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SUPREME COURT STRIKES DOWN RBI'S FRAMEWORK ON RESOLUTION OF STRESSED ASSETS

KEY IMPACTS

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Introduction

On February 12, 2018, the Reserve Bank of India (“**RBI**”) introduced a revised framework for resolution of stressed assets by scheduled commercial banks and the all-India financial institutions (“**Revised Framework**”).

With the introduction of the Revised Framework, all extant instructions on resolution of stressed assets such as Framework for Revitalising Distressed Assets, Corporate Debt Restructuring Scheme, Flexible Structuring of Existing Long-Term Project Loans, Strategic Debt Restructuring Scheme (SDR), Change in Ownership outside SDR and Scheme for Sustainable Structuring of Stressed Assets (S4A) (“**Erstwhile Framework**”) stood withdrawn with immediate effect. Accordingly, the Joint Lenders’ Forum was also discontinued.

The Revised Framework was formulated to provide for a harmonised and simplified generic framework for resolution of stressed assets in view of the enactment of the Insolvency and Bankruptcy Code, 2016 (“**IBC**”).

On April 2, 2019, the Supreme Court of India (“**Supreme Court**”), in the case of *Dharani Sugars and Chemicals Ltd. v. Union of India & Ors.*¹ (“**Dharani Sugars case**”), held that the Revised Framework is *ultra vires* section 35AA of the Banking Regulation Act, 1949 (“**BR Act**”) and consequently, all actions taken under the Revised Framework, including proceedings by financial creditors² against debtors under section 7 of the IBC pursuant to the Revised Framework, shall be null and void.

This note discusses the impact which the decision by the Supreme Court in the Dharani Sugars case may have on the ‘dirty dozen’³ and other insolvency proceedings filed pursuant to directions and/ or notifications issued by the RBI from time to time, the Project Sashakt inter-creditor agreement and the restructurings under the Revised Framework for which exemptions from applicability of the SEBI regulations in respect of issuance of shares have already been availed and whether all extant instructions on resolution of stressed assets in the pre-Revised Framework era will be restored.

Overview of the Revised Framework

Under the Revised Framework, all lenders were required to formulate policies approved by their board of directors for resolution of stressed assets, including the timelines for resolution. Further, as soon as a default was committed by a borrower vis-à-vis any lender, all lenders (singly or jointly) were required to initiate steps to cure the default including formulating a resolution plan as a first step.

In case of large accounts (i.e. accounts where the aggregate exposure was INR 20 billion or above), on or after March 1, 2018 (“**Reference Date**”), the resolution plan was required to be implemented, if the default existed as on the Reference Date, within 180 days of the Reference Date, and if the default was committed after the Reference Date, within 180 days from the date of the first default.

The Revised Framework also provided that if a resolution plan in respect of such large accounts was not implemented within the specified timelines, the lenders shall have to mandatorily file an insolvency application (singly or jointly) under the IBC within 15 days from the expiry of such

¹ Transferred Case (Civil) No. 66 of 2018 in Transfer Petition (Civil) No. 1399 of 2018.

² As defined in section 5(7) of the IBC.

³ The RBI *vide* press release dated June 13, 2017 identified 12 accounts for immediate reference under the IBC whose fund and non-fund based outstanding amount was greater than INR 5000 crore, with 60% or more classified as non-performing by banks as of March 31, 2016.

timeline. For other accounts with exposure ranging from INR 1 billion to INR 20 billion, the RBI was required to announce the reference dates for implementation of a resolution plan over a two-year period. However, this transition arrangement was unavailable for borrowers in respect of which specific instructions were already issued by the RBI to banks for reference under the IBC.

Certain exemptions from regulatory requirements promulgated by the RBI and the Securities and Exchange Board of India (“SEBI”) had been accorded in case of acquisition of shares upon conversion of debt to equity during a restructuring process under the Revised Framework.

The Revised Framework was introduced by the RBI in exercise of its powers under sections 35A, 35AA (read with the gazette notification S.O.1435(E) dated May 5, 2017 issued by the Government of India (“Central Government”)) and 35AB of the BR Act and section 45(L) of the Reserve Bank of India Act, 1934 (“RBI Act”).

Sections 35AA and 35AB of the BR Act were initially introduced by the Banking Regulation (Amendment) Ordinance, 2017 (“Ordinance”) on May 4, 2017. The Ordinance was subsequently replaced by the Banking Regulation (Amendment) Act, 2017 (“BR Amendment Act”).

The text of sections 35A, 35AA and 35AB of the BR Act is set out hereinbelow:

“35A. Power of the Reserve Bank to give directions.

(1) Where the Reserve Bank is satisfied that-

(a) in the public interest; or

(aa) in the interest of banking policy; or

(b) to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company; or

(c) to secure the proper management of any banking company generally, it is necessary to issue directions to banking companies generally or to any banking company in particular, it may, from time to time, issue such directions as it deems fit, and the banking companies or the banking company, as the case may be, shall be bound to comply with such directions.

(2) The Reserve Bank may, on representation made to it or on its own motion, modify or cancel any direction issued under sub-section (1), and in so modifying or canceling any direction may impose such conditions as it thinks fit, subject to which the modification or cancellation shall have effect.

35AA. Power of Central Government to authorise Reserve Bank for issuing directions to banking companies to initiate insolvency resolution process.

The Central Government may, by order, authorise the Reserve Bank to issue directions to any banking company or banking companies to initiate insolvency resolution process in respect of a default, under the provisions of the Insolvency and Bankruptcy Code, 2016 (31 of 2016). (emphasis supplied)

Explanation. – For the purposes of this section, “default” has the same meaning assigned to it in clause (12) of section 3 of the Insolvency and Bankruptcy Code, 2016 (31 of 2016).

35AB. Power of Reserve Bank to issue directions in respect of stressed assets.

(1) Without prejudice to the provisions of section 35A, the Reserve Bank may, from time to time, issue directions to any banking company or banking companies for resolution of stressed assets.

(2) The Reserve Bank may specify one or more authorities or committees with such members as the Reserve Bank may appoint or approve for appointment to advise any banking company or banking companies on resolution of stressed assets.”

On May 5, 2017, the Central Government, in exercise of the powers conferred by section 35AA of the BR Act issued a gazette notification, the text of which is set out hereinbelow:

“S.O. 1435(E).—In exercise of the powers conferred by Section 35AA of the Banking Regulation Act, 1949 (10 of 1949), the Central Government hereby authorises the Reserve Bank of India to issue such directions to any banking company or banking companies which may be considered necessary to initiate insolvency resolution process in respect of a default, under the provisions of the Insolvency and Bankruptcy Code, 2016.” (emphasis supplied)

Decision of the Supreme Court in the Dharani Sugars case

The Revised Framework has led to several petitions being filed before different high courts across the country, especially by companies and associations in the power sector. On September 11, 2018, the Supreme Court, in *Reserve Bank of India v. Dharani Sugars and Chemicals Ltd. & Ors. Etc.*⁴, allowed all such petitions to be transferred to itself and ordered maintaining *status quo* until final disposal of the matters.

Some of the key issues discussed in the Dharani Sugars case are set out hereinbelow:

Constitutional validity of sections 35AA and 35AB of the BR Act

In the instant matter, the petitioners primarily challenged the constitutional validity of sections 35AA and 35AB of the BR Act in view of the provisions being violative of Article 14 of the Constitution of India (“**Constitution**”) and also being arbitrary on the ground of excessive delegation of power to the RBI. The petitioners further argued that the Ordinance and the BR Amendment Act are unconstitutional as (i) sections 35AA and 35AB of the BR Act are manifestly arbitrary and (ii) they suffer from absence of guidelines.

The Supreme Court discussed that the sections 35AA and 35AB of the BR Act provide certain regulatory powers to the RBI and the ‘statement of objects and reasons’ and the ‘preamble’ to the BR Act, read together with various regulatory provisions in the BR Act (such as sections 14A, 17, 18, 20, 22, 25, 29, 30, and 31) provide ample guidance to the RBI to exercise the powers conferred pursuant to insertion of sections 35AA and 35AB of the BR Act.

Further, the Supreme Court relied on its recent decision in *Swiss Ribbons Pvt. Ltd. and Anr. v. Union of India & Ors.*⁵ wherein it was held that an economic legislation should be viewed with greater latitude. In view of this, the Supreme Court held that sections 35AA and 35AB of the BR Act cannot be said to be manifestly arbitrary and thus, the constitutional validity of the provisions was upheld.

⁴ Writ Petition (C) No. 1086/ 2018.

⁵ 2019 (2) SCALE 5.

Section 35A or 35AA – the better fit for introduction of the Revised Framework

It was contended by the petitioners that section 35A of the BR Act cannot be treated as a source of power authorising the RBI to introduce the Revised Framework as the same is an old provision which was introduced in 1956 i.e. much before the enactment of the IBC. In this regard, reliance was placed by the petitioners upon the decision of the Supreme Court in *Indian Banks' Association v. Devkala Consultancy Service*⁶ for the proposition that the RBI's functions under section 35A of the Banking Act, are confined to the boundaries of the RBI Act and the BR Act, and not to other statutes, such as the IBC.

The Supreme Court held that statutes are deemed to be 'always speaking' and there is nothing which indicates that the RBI cannot give directions under section 35A of the BR Act in relation to the IBC. The Supreme Court relied on various judicial precedents and rejected the contention that since section 35A of the BR Act was introduced prior to enactment of the IBC, therefore it cannot be a source of power for the introduction of the Revised Framework.

Whilst dealing with the present contention, the Supreme Court referred to sections 35AA and 35AB of the BR Act and held that any direction by the RBI to initiate insolvency resolution process under IBC can be given only pursuant to section 35AA of the BR Act. In this regard, the Supreme Court stated that when a statute confers power to do a particular act and has laid down the method in which that power has to be exercised, it necessarily prohibits the doing of the act in any manner other than that which has been prescribed⁷. In view of this, it can be said that section 35A of the BR Act, being generic in nature, cannot empower the RBI to initiate insolvency resolution process under IBC.

At the same time, the Supreme Court clearly stated that any direction issued by the RBI in respect of stressed assets, other than those pertaining to the IBC, will get covered under section 35AB of the BR Act read together with section 35A of the BR Act. Further, such powers have to be exercised separately by the RBI from the powers conferred by section 35AA of the BR Act.

RBI's powers to introduce the Revised Framework

In the instant matter, it was contended by the petitioners that a 'one size fits all' approach cannot be taken by the RBI and that the power sector should not be treated at par with the other sectors as it has faced multiple regulatory and other challenges such as shortage of resources due to government policies and judicial pronouncements. Further, applying a 180 days' limit to all sectors in the economy without considering the particular issues or problems faced by each sector, randomly picking all defaults amounting to INR 2000 crore and above and requiring an agreement by 100% of the lenders for restructuring makes the Revised Framework manifestly arbitrary and violative of Article 14 of the Constitution.

The Supreme Court held that the RBI can issue directions to a banking company to initiate insolvency resolution process under the IBC only in accordance with section 35AA of BR Act, which require (i) authorisation from the Central Government; and (ii) occurrence of a specific default. Thus, powers conferred under section 35AA of BR Act to refer defaulters under the IBC cannot be exercised by RBI unless the conditions mentioned therein are satisfied which shows that abundant caution has been exercised while introducing this section. (emphasis supplied)

It has further been held that the press note dated May 5, 2017 introducing the Ordinance particularly referred to resolution of 'specific' stressed assets empowering the RBI to intervene in 'specific' cases of resolution of non-performing assets. Moreover, the statement of objects and reasons for introduction of the provision makes it amply clear that the legislative intent was to empower the RBI to deal with specific accounts or instances of default and not to give overarching

⁶ (2004) 11 SCC 1.

⁷ *State of U.P. v. Singhara Singh*, (1964) 4 SCR 485.

power to the RBI to direct any default to proceedings under the IBC. The meaning of the word 'specific' has been interpreted by the Supreme Court to mean anything which is clearly defined or designated in light of meanings ascribed to the word in legal and general English dictionaries and other judicial pronouncements. Thus, section 35AA requires a specific case of default and does not envisage issuance of sweeping directions to banking companies generally (as prescribed under section 35A). (emphasis supplied)

The Supreme Court has held that the Revised Framework is not in compliance with the provisions of section 45L(3) of the RBI Act as the condition of exercising 'due regard' as contemplated in the said provision was absent whilst introducing the Revised Framework. It further stated that non-banking financial institutions are inseparable from banks *vis-à-vis* the application of the Revised Framework and accordingly, the Revised Framework cannot be made applicable to non-banking financial institutions as well.

In view of the foregoing, the Revised Framework was declared *ultra vires* as a whole, having no effect in law, as a result of which, all actions taken under the Revised Framework, including proceedings initiated by financial creditors against debtors under section 7 of the IBC pursuant to the Revised Framework, would become null and void.

In view of the retrospective effect of the judgment by the Supreme Court, the consequences of this decision can be far reaching especially in cases where matters have already been referred to the IBC pursuant to the Revised Framework. In cases where moratorium is underway and a resolution professional has taken over the charge of the affairs of a corporate debtor or a resolution process has been duly completed in accordance with the provisions of the IBC, it may become a practical challenge to deal with such situations in light of the Supreme Court's decision in the Dharani Sugars case.

Further, as discussed above, it has been held that the RBI can issue directions to a banking company to initiate insolvency resolution process under the IBC only in accordance with section 35AA of BR Act, which require (i) authorisation from the Central Government and (ii) occurrence of a specific default. It may be noted that the gazette notification S.O.1435(E) dated May 5, 2017 issued by the Central Government, in exercise of the powers conferred by section 35AA of the BR Act, gives ample power to the RBI to issue such directions to any banking company or banking companies which may be considered necessary to initiate insolvency resolution process in respect of a default, under the provisions of the IBC. Although the aforesaid notification should satisfy the essence of 'authorisation from the Central Government' but given the Supreme Court has interpreted the word 'specific' to mean anything which is clearly defined or designated, it can be said that this judgment will not impact the 'dirty dozen' and the other 29 accounts referred under the IBC by the RBI pursuant to its letter to the banks on December 13, 2017 as these accounts were specifically designated and referred by the RBI under the IBC. (emphasis supplied)

Concluding Remarks

A significant question which the Supreme Court's decision in the Dharani Sugars case has raised is whether the Erstwhile Framework will now be restored. In this regard, it may be noted that the judgment specifically lays down that "... *the impugned circular will have to be declared as ultra vires as a whole, and be declared to be of no effect in law.*"⁸. However, the RBI *vide* press release dated April 4, 2019 declared that it will take necessary steps, including issuance of a revised circular, for expeditious and effective resolution of stressed assets. It will have to be seen whether the RBI moves in the direction of revising the Revised Framework or going back to the Erstwhile Framework.

⁸ Paragraph 45, *Dharani Sugars and Chemicals Ltd. v. Union of India & Ors.*, Transferred Case (Civil) No. 66 of 2018 in Transfer Petition (Civil) No. 1399 of 2018.

It appears that the Supreme Court's decision will certainly give more time and discretion to the banks and all-India financial institutions on finalizing a resolution plan and any eventual referral to insolvency proceedings will also no longer be time-bound.

In case of the restructurings under the Revised Framework for which exemptions from applicability of the SEBI regulations in respect of issuance of shares have already been availed, it has to be seen what the practical implication will be in light of this judgment.

Further, given the Project Sashakt inter-creditor agreement was implemented subsequent to the introduction of the Revised Framework, it remains to be seen whether the intercreditor agreement itself will need to be re-executed by banks pursuant to the Revised Framework being declared unconstitutional.

It will have to be seen how things practically pan out pursuant to the Supreme Court's decision in the Dharani Sugars case and what circular/ notification/ direction the RBI comes up with, for resolution of stressed assets but it is evident that the consequences of this decision will be far reaching.

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