Nishith Desai Associates
LEGAL AND TAX COUNSELING WORLDWIDE

MUMBAI SILICON VALLEY BANGALORE SINGAPORE MUMBAI BKC NEW DELHI MUNICH NEW YORK

Foreign Investment Into Indian Special Situation Assets

A Primer

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Contents

List of abbreviations

Abbreviation	Full Form
AE	Aggregate exposure
Amendment Act	The Enforcement of Security Interest and Recovery of Debts Laws and Miscellaneous Provisions (Amendment) Act, 2016
AQR	Asset Quality Review
ARC	Asset Reconstruction Companies
CAP	Corrective Action Plan
CDR	Corporate Debt Restructuring
CDR-EG	CDR Empowered Group
DCA	Debtor-Creditor Agreement
ECB	External Commercial Borrowings
ED	Executive Director
FDI	Foreign Direct Investment
FDI Policy	Consolidated FDI Policy, issued by Department of Industrial Policy and Promotion, effective June 7, 2016
Feb Circular	RBI circular dated February 26, 2014 introducing the JLF
FI	Financial Institutions
FIPB	Foreign Investment Promotion Board
FPI	Foreign Portfolio Investor
FVCI	Foreign Venture Capital Investor
IBA	Indian Banks' Association
ICA	Inter-Creditor Agreement
IEC	Independent Evaluation Committee
Insider Trading Regulations	SEBI (Prohibition of Insider Trading) Regulations, 2015
JLF	Joint Lenders' Forum
JLFA	JLF Agreement
JLF-EG	Joint Lenders Forum-Empowered Group
LODR	SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015
NBFC	Non-banking financial company
NPA	Non-performing assets

Prudential Norms Master Circular	Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated July 1, 2015, RBI/ 2015-16/101
RBI	Reserve Bank of India
SARFAESI	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
SDR	Strategic Debt Restructuring
SEBI	Securities and Exchange Board of India
SMA	Special Mentioned Accounts
SR	Security Receipts
Takeover Code	SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011
TEV	Techno-Economic Viability

1. Introduction

"You can put lipstick on a pig but it doesn't become a princess. So dressing up a loan and showing it as restructured and not provisioning for it when it stops paying, is an issue. Anything which postpones a problem than recognizing it is to be avoided"

- Raghuram Rajan[1]

The above quote underlies the unprecedented challenge the financial sector in India is reeling under. With the quantum of stressed assets on the books of banks increasing at an exponential rate, the financial regulator, the Reserve Bank of India ("**RBI**") has been compelled to take some stringent measures in an attempt to bring about financial discipline into the economy, and to assist in cleaning up the books of these banks.

Non-performing assets ("**NPA**"), or loans provided by banks where the interest or the principal, or both, remain unpaid for a period of time has been on the rise in India. NPAs, which stood at INR 53,917 crores (Approximately USD 8.2 billion) as of September 2008, increased to INR 341,641 crores (Approximately USD 51.8 billion) as of September 2015.

As a result, the RBI has been compelled to take a slew of measures to deal with the menace of increasing NPAs and take adequate measures to facilitate identification and rectification of stressed loans before they become NPAs. One of the significant measures undertaken by the RBI was an asset quality review ("**AQR**") of commercial lenders, under which the RBI required lenders to recognize stressed loans immediately. The short term implication of the AQR has been substantial on banks, since the profit margins of banks deteriorated, and substantial losses had to be booked in the banks. These figures have been unprecedented, with banks delivering their worst respective numbers in years.[2]

1. http://articles.economictimes.indiatimes.com/2013-11-15/news/44113811_1_30-npa-accounts-bad-loans-gross-npa

2. The losses reported by some Indian banks for the financial quarter ended March 31, 2016 are as follows: United Bank of India: INR 4.1 billion; Bank of Baroda: INR 32.3 billion; Punjab National Bank: INR 53.6 billion; Dena Bank: INR 3.26 billion; Bank of India: INR: 35.8 billion;

2. The regulatory environment

The measures taken by RBI have brought to the books enormous levels of NPAs prevailing in the banking system in India. Reducing the malaise of window-dressing of NPAs was the intent of the RBI while introducing the measures.[3] Realizing that determining the quantum of the NPAs in the banking system was only the beginning of the larger issue, the RBI and the central government have taken substantial steps recently in an attempt to control the increasing NPAs as well.

I. Asset classification and provisioning norm

The RBI has laid down objective criteria for classification of assets in the books of banks.

As per the Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances[4] (“**Prudential Norms Master Circular**”), banks are required to classify certain assets as ‘Non-Performing Assets’ or NPAs.[5] Further, the Prudential Norms Master Circular requires banks to classify NPAs as (i) sub-standard assets,[6] (ii) doubtful assets[7] or (iii) loss assets.[8] The classification of accounts as NPA is required to be borrower-wise and not facility-wise. Accordingly, if an account of a borrower becomes an NPA, all such accounts are required to be categorized as an NPA. The Prudential Norms Master Circular also requires the classification of accounts where the security provided by the borrower has eroded as doubtful assets[9] or loss assets.

In addition, the Prudential Norms Master Circular imposes stringent prudential norms on banks in relation to NPAs. It requires banks to create provisioning for NPAs as follows:

i. For loss assets: 100% of the outstanding;

ii. For doubtful assets: 25%, 40% or 100%[10] depending on the period for which such amount is outstanding;

iii. For sub-standard assets: 15% in all cases, and generally up to an additional 10% where there is unsecured exposure;

iv. For standard assets: 0.25% to 1%, depending on the sector in which the borrower is engaged in.[11]

The prudential norms are a major challenge faced by banks, since all interest payment receivable from NPAs are recorded in the books of the banks, whether for the current period, or for past periods (which were not received) had to be reversed.

3. http://articles.economictimes.indiatimes.com/2013-11-15/news/44113811_1_30-npa-accounts-bad-loans-gross-npa

4. Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated July 1, 2015, RBI/ 2015-16/101

5. As per the Prudential Norms Master Circular, inter alia, any loan or advance, which satisfies the following, are classified as NPAs:
   (i) interest and/ or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan,
   (ii) the bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,
   (iii) the account remains ‘out of order’ as indicated at paragraph 2.2 below, in respect of an Overdraft/ Cash Credit;

6. A ‘sub-6standard asset’ is an advance or loan which has remained an NPA for a period less than or equal to 12 months.

7. An advance or loan would be classified as a ‘doubtful asset’ if it has remained in the sub6standard category for a period of 12 months or more.

8. A ‘loss asset’ is one where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.

9. When the realisable value of the security at any time is less than 50% of the value assessed by the bank during the last last inspection, such NPAs are to be classified as doubtful assets. When the realisable value of the security at any time is less than 10% of the outstanding advance/ loan in the accounts of the bank, the NPA should be classified as ‘loss asset’.

10. The provisioning requirements are as follows: where the amount is outstanding for up to 1 year: 25% of the amount outstanding; where the amounts are outstanding for more than 1 year but less than 3 years: 40% of the amount outstanding, and where amounts are outstanding for more than 3 years: 100% of the amount outstanding.

11. For farm credit to agricultural activities and SMEs sector: 0.25% of the amount outstanding; commercial real estate sector: 1%; advances to commercial real estate – residential housing sector: 0.75%; all other loans and advances: 0.40%.

II. Corporate debt restructuring

The RBI, in August 2001, introduced a voluntary non-statutory mechanism for restructuring of certain loans and advances. This mechanism was termed the Corporate Debt Restructuring (“**CDR**”). The CDR was governed by agreements entered into (i) between the creditors, i.e. the inter-creditor agreement (the “**ICA**”), and (ii) between the creditors and the debtor, i.e. the debtor-creditor agreement (“**DCA**”).

Borrowers which had borrowed from more than 1 bank and had exposures above INR 100 million were subject to resolution under the CDR. Both standard and sub-standard accounts are eligible for restructuring under the CDR mechanism, with accounts classified as NPAs being given priority. Accounts of corporates involved in wilful default, fraud or misfeasance have been kept outside the ambit of the CDR mechanism.[12] Reference to the CDR can be made by (i) any secured creditor holding minimum 20% of the borrowed capital, or (ii) the borrower, if supported by any secured creditor holding minimum 20% of the borrowed capital. While the CDR mechanism was restricted to standard assets and sub-standard assets, it has been expanded to include doubtful assets as well, in cases where the lenders are satisfied of the viability of the asset.

To provide some certainty to the CDR mechanism, RBI provided that if 75% of the creditors (by value), and 60% of the creditors (in number) of the borrower have agreed to a debt restructuring package, it shall be binding on 100% of the creditors. If a restructuring package is approved, the borrower would be entitled to raise additional funding, which would rank superior to other the claims of the existing lenders. In cases where the asset is standard/ sub-standard, the additional funding is to be infused by the existing lenders in proportion to their existing exposure. When the asset is a doubtful asset, the promoter of the borrowing company is required to obtain the additional funding on its own accord.

Further, the parties to the CDR mechanism are also bound by a ‘stand-still provision’, whereby the parties have agreed that they shall not undertake any legal recourse for a period of 90, or 180 days from the execution of the DCA. During the stand-still period, the borrower is prohibited from approaching any other forum for recourse, or for any of its directors to resign from the board of the company.

For an overview of the regulatory framework in relation to CDR, please see Annexure A.

A. Failure of the CDR

The CDR mechanism could not live up to expectations.[13] The number of failed cases under CDR were considerably increasing.[14] Reasons for such failure were multi-pronged.

First, it was expected that the CDR was being considered as a safety net, rather than a means of last resort by lenders. Accordingly, banks were doling out loans to corporates without proper levels of diligence being conducted.[15] There is not enough empirical evidence to prove this, largely due to the lack of transparency in the CDR process being run by banks.[16] The lack of transparency has also been acknowledged by the RBI.[17]

12. However, the CDR Core Group has been empowered to refer certain cases of wilful default also for restructuring, based on the reasons why they have been categorized as wilful.

13. The number of failed exits from the CDR was substantially larger than positive exits. In the first half of 2015-16, there were 4 cases of successful exits (amounting to INR 18 billion) as compared to 24 cases of failed exits (amounting to INR 193 billion).

14. http://indianexpress.com/article/business/business-others/debt-recast-scheme-failing-npas-may-cross-r30k-crore/

15. Dr. K. C. Chakrabarty, Deputy Governor, Reserve Bank of India at the Corporate Debt Restructuring Conference 2012 organized by Centrum Group at Mumbai on August 11, 2012, text of the speech available at https://rbi.org.in/scripts/BS_SpeechesView.aspx?Id=716

16. See http://www.thehindubusinessline.com/money-and-banking/more-transparency-needed-in-audit-of-big-ticket-cdr-cases-rbi/article6735735.ece

17. *“With the increased regulatory focus on segregating the cases of wilful defaults and ensuring the equity participation of promoter(s) in the losses leading to defaults, there is a need for greater transparency in the process of carrying out a net economic value impact assessment of large Corporate Debt Restructuring (CDR) cases.”* See RBI’s Financial Stability Report, Issue No. 10, December, 2014.

Second, the lack of any body regulating the CDR mechanism was proving detrimental to the system. While the CDR scheme clarified that restructuring should not be undertaken for entities engaged in fraud or wilfully misappropriating funds, CDR schemes were being approved for entities which were allegedly engaged in unethical practices.[18] Since the CDR is a voluntary mechanism, RBI is not a regulatory authority for ensuring proper implementation of the CDR.[19]

Third, in cases where additional funding from the promoters' is required, the lack of cash, resulting in further leveraging, coupled with lack of a suitable plan for such fund raising has led to cases where the restructuring failed due to lack of promoter funding.[20]

Fourth, the CDR mechanism was being resorted to by banks merely to ensure that the restructured loans were not classified as NPAs, thereby benefitting from the lower provisioning requirements.[21] This is evidenced by the fact that since April 2015, when the increased provisioning requirements kicked in, the number of CDR references reduced to a minimum.[22]

Finally, the stage at which the restructuring is undertaken as a part of the CDR process, i.e. after an account becomes an NPA was noticed to be too late in the day for reviving assets. If assets which are under stress could also be referred, it could have helped assets revive.[23]

B. Cases

While there have been issues, cases of successful exits have ensured CDR does not result in a complete failure. Some examples of successful exits from CDR and some of the not-so-successful cases are provided below.

Successful Exits from CDRs	Failure of restructuring under CDR
▪ Essar Oil (2004) - exited the CDR cell in 2013;	▪ Arshiya Limited exited the CDR mechanism in November 2015;
▪ Wockdhart Limited (2009) - exited the CDR in 2013;	▪ Hotel Leelaventure Limited exit the CDR in 2014 unsuccessful;
▪ India Cements Limited (January 2003) - exited in March, 2014.	▪ KS Oil Limited exited CDR in july 2013

18. The loans of a company in the infrastructure space, BL Kashyap and Sons was restructured under CDR, despite cases of a fraud case in relation to evasion of workers' provident fund amounts.

19. In the BL Kashyap and Sons case, the RBI had specifically clarified that since it did not have any regulatory or supervisory process over the CDR, and the CDR was a voluntary process undertaken by banks, see http://www.firstpost.com/business/npas-operating-in-regulatory-vacuum-cdr-cell-gives-rs-840-cr-deal-to-firm-charged-with-fraud-rbi-helpless-2575376.html .

20. See http://www.iibf.org.in/documents/reseach-report/CDRultimateFinal_Report_2909.pdf

21. In case where an account was restructured under the CDR mechanism, the asset classification as on the date of the reference would be the classification going forward as well. Additionally, a reduced provisioning requirement was applicable in case the accounts were restructured, as compared to an NPA generally.

22. See http://www.financialexpress.com/article/industry/banking-finance/no-new-cases-with-cdr-cell-in-6-months/146338/

23. *Outlook for Stressed Assets Markets in India*, 2014, Alvarez and Marsal, see http://www.alvarezandmarsal.com/sites/default/files/sidebar-callouts/india-stressed-assets.pdf

III. Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002

In the backdrop of increasing NPAs, the RBI in the 1990s set up two committees – the Narasimham Committee and the Verma Committee. On the recommendations of the committees for creating a vehicle to address the concern of increasing NPAs, the Central Government enacted the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ("**SARFAESI**"). The SARFAESI introduced the concept of asset reconstruction companies ("**ARC**") in India, a model already existing in various parts of the world then.

Supplementing the SARFAESI, the Central Government enacted the 'Security Interest (Enforcement) Rules, 2002' and the 'Change in or takeover of the management of the business of the borrower by Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines, 2010'. Additionally, the RBI notified the 'Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003'.

The ARCs have been permitted to undertake a host of measures for the purpose of restructuring of assets, including changing or taking over the management of the borrower, selling a part or whole of the assets of the borrower, converting any portion of the debt into equity and enforcing the security interest.[24] Additionally, SARFAESI also provides for measures that may be taken by the lender for the purpose of the enforcement of security interest, which include taking over the possession of the secured assets and appointing any person to manage the secured assets.[25]

In accordance with the provisions of SARFAESI, only NPAs and certain specified non-NPAs[26] could be transferred to ARCs by banks and specified financial institutions ("**FI**"). ARCs have been permitted to acquire the NPAs by issuing debentures / bonds for the agreed consideration between the ARC and the bank/ FI, or by way of entering into an agreement for the transfer of the financial assets on terms mutually agreed between the ARC and the bank/ FI.

A. SARFAESI: A failing experiment?

SARFAESI has been unsuccessful in delivering results as anticipated. This can be attributed to a host of reasons.

First, only NPAs (and very limited non-NPAs) could be transferred to ARCs. This was a cause

24. Section 9: Measures for assets reconstruction
Without prejudice to the provisions contained in any other law for the time being in force, a securitisation company or reconstruction company may, for the purposes of asset reconstruction, having regard to the guidelines framed by the Reserve Bank in this behalf, provide for any one or more of the following measures, namely:--
(a)the proper management of the business of the borrower, by change in, or take over of, the management of the business of the borrower;
(b)the sale or lease of a part or whole of the business of the borrower;
(c)rescheduling of payment of debts payable by the borrower;
(d)enforcement of security interest in accordance with the provisions of this Act;
(e)settlement of dues payable by the borrower;
(f)taking possession of secured assets in accordance with the provisions of this Act.
(g)to convert any portion of debt into shares of a borrower company

25. Section 13 - Enforcement of security interest
In case the borrower fails to discharge his liability in full within the period specified in sub-section (2), the secured creditor may take recourse to one or more of the following measures to recover his secured debt, namely:--
(a)take possession of the secured assets of the borrower including the right to transfer by way of lease, assignment or sale for realising the secured asset;
(b)take over the management of the business of the borrower including the right to transfer by way of lease, assignment or sale for realising the secured asset [...]
(c)appoint any person (hereafter referred to as the manager), to manage the secured assets the possession of which has been taken over by the secured creditor;
(d)require at any time by notice in writing, any person who has acquired any of the secured assets from the borrower and from whom any money is due or may become due to the borrower, to pay the secured creditor, so much of the money as is sufficient to pay the secured debt

26. As per RBI's Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines, 2010, a standard asset may be sold to an ARC where:
(a)the asset is under consortium/multiple banking arrangements,
(b)at least 75% by value of the asset is classified as non-performing asset in the books of other banks / FIs, and
(c)at least 75% (by value) of the banks/FIs who are under the consortium/ multiple banking arrangements agree to the sale of the asset to SC / RC.

of concern for banks, which wanted to offload assets before they became NPAs. This was crucial since it ensured the additional provisioning norms would not apply to banks. Additionally, the valuation for a standard asset would be more than an NPA, and hence the realizable value of the assets would be higher prior to the accounts being classified as NPA. On the buy side, loans which were stressed (and not yet NPA) are considered valuable to the ARCs, since they have a substantial turnaround potential and hence, going concern value. To address this concern, the RBI permitted banks and FIs to sell even accounts categorized as SMA-2 to ARCs.

Secondly, the lack of options for additional funding has been a cause of concern for ARCs. In the case of CDR/ JLF, the borrowers have an option of raising additional financing. Comparatively, in case of sale of assets by the banks to ARCs, the borrowers are generally starved of additional funding options, thereby resulting in failure to turn around.[27]

Thirdly, mismatch of valuation expectations between banks/ FIs and ARCs. While sellers (i.e. banks and FIs) expect a fair value of the assets, ARCs intend to acquire the assets at a discounted valuation. The demand of the seller to sell at higher prices, at times, is motivated by its inability to absorb the losses in its books.[28]

Fourthly, 'sale' or 'exchange' While the assets are sold by banks to ARCs, the ARCs have hitherto been thinly capitalized and have issued to banks secured instruments/ security receipts (**"SR"**) as consideration for the acquisition of the NPAs. While this cleans up the books of the banks with respect to the banks currently, in case the NPA is unable to be restructured by the ARC, all the sale does is deferring the implications of the NPA.

Fifth, the judicial interpretation of SARFAESI, and the powers of the lenders therein, which have tried to strike a balance between the power of the lenders and the rights of the borrowers have resulted in limiting the rights of the lenders to some extent.

Sixth, the inability of a single entity to control the affairs of the ARC proved to be a hindrance for ARCs,[29] and delayed operations of the ARCs, including most importantly, enforcement measures.[30]

Next, the SARFAESI, was not dynamic in light of the changing financial sector in India. SARFAESI only covered banks and certain FIs, as mentioned above. The legislature empowered the central government to expand the list of FIs, in light of changing market dynamics. The Central Government has recently notified 196 NBFCs as FIs under SARFAESI.

Finally, one of the most important reasons for the failure of ARCs had been the lack of capital infused in ARCs. Resident investment was limited, and foreign investment and expertise has always been restricted by the RBI into ARCs. This led to a major shortfall in availability of capital for ARCs.[31] Due to restrictions imposed by SARFAESI, as well as RBI, very few players showed interest in the industry.[32] Foreign investment into an ARC was permitted up to 100%, although any investment above 49% required approval from the Foreign Investment Promotion Board (**"FIPB"**). Further, only foreign investment up to 74% was permitted in security receipts issued by schemes of ARCs.[33]

27. http://www.livemint.com/Industry/HeofqWN4JlpBoZLuQT-1fkO/Bad-loans-ARCs-and-asset-reconstruction.html

28. See http://shodhganga.inflibnet.ac.in/bitstream/10603/26960/6/chapter%206.pdf

29. Under Section 3 (3) (f) of SARFAESI, one of the conditions to be complied with for an application for the registration of an ARC include a confirmation:
"that a sponsor, is not a holding company of the securitisation company or reconstruction company, as the case may be, or, does not otherwise hold any controlling interest in such securitisation company or reconstruction company;"

30. See http://www.thehindubusinessline.com/economy/budget/dealing-with-bad-loans/article8296158.ece

31. See http://www.businesstoday.in/magazine/cover-story/distressed-assets-market-in-india-witnessing-unprecedented-boom/story/221604.html and https://ajayshahblog.blogspot.in/2014/08/npas-processed-by-asset-reconstruction.html

32. Over the last decade, very few investors globally showed interest in ARCs. KKR wanted to invest in International Asset Reconstruction Company (IARC) and SSG Capital in Delhi-based ACRE. See http://www.businesstoday.in/magazine/cover-story/distressed-assets-market-in-india-witnessing-unprecedented-boom/story/221604.html

33. These sectoral caps were introduced in August 2013 vide Press Note 6 of 2013 dated August 22, 2013. For a detailed

To add to the already enlarging concerns, the RBI in 2014, increased the minimum holding requirements for ARCs, by mandating ARCs to hold a minimum of 15% of the security receipts of each scheme of the ARC, as compared to the earlier requirement of 5%.[34] This additional investment requirement further exacerbated the issues faced by ARCs.[35] Till the requirement was increased, most of the acquisitions of NPAs by ARCs were under a model where the ARC acquired 5% of the SRs, and issued 95% of the SRs to the banks.[36] In an environment where ARCs were already reeling under the pressure of under-capitalization, this 5% was increased to 15%. This resulted in the number of sales to ARC decreasing substantially.[37]

B. SARFAESI: Corrective measures

Considering that the ARCs were not buying out NPAs from banks at the rate at which they were expected to, RBI and the government have taken certain measures to mushroom ARCs.

The first step in this regard was taken in 2014-15, when the RBI stressed on the importance of ARCs and encouraged banks to offload NPAs to ARCs.[38]

This was followed by the introduction of the JLF,[39] which permitted the sale of SMA-2 accounts, or accounts for which principal/interest were pending for over 60 days, but below 90 days to be sold to ARCs.

The Indian Finance Minister, in his speech while introducing the budget for the year 2016-17 proposed certain changes to the regulatory environment concerning ARCs, including relaxing foreign investment limits and maximum shareholding norms.[40]

The next positive step taken in this respect has been the relaxation of foreign investment into ARCs. The position has been relaxed in May 2016,[41] whereby foreign investment into ARCs has been permitted up to 100% under the automatic route, and foreign investors have been permitted to acquire 100% of the SRs issued by a scheme of the ARC.[42]

Next, the Central Government has finally notified RBI registered NBFCs having an asset size of INR 5 billion or above as FIs under SARFAESI extending the protection to these NBFCs, in line with the Budget Speech 2015. The said notification,[43] dated August 5, 2016 has notified 196 NBFCs as FIs. These NBFCs will have the measures under SARFAESI for enforcement of security, provided the secured loan is worth INR 10 million or more. This is a major boost for the financial sector, especially considering the financial situation today, where NBFCs are fast becoming substitutes to banks for lending and investment purposes.

analysis of this, please see http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/lifeline-for-distressed-assets-relaxation-of-foreign-investment-caps-in-arcs.html .

34. RBI Circular No. RBI/ 2014-15/164 dated August 5, 2014

35. As a background, RBI was of the opinion that by charging a slightly higher management fee, the ARC is in a position to reduce its exposure to the scheme, considering that 5% was a relatively small amount. In light of the same, RBI sought to increase this to 15%.

36. See http://www.businesstoday.in/magazine/cover-story/distressed-assets-market-in-india-witnessing-unprecedented-boom/story/221604.html

37. See http://www.livemint.com/Money/rkEKHiRUtGdrcPF8l-CwAEM/ARCs-assetbuying-drops-in-December-quarter-due-to-tougher-R.html

38. In a discussion paper dated January 30, 2015, RBI stated *"ARCs should be construed as a supportive system for stressed asset management with greater emphasis on asset reconstruction rather than asset stripping. Towards this end, sale of assets to ARCs at a stage when the assets have good chance of revival and fair amount of realisable value, for rehabilitation and reconstruction is encouraged,"*

39. See Below

40. See Pages 17 and 34 of the Budget Speech 2016-17 available online at http://indiabudget.nic.in/ub2016-17/bs/bs.pdf

41. See Press Note 4 of 2016 dated May 6, 2016

42. For a detailed analysis, please see http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/100-foreign-investment-in-arcs-finally-there.html?no_cache=1&cHash=f0ad22277bb0ddd46e04a3e1b5ab5045

43. Notification No. S.O. 2641 (E) dated August 5, 2016, Ministry of Finance

Finally, the Central Government tabled a bill in the Lok Sabha[44] on May 11, 2016[45] to amend SARFAESI to amend certain provisions of SARFAESI. This bill was approved and effected into law on August 16, 2016 as 'The Enforcement of Security Interest and Recovery of Debts Laws and Miscellaneous Provisions (Amendment) Act, 2016'("**Amendment Act**"). Certain provisions of the Amendment Act were notified on September 1, 2016 [46]

C. Amendment Act

The Amendment Act has expanded the definition of FIs, including SEBI registered debenture trustees within the definition of FIs, encompassing the scope of SARFAESI to debenture holders. Further, more importantly, the Amendment Act removes the restriction on the maximum holding by a single sponsor in an ARC, paving the way for investors, including foreign buyout funds or special situation groups of large funds to hold 100% in an ARC.

IV. Joint lenders forum

For the reasons mentioned above, the CDR mechanism, was failing on its expectations considerably.

In a bid to ensure that accounts undergoing stress were identified prior to these accounts becoming non-performing assets and appropriate actions taken in advance, the RBI introduced the joint lenders' forum ("**JLF**") mechanism in early 2014.

The JLF mechanism recognized the concepts of special mentioned accounts ("**SMA**"), and characterized all accounts as SMA-0, SMA-1 and SMA-2 depending on the time period for which amounts were outstanding under the accounts.[47]

A JLF is required to be formed as soon as an account was categorized SMA-2, and the aggregate exposure of the lenders is INR 1 billion. However, lenders have also been given the option to form a JLF in case (i) the aggregate exposure of the lenders is lesser than INR 1 billion; or (ii) the account is not categorized as an SMA-2. Additionally, the borrower may also request for the formation of a JLF, on account of imminent stress. If the aggregate exposure is INR 1 billion or above, the lenders shall immediately form the JLF.

For the purpose of the operation and functioning of the JLF, the lenders should execute a JLF agreement ("**JLFA**"). RBI has suggested a draft JLFA to be released by the Indian Banks' Association ("**IBA**").[48]

The RBI, through a subsequent circular,[49] has introduced the concept of a Joint Lenders Forum-Empowered Group ("**JLF-EG**") to facilitate approving rectification/ restructuring packages, and has also laid down the composition of the JLF-EG.[50]

For a brief overview of the JLF, please refer to Annexure B.

The objective of the JLF is to explore options to resolve the stress in the account of the borrower, which could be any of the following:

- Rectification: This step envisages commitment from the borrowers to ensure that the

44. The House of the People in the Parliament of India
45. 'The Enforcement of Security Interest and Recovery of Debts Laws and Miscellaneous Provisions (Amendment) Bill, 2016', text available at http://www.prsindia.org/administrator/uploads/media/Enforcement%20of%20Security/Enforcement%20of%20Security%20Bill,%202016.pdf
46. Sections 2, 3, 4 (except clause (xiii)), 5, 6, 8 to 18, 22 to 31, 33 to 44 have been notified vide S.O. No. 2831 (E) dated September 1, 2016

47. The categorization was as follows:
SMA-0: Where the principal or interest payment was not overdue for more than 30 days, but the account shows signs of incipient stress
SMA-1: Where the principal or interest payment was overdue between 31-60 days
SMA-2: Where the principal or interest payment was overdue between 61-90 days
48. IBA on April 29, 2014, vide circular No. C&I/CIR/2013-14/9307 released the format of the draft JLFA.
49. RBI Circular RBI/2015-16/182 dated September 24, 2015
50. The JLF-EG shall comprise of (i) representatives of SBI and ICICI as standing members; (ii) representatives of the top three lenders (excluding SBI and ICICI, if they are lenders), (iii) representative of two banks (largest in terms of advances) not having any exposure to the borrower.

account is regularized, and does not become an NPA. The measures may include additional funding, by the promoters themself, or by the existing lenders, or through any third party, in a manner agreeable to the borrower. Rectification of accounts does not involve any sacrifice by the lenders.

- Restructuring: In a case where the JLF intends to restructure the account, they shall proceed to execute an ICA and a DCA, in the format provided for CDR. For any restructuring, extending promoters' personal guarantees may be resorted to. The borrower is generally restricted from selling any of its assets, without the consent of the JLF.
- Recovery: In case the above options are not feasible, the JLF may resort to recovery, in accordance with the process considered optimal by the JLF.

For the purpose of the restructuring, a resolution of 75% (in value) and 60% (in number) of the creditors must agree. In case of a restructuring, the JLF may proceed to restructure an account under the CDR mechanism, or independently.

As per the RBI, one of the main principles underlying restructuring is that the first loss should be borne by the shareholders, as opposed to the lenders. In light of the same, the JLF is permitted to consider options including (i) transferring the shares of the company held by the promoters; (ii) promoters infusing further equity into the company; and (iii) transferring promoters' shareholding in the company to a security trustee/ escrow account to ensure change in management control, should the lenders favor such a change.

V. Strategic Debt Restructuring

In furtherance of the option to lenders to change the management of the borrowing company, the RBI in June 2015 issued a circular formalizing the mechanism to change the shareholding of the company.[51]

Under the abovementioned circular, RBI introduced the strategic debt restructuring scheme ("**SDR**"). In cases where the restructuring was not successful, whereby companies were unable to come out of stress due to operational/ managerial inefficiencies, change of ownership would be the preferred option. In such cases, lenders (representing at least 75% of the creditors by value, and 60% in number) are permitted to invoke SDR and convert whole or part of their loans into equity shares of the borrower company. While banks exercising the SDR option were exempted from certain regulations[52] issued by the securities market regulator, i.e. the Securities and Exchange Board of India ("**SEBI**"), invocation of this option was subject to certain conditions:

- Breach of borrower: SDR can be invoked by lenders, if the borrower company was unable to meet viability milestones and/ or comply with certain 'critical conditions', as stipulated in the restructuring package.
- The lenders collectively, must hold the majority of the equity shares (i.e. 51%) of the company.
- The lenders shall ensure that they divest the shares of the company to any person 'as soon as possible'. The RBI has clarified, through a subsequent circular[53] that the asset classification benefit[54] would be available to banks only if they divest at least 26% of the shares

51. RBI Circular RBI/2014-15/627 dated June 8, 2015
52. Under SEBI (Issue of Capital and Disclosure Requirements) (Second Amendment) Regulations, 2015 dated May 5, 2015, SEBI has waived the applicability of Chapter VII of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (*Preferential Issue*) for banks invoking SDR; Further, SEBI (Substantial Acquisition of Shares and Takeovers) (Second Amendment) Regulations, 2015 dated May 5, 2015 also exempted lenders from the requirement to make an open offer in case of the invocation of the SDR.
53. RBI Circular RBI/2015-16/330 dated February 25, 2016
54. On completion of the conversion of debt into equity shares, the classification of the account as on the reference date shall continue for a period of 18 months, post which the asset classifications shall be as per extant RBI norms. Upon the transfer of the equity shares, the account can be categorised as 'standard'.

of the borrower company within 18 months from the date of the invocation of the SDR, and the incoming shareholder takes control of the company. For subsequent divestments, which may be undertaken by the banks over a period of time, the new shareholder (who acquired 26%) shall have the right of first refusal.

- The incoming shareholder[55] shall hold a minimum of 51% shares of the company, provided, if the exchange control regulations restrict such shareholding, the new share-holder shall hold up to the extent permitted by the exchange control regulations. The underlying principal for this divestment is that the incoming shareholder must acquire control over the borrower company.
- In no case should the current management of the company be permitted to continue, with-out the lenders' representatives on the board of the company, or without any supervision of the banks. Further, the banks are required to form a panel of experts with sufficient exper-tise for the management of companies till the shares are transferred to a new shareholder.
- The price of the shares for the conversion shall be the 'fair value' of the shares, which shall not exceed the lower of (i) the aver-age price of shares on a recognised stock exchange for the 10 days immediately prior to the date on which the JLF decides to under-take SDR; and (ii) book value of the shares calculated as per the latest audited balance sheet, adjusted for cash flows post the earlier restructuring; (iii) in case, where the latest audited balance sheet is not available.

Lenders have already decided to invoke SDR in a number of cases, being 21 as of August 2016, among which are:

- Jyoti Structures Limited (August 2015) ;[56]
- GMR Rajahmundry Energy (May 2016) [57]
- Jaiprakash Power Ventures (July 2016)[58]

However, from the cases where SDR has been invoked, the banks have managed to convert their debt into equity in only a few cases:

- Gammon India Limited (December 2015) ;[59]
- IVRCL Infrastructure Ltd (March 2016) ;[60]
- Electrosteel Steels Limited (January 2016).

VI. Change of ownership of borrowing entities outside SDR

In order to further empower banks with respect to restructuring stressed companies, the RBI introduced the norms on change of ownership of borrowing entities outside the SDR.[61] Under the said circular, RBI permitted lenders to facilitate change in the ownership of borrowing entities outside the SDR through (i) invocation of pledge of shares of the borrowing company and subsequent sale of securities by lenders to a new promoter; (ii) conversion of loans extended by the lenders into equity shares of the borrowing company and subsequent sale of securities by lenders to a new promoter; (iii) requiring the borrowing company to issue fresh shares to a new promoter; or (iv) acquisition of the borrowing entity by another entity.

55. The proposed purchaser of the shares from the banks should not be a person related to the (existing) promoter group. Banks are required to take necessary diligence to comply with this condition.

56. http://www.livemint.com/Companies/SHPJkCo9OPh-JKEzYOSrsrO/SBI-pushing-for-Jyoti-Structures-takeover-by-Dubais-Amin-Gr.html

57. http://www.business-standard.com/article/companies/gmr-infra-announces-sdr-of-gmr-rajahmundry-energy-116051301163_1.html

58. http://www.business-standard.com/article/finance/jaiprakash-power-banks-invoke-sdr-116072700055_1.html

59. http://www.livemint.com/Companies/WzCYSemCs5Kx5a-DjswFzyH/Gammon-India-lenders-invoke-SDR-to-convert-Rs245-crore-debt.html

60. http://www.business-standard.com/article/companies/lenders-to-acquire-additional-stake-in-ivrcl-at-rs-8-7-per-share-116022400729_1.html

61. Prudential Norms on Change in Ownership of Borrowing Entities (Outside Strategic Debt Restructuring Scheme), Circular No. RBI/2015-16/187

Similar to the case in SDR, the incoming shareholder[62] shall hold a minimum of 51% shares of the company, provided, if the exchange control regulations restrict such shareholding, the new shareholder shall hold up to the extent permitted by the exchange control regulations. The underlying principal for this divestment is that the incoming shareholder must acquire control over the borrower company. On the change in the ownership, the account of the borrower can be classified as 'standard'. However, for change in promoter, no exemptions have been provided where the change is outside SDR.

Need for change: The 18 month period provided under SDR was proving to be too little.[63] In fact, the country's largest bank, the State Bank of India decided to invoke SDR only where there was sufficient clarity on the buyer.[64] This results in substantial issues. Diligence was difficult in cases where the banks were not already holding a majority stake, thereby resulting in valuation issues. Additionally, valuation mismatches between banks and potential buyers were resulting in situations where banks are finding it difficult to offload their shares in companies.[65]
In a bid to overcome this issue, the RBI introduced the S4A scheme in June, 2016.

VII. Scheme for Sustainable Structuring of Stressed Assets

In a recent circular,[66] the RBI introduced the Scheme for Sustainable Structuring of Stressed Assets, or the S4A scheme. Acknowledging the shortcomings of the SDR, the RBI, through the S4A scheme dilutes the SDR to some extent. S4A are applicable to large accounts (being accounts of an amount in excess of INR 5 billion) which have commenced commercial operations and have their debt at sustainable levels.

The lenders are required to determine the quantum of the debt currently owed by the borrower which can be met by the cash flows of the borrower, which shall be done by way of a techno-economic viability through credible professional entities. The remaining portion of the debt can be converted into equity by the banks, provided such conversion is approved by a majority of the lenders, (representing at least 75% of the creditors by value, and 50% in number). The S4A, importantly, does not require any moratorium or extension of time period on the part of the lenders to the borrower, since the lenders are required to determine the portion of debt which can be serviced from the current cash flows and convert only the remainder.

62. The proposed purchaser of the shares from the banks should not be a person related to the (existing) promoter group. Banks are required to take necessary diligence to comply with this condition.

63. See http://www.livemint.com/Opinion/otjjJ3EIJsuA-K52VFJyoZO/S4A-wont-solve-the-bad-loans-problem.html and http://www.livemint.com/Industry/ph1OegkEV72oxn-1FjNXp3H/SBI-decides-to-go-slow-on-using-SDR.html

64. http://www.livemint.com/Industry/ph1OegkEV72oxn-1FjNXp3H/SBI-decides-to-go-slow-on-using-SDR.html

65. See http://www.livemint.com/Companies/3aY7J93S6jZV6Bc-73jx2WM/Bankers-face-hurdle-in-finding-foreign-buyers-for-SDR-assets.html

66. See RBI Circular No. RBI/2015-16/422 dated June 13, 2016

3. Investment into Indian stressed assets

The rapidly changing regulatory scenario with respect to stressed assets has opened up a large number of avenues for investment, especially for foreign investors. In this chapter, these avenues are discussed.

I. Direct equity investment into stressed companies

Direct equity investment into stressed companies can be either by way of subscription to fresh capital into the company, or by way of acquisition of existing shares by the foreign investor from the promoter or other existing shareholders.

Fresh infusion: Fresh infusion involves subscription by the foreign investor to freshly issued shares of the company, resulting in infusion of fresh capital into the company. This could be by way of investment into equity, CCPS, CCDs under the FDI route, equity shares (if the shares are listed) under the FPI route, or debt/ equity or hybrid instruments under the FVCI route.

Secondary acquisition: Secondary acquisition, as the name suggests, is the acquisition by the foreign investor of existing shares from the existing shareholders, which may include the promoter. Secondary acquisitions may be structured in a manner similar to the means available under the fresh infusion route mentioned above.

II. Considerations for direct investment

- Valuation: The investee company in such cases would generally be under stress and the assets may be undervalued.
- Security: Since the company is likely to be highly leveraged, most of the assets (fixed and otherwise) would be charged with the lenders. Additionally, the shares of the company would also be pledged with the lenders. Accordingly, the possibility of receiving any security for the said investment would be remote.
- Preferred returns / liquidation preference: As mentioned above, the company is likely to be highly leveraged and the lenders would generally have escrow arrangements which would provide the lenders the first right on the cash flows of the company in any situation. Accordingly, it is unlikely that the investor, who would probably require a much higher rate of return (compared to banks), would be given a priority on payments.
- Change in management: The infusion of fresh capital is generally also accompanied by changes to the management of the company, which the investor facilitates to turn around the operations of the company. In addition, the investor may also require substantial rights on the board of the company to oversee the performance and ensure that the operations of the company are conducted in the best possible manner to encourage a revival.
- Exit rights: While most of the generally available exit rights[67] may be negotiated and documented, the feasibility of these rights need to be evaluated. These exit rights may work akin to a normal non-distressed situation, where the company is revived, and the lenders are paid. However, the situation may be quite different in cases where the company does not revive, and is required to be wound up/ liquidated.
- Listed companies: In cases where the company is a listed entity, the following would need to be evaluated:
  - Open offer: If the investor is acquiring a substantial stake, i.e. 25% or above, an open offer would need to be made, in accordance with the provisions of the Takeover Code, by the foreign investor to acquire at least 26% of the shares of the company from the public. It is pertinent

67. Such as drag along right, causing an IPO, strategic sale, etc.

to note that an exemption from making an open offer is only provided in case of SDR, and not when the investment is outside the SDR.

- *Lock-in*: In case of issuance of shares by way of a preferential allotment,[68] the investor is locked-in for a period of 1 year from the date of the allotment of the shares. This may be crucial for investors looking for a quick exit from the company. This restriction, as mentioned above, does not apply to investments by FVCI.
- *Insider trading*: Under the SEBI (Prohibition of Insider Trading) Regulations, 2015 (“**Insider Trading Regulations**”), an insider[69] is not permitted to trade in securities that are listed, when in possession of unpublished price sensitive information, or UPSI.[70] Accordingly, any foreign investor needs to be sure that it does not trade or acquire securities when it is in possession of any UPSI. There is no specific exhaustive definition of UPSI and whether an information tantamount to UPSI or not depends on case to case.

68. In a preferential allotment, shares are issued to a certain entity, as opposed to the rights issue process, where the fresh shares are offered to all existing shareholders to invest in proportion to their existing shareholding in the company.

69. ‘Insider’ means any person who, inter alia, is in possession of or has access to UPSI. Accordingly, any person, who may or may not be connected to the company intricately would also fall under the scope of an ‘insider’ if such person is in possession of UPSI

70. ‘UPSI’ is defined to mean any information which (i) is related to the company or its securities, directly or indirectly; (ii) is generally not available; and (iii) upon becoming available generally, is likely to materially affect the price of the securities. Any information which can be accessed by the public on a non-discriminatory basis is considered to be generally available information. There is no specific exhaustive definition of UPSI and whether an information tantamount to UPSI or not depends on case to case, and needs to be analyzed in light of the facts of the case in hand. The Insider Trading Regulations provide an illustrative list of certain items which may constitute UPSI, namely (i) financial results; (ii) dividends; (iii) change in capital structure; (iv) mergers, de-mergers, acquisitions, delistings, disposals and expansion of business and such other transactions; (v) changes in key managerial personnel; and (vi) material events in accordance with the listing agreement.

II. Debt investments into stressed companies

Investments may be made by foreign investors into stressed companies by way of debt infusion as well. Debt investment may be undertaken under the ECB route, by subscription to listed/ unlisted non-convertible debentures under the FPI route, debt investment under the FVCI route,

A. Considerations for investment through the debt route

- Security: While security may be created under the FPI and ECB routes, the possibility of creation of security may be a challenge, considering the assets would be secured, as discussed above in the case of equity investments, as mentioned in the previous section. However, considering that the company may be in dire need of funds, and the funding by the investor may be looked at as one of the most viable options for the lenders (without a hair-cut on their extended loans), lenders have, in certain cases agreed to provide the incoming investor a pari passu first charge on the assets of the company.
- Change in management rights as provided in case of equity investments apply here as well.
- Exit rights: In situations where lenders do not agree to cede first charge or pari passu first charge, exit for the incoming investors becomes a major challenge. If the company fails to revive, in the lack of security or a pari passu / subordinate charge, the feasibility of returns may not be high.
- Interest / coupon: The existing lenders would have the first right on the cash flows generated, and it is unlikely that they would permit the investor to have first right to substantially high rates of interest.
- Listed company: Considering that debt investments are generally made through subscription to debt instruments, the Takeover Code or the Insider Trading do not apply in these cases. If the debt instruments are listed, the

provisions of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("LODR") would apply, and the provisions contained in the LODR with respect to disclosure would need to be complied with.

However, if the debt investor is in possession of any UPSI of the borrower, it must ensure it does not deal with any listed equity shares of the borrower.[71]

III. Combination of debt and equity investments

Investors may also implore the possibility of a combination of equity investments and debt investments. The conditions applicable depend on the mode of investment as discussed above. The pertinent points to consider for a mix of debt-equity investments are provided below:

- Rationale: The most usual rationale for this approach is combining the benefits of both forms of investment. For example, the equity investment provides more control over the operations under law, since law entitles equity shareholders certain rights which are not afforded to lenders. On the other hand, debt investments may provide for security and prior payments in case of liquidation over the shareholders.
- Returns: One important factor to be considered is that the pricing guidelines do not apply to debt instruments. As such the returns should be structured in a manner that the investor could take the returns on equity, to the extent permitted, and the balance on the debt instrument.
- Tax structuring: Combination of equity and debt provides investors with enough leeway to structure returns in a tax optimized manner, both for the investor as well as for the company. For example in cases, where a minimum return is assured to the investor (with such return not being substantial), in addition to the upside on the equity valuation, the minimum return could be paid as interest on the debt instrument, with the upside being a component of the sale/ buy-back of the equity investment.

IV. Investment through the ARC route

Another mode of investment which has opened up in, and been liberalized in the recent past is investment through the ARC route. This mode of investment is a lucrative option since it gives the investor protection under SARFAESI, which is currently not available under any of the other means.

Investment through ARCs can be either (i) by way of investment into an ARC; or (ii) through acquisition of SRs issued by a scheme of the ARC.

A. Investment by way of subscription to SRs

In this mode of investment, the ARC acquires financial assets from banks, and then securitizes the loan portfolio. Subsequently, the SRs are issued to investors, including an FPI. As mentioned above, the RBI mandates that the ARC itself holds at least 15% of the SRs issued by each of its scheme to ensure sufficient 'skin in the game'.

While foreign investment in SRs were permitted up to a maximum of 74% for each scheme of the ARC, the same has been revised recently in May 2016, to increase this to 100%.[72] Accordingly, a foreign investor can now acquire up to 85% of the SRs (since 15% needs to be held by the ARC itself). Since the relaxation permitting FPIs to acquire up to 100% of SRs of each scheme of an ARC is relatively new, the modus operandi for such investments earlier was to have a co-in-

71. A company may have only its NCDs listed, and hence a situation where the NCDs are listed, while the equity shares are not is quite common.

72. Press Note No. 4 of 2016 dated May 6, 2016

vestment model, where the FPI acquired 74%, the ARC acquired 15% and a resident investor acquired the balance 11%. In most cases, the 11% was acquired by entities related to or connected to the FPI acquiring 74%.

Some of the considerations for investment under this option are as follows:

- Enforcement: The major challenge here is that the investor does not have any control over the ARC, and hence the enforcement is not driven by the investor, but by the sponsor of the ARC.
- Classes or schemes of units: ARCs have at times issued separate classes/ tranches of units for a single scheme. The units are differentiated in terms of the distribution waterfall, i.e. one class of units have a preference over the other classes. Accordingly, foreign investment can be structured such that they have a priority over other classes (see below).
- Capital shortfall: As mentioned earlier, one of the major reasons why ARCs had not been successful was the lack of capital to acquire financial assets from banks. Most of these acquisitions were by way of issuance of SRs. More than 90% of the acquisition of NPAs by ARCs have been by way of issuance of SRs.[73] In light of this, the possibility of issuing SRs to foreign investors with a preferential right on the cash flows may be a win-win for everyone.

However, recently, RBI notified higher provisioning norms, if the selling bank, or 'originator' is paid in SRs beyond 50% of the consideration, reduced to 10% from April 1, 2018.[74]

B. Investment in capital of an ARC

This mode of investment involves setting up of a new ARC or investing in or acquisition of an existing ARC by a foreign investor. With the recent relaxation of foreign investment rules in ARCs, this mode of investment is seeing excessive interest by investors currently, especially since this would mean that the enforcement process is within the control of the concerned investor, as compared to the situation in case of an investment through SRs.[75]

While acquisition of an ARC may be less cumbersome, considering that ARCs are highly regulated, and there are a limited number of ARCs operational today (14), it may not be plausible to find an ARC for acquisition.

As mentioned above, the regulatory framework, till the passage of the Amendment Act did not allow any single sponsor to take control of an ARC, nor did it permit to hold more than 50% of the equity shares of the ARC. However, post the passing of the Amendment Act, the restriction on a single sponsor to hold more than 50% equity shares or to solely control the ARC has been done away with.

i. Current scenario

It would be pertinent to note that currently Assets Care & Reconstruction Enterprise Ltd ("**ACRE**") is an ARC which has 49% foreign investment,[76] with SSG Capital Management Pte. Ltd. of Singapore holding the entire stake.[77] With this 49% shareholding, SSG is the largest shareholder is ACRE, with the remainder of the shareholding being fragmented between various financial institutions.[78]

A closer look at the shareholding patterns of some of the other registered ARCs show that the holdings of the sponsors in a number of cases is 49%, which seems to be the case due to the

73. http://www.livemint.com/Industry/HeofqWN4JlpBoZLuQT-1fkO/Bad-loans-ARCs-and-asset-reconstruction.html

74. RBI/ 2016-17/56, Guidelines on Sale of Stressed Assets by Banks

75. As per news reports, JC Flowers & Co along with Ambit Holdings, IIFL Holdings Limited, Eight Capital Management LLC have either applied for ARC license or are in the process of filing these applications.

76. http://acreindia.co/about-us/shareholders

77. See http://www.business-standard.com/article/pti-stories/acre-sells-49-stake-to-ssg-capital-management-of-singapore-114091200571_1.html

78. IFCI (19.5%), Punjab National Bank (15%), Tourism Finance Corporation of India (5.5%), Bank of Baroda (5.3%), etc. See http://acreindia.co/about-us/shareholders

regulatory restriction.[79] Also, as a result of the regulatory restrictions, the shareholding pattern across ARCs is diversified, with a number of financial institutions owning stakes in ARCs.[80]

In addition, a few investors already seemed to have filed for registration of ARCs. JC Flowers & Co. and Ambit Holdings Private Limited have formed a joint venture to form an ARC, with each of them owning 47.5% in the proposed ARC.[81] IIFL Holdings Limited, in partnership with Fortune Financial Services and Piramal Enterprises, in partnership with Brescon Advisors have also have applied for an ARC license.[82] Please note that while these applications were made prior to the relaxation of foreign investment into ARCs thereby limiting the extent of foreign participation in the ventures, the maximum shareholding requirements under SARFAESI may have restricted increase in the extent of foreign participation in these ventures.

Some of the considerations for investment under this option are as follows:

- **Enforcement:** The biggest benefit is that the investor has certain degree of control over the ARC, and consequently, the enforcement process.
- **RBI approval:** For setting up a new ARC, an application needs to be made to the RBI in the prescribed format.[83] RBI is the authority which permits the setting up of an ARC, and accordingly, the approval of the RBI, in the form of a certificate for registration, is required for setting up an ARC. In case the investor decides to make an investment into an existing ARC, or acquire an ARC, it would require the approval of the RBI as per SARFAESI.[84]

C. Combination of setting up / acquisition / investment into an ARC and acquisition of SRs issued by a scheme of the ARC

A dual approach, whereby an investor sets up or acquires an ARC, or invests in an existing ARC; and simultaneously invests in the SRs through their FPIs offshore may be also be an option to be considered.

The relevant conditionalities for each of the options mentioned above would continue to apply. Some of the characteristics of this option would be as follows:

- **Limited investment upfront:** The investor would have the option of infusing limited amount of funds into the ARC, i.e. to the extent of 15% of the price of the financial assets to be acquired. This would reduce the upfront load on the investor as well.
- **Reduced stake and control:** The limited investment would result in the foreign investor acquiring only a small stake of the ARC, as opposed to a substantial controlling stake.

79. Kotak Mahindra Prime Limited and Kotak Mahindra Investments Limited in Pheonix ARC Private Limited, Reliance Capital Limited in Reliance Asset Reconstruction Company Limited, SSG Capital in ACRE.

80. Punjab National Bank, UCO Bank and Andhra Bank in Pridhvi Asset Reconstruction and Securitisation Company Limited; Central Bank of India, Bank of Maharashtra, Punjab National Bank, Union Bank of India, Bank of India in UV Asset Reconstruction Company Limited; Union Bank of India, Bank of Baroda, Punjab National Bank, Punjab and Sind Bank, Bank of Maharashtra, Syndicate Bank, Corporation Bank, etc. in India SME Asset Reconstruction Company Limited; HDFC Bank Limited, Tata Capital Financial Services Limited, ICICI Bank, etc. in International Asset Reconstruction and Company Private Limited; Allahabad Bank, Bank of India, Andhra Bank, Indian Bank, Life Insurance Corporation of India, etc. in ASREC (India) Limited

81. See http://www.vccircle.com/news/alternative-investment/2016/03/11/pe-firm-jc-flowers-float-jv-ambit-holdings-distressed-assets

82. See http://www.financialexpress.com/article/industry/companies/worlds-largest-publicly-traded-retail-debt-buyer-eyes-arc-in-india/265060/

83. RBI Notification No.DNBS.1/CGM(CSM)-2003 dated March 7, 2003. Details of the requirements for setting up of an ARC are provided in Annexure X.

84. Section 3(6) of SARFAESI reads:
Every securitisation company or reconstruction company, shall obtain prior approval of the Reserve Bank for any substantial change in its management or change of location of its registered office or change in its name:
Provided that the decision of the Reserve Bank, whether the change in management of a securitisation company or a reconstruction company is a substantial change in its management or not, shall be final.
Explanation--For the purposes of this section, the expression "substantial change in management" means the change in the management by way of transfer of shares or amalgamation or transfer of the business of the company.

The investment is made primarily to ensure that they have sufficient clarity and control over the ARC to ensure that the enforcement process is undertaken as agreed, and there is no reluctance on the part of the ARC to enforce its security for reasons extraneous to business decisions.

- **Investor base:** The FPI investing into the SRs could be set up as a pooling vehicle, which may also raise funds from other investors, thereby catering to a larger investor base, with sufficient control over enforcement. The FPI could also cater to separate asset classes by issuing instruments to each of the investors at the offshore level instruments linked to the units of different trusts/ schemes, which could be sector/ asset class specific.

4. Conclusion

Ironically, the increasing quantum of bad debts in the books of the banks are leading to increasing opportunities for investment into distressed assets. The recent splurge in bad debts, has fortunately, been matched by constant relaxation of restrictions on foreign investment into distressed assets as well, providing more and more comfort to foreign investors. The recent relaxation of norms for investment through ARCs, the amendment of the Arbitration and Conciliation Act, 1996 to bring it in line with international standards, and the passing of the Insolvency and Bankruptcy Code, 2016 is expected to mushroom foreign investment into special situations assets in India.

Annexure A

Corporate Debt Restructuring mechanism

The CDR Mechanism is a voluntary non-statutory system based on DCA and ICA. The CDR Mechanism covers multiple banking accounts, syndication/consortium accounts, where all banks and institutions together have an outstanding aggregate exposure of Rs.100 million and above.

CDR Administrative Set-up:-

1.CDR Standing Forum

The CDR Standing Forum is a representative general body of all Financial Institutions and Banks participating in CDR system, which lays down the policies and guidelines to be followed by the CDR Empowered Group and the CDR Cell for Debt Restructuring.

2.CDR Empowered Group

The individual cases of corporate debt restructuring are decided by the CDR Empowered Group ("**CDR-EG**"). The EG in respect of individual cases comprises of Executive Director ("**ED**") level representatives of Industrial Development Bank of India Ltd., ICICI Bank Ltd., State Bank of India as standing members, in addition to ED level representatives of FIs and banks which have an exposure to the concerned company.

3.CDR Cell

All references for corporate debt restructuring by lenders/borrowers are made to the CDR Cell. It is the responsibility of the lead institution/major stakeholder to the corporate to work out a preliminary restructuring plan in consultation with other stakeholders and submit to CDR Cell.

Eligibility for CDR:-

The CDR Scheme does not apply when there is only one bank/ financial institution.
The CDR Mechanism only covers multiple banking accounts/ syndication/ consortium accounts with exposure of INR 20 crores and above by banks/ institutions.

There is no requirement for the Company/ Account being sick, NPA or being in default before bringing the reference to the CDR. Prescribing a threshold might not be necessary since the CDR process is triggered by the banks/ financial institutions themselves.

Steps in CDR Process:-

1. Inter-Creditor Agreement: the Inter-Creditor Agreement is an agreement that has been entered into between all banks/ financial institutions that are a part of the CDR Mechanism. This Agreement is valid for 3 years. Subsequent to this, an amended ICA is entered into, or the tenure of the ICA can be extended to 3 years.

   Under the ICA, a Lender has the option of opting out of the CDR Process. It might either be bought out by any other existing/ new lender. In the alternative, he will have to agree to a deferment of the first year's interest due to him after the CDR Process becomes effective.

2. Reference to the CDR Cell: Any person entitled to make a reference to the CDR Cell shall make a reference to the CDR Cell. Such reference shall be accompanied by a Preliminary Restructuring Scheme.

Person entitled to make a reference include:

a. one or more creditors who have minimum 20% share in either working capital or term finance;

b. by the concerned company, with the support of one or more creditors having minimum 20% share in either working capital or term finance

3. Debtor-Creditor Agreement: For the purposes of the ICA to be applicable in each case, the entering into a DCA between the Company and the Lenders is a Condition Precedent. Only on the entering of the DCA, is the ICA applicable with respect to the Company. The DCA must be submitted to the CDR Cell before the CDR EG examines the Scheme. (The DCA's provisions are detailed later)

4. Referral to CDR-EG: The CDR Cell shall, after receipt of the Preliminary Restructuring Scheme, prepare a Restructuring Scheme in terms of the general policies and guidelines approved by the CDR Standing Forum and submit the same to the CDR Empowered Group for taking a view on the *prima facie* feasibility of the said scheme within 90 days from the date of receipt of Reference. The CDR-EG can extend the period for another 90 days, if there are reasons for the same.

5. If considered not feasible, the Lenders may initiate recovery process under various options open to them.

   If considered feasible, the CDR Cell prepares a Detailed Rehabilitation Plan with the help of the Lenders and/or External Experts.

DCA

The DCA is an agreement between the Company and the Lenders. The authority for entering into a DCA is generally by a Board Resolution, which is acting within its powers to authorize such restructuring.

A format of the DCA has been provided, and it is hardly ever the case that the actual DCA is very different from the Format provided. Some of the important clauses of the Format of the DCA are:-

Stand Still Clause: For a period of 90 days (or 180 days), the parties to the DCA agree that no civil action will be taken by both sides. In the absence of such stand still provision, the CDR process might be regularly interrupted by judicial authorities.

During the consideration, preparation or implementation of the Restructuring Scheme, the Company shall not do the following without the prior approval of the CDR-EG:

a. create or assume additional indebtedness;

b. make any investments or incur any expenses or divert the funds except in the ordinary course of its business;

c. divert the funds for purposes other than its own business;

d. transfer, alienate or dispose of any assets (tangible or intangible) outside the ordinary course of its business;

e. guarantee any other person's obligations;

f. effect material change in its management set up or the composition of its Board of Directors;

g. effect any change in its capital structure including the shareholding pattern of its promoters;

h. suffer or initiate any proceedings for the winding-up or reorganization of its affairs;

i. create any additional charge, mortgage or any other security interests in respect of its properties and other assets (including but not limited to any balance in bank accounts or receivables) save and except pursuant to its existing obligations in respect of any of its existing Financial Assistance;

j. make any preferential payments including any debt repayments to creditors, save and except the repayment of the Financial Assistance as per the terms thereof;

k. enter into any foreign exchange, swap, or derivative transactions except in the ordinary course of its business to cover existing commercial exposures;

l. engage in any activity, directly or indirectly, other than its existing business activities;

m. make any payments to shareholders, whether in the form of dividends, redemption of equity, repayment of subordinated loans or otherwise; or

n. amend or modify its Memorandum of Association or Articles of Association.

The debtors may accede to the DCA either at the time of the original loan documentation, or at the time of making the referral.

Features of the Restructuring Schemes:-

Under the restructuring scheme, it is commonly noticed that the Lenders convert a portion of their debt into the shares of the borrowing company.

The Company generally requires some additional finance to run its operations. The existing lenders may agree to bring in this additional finance, or new lenders might be included in the CDR process for such additional financing. The Promoters of the Company are also required to bring in additional capital, and are generally subjected to lock-in provisions.

WCTL and FITL shall be secured by pari passu charge on the fixed assets. However, the Lenders who bring in additional finance shall be given priority over the lenders as per CDR policy on priority.

However, lenders having exclusive charge over any asset of the Company cannot be forced to share his assets with the other lenders.

For a CDR process to be binding on all lenders, a minimum of 60% (in number) and 75% (in value) of lenders must agree to the CDR Plan. If the threshold is met, the CDR Proposal is binding on all lenders.

Annexure B

Joint Lenders' Forum

1. Background

The RBI, in order to reduce the increasing NPAs on the books of the banks in India, introduced the JLF by way of circular dated February 26, 2014 ("**Feb Circular**").[85] The Feb Circular laid down the various categorization of accounts in stress, and the actions to be taken by banks in order to prevent such assets becoming NPAs and/ or ensuring these assets are no longer stressed.

2. Categorization

Under the Feb Circular, the accounts under stress are categorized in 3 (three) broad heads:

- SMA-0: Principal or interest payment not overdue for more than 30 days but account showing signs of incipient stress;
- SMA-1: Principal or interest payment overdue between 31-60 days;
- SMA-2: Principal or interest payment overdue between 61-90 days.

3. Joint Lenders' Forum

Under the Feb Circular, lenders are required to form a JLF in the following cases:

- Mandatorily in cases where the account is characterized as SMA-2 if the aggregate exposure (fund based and non-fund based together) ("**AE**") is above INR 1,000 million;
- Optionally in cases even when the AE is less than INR 1,000 million and/ or the account is not characterized as SMA-2;
- Mandatorily in cases where the borrower requests the lenders (with substantial grounds) to form a JLF, where the AE is INR 1,000 million or above.

The convener of the JLF shall be (i) in case of existing consortium agreement between the lenders, the consortium leader; (ii) in case of multiple consortiums, the lender with the maximum AE, and (iii) in case of multiple banking arrangements, the lender with the maximum AE.

The lenders are required to enter into a JLF Agreement (which shall be based on the Master JLF Agreement issued by the IBA.

The options available to the lenders for a corrective action plan ("**CAP**") are as follows:

- Rectification: This involves ensuring the account comes out of the SMA category or does not fall into the NPA category. This process does not require any sacrifice on the part of the lenders. Infusion of funds for acquisition of equity from the promoters of the company, or any third person may be considered. Additional financing from the lenders may also be an option.
- Restructuring: The lenders decide to restructure the accounts in this process if they consider it as a viable option. A DCA and an ICA, (similar to the CDR drafts) would be entered into between the lenders and the company and between the lenders respectively. A standstill clause could be included in the DCA to ensure smooth restructuring. The borrower under the standstill clause would agree not to approach any other forum or authority for any relief.
- Recovery: Due recovery may be resorted to by the lenders in case they are of the view the above options are not feasible.

All decisions in this regard would be taken by a majority of lenders representing 60% of creditors in number and 75% of creditors by value.

85. Available online at http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=8754&Mode=0

Such decision must be taken within 45 days[86] from the date of the account being classified as SMA-2 or from the date of receipt of the request from the borrower.

4. Restructuring

Under the Feb Circular, restructuring may be undertaken by the JLF itself, or by referral to the CDR Cell (“**CDR Cell**”).

i. Restructuring by the JLF

In case of a restructuring by the JLF itself, a detailed techno-economic viability (“**TEV**”) study shall be undertaken by the JLF and the package, if viable, shall be finalized within 30 days from the date of the signing of the CAP. The package so finalized would be approved by the JLF and conveyed to the borrower within 15 days for implementation. However, if the AE is equal to or more than INR 5,000 million, the package will have to be approved by an independent evaluation committee (“**IEC**”).[87] The IEC will be required to provide its comments within 45 days, and if on consideration of these comments, the JLF agrees to proceed with the restructuring, the same as approved by all lenders would be communicated to the borrower within 15 days.

ii. Restructuring by CDR

On the account being referred to it by the JLF, the CDR Cell should proceed with the TEV study directly and prepare the restructuring plan within 30 days from the date of the reference. The restructuring plan approved by the CDR Cell is submitted to the CDR- EG for its approval. Such decisions shall have to be decided by the CDR EG within 30 days. On approval by the CDR EG, the package should be communicated to the borrower within 30 days for implementation. However, if the AE is equal to or more than INR 5,000 million, the TEV Study and the restructuring package shall be evaluated by an IEC (after finalization by the CDR Cell), which shall communicate its comments within 45 days. If the JLF agrees with the comments of IEC, it shall communicate the same to the CDR Cell, which shall forward the same to CDR EG within 7 days from the receipt of views of the IEC. CDR EG shall approve/ reject the same within 30 days of receipt, and the lenders shall then communicate the same to the borrower within 30 days for implementation.

Under the restructuring, options include (i) possibility of transferring the equity from the promoters to the lenders; (ii) promoters infusing more equity into the borrower; or (iii) transfer promoter shareholding to a security trustee / escrow arrangement till turnaround. Suitable clauses to address differential security interest may also be included in the ICA.

For a listed company, the lenders may be issued equity shares to compensate them for the sacrifice made by them. The limits of banks’ exposure to capital markets have been waived for such purpose by RBI by the Feb Circular.

86. Extended from 30 days by circular dated October 21, 2014, available online at http://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=9291&Mode=0

87. The constituents of the IEC, as formed by the IBA are provided in IBA Circular No. C&I/ CIR/IEC/2014-15/214

About NDA

Nishith Desai Associates (NDA) is a research based international law firm with offices in Mumbai, Bangalore, Palo Alto (Silicon Valley), Singapore, New Delhi, Munich and New York. We provide strategic legal, regulatory, and tax advice coupled with industry expertise in an integrated manner.

As a firm of specialists, we work with select clients in select verticals. We focus on niche areas in which we provide high expertise, strategic value and are invariably involved in select, very complex, innovative transactions.

We specialize in Globalization, International Tax, Fund Formation, Corporate & M&A, Private Equity & Venture Capital, Intellectual Property, International Litigation and Dispute Resolution; Employment and HR, Intellectual Property, International Commercial Law and Private Client. Our industry expertise spans Automotive, Funds, Financial Services, IT and Telecom, Pharma and Healthcare, Media and Entertainment, Real Estate, Infrastructure and Education. Our key clientele comprise marquee Fortune 500 corporations.

Equally passionate about philanthropy, social sector and start ups, our role includes innovation and strategic advice in futuristic areas of law such as those relating to Bitcoins (block chain), Internet of Things (IOT), Privatization of Outer Space, Drones, Robotics, Virtual Reality, Med-Tech and Medical Devices and Nanotechnology.

Nishith Desai Associates is ranked the 'Most Innovative Asia Pacific Law Firm in 2016' by the *Financial Times - RSG Consulting Group* in its prestigious **FT Innovative Lawyers Asia-Pacific 2016** Awards. With a highest-ever total score in these awards, the firm also won Asia Pacific's best 'Innovation in Finance Law', and topped the rankings for the 'Business of Law'. While this recognition marks NDA's ingress as an innovator among the globe's best law firms, NDA has previously won the award for 'Most Innovative Indian Law Firm' for two consecutive years in 2014 and 2015, in these elite *Financial Times* Innovation rankings.

Our firm has received much acclaim for its achievements and prowess, through the years. Some include:

IDEX Legal Awards: In 2015, Nishith Desai Associates won the "M&A Deal of the year", "Best Dispute Management lawyer", "Best Use of Innovation and Technology in a law firm" and "Best Dispute Management Firm". IDEX Legal recognized Nishith Desai as the Managing Partner of the Year in 2014.

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Legal 500 has ranked us in tier 1 for Investment Funds, Tax and Technology-Media-Telecom (TMT) practices (2011, 2012, 2013, 2014).

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We believe strongly in constant knowledge expansion and have developed dynamic Knowledge Management ('KM') and Continuing Education ('CE') programs, conducted both in-house and for select invitees. KM and CE programs cover key events, global and national trends as they unfold and examine case studies, debate and analyze emerging legal, regulatory and tax issues, serving as an effective forum for cross pollination of ideas. Our trust-based, non-hierarchical, democratically managed organization that leverages research and knowledge to deliver premium services, high value, and a unique employer proposition has been developed into a global case study and published by John Wiley & Sons, USA in a feature titled 'Management by Trust in a Democratic Enterprise: A Law Firm Shapes Organizational Behavior to Create Competitive Advantage' in the September 2009 issue of Global Business and Organizational Excellence (GBOE).

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Research has offered us the way to create thought leadership in various areas of law and public policy. Through research, we discover new thinking, approaches, skills, reflections on jurisprudence, and ultimately deliver superior value to our clients.

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We regularly write extensive research papers and disseminate them through our website. Although we invest heavily in terms of associates' time and expenses in our research activities, we are happy to provide unlimited access to our research to our clients and the community for greater good.

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