Recent developments in India's corporate & commercial laws

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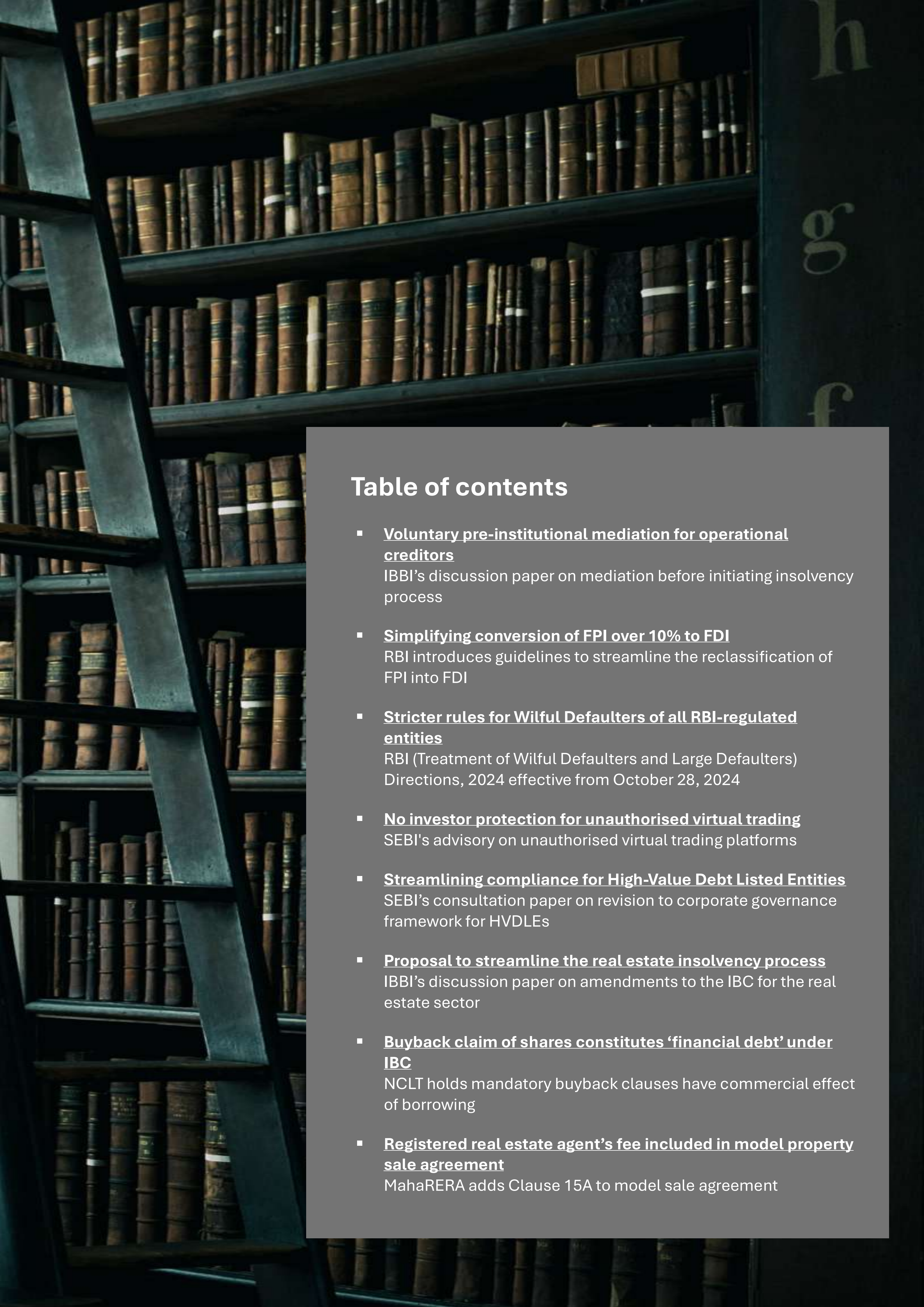

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Voluntary pre-institutional mediation for operational creditors

IBBI's discussion paper on mediation before initiating insolvency process

The Insolvency and Bankruptcy Board of India (**IBBI**) issued a paper calling for public comments on its proposal to include a provision for operational creditors to initiate mediation with the corporate debtor and settle its disputes before initiating insolvency.

Since only around 15% of insolvency applications arising out of operational debt have been admitted, with most settlements happening pre-admission compared to any subsequent stage, the IBBI concluded that operational creditors are more interested in repayment of their dues rather than the resolution of the corporate debtor. With the view to resolve the conflict and expedite the admission process, the IBBI proposed to include a provision for mediation under the Mediation Act, 2023 which can be voluntarily invoked by the operational creditor prior to the filing of an application under Section 9 of the Insolvency and Bankruptcy Code, 2016 (**Code**).

The current framework requires a financial creditor to simply file an application under Section 7 of the Code before the National Company Law Tribunal (**NCLT**) which is admitted on proving a default of over INR 1 crore, whereas for an operational debt, the operational creditor is required to deliver a demand notice of unpaid operational debt to the corporate debtor under Section 8 of the Code, and in case no payment is made within 10 days, the operational creditor may file an application under Section 9 before the NCLT. Even then, the corporate debtor may take the defence of a pre-existing dispute (regarding quality, performance, breach, etc) requiring further adjudication by the NCLT before the corporate debtor is admitted into insolvency.

Given the insignificant position generally accorded to unsecured operational creditors in successful resolution plans that ultimately provide repayment of only a miniscule percentage of the unpaid operational debt, as well as the risk to the corporate debtor of undergoing insolvency, pre-admission settlement is beneficial for all parties. As such, despite the parties having likely attempted to mediate their disputes prior to approaching the NCLT, invoking such a statutory provision increases the incentive of parties to settle their disputes to prevent the risk of CIRP.

Simplifying conversion of FPI over 10% to FDI

RBI introduces guidelines to streamline the reclassification of FPI into FDI

On November 11, 2024, the Reserve Bank of India (**RBI**) introduced new guidelines to simplify the process for Foreign Portfolio Investors (**FPIs**) to convert their holdings into Foreign Direct Investment (**FDI**) if their stake in an Indian company surpasses 10%.

Under prior regulations, FPIs in Indian companies were limited to a maximum stake of 10% of the company's paid-up equity. If this limit was breached, the FPI had to divest the excess shares or navigate a cumbersome reclassification to FDI. This lack of a streamlined reclassification process often led to delays and additional compliance hurdles for FPIs who wished to retain investments over the limit. The current FPI ownership cap remains at 10% of an Indian company's equity. However, FPIs now have a 5-trading-day window to reclassify any excess holdings as FDI, provided they secure approvals from the Indian government and the investee company. FDI restrictions still apply to sectors where foreign investment is prohibited, such as lotteries, chit funds, casinos, and atomic energy.

FPIs wishing to reclassify excess holdings as FDI must follow specific compliance procedures. These include adhering to the Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019 and instructing custodians to transfer shares from the FPI demat account to an FDI-designated demat account. Additionally, custodians must notify SEBI if an FPI breaches the 10% ownership limit and suspend further equity transactions in the company until the reclassification is completed. This framework is effective immediately, allowing SEBI and custodians to enforce these guidelines and ensure market compliance and integrity.

The updated guidelines provide a structured pathway for FPIs to retain holdings that exceed the 10% ownership cap without the need for divestment, making Indian markets more attractive to long-term foreign investors. By reducing compliance burdens, the framework supports the government's goal of fostering sustained foreign investment and creating a more investment-friendly environment. However, the framework does come with challenges such as the requirement to complete reclassification within 5 trading days, which can be difficult, particularly if regulatory approvals are needed. FPIs must also ensure compliance with both reporting requirements and sectoral FDI restrictions.

Stricter rules for Wilful Defaulters of all RBI-regulated entities

RBI (Treatment of Wilful Defaulters and Large Defaulters) Directions, 2024 effective from October 28, 2024

On July 30, 2024, the Reserve Bank of India (**RBI**) issued Master Directions on the 'Treatment of Wilful Defaulters and Large Defaulters' (**Master Directions**), effective from October 28, 2024. These directions apply to banks, higher-tier Non-Banking Financial Companies (**NBFCs**), All India Financial Institutions (**AIFIs**), and extend reporting requirements to Asset Reconstruction Companies (**ARCs**) and Credit Information Companies (**CICs**). They introduce stricter rules on large defaulters and restrict additional credit for wilful defaulters across all RBI-regulated entities.

Previously, the identification and management of wilful defaulters was guided by broad, unspecific norms, making consistent monitoring and debt recovery difficult. The new framework aims to address these challenges.

Key aspects:

- A 6-month timeline for classification wherein banks and financial institutions must classify a borrower as a wilful defaulter within 6 months of their classification as a Non-Performing Asset (**NPA**), following internal reviews that detect wilful default.
- An additional ground for classification has been introduced according to which a borrower or their promoters can now be classified as wilful defaulters if they fail to meet an equity infusion commitment, provided they have the capacity to fulfil it. Lenders are required to act on this by classifying the borrower as a wilful defaulter if promoters fail to meet any shortfall undertakings.
- Lenders must include clauses that prevent borrowers from appointing individuals listed as wilful defaulters to management positions.
- Borrowers whose promoters, directors, or management are on the wilful defaulter list cannot receive renewals, enhanced facilities, new credit, or restructurings.
- Companies linked to wilful defaulters are prohibited from obtaining new financial facilities or funding for new ventures for up to five years after being removed from the wilful defaulter list. They are also barred from restructuring existing facilities for 1 year after removal.
- The Master Directions require lenders to adopt specific policies and guidelines, including the creation of identification and review committees, clear guidelines for settlements with wilful defaulters, forensic audit thresholds, and the appointment of designated officials to issue show-cause notices and finalise classification decisions. This ensures a more structured and consistent approach to managing wilful defaulters across institutions.

The RBI's revised framework aims to enhance transparency and accountability by providing clear guidelines for identifying and managing wilful defaulters. With stricter covenants and defined timelines, the framework is designed to streamline the debt recovery process and reduce the risks associated with repeat defaulters. However, these changes may require financial institutions to implement rigorous internal processes to meet the new classification timelines and comply with the additional reporting requirements for both large and wilful defaulters.

By addressing gaps in the previous framework, these guidelines empower banks, NBFCs, and other financial institutions to uphold stricter accountability standards. This regulatory clarity is likely to instil greater confidence among creditors, ultimately strengthening India's financial ecosystem and promoting more responsible lending practices.

No investor protection for unauthorised virtual trading

SEBI's advisory on unauthorised virtual trading platforms

The Securities and Exchange Board of India (**SEBI**) issued an advisory on November 4, 2024, regarding unauthorised virtual trading, paper trading, or fantasy games based on the stock price data of listed companies. These activities are outside SEBI's regulatory purview and violate the Securities Contracts (Regulation) Act, 1956 (**SCRA**) and the SEBI Act, 1992. SEBI reiterated its previous warning (issued on August 30, 2016) that securities trading should only occur through registered intermediaries. Investors engaging with unregulated platforms do so at their own risk and without the investor protections provided by SEBI.

These unauthorised platforms, which mimic real stock prices and simulate market conditions, often masquerade as educational tools but are profit-driven, blurring the line between trading and pseudo-gambling. SEBI's current advisory raises significant concerns regarding the regulation of such platforms, their risks, and their overlap with the largely unregulated crypto industry.

Under Section 2(h) of the SCRA, 'securities' are defined as financial instruments representing ownership, debt, or rights to ownership, typically traded on exchanges. The securities market, including stocks, bonds, and derivatives, plays a crucial role in capital formation and is tightly regulated by SEBI to ensure transparency, fairness, and investor protection. By requiring brokers, exchanges, and other intermediaries to be registered, SEBI reduces the risk of fraud and enhances market integrity, providing a structured environment for trading securities.

The risks associated with unauthorised virtual trading platforms are significant. First, there is a lack of investor protection, as these platforms are not regulated by SEBI, meaning investors miss out on safeguards like dispute resolution mechanisms that are available on registered platforms. Additionally, users are often required to share sensitive personal and financial information, creating a risk of data misuse since these platforms do not adhere to the stringent data protection standards of regulated entities. Legally, trading on such platforms may violate the SCRA, as they operate outside the legal framework. Even if these platforms use real market data, they can mislead investors into believing virtual 'securities' are backed by actual listed assets, raising legal concerns. Moreover, these platforms often target inexperienced retail investors, offering the illusion of real stock market trading, which can result in significant financial losses and expose them to fraud.

The existence of these virtual trading platforms draws an interesting parallel with the cryptocurrency industry, which similarly operates in a largely unregulated space in India. Cryptocurrencies are not currently classified as 'securities' under Indian law, positioning them in a regulatory grey area. Although they are popular, they lack the investor protections found in traditional markets. The rise in cryptocurrency-related frauds, hacks, and exchange collapses, such as the WazirX hacking incident, underscores the risks of operating in an unregulated environment. Virtual trading platforms may face similar challenges, including increasing fraud risks, lack of recourse for investors, and potential disruption to the regulated financial markets.

In conclusion, SEBI's advisory urges caution against these unauthorised platforms that gamify real-time stock price movements and offer financial incentives. It emphasises the importance of a comprehensive regulatory framework to protect investors, whether in traditional securities markets or emerging digital platforms. While educational apps using historical data may be unaffected, platforms that mimic real-time trading or offer financial rewards need to comply with SEBI regulations to ensure investor protection and market integrity.

Streamlining compliance for High-Value Debt Listed Entities

SEBI's consultation paper on revision to corporate governance framework for HVDLEs

On October 31, 2024, the Securities and Exchange Board of India (**SEBI**) released a consultation paper to revise the corporate governance framework for High-Value Debt Listed Entities (**HVDLEs**) under Chapter IV of the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 (**LODR**). The paper proposes a series of changes to improve governance while reducing compliance burdens for these entities.

HVDLEs, as defined in Regulation 15(1A) of the LODR, are entities with listed non-convertible debt securities worth INR 500 crore or more. SEBI previously extended corporate governance norms to these entities in 2021. The new proposals aim to enhance governance efficiency, address gaps, and align regulations with market realities.

Key proposals:

- **Separate governance chapter for HVDLEs:** Corporate governance provisions in the LODR are currently designed for equity-listed entities, complicating compliance for debt-listed ones. SEBI proposes creating a separate chapter for HVDLEs to simplify governance and reduce confusion, simplifying compliance by distinguishing their requirements from those applicable to equity-listed entities.
- **Increased threshold for applicability:** Currently, HVDLEs must comply with LODR provisions when their debt exceeds INR 500 crore. The consultation paper suggests raising this threshold to INR 1000 crore, aligning with the revised long-term borrowing limit introduced in October 2023 by SEBI.
- **Sunset clause:** A sunset clause would allow HVDLEs to exit governance requirements once their debt falls below the prescribed threshold for 3 consecutive years, removing indefinite compliance for smaller entities.
- **Stronger Related Party Transaction** (**RPT**) **controls:** SEBI proposes stricter RPT disclosures, upfront declarations in offer documents, and enhanced monitoring by credit rating agencies and debenture trustees. Entities would need to obtain No-Objection Certificates (**NOCs**) from debenture holders for material RPTs, offering better protection for debenture holders. SEBI expects that these measures will ensure that the interests of the debenture holders are not hampered and will provide them protection against any unfair treatment by the shareholders being related parties to the entity.
- **Relaxed committee requirements:** To reduce administrative burden, SEBI proposes allowing HVDLEs to delegate the functions of committees like the Nomination and Remuneration Committee (**NRC**) and Risk Management Committee (**RMC**) to the Audit Committee. The Stakeholders Relationship Committee (**SRC**) functions could be managed by the Board of Directors.
- **Flexibility for non-company entities:** Non-company HVDLEs (e.g., NABARD and SIDBI) would only need to comply with governance norms when they do not conflict with their respective regulatory frameworks.
- **Directorship limits:** SEBI proposes including HVDLE directorships in the existing cap of 7 directorships across listed entities, ensuring directors dedicate sufficient time to their roles. Committee memberships in HVDLEs would also count toward this cap.

SEBI's proposed reforms aim to create a more tailored and efficient regulatory framework for HVDLEs. The changes are designed to improve governance while reducing compliance burdens and reflect SEBI's commitment to enhancing transparency, safeguarding debenture holders' interests, and improving the overall efficiency of HVDLEs.

Proposal to streamline the real estate insolvency process

IBBI's discussion paper on amendments to the IBC for the real estate sector

On November 7, 2024, the Insolvency and Bankruptcy Board of India (**IBBI**) issued a discussion paper on several issues pertaining to insolvency cases in the real estate sector based on the findings and recommendations of the Indian Institute of Insolvency Professionals of ICAI (**IIIPI**) as well as concerns raised by stakeholder groups.

Key aspects:

- **Inclusion of the 'competent authority' as defined under Section 2(p) of the Real Estate (Regulation and Development) Act, 2016 (land authorities) in Committee of Creditor (CoC) meetings:** Owing to the crucial role played by land authorities in real estate projects, the IBBI has proposed to include them as invitees in CoC meetings without any voting rights by inserting a new sub-regulation to Regulation 18 of the IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 (**CIRP Regulations**). This will ensure that land authorities are able to offer their inputs on regulatory issues, potentially curbing unforeseen delays and complications during the implementation of the resolution plan, and thereby significantly enhancing the viability of the resolution plan.
- **Cancellation of land allotment:** Noting the primacy of land lease and allotments for continuation of the corporate debtor as a going concern, the IBBI proposed to include a provision in the CIRP Regulations requiring the resolution professional to report to the CoC and the National Company Law Tribunal (**NCLT**) when such allotment and/or lease is cancelled prior to the initiation of Corporate Insolvency Resolution Process (**CIRP**). Since the NCLT is empowered to stay only those cancellations that are motivated by the initiation of CIRP, early information on pre-CIRP cancellations is crucial to enable the CoC to make informed decisions on possible alternatives to the continuation of CIRP such as withdrawal and/or early liquidation for maximising the value of assets.
- **Calculation of interest in homebuyers' claims:** Regulation 16A(7) of the CIRP Regulations provides an interest rate of 8% on the financial debt for calculating the voting share of each creditor in a class. Noting discrepancies amongst resolution professionals on using the said interest rate either exclusively for the purpose of calculating the voting share or to also determine the actual claim amount, the IBBI has proposed to issue a clarification that such interest rate should also be used for calculating the claim amount. This clarification will not only create consistency by aligning the calculation of voting share with the valuation of claims, but will also prevent additional consumer litigation for inclusion of the said interest amount.
- **Handover of possession during CIRP:** Noting that the objective in a real estate resolution is smooth handover of flats to the allotees, the IBBI has proposed to empower the resolution professional to complete transfer of property and handover possession of flats during the moratorium with the prior approval of the CoC. While preserving the rights of homebuyers as a class of creditors, this proposal ensures the accrual of revenue in the account of the corporate debtor in order to keep it running as a going concern.
- **Proposal to disseminate minutes of CoC meetings to all creditors:** The CoC discussion not only addresses the challenges in the resolution process but also the status, timeline and the challenges faced in the real estate project. While creditors have the statutory right to access the CoC meetings, an authorised representative for a class of creditors is required to review and communicate the discussions in CoC meetings to homebuyers. To prevent a situation of lack of communication and/or miscommunication, ensure transparency and counter rumours, the IBBI has proposed to facilitate the resolution professional to upload the minutes of the meeting on the website of the corporate debtor for access by all individual creditors as a single authoritative source of information.

Buyback claim of shares constitutes ‘financial debt’ under IBC

NCLT holds mandatory buyback clauses have commercial effect of borrowing

Recently, in ***Spectrum Trimpex Pvt Ltd*** (**Spectrum**) ***v. VPhrase Analytics Solutions Pvt Ltd***[1] (**VPhrase**), the National Company Law Tribunal, Mumbai Bench (**NCLT**) held that claims arising out of buyback clauses under Share Purchase Agreements constitute ‘financial debt’ under the insolvency framework if they imply an obligation that mirrors the commercial effect of borrowing. While the Insolvency and Bankruptcy Code, 2016 (**Code**) provides for a broad and inclusive definition of ‘financial debt’ under Section 5(8), clarity has been required on what may constitute a financial debt beyond the general understanding of loans disbursed by banks and financial institutions.

In this case, Spectrum had invested in VPhrase under a Share Subscription and Shareholders Agreement (**SSA**) involving the allotment of 378 equity shares to Spectrum, with a clause for mandatory buyback to provide an exit at fair market value after 5 years. Spectrum invoked this buyback clause calling upon VPhrase to make the payment based on its audited financial statements. However, VPhrase did not respond, constraining Spectrum to file an application under Section 7 of the Code claiming that the unpaid buyback amount constituted a ‘financial debt’.

While deciding on whether the buyback claim of shares by Spectrum constituted ‘financial debt’, the NCLT referred to the decision in ***Kotak Mahindra Bank Ltd v. A Balakrishnan & Anr***[2] wherein the Supreme Court held that raising of an amount by a company through a Shareholders Agreement had the commercial effect of borrowing since the said transaction has direct effect with the business.

The NCLT also referred to the judgment in ***Sanjay D Kakade v. HDFC Ventures Trustee Co Ltd***[3] wherein the National Company Law Appellate Tribunal (**NCLAT**) held that investments made in the corporate debtor by means of Share Subscription and Shareholders Agreements involving a pre-emption right in favour of the financial creditor and/or a put option in the Shareholders Agreement obligating the promoters to buy-back shares at a fair market value, would be treated as a ‘financial debt’ as the transaction has the commercial effect of borrowing.

Thus, NCLT held that in light of the mandatory buyback clause, the allotment of equity shares to Spectrum will constitute a ‘financial debt’ under Section 7 of the Code. This judgment provides much-needed guidance on the interpretation of financial debt in the context of corporate transactions and highlights the evolving relationship between the insolvency regime and corporate investments. The judgment underscores the growing recognition that investment structures, such as buyback clauses in shareholder agreements, may carry characteristics akin to borrowing, thus broadening the scope of financial debt and enhancing legal certainty for corporate stakeholders, including investors, promoters, and creditors.

Registered real estate agent’s fee included in model property sale agreement

MahaRERA adds Clause 15A to model sale agreement

The Maharashtra Real Estate Regulatory Authority (**MahaRERA**) issued an order dated October 22, 2024 inserting Clause 15A into the model form of sale agreement addressing the fees payable to a real estate agent registered under Section 9 of the Real Estate (Regulation and Development) Act, 2016 (**RERA**) that facilitated the transaction between the promotor and the homebuyer. Clause 15A obligates parties to pay the commission/fee/brokerage to the real estate agent as per the terms agreed upon between the parties.

Although this order marks the first step in securing the rights of a real estate agent as it formally incorporates the contractual obligations qua the real estate agent into the sale agreement, it may fall short in substantially achieving this purpose for the following reasons:

- **Not mandatory:** MahaRERA has not stated that this provision is mandatory to be included in sale agreements.
- **No locus:** The clause does not empower the real estate agent to file a complaint with MahaRERA.
- **Privity of contract:** The sale agreement remains a private agreement between the promotor and the homebuyer and the said provision may not be enforceable at the behest of the agent, a third party.

Despite the above inadequacies, this order provides impetus for property brokers to register themselves under the provisions of RERA and avail formal protections under law. Incorporating this provision would also reinforce homebuyers' ability to hold promoters accountable for paying the broker's fee, should the need arise, by clearly delineating this obligation within the sale agreement.

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[1] Company Petition (Insolvency) No. 249 of 2024
[2] 2022 (9) SCC 186
[3] Company Appeal (Appellate Tribunal) (Insolvency) No. 481 of 2023

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