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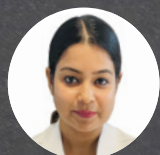
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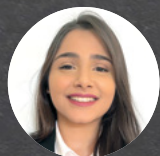


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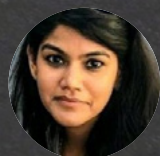
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YOUR WITNESS PLEASE!



Enigma Surrounding Take Over of Company by ARCs

■ **Varsha Banerjee & Rishika Kumar**

A

Asset Reconstruction Companies (ARCs), were introduced under the Securitization and Reconstruction of Financial Assets and

Enforcement of Securities Interest Act, 2002 (SARFAESI Act) for the purposes of asset reconstruction or realization of debts to address the growing menace of the non-performing assets (NPAs) being faced by Banks and Institutional Lenders. Although ARC's came into existence with the SARFAESI Act, but the registration and regulation was under the supervision of the Central Bank of India i.e., Reserve Bank of India (RBI).

Primarily, the aim of ARC was only recovery of stressed assets, which is now evolving with the change in economy and business scenario of the country. The law makers, while paying heed to the demands of the sector, are gradually making efforts to streamline the scope of ARC's operations to empower them to stride ahead in actual reconstruction of stressed assets as against mere recovery.

ARCs Role under SARFAESI Act and Insolvency & Bankruptcy Code, 2016 (IBC/Code):

The SARFAESI Act provides specific powers to the ARCs for revival of stressed assets. Under Section 9 of the SARFAESI Act, ARC's are allowed to take measures for asset reconstruction, which not only inter-alia envisages a right available to ARC to manage the business of the Borrower Company by taking over the business of such Borrower Company, but also authorizes ARC to convert portions of debt into equity of the Borrower Company. Section 13(4)(b) of the SARFAESI Act empowers the secured creditors, including ARCs, to take over/change management of the business of the Borrower Company, transfer of asset of borrower company by way of lease, assignment or sale; for realizing and recovery of the secured debts. Further, Section 15 of SARFAESI Act provides the procedure for change or takeover of the management of Borrower Company's by ARC under Section 9(1)(a) or by secured creditor under Section 13(4)(b) of the Act.

RBI, as the regulator of ARCs keeps on issuing several guidelines every now and then, which eases the functioning of ARCs. The RBI issued one such guideline on 21.04.2010 bearing DNBS (PD) CC.No.19/SCRC/26.03.001/2009-2010 for change or takeover of management of the borrower company. However, on



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the very same date i.e., 21.04.2010, a notification - DNBS/ PD(SC/RC) No.7/ CGM(ASR)/ 2010 was also issued by RBI as applicable to ARC, which while permitting ARCs to take over the management of a Borrower Company under Section 9(1)(a) provided that ARC will not sell or lease a part or whole of the Borrower Company's business until RBI issues necessary guidelines with regards to the same. Therefore, even though there is legal sanctity for ARCs to take over the management of a Borrower Company, the recovery of its dues from such a Borrower Company by sale or lease of its assets is still in limbo.

It is essential to note herein that RBI vide notification dated 23.01.2014 instilled ARCs with the power to convert debt into equity, with a cap of 26%. This cap was later on removed vide notification - DNBR.PD(ARC)

CC.No.04//26.03.001/2017-18 dated 23.11.2017. Meanwhile, SARFAESI Act was also amended in 2016, wherein clause (g) was added under Section 9, with effect from 01.09.2016, permitting ARCs to convert debt into equity with the proviso that any conversion of debt into equity, even if made before this amendment, will be deemed valid. Since the ARCs can become shareholders of a Borrower Company by converting debt into equity there cannot be said to be any legal restraint regarding ARCs right to be allotted with equity shares for restructuring of the Borrower Companies. Further, proviso to Section 15(4) as inserted vide SARFAESI Amendment Act of 2019, which came into effect from 01.09.2019 provides that if an ARC or secured creditor singly or jointly have converted part of their debt into equity, then they are not required to hand back the management of the business to the Borrower Company. Thus, SARFAESI

Act has envisioned the process by which ARCs can change or takeover the management of a Borrower Company and can further convert debt into equity and operate the business of such Borrower Company through Directors' appointed by the ARCs.

PROCEDURE TO CHANGE OR TAKEOVER THE MANAGEMENT BY ARC

Section 15 of SARFAESI describes the manner in which an ARC can change or takeover the management of a Borrower Company. However, if we look closely at the provision, the said provision initially states that through a newspaper publication, Directors (in case of Company) or Administrators (in any other case) are appointed to carry out necessary actions as may be necessary to take into custody all the property, effects or actionable claims to which



the Borrower is entitled. With the new management on board, it is eventually deemed that erstwhile Directors have vacated their offices and terminated the contracts between the Borrower and managerial personnel. This empowers the Directors or Administrators appointed by ARC or secured creditor to exercise the power of superintendence, direction and control of the assets and business of the Borrower. Further, the Section states that where the management of the company is taken over by secured creditors, then, it shall not be lawful for the shareholders of such Borrower Company or any other person to nominate or appoint any person to be a Director of the company; no resolution passed at any meeting of the shareholders of such company shall be given effect, unless approved by the secured creditor and no proceedings for the winding up of such company or for the appointment of a receiver, in respect thereof, shall lie in any court, except with the consent of the secured creditor. The said provision clarifies that on realization of the debt in full, the management of the business taken over from the Borrower, shall be reverted to the erstwhile management of the Borrower Company. If the debt is converted into equity then no such reversion can take place.

It is imperative to note that Section 15 focuses more on the consequences of takeover and how the same is to be dealt with. Further, the words 'ARCs' or 'Secured Creditors' are often used in conjunction or individually, thereby causing confusion as to whether the same provision applies to ARC and secured creditors together or separately.

Evaluating the procedure set out under the RBI notification dated 21.04.2010 bearing DNBS/ PD (SC/

RC) No. 17/26.03.001/2009-10 with respect to change or takeover of the Borrower Company's management, it is essential to understand that even though the notification lays down its objectives of fairness, transparency, non-discrimination, non-arbitrariness and building a system of checks and balances, the process built on these objectives has become complicated and cumbersome for ARCs. Through such notifications, the Borrower Company is provided with multiple opportunities to challenge every action of the ARC before the Debts Recovery Tribunal (DRT), thereby making the whole process nugatory and a landmine for the ARC.

Clause 5 of the RBI notification lays down twelve grounds for change or takeover of management along with explanations. Still the major issue arising out of the same is with regards to the fact that enlisting the grounds provides an ingenious method for the Borrower to challenge the action of ARC, thereby making the entire process time consuming and interdicted with roadblocks. However, these grounds can be removed for the ARCs to decide as per its own discretion.

Further, Clause 6 of the notification provides that ARC should have a policy duly approved by its Board of Directors and the Borrowers should be made aware of this policy. It is essential to notice herein that there is no reason for such a requirement as Borrowers would challenge the policy itself in the Hon'ble Courts. Therefore, either RBI can provide a standard policy for all ARCs to follow or direct that the policy be uploaded on its website, thereby relieving itself of the tedious task of informing or making each Borrower aware of the said policy. Additionally, Clause 6(B) provides for

setting up of an Independent Advisory Committee (IAC) to consider and give a report recommending or approving the proposal for change or takeover of management by the ARC. Thereafter, the Board (with at least two Independent Directors) is required to consider the recommendations or the report of the IAC and contemplate various options for recovery before deciding to change or takeover the Borrower's management and such decisions shall be specifically included in the minutes. The ARC is also required to conduct due diligence, record details of due diligence including findings on circumstances which led to default and why change or takeover of management is necessary. Thereupon, ARC has to identify suitable personnel or agencies, who can take over the management of the Borrower's business by formulating a plan for operating and managing the business of the Borrower effectively, so that the ARC may realize the dues within the time frame. The said plan aims to provide a procedure for restoring the business of the Borrower after recovery of the dues and the ARC is also required to inform the new management that its role is limited to recovery of dues by prudently managing the business.. Thus, this whole provision is extremely cumbersome, subject to challenge and makes the process complicated to execute.

The 7th Clause of the notification pertains to procedure for change or takeover of management, which specifically provides that ARC should give 60 days' notice to the Borrower of its intention to change or takeover management and call for objections, if any. If the Borrower raises objections then consideration is done by IAC, wherein a report is prepared and submitted to the Board. After

considering the IAC report, the Board is required to pass a reasoned order within 30 days of the notice period's expiry indicating their decision in this regard, which is then further communicated to the Borrower, which is challengeable. Hence, it is evident that even after going through several communication channels, the final decision can be challenged, thereby resulting in making the whole process tiresome and futile. It is imperative to note that the procedure to be followed by an ARC before takeover of possession of assets of a Borrower is inbuilt under Sections 13(2), 13(3A) and 13(4)(b) of the Act and the same procedure can be made applicable to change in or transfer of Borrower's management to dilute the whole procedure under clause 7.

Under IBC, when a Borrower Company or the Corporate Debtor makes a default in paying the outstanding dues of creditors, the creditors have been empowered to initiate Corporate Insolvency Resolution Process (CIRP) against such Corporate Debtor. CIRP is a revival mechanism of the Corporate Debtor, wherein at the final stage of the proceedings a Resolution Applicant must submit a Resolution Plan to resolve the financial distress of the Corporate Debtor and take over the Corporate Debtor. Incidentally, Section 29A of IBC enlists persons who are not eligible to be a Resolution Applicant but there are no restrictive provisions under the Code which prohibits an ARC from being a Resolution Applicant. On the contrary, the proviso to Explanation under Section 29A specifically exempts an ARC from the disqualification provided under Section 29A(c), which disqualifies related parties in management and control of Companies having an NPA to act as Resolution Applicant. This evidently showcases that



the legislature has clarity regarding ARCs being financial entities which can clearly act as Resolution Applicants under IBC and have, thus explicitly been exempted from the disqualification, if any, under Section 29A(c).

Accordingly, to grant adequate certainty and to avoid any ambiguity pertaining to locus of ARCs to act as Resolution Applicant under the Code, RBI may issue notification under the SARFAESI Act permitting ARCs to act as Resolution Applicants in line with clear statutory framework as laid down under IBC.

THE WAY FORWARD

For the ARCs to operate and meet their desired purpose, the whole process of change in or takeover of management

for the ARCs can be streamlined.

- RBI may consider issuing a notification to enable the ARCs to sell or lease part or whole of the Borrower Company's business as under Section 9(b) of the SARFAESI Act, on similar lines as the rules providing for the sale of mortgaged property under Section 13 (4) of the Act.

- The notifications dated 21.04.2010 on the guidelines issued by RBI for change/takeover of management be modified and simplified, in order to provide an effective remedy for the ARCs to recover its dues by change in or takeover of management and this will go a long way in reducing the burden of National Company Law Tribunals (NCLTs) for IBC cases.

Additionally, ARCs be granted more freedom and flexibility as the same is vital and improves efficacy of ARCs. A powerful framework with regards to operations of ARCs coupled with high liquidity ratio is critical for the ARCs to achieve their designed objective. The liquidity of ARCs is essential and can be achieved by:

- Encouraging Banks to lend to ARCs on Security Receipts (SRs).
- Encouraging Banks to accept debentures or other instruments as consideration for assignment of Debt.
- The Banks to treat ARCs as Non-Banking Financial Companies (NBFCs) for lending money and allow Targeted Long-Term Repo Operation (TLTRO) window to ARCs.
- Provisioning be applicable to SRs as a treasury instrument on the basis of rating rather than being treated as NPA in the books of Banks in case the originating bank holds more than 10% of SRs. Alternatively, banks that hold 75% of SRs (i.e., cash component is more than 25%) may be treated as a treasury instrument and not as an NPA for the purpose of provisioning.
- Permitting listing of SRs by an ARC would enhance capital flows into securitization industry. ARCs accordingly, should be encouraged to list SRs and a facilitative framework should be formulated.
- ARCs be entitled to list their shares in a stock exchange.

It is worth mentioning that ARC is required to account for income only

after the entire acquisition price of debt is recovered. Hence, the ARCs have a typical depressed balance sheet. Now that NBFCs or Alternate Investment Funds or Foreign Portfolio Investments etc., can also acquire Financial Assets from Banks or NBFCs etc., there should be an alignment of accounting norms for Financial Assets acquired on 100% cash basis with the accounting standards applicable to such Financial Institutions.

Mostly the ARCs carry debt aggregation, but, unless a majority of the debt is aggregated in one ARC, fast and efficient resolution will be tough to achieve. In case ARCs acquire 66% of Borrower's debt, the other lenders should be required to sell their debt to ARC on the terms under which the ARC acquired the 66% debt of the Borrower. Alternatively, an Inter Creditor Agreement similar to the arrangement as provided under the Prudent Framework for Stressed Assets notified by RBI on 07.06.2019 should be made available to ARCs so that in case ARCs has more than 75% of a debt of a Borrower, then other Lenders should be required to fall in line to facilitate quick recovery/resolution of debt by ARC and other lenders. Thus, a good debt aggregation capability would provide better control or leverage over the creditor in implementing a desired resolution strategy.

All in all, it is highly recommended that the policies governing ARCs requires an urgent up-gradation so that stressed assets can speedily be recovered and the economy is freed from prolonged issues of NPAs. Since, ARCs are a vital institution for restructuring the impaired assets in the current scenario, it is essential for the law makers to act with a more realistic and prudent approach, which may aid the ARCs to act efficiently. **w**



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