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Essar Steel NCLAT Decision: Operational Creditors' Deliverance?

The Insolvency and Bankruptcy Code of India, 2016 ("**Code**") introduced the concept of corporate rescue proceedings designed to resuscitate debtor companies from financial distress and to (a) achieve maximisation of value of assets of the debtor companies to promote entrepreneurship;(b)achieve availability of credit; and (c) balance the interests of all its stakeholders. As the Code evolves one pronouncement at a time, each such pronouncement is minutely scrutinized to assess the ramifications on the relevant stakeholders and the relevance of the Code itself. The order passed by the National Company Law Appellate Tribunal ("**NCLAT**") in the matter of *Standard Chartered Bank vs. Satish Kumar Gupta, Resolution Professional for Essar Steel Limited & Others* ("**Order**") is one such pronouncement. The NCLAT adjudicated upon a batch of approximately thirty odd petitions and rendered over a hundred-page Order, where it has examined a host of issues. Onesuchissue and its consequent outcome in the Order has riled up the most dominant stakeholder in the corporate insolvency resolution process ("**CIRP**") – the financial creditor ("**FC**").

This issue germinates from the resolution plan ("**RP**") submitted by Arcelor Mittal India Private Limited ("**Resolution Applicant**") during the CIRP of Essar Steel Limited ("**Corporate Debtor**") which was approved by the committee of creditors("**CoC**"), consisting of FCs and the National Company Law Tribunal, Ahmedabad ("**NCLT**"). Under the RP, the admitted claims of FCs and operational creditors ("**OCs**") were proposed to be paid as under:

(a) *Workmen & employees: 100% out of total admitted claim amount of Rs. 18.07 crore;*
(b) *FC with charge on project assets: 91.99% out of the total admitted claim amount of Rs. 45,559.24 crore;*
(c) *FC without charge on project assets: 1.74% out of the total admitted claim amount of Rs. 49,064.34 crore;*
(d) *Unsecured FC (admitted claim >/= Rs.10 lakhs): 4.08% of the total admitted claim amount of Rs.426.81 crore;*
(e) *Unsecured FC (admitted claim < Rs.10 lakhs): 100% of the total admitted claim amount of Rs.0.30 crore;*
(f) *OC (admitted claim >/= Rs.1 crore): NIL out of total admitted claim amount of Rs.4877.99 crore;*
(g) *OC (admitted claim < Rs.1 crore): 100% of the total admitted claim amount of Rs.196 crore.*

As set out above, the FCs were segregated into four sub-classes – two based on security interests and further two based on a monetary threshold mentioned above. The OCs were segregated into two sub-classes based on monetary threshold mentioned above. The CoC, acting through a sub-committee, approved the above payment distribution under the RP. Notably, not only did the RP fail to provide any rationale for segregation of FCs and OCs into the said sub-classes, but it also failed to provide any rationale for non-payment of claims to OCs. To add to this conundrum, the resolution professional for the Corporate Debtor ("**Resolution Professional**") rejected claims of various OCs at the CIRP stage and such OCs challenged the rejection before the NCLAT. It is in this backdrop that the NCLAT felt compelled to examine the RP, the authority of CoC and arrive at a more equitable distribution of the resolution package of Rs.42,000 crore offered by the Resolution Applicant ("**Resolution Package**") amongst the creditors.

At the outset the NCLAT held that, the Code is alien to the concept of core committee or sub-committee of CoC, hence any delegation of powers, which are exercisable exclusively by CoC, to any other body or authority is outside the purview of the Code. Furthermore, the NCLAT held that while the role of CoC is to examine commercial aspects of the RP, including the viability and feasibility of an RP with respect to the reorganisation of the Corporate Debtor under Section 30 of the Code *read with* Regulation 38 IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 ("**CIRP Regulations**"), the mode and manner of distribution of the Resolution Package is to be determined by the Resolution Applicant. Therefore, it was illegal of the CoC to assume the authority to distribute the

Resolution Package and create class-wise segregations akin to the liquidation waterfall contemplated under Section 53 of the Code ("**Liquidation Waterfall**"). The NCLAT emphatically stated that the distribution under RP is distinct from the Liquidation Waterfall and the same cannot be relied upon by the CoC to appropriate the Resolution Package in manner detrimental to the OCs. Subsequently, the revised RP submitted by CoC too was rejected by the NCLAT.

It is at this juncture that NCLAT sought assistance of learned senior counsel Mr. Harish Salve, appearing on behalf of the Resolution Applicant, to devise a mechanism for equitable and fair distribution of the Resolution Package. The learned counsel suggested that the creditors should be paid in terms of percentage which will be a quotient arrived at by dividing the total amount available for distribution by the total amounts of claims ("**Specified Formula**"). The NCLAT applied the Specified Formula for arriving at the amounts that will be paid to the FCs as well as the OCs through the Resolution Package. This has resulted in a situation where, both, OCs and FCs will receive 60.7% of their claim amount. Effectively, vide the Order, in value receivable terms OCs and FCs have been brought at par with each other.

The Order has been criticised by the FCs for transgression by judiciary into the commercial territory and possibly placing creditors in a worse situation in resolution as compared to liquidation. The Order has sparked wide-spread debate amongst bankers and financial institutions as to (a) if the Specified Formula sets a wrong precedent and (b) if applied in all cases, would leave impetus for mobilising and making available credit for operations and projects across businesses. Given the present liquidity crisis coupled with slump in the overall economic development plaguing the country, the policy makers were swift to quell the borderline socialist position of the Order by introducing and the passing the Insolvency and Bankruptcy Code (Amendment) Act, 2019 ("**2019 Amendment Act**").

The 2019 Amendment Act, *inter alia*, clarifies that CoC may approve an RP after considering its feasibility and viability and the manner of distribution of Resolution Package offered under the RP, keeping in view priority of the creditors and their security interests. Furthermore, the 2019 Amendment Act clarifies that the OCs shall not be paid *less* than the amount payable to them in the event of liquidation of the Corporate Debtor; or the amount payable to them if realisations under the RP were distributed in accordance with the priority in the Liquidation Waterfall, whichever is higher. The 2019 Amendment Act, therefore, places absolute commercial authority in the hands of the CoC and legitimises distribution as per Liquidation Waterfall, be it in a resolution scenario or liquidation scenario.

While the larger risk is indeed unwritten by the FCs, it may be remembered that during the CIRP, Corporate Debtors remain a '*going-concern*' on account of goods and services supplied to such Corporate Debtors by the OCs and as such OCs had welcomed the Order as deliverance. Now, the Hon'ble Supreme Court has the herculean task to reconcile these competing interests in the backdrop of the Order and 2019 Amendment Act, both of which stand in appeal before the Hon'ble Supreme Court.

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AIFs in IFSC: A Nudge in the Right Direction

I. What is an IFSC?

An International Financial Service Centre ("**IFSC**"), is a special economic zone set-up under the Special Economic Zones Act, 2005 ("**SEZ Act**") which is set up to carry out financial service transactions that are currently being undertaken outside India by overseas branches/ subsidiaries of Indian financial institutions and overseas financial institutions.

Per the SEZ Act, it is defined as an IFSC which has been approved by the Central Government under Sub-section (1) of Section 18 of SEZ Act. As per sub-section (1) of Section 18 of SEZ Act, the Central Government may approve the setting up of an IFSC and may prescribe the requirements for setting up and operating an IFSC.

The primary objective of setting up such centres is to facilitate the ease of undertaking financial services activities. This objective is attained by heavily incentivizing the set-up of units in such centres.

II. SEBI's regulatory framework pertaining to IFSCs

The Securities and Exchange Board of India ("**SEBI**") has notified the SEBI (International Financial Services Centres) Guidelines, 2015, which aims to facilitate and regulate financial services relating to the securities market in an **IFSC**. The guidelines lay down the broad framework for entities desirous of undertaking any financial services relating to the securities market, including mutual funds and Alternative Investment Funds ("**AIFs**"), being set-up in an IFSC.

In November 2018, SEBI subsequently released the '*Operating Guidelines for Alternative Investment Funds in IFSC*' to provide a broad framework for setting up AIFs in an IFSC.

SEBI's decision to allow AIFs to operate from an IFSC can be construed as an effort to bring the AIF industry onshore from offshore jurisdictions like Mauritius, Hong Kong, Dubai and Singapore.

III. Incentives provided to units in IFSC through the years

Some important incentives provided to units in an IFSC have been detailed below:

- *Exemption from Dividend Distribution Tax*

  A company in an IFSC, deriving income solely in convertible foreign exchange and distributing profits by way of dividends out of its current income shall be exempt from levy of tax on such distributed profits for any assessment year and on any amount declared, distributed or paid by such company on or after 01.04.2017.[1]

- *Exemption from STT & CTT*

  Exemption from securities transaction tax[2] and commodities transaction tax[3] for transactions carried out on stock exchanges set up in IFSC.

- *Reduction in levy of Alternate Minimum Tax (AMT) and Minimum Alternate Tax (MAT)*

  MAT shall be chargeable at a rate of 9% in case of a company in IFSC and generating income solely in foreign exchange (otherwise levied at 18.5%). In case of a taxpayer in IFSC other than a company, AMT shall be chargeable at a reduced rate of 9% (otherwise levied at 18.5%).[4]

[1] Section 57(b), FINANCE ACT 2016.
[2] Section 26(1)(f), THE SPECIAL ECONOMIC ZONES ACT 2005.
[3] Section 237, FINANCE ACT 2016.
[4] Section 57(b), FINANCE ACT 2016.

❖ *Flexibility to invest under varying routes*

AIFs set up in an IFSC can invest in India through the Foreign Venture Capital Investor (FVCI) route, Foreign Direct Investment (FDI) route or under the Foreign Portfolio Investment (FPI) routes.

IV. Incentives provided in the Union Budget, 2019

❖ *Tax Holiday*

A unit in an IFSC is allowed to deduct 100% of its gross total income from the purview of income tax. Such deduction can be claimed for any 10 consecutive years out of 15 years from the year of its commencement.[5]

❖ *Category III AIFs in IFSC exempt from capital gains*

Category III AIFs that are set up in an IFSC are exempt from payment of capital gains tax on transfer of bonds, global depository receipts, Rupee denominated bonds of an Indian company, derivatives and such other securities that shall be notified by the Central Government provided that such an AIF is located in IFSC, derives income solely in convertible foreign exchange and all units of the AIF are held by non-residents.[6]

V. Penny for our thoughts

The extent of incentives provided to the AIFs in an IFSC clearly illustrates the intent of the government and SEBI, which is to open the doors for offshore funds to set-up /shift base in India.

However, the Union Budget, 2019 has been bittersweet for AIF structures. The Union Budget, 2019 has proposed the pass through of losses to investors of Category I and II AIFs. The Union Budget, 2019 also proposes to boost investments by Category II AIFs in venture capital undertakings by exempting investments received by venture capital undertakings from Category II AIFs being above the fair market value which is currently available only to Category I AIFs.[7] The Union Budget, 2019 has also proposed an increase in the surcharge on income tax that directly affects and increases the rate at which trusts, and more particularly Category III AIFs structured as trusts (presently not having a pass through status), are taxed.

The proposed amendment to Section 115UB of the Income Tax Act, 1961 allows investors of Category I and II AIFs to set off losses (except business losses) made by the AIFs against their own income, provided that they have held units of the AIF for at least 12 months.

These proposed amendments to the Income Tax Act, 1961 and the incentivisation of AIFs being set up in IFSC demonstrates the Central Government's inclination and intention to facilitate raising of funds through the medium of AIFs.

While the nuances for facilitating the incentives to AIFs and providing an ease of doing business does require some elbow grease, *in toto*, it can be said that this does seem to be a nudge in the right direction for AIFs.

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[5]Clause 28, FINANCE (NO. 2) BILL 2019.
[6]Clause 17(c), FINANCE (NO. 2) BILL 2019.
[7]Clause 21, FINANCE (NO. 2) BILL 2019

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❖ **SECURITIES AND EXCHANGE BOARD OF INDIA (PROHIBITION OF INSIDER TRADING) REGULATIONS, 2015**

SEBI has stipulated that the board of directors of listed companies, intermediaries and fiduciaries are required to formulate a Code of Conduct to regulate, monitor and report the compliance of any violation of the Code of Conduct by designated persons and their immediate relative in the standardised format to SEBI. The aforesaid entities are required to maintain a database of violation of the said Code of Conduct and are empowered to take actions against the designated person in case of any violation of Code of Conduct by any designated person or their immediate relatives.

[Read more at: https://www.sebi.gov.in/sebi_data/commondocs/jul-2019/Circular%20on%20Reporting%20of%20Code%20of%20Conduct%20Violations_p.pdf]

❖ **AMENDMENTS TO COMPANIES ACT, 2013 BY THE COMPANIES (AMENDMENT) ACT, 2019**

The Companies (Amendment) Act, 2019 (“**Act**”) received the assent of the President on 31.07.2019. The provisions of the Act except Sections 6, 7 and 8, Clauses (i), (iii) and (iv) of Section 14, Sections 20, 21, 31, 33, 34, 35, 37 and 38 are deemed to have come into force on 02.11.2018. Some of the key takeaways from the Act are:

1. The Act provides that any unutilised corporate social responsibility amounts are to be transferred by companies to a special account opened by the company for that purpose and requires the company to disclose the reason for such non-utilisation in its annual report. In the event such amount remains unspent for three financial years, the amount will be transferred to the funds prescribed under Schedule VII of the Companies Act, 2013.
2. The Act authorises the National Financial Reporting Authority to debar any Chartered Accountant firm for a minimum period of 6 months and not exceeding 10 years, if any professional or other misconduct is proved.
3. The Act authorises any person not below the rank of an Assistant Director of Serious Fraud Investigation Office (SIFO)to arrest any person if the investigation report filed by SIFO establishes a fraud having taken place.
4. The Act provides that any person who is found to be unfit and improper by the National Company Law Tribunal shall not be allowed to hold the office of a director or any other office connected with the conduct and management of affairs of the company for a period of five years.
5. The Act proposes to re-categorise the penalty of various offences under the Companies Act, 2013.

[Read more at: http://www.mca.gov.in/Ministry/pdf/AMENDMENTACT_01082019.pdf]

❖ **KEY HIGHLIGHTS OF UNION BUDGET, 2019**

The Union Finance Minister, Mrs. Nirmala Sitharaman, presented the ‘Green Budget’ on 05.07.2019. The key highlights of the budget are as follows:

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1. Increase in threshold of annual turnover from Rs. 250 crore to Rs. 400 crore for paying corporate tax at the rate of 25%.
2. Custom duty on gold and precious metal has been increased from 10% to 12.5%.
3. Granted exemption to Category II Alternative Investment Fund from the angel tax on investment in start-ups.
4. Provides for setting off and carry forward of losses by eligible start-up.
5. Rationalising and streamlining the KYC norms for foreign portfolio investor ("**FPI**") to make them investor friendly.
6. Increased the statutory limit for FPI investment in a company from 24% to the sectoral foreign investment limit.
7. To permit FPIs to subscribe to listed debt securities issued by real estate investment trusts and infrastructure investment trusts.

[Read more at: http://pib.nic.in/newsite/docpagenew.aspx?docid=652]

❖ MCA NOTIFIES COMPANIES (SIGNIFICANT BENEFICIAL OWNERS) SECOND AMENDMENT RULES, 2019

The Ministry of Corporate Affairs (MCA) vide notification dated 01.07.2019 amended the Companies (Significant Beneficial Owners) Rules, 2018 vide Companies (Significant Beneficial Owners) Second Amendment Rules, 2019 to introduce the new Form BEN-2 (Return to the Registrar in respect of declaration under Section 90). The date for filing Form BEN-2 has further been extended to 30.09.2019 without payment of additional fees vide MCA circular dated 29.07.2019.

[Read more at: (i) http://www.mca.gov.in/Ministry/pdf/CompaniesSignificantRules_01072019.pdf
(ii) http://www.mca.gov.in/Ministry/pdf/GeneralCircular_29072019.pdf]

❖ NOTIFIES COMPANIES (APPOINTMENT AND QUALIFICATIONS OF DIRECTORS) THIRD AMENDMENT RULES, 2019

The MCA vide notification dated 25.07.2019 amended the Companies (Appointment and Qualifications of Directors) Rules, 2014 vide Companies (Appointment and Qualifications of Directors) Third Amendment Rules, 2019 to introduce a web-based verification service for every person who has already filed Form DIR-3 KYC in Web-Form DIR-3 KYC-WEB. The amendment also extends the filing date for the said form from June 30th to September 30th.

[Read more at: http://www.mca.gov.in/Ministry/pdf/ThirdAmendRules_25072019.pdf]

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