Between the lines...

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Highlights

I. Relief for foreign investors: Supreme Court of India sets aside the Bombay High Court ruling in IDBI Trusteeship Services case

The Supreme Court of India in the case of ***IDBI Trusteeship Services Limited vs. Hubtown Limited*** (decided on November 15, 2016) set aside a Bombay High Court ruling which had garnered quite a lot of attention among the foreign investors and in the legal circles.

Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V. (**"FMO"**) had invested in certain equity shares and compulsorily convertible debentures (**"CCDs"**) of Vinca Developer Private Limited (**"Vinca"**). Such investment by FMO was utilized by Vinca to subscribe to certain optionally partially convertible debentures (**"OPCDs"**) issued by Rubix Trading Private Limited (**"Rubix"**) and Amazia Developers Private Limited (**"Amazia"**). The Plaintiff was appointed as the debenture trustee vide two debenture trust deeds.

An unconditional, absolute and irrevocable corporate guarantee in favour of the Plaintiff was issued by the Defendant inter alia for the benefit of Vinca (the **"Guarantee"**). The Plaintiff alleged that Amazia and Rubix committed several defaults under the said debenture trust deeds and notices were issued by the Plaintiff regarding the same. As the defaults were not rectified, the Plaintiff issued redemption notices to Amazia and Rubix. Amazia and Rubix however failed to pay the sums due and payable in terms of the said debenture trust deeds. Demand certificate for the enforcement of the guarantee came to be issued by the Plaintiff which remained unanswered.

The defence to the allegations as above was that the structure of the transaction was not lawful as it violated the Foreign Exchange Management Act, 1999 and regulations thereunder (**"FEMA"**) read with the Foreign Direct Investment Policy (the **"FDI Policy"**) and was also opposed to public policy. To elaborate a little on the defence adopted, the FDI Policy and FEMA permit foreign direct investment only by way of equity investments and instruments which are

fully and compulsorily convertible into equity. Any other form of investment (non- equity) with an assured return/rate of return is not permitted. It was pointed out that the nature of the transaction in this case enabled a fixed rate of return for FMO on its investments in violation of FEMA and the FDI Policy.

The learned Single Judge of the Bombay High Court took the view that structure adopted in the instant case, which enabled routing of FMO's foreign direct investment to Amazia and Rubix through Vinca was a colourable device which was structured only to enable FMO to secure repayment through Vinca of its invested sums with interest in contravention of FEMA and the FDI Policy. The learned Single Judge thus found the Guarantee as illegal and unenforceable and passed certain orders.

The learned Counsel for the Plaintiff argued before the Supreme Court that there was no violation of FEMA as there was no possibility of funds going out of India, its purpose being for the benefit of an Indian company, Vinca.

The Supreme Court observed, inter alia, that there was no contravention of FEMA as the payment under the Guarantee was to the debenture trustee which was an Indian company for and on behalf of Vinca which was another Indian company. The Court further observed, *"Based on the aforesaid, it cannot be said that the defendant has raised a substantial defence to the claim made in the suit. Arguably at the highest, as held by the learned Single Judge, even if a triable issue may be said to arise on the application of the FEMA Regulations, nevertheless, we are left with a real doubt about the Defendant's good faith and the genuineness of such a triable issue."*

The Court held that it was possible to grant leave to defend the suit to the Defendant only if it was ready to deposit the principal sum of INR 418 Crores invested by FMO or give security for the said amount. Appeal was allowed and the Bombay High Court judgment was set aside.

VA View

To fully understand the implications of the Supreme Court ruling in this case, it is pertinent to refer to the Bombay High Court observations. The view taken by the Bombay High Court was that Vinca was only a nominal recipient of foreign direct investment inflow and it had routed the amount to Rubix and Amazia for which optionally convertible debentures carrying fixed rate of interest came to be issued. This was, as was noted by the Bombay High Court, in violation of the foreign direct investment regime for the sector which permitted foreign direct investment only by way of equity or compulsorily convertible instruments in Indian companies.

The Supreme Court pointed out that permission of the Reserve Bank of India was warranted if FMO wished to have the funds repatriated. If the approval was not granted, there could be no violation of FEMA. It may be inferred that Courts would not go into alleged violations of FEMA and the FDI Policy in case of foreign direct investments in the absence of any specific prohibition in so far as such investments are within the purview of and regulated by the Reserve Bank of India.

In view of the uncertainty created by the decision of the Bombay High Court, this ruling by the apex court gives a respite to foreign investors in respect of their foreign direct investments in India.

II. SEBI clarifies on contra trade restriction under the Insider Trading Regulations

The Securities and Exchange Board of India (**"SEBI"**) issued interpretative letter dated November 25, 2016 in the matter of SBI Capital Markets Limited (**"SBICAP"**) under the SEBI (Informal Guidance) Scheme, 2003. This informal guidance was in relation to the SEBI (Prohibition of Insider Trading) Regulations, 2015 (the **"PIT Regulations"**).

SBICAP had submitted that as an intermediary, the PIT Regulations were applicable to it only in case it was in possession of Unpublished Price Sensitive Information (**"UPSI"**) or if it was within the purview of the definition of connected person with respect to the company whose shares were traded by it. SBICAP had further submitted that it was maintaining a restricted list as required under the PIT Regulations in which names of all companies for which SBICAP was handling assignment and was privy to USPI were listed. SBICAP and its employees were barred from trading in the shares of companies in the restricted list.

"Insider" is defined under Regulation 2(1)(g) of the PIT Regulations as i) a connected person; or ii) in possession of or having access to unpublished price sensitive information. SBICAP's submission to SEBI with regard to companies not in its restricted list was that it was not an "insider" with respect to such companies as it was not a connected person and was not in possession of UPSI with regards such companies.

Schedule B of the PIT Regulations titled *"Minimum Standards for Code of Conduct to Regulate, Monitor and Report Trading by Insiders"* provide certain minimum standards which should be incorporated in the code of conduct which is required to be formulated under Regulation 9 of the PIT Regulations.

Clause 3 of said Schedule provides that, *"Employees and connected persons designated on the basis of their functional role ("designated persons") in the organisation shall be governed by an internal code of conduct governing dealing in securities. The board of directors shall in consultation with the compliance officer specify the designated persons to be covered by such code on the basis of their role and function in the organisation. Due regard shall be had to the access that such role and function would provide to unpublished price sensitive information in addition to seniority and professional designation."*

Further, clause 10 of the said Schedule provides, *"The code of conduct shall specify the period, which in any event shall not be less than six months, within which a designated person who is permitted to trade shall not execute a contra trade. The compliance officer may be empowered to grant relaxation from strict application of such restriction for reasons to be recorded in writing provided that such relaxation does not violate these regulations. Should a contra trade be executed, inadvertently or otherwise, in violation of such a restriction, the profits from such trade shall be liable to be disgorged for remittance to the Board for credit to the Investor Protection and Education Fund administered by the Board under the Act."*

SBICAP put forth its view that as it was not a connected person for companies not in its restricted list, SBICAP and its employees could not come under purview of "designated persons" as per clause 3 of said Schedule. With regards the contra trade restriction under clause 10 of said Schedule, the view of SBICAP was that the restriction was applicable to companies in its restricted list and not to other companies.

The query raised by SBICAP before SEBI was, *"Whether the restriction on SBICAP or any of its employees, of not executing a contra trade within six months as provided in clause 10 of Schedule B of PIT Regulations, is applicable on securities which are not in their restricted list?".* SEBI cited relevant provisions under the PIT regulations in its letter and opined that with regards trading in securities of listed companies not in the restricted list of SBICAP, contra trade restriction on SBICAP or its employees was dependent on the connection between SBICAP or its designated employee with the concerned listed company and subsequent possession of or access to UPSI.

SEBI's view in the matter was that, *"If SBICAP or its employee is a connected person with a listed company and possess or have access to UPSI, such restriction shall be applicable, while on the other hand, for securities of the listed companies where no connection and possession or access to UPSI is envisaged, there may not be a need to impose the above restriction."*

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With this informal guidance issued by SEBI, it becomes clear that contra trade restriction becomes applicable to a company or its employees only if they are connected persons and are privy to UPSI. Therefore, with respect to companies which do not find mention in the restricted list maintained under the PIT Regulations, applicability of contra trade restriction with regards these companies depends on whether the tests of being a connected person and having access to UPSI are satisfied.

III. SICA finally repealed, BIFR and AAIFR dissolved; plus other related developments

The Ministry of Finance issued two Notifications, both dated November 25, 2016, whereby it appointed December 1, 2016 as the date on which the provisions of the Sick Industrial Companies (Special Provisions) Repeal Act, 2003 (**"Repeal Act"**) shall come into force and as the date for the purposes of clause (b) of section 4 of the Repeal Act. The effect is that the Sick Industrial Companies (Special Provisions) Act, 1985 (the **"SICA"**) has been repealed. The Board for Industrial and Financial Reconstruction (the **"BIFR"**) and the Appellate Authority for Industrial and Financial Reconstruction (the **"AAIFR"**) stand dissolved.

Provisions of the Insolvency and Bankruptcy Code, 2016 (the "**Code**") have been notified by the Government in parts. By Notification dated November 15, 2016 issued by the Ministry of Corporate Affairs, provisions related to Insolvency Professional Agencies and Insolvency Professionals under the Code are now in force. With Section 255 of the Code being notified by this notification, Chapter XIX (Sections 253 to 269) of the Companies Act, 2013 laying down separate set of provisions for revival and rehabilitation of sick companies stands omitted.

Insolvency Professional Agencies and Insolvency Professionals play a vital role with respect to proceedings under the Code. The Insolvency and Bankruptcy Board of India has notified the Insolvency and Bankruptcy Board of India (Insolvency Professionals) Regulations, 2016 by Notification dated November 23, 2016 with effect from November 29, 2016 and the Insolvency and Bankruptcy Board of India (Insolvency Professional Agencies) Regulations, 2016 by Notification dated November 21, 2016 with effect from the same date. These regulations provide for the

qualifications, eligibility criteria, registration details, etc. With these regulations being notified, the registration process is set to slowly but steadily gain pace in the coming days.

Corporate insolvency process under the Code is set to kick start as the provisions related to corporate insolvency are in force with effect from December 1, 2016 and related to liquidation process are in force with effect from December 15, 2016. The Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016 and the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 have been notified as well.

VA View

After the passage of more than a decade since the enactment of the Repeal Act, the SICA has finally been repealed. The SICA, which remained in the statute book for more than three decades, was subject to criticism for its misuse as the SICA was quite often resorted to in order to delay and defeat the process of debt recovery.

Another important aspect to note is that all proceedings before the BIFR and the AAIFR stand abated and now the jurisdiction lies with the National Company Law Tribunal. The Government seems very keen to implement various provisions under the new regime at the earliest.

IV. Challenges ahead for several companies as compromise, arrangements and other matters stand transferred to NCLT

The Ministry of Corporate Affairs (**"MCA"**) issued notifications S.O. 3676(E) and 1119(E) dated December 7, 2016 (collectively **"Notifications"**), pursuant to which the proceedings relating to arbitration, compromise, arrangements and reconstruction as well as certain winding up matters except reserved matters (**"Matters"**) stand transferred from the concerned High Courts to relevant National Company Law Tribunal (**"NCLT"**) with effect from December 15, 2016.

With respect to such matters which are pending before various High Courts, these Notifications have thrown up several difficulties and challenges, some of which are listed as under:

- **Change in jurisdiction:** Earlier, the High Courts of a state where the registered office of the applicants/petitioners were located had jurisdiction to adjudicate the Matters. This position now changes and pending cases before various High Courts stand transferred to the NCLTs as specified by the Government.
- **Legal fees and official liquidator:** Fees payable to the High Court is lower than fees payable to NCLT with regards compromise, arrangements and reconstruction. Notifications do not clarify on the payment of fees in case of pending matters. Also as official liquidator associated with the concerned NCLT will now take charge, several problems are bound to arise especially in cases where service of notice on the official liquidator associated with the High Court has already been completed.

- **Hearing of matters and staff crunch:** If NCLT insists on fresh hearing of Matters transferred to it, it will lead to unexpected delays in disposal of Matters. Delays will also be caused by the lack of staff at the NCLT and their relative inexperience in dealing with the new procedures.
- **Stamp duty and other costs:** As a court order sanctioning a scheme, is chargeable to stamp duty under respective state laws, change in jurisdiction will require re-working of the same leading to change in budget estimations. Also, services of lawyers and other professionals will need to be hired for dealing with the cases transferred to the concerned NCLT, which will further add to costs.
- **Missing deadlines:** Matters may get indefinitely prolonged and the petitioner/applicants may miss crucial deadlines due to delays in transfer of case papers more so when there are no prescribed timelines for such transfers and also on account of the inherent risk of the case papers being misplaced, destroyed or lost in transit.

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Although this is a welcome step, the implementation of these notifications has impeded the smooth completion of compromise or arrangements transactions, reconstruction matters under Sections 391 to 394 of the Companies Act, 1956. Some of these matters which have already progressed and/or are nearing completion will now come to a standstill. Some clarifications to remove the difficulties enumerated above will be in order.

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