultaneously. This was done in order to ensure that the directors give adequate time and effort to the Board they serve on. Despite being allowed to serve on as many as seven boards, some Independent Directors have been found circumventing this cap by altering their status as 'non-independent non-executive director' in some boards to get appointed as an Independent Director in a new company.[76] Additionally, influence over the selection of directors directly or indirectly by the family calls into question the effectiveness of the independent directors as champions or protectors of public shareholders.[77]

Although independent directors have been given independence from a legal standpoint, good governance can only be achieved if the same is conferred in substance. Director's independence is often compromised by the presence of multiple strong owners and controllers on the Board and is swayed by the excessive remuneration and other perks offered by those in control. Considering their minority status, these directors tend to focus more on their ties with the company's business and its management rather than the duty owed to the minority shareholders. Further, effective service as an Independent Director becomes extremely difficult as family representation on the board is mostly secured through voting agreements within the family shareholders leaving no say for the minority opinion.[78]

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[74] ENS Economic Bureau, *India Inc: 1/4th of Independent Directors aren't independent, reveals survey*, THE INDIAN EXPRESS (Nov. 28, 2015, 1:25 AM), http://indianexpress.com/article/business/economy/india-inc-14th-of-independent-directors-arent-independent-reveals-survey/.

[75] *Id.*

[76] N. Sundaresha Subramanian, *Independent Directors Circumvent Board Cap*, BUSINESS STANDARD (Jul. 17, 2016, 8:28 PM), http://www.business-standard.com/article/companies/independent-directors-redesignate-as-non-independent-to-ensure-compliance-of-sebi-cap-116071700659_1.html.

[77] DeMott, *supra* note 61.

[78] *Id.*

The law on Corporate Governance should work towards positioning independent directors in a manner that allows them to exercise their functions in a way that is unaffected by the presence and influence of the controlling shareholders. It is also crucial to understand that such independence is difficult to be codified and must come professionally to the directors responsible for representing the minority stake. In order to achieve independence in true sense, the Director must aim towards engaging in constructive discussion challenge within the board room rather than serving as a puppet of the majority.

Given the present state of Independent Directors in India, the reliance placed upon them must be reduced unless rules can be effectively enforced and measures such as appointment through a larger democratic process involving minority shareholders can be taken in appointing such directors.[79] Some other measures that may be taken in this regard include facilitating a transition from the insider model to the outsider model by slowly diluting the concept of promoter.[80] However, as an immediate measure, adequate and stringent fiduciary duties must be cast on the controlling shareholders in order to ensure that the minority interests are not overlooked.[81]

However, Professor Umakanth Varottil has pointed out a few 'autochthonous'[82] measures that address issues endemic to our Insider economy. Perhaps the most critical of these is the strict regime surrounding Related Party Transactions– whereby the Companies Act[83], its Rules[84], and the listing agreement[85] mandate a series of disclosures and procedures to prevent self-dealing and tunneling. Another example of the Indian regime gradually developing autochthonous measures to combat systemic issues in the corporate governance regime is the addition of a positive list of qualifications for the appointment of independent directors.[86] The 1956 Act only prescribed negative qualifications that resulted in some confusion over what an independent director's primary role should be – to promote the economic interests of the company over all else, or to protect minority shareholders? The addition of a positive list in Schedule IV of the 2013 Act has given a specifically protective role to independent directors.[87] The inclusion of positive criteria also

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[79] Umakanth Varottil, *A Cautionary Tale of the Transplant Effect on Indian Corporate Governance*, N.L.S.I.R, Jan. 2009, at 1,6.
[80] *Id.*
[81] *Id.*
[82] The word roughly translates to 'indigenous'.
[83] Companies Act, s 188 (2013).
[84] Companies (Meetings of Board and its Powers) Rules, Rule 15 (2014).
[85] Revised Clause 49 of the SEBI Equity Listing Agreement.
[86] Companies Act, Schedule IV.
[87] *Id.*, Entry 14.

reflects the overarching hand of the State in the Indian framework – further separating it from British or American regimes. This is perhaps necessitated since India's capital markets systems aren't sophisticated enough (yet) to exercise a 'check' on the economy. Thus, while the UK's 'Combined Code on Corporate Governance'[88] follows a 'comply-or-explain' approach, Clause 49 of SEBI's Listing Agreement makes onerous disclosures mandatory for large public companies. Clause 49 was conceivably the result of worldwide panic following the Enron scandal, however, the Narayan Murthy Committee tailored it specifically to suit Indian needs.[89] Furthermore, Section 245 of the Companies Act, 2013 – though not in force yet – is yet another step in the right direction. By statutorily allowing class action suits as a remedy, it would enable minority shareholders to extract a greater degree of control using the external pressure of courts. It is unsurprising, therefore, that such autochthonous measures have resulted in India achieving a highly respectable rank of 13 out of 190 countries in the World Bank's 'Ease of Doing Business Rankings' in the category of 'minority protection.[90]

VI. CONCLUSION

The deconstruction of corporate governance structures leads one to the conclusion that no single efficient model of ownership exists. In such a scenario, convergence towards the Anglo-Saxon Outsider model may not be appropriate in all cases. Recently in Japan, Prime Minister Shinzo Abe has introduced a code of governance that seeks to reduce the proliferation of cross-holdings in the country. [91] However, critics of the proposed shift are suspicious of the code, and contest its applicability in the context of the prototypical Insider economy that is Japan. While the success or failure of the code is a question that can only be proven empirically in the future, the Indian experience does convey that rather than try and mould ownership patterns, it would be more expedient to establish corporate governance systems that reflect the reality of ownership.

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[88] The Combined Code on Corporate Governance, Preamble, Section 4 (2003).

[89] Umakanth Varottil, *A Cautionary Tale of the Transplant Effect on Indian Corporate Governance*, N.L.S.I.R, Jan. 2009, at 31-34.

[90] The World Bank Group, *Doing Business: Economy Rankings* (July, 2017),http://www.doingbusiness.org/rankings.

[91] Atsuko Fukase, *Asian Firms Scramble to Unravel Cross-Shareholding Structures*, THE WALL STREET JOURNAL (June 16, 2015, 8: 59 AM) http://www.wsj.com/articles/japan-banks-target-cross-shareholdings-1434428677.

Restructuring Corporate Debt: Assessing The Efficacy of Contractual Approaches vis-à-vis The Statutory

Jessamine Therese Mathew[*]

The year 2016 saw a great many law and policy changes that would significantly affect the financial and economic landscape of the country. Among those changes was the passing of the Insolvency and Bankruptcy Code of India in May, 2016. The Code sought to reform the scattered legislation relating to insolvency and bankruptcy in India and overhaul the diverse and often conflicting provisions that dealt with the same. The Code and its associated Rules lay down a regime that creates a step-by-step process to resolve insolvency and bankruptcy. However, the changes to the legislative framework were not to affect certain erstwhile methods of insolvency resolution, one of those being corporate debt restructuring. In this paper, I will examine different approaches to insolvency resolution and assess the efficacy of the Reserve Bank of India mandated debt restructuring guidelines in the face of the new insolvency resolution. While the RBI guidelines point towards a more "privatized" form of resolution, the regulatory approach of the Code and its Rules adopt a more systematic method of examining the same. Through this paper, I will evaluate both approaches and conclude on which may be better for financial entities in India.

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INTRODUCTION

In early 2016, Bhushan Steel Ltd. (the largest manufacturer of auto-grade steel in India) was classified as a non-performing asset ('NPA') by the Reserve Bank of India ('RBI').[109] The debt mounting upon Bhushan Steel Ltd. was to the tune of Rs. 40,000 crore and the account had been struggling since 2014. In that year, the creditors of Bhushan Steel formed a Joint Lenders' Forum ('JLF') in order to oversee the affairs of the company following the arrest of its Vice-Chairman in a bribery scandal. The banks collectively reviewed and implemented several options, including a refinancing scheme wherein the tenor of the loan was extended.[110] In 2016, after almost two years of a highly stressed account, the loan was declared to be an NPA.

In October, 2016, the creditors of Bhushan Steel agreed to restructure the debt (which has since increased to almost Rs. 45000 crore) under the debt restructuring regulations issued by the RBI over the last decade and a half.[111] The consortium of banks is led by the State Bank of India and the Punjab National Bank. In the event that the restructuring is successful, this will be the largest debt that has been restructured under the regula-

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[1] *See*, Vishwanath Nair, *Banks classify Bhushan Steel loans as non-performing assets*, LIVEMINT, April 22, 2016, *available at* http://www.livemint.com/Companies/dJysX-hum8SFZFQO9uzFUTK/Banks-classify-Bhushan-Steel-loans-as-nonperforming-assets.html (Last visited on November 2, 2016).

[110] *Id.*

[111] *See*, Vishwanath Nair, *Bhushan Steel lenders to restructure loans*, LIVEMINT (October 7, 2016), *available at* http://www.livemint.com/Companies/RVPIcHk97jPtTBzRJ65A8O/Bhushan-Steel-lenders-to-restructure-loans.html (Last visited on November 2, 2016).

tions issued by the RBI (the S4A or the Scheme for Sustainable Structuring of Stressed Assets).

Debt restructuring as a concept is not a new phenomenon. It has been a tool used by multiple lenders to ensure that loans are repaid and has aided many borrowers in settling debt accounts without resorting to judicial methods. It occurs at various levels, from individual lenders reworking the terms of debt agreements with their debtor to sovereign debt restructuring, wherein governments that are in debt work out plans to settle accounts. The options to restructure debt in India are manifold and with the coming of the Insolvency and Bankruptcy Code, 2016, the process has been streamlined even more. Although the RBI has claimed that the Code will not replace RBI guidelines and that corporate debtors will be free to utilise these avenues for debt restructuring, it remains to be seen whether it is an option that will continue to be used.[112]

The example of Bhushan Steel is one among many that shed light on the state of debt recovery in the country. In this paper, I seek to analyse key points relevant to working of the the debt restructuring regime in India, and how recent changes in law have affected the same. In Part I, I will provide a general overview of what debt restructuring is and introduce its crucial components. In Part II, I will examine how corporate debt restructuring has been subject to a governing framework internationally and assess the underlying rationale for the same. In Part III, I will elaborate on the informal mechanism available in India under multiple RBI Circulars. In Part IV, I will examine the ambit of debt restructuring under the Insolvency and Bankruptcy Code. Finally, I will offer concluding remarks.

I. OVERVIEW OF THE CONCEPT OF DEBT RESTRUCTURING

In a debt restructuring similar to that proposed by Bhushan Steel, the cornerstone is an agreement between the debtor and her creditors. This agreement is privately entered into between the two parties in order to rework crucial terms of the debt agreement and to reach a solution that is most viable and practical for the debtor and her creditors. When a company is facing financial trouble, there are multiple routes that it can take to resolve the crises. One is, of course, the private re-negotiations of key terms, which will be explained subsequently in this paper. Alternatively, the crisis may

[112] *See*, Gopika Gopakumar, *Insolvency and bankruptcy code won't replace SDR and S4A: Sudarshan Sen*, LIVEMINT, November 2, 2016, *available at* http://www.livemint.com/Industry/KCAE2uvgB54HpDCLtzbykL/Insolvency-and-bankruptcy-code-wont-replace-SDR-and-S4A-Su.html (Last visited on November 3, 2016).

be resolved through judicial or regulatory reorganization wherein a specific body seeks to formulate an action plan to resolve the debt – this is what the Insolvency and Bankruptcy Code of 2016 seeks to crystallise. Finally, the company may opt for winding-up and liquidation to pay off its creditors.[113]

Renegotiating or restructuring debt agreements outside of a court or a formal mechanism is often done so as to increase the overall efficiency of the transaction and to ensure that time is not wasted in complying with the procedural steps under relevant statutory laws. Much the same as full-blown formal regulatory measures, private restructuring takes place by changing the nature of the assets and liabilities of the debtor so as to ensure time and cost-efficient payback. Restructuring can take place in mainly two ways – *operational restructuring* and *financial restructuring*.[114] Operational restructuring refers to measures wherein the debtor's business is restructured. This can include a plan to merge with another company, shut down a branch of the company, sell a part of the company etc.[115] In essence, these are large-scale business measures which seek to make the corporate debtor a more economically viable and valuable asset in the eyes of the creditor. On the other hand, financial restructuring is when the debtor's finances are restructured. This could be by altering the rate of interest, the tenor, or the number of repayment instalments, availing refinancing options etc. in a debt agreement. In either case, these measures are taken through an agreement between both parties, free of any regulatory hindrance or procedure.

A. Prerequisites to a Debt Restructuring Agreement

In order for a debt restructuring agreement to be valid, there are certain general prerequisites that must be complied with. The *first* is that the debtor must be in a situation of "financial difficulty" – that is to say, they should be in a state of insolvency or potential insolvency or any other state of being financially unstable such that it could lead to the possibility of a prior debt agreement being defaulted upon. The *second* is that there should be a "plurality of creditors".[116] In the case of a sole creditor, the procedure to reclaim debt is through one-on-one negotiation or formal judicial or regulatory mechanisms.

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[113] PHILIP R. WOOD, PRINCIPLES OF INTERNATIONAL INSOLVENCY 619 (2007).

[114] *See*, Jose M. Garrido, *Out-of-court Debt Restructuring*, *available at* http://siteresources.worldbank.org/INTLAWJUSTICE/Resources/OutOfCourtDebtRestructuringBeforeTypesetting.pdf 7 (Last visited on November 2, 2016).

[115] *See*, Ian H. Giddy, *Corporate Financial Restructuring*, *available at* http://people.stern.nyu.edu/igiddy/restructuring.htm (Last visited on November 2, 2016).

[116] Garrido, *supra*, note 6, at 12.

Further, it is usually advisable for such agreements to be entered into solely with financial creditors such as banks and financial institutions. This means that other creditors of a company like employees, tax authorities, etc. would not be party to any such agreement. This particular stipulation exists in order to ensure that similar debts are discharged through a common contract. If all the creditors of a debtor are lumped into the same contractual agreement, there arises a significant problem of adequately and appropriately coordinating the debt repayment.[117] Restructuring agreements are also most effective when the group or consortium of banks and financial institutions are owed the majority of the company's debt.[118] It is mostly in this situation that the debtor is likely to take the agreement and obligations thereunder into serious consideration.

Along with these technical factors, there is also the requirement that the debtor in question must be facing some form of financial inability which causes him/her to be unable to repay the debt according the original terms agreed upon. Whether this difficulty is in the form of complete insolvency or foreseen inability to repay is immaterial for the purposes of a restructuring agreement.[119] What must be focused on is the nature of the indebtedness and the extent to which it affects the capability of the debtor to service the financial debt that she is in. In that light, the ability of the debtor to service other debts such as wages or tax payments is immaterial.[120]

B. Parties in a Restructuring Agreement

There are two primary parties who will be involved in or affected by the contents of such an agreement: the corporate debtor and the corporate creditor or creditors. The extent of each party's role in decision-making and impact is elucidated below.

1. The Corporate Debtor

The corporate debtor is the most important party in this agreement as it is the entity that is to implement a large majority of the actions set out in the agreement. The most ubiquitous form of a corporate debtor is a public or a private company registered under the Companies Act, 2013, or the Companies Act, 1956. As companies grow larger, there is a move towards increasing the capital invested in the company so as to increase production

[117] Garrido, *supra*, note 6, at 13.
[118] Garrido, *supra*, note 6, at 13.
[119] Garrido, *supra*, note 6, at 13.
[120] Garrido, *supra*, note 6, at 13.

or maximise the output of services. This is done through larger debt contracts and increased public shareholding.[121] This often means that their obligations tend to be proportionate in magnitude, whether to lenders or to shareholders. In these types of companies, the duties that directors have to the shareholders often takes precedence[122] which can pose problems for large and small scale lenders. For example, from a different jurisdiction, French online communications company Solocal SA was in talks to restructure its debt of 1.2 billion euros. However, these arrangements had to be approved by two-thirds of the company's shareholders which could not be secured at the company's general meeting.[123] This highlights one of the crucial factors that go into a debt restructuring agreement being successful in public and private companies.

Along with the general health of the company, a priority for the corporate debtor is to ensure that its affairs are still run by a competent management. As a result, companies will examine restructuring agreements so as to evaluate whether a change in management is required or sought by the same.[124]

2. Banks or Corporate Creditors

Creditors in restructuring agreements are usually the bank or the consortium of banks that lends the corporate debtor money. Banks often dictate the course of company actions through their ability to finance key company operations through multiple loan arrangements such as term loans, working capital loans, syndicated loans and so on. While they have considerable influence in directing the course and plan of a debt restructuring agreement, there are certain crucial factors that affect banks in their operations as well. At the *first* instance, the banks must ensure that depositors' interests are not affected by any restructuring agreement that they enter into with the corporate debtor. Banks themselves are involved in the business of borrowing from the public and defaulting on that obligation can lead to serious consequences for the bank itself. *Second*, the bank must ensure that the agreement entered into is likely to benefit the bank. For example, debt-equity swaps are now gaining traction as a means of debt recovery.[125]

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[121] Garrido, *supra*, note 6, at 625.

[122] Garrido, *supra*, note 6, at 625.

[123] *See*, Luca Casiraghi, *Solocal Bonds Fall as Shareholders Reject Debt Restructuring*, (October 20, 2016), *available at* http://www.bloombergquint.com/onweb/2016/10/20/solocal-s-bonds-fall-as-shareholders-reject-debt-restructuring (Last visited on November 3, 2016).

[124] PHILIP R WOOD, *supra*, note 5, at 625.

[125] *See, for e.g.*, Rimin Dutt, *Why RBI's Debt-Equity Swap Scheme Is Good News For Indian Banks Saddled With Bad Loans*, HUFFINGTON POST INDIA, June 14, 2016, *available at*

However, it must be ascertained whether such a move (which includes change of control of the corporate debtor) will indeed yield greater profits in order to service the original debt of the company with the consortium of banks. In the case of the ABG Shipyard debt-equity swap, the original promoters were in a minority and the change in management is doing very little to revive the company's production output.[126] *Finally*, banks must ensure that their reputation as bankers, lenders, and creditors is not damaged by their actions attempting to leniently restructure debt instead of invoking liquidation and sale of the corporate debtor's assets. As an example, the recent case of Vijay Mallya's wilful default upon company loans may be cited. While Mallya's actions were heavily criticised, a major portion of the backlash was on the consortium of banks which continued to refinance and restructure loans instead of invoking guarantees or securitising assets.[127]

C. Features of a Debt Restructuring Agreement

Before proceeding to look at how such agreements are governed by different regulatory bodies, I will briefly look at options that are available to the corporate debtor and creditors under these agreements. In most cases, these measures involve a change in the debtor's original commitments, resulting in a novation of the original debt agreement.

The first option is to change the interest rate at which the loan has been serviced. Being unable to service debt due to high interest rates is a recurring phenomenon in the world of financial debt. This can be due to variable interest rates (as opposed to fixed rates) which are difficult to keep up with in the face of falling company finances. It may also be that a fixed rate of interest is incommensurate to the company's overall earnings and cannot be repaid in time. In 2012, when Bharati Shipyard was undergoing initial Corporate Debt Restructuring formulations, lenders agreed to reduce interest to 11% for easier servicing of the debt.[128]

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http://www.huffingtonpost.in/2016/06/14/indian-banks-and-bad-debt_n_10452542.html (Last visited on June 20, 2017).

[126] *See*, Shishir Asthana, *Why debt conversion to equity is a bad deal for ABG Shipyard shareholders*, BUSINESS STANDARD, October 7, 2016, *available at* http://www.business-standard.com/article/markets/why-debt-conversion-to-equity-is-a-bad-deal-for-abg-shipyard-shareholders-116100700279_1.html (Last visited on November 3, 2016).

[127] *See*, M.G. Arun, *Banking on a goodwill that wasn't*, INDIA TODAY, March 16, 2016, *available at* http://indiatoday.intoday.in/story/vijay-mallya-kingfisher-airlines-kfa-money-laundering-loan-default-case/1/622051.html (Last visited on November 3, 2016).

[128] *See*, Shayan Ghosh, *'Bharati Defence approached BIFR with malafide intention*, FINANCIAL EXPRESS October 25, 2016, *available at* http://www.financialexpress.com/markets/bharti-defence-approached-bifr-with-malafide-intention/428832/ (Last visited on November 3, 2016).

Another option is to alter the due dates of the loan. Under this method, the interest rate may remain the same but the date on which the debt is due is extended. This option has been adopted by creditors of Malaysian oil company TH Heavy Engineering Bhd wherein the maturity date of its debt is extended by one year (from September 2016 to September 2017).[129] This can take place with altered interest rates as well.

In some cases, the currency of the debt can be changed. This usually happens due to fluctuating interest rates and presence of a cross-border loan transaction. Some parties also opt to modify key covenants in their debt agreements so as to service the debt more effectively.

Another option is refinancing. In this method, new loan facilities can be extended to the creditors which will aid its operations.[130] In this arrangement, there are multiple measures taken to ensure that the additional risk is taken into account – either through an agreement between creditors or increased security.

In some cases, creditors will choose to waive the interest requirement in order for the debtor to pay back the principal amount at a faster rate. While this is an extreme move, it can have several variations, such as waiving past interest or interest up until a point so that future interest is paid.

A more extreme path is for the debt to written off by the creditor. Partial or total writing off of debt involves waiving the debt amount along with interest which effectively means that the debtor pays nothing and the creditors suffer a potential loss. This is an extremely contentious plan to implement and must be done with extreme caution. History is replete with examples of writing off at political levels such as Germany during World War II and Europe during the 1930s Depression.[131] In early 2016, the RBI released a statement on how Rs. 1.14 lakh crore worth of debt was written off by various banks between 2013 and 2015 in India.[132]

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[129] *See*, *TH Heavy seeks to extend maturity date of debt papers*, THE STAR, October 12, 2016, *available at* http://www.thestar.com.my/business/business-news/2016/10/12/th-heavy-seeks-to-extend-maturity-date-of-debt-papers/ (Last visited on November 3, 2016).

[130] *See, for e.g.,* The RBI's 5:25 scheme: Reserve Bank of India, *Flexible Structuring of Long Term Project Loans to Infrastructure and Core Industries*, (July 15, 2014), *available at* https://rbi.org.in/scripts/NotificationUser.aspx?Id=9101&Mode=0 (Last visited on November 3, 2016).

[131] *See*, Mehreen Khan, *The biggest debt write-offs in the history of the world*, THE TELEGRAPH, February 2, 2015, *available at* http://www.telegraph.co.uk/finance/economics/11383374/The-biggest-debt-write-offs-in-the-history-of-the-world.html (Last visited on November 3, 2016).

[132] *See*, Utkarsh Anand, *Rs 1.14 lakh crore of bad debts: The great government bank write-off*, INDIAN EXPRESS, February 9, 2016, *available at* http://indianexpress.com/article/india/india-news-india/bad-loan-financial-year-rti-rbi-bank-loan-raghuram-rajan-

Finally, the debtor and creditor may restructure the debt security. Through this plan of action, earlier securitised assets may be brought back against the loan or security interests in general can be altered and reworked.

II. A Governing Mechanism For Debt Restructuring Agreements

While the entire process and plan of restructuring is according to a contract between the aforementioned parties, there is still significant risk in such an endeavour. This is due to difficulty in executing contracts which have a large number of participants whose risks and expectations may vary according to individual interests. Through these coordination and aggregation problems, a standalone contractual modification of original terms hardly seems like a viable option for restructuring debt agreements.

It is in that light that the creation of informal norms to govern restructuring agreements and their contents is a popular concept in financial governance. By looking at the problem through the lens of behavioural science, the presence of informal norms to guide the placement and practice of restructuring agreements facilitates an easier mechanism to go about restructuring and eventually recovering debt. This ease of doing business motivates banks, financial institutions and corporate debtors to work within the set framework of regulations. These norms can be adopted by a central agency – in India's case the concept of debt restructuring has been espoused in multiple RBI circulars and notifications, spanning over fifteen years, from 2001 till 2016. These circulars will be analysed in the next part of this paper. This centralised guideline incentivises corporate debtors and creditors and straying from it may cause social difficulties for such parties.[133]

Below, I have outlined key international approaches to regulating restructuring debt. There are multiple jurisdictions which have dealt with the matter. I have limited my analysis to the approaches followed in London, Bangkok, and Istanbul.

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bad-loan-financial-year-rti-rbi-bank-loan-raghuram-rajan-1140000000000-bad-debts-the-great-govt-bank-write-off/ (Last visited on November 3, 2016). *But see*, clarification by the RBI: Reserve Bank of India, *Bank Write-Offs: Clarification* (February 9, 2016), *available at* https://www.rbi.org.in/scripts/rbi_clarification.aspx (Last accessed on November 3, 2016).

[133] Gopakumar, *supra*, note 4, at 49.

A. London Approach

A 1990 document by the Bank of England titled 'The Provision of Financial Support for Companies with Liquidity Problems' contained elaborate guidelines on how to regulate and manage debt restructuring agreements.[134] The guidelines themselves are called the London Approach and are non-statutory. The main pillar of the Approach is that banks should be supportive towards companies facing financial troubles and work with them to find an effective solution. In principle, the London Approach espouses several key ideas:

a) Standstill: This means that lenders agree not to initiate formal insolvency proceedings against the borrower for a particular period of time or until a conclusion is reached between the debtor and the creditor.[135]

b) Information: This entails sharing all vital information relating to the debt and the borrower's status with each bank that is a lender. Further, it brings forth the point of retaining the confidentiality of all information that is passed during these channels.[136]

c) Viability of restructuring: The banks together must come to a conclusion on whether restructuring the debt is a viable option for all financial creditors.[137]

d) Lead bank and steering committee: There should be a lead bank whose role is to coordinate the agreement and obligations between all other banks in a procedural and set manner. Further, there should be a steering committee which will contain representations from all banks.[138]

e) Unanimity: The only way in which the agreement and restructuring plan will work out to the benefit of all parties is if all banks are unanimous in their decisions and operations.[139]

The London Approach also states the importance of the Bank of England itself in mediating disputes and negotiating restructuring agreements. Although the Bank of England no longer adopts a major role in such

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[134] *See*, *The London Approach*, BANK OF ENGLAND (1990), *available at* http://www.bankofengland.co.uk/archive/Documents/historicpubs/qb/1993/qb93q1110115.pdf (Last visited on November 3, 2016).
[135] *Id.*
[136] *Supra*, note 26.
[137] *Supra*, note 26.
[138] *Supra*, note 26.
[139] *Supra*, note 26.

mediations or negotiations,[140] the Approach envisages a financial supervisor doing the same.

The major critique of the London Approach lay in its non-addressal of debt trading as a means of recovery.[141] When debt is traded, it leads to new parties being involved in the restructuring agreement, thereby further complicating matters for the consortium and the corporate debtor. This issue was partially addressed and resolved by the 1998 Bangkok Approach.

B. Bangkok Approach

Following the Thai economic crises of 1997, the government went through intensive stages of developing an appropriate policy for debt restructuring and recovery in the country. In what is called the "Bangkok Approach", the principles and procedures for the same were laid out for non-performing loans involving multiple creditors in Thailand.[142] The goal of this framework was to minimise losses to the corporate debtor and creditors as well as to avoid company liquidation. While it mirrored many of the Bank of England's key principles such as the requirement of complete and accurate information, the presence of a lead bank and a steering committee, and a standstill period, it also contained guidelines on the creation of a separate committee to review all restructuring plans and debt trading. It also contained elaborate timelines within which certain procedural requirements, like meetings between creditors and the debtor, the formulation of the restructuring plan and so on were laid out.[143]

The formation of the Corporate Debt Restructuring Advisory Committee ('CDRAC') is a measure that was taken to ensure that all restructuring agreements were in tandem with the principles of the Framework. The CDRAC's role as a mediator between differing parties has been crucial in restructuring debt in Thailand. It oversaw restructuring agreements and worked out appropriate plans for the same.[144]

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[140] WOOD, *supra*, note 5, at 627.

[141] Garrido, *supra*, note 6, at 53.

[142] *See*, Tumnong Dasri, *Out-of-court Corporate Debt Restructuring in Thailand*, *available at* http://unpan1.un.org/intradoc/groups/public/documents/apcity/unpan005376.pdf for a useful summary and analysis (Last visited on November 3, 2016).

[143] *Id.*

[144] *See*, Tilleke & Gibbins, *Bankruptcy and Restructuring*, November, 2011, *available at* http://www.tilleke.com/sites/default/files/2011_TLB_bankruptcy.pdf (Last visited on November 3, 2016).

C. Istanbul Approach

In the wake of the 2001 Turkish financial crises, the government moved towards intervening in nineteen private banks, which were acquired by a state public asset management agency. Following this, the Banking Regulation and Supervision Agency worked out a plan to ensure that non-performing loans in the non-intervened banks were repaid.[145] This plan was developed by Turkish Bankers Association and was based on the London Approach. At its core, the Istanbul Approach is characterised by the Inter-Creditor Agreement, which was approved and signed by the major banks in the country.[146]

The program, like its international counterparts, had several key elements. In the *first* place, creditors had to agree to move forward with a non-judicial method of resolving this debt conflict instead of resorting to formal methods.[147] *Second*, there should be a lead bank and a creditors committee which work out the modalities of each individual plan and direct the course of action that is to be taken.[148] *Third*, it looked at specific timelines for resolution of debt-related conflicts.[149] *Fourth,* all decisions had to be approved by a 75% majority of the creditors. In addition, there were previously mentioned clauses on standstill periods and confidentiality.[150]

III. Regulation of Corporate Debt Restructuring in India

In India, the framework for corporate debt restructuring has surfaced through multiple RBI circulars over the last fifteen years. These guidelines and regulations have been heavily based on the London Approach, along with significant inputs from the Bangkok Approach as well. In this Part of the paper, I will chronicle the key features of main circulars in this time period.

A. Initiation of the Corporate Debt Restructuring Process in India: 2001

In 2001, an RBI circular was issued which provided a set of guidelines for the process and mechanism of Corporate Debt Restructuring ('CDR') in

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[145] Michael Pomerleano, Corporate Restructuring: Lessons From Experience 76 (2005).
[146] *Id.*, at 81.
[147] Pomerleano, *supra*, note 37, at 82.
[148] *Id.*
[149] *Id.*
[150] *Id.*

India.[151] This mechanism was formulated following extensive analysis of laws and policies in other jurisdictions like the United Kingdom, Korea, and Thailand. The primary objective of this mechanism was to alleviate debt obligations and restructure them in an efficient manner without involving legal or regulatory bodies like the Board of Industrial and Financial Reconstruction and the Debt Recovery Tribunal. By creating this overarching system, governance systems began to move closer towards settling potential and ongoing disputes in a more efficient – and even privatised – fashion, with minimal interference from government-mandated regulatory bodies. These guidelines have allowed for a decentralised method of resolving corporate insolvency or potential insolvency by allowing the process to be formulated and governed by a non-governmental and non-regulatory body.

In terms of structure, there is a three-tier structure of the CDR mechanism. At the *first* level, there is the CDR Standing Forum which is a body which represents all financial institutions and banks that wish to be a part of the CDR system. The role of the Standing Forum is to formulate policies and guidelines which will cover the way in which CDR is to work in India. At the *second* level, there is the CDR Empowered Group which consists of high-level representatives of financial institutions and banks. The Empowered Group will play the role of deciding specific and individual cases of CDR. The Empowered Group is to look at each application for debt restructuring and conclude upon whether it is viable and possible for the Company in question to restructure its debt in a specific manner. It will then approve the restructuring package within a time frame. If the Empowered Group does not find the possibility of restructuring viable for the Company, the creditors are then free to take any step for recovery of debt, which may include winding up of the Company and liquidation of assets. At the *third* level, there is the CDR Cell. This Cell will receive all references and applications for CDR by borrowers/lenders and conducts the initial examination of proposals from borrowers or lenders. The Cell will examine them in light of the general policies laid down by the CDR Standing Forum and submit the restructuring plan before the Empowered Group.

The RBI Circular also provides for the creation of a "stand still" clause in the Debtor-Creditor Agreement. According to this, both parties will agree to not take any recourse in legal or formal dispute resolution bodies for a period of 90 or 180 days, during which the CDR scheme is being devised by the CDR Cell, Empowered Group, or Standing Forum.[152]

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[151] *See*, Reserve Bank of India, *Corporate Debt Restructuring*, (August 23, 2001), *available at* https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=440&Mode=0 (Last visited on November 3, 2016).

[152] *Id.*

CDR can take place before the commencement of commercial production, after the commencement of commercial production but before the asset is classified as sub-standard, or after the commencement of commercial production and after the asset is classified at 'sub-standard' or 'doubtful'.[153]

The CDR mechanism is to be legally provided for in the Debtor-Creditor Agreement and the Inter-Creditor Agreement. The Debtor-Creditor Agreement can be entered into at the time of signing the original debt agreement or later while enforcing the CDR mechanism.[154] This mechanism is not available to one debtor or one creditor but is applicable only when there are multiple banking accounts or a syndication/consortium of banks. All banks and financial institutions must necessarily enter into Inter-Creditor Agreements which contain enforcement and penal provisions. The CDR mechanism is completely non-statutory and is to proceed on a voluntary basis with full consent between the debtor and creditor. The most crucial part of the CDR mechanism, however, remains the stipulation that if 75% of creditors (by value) agree to a debt restructuring plan, it will be compulsorily enforced on the remaining creditors also. There is no need for a unanimous agreement upon a particular plan to be taken.[155] A CDR can occur without a company being sick, a non-performing asset ('NPA') or in default. However, cases which appear to be NPAs will get priority by the CDR Cell. The process can be initiated by any creditors who jointly have at least 20% share in the company's working capital or term finance or by the company itself, if the idea is supported by the bank or financial institution having a minimum of 20% share.[156]

B. Revised Guidelines of 2003

In 2003, the RBI issued amendments and revisions to the guidelines of 2001. One major change was the division of accounts into two categories: accounts which are 'standard' or 'sub-standard' would be restructured under 'Category 1' whereas accounts which are 'doubtful' would be restructured under a new Category 2. Under Category 2, the existing loans will be restructured and there is not *per se* requirement to create an additional financing arrangement. Other than that, the procedure and manner of CDR are the same as for standard or sub-standard accounts.[157]

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[153] Added by the 2003 Circular. Reserve Bank of India, *Corporate Debt Restructuring* (February 5, 2003), *available at* http://www.cdrindia.org/downloads/CDR-RBI-Circular%20-5%20February%202003.pdf (Last visited on November 3, 2016).

[154] *Id.*

[155] *Supra*, note 45.

[156] *Supra*, note 45.

[157] *See*, Reserve Bank of India, *Corporate Debt Restructuring* (February 5, 2003), *available at* http://www.cdrindia.org/downloads/CDR-RBI-Circular%20-5%20February%202003.

Additionally, the concept of stand still clauses was expanded upon. It stated that these clauses only apply to civil action and that criminal actions could be initiated during the concerned period. Further, the borrower must confirm that the documents would be extended for the purposes of limitation. Additionally, the borrowing company must state that its directors will not resign from the Board during the pendency of the stand still period.[158]

This revision also creates an option to convert debt or a part of the debt into equity. This option has been elaborated upon in future circulars dealing with the matter.

C. 2014 Guidelines

After several circulars and notifications in 2005 and 2008, the next prominent guidance on CDR came in the 2014 *Framework for Revitalising Distressed Assets in the Economy*.[159] A new mechanism was established in 2002 wherein banks would identify certain accounts as Special Mention Accounts ('SMA') in order to pre-empt the possibility of default. These SMA accounts are to be reported to the RBI and in case the potential of default reached a particular threshold, the lenders were to form a Joint Lenders' Forum ('JLF') and work out a Corrective Action Plan ('CAP') for the account in question. This CAP by the JLF could provide multiple options to the debtor such as rectification, restructuring and recovery. The Framework covers the process in which restructuring is to be done. However, it also briefly covers rectification and recovery as viable options for the lenders. Rectification involves creating a plan of action wherein the borrower makes a commitment that the account will not become a non-performing asset and agrees to regularise the debt repayment through proper cash flows. In the event that the company's promoters cannot do so, they can explore the option of getting external investment, in consultation with the JLF.[160] Additional financing can also be provided if the JLF is certain that this will regularise the account. Restructuring involves rethinking the terms of the debt agreement. This will be elaborated upon in the following paragraphs. A final option is recovery, which may be resorted to in case rectification or restructuring is not possible. This may be done through legal options like application to Debt Recovery Tribunals or the new Insolvency and Bankruptcy Board of India.

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pdf (Last visited on November 3, 2016).

[158] *Id.*

[159] *See*, Reserve Bank of India, *Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalising Distressed Assets in the Economy* (January 30, 2014), *available at* https://rbidocs.rbi.org.in/rdocs/content/pdfs/NPA300114RFF.pdf (Last visited on November 3, 2016).

[160] *Id.*

The process to restructure an account can be formulated by the JLF or by the CDR Cell.[161] While there are specific technical differences in how this can be done, the overarching principle is that the loss should be borne by the shareholders of the company and not the creditors. Apart from a general renegotiation of the terms of the loan agreement, this Framework creates the possibility of converting the debt of the company into equity. This is done through transfer of the promoters' equity to the lenders so that there is some form of compensation for the potential loss of cash flow. Alternatively, promoters can issue further shares to increase the capital of the company and also increase cash flow. Finally, the promoters' holdings can be transferred to a security trustee or an escrow account until the company resolves its financial difficulties. If the lenders so wish, this can also provide for a change in management or control of the company.[162]

These Guidelines also lay down which cases would not be considered for CDR. In the first place, cases which were referred to the Board for Industrial and Financial Reconstruction are not eligible. Similarly, debtors who are wilful defaulters are not allowed. However, in both of these cases, if the CDR Core Group grants approval, they may have their debts restructured under CDR mechanisms. However, cases in which corporate creditors or debtors have engaged in fraud or malfeasance are completely barred from accessing relief through CDR.[163]

D. Reasons for Adopting CDR

Despite flaws in its working, CDR in India has been a huge source of attention for the past several years. It is important to understand why it is such a popular option for both debtors and creditors before analysing the problems associated with it.

In the first place, it appears to be a more convenient option that the other formal means of recovering debt such as the revival of sick companies or winding up under the Companies Act, 2013. Both these processes can be long-winded and tedious as they involve considerable interaction with tribunals or courts, particularly for recognition of sick or unprofitable status, formulating of plans, and enforcement. Alternatively, the company can explore options under the Sick Industrial Companies Act, 1985. However, this only applies to industrial companies, in the first place, and in the second place,

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[161] *See infra,* Part V-C for a step-by-step explanation of the process.

[162] *Id.*

[163] *See*, Reserve Bank of India, *Review of Prudential Guidelines - Revitalising Stressed Assets in the Economy* (February 25, 2016), *available at* https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=10293&Mode=0 (Last visited on November 3, 2016).

companies whose losses exceed their net worth – and are usually beyond any meaningful restructuring of debt. In that light, opting for CDR, with its set timelines and relatively lenient and flexible procedures is a highly efficient plan of action for debtors.

On the other hand, from a lender's perspective, CDR is a non-statutory form of debt recovery which allows creditors to avoid losses coming out of debt transactions. Unlike formal procedures like liquidation, which are likely to yield lower returns, the various schemes and possibilities under a Debtor-Creditor Agreement in accordance with CDR mechanisms can be more efficient for the creditors. Further, with the existence of useful feasibility studies, it does look like an attraction option for creditors as well. All in all, it would appear that a non-regulated private workout between the borrower and lenders would enable parties to arrive at a mutually desirable solution.

Therefore, despite flaws in terms of implementation, CDR seems to be a meaningful departure from strictly rule-based methods of debt recovery. Although there are these positive aspects of CDR, the difficulties associated with it must not be neglected and will be discussed later in this paper.

E. Key Components of CDR

The mainstay of any CDR process lies in the two agreements upon which the entire plan rests: the Debtor-Creditor Agreement and the Inter-Creditor Agreement. In this Part, I will examine both the form and content of both these agreements.

1. Debtor-Creditor Agreement ("DCR")

In this kind of agreement, the two parties are the consortium of banks and the debtor. This agreement often works in such a manner that it consolidates all the debt that the debtor owes to various creditors in one document and sets out new terms for repayment of the debt. The advantage of this is that the new terms apply across the board to all creditors, making the debtor's burden slightly less for the purposes of this consolidated debt. Further, the restructuring of loans into one arrangement ensures that all debt is covered in a way that lists all obligations of the debtor in a systematic manner. The terms of restructuring may be any of the options listed above in Part II-C.

An absolutely crucial part of the DCA is the standstill clause – which is a necessity in light of how the process of debt restructuring is sought to work. This clause is vital as it seeks to provide a window of time within which

information will be collected and plans to restructure the debt will be made. At the first instance, all lenders will agree to refrain from seeking formal adjudication or debt resolution means like courts or tribunals.[164] Secondly, the creditors will maintain their facilities at erstwhile agreed conditions until the plan has been formed. More specifically, however, there are some terms of the standstill clause that deserve to be mentioned:

a) All creditors to be treated equally: This means that no creditor will be given an undue advantage once the CDR mechanism is brought into operation. Clauses which seek to protect this include those which prohibit prepayment of specific loans, new security to specific creditors, no increases in interest rates, disclosing relevant information for the better working of the Agreement as a whole.[165]

b) Creditors maintain status quo: This means that no bank will undertake measures which will adversely affect the working of the CDR plan. Appropriate covenants in this regard are bans on termination of accounts, enforcement of security, set-offs, petitions for insolvency, assignment of debt, or loan acceleration agreements.[166]

There will also be clauses on fees to be paid to various committees or to the CDR Cell for the formulation of the plan. Additionally, maintaining confidentiality will be a major term in this agreement.

Indispensable to such an agreement are clauses which pertain to a monitoring and review of the debtor throughout the course of the plan. At a preliminary stage, this will involve complete access to all of the company's documents pertaining to its debt obligations, such as analysis on profit and loss, sales projections, transactions within the industry, the value of its assets, documents on its banking and credit history, prominent sales/service contracts, licences, clearances, approvals, and so on.[167] In essence, the consortium of banks and the CDR Cell will perform the equivalent of a due diligence on the bank in order to ascertain the possibility and extent of debt restructuring. In addition, the DCA can contain milestones that must be achieved by the corporate debtor, which will be periodically reviewed by a committee constituted under the Agreement itself.

A DCA will also contain a clause on consequences in case of default, which can include liquidation of assets or change of management and control of the company itself.

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[164] WOOD, *supra,* note 5, at 629.
[165] *Id*, at 630.
[166] *Id*, at 631.
[167] *Id*, at 631.

2. Inter-Creditor Agreement ("ICA")

Inter-creditor agreements are common in cases where a common borrower has two or more creditors. In order to avoid and resolve any potential conflict with respect to the repayment of debt to these creditors, they may enter into an ICA. The primary purpose of such an agreement is to ensure that there is parity among all the creditors in the CDR process and that no creditor is disadvantaged during the implementation of the plan.[168]

In essence, the ICA involves multiple creditors agreeing to abide by the CDR plan that will be formulated by the CDR Cell. It also contains procedural guidelines on how the CDR Cell and EG will carry out their responsibilities and how the banks or creditors in question will respond to the plan so made. This agreement also includes a standstill provision, which under the 2001 RBI Guidelines, is required to be a period of 90 days, and may be extended to 180 days.[169] The ICA will look at how major decisions such as loan acceleration, waiver, change of interest rate or tenor may be made by the consortium of banks.[170] Additionally, these agreements may have loss-sharing clauses, which will deal with how loss will be distributed among different banks in the case of a default or a lack of output on the part of the corporate debtor.[171] This kind of agreement also attempts to place an order of priority among the banks themselves, by working out which debt is to be paid first.

F. Working of CDR

The website of the CDR Cell frequently updates the status of applications and plans made before it. As of June 2016, the Cell has received a total of 655 debts to restructure, which aggregates to a total of Rs. 4,74,002 crore.[172] Of these, 125 cases (Rs. 70,998 crore worth of debt) have been rejected by the Cell, leaving 530 cases accepted (with Rs. 4,03,004 crore of debt). Out of this 5,30, 228 cases have failed to achieve set goals and were withdrawn (the debt amounted to Rs. 97,242 crore). However, 94 cases were successful and Rs. 68,894 crore worth of debt was restructured. There are currently 208 "live cases", of which 207 have been approved and implemented (with Rs.

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[168] *See*, Debra J. Schnebel, *Intercreditor and Subordination Agreements - A Practical Guide*, 118 Banking LJ 48 (2001).

[169] *Supra*, note 44.

[170] WOOD, *supra*, note 5, at 641.

[171] *Id*,

[172] *See*, Corporate Debt Restructuring Cell, PROGRESS REPORT (June 30, 2016), *available at* http://www.cdrindia.org/pdf/CDR%20Performance%20upto%20June%202016.pdf (Last visited on November 3, 2016).

2,34,959 crore) and one case (debt of Rs. 1,909 crore) is under implementation. Here is a percentage-wise analysis of these figures:

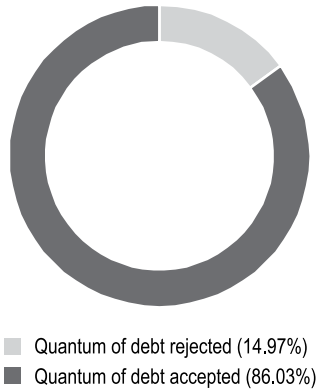

Fig. 1

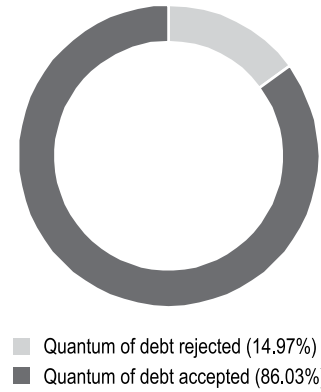

Fig. 2

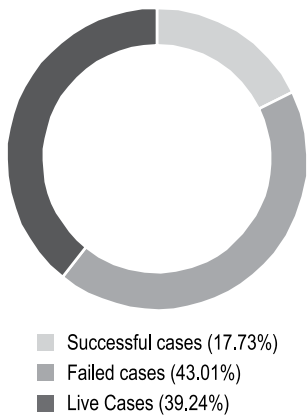

Fig. 3

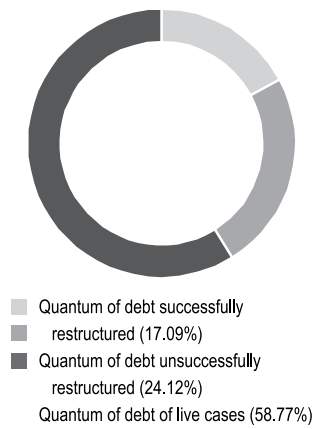

Fig. 4

In addition, it is seen that the iron and steel industry has formed the largest proportion of live cases to be restructured under CDR, with 48 cases and Rs. 52,190 crore in debt (forming 23.07% of the total number of cases and 22.03% of the debt). This is followed by infrastructure, which constitutes 17 cases and Rs. 40.941 crore (8.17% of cases and 17.28% of the debt).[173]

Despite the seeming popularity of CDR mechanisms with respect to application numbers, it is clear that the process has largely failed to produce any meaningful outcome in the scheme of debt restructuring in India.

[173] *Id.*

With such a large percentage of failed cases, it is doubtful as to whether this policy measure is likely to result in any positive outcome for debt recovery in India. Once the restructuring package has failed to produce any tangible output, the creditors have three main options: i) to recognise the account as an NPA; ii) to invoke measures like Strategic Debt Restructuring ('SDR') or 5:25 refinancing; or iii) sell the account to asset reconstruction companies.[174]

The failure of the CDR mechanism, albeit carefully thought out over a period of fifteen years, can be attributed to several key reasons. At the first instance, the entire scheme is non-statutory and hence, defaulting or dissenting from a proposed plan causes minimal consequence within the ambit of the scheme. Furthermore, the non-statutory backing of the schemes also allows creditors to default on the Inter-Creditor Agreement, even when a majority has agreed to its implementation.

Another reason for failure may lie within the process of implementing the CDR mechanism. Prior to allowing for CDR in a particular case, it is necessary for the CDR Cell to conduct a techno-economic viability study which will look at the feasibility of restructuring the loans. After this, plans are made regarding the concessions to be made. This analysis is made on the basis of the projected profit and loss margins as against the expected sales of the concerned company. However, it is often seen that this projection is flawed. In a case study of 73 companies, it was seen that 42 of them did not match up to the required projections necessary for compliant restructuring of the existing loan amounts.[175]

In other cases, the lack of coordination among lenders is a source of considerable confusion for plans. This is often due to information asymmetry and different timelines for approvals from boards and members.[176] In yet other cases, the promoters of the company cannot bring sufficient capital to the company so as to achieve production goals.[177] Finally, in cases of debt-equity swap, the new management is less invested in the health of the company and projected output cannot be attained due to this reason.[178]

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[174] *See*, Religare, SDR: A Band-aid For A Bullet Wound (January 4, 2016), *available at* http://research.religarecm.com/INDIA/India%20Banks%20-%20Sector%20Report%204Jan16.pdf 12 (Last visited on November 3, 2016).

[175] *See*, Indian Institute of Banking and Finance, CDR Report, *available at* http://www.iibf.org.in/documents/reseach-report/CDRultimateFinal_Report_2909.pdf 55 (Last visited on November 3, 2016).

[176] *Id.*, at 61.

[177] *Id.*

[178] *See, for e.g.*, Shishir Asthana, *Why debt conversion to equity is a bad deal for ABG Shipyard shareholders*, Business Standard (October 7, 2016) *available at* http://www.business-standard.com/article/markets/why-debt-conversion-to-equity-is-a-bad-deal-for-abg-shipyard-shareholders-116100700279_1.html (Last visited on November 3, 2016).

G. 2015 Guidelines

In June 2015, the RBI released another guideline on Strategic Debt Restructuring ('SDR'), wherein debt can be converted to equity shares after the failure of CDR mechanisms to resolve the debt conflict.[179] Such a debt restructuring agreement must possess certain vital features, which the RBI has listed out. First among these is that the JLF must place the proposal to convert a part of or the entire loan amount with interest into shares in case the debtor is not able to reach certain milestones in the restructuring agreement. However, this move must be supplemented by the required approvals and authorisations (including those by shareholders) that are mandated by law. The process works as follows: the JLF must monitor whether the account is able to reach certain milestones and in the event that it does not or reaches certain "critical conditions", the JLF should review the account and decide whether a change in ownership will be beneficial to the account and its associated creditors. This decision to convert debt to equity shares should be taken within at least thirty days of the JLF's review and must be approved by a majority of the JLF (which means 75% of the creditors by value and 60% by number). The creditors should become majority shareholders. The entire package must be approved by the JLF within 90 days of deciding to adopt this method and the conversion should be complete within 90 days of this approval.[180]

This plan would require shareholder approval as it would result in a 51% shareholding of the consortium of banks and would dilute the shareholding of erstwhile shareholders. The JLF will hold the asset status of the loan for eighteen months, at the end of which it must divest its holding in the distressed company.

H. 2016 Guidelines

In mid-2016, the RBI issued yet another Circular, this time containing the S4A or the Scheme for Sustainable Structuring of Stressed Assets.[181] This is a closer regulation of the SDR mechanism. In order for accounts to qualify for this scheme, there are three criteria: the project must have begun operations; the total debt including interest is more than Rs. 500 crore; and the

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[179] *See*, Reserve Bank of India, *Strategic Debt Restructuring* (June 8, 2015), *available at* https://rbi.org.in/Scripts/NotificationUser.aspx?Id=9767 (Last visited on November 3, 2016).

[180] *Id.*

[181] *See*, Reserve Bank of India, *Scheme for Sustainable Structuring of Stressed Assets* (June 13, 2016), *available at* https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=10446&Mode=0 (Last visited on November 3, 2016).

debt must be sustainable as concluded by the JLF or the consortium or they must conclude that the principal amount can be repaid at the same tenor and sustainable debt must also not be less than 50% of the current funded liabilities. The JLF or consortium will divide the debt into two parts: Part A and Part B. Part A will be the sustainable debt and the remaining part of the debt which is unsustainable will be Part B. There will be a resolution plan drawn up which will not include a fresh moratorium, extension of the repayment schedule, or reduction in interest rate of Part A of the debt. Part B will be converted to equity or redeemable cumulative optionally convertible preference shares.[182]

The conclusion of the resolution may result in one of the following three outcomes:

a) The existing promoter continues to possess majority shareholding and control over the debtor company.

b) The existing promoter is replaced by a new promoter – through conversion of the debt into equity under the Strategic Debt Restructuring scheme and following sale to a new promoter or according to the norms under Prudential Norms on Change in Ownership of Borrowing Entities.

c) The creditors have majority holding in the shares and either allow the existing management to continue or change the management to another body under an "operate and manage" contract.[183]

The resolution plan should be submitted to an Overseeing Committee which will review the plan before its implementation.

I. Analysis of Debt-Equity Conversion as an Option For Creditors

The 2015 and 2016 Guidelines (as elaborated upon above) pertain to the possibility of converting debt to equity in order for the creditors to be repaid through returns on their equity. Through this method, the creditors become the shareholders. It is usually effected by setting off the debt amount against the subscription price of the shares or by releasing debt to to the extent of the subscription price. This option is only taken as a last resort measure and requires existing shareholder approval in order to be effective.[184]

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[182] *Id.*
[183] *Id.*
[184] *See*, Steptoe & Johnson LLP, *Debt to Equity Swaps* (May, 2009), *available at* http://www.steptoe.com/publications-6418.html (Last accessed on November 3, 2016).

The primary reason for engaging in such a swap is that it reduces the burden on a loss-making company at the first instance. Since returns on shares and investments are made only out of profits and not the company's capital, it is beneficial for the company to convert debt to equity for short-term relief. Additionally, the banks are likely to receive returns on profits if the debtor picks up and resumes production, which is an incentive to invest in the company. In what is relevant to the health of the company and the creditors' interests, the lender will have a degree of control in the affairs of the company and will be able to vote in major decisions as a shareholder. In this manner, they will be motivated to ensure that the company is revived and that its dues are settled as a result thereof.[185]

However, there are flipsides to such conversions. The first is that the creditor loses priority upon becoming a shareholder and will rank only after creditors of the company.[186] Additionally, it is time-consuming and involves heavy procedure to redeem shares, as opposed to debt which is simpler in its repayment procedure.[187] Swapping debt for equity will also result in the loss of securities and guarantees which are given against loans, which means that obtaining the borrowed money against some kind of surety or collateral becomes impossible.[188] Existing shareholders will find that their shareholding has been diluted due to this plan and may be in favour of the move if it appears likely that it will result in a profit for the company. Under the Indian guidelines, SDR schemes prove difficult due to the possibility of not finding new promoters (elaborated upon later), resistance from shareholders and workers, and the need for constant monitoring of the corporate debtor post the swap.[189]

J. Working of SDR and S4A

Much like CDR, the debt-equity conversion guidelines by the RBI have been heavily criticised on the ground that it will only result in further debt and bring about no tangible change to the indebtedness in the industry.

A preliminary practical problem that arises in this operation is that the banks often have difficulty in finding new promoters for the company, which

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[185] WOOD, *supra*, note 5, at 645.
[186] *Id*, at 646.
[187] Companies Act, 2013, §5 which imposes conditions on the redemption of preference shares.
[188] WOOD, *supra* note 5, at 648.
[189] *See*, RBSA, STRATEGIC DEBT RESTRUCTURING (September, 2015), *available at* http://rbsa.in/archives_of_research_reports/Strategic_Debt_Restructuring.pdf (Last visited on November 3, 2016).

must be done within 18 months as per the guidelines.[190] In a telling report by Religare, the analysis concluded that SDR mechanisms were unfit to deal with the mounting debt in India. At the first instance, the report concluded that by the time SDR measures are invoked, the debt levels will have risen by 70% upon finishing the SDR process from the date of restructuring.[191] If the SDR mechanism fails, the company will be written of as an NPA which will be detrimental to the creditors.[192]

The functioning of these schemes also pose several legal and practical challenges. Take the case of Kingfisher Airlines, which in 2010 underwent a debt-equity conversion of Rs. 1355 crore, resulting in the banks owning 23.21%.[193] Despite this and promoter conversion of debt into equity, the company could not be revived. Equity is also more expensive than debt due to tax liabilities that arise in the case of shareholding. Another problem that has been highlighted is that unsecured creditors can approach formal adjudication forums and demand repayment of their debt. Since SDR and S4A schemes are non-statutory, courts and tribunals are likely to pay heed to unsecured creditors and outstanding debt will have to be paid.[194]

IV. THE INSOLVENCY AND BANKRUPTCY CODE: A GAME CHANGER?

In May, 2016, the Parliament passed the Insolvency and Bankruptcy Code ('the Code'). This Code was brought in to simplify insolvency proceedings as a whole and to replace the multiple Acts and regulations which governed debt recovery in India. In this Part of the paper, I will look at the efficacy of "hybrid" procedures dealing with insolvency over completely informal and non-statutory procedures like CDR, SDR and S4A – and assess whether the Code falls within this category. I will then look at how the Code may serve as a viable alternative for CDR and SDR agreements by closely examining the provisions of the Code and of the Draft Rules associated with the Code.[195]

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[190] *See*, Namrata Acharya & Ishita Ayan Dutt, *Little success for SDR as banks scout for promoters*, BUSINESS STANDARD (November 30, 2015), *available at* http://www.business-standard.com/article/companies/little-success-for-sdr-as-banks-scout-for-promoters-115112700444_1.html (Last visited on November 3, 2016).

[191] *Supra*, note 66.

[192] *Supra*, note 66.

[193] *See*, Tamal Bandyopadhyay, *S4A won't solve the bad loans problem*, LIVEMINT, June 27, 2016, *available at* http://www.livemint.com/Opinion/0tjjJ3EIJsuAK52VFJy0ZO/S4A-wont-solve-the-bad-loans-problem.html (Last visited on November 3, 2016).

[194] *Supra*, note 66.

[195] The Rules have been placed on the Ministry of Corporate Affairs website for public comments and are expected to be finalised by November.

A. Hybrid Procedures

Hybrid procedures are those that fall between formal insolvency proceedings such as winding up before the Company Law Board and informal agreements such as those under CDR and SDR in India. Hybrid procedures combine elements of both formal and informal options.[196] This means that there is usually a contractual agreement between the creditors and the debtor but there is oversight by a judicial or quasi-judicial body at the same time.[197] There are several ways in which a hybrid procedure can play out. It can be such that a court order is sought for a stay on all creditors to call for liquidation while the majority of creditors are formulating a workout plan. Alternatively, it can be that the court appoints a mediator to resolve the debt dispute and reach an appropriate plan.

Hybrid measures often have an advantage over wholly formal and wholly informal means of debt restructuring as they provide parties with the flexibility to decide the terms of the workout and restructuring but still subject the entire procedure to adjudicatory control.

Under the Code, the procedure is one that adopts a hybrid approach to insolvency and debt restructuring. According to the provisions of the Code, upon default of loan payment, any creditor can apply to the Insolvency and Bankruptcy Board for insolvency of the corporate debtor. Upon this application, the Board will appoint an Insolvency Professional[198] who will be approved by the Committee of Creditors.[199] This Insolvency Professional will also take over the management of the company as the Board of Directors will be suspended and all powers will be in the hand of the Insolvency Professional.[200] The Insolvency Professional will then create the information memorandum,[201] following which the resolution plan will be proposed by the creditors along with the Insolvency Professional.[202] This plan must be approved by 75% of the creditors[203] and then by the Adjudicating Authority.[204] Failing this approval, the company will go into liquidation.[205]

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[196] *See*, Francisco J. Garcimartin, *The Review of the Insolvency Regulation: Hybrid procedures and other issues*, *available at* http://www.eir-reform.eu/uploads/papers/PAPER%206-1.pdf (Last visited on November 3, 2016).
[197] Garrido, *supra*, note 6, at 57.
[198] Insolvency and Bankruptcy Code, 2016, §16.
[199] Insolvency and Bankruptcy Code, 2016, §22.
[200] Insolvency and Bankruptcy Code, 2016, §17.
[201] Insolvency and Bankruptcy Code, 2016, §29.
[202] Insolvency and Bankruptcy Code, 2016, §30.
[203] Insolvency and Bankruptcy Code, 2016, §30(4).
[204] Insolvency and Bankruptcy Code, 2016, §31.
[205] Insolvency and Bankruptcy Code, 2016, §33(1).

Under the Code, therefore, it is clear that the process to resolve insolvency and to develop a plan for recovering and restructuring the debt is not one that is fully subject to court or tribunal intervention but follows a hybrid approach of allowing parties to come to a conclusion among themselves and work out a solution.

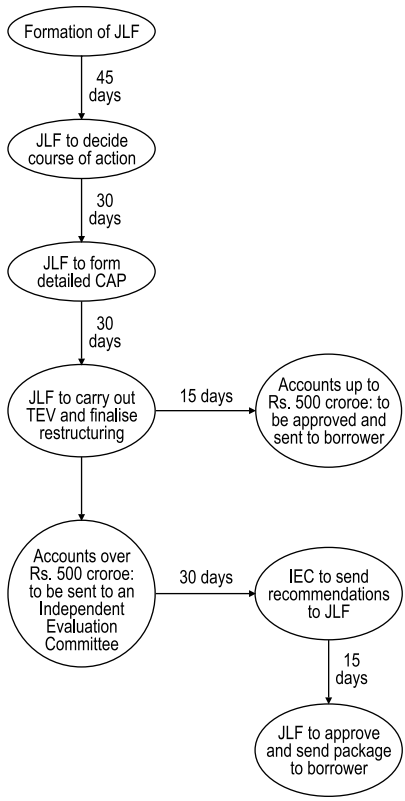
B. Comparison between CDR (JLF Route) and The Code[206][207][208]

	Corporate Debt Restructuring (JLF route)	**Insolvency and Bankruptcy Code, 2016**
Is there a minimum debt amount?	Yes. Rs. 10 crore.	Yes. Minimum default amount is Rs. 100,000. The Central Government can increase this minimum amount to a higher value, which cannot exceed Rs. 10,000,000.[98]
What is the trigger event that causes initiation of the mechanism?	The reporting of an account to the RBI as SMA-2 by one of more lending banks/ non-banking financial companies. OR A request from the borrower to form a JLF (if it foresees financial distress). [***SMA-2****: Payment of principal or interest is overdue for 61-90 days*]	An application by a financial creditor or operational creditor or the corporate debtor to initiate the corporate insolvency resolution process before the Adjudicating Authority (currently the NCLT).[99]
Can either the debtor or the creditor cause the trigger?	Yes.	Yes.
What happens post-trigger?	The JLF should be formed and it must formulate a Corrective Action Plan.	The Adjudicating Authority appoints and Insolvency Resolution Professional.[100]

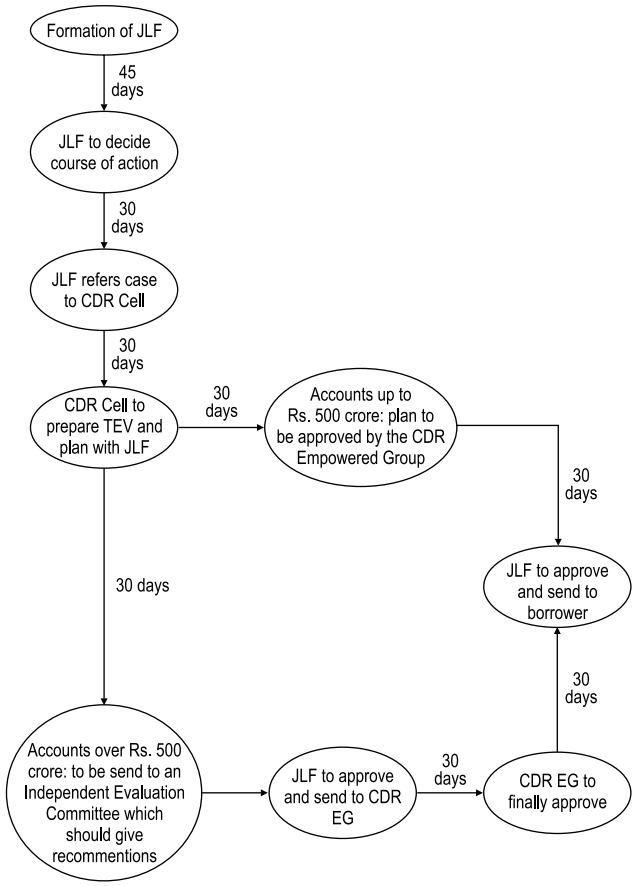
[206] Insolvency and Bankruptcy Code, §4.
[207] Insolvency and Bankruptcy Code, 2016, §§7-10.
[208] Insolvency and Bankruptcy Code, 2016, §13.

What is the procedure to formulate the plan?

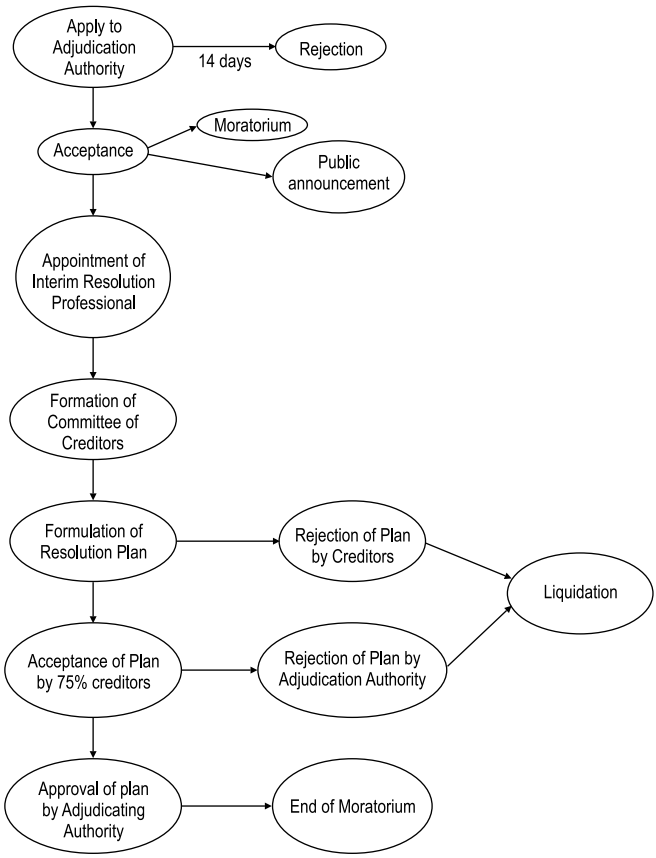
JLF:



CDR:


Formation of JLF
45 days
JLF to decide course of action
30 days
JLF refers case to CDR Cell
30 days
CDR Cell to prepare TEV and plan with JLF
30 days
Accounts up to Rs. 500 crore: plan to be approved by the CDR Empowered Group
30 days
JLF to approve and send to borrower
30 days
30 days
Accounts over Rs. 500 crore: to be send to an Independent Evaluation Committee which should give recommentions
JLF to approve and send to CDR EG
30 days
CDR EG to finally approve

IBC:



What is the total number of regulatory steps to be complied with?	JLF Route Accounts up to Rs. 500 crore: 5 Accounts up to Rs. 500 crore: 7 CDR Cell Route Accounts up to Rs. 500 crore: 6 Accounts up to Rs. 500 crore: 8	7

What are the broad timelines to be followed?	JLF Route Accounts up to Rs. 500 crore: 120 days Accounts over Rs. 500 crore: 150 days CDR Route Accounts up to Rs. 500 crore: 165 days Accounts over Rs. 500 crore: 195 days	The plan must be approved by the creditors within 180 days of the date of application; this can be extended by 90 days.[101]
What is the legal basis for the plan?	The Inter-Creditor Agreement and the Debtor-Creditor Agreement.	Part II, Chapter II, Section 6-32.
Is any class of debtors/creditors barred from availing this option?	Yes. Wilful defaulters; may be allowed if the JLF is satisfied that the defaulter can rectify. Borrowers who have engaged in fraud or malfeasance.	Yes. The following debtors/creditors cannot initiate an IRP: A corporate debtor undergoing the IRP; A corporate debtor that has completed an IRP in the twelve months preceding the application date; A corporate debtor/financial creditor which has violated the terms of an IRP in the twelve months preceding the application date; A corporate debtor who has been ordered into liquidation.[102]
Are unsecured creditors covered under the plan?	They may be, if covered in the ICA.	Yes.
What percentage of creditors must agree to the plan?	75% (by number) and 60% (by value).	75% of financial creditors (by value).[103]
Are there any compulsory terms in the plan?	Standstill clause.	Yes. Terms concerning the cost of insolvency resolution, i.e., estimates, timelines, burden etc.; Payment of operational creditors' liquidation value; Payment of dissenting financial creditors' liquidation value; Duration of the plan; Transfer of management of the corporate debtor.[104]

[101] Insolvency and Bankruptcy Code, 2016, §22.
[102] Insolvency and Bankruptcy Code, 2016, §11.
[103] Insolvency and Bankruptcy Code, 2016, §12.
[104] Draft Insolvency and Bankruptcy (Insolvency Resolution Process) Regulations, 2016, Regulation 42.

What is the standstill/ moratorium period?	Depends on the DCA/ICA; usually 90 days, which can be extended to 180 days.	180 days; can be extended to 270 days.
Is it applicable to foreign creditors?	Yes. It applies to all commercial banks.	Yes. Sections 5(7) and 5(20) define financial and operational creditors respectively as *persons* to whom a financial or operational debt is owed. Section 2(23) further defines a person to include a person resident outside India.
Is there an exit option for dissenting creditors?	Yes, with a condition precedent. Dissenting lenders can exit the ICA and CAP by selling their debt to new or existing lenders. If a buyer cannot be arranged for, the lender must agree to the ICA and CAP.[105]	Yes. The dissenting financial creditors can be paid their liquidation value before recoveries are made by operational or majority financial creditors.[106]
Is a change of management at any stage envisaged?	Not in the ordinary course – it may happen if SDR or S4A is invoked.	Yes. The Interim Resolution Professional will be responsible for the management of the corporate debtor and run the business as a going concern with direction from the committee of creditors[107] - but this is subject to change according to the resolution plan.
Who oversees the implementation of the process?	Unclear. The lenders are supposed to monitor the process but there is no clear stipulation of a body for the same.	The Resolution Professional or else an Insolvency Professional appointed by the Committee of Creditors.[108]

[105] *See*, Reserve Bank of India, *Review of Prudential Guidelines – Revitalising Stressed Assets* (February 25, 2016), *available at* https://rbidocs.rbi.org.in/rdocs/notification/PDFs/330NT250216EFF71EF8EC454943A584E9DD0A3E77FB.PDF (Last visited on November 3, 2016).

[106] Draft Insolvency and Bankruptcy (Insolvency Resolution Process) Regulations, 2016, Regulation 42.

[107] Insolvency and Bankruptcy Code, 2016, §§17-23.

[108] Draft Insolvency and Bankruptcy (Insolvency Resolution Process) Regulations, 2016, Regulation 43.

What happens in case the plan is not successful?	The JLF can enter into an SDR or S4A arrangement, 5:25 scheme (for infrastructure and core industries). If this is also unsuccessful, the creditors can initiate recovery proceedings.[109]	The corporate debtor goes into liquidation.[110]

C. The Resolution Plan

The Draft Insolvency and Bankruptcy (Insolvency Resolution Process for Corporate Persons) Regulations, 2016, which have been uploaded on the Ministry of Corporate Affairs website, contain comprehensive guidelines on the content of insolvency resolution plans. Unlike the RBI circulars which contain vague directions on options available to defaulting debtors and desperate creditors, the Regulations mentioned herein are a far more reliable guideline for what the contents of the DCA ought to be.

At the first instance, Regulation 42 provides for mandatory components of the plan. These are an estimate of costs, of the time that will be taken, identification of assets and funds in relation to the corporate debtor, payment of resolution costs. Since the Code draws a difference between operational and financial creditors, the Regulations also provide for separate relief. Operational creditors are to be paid earlier than financial creditors. Operational debt, as defined in Section 5(21) of the Code includes debt accruing from goods, services, employment agreements, and government dues. Financial debt, under Section 5(8) consists of debts disbursed against the time value of money. The earlier payment of operational creditors means that contracts or dues external to corporate financing are to be paid first. Another notable part of the Regulations is that it provides for any dissenting financial creditors to be paid their debts in liquidation value before the consenting financial creditors are paid. The plan must also specify what happens to the management and control of the company for the duration of implementation of the plan.

[109] However, analysts predict that the outcome of unsuccessful SDRs will be massive write-offs. *See supra*, note 66.

[110] Insolvency and Bankruptcy Code, 2016, §33.

Regulation 42 provides for the different measures that can be included in the plan, which vary from extension of maturity date to change in interest rate to debt-equity conversions.

D. Analysing Qualitative Differences between the Code and Existing CDR/SDR measures

With the coming of Code, it is clear that the process of recovering debt in India promises to simplify itself. By replacing the earlier swarm of often conflicting laws, the Code attempts to bring some clarity to the domain of insolvency and bankruptcy. While the Code effectively overrides erstwhile legislative measures to recover debt, the question of it fully replacing informal methods such as CDR and SDR still remains. Upon a close analysis (as elucidated above) of the provisions of the Code and its associated Regulations, it appears that these newly passed laws and guidelines do act as an effective substitute to CDR and SDR schemes that the RBI had promulgated, proving to be simpler, more straightforward, and with lesser steps of compliance to be adhered to, but without compromising on the enforcement aspect of debt recovery options. This can be attributed to the hybrid approach that has been adopted in debt recovery, wherein parties can reach their own resolution and also be subject to a quasi-judicial authority. This is definitely a positive step in debt recovery as the failures of CDR lay in the inability of banks and lenders to effectively enforce the terms of the Debtor-Creditor Agreement, despite allowing parties to work out a common solution.

The need for a proper code can be put into perspective by looking at World Bank Rankings for Resolving Insolvency (2017), which is based on data collected till June, 2016, one month after the coming of the Code. India currently ranks 136th, with a recovery rate placed at 26 cents on the dollar, and an average time of 4.3 years. This is in comparison to Finland, which is ranked 1st, with a recovery rate of 90.3 cents and, an average time of 0.9 years. Even in South Asia, India fares poorly, with Pakistan ranking 85th, having a recovery rate of 43 cents, and average time of 2.6 years; and Sri Lanka, ranking 75th, with a recovery rate of 46.2 cents, and average time of 1.7 years. India's neighbours at ranks 135 and 137 are the Maldives (recovery rate: 50 cents; average time: 1.5 years) and Papua New Guinea (recovery rate: 24.9; average time: 3 years).[111] It cannot be doubted that a revamped insolvency regime was the need of the hour and its coming into force promises to bring forth revolutionary change.

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[111] *See*, World Bank, *Doing Business, Resolving Insolvency* (2017), *available at* http://www.doingbusiness.org/data/exploretopics/resolving-insolvency (Last visited on June 20, 2017)

The following characteristics of the Code are a definite game-changer in the process of debt recovery and deserve to be highlighted. *First*, the presence of a formal body which oversees the working of the resolution plan is a welcome step as it ensures that there is constant accountability on the part of the debtor and creditors to a higher regulatory authority. *Second*, the Code also creates Information Utilities, which will make the process of obtaining relevant credit information much easier. The creation of a separate class of professionals who will work on the resolution plan is also a welcome change as it enables resolution plans to be neutral of creditor or debtor biases and will move towards the most efficient solution for all parties. *Third*, the institutionalisation of such professionals in an organised and regulated manner will make it easier for corporate debtors and their creditors to access quality advice on how to go about restructuring debt. This is a worthy replacement for the position of lead bank and a steering committee, both of which may be unsuitable in monitoring the entire process of debt restructuring in the long run.

Fourth, with respect to the manner in which the debt can be dealt with, the Code provides a far more flexible paradigm by ensuring that the option to undertake debt-equity swaps may be done at an earlier stage and not when other methods have failed. This may go a long way in recovering debt. *Finally*, a uniform process that applies to all corporate debtors, irrespective of the quantum of debt provides a far more efficient and homogenous system. On the whole, the Code lays down a hard regime for debt defaulters and its strict timelines may aid creditors in their efforts to recover debt.

Despite the obvious advantages that the Code has over existing RBI guidelines, it cannot be said that they have no value. The greatest advantage of the CDR mechanism lies in its early identification of stressed assets, which could potentially save considerable time and energy over addressing non-performing loans after more significant defaults. Furthermore, the CDR mechanism does not provide for a change in management at the first instance – this option is triggered only under SDR/S4A invocation. This may be positive for the corporate debtor whose management will compulsorily change (even if just for a time) under the Code. At present, the conflict that exists is between informal methods under CDR and SDR mechanisms and the formal, legislative route under the Code. If this is not resolved, it could lead to a situation where debtors and creditors are stuck in between two legitimate methods of debt recovery, which is what the Code itself tries to eliminate. One method of resolving this conflict is by the RBI remodelling its guidelines and limiting them to identification of stressed assets and formulation of plans to neutralise potential NPAs, i.e., to minimising the possibility of debt defaults *prior*

to actual default. Upon actual default, the provisions of the Code would come into effect and the timelines and options therein would be applicable.

The Code, much like CDR, also incorporates principles from the international approaches outlined earlier in the paper. The major parts of the London Approach are seen in the standstill clause and the creation of information utilities. The Bangkok Approach is also incorporated in the form of an overseeing entity, whose duty it is to ensure implementation. However, the concept of Inter-Creditor Agreements, as outlined in the Istanbul Approach is conspicuously missing in the Code. In fact, Section 53(2) clearly states that agreements between equal-ranking creditors will be disregarded by liquidators. This is in contrast with American law, wherein Section 510(a) of the United States Bankruptcy Code, allows for the enforcement of debt subordination agreements by bankruptcy court – therefore, agreements between creditors can impact distribution of assets.[112] This is another area where the Code could look to reform itself and allow for more flexibility in debt recovery, particularly where there is a consortium of lenders, as envisaged by the RBI guidelines as well.

Overall, the Code certainly offers a more holistic and comprehensive plan of action for debt restructuring in India. It incorporates many of the attractive parts of CDR mechanisms, most importantly the idea of a moratorium period, and the possibility of exit of dissenting creditors. Additionally, since the Code offers a hybrid approach to restructuring and allows the creditors (along with the Insolvency Professional) to decide the exact terms of the resolution plan, it appears to be far more flexible than CDR, which allows certain options only after the occurrence of certain events – case in point is how SDR cannot be invoked until CDR measures have failed. In light of the positive outlook that can be gleaned from an analysis of the Code, it can safely be said that it can act as an effective replacement for informal mechanisms like CDR as well.

CONCLUSION

Through the course of this paper, I have examined informal arrangements on debt restructuring and assessed how these measures have panned out in the Indian financial scenario. While the RBI Guidelines have been issued with the London Approach in mind, recent evidence makes the casual observer wonder whether they prove to be effective at all, considering the massive failures of CDR mechanism to recover corporate debt. The new Insolvency and

[112] 11 U.S.C. §510(a).

Bankruptcy Code, on the other hand, showcases considerable potential to overtake the RBI Guidelines, and indeed, several other outdated legislations in regulating corporate finance in India. Through a comparative analysis of the two, I have attempted to look at which option may be more viable for a corporate debtor. In conclusion, I am of the opinion that considering the drawbacks of CDR and SDR in India and indeed, the ineffectiveness of non-enforceable and informal means of debt recovery, the Code would be a viable alternative.

Engaging with the World: An Analysis of India's Trade Policy in the Wake of the Belt and Road Initiative

James J. Nedumpara[*] *and Archana Subramanian*[**]

India's trade policy goals have turned a full-circle since its Independence in 1947. While agriculture is the backbone of its economy, more recently, India has become a powerhouse in providing manpower and backbone services to a range of sectors such as information technology and software, banking, medical, transport and logistics, telecommunications, engineering services and professional services. This article seeks to place in perspective, India's rise from an inward looking and autarkic economy to an increasingly powerful economy in the world, currently the sixth largest. The objective of this article is to examine India's economic and development paths adopted since its independence and also its engagement with countries and trading blocs through economic treaties and preferential trade agreements. Such an examination is critical as India seeks to assert its place in the global trading community. This examination assumes further significance in light of the Belt and Road Initiative (BRI) spearheaded by China. While India's participation in the BRI is dependent on a myriad of factors, the BRI project promises to shake up the landscape of international economic relations in the years to come. The BRI is not merely an economic initiative, but has strategic and nationalistic undertones, which are too important to ignore. While the contours of BRI are still unfolding, an evaluation of India's own development path and economic interests could be the key to evaluating India's approach towards it.

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I. INTRODUCTION

The Indian economy has seen steady and progressive growth in the last twenty years with significant reduction in poverty and unemployment. India's balance of payments is roughly around US$ 370 bn in 2016, which is a remarkable increase from its pre-1991 crisis levels. Foreign investment has surged in several sectors and the economy has performed well on a number of parameters.[1] While India's place in the global economy is notable, it faces important challenges, which include preserving its growth momentum, securing key export markets and turning around the country's sluggish performance in the merchandise sector. In addition, India has been less successful in exploring free trade agreements and other economic treaties with other developing states, especially in South Asia.

In the above context, this article analyses the impact of the Belt and Road Initiative (BRI) – China's grand project to establish trade routes and infrastructure from China to Europe and stretching all the way up to Africa while entrenching deeper economic cooperation and development assistance within Asia. While India's participation in the project is dependent on a multitude of factors, the BRI offers benefits in trade facilitation, increased participation in value chains as well as an opportunity for India to deepen its trading relationships with its neighbours. However, India's strategic interests and foreign policy sensitivities cannot be lost sight of.

For ease of analysis, this article has divided India's post-Independent experiences in trade and economic liberalization into three phases: from 1950 to 1971; from 1971 to 1991; and the post- 1991 reforms. The article further highlights the present day challenges facing India's trade and investment outlook. Lastly, the article examines whether the BRI is an option, which India should seriously consider in the light of the recent developments that have unfolded as part of the BRI.

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[1] Office of the Economic Advisor, MINISTRY OF COMMERCE, *Key Economic Indicators as on June, 2017* (2017), http://eaindustry.nic.in/key_economic_indicators/Key_Economic_Indicators.pdf (last visited June 28 2017).

II. Towards Economic Independence: 1950-75

At the time of independence from the British in 1947, India was still an impoverished country and its resources were not adequate to support its almost 350 million population. Despite centuries of foreign occupation and its colonial past, India adopted an open and liberal position to trade. The early 1950's were characterized by 'progressive liberalization'.[2] Exports were limited to traditional agriculture goods such as spices, tea and raw cotton. The Government encouraged foreign investment by according 'national treatment' to existing foreign industries, permitting remittances of profits and dividend of foreign companies abroad and reduced a variety of taxes including business profit tax, personal income tax and super tax as applied to foreign companies and their employees.[3] However, the mid-1950s were characterized by low demand for agriculture-based products on account of a downturn in the global economy. Further, the sterling balance that India had accumulated in the Second World War was also exhausted. The resultant domestic foreign exchange shortage was further aggravated on account of the policies adopted in the Second Five Year Plan, which mandated the need for foreign exchange in sectors such as industry, mining and transport.[4]

The consequent balance of payment crisis erupted with the onset of the Second Five Year Plan (1956-61). The economic policies enumerated in the plan were broadly in line with the *Mahalanobis*[5] model that strongly influenced economic planning in India in the initial years after independence.[6] While India adopted the mantra of 'self-reliance' in the Second Five Year Plan, the demand for imported goods grew at a pace that put inordinate pressure on the scarce foreign exchange that India had. Trade policy at this time was characterised with 'export pessimism', which could be attributed to factors such as the structure and orientation of planning and fiscal policy,

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2 *See* Jagdish N. Bhagwati & Padma Desai, India: Planning for Industrialization (1970).

3 Arvind Panagariya, India: The Emerging Giant 25 (4th ed. 2013).

4 T.P. Bhat, *Structural Changes in India's Foreign Trade* 3 (Institute for Studies in Industrial Development, 2011), http://isidev.nic.in/pdf/icssr_tpb.pdf.

5 The Feldman-Mahalanobis model is a neo-marxist model of economic development, independently created by Soviet economist G.A. Feldman and Indian statistician P.C. Mahalanobis. The model aims at promotion of investment in the production of capital goods with the aim for building up domestic consumption in the goods sector. The Mahalanobis model, therefore, aims to connect capital accumulation and economic growth. It focuses on an inward orientation of the economy and accords importance to basic investment goods. The economic policy at this time recognized the importance of self-sufficiency in the primary and secondary sectors of the economy for capacity building for production of consumer goods.

6 Jagdish N. Bhagwati & T.N. Srinivasan, *An Overview: 1950-70, in* Foreign Trade Regimes and Economic Development: India 5 (Jagdish Bhagwati & T.N. Srinivasan eds., 1975).

relative shortage of natural resources and technology and the focus of policy makers on protecting the domestic industry.[7] The experiences of colonialism also began to influence trade policy, with policymakers becoming increasingly suspicious of foreign trade.[8]

The inward looking attitude of policy makers continued with the intensification of industrial licensing and exchange control under the Second Five Year Plan – two ideas that would influence the Indian economy for the next four decades.[9] The exchange control system was implemented which required exporters to surrender their foreign exchange earnings to the Reserve Bank of India at the official exchange rate, and this foreign exchange was later allocated through the import licensing regime.[10] The import and industrial licensing regimes functioned in parallel – with any expansion or new investment requiring both import and industrial licences. While import licensing was undertaken with a view to protect domestic industries, industrial licensing was implemented with the need to avoid concentration of economic resources in the hands of a few corporate houses. Consequently, the public sector continued to dominate the economy through this phase.[11]

The Second Five Year Plan also marked the adoption of an import substitution led model of growth, wherein the focus was shifted from importation to setting up of indigenous industries for replacing such imported goods. Significant amounts of state resources were spent on developing capital-intensive industries in areas such as iron and steel, minerals and metals, coal, energy and natural gas, and aeronautics.[12] The Industrial Policy of 1956 encouraged the entry of foreign capital in order to develop a strong industrial and manufacturing base.[13] The focus was on rapid economic development and to develop industries that produced machines and capital equipment, which were viewed as essential for industrial growth and development, under the Second Five Year Plan.

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[7] Deepak Nayyar, India's Exports And Export Policies In The 1960s 220 (1976).

[8] Anne Krueger & Sajjid Chinoy, *The Indian Economy in a Global Context*, *in* Economic Policy Reforms and the Indian Economy 13 (Anne Krueger eds., 2002).

[9] Bhagwati & Srinivasan, *supra note* 6, at 21.

[10] T.N. Srinivasan, *India's Economic Growth and Global Integration: Experience since Reforms and Future Challenges*, Economic Policy Symposium – Jackson Hole 195, 196 (2006), https://pdfs.semanticscholar.org/b9b2/a27ced03e78745d7e3b26fb341d-0cd1dc259.pdf (last visited June 22, 2017).

[11] Bhagwati & Srinivasan, *supra note* 6, at 37.

[12] Panagariya, *supra note* 3, at 25.

[13] Abhijit Das & Rashmi Banga, *Roles of Trade Policy in the Growth of Indian Manufacturing Sector, in* Twenty Years Of Economic Liberalization: Experiences and Lessons 12 (Abhijit Das and Rashmi Banga eds., 2012), http://unctad.org/en/PublicationsLibrary/osg2012d1_en.pdf (last visited May 22, 2017).

The later part of the 1960s have been described as a period when policymakers sought to reduce the adverse impact of the autarkic policies adopted in the earlier decade. The Government introduced subsidies and other incentive schemes to encourage the industry to seek export markets, provide credit to exporters through newly established institutions like the Export Credit and Guarantee Corporation (ECGC) as well as provide direct financial support to exporters in the form of cash subsidies.[14] While these efforts can be regarded to be a partial attempt at liberalization, it did not restructure the system towards an open regime.

In 1966, India suffered its second BoP crisis when its fiscal stability was threatened on account of a flat rate of growth and wars with China and Pakistan. By 1965-66, India's fiscal debt had risen to almost 6.7 percent of the GDP.[15] The Indian Rupee was devalued in order to alleviate the export bias and the devaluation was accompanied by liberalization of import licensing, increased taxes on exports and reduced export subsidies.[16] While these measures were targeted at making India's exports competitive in international markets, the effects of liberalization were not palpable.[17] This coupled with a political backlash to the devaluation[18] led to a reversal in trade policy with Indian policy makers choosing to look inwards through regulations imposed on businesses under the Monopolies and Restrictive Trade Practices Act, 1969 (MRTP Act) and control of foreign investment through the Foreign Exchange Regulation Act, 1973 (FERA). Policy hindered the availability of private foreign investment in India. The MRTP Act curtailed business freedom by, *inter alia*, imposing approval requirements from the Central Government for all new undertakings, takeovers, mergers etc., if the same was in 'public interest'. This lack of commercial independence was further compounded under FERA. FERA stipulated that foreign equity holding was subject to a cap of 40%, and exceptions were granted at the discretion of the Foreign Investment Board. Apart from the exceptions granted, companies that did not dilute their foreign shareholding to less than 40% had to wind up. Though several multinational firms such as IBM and Coca Cola left India in the late 1970s, exceptions in FERA allowed many technologically intensive, export intensive firms to preserve majority foreign ownership, even up to 74%. Many existing multinationals consolidated their positions in India, demonstrating that FERA was more hostile to *new*

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[14] Bhagwati & Srinivasan, *supra note* 6, at 37; Nayyar, *supra note* 7, at 242.

[15] Arvind Panagariya, *India's Trade Reforms* BROOKINGS INSTITUTION 3 (2004) https://www.brookings.edu/wp-content/uploads/2016/07/2004_panagariya.pdf (last visited May 10, 2017).

[16] Panagariya, *supra note* 3, at 56.

[17] Panagariya, *supra note* 3, at 57.

[18] Panagariya, *supra note* 3, at 57.

foreign investment than existing foreign collaborations.[19] However, the policies at this time were restrictive and foreign collaborations were down from 36.36% during 1959-1966 to a mere 16.11% during 1969-79.[20]

Liberalization was also curtained by way of the Industrial Licensing Policy adopted by the Government in 1970, which allowed for selective grant of licenses to private companies based on the classification of industry into core industries, heavy investment and middle sector industries. Under this regime, businesses that had inroads into policy making flourished, but industrial sectors as a whole declined. As Panagariya notes, all these measures resulted in a substantial decline in the performance of the Indian industry with the share of non-oil, non-cereal imports in GDP falling from an already low 7% in 1957-58 to 3% in 1975-76.[21]

India's move towards liberalization in the next decade was motivated by several factors: *first,* even though the import regime was partially liberalized, the licensing system led to a shortage of imported capital equipment and raw materials which had an adverse impact on the domestic industry; and *second*, a marginally improved export performance as well as an increase in remittances from overseas Indian workers helped in the accumulation of healthy foreign reserves, thereby lessening doubts of policymakers on the effect of liberalization on the BoP status.[22]

Section C of this article examines the second phase of India's economic planning. The second phase started in the mid-1970s and continued up to 1991, during which India implemented a number of schemes to incentivize trade. This phase presents an interesting study as the GDP grew at a much faster pace compared to the previous decades although the overall level of trade restrictiveness remained almost static.

III. Inching towards Liberalization: 1976-91

India's economic policy in the 1960's, though promoting exports, did not achieve the desired levels of economic or social growth with a resulting adverse effect on employment and wages.[23] The realization of the failure of

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[19] Suma Athreye & Sandeep Kapur, *Private Foreign Investment in India*, 24 (3) THE WORLD ECONOMY 6 (2001).

[20] Nagesh Kumar, Multinational Enterprises and Industrial Organization: The Case of India 44 (1st ed. 1994).

[21] Panagariya, *supra note* 15, at 5.

[22] Panagariya, *supra note* 15, at 5.

[23] Rahul Mukherji, Globalization and Deregulation: Ideas, Interests and Institutional Change in India 66 (2014).

an inward looking strategy coupled with the need for technological modernization of the local industry led to a series of reforms in the late seventies and eighties to liberalize and integrate the economy with the rest of the world.[24] Globally, this period marked the beginning of the neoliberal state and the 'Washington Consensus', with trade theorists advocating privatization, reduced state involvement in the economy as well increased operation of market forces.[25] India did not embrace these changes wholeheartedly although some incremental changes were made to make trade more open.

The most fundamental step in this regard was the introduction of the Open General Licensing (OGL) regime. If an item was not on the OGL list, a license was required from the Ministry of Commerce to import the same. However, an importer of an item on the OGL List was required to meet the 'end use' requirement, which was a component of the import regime at the time.[26] The OGL list was still a small category comprising only 30% of imports in 1988. With respect to exports, licensing and canalization was kept to the minimum and the Government introduced several incentives to promote exports, especially after 1985.[27] However, the economy remained comparatively closed to private players with the continuance of the industrial licensing regime as well as establishment of public sector enterprises such as the Minerals and Metals Trading Corporation and the Food Corporation of India which exercised a monopoly in respect of import and export of specified products. The fact that by 1987, sixteen of such agencies were in operation indicates the substantial control that the state exercised over the economic landscape at that time.[28]

The pervasive role of the state in economic regulation was also witnessed in areas such as the regulatory regime for foreign investment. In the 1980's, growing concerns about technological stagnation and poor export performance drew the attention of policy makers to these restrictive procedures and consequently, there was a softening of the regulatory restrictions on foreign investment. While firms that were export oriented were granted exemptions from FERA requirements on foreign shareholdings, restrictions on technological transfers and royalty payments were relaxed to boost manufacturing within the country.[29] However, foreign investment flow continued

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[24] Uma Kapila, India's Economic Development Since 1947 694 (4th ed. 2009).

[25] Gregory Shaffer, James Nedumpara and Aseema Sinha, *State Transformation and the Role of Lawyers: The WTO, India, and Transnational Legal Ordering*, 49 Law & Society Review 595, 601 (2015).

[26] Panagariya, *supra note* 3, at 86.

[27] Panagariya, *supra note* 3, at 90.

[28] Panagariya, *supra note* 3, at 87.

[29] Athreye & Kapur, *supra note* 19 at 9.

to be impacted on account of bureaucratic discretion and regulatory bottlenecks. Thus, there was only a marginal increase in foreign inflows and the domestic industry started to rely more on foreign debt capital rather than equity participation to meet its foreign exchange needs.[30]

The 1991 reforms are, to an extent, the result of several failed policies that India had adopted in the seventies and eighties. Economic growth, at that time, was witnessing an extremely modest rate in consonance with the "Hindu Growth Rate" – a term coined to depict the sustained and abnormally low annual growth of India after independence – a rate of growth of 3.5% or less and much lower than the rate of growth in other developing economies at that time.[31] Further, India's external debt witnessed a rise from 12% to 23% of the GDP by 1990-91, on account of heavy internal and external borrowing.[32] By mid-1991, India's foreign exchange reserves were in the range of Rs. 2500 crore[33] and could merely sustain two weeks of imports.[34] The fiscal deficit and the depletion in foreign exchange reserves lead to the third BoP crisis for the country.

Apart from addressing India's fiscal vulnerability, the 1991 reforms were also a response to IMF's conditions that India liberalize its external trade policies and encourage private participation in order to avail international credit. Several key economists at the time were in favour of trade liberalization but suggested gradual liberalization due to the socialist leanings of the then political establishment.[35] Indian policy makers were also disheartened with the socialist model following the fall of the Soviet Union and Eastern Germany in the late 1980s.[36] Many countries in East Asia that had achieved high growth also inspired the shift in policy and poverty reduction through export oriented policies and increased private sector participation.[37] This led to a shift in the attitude of the Government in steering India from an autarkic economy to a more open and market-oriented economy.

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30 Athreye & Kapur, *supra note* 19 at 9.
31 Shaffer et al., *supra note* 25 at 695.
32 Jeffrey D. Sachs, Ashutosh Varshney & Nirupam Bajpai, *Introduction, in* INDIA IN THE ERA OF ECONOMIC REFORMS 14 (Jeffrey Sachs eds., 2010).
33 Dr. Manmohan Singh, Budget Speech of the Finance Minister, 1991-1992 ¶ 3, (July 24, 1991), http://indiabudget.nic.in/bspeech/bs199192.pdf.
34 Sachs et al., *supra note* 32 at 22.
35 Shaffer et al., *supra note* 25 at 695.
36 Shaffer et al., *supra note* 25 at 695.
37 Montek S. Ahluwalia, *Economic Reforms in India since 1991: Has Gradualism Worked?* 16 Journal of Economic Perspectives 64, 73 (2002).

IV. India opens up to the world: Reforms of 1991

The 1991 economic reforms in India are perhaps the most defining moment in India's economic history. Prior to the launch of the 1991 economic reforms, more than 80 % of the goods were subject to quantitative restrictions and India's peak tariff was 355%.[38] In July 1991, the Government introduced reforms in respect of trade of goods, services and liberalization of foreign investment. In respect of goods, removal of quantitative restrictions was accomplished by moving away from a positive OGL list to a narrow category of negative list.[39] However, removal of trade restrictions on consumer goods was more difficult on account of the large number of domestic producers, many of which were small-scale industries. While important economic reforms were made in the 1990's, the import licensing on consumer goods was removed only on April 1, 2001 after a ruling by the World Trade Organization (WTO) dispute panel and later the Appellate Body on a complaint initiated by the United States.[40]

One of the key impacts of joining the WTO was that India brought about wide changes in pursuance of its commitments under the Uruguay Round. India gradually reduced quantitative restrictions, ending the import-licensing regime in 2001.[41] With the ending of broad import licensing, the Government sought to reduce tariff rates in a structured manner with reduction in the number of tariff bands.[42] The average duties on goods which were in excess of 80 percent came down to less than 20% in the next decade or so. Export controls were also substantially reduced and the Government initiated export promotion steps such as permitting 100% foreign equity participation in export promotion zones, enhancement of duty replenishment certificate, introduction of EXIM scrips and removal of the phased manufacturing programme.[43] The reforms in the import and export regime led to a rise in imports and exports from an average of 15% of the GDP in the 1980s to 23% in 1994-95 and to an impressive share of 53 % by the end of 2015.[44]

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[38] Das and Banga, *supra note* 13 at 29.

[39] Pankaj Vashisht, *Creating Manufacturing Jobs in India: Has Openness to Trade Really Helped?* 7 (Indian Council for Research on International Economic Relations, Working Paper No. 303, 2015), http://icrier.org/pdf/Working_Paper_303.pdf.

[40] *See* Appellate Body Report, *India - Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products*, WT/DS146/AB/R and WT/DS90/2/Add.1 (Aug. 23, 1999).

[41] Vashisht, *supra note* 39 at 7.

[42] Vashisht, *supra note* 39 at 7.

[43] Vashisht, *supra note* 39 at 8.

[44] David B.H. Denoon, *Cycles in Indian Economic Liberalization*, 31 Comparative Politics 43, 54 (1998).

While the 1991 reforms were also marked by the devaluation of the Rupee – from 21.2 Rupees to 25.8 Rupees to the U.S. Dollar, the most significant contribution of the 1991 reforms was perhaps the opening up of India's dormant services sector. At the time of joining the WTO, India made market access commitments regarding services for the first time under the General Agreement on Trade in Services (GATS) involving 33 service sectors.[45] Considering the wide overreach of GATS (it covers 4 modes of services), there was a plausible need for Governments to maintain a 'level playing field' in domestic markets to ensure the competitiveness of the domestic industry. In addition, the 'positive list' approach advocated by the GATS provided considerable flexibility to a developing country such as India.

In respect of trade, India has followed autonomous liberalization both on industrial goods and services. India uses a pro-trade negative list for eliminating duties on goods especially in relation to the various preferential trade agreements it has signed after opening up its economy. In particular, India has liberalized its trade in services with several South-East Asian countries as well as Far Eastern economies such as Japan and South Korea which are significantly higher than its WTO commitments under the GATS.

To provide an update, opening up of the services sector has led to foreign investments of upto USD 7.55 billion in 2015-16 alone, contributing to roughly 60% to India's GDP and leading to an increase in foreign inflows by over 22% when compared to the previous year.[46] India's acknowledgement of the growing importance of the services sector is best witnessed by its backing of the negotiations on Trade Facilitation in Services before the WTO. In its communication to the WTO, India has laid down broader ideas including transparency of services related measures, free flow of data for Mode 1 services, ease of visa formalities for Mode 2 and 4 services etc.[47] However, India's services sector is still characterized by trade restrictions in the legal, accounting, logistics, insurance, telecom and banking sectors where India lags behind other developing countries such as China and South Africa.[48] Further, service reform including efficient infrastructure and quicker response mechanisms assume special significance as India seeks

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[45] Shaffer et al., *supra note* 25 at 697.

[46] Press Trust of India, *FDI in services sector up 77.6% in 9 mths of FY'17*, Business Standard (Mar. 5, 2017), http://www.business-standard.com/article/economy-policy/fdi-in-services-sector-up-77-6-in-9-mths-of-fy-17-117030500250_1.html (last visited May 9, 2017).

[47] Communication from India: Concept Note for an Initiative in Trade Facilitation in Services, S/WPDR/W/55 (2016); and Communication from India: Possible Elements of a Trade Facilitation in Services Agreement, S/WPDR/W/57 (2016).

[48] Harsha Vardhana Singh, *Trade Policy Reform in India since 1991* 40 (Brookings India, Working Paper No. 2, 2017), https://www.brookings.edu/research/working-paper-trade-policy-reform-in-india-since-1991/

to engage more proactively in integrating with international production or value chains.

V. India's future trade policy: Challenges and Concerns

"India Poised" was a buzzword that Indian corporate leaders and policy makers used very often in the mid-2000s, while comparing India's growth patterns with China's. While the Indian economy has grown at impressive rates during 2002-2012, and more recently during 2015-17, there is a growing feeling that the growth rates and the pace of economic reforms have been below par. This section seeks to set out the key issues plaguing India's trade policy including governance challenges, lack of trade facilitation measures, less than desirable participation in regional and global value chains as well as a failure to engage more efficiently in trading partnerships in the South Asian region.

It appears that the Indian Government's immediate goal is to increase India's share in global trade from 2.1% to 3.5% by 2020.[49] Towards this objective, the Government has introduced initiatives such as 'Make in India', 'Skill India' and 'Digital India'. These measures also seek to promote local manufacturing and provide an impetus to the domestic service sector.[50] However, it is rather ironical that India's exports have remained stagnant over the last one year despite the emphasis on an export driven foreign trade policy.[51] The stagnation of exports can be attributed to several factors such as the global economic slowdown, lower demand for petroleum exports as well as the limited diversification of India's exports – with the top 10 principal exports accounting for as much as 78% of the exports, making India's export performance extremely dependent on these commodities.[52] Further, India is also overly dependent on the U.S. and the European Union (EU) markets which account for more than 40% in India's total exports.[53] The

[49] Directorate General of Foreign Trade, *Foreign Trade Policy Statement* 1 (2015), http://dgft.gov.in/exim/2000/policy/FTP_Statement.pdf.

[50] Press Trust of India, *Narenda Modi Government unveils its first trade policy, targets doubling of exports at $900 bn*, Financial Express (Apr. 1, 2015), http://www.financialexpress.com/economy/narendra-modi-govt-unveils-its-first-trade-policy-targets-900-bn-in-exports/59535/ (last visited May 9, 2017).

[51] The export-import policy (EXIM policy) is framed for a period of five years under the Foreign Trade (Development and Regulation) Act, 1992.

[52] C.P. Chandrasekhar and Jayati Ghosh, *Understanding India's export collapse*, Hindu Business Line (Nov. 21, 2016), http://www.thehindubusinessline.com/opinion/columns/why-indias-exports-are-falling/article9370929.ece.

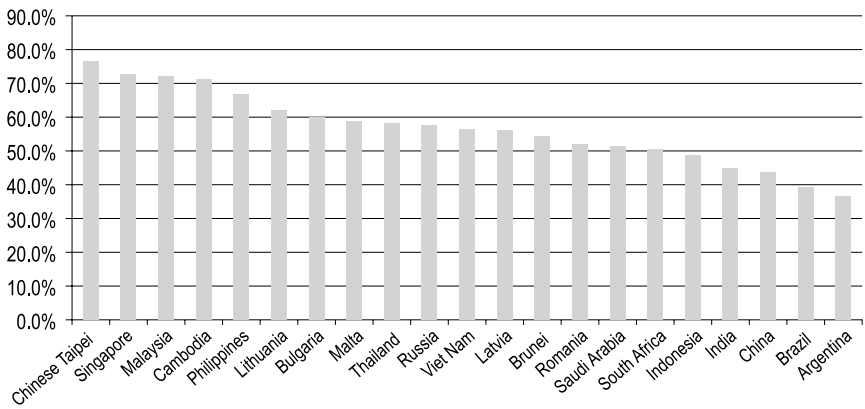
[53] Pradeep Mehta, *How to solve India's exports puzzle*, Hindu Business Line (Apr. 28, 2016), http://www.thehindubusinessline.com/opinion/how-to-solve-indias-exports-puzzle/

Regional Hirschman Index (RHI), which is a standard measure of export market diversification, shows that while India's RHI with the EU and the U.S. have declined from their respective shares of 0.067 and 0.061 in 2005 to 0.033 and 0.036 in 2015; the RHI with Asia and Africa does not reflect a substantial change.[54] These figures only highlight the need for India to re-evaluate its trading relationships with Asia and Africa and the need to diversify its export markets.

India's participation in global value chains (GVC) is another important consideration to be discussed in the context of its future trade policy. The Indian Government has recognized the need to integrate the manufacturing sectors with GVCs - a trend that has been on the rise with 11% foreign value addition in 1995 to 22% in 2011. Notwithstanding these developments, India still lags behind other Asian economies such as Singapore, Malaysia and Vietnam.[55]

Figure 2. GVC participation index for selected non-OECD economies, 2008

Foreign value-added and domestic vlaue-added used in third countires' exports, as a share of gross exports (%)



Source: Author's calculations using the OECD ICIO model, December 2012 release.

Source: Organization for Economic Co-operation and Development

Further, India's skewed import duty structure imposes higher customs duties on raw materials and intermediaries and lower duties on finished

article8533094.ece.

[54] *Id.*

[55] Bishwanath Goldar et al., *Domestic Value addition and Foreign Content: An Analysis of India's Exports from 1995 to 2011*, 29 (Indian Council for Research on International Economic Relations, Working Paper No. 332, 2017), http://icrier.org/pdf/Working_Paper_332.pdf.

goods, and tariff escalation exists on several products.[56] This discourages domestic production and export of value added items, thereby impairing India's attempt to play a greater role in GVCs. Apart from GVCs, India's participation in regional value chains (RVCs) is also of consequence. China's emergence as the global leader in manufactured goods is underpinned by its unique relationship with the South-East Asian region where it is a major importer of intermediaries from most regional economies and is a major assembling and production hub. India, on the other hand, has a much-limited presence in regional supply chains and imports of both intermediaries and finished products.[57]

Apart from the issue of integration into GVCs and RVCs, India's current focus is on the implementation of trade facilitation measures as part of its trade policy.[58] Though India has come up with cost-reducing processes like compulsory filing of online applications, self-assessment of customs, single-window schemes in customs etc., India continues to lag behind its peers including Brazil, Russia and China.[59] According to a World Bank Report of 2017, India stands 130 out of 190 countries in ease of doing business.[60] Further, a recent report of the Public Accounts Committee also noted that lack of infrastructure facilities like port to road connectivity, rail infrastructure to move containers to inland depots as well as arduous documentation mechanisms lead to delays in various stages of import and export clearances.[61] According to the Organisation for Economic Co-operation and Development (OECD), trade flows for developing countries are most impacted by streamlining of formalities, governance and impartiality and

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[56] Raj Bhala, *First Generation Indian External Sector Reforms in Context*, 5(1) Trade, Law and Development 5, 30 (2013).

[57] Amitendu Palit, *Regional Supply Chains in Asia: Examining India's Presence and Possibilities in the RCEP*, 12 (Centre for WTO Studies, Working Paper No. CWS/WP/200/20, 2016), http://wtocentre.iift.ac.in/workingpaper/Final%20version%20%20RCEP%20India%20Value%20Chain.pdf.

[58] Department of Commerce, Government of India, *Task Force on Transaction Cost in Exports: A Report* (2011), http://dgft.gov.in/exim/2000/tcostrep2011/tcostenglish.pdf.

[59] Pravakar Sahoo, Niloptal Goswami and Rahul Mazumdar, *Trade Facilitation: Must for India's Trade Competitiveness*, 15 Journal of World Trade 285, 286 (2017).

[60] World Bank Group, *Doing Business 2017: Equal Opportunities for All* 7 (2017), http://www.doingbusiness.org/~/media/WBG/DoingBusiness/Documents/AnnualReports/English/DB17-Report.pdf (last visited May 10, 2017).

[61] Anand Mishra, *House panel slams Commerce, Textiles ministries over 'lackadaisical approach' on facilitating trade*, Indian Express (May 8, 2017), http://indianexpress.com/article/india/house-panel-slams-commerce-textiles-ministries-over-lackadaisical-approach-on-facilitating-trade-4645403/ (last visited May 9, 2017).

information availability. Consequently, India could draw considerable benefits from improvements in the areas of fees and streamlining of import-export processes.[62]

The prospect of effecting trade liberalization through the multilateral routes looks extremely bleak as of now. Though waning confidence in the multilateralism system has resulted in an increase in regional trade arrangements, the future of the latter is also clouded as demonstrated by the U.S backing out of the Trans-Pacific Partnership (TPP) and the uncertainties surrounding the Transatlantic Trade and Investment Partnership (TTiP). In these times, formulation of a long lasting trade policy is a challenge for any country. There is no denying the fact that with the rapid improvements in technology and the ever-increasing movement of goods, services, capital and people, trading nations require newer models of economic cooperation. In the above context, the BRI also claims to offer a new model for economic integration without the drawbacks of preferential regional trading agreements.[63] In the light of this, we have sought to examine the contours of the BRI and assess India's approach to this initiative.

VI. BELT AND ROAD INITIATIVE: WHAT IS IN IT FOR INDIA?

Announced by the Chinese Premier Xi Jinping during his visit to Kazakhstan in 2013, the BRI has been hailed by China as the revival of the old trading routes, collectively known as the Silk Route, across Eurasia.[64] The BRI, in the current form, consists of two components: (i) the Silk Road Economic Belt (SREB) which links China to Central Asia and Europe; and (ii) the Maritime Silk Road (MSR) which would connect the eastern coast of China to Europe through the South China Sea and the Indian Ocean to the West.

The SREB will link the eastern part of China to Europe, cutting through the mountainous terrains of Central Asia while the MSR will extend from the Quanzhou province in China heading south to the Malacca Strait, and

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[62] *See* Organisation for Economic Co-operation and Development, *OECD Trade Facilitation Indicators* (2014), https://www.oecd.org/tad/facilitation/india-oecd-trade-facilitation-indicators-april-2014.pdf (last visited May 10, 2017).

[63] Andreas Grimmel and Sussane My Giang, *Why China's 'One Belt, One Road' initiative should be taken more seriously by the EU and how it can be an interregional success*, LSE BLOG (April 3, 2017), http://eprints.lse.ac.uk/75707/1/blogs.lse.ac.uk-(last visited June 10, 2017).

[64] National Development and Reform Commission, Ministry of Foreign Affairs, and Ministry of Commerce of the People's Republic of China, *Vision and Actions on Jointly Building Silk Road Economic Belt and 21st-Century Maritime Silk Road* (2015), http://en.ndrc.gov.cn/newsrelease/201503/t20150330_669367.html (last visited May 10, 2017).

from Kuala Lampur to Kolkata via the Indian Ocean, and will then proceed to Nairobi, Kenya and into the Mediterranean Sea via the Suez Canal.[65] The BRI is estimated to consist of roughly 900 infrastructure projects to promote connectivity across Eurasia and Africa through a series of composite and multitier networks. The Chinese statement on the BRI provides that the project is aimed at promoting a free flow of resources, economic factors and deeper integration of markets of countries forming part of the Belt and the Road. The statement also mentions that the BRI aims to tap market potential, promote investment and trade and create job opportunities among the people of the relevant countries. It further seeks to promote trade facilitation measures along the Belt and the Road including simplification of customs processes by resorting to online checks, lowering of non-tariff barriers, elimination of investment barriers and entering into double taxation avoidance agreements.[66] Financed by several Chinese backed institutions including the Asian Infrastructure Bank (where India is the second largest shareholder)[67], the BRI has been described as "*the most significant and far-reaching project that any nation has put forward*".[68] With approximately 60 countries, the BRI roughly accounts for an economic aggregation of USD 21 trillion and comprises of 29% of global trade, two-thirds of the world's population and 55% of the world's GDP.[69] These estimates are tentative as the list of countries that may eventually join the BRI initiative is rather uncertain at this moment.

The BRI is still evolving and its substantive and geographical contours are far from clear. While skeptics are concerned about the extent of China's involvement in the project, there is a lack of clarity regarding the nature of the project itself. While the initiative seeks to promote free and inclusive trade by promoting economic coordination and cooperation of the Belt and Road countries, it is unclear how the same will be implemented. One of

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[65] Geethanjali Nataraj and Richa Sekhani, *China's One Belt One Road: An Indian Perspective* 50 Economic and Political Weekly 68 (2015).

[66] Helen Chin, Fong Lau, Winnie He and Timothy Cheung, *The Silk Road Economic Belt and the 21st Century Maritime Silk Road*, Fung Business Intelligence Centre (2015), https://www.fbicgroup.com/sites/default/files/The%20Silk%20Road%20Economic%20Belt%20and%2021st%20Century%20Maritime%20Silk%20Road%20MAY%2015.pdf (last visited May 5, 2017).

[67] Press Trust of India, *AIIB grants $160 mn for Andhra Pradesh Power Project*, Hindu Business Line (May 3, 2017), http://www.thehindubusinessline.com/news/national/aiib-grants-160-mn-for-andhra-pradesh-power-project/article9678140.ece (last visited May 5, 2017).

[68] *One belt, one road' initiative will define China's role as a world leader*, South China Morning Post (April 2, 2015), http://www.scmp.com/comment/insight-opinion/article/1753773/one-belt-one-road-initiative-will-define-chinas-role-world (last visited May 5, 2017).

[69] Nataraj and Sekhani, *supra note* 65, at 68.

the main questions is whether the BRI seeks to form a free trade area *via* a common trade agreement or if the project is Asia's 'Marshall Plan'.[70] One can further deliberate if the BRI can transmute into a comprehensive economic cooperation agreement in the future linking Asia, Australia, Africa and Europe. At present, the BRI appears to be different from conventional free trade agreements in that there are no barriers to entry or preconditions to join. To that extent, the BRI represents a new model of international cooperation.[71] It does not appear as a market-opening instrument or initiative in itself, but more as a trade and infrastructure facilitating exercise. While China has signed memorandums of understanding, cooperation agreements and transportation agreements with several countries during the course of the Belt and Road Forum organized in China[72], it is still unclear what these engagements envisage. Does it allow Chinese firms to develop projects in third countries or does it relate to foreign investment or development aid to support infrastructural projects in other countries? Many BRI projects appear to involve both Chinese investment and involvement of Chinese firms. For example, the railway line to link Nairobi to the port of Mombasa is being constructed by the Chinese state-owned China Road and Bridge Corporation with the project being primarily financed by China's Exim Bank (to the tune of almost USD 3.6 bn).[73] If BRI projects primarily allow for Chinese investment, greater role for Chinese firms and more participation for Chinese labour[74], the utility of the project for investors from other states remains to be clarified. These questions along with the lack of clarity on the trade measures accompanying the project or its larger economic model have created apprehensions for several states, including India, in respect of its participation and involvement in the BRI.

Though China sees India as an essential player in the BRI, India has expressed its reservations about the project. Considering the several policy implications for India, it has chosen to remain cautious towards the project. One of India's biggest concerns of the BRI has been the 'unilateral' and

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[70] Enda Curran, *China's Marshall Plan*, Bloomberg (Aug. 8, 2017), https://www.bloomberg.com/news/articles/2016-08-07/china-s-marshall-plan (last visited May 10, 2017).

[71] Longyue Zhao, *China Trade Strategies: FTAs, Mega-Regionals and the WTO* (2015), RSCAS Policy Papers, European University Institute, *available at*: http://cadmus.eui.eu/bitstream/handle/1814/38270/RSCAS_PP_2015_11.pdf;sequence=1.

[72] Xinhua, *Full text: List of deliverables of Belt and Road forum*, Xinhua (May 15, 2017), http://news.xinhuanet.com/english/2017-05/15/c_136286376.htm.

[73] Briana Duggan and Idris Muktar, *Nairobi to Mombasa high-speed railway opens*, CNN (May 31, 2017), http://edition.cnn.com/2017/05/31/africa/kenya-nairobi-railway/index.html (last visited June 10, 2017).

[74] *Tapping Chinese Belt and Road Capital for Power Projects: Ten Points to Know*, Norton Rose Fulbright (April 2016), http://www.nortonrosefulbright.com/files/tapping-chinese-belt-and-road-capital-for-power-projects-137672.pdf (last visited June 10, 2017).

'nationalistic' nature of the entire project itself.[75] India is concerned that the BRI, rather than being based on economic cooperation and dialogue, could end up being a vehicle for China to assert its influence over the rest of the region.[76] Further, the lack of a consultative process from the conception of the BRI has raised alarm bells for India.[77] India is also concerned about the China – Pakistan Economic Corridor, which consists of a system of roads, rail and energy projects stretching from the port of Gwadar in Pakistan to Xinjiang in China, and is likely to pass through Pakistan Occupied Kashmir (PoK) and Gilgit-Baltistan. India is apprehensive that the corridor will not only lead to increased land connectivity between its neighbours to India's detriment, but will also allow China to establish troops close to sensitive areas such as Kashmir.[78] While the project itself raises several questions in respect of foreign and economic policy, this article will focus on the impact of Belt and Road on India's trading goals. Though the BRI could provide India with an opportunity to further economic integration with South Asia, India's participation in the project is marked with concern for India's national and strategic interests.

The BRI seeks to offer several mechanisms, which could address India's trading woes. As discussed earlier, the Indian economy has been affected by slow progress in trade facilitation. Trade facilitation measures such as simplification of the customs regime and upgrading the financial and physical infrastructure results in reduced transaction cost and thereby reduces the overall costs of exports and imports making India more trade and investment competitive.[79] It is also crucial to the success of Governmental initiatives such as 'Make in India', which are dependent on India's trade competitiveness.[80] The BRI also focuses on ensuring cooperation in matters of custom procedures, certification and accreditation of products, development of 'single window' in border posts, among other things.[81] Availing the benefit of such facilities would result in value addition for India in both imports and exports.

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[75] Tanvi Madan, *What India thinks about China's One Belt One Road Initiative (but does not explicitly say)*, Brookings Blog (March 14, 2016), https://www.brookings.edu/blog/order-from-chaos/2016/03/14/what-india-thinks-about-chinas-one-belt-one-road-initiative-but-doesnt-explicitly-say/ (last visited May 10, 2017).

[76] Talmiz Ahmad, *Who's Afraid of the One Belt One Road*, The Wire (June 3, 2016), https://thewire.in/40388/one-belt-one-road-shaping-connectivities-and-politics-in-the-21st-century/ (last visited May 10, 2017).

[77] *Id.*

[78] D.S. Rajan, *China: President Xi Jinping's South Asia policy- Implications for India*, Paper No. 5920, South Asia Analysis Group, http://www.southasiaanalysis.org/node/1763 (last visited May 10, 2017).

[79] Sahoo et al., *supra note* 59 at 286.

[80] Sahoo et al., *supra note* 59 at 286.

[81] National Development and Reform Commission, *supra note* 64.

The BRI also provides India with an opportunity to tap South Asian markets. Since the initiation of the 'Look East' policy in 1991, India has sought to expand its trading relationships with South Asia. Though India has entered into free trade agreements with the Association of Southeast Asian Nations (ASEAN) in respect of goods and services, India's trade performance in this regard has not been upto the expectations. In 2015, India-ASEAN trade stood at US$ 58.7 billion, much below the target of US$ 100 billion and has declined from US$ 67.7 billion in 2014.[82] One of the reasons underlying India's insignificant integration in this region is the lack of infrastructural connectivity to the ASEAN region. There is a need for development of trade infrastructure, and especially in the Northeastern region of the country.[83] It has been argued that India must take advantage of heavy infrastructure investment by Chinese firms into BRI projects, and focus on developing connectivity infrastructure within and outside India.[84] Though this would be of benefit to India, it would be strategically irrational to allow Chinese involvement in key infrastructural projects in the country.

In analyzing India's response to the BRI, it is also important to consider India's trading relationship with its neighbours. While China is India's largest import partner, India also has the largest trade deficit with China – USD 53 billion in 2015-16, which has been steadily increasing over the last five years, driven by declining exports and increasing imports.[85] Chinese imports consist of consumer and intermediary goods, and imposing tariffs on such intermediaries will only lead to losses for the domestic industry where such intermediaries are used.[86] In respect of Pakistan, the tension between the two states has severely impacted the trading relationship between these two countries. Pakistan accounted for only 0.74% of India's total exports, and 0.12% of India's imports in 2015-16, though this does not account for the informal trade between the two countries, which has been predicted to be

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[82] Rahul Mishra and Shamshad Khan, *Why India needs to expand its engagement with ASEAN*, Daily News and Analysis (Sep. 7, 2016), http://www.dnaindia.com/india/comment-why-india-needs-to-expand-its-engagement-with-asean-2252804 (last visited May 10, 2017).

[83] The Associated Chambers of Commerce and Industry of India, *India ASEAN Trade and Investment Relations: Opportunities and Challenges*, 48 (2016), http://www.assocham.org/upload/docs/ASEAN-STUDY.pdf (last visited May 10, 2017).

[84] Samir Saran and Ritika Passi, 'Seizing the 'One Belt One Road' Opportunity, *The Hindu* (New Delhi, 16 September 2016), Available at: http://www.thehindu.com/opinion/op-ed/Seizing-the-%E2%80%98One-Belt-One-Road%E2%80%99-opportunity/article14054927.ece (last visited May 10, 2017).

[85] Tulsi Jayakumar, *Good Neighbours, Bad Neighbours*, The Hindu (Nov. 14, 2016), http://www.thehindubusinessline.com/opinion/india-needs-strong-ties-with-china-and-pakistan/article9345769.ece (Last visited May 8, 2017).

[86] *Id.*

twice as much as the formal trade.[87] Currently, trade between India and Pakistan is plagued with heavy transactional costs due to the long circuitous route that the trade takes, mainly the Delhi-Mumbai-Dubai-Karachi-Lahore route.[88] While India's trade with its neighbours has been slackening, China is steadily stepping into territory, which has historically been considered 'India's backyard'.[89] With the proposed free trade agreement with Sri Lanka, funding of infrastructure and hydropower projects in Nepal as well as entering into agreements with Bangladesh for 25 projects worth more than USD 20 billion in 2016[90], China is keen on consolidating its power in the South-Asia region. In the light of these facts, there is a higher need for India to further its trading relationships with its neigbours. The BRI, with its offer of better infrastructural connectivity and facilitation mechanisms, could further serve this purpose.

While the BRI seems to offer several benefits, there are other foreign policy and strategic concerns with the project that are hard to ignore. Regardless of participation in the BRI, India must have a forward-looking trade policy, which is focused on trade facilitation and greater infrastructural connectivity. In this regard, the opening up of the Dhola-Sadia bridge, which not only ensures continued connectivity to Arunachal Pradesh in northeastern India, but also helps reduce transit timelines, is a welcome move to improve infrastructure development in the hitherto overlooked region. Furthermore, while China is consolidating links with its neighbours by supplying them with personnel, equipment, technology and standards[91], India must speed up its trade deals and free trade agreements with other Asian and African economies, especially to take advantage of its booming services sector. A positive effort in this regard has been the proposed 'Asia-Africa Growth Corridor', spearheaded by India and Japan, which seeks to the increase financial and infrastructural connectivity within Africa. Further, it is also imperative for India to mobilise funds to build its current projects such as 'Project Mausam' (which aims to re-establish India's ancient maritime routes and connects East Africa, the Arabian Peninsula, the Indian Subcontinent and Sri Lanka to the Southeast Asian archipelago) and the 'Spice Route' project (which

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87 Jayakumar, *supra note* 85.

88 Jayakumar, *supra note* 85.

89 Nataraj & Sekhani, *supra note* 65, at 69.

90 Shubha Singh, *China to hold grand Belt and Road Forum next week: Will India skip biggest diplomatic event of the year?*, Firstpost (May 9, 2017), http://www.firstpost.com/world/china-to-hold-grand-belt-and-road-forum-meet-next-week-will-india-skip-biggest-diplomatic-event-of-the-year-3432194.html (last visited May 9, 2017).

91 Sushil Aaron, *Why India needs to take China's One Belt One Road initiative seriously*, Hindustan Times (March 31, 2017), http://www.hindustantimes.com/analysis/why-india-needs-to-take-china-s-one-belt-one-road-initiative-seriously/story-OpfzM34MJoEyGLE7z8GkSI.html (last visited May 9, 2017).

aims to re-establish maritime ties from countries stretching across Africa to East Asia). This will allow India to align its national interests with the larger outlook of knitting together an integrated Asia.

VII. Conclusion

India's trade policy has traversed a full spectrum in the last seven decades. Although India followed a progressive trade policy in the initial years after independence, the absence of an industrial base and an uncompetitive agriculture sector forced India to embrace an import-substitution led economic policy. Such a policy was essential to preserving India's scare foreign exchange reserves but had the unintended consequence of leading India to a spiraling trap of economic protectionism and isolation. Although India has reversed much of its inward looking economic policies in the manufacturing sector and has enabled its services sector to expand and flourish in the last three decades, India still has much to do in respect of upgrading trade infrastructure, lowering regulatory hurdles and nurturing deeper trading and economic relations with its neighbours.

In this regard, the BRI assumes special significance in light of its proposed economic impact in the region. Although the BRI offers a platform for India to expand its trading opportunities, the lack of clarity and vagueness of this initiative has led to skepticism in several countries including India. Admittedly, the BRI is an 'evolving concept' and many of its structural components and action plans would require further deliberation and careful study.[92] Perhaps, it would be fruitful to wait until there is fuller understanding on the legal nature of BRI as well as the extent of Chinese involvement. At this juncture, India may have certain reservations to joining a grandiose project that seeks to realign the geopolitical ordering in South Asia and beyond. A grandiose project of rediscovering and establishing connectively along the old Silk route is unlikely to achieve its potential unless the countries that are located along the Belt and the Road are taken into full confidence. It is beyond doubt that China and India are poised to be the dominant economies in the upcoming decades with business engagements between the two likely to multiply several folds. Any economic or infrastructure cooperation that adequately accommodates the territorial sovereignty, national security, and development concerns of both these countries should be a welcome development for the global economy.

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[92] Talmiz Ahmad, *supra note 76*; Talk by Minister Liu Jinsong, DCM and Minister, Chinese Embassy in India on 'Challenges and Development of One-Road and One-Belt Initiative', O.P. Jindal Global University (Apr. 11 2017) (notes available with the authors).

Resolution of Distressed Financial Institutions: An Overview of Recent Reforms in India*

Debanshu Mukherjee & Aditya Ayachit

Need for a special resolution regime for financial institutions

This paper examines the need for a separate resolution regime for distressed financial institutions in India. It provides an overview of extant statutory provisions on the subject and notes that the law as it currently exists is inadequate and fragmented that leaves India ill-prepared for dealing with a financial crisis. This paper also examines the recommendations of the Financial Sector Legislative Reforms Commission and the Committee to draft a Code on Resolution of Financial Firms that propose large scale reforms to address the situation. The recommended measures are a step in the right direction and can go a long way in ensuring a robust resolution regime for protecting India's financial stability.

After the global financial crisis of 2007-09, jurisdictions across the world adopted initiatives to strengthen the ability of financial institutions (**"FIs"**) to withstand systemic shocks. Some of these were oriented towards promoting prudential management in FIs and have included measures like adoption of new capital and liquidity requirements[1], harmonisation of accounting and

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data collection standards[2] and prescription of principles of sound compensation practices for managers[3] etc. Some others were driven by the recognition that FIs are prone to failure despite superior regulation and that inadequate management of such failures could cause enormous financial and social losses.[4] A consensus seems to have emerged that specialized regimes are needed for managing failing FIs and several jurisdictions have enacted such regimes into law.[5]

Čihák and Nier note that in the early days of the crisis, regulators facing imminent failures of FIs in their jurisdictions were left with two choices – either to let FIs fail and file for insolvency or to bail them out through injection of public funds.[6] Subsequent experience demonstrated that both these choices resulted in sub-optimal outcomes. In the US, the Lehman Brothers insolvency filing led to a fall in global bank equity prices, rise in interbank spreads and creditor runs, compromising cash flows to corporate debtors.[7] Furthermore, the financial contagion lead to the disruption of key payment and settlement services causing further systemic instability.[8]

The alternative to insolvency were bail-outs which required infusion of enormous sums of public funds into the failing FIs. Such bail-outs resulted in significant fiscal outlays amounting to several trillion dollars in 2008-09 in the US alone.[9] Aside from the impact on the sovereign balance sheets, such bail-outs also brought into focus moral hazard concerns. It has been suggested that problems of moral hazard were a real contributing cause of the crisis and FIs emboldened by the implicit assurance of governmental support

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1 Stijn Claessens & Laura Kodres, *The Regulatory Responses to the Global Financial Crisis: Some Uncomfortable Questions* 8-9 (IMF, Working Paper-WP/14/46), https://www.imf.org/external/pubs/ft/wp/2014/wp1446.pdf.

2 See e.g., Financial Stability Board & IMF, *Financial Crisis and Information Gaps-Report to the G-20 Finance Ministers and Central Bank Governors* (2009), http://www.fsb.org/wp-content/uploads/r_091029.pdf.

3 *See* e.g., Financial Stability Forum, *FSF Principles for Sound Compensation Practices* (2009), http://www.fsb.org/wp-content/uploads/r_0904b.pdf?page_moved=1.

4 Financial Services and the Treasury Bureau, The Hong Kong Monetary Authority & The Securities and Futures Commission and the Insurance Authority, *An Effective Resolution Regime for Financial Institutions in Hong Kong* 7 (Jan. 2014), http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolution/RR_Consultation_Paper.pdf.

5 *See* e.g., Financial Stability Board, *Effective Resolution of Systemically Important Financial Institutions-Recommendations and Timelines* (2011), http://www.fsb.org/wp-content/uploads/r_110719.pdf.

6 Martin Čihák & Erlend Nier, *The Need for Special Resolution Regimes for Financial Institutions—The Case of the European Union* 4 (IMF, Working Paper, WP/09/200), https://www.imf.org/external/pubs/ft/wp/2009/wp09200.pdf.

7 *Id.*

8 *Id.*

9 John Armour, *Making Bank Resolution Credible, in* The Oxford Handbook of Financial Regulation 457 (Moloney et.al. eds., 2015).

made making risky investments knowing that they would be bailed out in the event of a collapse.[10] The experience during the crisis showed unsuitability of the aforesaid mechanisms to deal with distress in FIs. The difficulty seemed to lie in the inability of these mechanisms to maintain financial stability at an acceptable fiscal cost.[11]

The first section of the article explains why there is a need for a separate regime for FIs. The subsequent section discusses the current regime in India concerning FIs. The third section deals with the proposed reforms to this regime, while the last section concludes by analysing the interaction of these positive reforms with the Insolvency and Bankruptcy Code of 2016.

REASONS FOR A SEPARATE REGIME FOR FIS.

- Unique position of FIs: The financial sector is characterised by the structural fragility and inter-connectedness of various actors operating in the sector.[12] This makes these institutions vulnerable to contagions whereby, distress in one FI can potentially generate negative externalities extending beyond losses to the institution's immediate creditors. Additionally, some FIs may be responsible for carrying out critical functions which are fundamental to the economy. These may include activities like provision of credit, acceptance of deposits, and operation of systems of "clearing, settlement and recording of monetary and other financial transactions, such as payments, securities and derivative contracts."[13] All this, puts FIs in a unique position vis-à-vis other corporate actors which may not share the characteristics of FIs.
- Inadequacy of 'ordinary' insolvency regimes in resolving financial sector distress: Armour notes that ordinary insolvency frameworks are inadequate for managing distress in FIs owing to the time-consuming nature of the proceedings (generating unacceptable levels of risk for the creditors) and the non-appreciation of concerns of systemic stability during such proceedings.[14] Such mechanisms can further

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[10] *Id.* at 458-59. See also, Mike Mariathasan et.al., *Bailouts and Moral Hazard: How Implicit Government Guarantees Affect Financial Stability* (2014), https://gdrenice2015.sciencesconf.org/52277/document.

[11] Čihák and Nier, *supra* note 6, at 5.

[12] Armour, *supra note* 9.

[13] Reserve Bank of India, *Report of the Working Group on Resolution Regime for Financial* Institutions 76-77, http://www.sebi.gov.in/sebi_data/attachdocs/1398147216563.pdf.

[14] Armour, *supra note* 9 at 459 ["First, bankruptcy procedures take time to complete. A pay-out is not usually made to creditors until it is determined how much money will be available to do so. Consequently, creditors must bear liquidity risk associated with delay

aggravate systemic risks by "interrupting critical services, disrupting key financial relationships, and freezing financial markets [thereby] destroying value and harming the real economy."[15] The aftermath of the failure of Lehman Brothers (noted above) is a representative instance of the negative externalities generated by the application of such regimes to distressed FIs.

- Drawbacks of bail-outs: Despite their extensive use during the 2007-09 crisis, bail-outs have a number of limitations as mechanisms of addressing distress in the financial sector. Aside from the hefty costs they impose on the exchequer, frequent bail-outs can translate into implicit governmental guarantees of the continued viability of FIs. This can promote reckless behaviour by FIs and creditors and further compromise the integrity of the financial system. Furthermore, bail-outs provide authorities, limited powers to influence the functioning of the distressed institution (such as powers of replacing the management, cancellation of dividends, determination of executive compensation etc.).[16] This prevents the overhaul of institutional policies and practices which were responsible for the distress in the first place.

EXTANT REGIME IN INDIA

The financial sector in India consists of a range of functionaries.[17] It must be noted that no unified legislative framework or regulator exists in relation to the management of financial sector distress in the Indian context.[18] The following part examines the extant regime in relation to banks, insurance companies, pension funds and Non-Banking Financial Institutions (**"NBFCs"**).

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in the proceedings, even if funds are eventually paid. Second, wholesale liquidation of a financial firm's assets can depress the value of these assets generally, harming the balance sheets of any other firm also holding those assets. Third, speculation about where losses will fall during the period before final accounts are prepared can lead to runs by creditors of institutions who are believed to be exposed to the failed bank."].

[15] Fed. Deposit Insurance Corp. & Bank of England, *Resolving Globally Active, Systemically Important, Financial Institutions* 2 (2012), https://www.fdic.gov/about/srac/2012/gsifi.pdf.

[16] Čihák and Nier, *supra* note 6, at 6-7.

[17] These include banks (commercial banks, regional rural banks, and co-operative banks); non-banking financial institutions; primary dealers; development financial institutions; insurance companies (including life insurance companies, general insurance companies and reinsurer companies), securities market functionaries (including merchant bankers, venture capital funds, stock exchanges, depositories, depository participants, qualified depository participants, stock brokers, sub-brokers, debenture trustees and credit rating agencies), provident and pension funds, housing finance companies and financial market infrastructures.

[18] Reserve Bank of India, *supra* note 13, at 43.

- Banks: Multiple legislations prescribe mechanisms which may be used for the management of financial distress in commercial banks (i.e., banking companies, foreign bank branches and public sector banks), regional rural banks (**"RRBs"**) and cooperatives.

Commercial Banks

S No.	Legislations	Mechanism
1.	[Banking Regulation Act 1949, SBI Act 1955, SBI (Subsidiary Banks) Act 1959, Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980][19]	Power to appoint and remove directors in cases when directors are not deemed fit and proper, or in interests of public, banking policy or to secure proper management.
2.	[Banking Regulation Act 1949][20]	Power to issue directions and prohibitions from entering a particular business
3.	[Banking Regulation Act 1949][21]	Power to acquire/transfer or sell assets and liabilities, legal rights and obligations

[19] Banking Regulation Act 1949, §10(B)(6)[RBI's power remove Chairman/Managing Director when an appointed person is not regarded fit or suitable for the post by the RBI], §36AA [RBI's power to remove managerial or other persons and appoint suitable persons in that place in public interests or in interests of depositors or securing the proper management of the company] and §36AB [RBIs power to appoint additional directors in interests of banking policy, public interest or depositors' interests]; SBI Act 1955, §19 [appointment of chairman/managing directors by Central Government ("CG") in consultation with RBI], §19B [power of RBI to appoint additional directors in interests of public or banking policy or depositors of SBI], §24 [power of CG to remove chairman/managing directors]; SBI (Subsidiary Banks) Act 1959, §25A [RBI's power to remove a director when deemed not fit and proper], §25B [RBI's power to appoint additional directors in interests of banking policy or public or depositors or subsidiary bank], §31 [CG's and SBI's power to remove a director for sufficient reason]; Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980, §9(3)(a) [appointment of whole time directors by CG], §9A[appointment of additional directors by RBI in interests of banking policy, public interest or new bank], §9(3B) [removal of directors by RBI for non-fulfilment of legislative criterion].

[20] Banking Regulation Act 1949, §35A [RBI's power to give directions in public interest, depositors' interests or to secure the proper management of the banking company or in interests of banking policy] and §36(1) [RBI's power to caution or prohibit banking companies from entering into particular transactions].

[21] Banking Regulation Act 1949, §36AE [relating to power of CG to acquire undertakings of banking companies in cases when the banking company is non-compliant with directions of CG or is being managed to the detriment of depositors or in interests of baking policy etc.], §36AF [relating to power of power of CG to make schemes in relation to acquired banks].

S No.	Legislations	Mechanism
4.	[Banking Regulation Act 1949, SBI Act 1955, SBI (Subsidiary Banks) Act 1959, Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980][22]	Power to supersede board of directors in interests of public or to secure proper management.
5.	[Banking Regulation Act 1949; Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980][23]	Power to apply for moratorium and prepare scheme of amalgamation
6.	[Banking Regulation Act 1949, SBI Act 1955, SBI (Subsidiary Banks) Act 1959, Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980][24]	Liquidation and appointment of liquidators.

Regional Rural Banks and Cooperatives- Central Government (**"CG"**) after consultation with the National Bank, concerned State Government and Sponsor Bank is empowered to amalgamate RRBs, on grounds of public interest, in the interests of the development of the area served by RRBs or RRBs themselves.[25] CG has the power to liquidate a RRB, in furtherance of a notification of amalgamation.[26] RBI is empowered to supersede the boards of multi-state cooperative banks in interests of public, depositors and for securing proper management[27] and apply to CG for suspension of business and issue of order of moratorium.[28] The Central Registrar of cooperative

[22] Banking Regulation Act 1949, §36 ACA [relating supersession of Board of Directors to further interests of depositors or secure proper management of the company]; SBI Act 1955, §24A [relating to supersession of Central Board in interests of public, depositors or to secure proper management of SBI]; SBI (Subsidiary Banks) Act 1959, §35A [ditto]; Banking Companies (Acquisition and Transfer of Undertakings) Acts 1970/1980, §18A [ditto].

[23] Banking Regulation Act 1949, §37 [relating to grant of moratorium by high court when a banking company is temporarily unable to meets its obligations], §45 [relating to suspension of business of banking company and preparation of scheme of amalgamation]; Banking Companies (Acquisition and Transfer of Undertakings) Acts 1970/1980, §9(2)(c) [power of CG to sanction schemes of reconstruction and grant moratorium].

[24] Banking Regulation Act 1949, §38 [liquidation by High Court], §39 [appointment of RBI as liquidator]; SBI Act 1955, §45 [Bar on liquidation except by order of CG]; SBI (Subsidiary Banks) Act 1959, §57 [Bar on liquidation except by order of CG]; Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980, §18 [Bar on liquidation except by order of CG].

[25] Regional Rural Banks Act 1976, §23A.

[26] Regional Rural Banks Act 1976, §23D.

[27] Banking Regulation Act 1949, §36AAA.

[28] Banking Regulation Act 1949, §45(2).

societies has powers to prepare scheme of amalgamation in such cases.[29] RBI also has the power to direct the winding up of a multi-state cooperative bank[30] and CG has the power to appoint a liquidator.[31]

- Insurance Companies: Under the Insurance Act, 1938, IRDA has the powers of formulating and sanctioning a scheme of amalgamation and transfer, appointment of an administrator for the management of insurance business and cancellation, reduction or variation of contracts and agreements.[32] High Court/National Company Law Tribunal has the power to wind up an insurance company in cases of its insolvency, non-compliance with the Insurance Act or when its continued operation is prejudicial to policy holders.[33] Also, insurance companies can be voluntarily wound-up for effecting amalgamation or reconstruction or in cases when it cannot continue its business on account of its liabilities.[34] As per the General Insurance Business (Nationalisation) Act 1972, the CG has the power to frame schemes for the efficient management of insurance business and provide for inter alia, transfer of undertakings and alterations of conditions of service of employees.[35] The CG by order may dissolve the General Insurance Corporation of India. Such dissolution cannot be effected by any other means.[36] Pursuant to the Life Insurance Corporation (**"LIC"**) Act 1956, the LIC may only be liquidated by an order of CG.[37]
- Pension Funds: Under the Pension Fund Regulatory and Development Authority (**"PFRDA"**) Act 2013, CG has the power to supersede PFRDA in cases when the authority is unable to discharge its functions, is non-compliant with the directives of CG or in cases when such supersession is justified in public interest.[38] CG is also empowered to appoint an administrator when it has a reason to believe that a pension fund or central record keeping agency is functioning in a manner prejudicial to the subscriber's interests.[39]

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29 Multi-State Cooperative Societies Act, 2002, §18.
30 Multi-State Cooperative Societies Act, 2002, §87. This power can be exercised in cases specified under §13D of the Deposit Insurance and Credit Guarantee Corporation Act, 1961.
31 Multi-State Cooperative Societies Act, 2002, §89.
32 Insurance Act 1938, §35-37A, §52A, §52C respectively.
33 Insurance Act 1938, §53.
34 Insurance Act 1938, §54.
35 General Insurance Business (Nationalisation) Act 1972, §16.
36 General Insurance Business (Nationalisation) Act 1972, §33.
37 Life Insurance Corporation Act 1956, §38.
38 Pension Fund Regulatory and Development Authority ("PFRDA") Act 2013, §44.
39 PFRDA Act 2013, §19.

- NBFCs: RBI is empowered to file winding up petitions in relation to NBFCs inter alia in cases when such entities are unable to meet their debts or when their continuance is not in public interest.[40]

Proposed Reforms

Several law reform commissions and working groups have recommended changes to the extant regime of distress management in the Indian financial sector. The proposal of two such bodies has led to the drafting of a new law on resolution of financial institutions in India. As of the date of writing this article, the proposed law, called the Financial Resolution and Deposit Insurance Bill, 2017 ("**Bill**") has been approved by the Union Cabinet and is ready to be introduced in the Parliament. Although the contents of the final Bill are not publicly available yet, the recommendations of the two bodies that seem to have shaped the Bill are as follows:

- Recommendations of the FSLRC[41]: The FSLRC noted that failure of financial firms is a part of the regenerative process of market economies. However, on account of disruptive effect of such failures on the economy, adequate mechanisms have to be instituted to allow smooth exit of failing firms. The Commission recommended the institution of a resolution corporation ("**RC**") which would allow speedy resolution of financial firms like banks, insurance companies, defined benefit pension funds, and payment systems. FSLRC envisioned that RC would have representation from across the financial regulatory architecture and would carry out the resolution process in the interests of protecting the stability and resilience of the financial system, enhancing financial market efficiency through efficient pricing and allocation of risk.

- Recommendations of the Committee to draft a Code on Resolution of Financial Firms ("**Committee**"):[42] The Committee recommends the constitution of a RC to be manned by representatives from RBI, SEBI, IRDAI and PFRDA, Central Government and independent members. The RC shall have jurisdiction over banks, insurance companies, financial market infrastructures, payment systems, and other finan-

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[40] Reserve Bank of India Act 1934, §45MC.

[41] Financial Sector Legislative Reforms Commission. See, *Report of the FSLRC, Vol. I: Analysis and Recommendations*, http://dea.gov.in/sites/default/files/fslrc_report_vol1_1.pdf.

[42] Ministry of Finance, Dept. of Economic Affairs, *Report of Committee to Draft Code on Resolution of Financial Firms* (2016), http://dea.gov.in/sites/default/files/report_rc_sept21_1.pdf.

cial service providers (excluding individuals and partnership firms) ("**FSPs**"). The Committee recommends classification of financial service providers into five categories of 'risk to viability', namely, low, moderate, material, imminent and critical. The criteria for designating a financial service provider in a particular 'risk to viability' category or stage will be determined by the RC in consultation with the relevant financial sector regulator. The Committee envisages that the resolution process will be triggered only if an FSP is designated to be in the category of 'critical' risk to viability. The Committee also recommends measures such as submission of resolution and restoration plans at earlier stages of 'risk to viability' such that the RC is better prepared to resolve or restore FSPs in the event of a crisis. As far as the resolution tools are concerned, the Committee recommends use of globally accepted measures like 'bail-in', such that existing shareholders and creditors (other than insured depositors) bear the losses before the Government is called upon to bail an FSP out. It is also envisaged that the RC will collect a resolution fee from FSPs at earlier stages of 'risk to viability', which may be used to resolve them if they ever reach the 'critical' stage. Such recommendations seem to be targeted at inculcating discipline in FSPs and reducing dependence on public funds for managing distress. In addition to proposing a new law for resolution, the Committee has recommended amendments and repeals to many financial sector laws to harmonize the fragmented regime outlined in the previous section. It has also been recommended that the RC takeover the deposit insurance functions from the 'Deposit Insurance and Credit Guarantee Corporation' for all insured bank deposits in India to protect insured depositors in the event of RC being required to invoke its resolution powers against a banking institution.

INTERACTION WITH THE BANKRUPTCY CODE

It may be noted that the Insolvency and Bankruptcy Code, 2016 ("**IBC**"), enacted by the Parliament last year, is targeted at resolving insolvencies in non-financial entities. Although IBC excludes FSPs from its purview, it provides some flexibility to the Government to notify some FSPs to be covered by it under Section 227. This power may have been retained at the time of the enactment of the IBC due to the uncertainty of future enactment of any law governing FSPs, and the scope of such a law. In view thereof, it is possible that some FSPs that are notified to be covered under the IBC will not get covered by the Bill. Going by international best practices, only

systemically important FSPs, large banks, insurance companies and market infrastructure providers should be covered under the special resolution regime envisaged by the Committee. Once the Bill is enacted, it will be interesting to see how the IBC and the new resolution regime for financial entities interact with each other. The successful implementation of the two laws will be important for securing India's financial stability in future. Regardless of how this interaction between the two codes may play out, what can be said without doubt is that the proposed reforms are indeed a step in the right direction. The Bill is a massive improvement over the existing scattered regulatory structure, and seeks to maintain a fine balance between assistance to critical FIs and minimization of negative externalities. One can only hope that is passed without much ado and implemented in the right spirit.

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