BLOCK-4

LEGAL AND REGULATORY FRAMEWORK FOR FINANCING AND INVESTMENTS OF BUSINESS

ignou
THE PEOPLE'S
UNIVERSITY

UNIT 7 BANKING AND OTHER ALLIED REGULATIONS

Objectives

After studying this unit you should be able to:

- Understand the evolution of Banking Regulation
- Explain the terms and conditions to be complied with for obtaining a bank license.
- Discuss the interface of Banking Regulation Act with other laws
- Describe the role of Central Government in regulating the banking sector in India

Structure

7.1 INTRODUCTION

Regulation of financial sector is extremely important. But within the sector, banking sector regulation is most important. The reason has to do with the importance of the role it plays in the economy, the fragile nature of the business model of the banks and the consequences of bank failures, as has been observed in most serious recessionary phases in recent history, including Great Recession of 2008.

Banks not only serve as depository of people's savings, but also serve as a payment mechanism. The payment system, which majorly runs on payment orders made to and cheques drawn by us on our banks, runs on the assumption that the amount standing to our credit in the account is as good as real money. The agreement between two parties to do an impossible act itself is void. A contract may also void because of an event which makes the performance of promise impossible or unlawful after the completion of the contract. The amount shown in our account as credit is a mere debt due to us from the bank which is repayable on our demand. Our confidence that it would be so paid whenever asked for, and the ability of banks in almost all instances to do so ensures that we treat it as good as money. But we tend to forget that the bank lends this money, and to cover for its cost of

operations and the interest paid to us, it has to lend it at a higher interest rate which would usually be for a fixed duration. Thus, we come to a situation where the bank has liabilities which are short term in nature, and assets which are long term. This mismatch between the time frame of assets and liabilities is what underlies the fragility of the banking business. The business not only has to manage the liquidity, but also ensure that the depositors retain confidence in the bank, so that not only fresh funds keep coming in to match the payment orders and instructions, but also that the depositors do not lose confidence in the bank as the loss of confidence would certainly would cause a run on the bank causing it to fail.

A bank failure has an effect on all segments of the economy. The depositors not only lose their liquid assets, but may even be the cause of failure of businesses which used the failed bank for receiving and making payments, for providing bank guarantees or which had an overdraft facility on the back of the security given by them. This would now not be released any time soon till the bank insolvency process is completed. This may even have a systemic effect, if the entity is large. A bank failure may lead to a panic reaction amongst the general mass of depositors, leading them to withdraw deposits from other banks, causing a bank run. Healthy banks would fail if suddenly there is a run on their deposits. Depositors and businesses dependent upon them fail and soon enough an isolated instance of bank failure balloons into a system wide series of failures as was experienced during the Great Depression of 1929 and Great Recession of 2008. The failures also affect the money supply floating in the economy, as the banking system multiplies the money. The money in circulation due to the operation of the banking system is usually a few multiples of the base money (the printed money or the issued coins).

7.2 EVOLUTION OF BANKING REGULATION

After understanding the importance of banks in the economy and the necessity of regulating them, more than other players in the economy, the question arises as to who is best placed to regulate the banks and the legal basis of the regulatory power.

The first necessity for bank regulation came by the need for cooperation amongst the banks in executing payment instructions and making collections on the cheques deposited with them. Instead of chasing each bank individually, it was thought fit to have a central place where the banks of a local area could meet and instead of paying each cheque individually to another bank for the other bank's customers, only the net balance due to each bank be paid. So, local areas had a clearing houses. Since cheques honoured in the interim may bounce, either due to insufficiency of funds or signature of the purported cheque writer not matching, the collecting bank had to be solvent enough for return of moneys in such cases. Clearing house membership was an informal regulation of the industry as it was dependent upon confidence in the solvency of the banks who met. But the role of industry specific bodies in forming standards for the guidance of its members has over a period of time has become more formal, and recognized by courts in determination of industry standards for service.

The fragility of the banking system meant that whenever there was a run on the banks, howsoever well run and solvent they might be individually, howsoever

good their asset quality be, there would always be a chance that they might fail. No other financier would be willing to lend to the bank because it would be afraid that even if the money lent is not lost, it may not be available to it in times of crisis. So, a need was felt for a lender of last resort in times of crisis – an entity willing to lend when no one is willing to do so because they are dependent on demand deposits to lend. The entity should not depend on retail deposits and have the power to create the money which is accepted as a valid tender.

In the late nineteenth century, Bank of England emerged as a lender of last resort to the English banks. In the first decade of the twentieth century, the Federal Reserve Board was formed to be the lender of last resort in the United States of America. During the Great Depression a need was felt to have a lender of last resort. In pursuance of this strongly felt need, the Reserve Bank of India (RBI) was formed in 1934. Basically, the structure followed was that the banks which wanted to be eligible to be considered for lending by the RBI, had to maintain a certain percentage of their deposits with such lender of last resort (central bank) and had to observe prudent business practices to be considered for lending in emergency situations. It is like a bank exercising some control and surveillance over a borrower who has been given an overdraft facility. With banks having deposits with the RBI, it also has a role in the clearing house operations, thus giving it a bird's eye view of the working of the financial system and the solvency of the individual players.

Regulation by perceptions of solvency and contract were thought to be insufficient. Regulatory power was not statutory, as though the entities like Bank of England or RBI may have come into existence either by charter or statute, the shareholders were private individuals. After the nationalization of Bank of England and the Reserve Bank of India, regulatory powers were given to the central bank, in the same way as they could be exercised by the said executive wing of the government. The powers have been reserved with the executive wing of the government in some countries. But it was thought appropriate to give it to an entity which has expertise in the sector, which would anyway perform a regulatory role with regard to most of the banks because of it being the lender of last resort and thus avoid duplication of effort. In this way, Banking Regulation Act, 1949, gave the Reserve Bank of India the statutory regulatory power over most of the banks. The government retained for itself the role of giving directions where it found appropriate, and being a forum for appeal for most decisions taken by the RBI.

While RBI has the primary role in regulation of banks, it shares the regulatory space with certain other bodies. In the case of agricultural cooperative banks and regional rural banks, National Bank for Agriculture and Rural Development (NABARD) also has a regulatory role as it is the principle refinancing body for these banks serving specific needs of a sector of the economy. In the case of urban cooperative banks, the principle means by which the RBI used to regulate was by being the lender of the last resort for the banks which were in the second schedule of the RBI Act. Recently, by amendment to the Banking Regulation Act, RBI has been given a primary regulatory role over these banks, almost at par with what it has in the case of commercial banks. However, it ought to be noted that cooperatives having been organized under the state statutes relating to cooperatives, the registrar of cooperatives of the state of incorporation will also have a regulatory role (not so in the case of multi state cooperatives). In the case of public sector banks, the regulatory role of the RBI is dependent upon how much of the regulatory powers relating to them is ceded by the Central

Government to the RBI under the Banking Regulation Act (BRA). At present, Central Government has given the RBI almost all the powers over the public sector banks which the RBI has over the private commercial banks, with the exception of the powers over the Board and other Officers of the bank.

We have considered the regulation by industry standards setting bodies, contractual arrangements for deriving of benefits, either as lender of last resort or refinancing arrangements or deposit insurance etc., and by statute. Another source of regulation is the soft law framed by different international associations for regulators for the guidance of the member regulatory bodies. As far as banking is concerned two transnational bodies are important. The first is Bank of International Settlements, Basel, and the Financial Action Task Force.

Bank for International Settlements (BIS) was originally a small body of central banks of developed economies, but its membership has recently expanded. The bank has as its primary remit the stability of the international financial system. After the Herstatt crisis in the mid 1970s, when the failure of a German bank created problems for the payment system in New York, BIS has sought to address the issue of how to ensure that the banks which are participants in the international payments systems and mechanisms, stay solvent to honour their commitments. Towards this end, with the sanction of the member central banks it has periodically made rules for calculation of the capital required by a bank for doing business. Though the rules are meant only for the banks engaged in cross border payments and which belong to the member states, requirements of international trade and international payment system operation almost made it incumbent to most central banks to frame regulations based on the BIS guidelines. International trade depends upon letters of credit and banks must have confidence in the letter of credit opened by its counter party in another country to agree to become the payer on being presented the documents by the exporter. In a similar manner, the guidelines of the Financial Action Task Force (FATF), formed for the purpose of curbing the use of the financial system for money laundering, are adopted by not just the member countries but all others who want their financial institutions not to be excluded from the international financial system.

One has to remember that regulatory bodies acquire expertise in certain sectors of the economy. The legislature may want to use the expertise developed by these bodies for regulating the allied sectors. Sometimes it is necessary, as carrying out the responsibilities in one area may require an input from or a corresponding action in another arena of economic activity. Inactivity in the allied area may lead to the players exercising what many would call the regulatory arbitrage - taking advantage of the absence of rules in the allied sector to carry on the same activity without checks and balances. Banks and non banking finance companies (NBFCs) are different. The deposits of the latter are not repayable on demand and they don't act as the agent of their customers in the payment system and so don't form part of the payment system. But a very short term deposit or commercial paper (as in the case of Lehman Bros which failed in 2008) may make them also very fragile. If the lenders to these institutions are banks, then the regulator for banks becomes interested in their solvency, more so if the banks form these NBFCs to bypass the regulatory barriers. That is why they are sometimes called shadow banks. As a result of this, the RBI was given the regulatory remit for the NBFC sector by an amendment to the RBI Act in 1997, when a regulatory vacuum in the NBFC sector was noticed after the failure of

many depository NBFCs. Similarly, since the RBI has the remit to maintain the monetary stability (stability in the value of the currency), it has the regulatory powers in the money market (short duration loan and short term debenture market) under the RBI Act, monetary payment and settlement systems (under Payment and Settlement Systems Act) and regulates the capital flows in the foreign exchange market (under Foreign Exchange Management Act).

7.3 REGULATION IN RELATION TO CHARTERING / LICENSING

Banking is a business of borrowing and lending money, but with special features which are absent in other borrowing and lending businesses. Not only are deposits with it repayable on demand, but they are repayable only in the branch with which the account is kept, and the bank also gives the cheque facility to its customers and would collect cheques on their behalf. The last requirement means that the bank has to take a debt/deposit from its customer and whenever the customer wants it the bank cannot refuse it as in case of ordinary debtors.

Banking Regulation Act prevents any person or entity to give a cheque writing facility to its customers if the person or entity is not a bank. Further it prevents the use of the term bank by any entity which is not a banking company registered under the Banking Regulation Act (though some entities use the terminology under the special statutes by which they are created or under which they are incorporated). While banks were in business long before BRA came to be enacted, a time frame was given for such banks to get the license to operate as a bank from the RBI. All new banks to operate as a bank needed a license from the RBI. The grant of a license is the discretion of the RBI, but the BRA lays down certain conditions for the exercise of its discretion, conditions which it is required to be satisfied about before grant of a license. The company must not only be in a position to repay present and future depositors in full as their claims accrue, but should have adequate capital structure and earning prospects along with the character of the proposed management and the conduct of its affairs not being opposed to public interest or interests of depositors . In addition, the RBI will look into the public interest and availability of banking facilities in the proposed area of operations. While granting license, the RBI may lay down conditions to be fulfilled by the licensee when operating as a bank.

Banking Regulation Act (BRA) gives RBI wide amplitude in the granting of a license. The RBI has in recent times given out a policy papers on how it would exercise its discretion. The conditions for license for different types of banks are different as each of them would pose different risks to the financial system. ***At present, banking license for commercial banks are in three categories - payment banks, small finance banks and full-fledged commercial banks.*** The first do not give out any commercial loans while the second give loans only up to a specific amount allowed by the RBI (Rupees twenty five lakhs at present). Since the first and second categories of banks pose a lower risk, the licensing conditions are less onerous for them. The third category of banks has more onerous conditions regarding capital and character of the management. One change by the RBI in the latest policy statement is that from now on the bank licenses are to be on tap provided the applicant meets its rigorous conditions for them and it has also laid out a roadmap for payments banks to progress to small finance banks and then to full-fledged commercial banks.

The RBI license is also required for the opening of bank branches, the definition of which is very wide in the BRA to take into account all payment offices. At present, such licenses are not individually given but banking companies have been given general permission to open branches provided a spatial distribution in terms of rural and urban branches is maintained. Foreign banks wanting to open branches in India are required to have a license from the RBI. The license is granted on the basis of reciprocity (Indian banks can open branches in the country of incorporation of the foreign bank). The latest guidelines of the RBI provide that the foreign banks wanting to start a bank in India will have to do so through a subsidiary incorporated in India, as it wants to insulate the Indian limb of the business of the foreign bank from the fluctuations in the fortunes of the foreign bank in other jurisdictions.

For any company to be licensed to operate as a bank, one essential aspect which is required to be looked into is its capital. Capital of the banking company will have two aspects, initial capital and capital in relation to business. BRA concerned itself only with the initial capital and the amounts mentioned therein have only a historical importance, no longer relevant in the present times. RBI gives out the minimum capital the bank requires to have(depending upon the type of bank license applied for), but also lays out the capital which a bank needs to have in accordance with the size of business and the risk profile of its loan assets. This is in pursuance of the application of the norms agreed upon by the central banks in the Basel Accords. Basel Accords (at present we have Basel III) take into account the reality that the shareholder, who controls the management, has a limited liability. Because the liability of the shareholder is limited, the shareholder body has an incentive to push the management to take greater risks in lending so as to increase the shareholder returns. This risk reward conundrum in a limited liability entity can only be broken by requiring that the shareholder put in additional capital where the risks are greater. So now the capital requirements of a bank are based on the size of its loan book and the quality of its loan book. Less shareholder capital is required when money is lent to the government, more capital is required when money is lent to an individual backed by the security of mortgage of self occupied house and most capital is required when an unsecured loan is given for a business. Basel norms also takes into account of balance sheet exposure of banks in the form of bank guarantees, etc. The Basel capital requirements refers to capital which is available to depositors of the bank as a cushion in the event of bank not performing well. The capital can be in the form of equity shares, irredeemable preference shares and debt in form of debentures (convertible or non convertible) or bonds which are subordinate to debt due to the depositors. The capital requirements can further be divided into tier one and tier two, depending upon how permanent the capital is. Tier one comprises equity shares, irredeemable preference shares and some debentures or bonds with the condition that their redemption is dependent upon the banking company fulfilling certain conditions and it wanting to redeem it.

7.4 REGULATION IN RELATION TO THE BANK MANAGEMENT

As was observed earlier, that the law is concerned about the general character of the proposed management and as to how the affairs of the bank are conducted so that the public interest and the interests of the depositors are not affected. There

are two aspects to the above issue. One is who controls the bank that is the shareholding composition and the degree of control a body of shareholders can exercise, and the second issue comprises the quality of the management and its conduct.

It is important for the banking company's depositors as to the ***distribution of the shareholding*** and the extent of the ***control*** that ***the dominant group of shareholders*** exercises over the bank. Part of the problem is taken care of by the BRA, and part of the problem is taken care of by the conditionalities laid out by the RBI in giving the license and its powers to issue directions to the banks.

First of all the statute denies voting rights to preference shareholders irrespective of the fact that they have not been paid preferential dividend for two years or more.

Secondly, even in the case of equity shares, no shareholder can exercise voting rights in excess of ten percent of the issued equity share capital. This cap on voting powers can be increased by the RBI up to twenty six percent. Thirdly, no one on his own or in concert with others can own- five percent or more of the equity share capital or voting rights in a company without the prior permission of the RBI.

In addition to these statutory restrictions, the RBI at the time of the granting the license lays down a schedule for the dilution of the promoter of the banking company. These are to ensure that individual interests do not get equivocated with the interests of the bank and there is a diversity of shareholding and voting power so that there is sufficient control over the dominant shareholder without there being a takeover which may not be in the interests of the depositors.

Second limb of ***ensuring good management is quality of management and its conduct***. BRA covers almost all aspects of potential control over the management and almost all the aspects of a Board of Directors working which may affect the bank. The provisions may appear at some times to be repetitive.

First of all, the BRA deals with the potential ***conflict of interest between the bank and its Board.*** A banking company is forbidden to lend to any director or any person in whom the director may be interested in. Further, a bank may not remit any debt due from a director or any person in whom the director may be interested in without the prior permission of the RBI. This blanket ban on power to remit extends to extension of time for repayment or change in the terms of repayment. A person to be a director must not be a proprietor of any business concern or have a substantial interest (defined by BRA) in any company or firm or be connected with it in any form if it were not a small scale industrial concern. The Act prevents a director on the board of a banking company to be a director on the board of any other company, even another banking company. The only exception granted to this ban is membership of the board of a subsidiary of the bank or that of a non-profit company. In addition, from a Chairman appointed on a whole time basis, directors to all employees of a bank, irrespective of whatever rank or office they hold, all are deemed to be public servants under Prevention of Corruption Act and can therefore be prosecuted for causing any loss to the bank by their corrupt actions.

After dealing with the conflict of interest, the BRA deals with ***the composition of the Board***. Majority of the board needs to have technical expertise specified

by the BRA, with a further requirement of special knowledge and practical experience in the case of a whole time Chairman or Managing Director (there can be only one of the two in a bank). What is important is the power of the RBI to interfere with the appointment process of the appointment of the Board, the Chairman and the Managing Director. No amendment in the articles of association or memorandum, no contract or resolution of the shareholders or the Board of Directors with regard to the appointment, termination or remuneration of a Chairman, Managing Director, Director or Chief Executive Officer shall be effective unless approved by the RBI. Other than Directors who are not whole time Directors, even the appointment, reappointment or termination of appointment of the aforesaid managerial personnel requires the prior permission of the RBI. The RBI can ask the banking company to reconstitute its Board if the composition of the Board is not in accordance with the BRA. Non compliance by the banking company of the direction would allow the RBI to remove the Director/s whose appointment is not in compliance of the law and appoint its own nominees on the Board. In the same vein, in case the RBI comes to the conclusion that the whole time Chairman or Managing Director of the company is not a fit and proper person, it may require the company to change the whole time Chairman or Managing Director and non compliance with the direction would allow the RBI to appoint its own nominee to the post. This power is in addition to the power of the RBI to appoint when the said post is vacant for an inordinately long period.

In public interest, interest of the depositors or for securing proper management of the banking company, the RBI can remove any managerial personnel (Chairman, Managing Director, Chief Executive Officer, etc.) or officer or employee from the office after following due procedure, and appoint its own nominee to the post. For the same reasons it may also appoint Additional Directors on the Board of the banking company and also in consultation with the Central Government supersede the Board of Directors and appoint an Administrator to manage the affairs of the banking company.

It would be worthwhile to note that many of these provisions with regard to managerial personnel, with suitable modifications are also applicable to cooperative banks. In the case of the public sector banks (which are governed by separate statutes by which they were formed or nationalized), the powers are exercised by the Central Government.

7.5 REGULATIONS WITH RESPECT TO ENSURING LIQUIDITY AND HEALTHY LENDING PRACTICES

As discussed above, the banking business is inherently fragile as it lends for long term purposes, from on the basis of funds which are borrowed from short term sources. Other than ensuring that the management should not be such that it may compromise the interests of the depositors, certain norms have to be in place so that liquidity is maintained and the bank's business is run in such a manner that it remains solvent. These statutory provisions came about in the background of historical experiences from some famous bank failures, which the legislature did not want to be repeated. So there are certain no go areas for the bank which the Parliament has itself prohibited, or allowed a relaxation only

with the prior permission of the RBI. As to the rest it has allowed the RBI to give guidelines or directions taking into account the best practices in the world and the economic reality of India.

First of all, a bank, in addition to banking business, can only do a business that is permitted by section 6(1) of the BRA, though the last sub-clause of section 6(1) allows the government to notify any other business or activity which a bank could engage in. What it cannot do directly, it cannot do indirectly, as well. So, no bank could have shares in excess of thirty percent of the shares in any entity not engaged in a business mentioned in section 6(1) of the BRA. This restraint on shareholding is with reference to holding in any form whatsoever i.e., as an absolute owner, mortgagee or pledgee. Pursuant to historical experience, a bank is forbidden to trade in goods and hold immovable property (which is not required for banking business) for a period of more than seven years. In addition, as the ambit of a bank's permissible activities are also circumscribed like any company by the object clause of its Memorandum of Association, and any change in the Memorandum of Association of the bank requires the prior approval of the RBI. RBI -can also caution or prohibit a bank or banks from entering into a transaction or class of transactions based upon its apprehensions. The reason for this comprehensive set of limitations is that the bank which has an opportunity to use the money parked by its depositors, should limit itself to the business related to money lending and allied activities. Banks should not venture into a full-fledged business entity by itself, as then the chances are that the easy liquidity made available to it by the unsuspecting depositors may incentivize the management to take risky bets and suppress losses and thus turning the bank in effect into a ponzi scheme, satisfying old depositors by new deposits of the unsuspecting customers. Moreover, the drafters of the BRA were concerned that the interests of the depositors should not be made subservient to the interests of other creditors of the bank. In pursuance of this objective, there is a prohibition on banks in giving a floating charge on its assets to any creditor without the prior approval of the RBI.

In addition to the restraints imposed expressly by it, the BRA gives rule making powers to the RBI. Though BRA uses the term guidelines and directions for such rules made by the RBI, they are binding on the bank, though a lending decision in contravention of them may still be enforceable in a court of law. BRA recognizes that such guidelines may be specific to a bank or may be general, applicable to all or a class of banks or a bank. The RBI, when granting a license, may grant it subject to conditions including conditions relating to loans which a bank can give, as it does in the case of small finance banks and payment banks. Then section 21 of the BRA allows the RBI to lay down the policy for bank advances, generally for all or specific to a bank, including laying down the purpose, margins for a security, considerations for determining maximum exposures which a banking company can have to an individual, company or group as well as rates of interests and conditions for financial accommodation of a borrower. It is in pursuance of these powers that the RBI lays out the policies for social sector lending, syndicate lending for large ticket loans, prompt corrective action for weak banks, margin requirements for different types of securities including market securities, purposes for which no money could be lent, minimum interest chargeable and calculation of interest rate in the case of floating rate loans, etc.

Even otherwise, the RBI in public interest or in the interests of the banking policy or interest of depositors or for proper management of the banking company

may give general or specific directions to banks. It is in pursuance of this power the RBI has implemented the Basel Accord norms in India and given banks guidelines as to income recognition (a frequent cause of bank failure by suppressing its weaknesses), NPA recognition and classification, debt restructuring of sick enterprises and hauling the insolvent enterprises to the NCLT for insolvency proceedings. As per one of its directions, every bank should have a risk management committee to monitor the lending practices of the bank so as to ensure its stability.

To handle potential liquidity crisis in a bank, even if it is well run, the law follows a two pronged approach. The first is to prevent a sudden abnormal surge in the need for liquidity due to panic amongst bank customers and the second approach is to ensure that the bank has enough investment in assets which can be considered liquid so that cash could be rustled up whenever the need for it arises. To prevent panic, BRA makes it a punishable offence any act which is designed to undermine the confidence of depositors in a banking company. Further, the depositors are automatically given a deposit insurance to the extent of Rupees five lakhs. To ensure liquidity in case of sudden demand, in addition to the lender of last resort role of the RBI under section 19 of the RBI Act to the scheduled banks (a lending done at the Bank Rate fixed by the RBI), every scheduled bank has to maintain a deposit with RBI a certain percentage (fixed by the RBI, but at a minimum three percent) of its time and demand liabilities. This cash reserve ratio helps in the settlement in interbank transactions via the RBI and also is an emergency liquid reserve available in an emergency. In addition to cash reserve ratio, the banks have also to invest a certain fixed percentage of deposits in assets which can be liquidated easily to raise cash. Called statutory liquidity ratio, these assets are generally government bonds or bonds guaranteed by the government, though few other assets have also been qualified to be part of the statutory liquidity ratio. Subject to the floor and ceiling rates prescribed by the BRA, the cash reserve ratio and the statutory liquidity ratio is fixed by the RBI. In addition to these three means to ensure liquidity, the RBI has also provided a repo window to the banks. Essentially, a repo transaction is a short term lending disguised as a sale and repurchase transaction between the parties. Securities are sold by the bank to the RBI with an understanding that they will be bought back by the bank after a specified period (usually a few weeks), at a fixed rate which represents the price of original sale and a specified interest rate called the repo rate (fixed by the Monetary Policy Committee).

7.6 REPORTING REQUIREMENTS, INSPECTIONS AND AUDIT

It is important for the regulator to be aware of the health of the regulated entities. This is not just to see whether compliance is in accordance with the letter and spirit of the regulations, but also to allow a preemptive action to be taken to ensure that the regulated entity does not fail or its failure, if inevitable, does not pose a systemic risk. ***The three pillars of this regulatory awareness are regular reporting, statutory audits by trusted auditors and inspections***. In the case of banks, these three serve as an additional avenue of information in addition to what is gleaned by the RBI from the working of the payment system.

The banks have to maintain the cash reserve ratio, statutory liquidity ration and a minimum of seventy five percent of assets in India equal to its demand and

time liabilities in India. These three ratios have to be regularly calculated at given intervals, so the RBI also needs to be informed about their compliance. Therefore, on the last Friday of every month, every bank has to submit in the given format data with regard to the liabilities and assets of the bank along with any other information which the RBI may ask for. Further, under the RBI Act, the banks have to share with the RBI credit information (which is much more than advances made by the banks and includes information about guarantees, securities and other potential liabilities), which the RBI can share with other banks (express provision for sharing of such information was necessary because of the customary law that banks should maintain confidentiality about their customers financial affairs). This was thought of as a way to reduce systemic risk. BRA now allows the RBI to publish any information received by it from the banks as well as any credit information disclosed under Credit Information Companies (Regulation) Act. This power should be read in consonance with the power given in the RBI Act by which the information shared with the public should not name the borrower and the lender.

The second limb of maintaining financial health through awareness is audit. While the company law provisions with regard to audit are also applicable in so far as they are not in conflict with the BRA, in the audit process of a company the RBI has a certain control as it is, on behalf of the depositors, also interested in the audit process. The auditor in addition to being deemed to be a public servant under Prevention of Corruption Act, has to be approved by the RBI before his/her appointment, reappointment or removal in addition to following the Companies Act in such matters (RBI has a list of approved auditors). The RBI can also order a special audit of the banking company, to be conducted either by the banking company's auditor or any other auditor appointed by the RBI. The auditors are also supposed to report on matters directed by RBI to be looked into and the report of the auditors, normal as well as the special shall be shared with RBI.

The third important pillar of this process to find the truth is the inspection powers of RBI, which it may do so on its own or shall do so on the directions of the Central Government. During inspections not only the records of the bank will be scrutinized, but the officers and employees may also be examined under oath.

7.7 PENAL POWERS

Any regulator's powers have three components i.e., legislative (rule making), executive and judicial (power to impose penal sanctions). The third component is as important as the first two components because it is the third component along with its expertise in the subject matter which puts the fear of the regulator in the hearts of the regulated. What can be the penal consequences for non observance of the regulatory guidelines and directions other than that of the change of key personnel, supersession of Board, nomination of additional members on the Board etc., which the RBI can exercise or threaten to exercise to ensure compliance?

At the ***first*** level the RBI can deny the permissions which can be expected from it, or deny the enjoyment by the regulated entity (banking company) of the general permissions granted to the sector. So as a disciplinary step it may not sanction the renewal of a Chairman or Managing Director's appointment, or tell a bank not to open new branches under a general permission given to all banks.

The ***second*** method of penalizing a bank is to forbid it from doing what constitutes the core of the banking business, a denial of which might mean a slow death of the bank. So, using its powers to prohibit a certain transaction or class of transactions generally or specifically, it can impose restrictions on a bank on making advances or certain types of advances. The Central Government, if it is convinced on the basis of an inspection report by the RBI that the banking company's affairs are being run in a manner which is detrimental to the interests of the depositors, then it may prohibit the bank from taking fresh deposits. Failure to comply with cash reserve ratio may also result in the RBI prohibiting the bank from accepting fresh deposits.

The ***third*** way of penalizing is imposing a fine on the bank and/or its officers. So non observance of the mandated cash reserve ratio and statutory liquidity ratio would result in the imposition of penal interest on the bank to the extent it is short of the required ratio and in addition the officers of the bank may be liable for fine calculated on the basis of per day the bank was in default. Penalty is also prescribed to those responsible for furnishing misleading information, not furnishing the asked for information, accepting fresh deposits in contravention of the prohibition or contravening the provisions of the BRA. However, a court can take cognizance of the offence only if the RBI approaches it. The RBI also has the powers to impose fines on its own.

The ***fourth*** way the penal consequence visits the non compliant bank is the cancellation of license of the bank itself or of its branch. There are certain conditions which BRA requires for grant of license (discussed above) and in addition there can be certain conditions which the RBI may impose in granting a license. If these conditions are not being fulfilled then the RBI may cancel the license issued by it.

The ***fifth*** way in which the RBI may discipline the bank is by initiating the winding up of the banking company. The RBI may make an application before the Tribunal for winding up a banking company if it is convinced that the affairs of the banking company are being conducted in a manner detrimental to the interests of the depositors. Non adherence to the capital requirements of a bank, non compliance with the conditions of the license, prohibition from acceptance of fresh deposits and non compliance with the provisions of the BRA are also grounds for initiating such action in addition to the insolvency of the bank.

The ***sixth*** tool to discipline a bank is by penalizing the shareholders without winding up the bank. The Central Government can acquire a banking company (on the basis of a report by the RBI) if it is in repeated violation of the RBI directions or the affairs of the banking company are being conducted in a manner detrimental to the interests of the shareholders. There is provision for shareholder compensation for the expropriation, but no control premium is paid. In a similar vein the RBI can reconstruct a banking company or amalgamate it with another after imposing a moratorium on the bank. Here, in addition to the shareholders, the depositors too may lose a part of their deposits (a 'haircut').

7.8 SUMMARY

Regulation of financial institutions is extremely important because of the unique nature of a financial asset. It is an asset which derives its value by description

and its own existence is dependent upon the solvency/existence of the parties. Amongst all the players in a financial system, the banks are the most unstable of the lot because of their business model. Regulation seeks to reduce the risks of operation to the bank itself, to the banking system and to the overall financial system and the economy. Since banking as an industry keeps in evolving and new risks keep on getting identified and the relative importance of some of the old identified risks may get reduced, regulatory legal structure needs to be flexible enough to take into account the new challenges with alacrity. Indian regulatory structure for the banking industry tries to merge flexibility, so as to take into account the global best practices and Indian reality, with some certainties as to the considerations which will go into the rule making. Some provisions also seek to ease the hurdles in the smooth conduct of the banking business. Therefore, provisions for evidence by banks in Bankers Book of Evidence Act, nomination in the BRA and sharing of credit information under the RBI Act and Credit Information Companies (Regulation) Act seek to remove the landmines which are there in law in the conduct of banking business.

7.9 SELF ASSESSMENT QUESTIONS

1) "RBI is the banker of the last resort". Do you agree with the statement?
2) Stringent terms and conditions are required to be complied with for obtaining a bank license. Please explain such terms and conditions.
3) Discuss the interface of Banking Regulation Act with other laws.
4) Discuss the socio-economic impact of the banking system in any country.
5) Discuss the role of shareholders in banking companies.
6) Discuss the role of Central Government in controlling and regulating the banking sector in India.

7.10 FURTHER READINGS

1) Gupta, S.N., 2017, *The Banking Law In Theory And Practice*, Universal Law Publishing
2) M.L. Tannan, M.L., 2014, *Banking Law And Practice In India*, Lexis Nexis

UNIT 8 FOREIGN EXCHANGE MANAGEMENT AND RELATED REGULATIONS

Objectives

After studying this unit you should be able to:

- understand by the term 'Foreign Exchange'
- Explain the objectives and background of Foreign Exchange Management Act (FEMA)
- Identify the prohibited transactions under the FEMA
- Describe the process of regulation and management of Foreign Exchange
- Distinguish between Person resident in India and Person Non-resident in India
- Differentiate between Capital account transactions and current transactions

Structure

8.1 INTRODUCTION

This Unit is designed to introduce the important regulations related to the foreign exchange management in India. It aims to provide the basic understanding of different concepts under the Foreign Exchange Management Act, 1999, and its related rules and regulations. It would also help the students to have a broad understanding of how foreign exchange is managed in India and what is the regulatory framework which govern the people who deal with foreign exchange.

8.2 OBJECTIVES OF FEMA

The Foreign Exchange Management Act (Act No 42 of 1999) has been formulated by the Central Government to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India.[1]

8.3 BACKGROUND OF FEMA

The Defence of India Act, 1939, was temporary yet the first legislative attempt to regulate and control the foreign exchange in India. With an aim to settle the foreign exchange crisis in the country, the Foreign Exchange Regulation Act was first enacted in 1947; however, it was further replaced by the FERA 1957. The immediate predecessor of FEMA was the Foreign Exchange Regulation Act, 1973. It was enacted with an objective to regulate the foreign exchange rather than managing it. FERA aimed to regulate the foreign exchange by preventing the outflow of Indian currency, regulating dealings in foreign exchange and securities, by imposing several kinds of restrictions on transactions involving foreign exchange and on persons dealing with foreign exchange. FERA also aimed to only conserve the foreign exchange and regulate the use of it. FERA provided for number of criminal offences with *mens rea* and had provision for easy arrest by the Enforcement Directorate, even without an arrest warrant.

In the light of the economic liberalisation policy adopted by the Government of India in 1991-92, and the changing economic and financial landscape in the country, there was a need to modify the foreign exchange regulation also. Hence, with an aim to modify the FERA and adopt more liberal policy and approach towards foreign exchange, the FERA was replaced by the Foreign Exchange Management Act, 1999. The FEMA 1999 was also formulated to encourage and attract more foreign investments in the country; hence the regulations related to the foreign investments were also simplified. Many provisions under FERA were liberalised or removed to facilitate foreign exchange; however, few others were still included under the FEMA.

The FEMA is more transparent in its approach and implementation than its predecessor. It marks and very clearly identifies those areas and situations which require specific approval by the RBI or the Central Government for acquiring or holding foreign exchange. The philosophical approach was shifted from that of conservation of foreign exchange to one of facilitating trade and payments as well as developing orderly foreign exchange market.

8.4 FEMA: AN OVERVIEW

The Foreign Exchange Management Act, 1999, provides the legal framework for the proper management and administration of the foreign exchange transactions in the country. The Act came into force from June 1, 2000 and since then, has been amended from time to time according to the changing economic policies and objectives of the government. There are approximately six Rules framed by the Central Government and twenty three Regulations notified by the Reserve Bank of India (RBI) under the FEMA Act.

The Act extends to the whole of India and also applies to all branches, offices and agencies outside India owned or controlled by a person resident in India and also to any contravention thereunder committed outside India by any person to whom this Act applies.

The statutory power under this Act empowers the RBI as well as the Central Government to frame and pass regulations and the rules from time to time, which are consistent with the foreign trade policy of the country. The Act provides for a legislative and regulatory framework, for inbound and outbound investments, and facilitates trade and business opportunity between Indian and other countries. FEMA lays down provisions for current account and capital account transactions. The RBI is the regulatory body and plays a controlling role in the management of the foreign exchange. The Act also makes provisions for enforcement, penalties, adjudication and appeal. FEMA along with the various rules and regulation applies to different practical aspects of the management of foreign exchange in India.

Structure of FEMA-

The Act is divided into 7 chapters, which are further divided into 49 sections. The following is the scheme of chapters under FEMA-

CHAPTER I – Preliminary (Section 1&2)

CHAPTER II- Regulation and Management of Foreign Exchange (Section 3 –9)

CHAPTER III – Authorised Person (Section 10 –12)

CHAPTER IV – Contravention and Penalties (Section 13-15)

CHAPTER V – Adjudication and Appeal (Section 16- 35)

CHAPTER VI – Directorate of Enforcement (Section 36-38)

CHAPTER VII- Miscellaneous (Section 39 – 49)

It also includes-

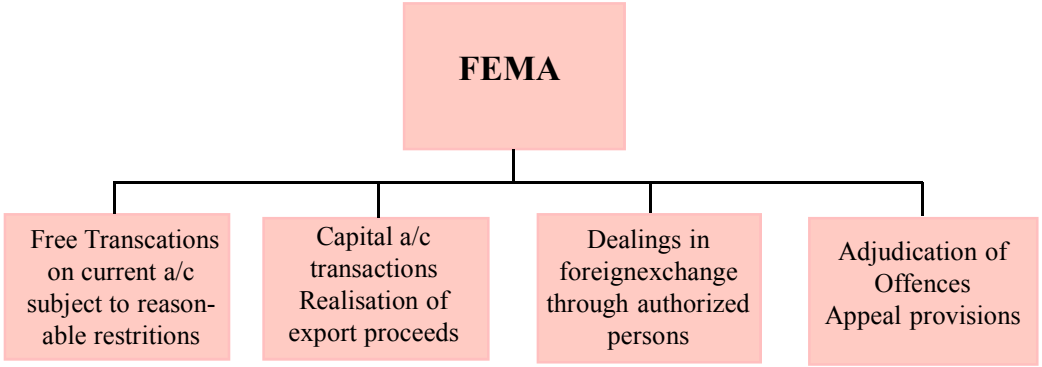
- Rules made by Ministry of Finance under Section 46 of FEMA (Subordinate or delegated Legislations)
- Regulations made by RBI under Section 47 of FEMA (Subordinate or delegated Legislations)
- Master Direction issued by RBI every year
- Foreign Direct Investment policy issued by the Department for Promotion of Industry and Internal Trade (DPIIT).
- Notifications and Circulars issued by Reserve Bank of India

Rules made under FEMA:

1) FEM (Encashment of Draft, Cheque, Instrument and Payment of Interest) Rules, 2000
2) FEM (Authentication of Documents) Rules, 2000
3) FEM (Current Account Transaction) Rules, 2000
4) FEM (Adjudication Proceedings and Appeal) Rules, 2000
5) FEM (Compounding Proceedings) Rules, 2000
6) The Appellate Tribunal for Foreign Exchange (Recruitment, Salary and Allowances and Other Conditions of Service of Chairperson and Members) Rules, 2000.

Regulations made under FEMA-

1) FEM (Acquisition and Transfer of Immovable Property outside India) Regulations, 2015
2) FEM (Borrowing and Lending in Rupees) Regulations, 2000
3) FEM (Borrowing or Lending in Foreign Exchange) Regulations, 2000
4) FEM (Deposit) Regulations, 2016
5) FEM (Export and Import of Currency) Regulations, 2015
6) FEM (Guarantees) Regulations, 2000
7) FEM (Acquisition and Transfer of Immovable Property in India) Regulations, 2000
8) FEM (Establishment in India of Branch office or a Project office or any other Place of Business) Regulations, 2016
9) FEM (Export of Goods and Services) Regulations, 2015
10) FEM (Foreign Currency Accounts by a Person Resident in India) Regulations, 2015
11) FEM (Insurance) Regulations, 2015
12) FEM (Investment in Firm or Proprietary Concern in India) Regulations, 2000
13) FEM (Manner of Receipt and Payment) Regulations, 2016
14) FEM (Permissible Capital Account Transactions) Regulations, 2000
15) FEM (Possession and Retention of Foreign Currency) Regulations, 2015
16) FEM (Realization, Repatriation and Surrender of Foreign Exchange) Regulations, 2015
17) FEM (Remittance of Assets) Regulations, 2016
18) FEM (Transfer or Issue of Security by a person Resident outside India) Regulations, 2017
19) FEM (Foreign Exchange Derivative Contracts) Regulations, 2000
20) FEM (Transfer or Issue of any Foreign Security) Regulations, 2004
21) FEM (Crystallization of inoperative Foreign Currency Deposits) Regulations, 2014
22) F.E.M (Transfer or Issue of any foreign Security) Regulations, 2004
23) FEM (International Financial Services Centre) Regulations, 2015
24) FEM (Regularization of Assets Held Abroad by a Person Resident in India) Regulations, 2015.



8.5 IMPORTANT DEFINITIONS AND CONCEPTS

Persons Resident in India[2] means:

i) a person residing in India for more than one hundred and eighty-two days during the course of the preceding financial year but does not include—

   A) a person who has gone out of India or who stays outside India, in either case:

      a) for or on taking up employment outside India, or

      b) for carrying on outside India a business or vocation outside India, or

      c) for any other purpose, in such circumstances as would indicate his intention to stay outside India for an uncertain period;

   B) a person who has come to or stays in India, in either case, otherwise than—

      a) for or on taking up employment in India, or

      b) for carrying on in India a business or vocation in India, or

      c) for any other purpose, in such circumstances as would indicate his intention to stay in India for an uncertain period;

ii) any person or body corporate registered or incorporated in India,

iii) an office, branch or agency in India owned or controlled by a person resident outside India,

iv) an office, branch or agency outside India owned or controlled by a person resident in India;

Person resident outside India[3] means a person who is not resident in India.

Mr. X landed in India on 1st August 2019 to take up employment.

For the Financial Year 2018-19, he was not in India. So for the financial year 20018-19 he is not resident of India.

For the Financial Year 2019-20, he was in India for more than 182 days, so for the financial year 2019-20 days, he is resident of India.

Authorized persons[4] means an authorised dealer, money changer, off-shore banking unit or any other person who are authorized to deal in foreign exchange or foreign securities.

Capital Account Transaction[5] means a transaction which alters the assets or liabilities, including contingent liabilities, outside India of persons resident in India or assets or liabilities in India of persons resident outside India, and includes transactions referred to in sub-section (*3*) of section 6 of the Act.

Current account transaction[6] means a transaction other than a capital account transaction and without prejudice to the generality of the foregoing such transaction includes;

i) payments due in connection with foreign trade, other current business, services, and short-term banking and credit facilities in the ordinary course of business,

ii) payments due as interest on loans and as net income from investments,

iii) remittances for living expenses of parents, spouse and children residing abroad, and

iv) expenses in connection with foreign travel, education and medical care of parents, spouse and children;

Foreign currency[7] means any currency other than Indian currency.

Foreign exchange[8] means foreign currency and includes;

i) deposits, credits and balances payable in any foreign currency,

ii) drafts, travellers cheques, letters of credit or bills of exchange, expressed or drawn in Indian currency but payable in any foreign currency,

iii) drafts, travellers cheques, letters of credit or bills of exchange drawn by banks, institutions or persons outside India, but payable in Indian currency

8.6 REGULATION & MANAGEMENT OF FOREIGN EXCHANGE

Chapter II of the FEMA Act, 1999, provides for the provisions related to the regulation and management of foreign exchange in India. There can be no dealing in foreign exchange without the general or special permission of the Reserve Bank of India. The Act also does not empower the RBI or any other person to directly handle the foreign exchange. For this, the RBI can authorize the "Authorized persons" and issue directions to such authorized persons from time to time.[9]Other than the ordinary or special permission of the RBI under the Act, or other than the manner provided under the Act, its rules or regulations, no person is allowed to:

a) deal in or transfer any foreign exchange or foreign security to any person not being an authorised person;

b) make any payment to or for the credit of any person resident outside India in any manner;

c) receive otherwise through an authorised person, any payment by order or on behalf of any person resident outside India in any manner.[10]

d) enter into any financial transaction in India as consideration for or in association with acquisition or creation or transfer of a right to acquire, any asset outside India by any person.

A financial transaction means making any payment to or for the credit of any person or receiving any payment for, by order or on behalf of any person. Financial transaction also includes drawing, issuing or negotiating any bill of exchange or promissory note or transferring any security or acknowledging any debt.

Situation 1) Whether Mr. X, a resident of USA, asks his uncle staying in Delhi to make a payment of Rs 20000 to Mr. Y?

Ans: No. Such payment is not permitted under clause (b) of section 3 of the Act.

Situation 2) Mr. X, a resident of Germany asks his Company Secretary in India to form a Company in India and proposes to reimburse all the expenses after the formation of the company. Whether, the Indian Company Secretary, can spend for the above purpose on behalf of Mr. X?

Ans: No. Such payment is not permitted under clause (b) of section 3 of the Act.

There is a blanket prohibition on a person resident in India to acquire, hold, own, possess or transfer any foreign exchange, foreign security or any immovable property situated outside India, except as permitted under the Act, Rules or Regulations thereunder.[11]

8.7 TYPES OF TRANSACTIONS UNDER FEMA

The Act recognises two types of transactions. They are; 1. Capital Account Transactions and, 2. Current Account Transactions. Each type of the transaction is governed by a relevant regulation. Let us discuss these in detail.

8.8 CAPITAL ACCOUNT TRANSACTIONS[12]

The capital account transactions are governed by the Act and the FEMA (Permissible Capital Account Transactions) Regulations 2000. Such transactions which alter the assets or liabilities, including contingent liabilities, outside India of persons resident in India or assets or liabilities in India of persons resident outside India are called as capital account transactions.[13] The Act allows any person to sell or draw foreign exchange to or from an authorised person for a capital account transaction subject to the condition that the RBI may, in consultation with the Central Government, specify[14]-

i) The permissible classes or classes of capital account transactions

ii) The limit upto which foreign exchange shall be admissible for such transactions

iii) Any condition which may be placed on such transactions

However, the Reserve Bank cannot impose any restriction on the drawal of foreign exchange for payments which are due on account of amortization of loans or not depreciation of direct investments in the ordinary course of business.

Similarly, the Central Government, in consultation with the RBI can also prescribe[15]—

a) the permissible class or classes of capital account transactions, not involving debt instruments;

b) the limit up to which foreign exchange shall be admissible for such transactions; and

c) any conditions which may be placed on such transactions.

Powers of RBI to regulate the foreign exchange[16]

The Act empowers the RBI to prohibit, restrict or regulate the following-

a) transfer or issue of any foreign security by a person resident in India;

b) transfer or issue of any security by a person resident outside India;

c) transfer or issue of any security or foreign security by any branch, office or agency in India of a person resident outside India;

d) any borrowing or lending in foreign exchange in whatever form or by whatever name called;

e) any borrowing or lending in rupees in whatever form or by whatever name called between a person resident in India and a person resident outside India;

f) deposits between persons resident in India and persons resident outside India;

g) export, import or holding of currency or currency notes;

h) transfer of immovable property outside India, other than a lease not exceeding five years, by a person resident in India;

i) acquisition or transfer of immovable property in India, other than a lease not exceeding five years, by a person resident outside India;

j) giving of a guarantee or surety in respect of any debt, obligation or other liability incurred—

   i) by a person resident in India and owed to a person resident outside India; or

   ii) by a person resident outside India.

Modes of Acquiring Property in and Outside India-

The FEMA Act 1999 lays down the mechanism for acquiring property in India by a non-resident and outside India by a resident. The Act provides the following-

I) Modes of acquiring property outside India by a resident-

A person resident in India can hold, own, transfer or invest in foreign currency, foreign security or any immovable property situated outside India, if such currency, security or property was acquired, held or owned by such person when he was resident outside India or inherited from a person who was resident outside India.[17]In this regard, the provisions laid down under the Foreign Exchange Management (Acquisition and transfer of immovable property outside India) Regulations, 2015 state that the following-

1) A resident can acquire immovable property outside India by way of gift or inheritance from:

   a) a person referred to in sub-section (4) of Section 6 of the Act, or referred to in clause (b) of regulation 4; or

   b) a person resident in India who had acquired such property on or before July 8, 1947 and continued to be held by him with the permission of the Reserve Bank.

   c) a person resident in India who has acquired such property in accordance with the foreign exchange provisions in force at the time of such acquisition.[18]

2) A resident can acquire immovable property outside India by way of purchase out of foreign exchange held in Resident Foreign Currency (RFC) account maintained in accordance with the Foreign Exchange Management (Foreign Currency accounts by a person resident in India) Regulations, 2015;

3) A resident can acquire immovable property outside Indiajointly with a relative who is a person resident outside India, provided there is no outflow of funds from India;

II) Modes of acquiring property in India by a non-resident

A person resident outside India is also permitted to hold, own, transfer or invest in Indian currency, security, or any immovable property situated in India if such currency, security or property was acquired, held or owned by such person when he was resident in India or inherited from a person who was resident in India.[19] The provisions related to acquisition of immovable property by a non-resident or Overseas Citizen of India (OCI) have been laid down in Foreign Exchange Management (Foreign Currency accounts by a person resident in India) Regulations, 2015.

Acquisition of Immovable Property by a non-resident or OCI[20]

Other than agricultural land, plantation property and farm house, an NRI or OCI can-

- acquire by way of purchase any immovable property in India[21].
- acquire by way of gift any immovable property in India from person resident in India or from an NRI or an OCI who in any case is a relative as defined in section 2(77) of the Companies Act, 2013.[22]
- acquire any immovable property in India by way of inheritance from a person resident outside India who had acquired the property in accordance with the provisions of the foreign exchange law in force at the time of acquisition.[23]
- acquire any immovable property in India by way of inheritance from a person resident in India.[24]

Similarly a non-resident or OCI can also transfer any immovable property to a person resident in India under the Foreign Exchange Management (Foreign Currency accounts by a person resident in India) Regulations, 2015.

Although, the Act as well as the Regulations facilitate the acquisition of immovable property, the Reserve Bank of India has wide powers to regulate, prohibit, restrict establishment in India of a branch, office or other place of business by a person resident outside India for carrying on any activity relating to such branch, office or other place of business.[25]

Classes of Capital Account Transactions

There are two main classes of capital account transactions which are permissible as per the Schedule I & II to Foreign Exchange Management (Permissible Capital Account Transactions) Regulations, 2000;[26] viz-

1) Classes of capital account transactions of Persons resident in India

- Investment by a person resident in India in foreign securities

- Foreign currency loans raised in India and abroad by a person resident in India
- Transfer of immovable property outside India by person resident in India
- Guarantees issued by a person resident in India in favour of a person resident outside India
- Export, import and holding of currency/currency notes
- Remittance outside India of capital assets of a person resident in India
- Loans and overdrafts by a person resident in India to a person resident outside India
- Maintenance of foreign currency accounts in India and outside India by a person resident in India
- Taking out of insurance policy by a person resident in India from an insurance company outside India
- Loans and overdrafts by a person resident in India to a person resident outside India
- Sale and purchase of foreign exchange derivatives in India and abroad and commodity derivatives abroad by a person resident in India

Examples of capital account transaction would include making equity investment in any other country, transfer including sale of immovable property situated outside India by a person resident in India.

2) Classes of capital account transactions of persons resident outside India

- Investment in India by a person resident outside India, that is to say:
  - o issue of security by a body corporate or an entity in India and investment therein by a person resident outside India; and
  - o investment by way of contribution by a person resident outside India to the capital of a firm or a proprietorship concern or an association of persons in India.
- Acquisition and transfer of immovable property in India by a person resident outside India
- Guarantee by a person resident outside India in favour of, or on behalf of a person resident in India
- Import and export of currency/currency notes into/from India by a person resident outside India.
- Deposits between a person resident in India and a person resident outside India
- Foreign Currency accounts in India of a person resident outside India
- Remittance outside India of capital assets in India of a person resident outside India.

Subject to the provisions of the Act or the rules or regulations or direction or orders made or issued thereunder, any person may sell or draw foreign exchange to or from an authorised person for a capital account transaction specified in the Schedules provided that the transaction is within the limit, if any, specified in the regulations relevant to the transaction.[27]

The FEMA (Permissible Capital Account Transactions) Regulations 2000[28] also envisage that save as otherwise provided in the Act, rules or regulations made thereunder, no person is allowed to undertake or sell or draw foreign exchange to or from an authorised person for any capital account transaction.[29] Similarly, no person resident outside India can make investment in India , in any form, in any company or partnership firm or proprietary concern or any entity, whether incorporated or not, which is engaged or proposes to engage in the[30]-

- Business of chit fund, or
- As Nidhi company, or
- In agriculture or plantation activities, or
- In real estate business or construction of farm houses, or
- In trading of Transferable Development Rights (TDRs)

For this purpose, the payment for investment can be made by remittance from abroad through normal banking channels or by debit to an account of the investor maintained with an authorised person in India in accordance with the regulations made by the Reserve Bank under the Act.[31] However, every person selling or drawing foreign exchange to or from an authorised person for a capital account transaction is required to furnish a declaration to the RBI in the form and within the time specified in the regulations relevant to the transaction.[32]

8.9 CURRENT ACCOUNT TRANSACTIONS

Transactions other than a capital account transaction are current account transaction. They include the following transactions[33]—

i) payments due in connection with foreign trade, other current business, services, and short-term banking and credit facilities in the ordinary course of business,

ii) payments due as interest on loans and as net income from investments,

iii) remittances for living expenses of parents, spouse and children residing abroad, and

iv) expenses in connection with foreign travel, education and medical care of parents, spouse and children.

The Act allows any person to sell or draw foreign exchange to or from an authorised person if such sale or drawl is a current account transaction. However, the Central Government may, in public interest and in consultation with the Reserve Bank, impose reasonable restrictions for current account transactions.[34]

The Foreign Exchange Management (Current Account Transactions) Rules, 2000 defines the term "Drawal" to mean drawal of foreign exchange from an authorised person and includes opening of Letter of Credit or use of International Credit Card or International Debit Card or ATM Card or any other thing by whatever name called which has the effect of creating foreign exchange liability.[35]

Rule 3 imposes prohibition on drawal of foreign exchange by any person for the following purpose[36]:

a) a transaction specified in the Schedule I; or

b) a travel to Nepal and/or Bhutan; or

c) a transaction with a person resident in Nepal or Bhutan. This prohibition may be exempted by RBI subject to such terms and conditions as it may consider necessary to stipulate by special or general order.

Rule 4 requires prior approval of the Government of India for the transactions as specified in Schedule II. However, this does not apply to the cases where the payment is made out of funds held in Resident Foreign Currency Account (RFC) of the remitter.

Rule 5 governs every drawal of foreign exchange for transactions included in Schedule III. However, it does not apply to those cases where the payment is made out of funds held in Resident Foreign Currency (RFC) Account of the remitter.

Schedule I- Transactions which are prohibited

1) Remittance out of lottery winnings.
2) Remittance of income from racing/riding etc. or any other hobby.
3) Remittance for purchase of lottery tickets, banned/proscribed magazines, football pools, sweepstakes, etc.
4) Payment of commission on exports made towards equity investment in Joint Ventures/ Wholly Owned Subsidiaries abroad of Indian companies.
5) Remittance of dividend by any company to which the requirement of dividend balancing is applicable.
6) Payment of commission on exports under Rupee State Credit Route, except commission upto 10% of invoice value of exports of tea and tobacco.
7) Payment related to "Call Back Services" of telephones. 8. Remittance of interest income on funds held in Non-Resident Special Rupee (Account) Scheme.

Schedule II- Transactions which require prior approval of the Central Government

S.No.	Purpose of Remittance	Approval of
1.	Cultural Tours	Ministry of Human Resources Development (Department of Education and Culture)
2.	Advertisement in foreign print media for the purposes other than promotion of tourism, foreign investments and international bidding (exceeding USD 10,000) by a State Government and its PSUs	Ministry of Finance (Department of Economic Affairs)
3.	Remittance of freight of vessel chartered by a PSU	Ministry of Surface Transport (Chartering Wing)
4.	Payment of import through ocean transport by a government department or a PSU on CIF basis	Ministry of Surface Transport, (Chartering Wing)

5.	Multi-modal transport operators making remittance to their agents abroad.	Registration Certificate from the Director General of Shipping
6.	Remittance of hiring charges of transponders by: • TV Channels • Internet Service Providers	Ministry of Information and Broadcasting (Ministry of Communication and Information Technology)
7.	Remittance of container detention charges exceeding the rate prescribed by Director General of Shipping	Ministry of Surface Transport (Director General of Shipping)
8.	Remittance of prize money/ sponsorship of sports activity abroad by a person other than International/ National/ State Level sports bodies, if the amount involved exceeds USD 100,000	Ministry of Human Resources Development
9.	Remittance for membership of P & I Club	Ministry of Finance (Insurance Division)

However, if the payment is made out of funds held in Resident Foreign Currency (RFC) Account of the remitter, prior approval of Government of India will not be required.

Schedule III- Transactions which require prior approval of the Reserve Bank of India

A) **Facilities for individuals**— Individuals can avail of foreign exchange facility for the following purposes within the limit of USD 2,50,000 only. Any additional remittance in excess thereof requires prior approval of the Reserve Bank of India.

1) Private visits to any country (except Nepal and Bhutan)

2) Gift or donation exceeding USD 5,000 per remitter/donor per annum

3) Exchange facility or going abroad for employment exceeding USD 100,000 or amount prescribed by country of emigration

4) Emigration

5) Maintenance of close relatives abroad

   i) exceeding net salary (after deduction of taxes, contribution to provident fund and other deductions) of a person who is resident but not permanently resident in India and –

      a) is a citizen of a foreign State other than Pakistan; or

      b) is a citizen of India, who is on deputation to the office or branch or subsidiary or joint venture in India of such foreign company.

   ii) exceeding USD 100,000 per year, per recipient, in all other cases.

6) Release of foreign exchange, exceeding USD 25,000 to a person irrespective of period of stay, for business travel, or attending a

conference or specialised training or for meeting expenses for meeting medical expenses, or check-up abroad, or for accompanying as attendant to a patient going abroad for medical treatment/ check-up.

7) Expenses in connection with medical treatment abroad exceeding the estimate from the doctor in India or hospital/doctor abroad.

8) Studies abroad exceeding the estimate from the institution abroad or USD 100,000, per academic year, whichever is higher.

9) Any other current account transaction

The FEM (Current Account Transaction) Rules, 2000, also provides that a person who is resident but not permanently resident in India and-

a) is a citizen of a foreign State other than Pakistan; or

b) is a citizen of India, who is on deputation to the office or branch of a foreign company or subsidiary or joint venture in India of such foreign company, may make remittance upto his net salary (after deduction of taxes, contribution to provident fund and other deductions).

A person resident in India on account of his employment or deputation of a specified duration (irrespective of length thereof) or for a specific job or assignments, the duration of which does not exceed three years, is a resident but not permanently resident: It is to be noted that a person other than an individual may also avail of foreign exchange facility, mutatis mutandis, within the limit prescribed under the said Liberalised Remittance Scheme for the purposes mentioned herein above.

B) Facilities for Persons Other than Individuals-

The following remittances by persons other than individuals require prior approval of the Reserve Bank of India.

i) Donations exceeding one per cent of their foreign exchange earnings during the previous three financial years or USD 5,000,000, whichever is less, for-

a) creation of Chairs in reputed educational institutes,

b) contribution to funds (not being an investment fund) promoted by educational institutes; and

c) contribution to a technical institution or body or association in the field of activity of the donor Company.

ii) Commission, per transaction, to agents abroad for sale of residential flats or commercial plots in India exceeding USD 25,000 or five percent of the inward remittance whichever is more.

iii) Remittances exceeding USD 10,000,000 per project for any consultancy services in respect of infrastructure projects and USD 1,000,000 per project, for other consultancy services procured from outside India.

iv) Remittances exceeding five per cent of investment brought into India or USD 100,000 whichever is higher, by an entity in India by way of reimbursement of pre-incorporation expenses.

8.10 AUTHORISED PERSON

The authorized persons are the authorized dealers, money changers, off-shore banking units or may be called by any other name; who are authorized on behalf of the RBI to deal in foreign exchange or foreign securities.[37] The RBI shall authorize such person in writing and shall be subject to the conditions laid down by the RBI.[38] The RBI can also revoke the authorization at any time if the revocation is required to be done in public interest or the authorized dealer fails to comply with the condition subject to which authorisation was granted. [39] However, before revocation, the authorized dealer has to be given a reasonable opportunity of being heard.

Duties of Authorised Person

1) An authorised person shall, in all his dealings in foreign exchange or foreign security, comply with general or special directions/or orders of the Reserve Bank. Without the prior permission of the Reserve Bank, an authorised person shall not engage in any transaction involving any foreign exchange or foreign security which is not in conformity with the terms of his authorisation.[40]

2) Before undertaking any transaction in foreign exchange on behalf of any person, the Authorised Person shall require that person to make such declaration and to give such information as will reasonably satisfy him that the transaction will not involve, and is not designed for the purpose of any contravention or evasion of the provisions of this Act or of any rule, regulation, notification, direction or order made thereunder. Where the said person refuses to comply with any such requirement or makes only unsatisfactory compliance therewith, the authorised person shall refuse in writing to undertake the transaction and shall, if he has reason to believe that any such contravention or evasion as aforesaid is contemplated by the person, report the matter to the Reserve Bank.[41]

3) The Reserve Bank may give any direction in regard to making of payment or the doing or desist from doing any act relating to foreign exchange or foreign security to the authorised persons.[42]

4) The Reserve Bank may also direct any authorised person to furnish such information, in such manner, as it deems fit.[43] However, where any authorised person contravenes any direction given by the Reserve Bank under this Act or fails to file any return as directed by the Reserve Bank, the Reserve Bank may, after giving reasonable opportunity of being heard, impose on the authorised person a penalty which may extend to ten thousand rupees and in the case of continuing contravention with an additional penalty which may extend to two thousand rupees for every day during which such contravention continues.[44]

The Reserve Bank also has the power to inspect the authorised persons by authorizing an officer on its behalf, for the purpose of –

a) verifying the correctness of any statement, information or particulars furnished to the Reserve Bank;

b) obtaining any information or particulars which such authorised person has failed to furnish on being called upon to do so;

c) securing compliance with the provisions of this Act or of any rules, regulations, directions or orders made thereunder.

Every authorised person is under a duty to produce such books, accounts and other documents in his custody or power and to furnish any statement or information relating to the affairs of such personas may be required.[45]

8.11 CONTRAVENTIONS & PENALTIES[46]

If any person contravenes with the provisions of the Act, Rules, Regulations, notification, direction or order thereunder or contravenes any condition subject to which an authorization is issued by the RBI , the following penalties have been provided for under the Act:

1) Such a person shall, upon adjudication, be liable to a penalty up to thrice the sum involved in such contravention where such amount is quantifiable, or up to two lakh rupees where the amount is not quantifiable, and where such contravention is a continuing one, further penalty which may extend to five thousand rupees for every day after the first day during which the contravention continues.[47]

2) If any person is found to have acquired any foreign exchange, foreign security or immovable property, situated outside India, of the aggregate value exceeding the threshold prescribed under the proviso to sub-section (*1*) of section 37A, he shall be liable to a penalty upto three times the sum involved in such contravention and confiscation of the value equivalent, situated in India, the foreign exchange, foreign security or immovable property.[48]

   If the Adjudicating Authority, deems fits, he may, after recording the reasons in writing, recommend for the initiation of prosecution. If the Director of Enforcement is satisfied, he may, after recording the reasons in writing, direct prosecution by filing a Criminal Complaint against the guilty person by an officer not below the rank of Assistant Director.[49]

3) In addition to the penalty, such a person shall also be punishable with imprisonment for a term which may extend to five years and with fine.[50]

   The court cannot take cognizance of an offence under section 13 except as on complaint in writing by an officer not below the rank of Assistant Director.

4) An Adjudicating Authority, in addition to any for contravention, may also direct that any currency, security or any other money or property in respect of which the contravention has taken place shall be confiscated to the Central Government and further direct that the foreign exchange holdings, if any, of the persons committing the contraventions or any part thereof, shall be brought back into India or shall be retained outside India in accordance with the directions made in this behalf.[51]

Enforcement of the Order of the AA

Any person who fails to make full payment of the penalty imposed on him under the Act within a period of ninety days from the date on which the notice for payment of such penalty is served on him, is liable to civil imprisonment.[52]

The Adjudicating Authority has been vested with the powers of issuing warrant of arrest and detention in the following circumstances-

1) An order for the arrest and detention in civil prison of a defaulter can be made[53]-

   i) When the Adjudicating Authority has issued and served a notice upon the defaulter calling upon him to appear before him on the date specified in the notice and to show cause why he should not be committed to the civil prison., and

   ii) When the Adjudicating Authority, for reasons in writing, is satisfied—

      a) that the defaulter, with the object or effect of obstructing the recovery of penalty, has, after the issue of notice, dishonestly transferred, concealed, or removed any part of his property, or

      b) that the defaulter has, or has had since the issuing of notice, the means to pay the arrears or some substantial part thereof and refuses or neglects or has refused or neglected to pay the same.

2) A warrant for the arrest of the defaulter may be issued by the Adjudicating Authority, upon satisfaction by affidavit or otherwise, that the defaulter is likely to abscond or leave the local limits of the jurisdiction of the Adjudicating Authority.[54]

3) Where appearance is not made pursuant to a notice issued and served, the Adjudicating Authority may issue a warrant for the arrest of the defaulter.[55]

4) A warrant of arrest issued by the Adjudicating Authority may also be executed by any other Adjudicating Authority within whose jurisdiction the defaulter may for the time being be found.[56]

The following provisions are also needed to be complied with:

a) Every arrested person shall be brought before the Adjudicating Authority as soon as practicable and in any event within twenty-four hours of his arrest (exclusive of the time required for the journey). Provided that the defaulter shall be released at once, if he pays the amount entered in the warrant of arrest as due and the costs of the arrest to the officer arresting him.[57]

b) When a defaulter appears before the Adjudicating Authority, he shall be given an opportunity by the Adjudicating Authority showing cause why he should not be committed to the civil prison.

c) Pending the conclusion of the inquiry, the defaulter can also be detained in the custody of such officer as the Adjudicating Authority may think fit. He can also be released on his furnishing the security to the satisfaction of the Adjudicating Authority for his appearance as and when required.

d) Upon the conclusion of the inquiry, the Adjudicating Authority may make an order for the detention of the defaulter in the civil prison and shall in that event cause him to be arrested if he is not already under arrest. Provided that in order to give a defaulter an opportunity of satisfying the arrears, the Adjudicating Authority may, before making the order of detention, leave the defaulter in the custody of the officer arresting him or of any other officer for a specified period not exceeding fifteen days, or release him on his

furnishing security to the satisfaction of the Adjudicating Authority for his appearance at the expiration of the specified period if the arrears are not satisfied.

e) The detention order may be executed at any place in India in the manner provided for the execution of warrant of arrest under the Code of Criminal Procedure, 1973.[58]

f) The Adjudicating Authority may, by order in writing, authorise an officer of Enforcement not below the rank of Assistant Director to recover any arrears of penalty from any person who fails to make full payment of penalty imposed on him within the period of ninety days from the date on which the notice for payment of such penalty is served on him.[59]

g) Any contravention may, on an application made by the person committing such contravention, be compounded within one hundred and eighty days from the date of receipt of application by the Director of Enforcement or such other officers of the Directorate of Enforcement and officers of the Reserve Bank as may be authorised in this behalf by the Central Government. Where a contravention is compounded, no proceeding or further proceeding, shall be initiated or continued, against the person committing such contravention under that section, in respect of the contravention so compounded.[60]

8.12 PROVISION FOR APPEAL

The Act provides the provision for appeal in three stages-

i) Appeal before the Special Director(Appeals) against the order of the Adjudicating Officer

ii) Appeal before the Appellate Tribunal Against the Order of the Special Director

iii) Appeal before the High Court

Appeal to the Special Director (Appeals)[61]

An appeal against the order of the Adjudicating Authority many be made to the Special Director (Appeals) appointed by the Central Government.[62] Every appeal should be filed within forty-five days from the date on which the copy of the order made by the Adjudicating Authority is received by the aggrieved person. The Special Director (Appeals) may entertain an appeal after the expiry of the said period of forty-five days, if he is satisfied that there was sufficient cause for not filing it within that period.[63]

Appeal before the Appellate Tribunal[64]

The Central Government or any person aggrieved by an order made by an Adjudicating Authority, or the Special Director (Appeals), may prefer an appeal to the Appellate Tribunal. Any person appealing against the order of the Adjudicating Authority or the Special Director (Appeals) levying any penalty, is required while filing the appeal, to deposit the amount of such penalty with such authority as may be notified by the Central Government. However, if the Appellate Tribunal is of the opinion that the deposit of such penalty would cause undue hardship to such person, the Appellate Tribunal may dispense with such deposit

subject to such conditions as it may deem fit to impose so as to safeguard the realisation of penalty.

Every appeal before the Appellate Tribunal must be filed within a period of forty-five days from the date on which a copy of the order made by the Adjudicating Authority or the Special Director (Appeals) is received by the aggrieved person or by the Central Government. The Appellate Tribunal may entertain an appeal after the expiry of the said period of forty-five days if it is satisfied that there was sufficient cause for not filing it within that period.

Appeal before the High Court[65]

Any person aggrieved by any decision or order of the Appellate Tribunal may file an appeal to the High Court within sixty days from the date of communication of the decision or order of the Appellate Tribunal to him on any question of law arising out of such order. The High Court may allow an appeal after the expiry of the said period for a further period not exceeding sixty days, if it is satisfied that the appellant was prevented by sufficient cause from filing the appeal within the said period., allow it to be filed within a further period not exceeding sixty days.

8.13 DIRECTORATE OF ENFORCEMENT

The Directorate of Enforcement is established under the Act by the Central Government. The Government appoints the Director and other officers who are together called the Officers of Enforcement.[66]

Powers of Directorate of Enforcement-

The following powers are being vested in the Directorate of Enforcement and its officers:

1) *Power of search & Seizure*[67]- The Director of Enforcement and other officers of Enforcement, not below the rank of an Assistant Director, can do investigation of the contraventions under the Act. The Central Government may also, by notification, authorise any officer or class of officers in the Central Government, State Government or the Reserve Bank, not below the rank of an Under Secretary to the Government of India to investigate any contravention under the Act. The officers are also vested with the like powers which are conferred on income-tax authorities under the Income-tax Act, 1961.

2) *Special provisions relating to assets held outside India in contravention of section 4-* [68] If the Authorised Officer has reason to believe that any foreign exchange, foreign security, or any immovable property, situated outside India, is suspected to have been held in contravention of section 4, he may after recording the reasons in writing, by an order, seize value equivalent, situated within India, of such foreign exchange, foreign security or immovable property. No such seizure can be made in case where the aggregate value of such foreign exchange, foreign security or any immovable property, situated outside India, is less than the prescribed value.

8.14 COMPOUNDING OF OFFENCES UNDER FEMA

The Act allows for compounding for contraventions under section 15 of the Act. However, in this regard, the RBI has issued a Master Direction on Compounding of Contraventions under the FEMA 1999. According to the notification issued dated May 3, 2000 and FEMA 20(R)/2017-RB dated November 07, 2017, the power to compound contraventions has been delegated to the Regional offices/ sub-offices of the Reserve Bank. In exercise of the powers conferred by section 46 read with sub-section (1) of section 15 of the Foreign Exchange Management Act, 1999, the relevant rules are the Foreign Exchange (Compounding Proceedings) Rules, 2000 made by the Central Government in this behalf. In terms of these Rules, the Reserve Bank is empowered to compound contraventions relating to Section 7, 8 and 9 and the third schedule to FEMCAT Rules. RBI was empowered to compound all the contraventions of FEMA 1999 except Section 3(a) of the Act.[69]

The following contraventions can be compounded by the RBI where the sum involved in such contravention is:

a) ten lakhs rupees or below, by the Assistant General Manager of the Reserve Bank of India;

b) more than rupees ten lakhs but less than rupees forty lakhs, by the Deputy General Manager of Reserve Bank of India;

c) rupees forty lakhs or more but less than rupees hundred lakhs by the General Manager of Reserve Bank of India;

d) rupees one hundred lakhs or more, by the Chief General Manager of the Reserve Bank of India;

No contravention shall be compounded unless the amount involved in such contravention is quantifiable.

8.15 SUMMARY

The objective of formulating the FEMA Act 1999 was to consolidate the laws related to foreign exchange, facilitate the external trade &payments and to promote the orderly development and maintenance of foreign exchange market in India. It can be said that the Central Government and the RBI have been able to fulfil the broad objectives of FEMA. FEMA has been a reformative legislation which has also been successful in eliminating the ills of its predecessor.

8.16 SELF ASSESSMENT QUESTIONS

1) Discuss the rights relating to immovable property of persons who are not resident in India.

2) What are the prohibited transactions under the FEMA?

3) What are the rights of persons who are alleged to have contravened provisions of the FEMA?

4) What do you understand by the term ‘foreign exchange’?

5) Distinguish between the following:
   a) Person resident in India and Person Non-resident in India
   b) Capital account transactions and current transactions

8.17 FURTHER READINGS/REFERENCES

Books:

1) R. Sridhar. R., 2019, FEMA Ready Reckoner with Commentary, Bloomsbury
2) Taxmann's Foreign Exchange Management (FEMA) Manual (2021)

References:

[1] The FEMA 1999
[2] Sec 2(v) FEMA Act 1999
[3] Sec 2(w) FEMA Act 1999
[4] Sec 2 (c) FEMA Act 1999
[5] Sec 2(e), FEMA Act 1999
[6] Sec 2(j), FEMA Act 1999
[7] Sec 2(m), FEMA Act 1999
[8] Sec 2 (n), FEMA Act 1999
[9] Sec 11, FEMA Act 1999
[10] Sec 3, FEMA Act 1999
[11] Sec 4, FEMA 1999
[12] Sec 6, FEMA 1999
[13] Sec 2(e) FEMA 1999
[14] Sec 6(2) FEMA 1999
[15] Sec 6(2A) FEMA 1999
[16] Sec 6(3) FEMA 1999
[17] Sec 6(4)
[18] Inserted by FEM (Acquisition and Transfer of Immovable Property Outside India) Regulations, 2015 with effect from January 21, 2016.
[19] Sec 6(5)
[20] Inserted by FEM (Acquisition and transfer of Immovable Property in India) Regulations, 2018 with effect from March 26, 2018 through FEMA 21(R), dated 26.03.2018
[21] ibid
[22] ibid
[23] ibid
[24] ibid
[25] Sec 6(6)
[26] Reg 3(1) FEMA (Permissible Capital Account Transactions) Regulations 2000
[27] Regulation 3(2) FEMA (Permissible Capital Account Transactions) Regulations 2000
[28] Annexure
[29] Reg 4 FEMA (Permissible Capital Account Transactions) Regulations 2000

[30] ibid
[31] Reg 5 FEMA (Permissible Capital Account Transactions) Regulations 2000
[32] Reg 6 FEMA (Permissible Capital Account Transactions) Regulations 2000
[33] Sect 2(j) FEMA 1999
[34] Sec 5, FEMA 1999
[35] Rule 2(b) Foreign Exchange Management (Current Account Transactions) Rules, 2000
[36] Rule 3 Foreign Exchange Management (Current Account Transactions) Rules, 2000
[37] Sec 10 (1)
[38] Sec 10(2)
[39] Sec 10(3)
[40] Sec 10(4)
[41] Sec 10(5)
[42] Sec 11(1)
[43] Sec 11(2)
[44] Sec 11(3)
[45] Sec 12 (2)
[46] Chapter IV FEMA 1999
[47] Sec 13 (1)
[48] Sec 13(1A)
[49] Sec 13(1 B)
[50] Sec 13(1 C)
[51] Sec 13(2)
[52] Sec 14
[53] Sec 14(2)
[54] Sec 14(3)
[55] Sec 14(4)
[56] Sec 14 (5)
[57] Sec 14(6)
[58] Sec 13(13)
[59] Sec 14
[60] Sec 15
[61] Sec 17
[62] Sec 17(1)
[63] Sec 17(3)
[64] Sec 19
[65] Sec 35
[66] Sec 36 (1)
[67] Sec 37
[68] Sec 37 A
[69] Vide GSR 609 (E) dated 13-09-2004

UNIT 9 INSOLVENCY AND BANKRUPTCY

Objectives

After studying this unit, you should be able to:

- Understand the basics of Insolvency Law & Practice.
- Describe the legal and regulatory system relating to distress or insolvency resolution in India prior to the enactment of the IBC.
- Explain the essential segments of the Corporate Insolvency under the Insolvency and Bankruptcy Code, 2016
- Discuss different aspects relating to individual bankruptcy, and liquidation of insolvent companies.

Structure

9.1 INTRODUCTION

This Unit explains the law and mechanism related to corporate insolvency resolution process for corporates in India. The Unit commences describing the legal and regulatory situation in place prior to enacting of the Insolvency and Bankruptcy Code 2016. It further examines the need to adopt the Insolvency and Bankruptcy Code, 2016 (hereinafter referred to as IBC or the Code). It discusses the salient aspects of the Code with the help of leading cases.

An effective and efficient insolvency regime should aim to achieve the key objectives which are identified below in a balanced manner:

- Provide certainty in the market to promote economic stability and growth;
- Maximize value of assets;
- Strike a balance between liquidation and reorganization;
- Ensure equitable treatment of similarly situated creditors;
- Provide for timely, efficient and impartial resolution of insolvency;

9.2 DEFINITION OF INSOLVENCY

The United Nations Commission on International Trade Law (UNCITRAL), Legislative Guide on Insolvency Law" defines 'insolvency' as;

> *"Insolvency is when a debtor is generally unable to pay its debts as they mature or when its liabilities exceed the value of its assets"*

In the context of the UK Insolvency Act, 1986, the renowned author, Sir Roy Goode observed;

> *"A company is insolvent when it is unable to pay its debts. The concept is simple enough but as we shall see there is more than one test of inability to pay debts and in marginal cases it may be far from easy to determine whether the test is satisfied as at the relevant time. Insolvency as such is not a condition to which legal consequences attach. These occur only after there has been some formal proceeding, such as winding up or the appointment of an administrator or administrative receiver. Thus it is neither a criminal offence nor a civil wrong for a company to become insolvent or even to trade while insolvent."*[1]

The Oxford dictionary defines word insolvent as,

> *"Not having enough money to pay debt, creditors, etc.; belonging or relating to insolvent people; or the stale of being insolvent "*[2]

Surprisingly, unlike the international laws, the Code does not define 'insolvency' in explicit terms. However, 'default' by the corporate debtor has been marked as a trigger for initiating the insolvency proceedings. The Bankruptcy Law Reform Committee Report (BLRC Report) explains in following terms:

- *Financial failure - a persistent mismatch between payments by the enterprise and receivables into the enterprise, even though the business model is generating revenues,*
- *Business failure - which is a breakdown in the business model of the enterprise, and it is unable to generate sufficient revenues to meet payments*[3].

9.3 CORPORATE INSOLVENCY LEGISLATIVE FRAMEWORK IN INDIA PRIOR TO 2016

India had a patchwork of insolvency courts and tribunals applying to different classes of stakeholders or processes which resulted in parallel proceedings, conflicts between different statutes and uncertainty for creditors over their recovery. The conflicts and multiple proceedings that have arisen from the multi-layered Insolvency law framework pointed towards a strong need for a unified bankruptcy code that could be applicable to all aspects of a company in distress and for all stakeholders. The complex web of laws which till recent past governed corporate bankruptcy and insolvency included:

- **Companies Act, 2013 (CA 2013)** – This Act contains provisions on collective insolvency resolution by way of restructuring, rehabilitation, or reorganization of entities registered under the Act. Adjudication Authority is the National Company Law Tribunal (NCLT). CA 2013 contains provisions for rescue and rehabilitation of all registered entities in Chapter XIX, and Liquidation in Chapter XX.

- **Companies Act, 1956** (**CA**, **1956**) – This legislation deals with winding up of companies. There is however no separate provisions for restructuring except through Mergers & Acquisitions (M&As) and voluntary compromise. Adjudication authority is the High Court.

- **Sick Industrial Companies Act, 1985** (**SICA**, **1985**) – This Act dealt with restructuring of distressed 'industrial' firms. Under this Act, the Board for Industrial and Financial Reconstruction (BIFR) assessed the viability of the industrial company, and referred an unviable company to the High Court for liquidation. SICA, 1985 contained special provisions for timely detection of sick industrial companies and for undertaking preventative, ameliorative, remedial and other measures in respect of such companies.

- **The Recovery of Debt Due to Banks and Financial Institutions Act, 1993** (**RDDBFIA**, **1993**) – This Act gives banks and a specified set of financial institutions greater powers to recover collateral at default. The law provides for the establishment of special Debt Recovery Tribunals (DRTs) to enforce debt recovery by these institutions only. The law also provides for the Debt Recovery Appellate Tribunals (DRATs) as the appellate forum.

- **The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI, 2002)** – This Act enables secured creditors to take possession of collateral without requiring the involvement of a court or tribunal. This law provides for actions by secured creditors to take precedence over a reference by a debtor to BIFR. The DRT is the forum for appeals against such recovery.

Issues relating to various legislations dealing with Corporate Insolvency and Restructuring;

- **SICA**: Under the SICA industrial companies whose networth has eroded by 100% are identified as being in distress and are referenced to the BIFR. Thereafter the BIFR must investigate the potential viability of the industrial company and then either recommend its rehabilitation scheme or winding up before the High Court.

  Major issues with the legislation are:

  * ***Delay:*** Under SICA provisions 5 to 7 years are required for reviving a company[4]. Out of which around 3 to 4 years are required just to decide whether a particular company needs rehabilitation or liquidation.

    Delays further contribute to other issues such as debtors using the delay to defer payments to the creditors because of the moratorium that is placed upon creditor enforcement, corporate assets being siphoned off during the long drawn process, managers coercing creditors into extending further finance or giving concessions in existing debts. It has been observed that SICA is capable of achieving a swift liquidation only where creditors rejected possibility of revival.

  * ***Improper identification of companies that can be restructured*:** It has been repeatedly stated that the BIFR has failed to satisfactorily identify companies capable of restructuring or have sanctioned schemes which have severely hampered the creditors' interests.

* ***SICA does not assist the creditor*:** In many cases where the creditors seek liquidation the cases have been sent back to the BIFR to conduct inquiry into rehabilitation.

- **SARFAESI:** The Act provides mechanism to the secured creditor to take possession of the property of the debtor without intervention by the Courts or Tribunals. Appeals against such possession may be made to the DRT.

- **RDDBFI:** This Act focuses specifically on the easing recovery for banks and other financial institutions both secured and unsecured creditors. The Act additionally provided for the establishment of DRTs and DRATs.

9.4 UNIFIED INSOLVENCY AND BANKRUPTCY LAW - THE INSOLVENCY AND BANKRUPTCY CODE, 2016

As mentioned above a host of legislation and forum combined with potentially conflicting jurisdictional issues had resulted in systemic delays and complexities in the insolvency and bankruptcy process. Additionally, all these legislations have been identified as being inadequate in by themselves. Thus the Insolvency and Bankruptcy Code, 2016 (hereinafter referred to as IBC or the Code) was enacted. This Code aims to consolidate the laws relating to insolvency of companies and limited liability entities (including limited liability partnerships and other entities with limited liability), unlimited liability partnerships and individuals, presently contained in a number of legislations, into a single legislation. Such consolidation will provide for a greater clarity in law and facilitate the application of consistent and coherent provisions to different stakeholders affected by business failure or inability to pay debt.

> *"An effective insolvency regime is a critical component of ease of doing business in India".*

This Code is considered as the biggest economic reform next only to GST[5]. The insolvency regime is expected not only to facilitate an easy revival and rehabilitation process for companies in financial trouble but also to be very effective in safeguarding the interests of the stakeholders such as creditors, shareholders, government, etc. It is also expected to stabilize the commercial dealings, financial stability and better environment for attracting investments, besides mitigation of corporate failures. Further, it should also ensure that the financial resources of a country are utilized efficiently to enhance the overall growth of the economy.

Salient features of IBC 2016

The salient features of the IBC 2016 are as follows:

- Clear, coherent and speedy process for early identification of financial distress and resolution of companies and limited liability entities if the underlying business is found to be viable.

- Two distinct processes for resolution of individuals, namely- "Fresh Start" and "Insolvency Resolution".

- Debt Recovery Tribunal and National Company Law Tribunal to act as

Adjudicating Authority and deal with the cases related to insolvency, liquidation and bankruptcy process in respect of individuals and unlimited partnership firms, and in respect of companies and limited liabilities entities respectively.

- Establishment of an Insolvency and Bankruptcy Board of India to exercise regulatory oversight over insolvency professionals, insolvency professional agencies and information utilities.
- Insolvency professionals would handle the commercial aspects of insolvency resolution process. Insolvency professional agencies will develop professional standards, code of ethics and be first level regulator for insolvency professionals leading to development of a competitive industry for such professionals.
- Information utilities would collect, collate, authenticate and disseminate financial information to be used in insolvency, liquidation and bankruptcy proceedings.
- Enabling provisions to deal with cross border insolvency.

9.5 FOUR PILLARS OF INSTITUTIONAL INFRASTRUCTURE UNDER IBC 2016

There exist four pillars of institutional infrastructure created by the IBC 2016. These are as follows:

1. Insolvency Professionals and Insolvency Professionals Agencies:

The first pillar of institutional infrastructure is a class of regulated persons, the Insolvency Professionals. They play a key role in the efficient working of the bankruptcy process and are regulated by Insolvency Professional Agencies.

An Insolvency Professional (IP) plays a central role in the effective and efficient implementation of an insolvency law, with certain powers over debtors and their assets and a duty to protect those assets and their value, as well as the interests of creditors and employees, and to ensure that the law is applied effectively and impartially.

An IP may hold any of the following roles under the Code:

i) **Resolution professional (RP)** to resolve insolvency for a firm or an individual;

ii) **Bankruptcy Trustee** in an individual bankruptcy process;

iii) **Liquidator** in a firm liquidation process;

Who can be Insolvency Professional under IBC, 2016?

Regulation 5 of the Insolvency and Bankruptcy Board of India (Insolvency Professionals) Regulations, 2016[6], provides the following qualifications and experience to become an "Insolvency professional":

Subject to the other provisions of these Regulations, an individual shall be eligible for registration, if he;

a) has passed the National Insolvency Examination;

b) has passed the Limited Insolvency Examination, and has fifteen years of experience in management, after he received a Bachelor's degree from a university established or recognized by law; or

c) has passed the Limited Insolvency Examination and has **ten years** of experience as -

   i) a chartered accountant enrolled as a member of Institute of Chartered Accountants of India,

   ii) a company secretary enrolled as a member of Institute of Company Secretaries of India,

   iii) a cost accountant enrolled as a member of the Institute of Cost Accountants of India, or

   iv) an advocate enrolled with a Bar Council.

2) Information Utilities

The second pillar of institutional infrastructure is a new industry of 'Information Utilities'. These are service providers which are required to store facts about lenders and terms of lending in electronic databases. This is intended to eliminate delays and disputes about facts when default takes place. Chapter V of Part IV of the IBC contains provisions with respect to Information Utilities[7]. An information utility is contemplated as a registered service provider, which shall be obliged to[8]:

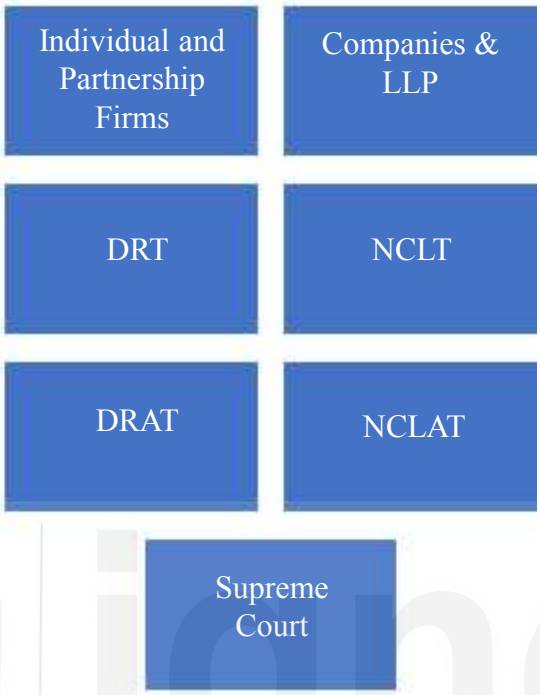
- Create and store financial information in a universally accessible format;
- Accept electronic submissions of financial information from persons who are under obligations to submit financial information under the CODE, in such form and manner as may be specified by regulations;
- Accept, in specified form and manner, electronic submissions of financial information from persons who intend to submit such information;
- Meet such minimum service quality standards as may be specified by regulations;
- Get the information received from various persons authenticated by all concerned parties before storing such information;
- Provide access to the financial information stored by it to any person who intends to access such information in such manner as may be specified by regulations;
- Publish such statistical information as may be specified by regulations;
- Have inter-operability with other information utilities.

Any person who intends to submit financial information to the information utility or access the information from the information utility shall pay such fee and submit information in such form and manner as may be specified by regulations[9].

3) Adjudication

The third pillar of institutional infrastructure are the adjudication authorities. The National Company Law Tribunal (NCLT) is the forum where insolvency

of corporate persons will be heard and DRT is the forum where individual insolvencies will be heard. These institutions, along with their Appellate bodies, viz., NCLAT and DRATs will be adequately strengthened so as to achieve world class functioning of the bankruptcy process.



i) Adjudicator for Corporate Insolvency and Bankruptcy- National Company Law Tribunal

The Adjudicating Authority, in relation to insolvency resolution and liquidation for corporate persons including corporate debtors and personal guarantors thereof shall be the National Company Law Tribunal.

Territorial jurisdiction

The NCLT will have territorial jurisdiction over the place where the registered office of the corporate person is located[10]. The NCLT, before which a corporate insolvency resolution process or liquidation proceeding of a corporate debtor is pending, will also have jurisdiction in the matter of the insolvency resolution or bankruptcy of a personal guarantor of such corporate debtor[11].

An insolvency resolution process or bankruptcy proceeding of a personal guarantor of the corporate debtor pending in any court or tribunal shall stand transferred to the NCLT dealing with insolvency resolution process or liquidation proceeding of such corporate debtor.

The NCLT is vested with all the powers of the Debt Recovery Tribunal and shall have jurisdiction to entertain or dispose of;

- Any application or proceeding by or against the corporate debtor or corporate person;
- Any claim made by or against the corporate debtor or corporate person, including claims by or against any of its subsidiaries situated in India; and
- Any question of priorities or any question of law or facts, arising out of or in relation to the insolvency resolution or liquidation proceedings of the corporate debtor or corporate person under the Code.

Civil court not to have jurisdiction

No civil court or authority has jurisdiction to entertain any suit or proceedings in respect of any matter on which NCLT or the National Company Law Appellate Tribunal has jurisdiction under this Code[12]. No court, tribunal or authority shall grant an injunction in respect of any action taken, or to be taken, in pursuance of any power conferred on the NCLT or the National Company Law Appellate Tribunal under the Code.

ii) Adjudicator for Insolvency Resolution and Bankruptcy of Individuals & Partnerships- Debt Recovery Tribunal (DRT)[13]

The Adjudicating Authority, in relation to insolvency matters of individuals and firms shall be the Debt Recovery Tribunal, having territorial jurisdiction over the place where the individual debtor actually and voluntarily resides or carries on business or personally works for gain and can entertain an application under this Code regarding such person.

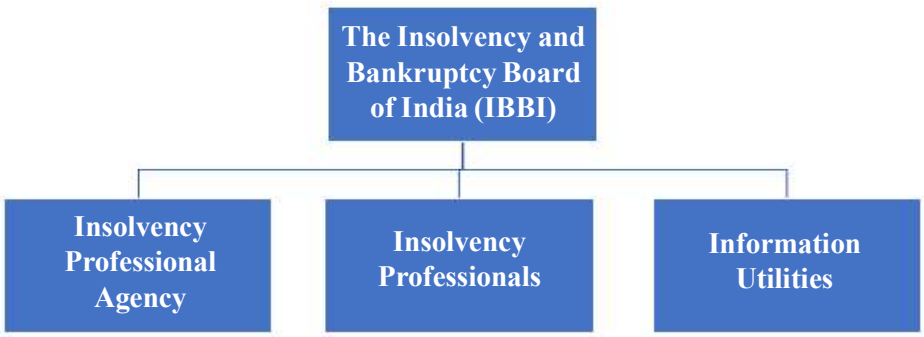
The Debt Recovery Tribunal shall have jurisdiction to entertain or dispose of:

- any suit or proceeding by or against the individual debtor;
- any claim made by or against the individual debtor;
- any question of priorities or any other question whether of law or facts, arising out of or in relation to insolvency and bankruptcy of the individual debtor or firm under this Code.

An appeal from an order of the Debt Recovery Tribunal under this Code shall be filed within thirty days before the Debt Recovery Appellate Tribunal (DRAT). An appeal from an order of the Debt Recovery Appellate Tribunal on a question of law under this Code shall be filed within forty-five days before the Supreme Court.

4) The Insolvency and Bankruptcy Board of India (IBBI)

The fourth pillar of institutional infrastructure is the regulator, *the Insolvency and Bankruptcy Board of India* (hereinafter referred to as the Board or IBBI) with head office in the National Capital Region and offices at other places in India.[14] The central government has the power to designate a financial sector regulator to perform the functions till such time the Board is constituted. Until the Board is constituted or a financial sector regulator is designated under Section 195, as the case may be, the powers and functions of the Board or such designated financial sector regulator, including its power to make regulations, shall be exercised by the Central Government.[15]



Constitution of Board and selection of Members

The Board shall consist of the following Members to be appointed by the Central Government, who shall appoint them (other than the ***ex officio*** members) after obtaining the recommendation of a selection committee. The Board consists of:

- Chairperson;
- Three ex-officio Members from amongst the officers of the Central Government not below the rank of Joint Secretary or equivalent, one each to represent the Ministry of Finance, the Ministry of Corporate Affairs and Ministry of Law;
- One ex-officio Member to be nominated by the Reserve Bank of India; and
- Five other Members to be nominated by the Central Government, of whom at least three shall be the whole-time members.

The tenure of the office bearers is given in Section 189(4) of the IBC 2016. The term of office of all the members (except ex office members) shall be for a period of 5 years or until they attain the age of 65, whichever is earlier. They are eligible for re-appointment as well.

Objectives of the Board:

The objective of the Board is to utilize all legislative, executive and quasi-judicial functions so as to achieve a well-functioning bankruptcy process in India. This would include features of:

- High recovery rates in an NPV sense;
- Low delays from start to end;
- Sound coverage of the widest possible class of claims e.g., bank loans, corporate bonds, etc.;
- A perception in the minds of persons in the economy that India has a swift and competent bankruptcy process.

9.6 CORPORATE INSOLVENCY RESOLUTION PROCESS

Trigger point for initiation

A corporate insolvency resolution process may be initiated under Chapter II of the Code in respect of a corporate debtor that has committed a default. The trigger point for initiating the corporate insolvency resolution process is the occurrence of default. A default[16] would have occurred when the debtor fails to pay whole or any part or installment of the amount of debt that has become due and payable. The "debt"[17] has been defined under Code as a liability or obligation in respect of a claim, which is due from any person and includes a financial debt and operational debt. While a financial creditor is required to present record of default before NCLT for initiation of corporate insolvency resolution process, an operational credit or must issue a statutory notice to corporate debtor in the manner provided in Code.

The "claim"[18], financial debt" and "operation debt" are defined in Code. A "claim" means ***(a)*** a right to payment, whether or not such right is reduced to judgment, fixed, disputed, undisputed, legal, equitable, secured, or unsecured; ***(b)*** right to

remedy for breach of contract under any law for the time being in force, if such breach gives rise to a right to payment, whether or not such right is reduced to judgment, fixed, matured, unmatured, disputed, undisputed, secured or unsecured. The corresponding obligation of the debtor to pay may arise out of a financial debtor or an operational debt.

Who can initiate the process?

The process for initiating corporate insolvency resolution may be initiated by any of the following:

- A financial creditor[19]
- An operational creditor[20] or
- The corporate debtor[21] itself

Commencement by financial creditor

Application by financial creditor

A financial creditor may initiate the process either by itself or jointly with other financial creditors by filing an application before the NCLT, if a default has occurred in respect of a financial debt owed not only to the applicant financial creditor but to any other financial creditor of the corporate debtor. A financial creditor is a person to whom a financial debt is owed and includes a person to whom such debt has been legally assigned or transferred to.

Ascertaining existence of debt default by NCLT

Within 14 days of receipt of application by NCLT[22], it must ascertain the existence of a default from the records of an information utility or on the basis of other evidence furnished by the financial creditor. If NCLT is satisfied that (i) a default has occurred; or (ii) the application made by financial creditor is complete; or (iii) there is no disciplinary proceedings pending against the proposed resolution professional, it may, by order, admit such application. Under SICA, admission of reference made to BIFR was by way of an administrative act of registration of reference by the registry of BIFR. Now, an order must be passed by NCLT. It appears that the corporate debtor need not be heard by NCLT while ascertaining the existence of default.

The NCLT can reject the application if it finds that default has not occurred or the application made by financial creditor is incomplete or any disciplinary proceeding is pending against the proposed resolution professional. The NCLT is required to provide an opportunity to the applicant to rectify the defect in the application if the NCLT finds the application to be defective. The applicant must rectify the defect in his application within 7 days of receipt of such notice from the Adjudicating Authority.

Date of commencement

The corporate insolvency resolution process shall commence from the date of admission of the application of financial creditor by the NCLT. Order of admission of such application shall be communicated by the NCLT to the applicant and corporate debtor, and of rejection to the financial creditor, within seven days.

Declaration of moratorium and public announcement[23]

With regard to creditors, one of the fundamental principles of insolvency law is that insolvency proceedings are collective proceedings, which require the interests of all creditors to be protected against individual action by one of them. Many insolvency laws include a mechanism to protect the value of the insolvency estate that not only prevents creditors from commencing actions to enforce their rights through legal remedies during some or all of the period of the liquidation or reorganization proceedings, but also suspends actions already under way against the debtor. Such a mechanism is variously termed a "moratorium", "suspension" or "stay", depending on the effect of the mechanism.

The Code provides for a moratorium from creditors action against the corporate debtor. Where the NCLT passes an order of admission of an application for commencement of corporate resolution process, the NCLT shall, by an order:

- Grant a moratorium mentioned in section 14.
- Appoint an interim resolution professional in the manner as laid down section 16 of the Code.
- Cause a public announcement of the initiation of corporate insolvency resolution process and call for the submission of claims immediately after the appointment of the interim resolution professional.

Moratorium

The order to declare moratorium prohibits:

- the institution of suits or continuation of pending suits or proceedings against the corporate debtor including execution of any judgement, decree or order in any court of law, tribunal, arbitration panel or other authority
- Transferring, encumbering, alienating or disposing of by the corporate debtor any of its assets or any legal right or beneficial interest therein
- Any action to foreclose, recover or enforce any security interest created by the corporate debtor in respect of its property including any action under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
- The recovery of any property by an owner or lessor where such property is occupied by or in the possession of the corporate debtor

Exclusion from moratorium

The order of moratorium should not affect supply of essential goods or services to the corporate debtor, which shall not be terminated or suspended or interrupted during moratorium period. This is important to explore resolution of the corporate debtor as a going concern.

Conduct of corporate resolution process by resolution professional

The resolution professional is responsible for the conduct of the entire corporate insolvency resolution process and manage the operations of the corporate debtor during the corporate insolvency resolution process period. For this purpose, the resolution professional has the same powers and must perform same duties as vested or conferred on the interim resolution professional.

Resolution Plan[24]

A resolution applicant may submit a resolution plan to the resolution professional prepared on the basis of the information memorandum[25]. A resolution plan means a plan proposed by any person for insolvency resolution of the corporate debtor as a going concern in accordance with Part II of the Code. As already mentioned, a resolution applicant means any person who submits a resolution plan to the resolution professional. The resolution professional shall examine each resolution plan received by him to confirm that each resolution plan is compliant of the specifications provided in the Code.

Approval of resolution plan by creditors

A resolution plan, which confirms the conditions referred above, must be placed before the committee of creditors by the resolution professional for its approval. The committee of creditors may approve a resolution plan by a vote of not less than seventy five per cent of voting share of the financial creditors. The resolution applicant may attend the meeting of the committee of creditors in which the resolution plan of the applicant is considered. However, the resolution applicant shall not have a right to vote at the meeting of the committee of creditors unless such resolution applicant is also a financial creditor.

Approval of plan by NCLT

The resolution plan as approved by the committee of creditors must be presented by resolution professional to the NCLT for approval. If the NCLT is satisfied that the resolution plan as approved by the committee of creditors meets the requirements of resolution plan referred above (sub-section *(2)* of section 30), it shall, by order, approve the resolution plan. The resolution plan approved by the NCLT shall be binding on the corporate debtor and its employees, members, creditors, guarantors and other stakeholders involved in the resolution plan. As a consequence of the order of approval, the moratorium order passed by NCLT shall cease to have effect. Following the order of approval of resolution plan by the NCLT, the resolution professional shall forward all records relating to the conduct of the corporate insolvency resolution process and the resolution plan to the Board to be recorded on its database.

Rejection of resolution plan

If the NCLT is satisfied that the resolution plan does not confirm to the requirements (of sub-section *(2)* of section 30), it may, by an order, reject the resolution plan.

Punishment for contravention of resolution plan

If a corporate debtor, any of its officers or creditors or any person on whom the approved resolution plan is binding under section 31, knowingly and willfully contravenes any of the terms of such resolution plan or abets such contravention, such corporate debtor, officer, creditor or person shall be punishable with imprisonment of not less than one year, but may extend to five years, or with fine which shall not be less than one lakh rupees, but may extend to one crore rupees, or with both.

Time limit for completion of insolvency resolution process[26]

The corporate insolvency resolution process provided in Chapter II must be completed within a period of 180 days from the date of admission of the

application to initiate such process (effective date). The period of 180 days can be extended by NCLT upto a maximum period of 90 days. Therefore, the total period for resolution of corporate insolvency, including extended period, can be upto a maximum of 270 days. An extension can be granted by the NCLT on an application filed by the resolution professional only if instructed to do so by a resolution passed at a meeting of the committee of creditors by a vote of seventy-five percent of the voting shares, and if it is satisfied that the subject matter of the case is such that corporate insolvency resolution process cannot be completed within 180 days. Any extension of the period of corporate insolvency resolution process cannot be granted more than once.

Appeal before National Company Law Appellate Tribunal

An appeal by a person aggrieved by an order approving the resolution plan by the NCLT may be filed before National Company Law Appellate Tribunal (hereinafter referred to as NCLAT) on the following grounds:

- The approved resolution plan is in contravention of the provisions of any law for the time being in force;
- There has been material irregularity in exercise of the powers by the resolution professional during the corporate insolvency resolution period;
- The debts owed to operational creditors of the corporate debtor have not been provided for in the resolution plan in the manner specified by the Board;
- The insolvency resolution process costs have not been provided for repayment in priority to all other debts; or
- The resolution plan does not comply with any other criteria specified by the Board.

Every such appeal shall be filed within 30 days. The NCLAT may allow an appeal to be filed after the expiry of the said period of 30 days if it is satisfied that there was sufficient cause for not filing the appeal but such period shall not exceed 15 days.

Appeal before Supreme Court of India

Any person aggrieved by an order of the NCLAT may file an appeal to the Supreme Court on a question of law arising out of such order under Code within 45 days from the date of receipt of such order. The Supreme Court may, if it is satisfied that a person was prevented by sufficient cause from filing an appeal within 45 days, allow the appeal to be filed within a further period not exceeding 15 days.

Fast track corporate insolvency resolution process[27]

The Code provides for a fast-track corporate insolvency resolution process to be completed within a period of ninety days from the insolvency commencement date. The period of 90 days may be extended by a maximum period of 45 days by the NCLT on an application filed by resolution professional. The resolution professional can make such application for extension if instructed to do so by a resolution passed at a meeting of the committee of creditors and supported by a vote of seventy five percent of the voting share. Any extension of the fast-track corporate insolvency resolution process can be granted by the NCLT only once.

9.7 LIQUIDATION PROCESS UNDER IBC 2016

Commencement

Liquidation order under this Code is passed only where the corporate insolvency resolution and no resolution plan can be passed within the time provided or a resolution plan passed is not complied with. Liquidation in other cases or other grounds is dealt as proceedings for winding up under the Companies Act, 2013.

Grounds for passing order of liquidation of corporate debtor by the NCLT

An order of liquidation is to be passed by the NCLT in the following circumstances[28]:

- If before the expiry of the insolvency resolution process period a resolution plan is not received for approval by the NCLT.
- If it rejects the resolution plan for the non-compliance of the requirements[29] specified.
- If the committee of creditors decides to liquidate the corporate debtor at any time during the corporate insolvency resolution process (but before confirmation of resolution plan by the NCLT), and an application is filed by the resolution professional to pass an order to liquidate the corporate debtor.
- If the corporate debtor contravenes the resolution plan approved by the NCLT, any person, whose interests are prejudicially affected by such contravention, can file a liquidation application.

Public announcement

Where an order of liquidation is passed by the NCLT, a public announcement stating that the corporate debtor is in liquidation must be issued. The NCLT shall also require such order to be sent to the authority with which the corporate debtor is registered. Protection of all interested persons is linked to publicity requirements, designed to apprise potentially interested persons that liquidation order has been passed.

9.8 INDIVIDUAL INSOLVENCY

The Insolvency and Bankruptcy Code, 2016, in its Part III provides for insolvency resolution and bankruptcy for individual and partnership firms.

The significant features of Part III are as follows:

- There exist two distinct processes in case of insolvencies: automatic fresh start and insolvency resolution.
- The code applies in all cases where the minimum default amount is Rs. 1000 and above.
- The insolvency resolution process consists of preparation of a repayment plan by the debtor, for approval of creditors. If approved, the DRT passes an order binding the debtor and creditors to the repayment plan. If the plan is rejected or fails, the debtor or creditors may apply for a bankruptcy order.

- The creditors and the debtor are required to agree on repayment plan for restructuring debts and affairs of the debtor under the supervision of an IP. Such a repayment plan requires approval of 75% of the financial creditors.
- The code prescribes a timeline of 180 days for the insolvency resolution process.[30]

Fresh Start Process[31]

Under the automatic fresh start process, eligible debtors (basis gross income) can apply to the Debt Recovery Tribunal (DRT) for discharge from certain debts not exceeding a specified threshold, allowing them to start afresh. Under this, an application may be made by eligible debtor for any debt (other than secured debt, which has been availed of 3 months prior to the date of application, 'excluded debt').

Eligibility for a fresh start process application under the code are: (i) applicant should not own a dwelling unit and has a gross annual income of less that Rs. 60,000/-, with assets of value not exceeding Rs. 20,000/-, and (ii) aggregate value of the qualifying debt of such individual or partnership firm should not exceed Rs. 35,000/-. In addition, the applicant should not be an un-discharged insolvent and there be no other previous fresh start process applications submitted by him.

Discharge Order and its effects

The bankruptcy trustee should apply to the Adjudicating Authority for a discharge order either on the expiry of one year from the bankruptcy commencement date, or within seven days of the approval of the committee of creditors of the completion of administration of the estates of the bankrupt. The discharge order releases the bankrupt from all the bankruptcy debt.

However, a discharge order will not be granted if the discharge:

- Affects the functions of the bankruptcy trustee; or
- affects the operation of the provisions of Chapters IV and V of Part III; or
- releases the bankrupt from any debt incurred by means of fraud or breach of trust to which he was a party; or
- discharges the bankrupt from any excluded debt

Disqualifications Provisions

On the bankruptcy commencement date, the bankrupt is disqualified from:

- Appointment or acting as a trustee or representative in respect of any trust, estate or settlement;
- Appointment or acting as a public servant;
- Election to any public office;
- Election as a member of any local authority

9.9 CROSS BORDER INSOLVENCY

Cross border insolvency arrangement with other countries:[32]

Sections 234 and 235 of the Code deals with cross border insolvency.

The Central Government may enter into an agreement with the government of any country outside India for enforcing the provisions of the Code. The Central Government may, by notification in the official gazette, direct that the application of provisions of the Code in relation to assets or property of corporate debtor or debtor, including a personal guarantor of a corporate debtor, as the case may be, situated at any place in a country outside India with which reciprocal arrangements have been made, shall be subject to such conditions as may be specified.

Letter of request to a country

If, in the course of insolvency resolution process, or liquidation or bankruptcy proceedings, as the case may be, the resolution professional, liquidator or bankruptcy trustee, as the case may be, is of the opinion that assets of the corporate debtor or debtor, including a personal guarantor of a corporate debtor, are situated in a country outside India with which reciprocal arrangements have been made under section 234, he may make an application to the NCLT or DRT as the case may be, that evidence or action relating to such assets is required in connection with such process or proceeding. On receipt of such an application the NCLT may issue a letter of request to a court or an authority of such country competent to deal with such request.

9.10 LEADING CASES

Some important cases on IBC are:

1) Innoventive Industries Ltd. Vs ICICI Bank Ltd. (Supreme Court CA No. 8337-8338 of 2017)

The Hon'ble Supreme Court held that in the event of any repugnancy between any State law and the Code, in respect of matters related to Insolvency & Bankruptcy, the Code would prevail over such State laws.

2) IDBI Bank Ltd. V. Lanco Infratech (CP (LB) No. 111/7 HDB/2017)

In this case the NCLT denied appointment of Interim Resolution Professional (IRP) on the ground that he was already handling three big assignments and had recently been appointed IRP for two large companies.

3) Lokhandwala Kataria Cons. Pvt. Ltd. Vs. Nisus Finance & Investment Managers LLP., (Supreme Court CA No. 9279 of 2017)

The Hon'ble Supreme Court, in exercise of its inherent power to ensure justice under Art.142, allowed the parties to withdraw the insolvency application upon the undertaking of the appellant to pay the outstanding dues to the applicant as per the consent terms.

4) Surendra Trading Co. vs. Juggilal Kamlapat Jute Mills Co. Ltd., (Supreme Court CA No. 8400 of 2017)

The issues for consideration by the Supreme Court were with regards to relaxation of time period prescribed under IBC

- Whether the time period of 14 days for admitting or rejecting an application by NCLT is directory or mandatory?

  The NCLAT held that that such time period is directory in nature.

- Whether the time limit of 7 days prescribed under the Code for rectifying or removing defects in the application filed by an operational creditor for initiating CIRP is mandatory?

  The Supreme Court observing that in a given case there might be weighty, valid and justifiable reasons for not able to remove defects within 7 days, held this to be merely a directory provision.

5) Mobilox Innovations Private Ltd vs Kirusa Software Pvt. Ltd., (Supreme Court C.A. No. 9405 of 2017)

The Supreme Court held that while examining admissibility of an Application u/s 9 of IBC, the NCLT will have to determine the three conditions mentioned under section 5(6). It was held that the definition of the term *'dispute'* is an inclusive one and the present case was not one where suit or arbitration proceeding had been filed before receipt of demand notice, only in which case the dispute must relate to the three sub clauses of section 5(6).

6) Arun Kumar Jagatramka v. Jindal Steel and Power Ltd., (2021 SCC OnLine SC 220)

The Supreme Court decided on 15th March 2021 that a person who is ineligible under Section 29A of the Insolvency Bankruptcy Code, 2016, to submit a resolution plan, is also barred from proposing a scheme of compromise and arrangement under Section 230 of the Companies Act, 2013.

7) Kalparaj Dharamshi v. Kotak Investment Advisors Ltd, (2021 SCC OnLine SC 204)

The Supreme Court held that the commercial wisdom of Committee of Creditors (CoC) is not to be interfered with, excepting the limited scope as provided under Sections 30 and 31 of the Insolvency and Bankruptcy Code, 2016. It stated that "*the Court ought to cede ground to the commercial wisdom of the creditors rather than assess the resolution plan on the basis of quantitative analysis"*

8) P. Mohanraj vs M/S. Shah Brothers Ispat Pvt. Ltd (CIVIL APPEAL NO.10355 OF 2018)

The Supreme Court in March 2021 decided that when an order of moratorium is passed under the Insolvency and Bankruptcy Code, parallel proceedings under Section 138 of the Negotiable Instruments Act against the Corporate Debtor cannot be allowed to continue as the same will be covered by the bar under Section 14 of the IBC

9) *Lalit Kumar Jain v. Union of India (*TRANSFERRED CASE (CIVIL) NO. 245/2020)

The provisions of the Insolvency and Bankruptcy Code, 2016 concerning the liability of the personal guarantors to the corporate debtors were upheld. With the decision in place, the creditors can now initiate insolvency proceedings against individuals such as promoters, managing directors and chairpersons who stand as personal guarantors on the monies lent or goods and services extended to the corporate debtors.

10) Phoenix Arc Private Limited Vs Spade Financial Services Limited & Ors (Civil Appeal No. 2842 of 2020).

The Supreme Court has held that a financial creditor which is not a "related party" to the corporate debtor at present can also be excluded from the Committee of Creditors (CoC) if it is found that he was earlier a related party and had removed this label only to bypass S.21(2) Proviso.

9.11 SUMMARY

This unit explains the law and mechanism related to corporate insolvency resolution process for corporates in India. The unit commences describing the legal and regulatory situation in place prior to enacting of the Insolvency and Bankruptcy Code 2016. It further examines the need to adopt the Insolvency and Bankruptcy Code, 2016 (hereinafter referred to as IBC or the Code). It discusses the salient aspects of the Code with the help of leading cases.

9.12 SELF ASSESSMENT QUESTIONS

1) Define 'Insolvency'.
2) Explain the corporate insolvency legislative framework in India prior to the Insolvency and Bankruptcy Code, 2016.
3) Discuss the corporate insolvency resolution process.
4) Explain the liquidation process under the Insolvency and Bankruptcy Code, 2016.
5) Discuss the four pillars of institutional infrastructure created by the Insolvency and Bankruptcy Code, 2016.

9.13 FURTHR READINGS/REFERENCES

Books:

1) Vinod Kothari & Sikha Bansal, 2016, *Law Relating to Insolvency & Bankruptcy Code, 2016;* Taxmann Publications Pvt. Ltd.
2) *Manzar Saeed Commentary on The Insolvency and Bankruptcy Code,* 2017, Thomson Reuters India.
3) Jyoti Singh & Vishnu Shriram , *Insolvency and Bankruptcy Code,* 2016-Concepts and Procedure, Bloomsbury India Professional.
4) *EBC's Insolvency and Bankruptcy Code, 2016: Manual of Bare Act along* with Regulations

Weblinks:

- http://www.ibbi.gov.in/
- http://www.ibbi.gov.in/wg-04report.pdf
- http://www.ibbi.gov.in/Wg-01%20Report.pdf
- http://ibbi.gov.in/16_Joint_Committee_on_Insolvency_ and_Bankruptcy_ Code_2015_1.pdf
- http://ibbi.gov.in/BLRCReportVol1_04112015.pdf

References

1 Professor Sir Roy Goode, *Principles of Corporate Insolvency Law* (Sweet and Maxwell, 4th ed, 2011).

2 Insolvency, https://www.oxfordlearnersdictionaries.com/definition/english/insolvency Last accessed 7th August 2021

3 The report of the Bankruptcy Law Reforms Committee, Ministry of Finance, Government of India (November 2015)

4 Kang, Nimrit & Nayar, Nitin. (2004). The Evolution of Corporate Bankruptcy Law in India. ICRA Bulletin Money and Finance. 3.

5 *Ministry of Finance on Insolvency and Bankruptcy Code, 2016;* NO. 31 OF 2016 [28th May, 2016]

6 Insolvency Professional, http://www.ibbi.gov.in/Law/GAZETTEIP_professional.pdf, Last accessed 7th August 2021

7 Sections 209 to 216 of IBC 2016

8 Section 214 of IBC 2016

9 Section 215 IBC

10 Section 60(1) IBC

11 Section 60(2) IBC

12 Section 63 IBC

13 Sections 179-183 of the IBC

14 Section 195, IBC 2016

15 Section 244, IBC 2016

16 S.3(12), IBC 2016

17 S.3(11), IBC 2016

18 S.3(6), IBC 2016

19 S.7, IBC 2016

20 S.9, IBC 2016

21 S.10,IBC 2016

22 S.7(4), IBC 2016

23 S.30 IBC

24 S.13,14 IBC 2016

25 S.29 IBC

26 S.12 IBC

27 S.55-58 of IBC

28 S.33 IBC 2016

29 S.31 IBC 2016

30 S.85(4) IBC, 2016

31 S.80, 81 IBC, 2016

32 S.234, 235 of IBC 2016