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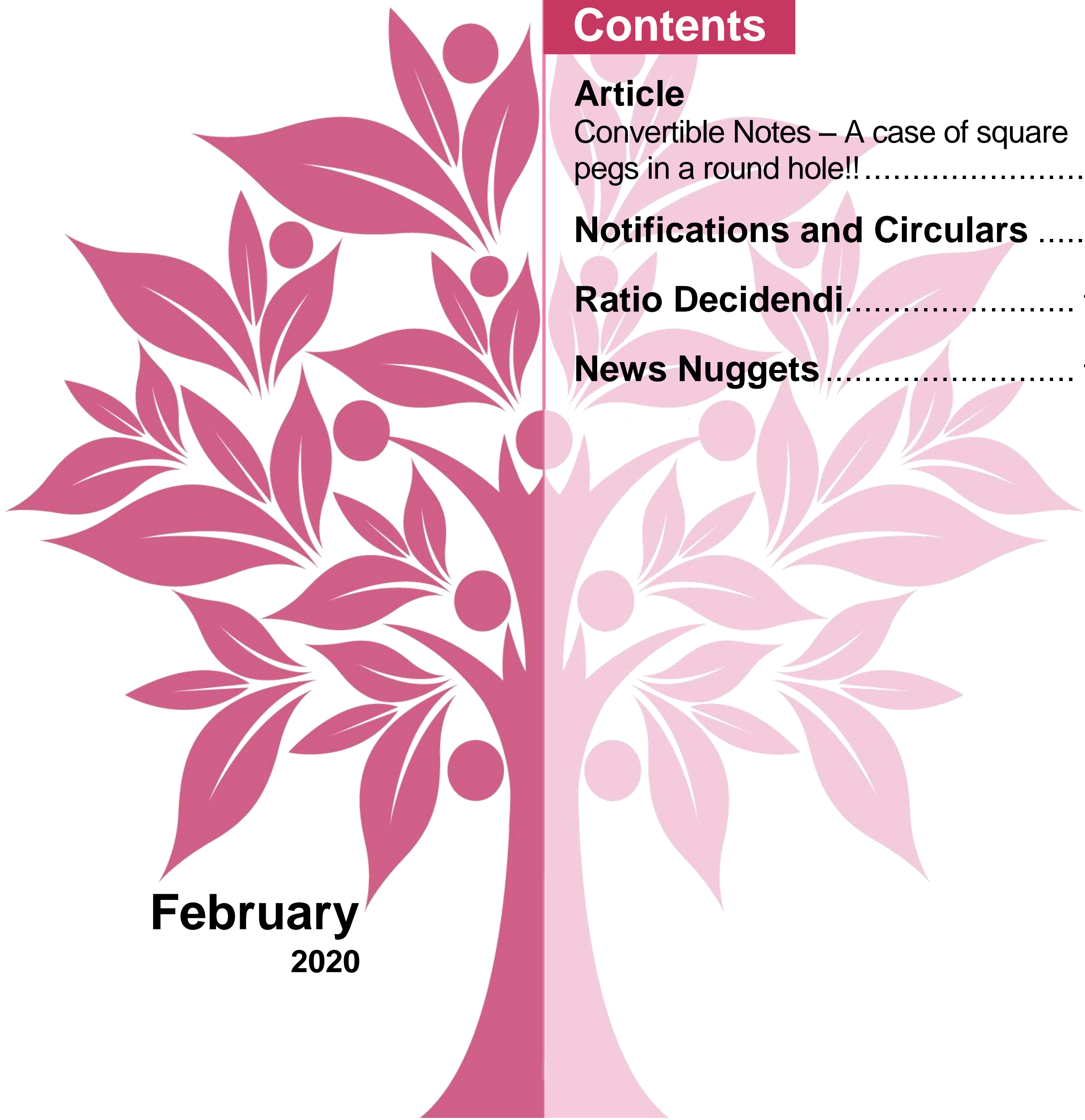
An e-newsletter from
Lakshmikumaran & Sridharan, India

February 2020 / Issue–101



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Article

Convertible Notes – A case of square pegs in a round hole!!

By **Rohit Subramanian**

Given the dynamic and volatile nature of India's start-up ecosystem, start-up(s) are always in the look-out for innovative and cost-effective fund-raising opportunities. To promote start-up(s), the government also upgrades regulatory norms and practices, in alignment with prevalent economic conditions and market dynamics. One of these initiatives is the introduction of "*convertible notes*" ("**C-Notes**") which was first introduced by the Ministry of Corporate Affair *vide* amendment to Companies (Acceptance of Deposits) Rules, 2014 ("**Deposit Rules**"), to exempt money received by a company through issuance of C-Notes from the definition of deposit. C-Notes have been defined as an instrument of debt, which can be converted to equity or redeemed at the option of the holder subject to the terms and conditions stated in the instrument and upon the happening of a specified event. In order to qualify for the said exemption, the issuance of C-Notes have to satisfy principal criteria(s) which are as stated below:

(i) The issuing entity has to be a private company incorporated under the Companies Act, 2013 or Companies Act, 1956 and recognized as such under notification dated 17.02.2016 ("**DIPP Notification**")[1] issued by Department of Industrial Policy and Promotion, Ministry of Commerce and Industry ("**DIPP**"); and

(ii) The amount against which C-Notes can be issued should be an amount equal to more than INR twenty-five lakhs (INR 25,00,000); and

(iii) The aforesaid amount should be received by the start-up in a single tranche.

Correspondingly, the Reserve Bank of India ("**RBI**") has defined "C-Notes"[2] as an instrument issued by a startup company, acknowledging receipt of money initially as debt, repayable at the option of the holder, or which is convertible into such number of equity shares of that company, within a period not exceeding five years from the date of issue of the convertible note, upon occurrence of specified events as per other terms and conditions agreed and indicated in the instrument.

In terms of the erstwhile Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017 ("**FEMA TISPRO Regulations**") and the recently notified Foreign Exchange Management (Non-debt Instruments) Rules, 2019 (**FEM NDI Rules**), a person resident outside India (*other than an individual who is citizen of Pakistan or Bangladesh or an entity which is registered/ incorporated in Pakistan or Bangladesh*), is permitted to purchase convertible notes issued by an Indian startup company, subject to the following conditions:

[1] Notification No. G.S.R. 180(E) dated February 17, 2016 has been superseded. Currently, Notification No G.S.R. 127(E) dated February 19, 2019 is in force.

[2] Rule 2(e) of Foreign Exchange Management (Non-debt Instruments) Rules, 2019.

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a.) The investment through C-Notes shall not exceed INR 25,00,000 (Twenty-Five Lakh rupees only);

b.) The start-up company shall be engaged in activities allowed under the Automatic Route and in the event, investment in the Company requires Government approval, C-Notes can be issued only after obtaining such approval.

c.) Mandatory compliance with entry route, sectoral caps, pricing guidelines and other attendant conditions for foreign investment.

d.) A non-resident can also transfer or acquire C-Notes by way of sale to a person resident in India or outside India subject to entry routes and pricing guidelines prescribed by RBI.

Basis the definition(s) and details stated hereinabove, it can be inferred that C-Notes are fashioned as debt instrument(s) until the holder exercises the option to convert the instrument into shares. If this inference is correct, C-note seems very similar to an optionally convertible debenture ("**OCD**"). Section 2(30) of the Companies Act provides an inclusive definition of a debenture to include debenture stock, bonds <u>or any other instrument of a company evidencing a debt,</u> whether constituting a charge on the company or not. On perusal of the aforesaid definition, one can argue that the definition of "*debentures*" as stated above is wide enough to include any instrument evidencing debt. As a result, C-Notes *may* be classified as a "*debenture*" for the purposes of the Companies Act.

A private limited company desirous of issuing OCD is required to follow the procedure prescribed under the Companies Act, 2013 (**Companies Act**), which *inter alia* includes the approval of shareholders by way of a special resolution and a debenture redemption reserve account to be created out of the profits of the company, for the purpose of paying dividends. Similarly, if C-Notes are treated as "debentures", then their issuance should mandatorily comply with Section 71 of the Companies Act read with Rule 18 of the Companies (Share Capital and Debentures) Rules, 2014.

Moreover, definition of "*securities*" prescribed under The Securities Contracts (Regulation) Act, 1956 ("**SCRA**") is broad enough to cover C-Notes as marketable securities equivalent to shares, scrips, stocks etc. Therefore, if C-Notes is to be classified as a "security", Section 42 of the Companies Act read with relevant rules, prescribes a rigorous issuance process which will have to be necessarily followed and shall include passing of a special resolution and valuation by registered valuer etc. Further, if money were to be invested in an Indian start-up entity from outside India, investment through C-Note(s) will be facilitated through the FDI route, subject to the provisions of the FEM NDI Rules. Whereas, investment through issuance of OCD(s), are presently treated as External Commercial Borrowing(s) ("**ECB**") and regulated by the provisions of the Foreign Exchange Management (Borrowing and Lending) Regulations, 2018.

It is relevant to note that an angel investor cannot be expected to invest huge capital in a business that is yet to be started, unless there is an assured return on his investment. Since, investing in a start-up is a high-risk investment, start-ups struggle to convince the investor on the commercial viability of their business venture which leads to disagreement on the valuation itself. While, there are no precedents in the Indian ecosystem, most western countries have a mature seed financing practice, wherein C-Notes are already a popular tool of investment. C-Note are preferred because in most jurisdictions, primarily because the issuance procedure does not involve valuation of the business and the

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option & timeline for "conversion" is pre-determined, which guarantees an assured return on investment. However, it must be noted that C-Notes does not entail incentives such as directorship and/or veto rights.

In the United States C-Notes are structured as a bridge financing tool, wherein valuation of the Company and subsequent conversion of the instrument is delayed until the company can secure its next round of funding. To maximize returns, a C-Note holder is sometimes granted the right to set a valuation cap on the equity shares acquired by the third-party investor(s) in the subsequent round of financing, when conversion is triggered. The investee company may also pre-determine and set a conversion rate in the C-Note instrument, irrespective of the value of the shares arrived at the time of conversion.

The regulatory landscape for start-ups in India is bound to be ever-evolving. Presently, investors are more inclined to adopt a traditional approach and opt for conventional equity/preference shares, which assures certainty in shareholding and board rights. However, if the regulatory issues discussed herein are addressed and the issuance procedure is further streamlined, C-Notes may yet prove to be a game changer in the start-up financing space

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Notifications and Circulars

Appointment and remuneration of managerial personnel - Companies (Appointment and Remuneration of Managerial Personnel) Rules amended: The Ministry of Corporate Affairs *vide* its notification dated 3rd January 2020, has notified the Companies (Appointment and Remuneration of Managerial Personnel) Amendment Rules, 2020 amending Rule 8A and Rule 9 of Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014 ('Managerial Rules'). As per the amended Rule 8A, every private company which has a paid-up share capital of ten crore rupees or more shall have a whole-time company secretary. The threshold of paid-up share capital has been increased from INR 5 Crores to INR 10 Crores. Further, in Rule 9, which for the purposes of Section 204(1) of the Companies Act, 2013 prescribes the class of companies which shall attach a secretarial audit report given by a practicing company secretary with the Board's report, a new class of company having outstanding loans or borrowings from banks or public financial institutions of INR 100 Crore or more, has been inserted. It is further clarified vide a newly inserted explanation, that the paid-up share capital, turnover, or outstanding loans/borrowings, as the case may be, existing on the last date of latest audited financial statement shall be taken into account. The new Rules will be applicable in respect of financial years commencing on or after 1st April, 2020.

Winding up - Companies (Winding Up) Rules, 2020 notified: The MCA *vide* its notification dated 24th January 2020 has notified the Winding up Rules which shall come into effect from 1st

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April 2020 and shall be applicable to all winding up proceedings under the provisions of the Companies Act, 2013. The Winding up Rules outlines the procedure of filing of the petition for winding up under Section 272(1) of the Companies Act, 2013 and statement of affairs with National Company Law Tribunal ("NCLT"). Further, it also prescribes procedure for the appointment of provisional/company liquidator by NCLT subsequent to the admission of the winding up petition and also prescribes the complete mode and method of winding up process resulting to the winding up of the company. The Winding up Rules in toto is divided into 6 parts and 191 rules. Further, the following class of companies can be wound up by making an application to the Central Government instead of NCLT under Section 361 of the Companies Act, 2013:

i) Company which has taken deposit and total outstanding deposits is not exceeding twenty five lakh rupees; or
ii) the company of which the total outstanding loan including secured loan does not exceed fifty lakh rupees; or
iii) the company of which turnover is upto fifty crore rupees; or
iv) the company of which paid up capital does not exceed one crore rupees.

Section 460 of Companies Act applicable to Limited Liability Partnerships: The MCA has directed that the provisions of Section 460 of the Companies Act, 2013, which provides for condonation of delay in case of non-filing of any application/document, which is required to be made to the Central Government under the provisions of the Companies Act within the time stipulated therein, be applicable to the limited liability partnerships incorporated under the provisions of the Limited Liability Partnership Act, 2008. Notification #G.S.R. 59(E), dated 30th January 2020 has been issued for the purpose.

Third-party assets in custody or possession of the financial service providers in insolvency/liquidation proceedings – Manner of dealing: The MCA vide its notification #S.O.464(E) dated 30th January 2020, has notified the manner of dealing with the third party assets in custody or possession of Financial Service Providers in liquidation/insolvency proceedings. As per Rule 10(2) of the Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, 2019, the administrator shall take control and custody of third-party assets or properties in custody or possession of the financial service provider, including the funds, securities and other assets required to be held in trust for the benefit of the third-parties. The manner prescribed is as follows:

(i) ***Receivable for Third Parties;*** When the FSP is contractually obliged to act as a servicing or collection agent on behalf of third-parties under any securitization or lending arrangement, the administrator shall prepare a statement of the transactions and continue to discharge the obligations of the FSP. It shall be the duty of the administrator to collect the receivables and deposit the same in a separate account. However, any fee received by the FSP as a servicing or collection agent shall not be transferred to the separate account made herein and it shall be dealt with as forming part of the assets of FSP.

(ii) ***Assets of Third Parties:*** When the FSP has in its custody or possession assets owned by its customers/counterparties under a contract and is under an obligation to return/transfer such assets, the administrator shall prepare a statement of such assets and ensure that

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the assets are maintained in a separate and distinct manner capable of being identified contract-wise. The administrator shall transfer such assets to the person entitled to receive it in accordance with the terms of such contract. However, when such assets are not returnable due to breach of the terms of the contract, the FSP becomes entitled to retain such assets for itself or dispose of the same to realize its dues.

Liquidation and Voluntary liquidation processes – IBBI amends two regulations: The Insolvency and Bankruptcy Board of India *vide* its Notification #IBBI/2019-20/GN/REG053, dated 6th January 2020 and #IBBI/2019-20/GN/REG054 dated 15th January 2020 has notified the amendments to the IBBI (Liquidation Process) Regulations, 2016 and IBBI (Voluntary Liquidation Process) Regulations, 2017, respectively. The key amendments are as follows:

(i) As per the newly inserted provisions in both the Regulations, the IBBI shall operate and maintain a Corporate Liquidation Account (“CLA”) and Corporate Voluntary Liquidation Account (“CVLA”).

(ii) The liquidator shall deposit the amounts of unclaimed dividends and undistributed proceeds into the CLA/CVLA before filing of application under Regulation 45(3) of the Liquidation Process Regulations or under Section 59(7) of the IBC for dissolution of the corporate person. Upon failure to make deposits, an interest at the rate of 12% per annum on the amounts from the due date of deposit till the date of deposit of amounts shall be paid by the liquidator.

(iii) In case of ongoing liquidation, the liquidator shall deposit the same within 15 days from the date of commencement of the amendments, i.e. 15th January 2020.

(iv) The liquidator shall submit proof of deposit to the authorities and a statement in specified Form setting forth the nature and particulars of the amount deposited in CLA/CVLA.

(v) A stakeholder who claims to be entitled to any amount deposited in the CLA/CVLA, may apply to IBBI in specified Form requesting withdrawal of the amount.

(vi) IBBI shall maintain a ledger of the amount deposited into and the amount withdrawn from the CLA/CVLA.

(vii) A person who is not eligible under the Insolvency and Bankruptcy Code, 2016 (“IBC”) to submit a resolution plan for insolvency resolution of the corporate debtor, such person shall not be eligible to be a party in the compromise/arrangement envisaged under Rule 2B of the Liquidation Process Regulations.

(viii) The secured creditor shall not sell/transfer an asset which is subject to security interest to any person who is ineligible to submit a resolution plan under Section 29A of the IBC.

(ix) The insertions discussed in (vii) and (viii) above, attempt to widen the scope of ineligibility of the promoters and individuals disqualified vide Section 29A of the IBC.

Operating Guidelines for Investment Advisers in International Financial Services Centre: On 27th March 2015, Securities and Exchange Board of India (“SEBI”) had issued SEBI (International Financial Services Centre) Guidelines, 2015 (“IFSC Guidelines”) for facilitating and regulating financial services relating to securities market in an International Financial Services Centre (“IFSC”) set up under the provisions of Special Economic Zones Act, 2005. Based on the representations of the stakeholders SEBI *vide*

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Circular SEBI/HO/IMD/DF1/CIR/P/2020/04 dated 9th January 2020 has issued the Operating Guidelines for Investment Advisers in IFSC ("Guidelines"). The significant features of the Guidelines are as follows:

(A) **Applicability of SEBI (Investment Advisers) Regulations, 2013 ("Investment Adviser Regulation"):** All provisions with future amendments, if any, of the Investment Advisor Regulation shall apply to Investment advisers setting up an IFSC.

(B) **Registration of Investment Advisers for IFSC:** An application for grant of certificate of registration shall be made in accordance with the provisions of Investment Advisor Regulation and can be made by any entity, being a company or a limited liability partnership.

(C) **Certification:** Partners and representatives of applicants residing in India, shall have a certification on investment advisory services from National Institute Securities Market/any other recognized body and in case of partners and representatives of the applicants residing outside India, a certificate from any other organization recognized by a financial market regulator in the foreign jurisdiction. However, it shall be mandatory for partners/representatives offering investment advice in relation to Indian securities market, to hold certification from NISM.

(D) **Net worth:** The applicant shall have a net worth of not less than USD 1.5 million.

(E) **Details of Applicants:** The overseas applicants shall submit the net worth certificate and a credit score.

Statement indicating deviation or variation in use of proceeds of issue of listed non-convertible debt securities or listed non-convertible redeemable preference shares: Securities and Exchange Board of India has issued Circular No. SEBI/HO/DDHS/08/2020 dated 17th January 2020 prescribing a format for the statement indicating deviation or variation in the use of proceeds of funds raised by issue of listed non-convertible redeemable preference shares or non-convertible debt securities. The first submission of the statement to the Stock Exchange(s) shall be made for the half year ended 31st March 2020 and subsequent submissions shall be made on half yearly basis within 45 days of end of the half year, until such funds are fully utilized for the purpose it was raised has been achieved. The statement indicating deviation shall be placed before the Audit Committee or Board of Directors in case the listed entity is not required to have an audit committee under the provisions of SEBI LODR Regulations of Companies Act, 2013, for the purpose of their review and comments.

Fines for non-compliance with SEBI (Listing Obligations and Disclosure Requirements) Regulations, revised: Securities and Exchange Board of India has issued Circular No. SEBI/HO/CFD/CMD/CIR/P/2020/12 dated 22nd January 2020 in supersession of the previous Circular bearing no. SEBI/HO/CFD/CMD/CIR/P/2018/77 dated 3rd May, 2018 which specified a uniform structure for imposing fines as a first resort for non-compliance of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 and further freezing of entire shareholding and suspension of trading in case of continuous non-compliance. The standard operating procedure and various fines have been carried forward from the erstwhile Circular, however, the new Circular has introduced some fines for non-compliance of

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various provisions of the Listing Regulations and few of the heftiest fines are, a fine of INR 10,000/- per instance for non-compliance with the requirements pertaining to the number and quorum of Board Meetings (Regulation 17(2) and 17(2A)), a fine of INR 50,000/- per day for non-compliance with obtaining in-principle approval of stock exchange(s) before issuance of securities (Regulation 28(1)), a fine of INR 25,000/- per instance for non-disclosure of dividend distribution policy in the annual report (Regulation 43A), non-convening of annual general meeting within 5 months from the close of financial year (Regulation 44(5)) and non-obtaining approval of stock exchange before filing request for change in name with registrar of companies (Regulation 45(3)).

E-commerce in India - Market Study by Competition Commission of India: The Competition Commission of India has released the observations and findings on E-commerce market study on 8th January 2020. The Market Study covers various aspects of e-commerce including trends, practices and issue relevant to the competition and revels that revenue from the e-commerce sector is expected to increase from USD 39 Billion in 2017 to USD 120 Billion in 2020, growing at an annual rate of 51%, the highest in the world. The key findings and observations of the Market Study are as follows:

i) *Platform neutrality:* E-commerce platforms essentially integrate vertically when operating in the products traded on it and to improve its market position relative to its competitors, it engages in preferential treatment to its own products on the platform. The three elements susceptible to manipulation are search results, seller's data and user review and rating mechanisms. Improving transparency in these areas can reduce information asymmetry, which in turn, can positively influence the platforms *inter se*.

ii) *Platform to business contract terms*: The bargaining power imbalance between the platforms and businesses in these platforms create a situation of asymmetry of bargaining power. The issue of unilateral revision in contract terms and imposition of "unfair" contract terms have led to conflicts and mistrust. Therefore, to foster trust and a sustainable relationship, the platforms may devise the following aspects to protect the interests of contracting parties – a) negotiating framework for basic contract terms; b) discount policy; c) penalties; and d) conflict resolution.

iii) *Platform Parity Clauses*: The platform parity clauses ("PPC") enables the platform to require that the suppliers do not offer lower prices or better terms on other platforms or on their own website. PPC can potentially lead to higher commission rates and discourage entry and on the other hand, it protects investment incentives by preventing free riding. The PPC can be examined by the CCI under Section 3(4) and section 4 (if dominant enterprise) of the Act. The factors enumerated under Section 19(3) of the Act will allow CCI to assess the harm or justification of any PPC.

iv) *Exclusive Agreements and Deep Discounts*: These agreements are not per se treated to be anti-competitive and therefore will be analyzed by CCI on case-by-case basis under section 3(4) and section 4 (if dominant enterprise) of the Act. Further, the competitive assessment of discounts is not covered by the Market Study and will be a fact-intensive exercise done on a case-by-case basis.

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v) *Self-Regulatory Measures*: CCI suggested the following self-regulatory measures to be adopted by the e-commerce platforms:

a) *Search Ranking:* The platforms' terms and conditions should contain a general description of the main search ranking parameters and possibilities of influenced ranking, drafted in plain and intelligible language.

b) *Collection use and sharing of data:* Clear and transparent policy on data collected on the platform and its use and sharing with third-parties.

c) *User review and rating mechanism:* Transparency in publishing and sharing user review and rating mechanisms. Reviews of only verified purchases to be published and mechanisms to be devised to prevent fraudulent reviews/ratings.

d) *Revision in contract terms:* Notify the change in terms and the proposed changes shall not be implemented before the expiry of the notice period which is reasonable and proportionate to the nature and extent of their consequences for the business users.

e) *Discount policy:* Clear and transparent policies on discounts including the basis of discount rates and the implications of participation/non-participation in discount schemes.

Implementation of Telecom Commercial Communications Customer Preference Regulations, 2018 - TRAI issues directions: Regulation 8 of the TCCPR, *inter-alia*, provides that every Access Provider shall, before allowing any commercial communication through its networks, develop Codes of Practice for registration of preference, recording of consent and revocation of consent. And whereas, TRAI observed that no significant progress has been shown by Access Providers for migration of existing headers and consents with principal entities to distributed ledger technology system of Access Providers as prescribed under TCCCPR. In the backdrop, TRAI has issued following directions to Access Providers:

a. Not assign new SMS and voice headers without registration in the new system established by Access Providers in accordance with TCCCPR;

b. Migrate the existing SMS and voice headers which are in use in last one year, to new system within four weeks' time;

c. Ensure that principal entities submit list of existing subscriber's consent to Access Providers within fifteen days from the issue of these Directions;

d. Ensure that consents recorded prior to six months from the date of issue of these directions, become invalid, and should not be migrated to the new system;

e. Ensure that all new consents of subscribers shall be registered in the new system, as per provisions of TCCCPR;

f. Ensure that principal entities are not able to send promotional messages or calls to the subscribers who have not opted for such preference, if they have not shared subscribers' consent with Access Providers or not acquired consent from the subscribers according to the provisions of the regulations;

g. Ensure that principal entities are not able to send any commercial communication till they register themselves with Access Providers;

h. Ensure that principal entities are not able to send any service and transactional messages till they register content template against specific registered header with Access Providers.

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Ratio Decidendi

No requirement under Insolvency and Bankruptcy Code, 2016 for the Resolution Plan to match the liquidation value of the Corporate Debtor

Key Points:

No provision in the Code or insolvency regulations dictates that the bid of any Resolution Applicant has to match liquidation value of the estate of the Corporate Debtor. If the resolution plan has been approved by the Committee of Creditors by application of their commercial sense, as well as the plan has been considered as proper in terms of Section 30 of the Code, the Adjudicating Authority cannot interfere or re-assess the same under Section 31 of the said Code.

Brief facts:

The order approving the resolution plan of the Appellant was appealed against by one of the promoters of the Corporate Debtor, as well as a financial creditor, on the grounds that the amount offered under the resolution plan is less than the liquidation value of the Corporate Debtor. Vide a common order, the NCLAT had allowed the appeals and directed the Appellant to increase the upfront payment accordingly and that failure to deposit the enhanced amount with the escrow account within thirty (30) days would lead to setting aside of the Resolution Plan.

Aggrieved by the said order of the NCLAT, the Appellant sought for sustaining of the Resolution Plan. However, an interlocutory application (IA) for withdrawal of the plan was also filed by the Appellant because of difficulties in implementation of the Resolution Plan. To the IA, the counsel for the respondents has argued that the only route for withdrawal of a resolution plan at this stage is under Section 12-A of the Code.

Observations of the Court:

Whether the scheme of the Code contemplates that the sum forming part of the resolution plan should match the liquidation value or not?

Held: No provision in the Code dictates that the bid of any Resolution Applicant has to match liquidation value arrived at in the manner provided in Regulation 35 of the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016. Further, basis the observations of the Apex Court in *Committee of Creditors of Essar Steel India Limited* v. *Satish Kumar Gupta,* whereunder great emphasis was laid on the commercial sense of the CoC, and that the approval of the same is the prime consideration while deciding on the approval of any resolution plan under Section 31 of the Code, it was re-iterated that the Adjudicating Authority may not be allowed to re-assess the said plan, if such an approval is obtained and that the plan meets the criteria laid down in section 30 of the Code.

Whether Section 12-A of the Code is the applicable route through which a successful Resolution Applicant can retreat?

Held: No. The procedure envisaged in the said provision only applies to applicants invoking Sections 7, 9 and 10 of the Code. In the present case, having appealed against the NCLAT order with the object of implementing the resolution plan, MSL cannot be permitted to take a contrary stand in an application filed in connection with the very same appeal

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Judgment:

The appeal was allowed and the impugned order of the NCLAT was set aside. The Resolution Professional was directed to take physical possession of the assets of the Corporate Debtor and hand it over to the Appellant. [*Maharashtra Seamless Limited* v. *Padmanabhan Venkatesh & Ors.*, Civil Appeal No. 4242 of 2019, Judgment dated 22-1-2020, Supreme Court]

Lease of immovable property cannot be considered as a supply of goods or rendering of any services and thus, cannot fall within the definition of 'Operational Debt'

Key Points:

For an amount to be classified for an operational debt under Insolvency and Bankruptcy Code, 2016**,** it is provided that: (a) the amount falls within the definition of "claim" as defined under Section 3(6) of the Code; (b) such a claim should claim within the confines of the definition of a 'debt' as defined under Section 3(11), meaning it should be by way of a liability or obligation due from any person; and (c) such a 'debt' should fall strictly within the scope of an "Operational Debt" as defined under Section 5(21) of the Code.

If the claim does not satisfy the requirements of an operational debt, the claim cannot be categorised as an operational debt as defined under Code, even though there may be a liability or obligation due from the corporate debtor to the creditor.

Facts:

An order passed by the NCLT, Hyderabad Bench, admitting the petition ("Petition") filed u/s. 9 of the Code was challenged. The Appellant herein was a director of the Corporate Debtor. The Corporate Debtor was a licensee of certain industrial premises ("Premises"), to which the respondents herein were Lessors ("Respondents").

Upon committing of default in monthly rental dues, the Corporate Debtor was instructed to hand over the property back to the Respondents. Thereafter, (a) a legal notice was served under Section 106 of the Transfer of Property Act, 1882, for termination of lease and the Corporate Debtor was asked to vacate the Premises, (b) an eviction suit was initiated before the jurisdictional civil court, and (c) a demand notice for a sum under Section 8 of the Code was served on the Corporate Debtor as well.

The Corporate Debtor claimed that there was a moratorium imposed on the enhancement of rental amounts as agreed between the said entity and the Respondents, due to which no dues were pending between both the parties. However, no documentary proof was furnished to that extent.

The Counsel for the Respondents herein placed reliance on the provisions of the Central Goods and Services Tax Act, 2017 to prove that the act of leasing of property was considered to be a 'service'. Schedule- II of the Act list down the activities that are to be treated as supply of goods or services which includes lease, rent, easement and license of property.

Observations by the NCLAT:

Whether a landlord by providing lease, will be treated as providing 'services' to the corporate debtor, and hence, treated as an 'operational creditor' within the meaning of Section 5(20) read with Section 5(21) of the Code?

Held: No. The NCLAT relied on its judgment in *Jindal Steel & Power Ltd.* v. *DCM International Limited,* Company Appeal (AT) (Insolvency) No. 288/ 2017 to hold that the legislature did not include the reference to rent dues of property within the term "operational debt". The current petition which has been filed for recovery of enhanced rent as per lease agreement is not about the goods or services and does not come

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within the meaning of 'Operational Creditor', as defined under the Code.

Further, the term 'operational' has not been defined anywhere in the Code. The General Clauses Act, 1897, also does not define the term. Hence, the term has to be given a meaning as ordinarily understood. The dictionary meaning of 'operational' is given as 'of or relating to operation' (Merriam Webster). Similarly, the meaning of 'operation' is given as 'ready for use or able to be used'. Therefore, **there has to be a nexus between the direct input to the output produced or supplied by the corporate debtor.** Leasing of premises is also not included within the meaning of "essential services" under Regulation 32 of the CIRP Regulations.

Whether the Petition, filed u/s. 9 of the Code, is not maintainable on account of 'pre-existing disputes'?

Held: Yes, on account of the legal notice issued under section 106 of TOPA much before the issuance of demand notice under Section 8 of the Code and in light of the judgment of the Hon'ble Apex Court in *Mobilox Innovations Private Limited* v. *Kirusa Software Private Limited,* 2018 (1) SCC 353, the application filed under Section 9 of the Code could not have been admitted by NCLT.

Judgment:

The appeal filed by the Corporate Debtor against the order admitting a petition u/s. 9 of the Code was allowed and as a result, the effect of the NCLT order, including imposition of 'moratorium', appointment of the Interim Resolution Professional, freezing of account etc. was declared illegal and set aside. [*M. Ravindranath Reddy* v. *G. Kishan & Ors.* - Company Appeal (AT) (Insolvency) No. 331 of 2019, Judgment dated 17-1-2020, National Company Law Appellate Tribunal]

Statutory Arbitral Tribunals have power to grant interim injunction under Section 17 of the Arbitration and Conciliation Act, 1996

Key Points:

Part I of the Arbitration and Conciliation Act, 1996 shall apply to all arbitrations, even carried out under another enactment, as long as the same is not inconsistent with such enactment or rules made thereunder.

Facts:

The Gujarat Public Works Contracts Disputes Arbitration Tribunal Act, 1992 ("Gujarat Act") was enacted with a view to compulsorily refer all disputes arising out of "works contract" entered into by the State Government or the Public Sector Undertakings with any other person for those works defined as "works contract" in terms of Section 2(k) of the Gujarat Act to an arbitral tribunal constituted under the said enactment.

Disputes arose between an Appellant herein and the State and the State in order to recover certain due amounts had laid threats to withhold payments payable to the contractor under other contracts executed between both parties.

By relying on the judgment of the Apex Court in *State of Karnataka* v. *Shree Rameshwara Rice Mills*, *Thirthahalli,* (1987) 2 SCC 160, the High Court of Gujarat had concluded that without quantification or crystallization of the amount sought to be recovered, the employer or the contractor cannot unilaterally recover the said amounts from the ongoing contract work of the same contractor in connection with another contract. The said judgment of the Hon'ble High Court has been appealed herein by way of the present Civil Appeal.

Counsel for the State has contended that the High Court has no jurisdiction to pass such an order and that the only remedy, if any, is to approach the arbitral tribunal, constituted under

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the Gujarat Act. However, the counsel for the Appellant has contended that, vide an order dated 24.11.2005, the arbitral tribunal had determined that the arbitral tribunal had no jurisdiction to grant any relief, whether by way of injunction or otherwise, and that the order of an interim injunction definitely did not fall under the ambit of an 'interim award' as defined under the said Gujarat Act.

Observations by the Court:

Whether the Gujarat Public Works Contract Disputes Arbitration Tribunal constituted under Section 3 of the Gujarat Act has jurisdiction to make interim orders in terms of Section 17 of the Arbitration and Conciliation Act, 1996.

Held: Yes. Part I of the Arbitration Act i.e. from Section 2 to Section 43 deals with Arbitration and Section 2(2) clearly states that the said Part would apply to all Arbitrations which take place in India. Section 2(4) makes it absolutely clear that other than Section 40(1), 41 and 43, Part I of the A&C Act shall apply to all arbitrations even if they are carried out under any other enactment as if the arbitrations were pursuant to an arbitration agreement except insofar as the provisions of Part I are inconsistent with the other enactment or any rules made thereunder. Even statutory arbitrations under other enactments would be governed by Part I. The only exception is that if there is any departure from Part I in the special enactment then the special enactment will prevail and the Arbitration Act will give way to the special enactment. Further, as long as the enactment thereof recognizes the powers of the statutory tribunal to pass interim awards, the powers to grant interim injunction are read into the same. It is relevant to note that the Gujarat Act specifically barred the jurisdiction of Civil Court altogether, whereby all powers that rest with the Civil Court ordinarily under the Arbitration Act cannot be exercised by the same in the present instance. Therefore, the sole jurisdiction to grant interim relief rests with the statutory arbitral tribunal itself.

Judgment:

The appeal was allowed, and the judgment of the High Court of Gujarat was set aside, with liberty to the contractor to approach the statutory arbitral tribunal constituted under the Gujarat Act. [*State of Gujarat* v. *Amber Builders* - Civil Appeal No. 8307 of 2019, Judgment dated 8-1-2020, Supreme Court]

Acceptance of Corporate Insolvency Resolution Plan is not a ground to quash proceedings under Section 138 of Negotiable Instruments Act, 1881

Key Points:

Moratorium imposed u/s. 14 of the Insolvency and Bankruptcy Code, 2016 does not preclude "prosecution" i.e., criminal proceedings.

The takeover of the management of the Corporate Debtor, after institution of the Corporate Insolvency Resolution Process (CIRP) against the said debtor, does not preclude the personal liability of the erstwhile management of the Corporate Debtor from criminal proceedings.

Brief Facts:

The present criminal original petition ("CRL.OP") has been filed under Section 482 of the CrPC to call for the records in the pending proceedings initiated by the Respondent viz., M/s. Tap Engineering ("Respondent") against Techpro Systems Limited ("Corporate Debtor") and its erstwhile directors under Section 138 of the Negotiable Instruments Act, 1881 ("NI Act") and quash the same as illegal, invalid and non-est in the eyes of law.

Post filing of the criminal complaints by the Respondent ("Criminal Complaints") under Section 138 of NI Act, the Corporate underwent a successful resolution process as per provisions

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of the Code pursuant to an application filed u/s 7 of the Code by one of the financial creditors. As per the resolution plan, all the outstanding negotiable instruments issued by the company or by any persons/entities on behalf of the company prior to the insolvency commencement date including demand promissory notes, cheques and letters of credit, were to stand terminated and all the legal proceedings relating thereto shall stand irrevocably and unconditionally abated.

The Petitioner, on behalf of himself as the erstwhile director of the Corporate Debtor as well as a co-accused to the criminal complaints, has therefore contended that criminal complaints filed, against the Corporate Debtor, the Petitioner and other directors, must be quashed.

Observations of the Court:

Whether the initiation of CIRP and acceptance of resolution plan is a ground by itself to quash proceedings initiated u/s. 138 of the NI Act?

Held: No. It was held that Section 14 of the Insolvency and Bankruptcy Code, 2016 contemplates declaration of moratorium over the institution/continuation of all pending suits or proceedings against the Corporate Debtor, but the same does not include criminal prosecution, basing reliance on the judgment in *Indorama Synthetics (I) Ltd., Nagpur* v. *State of Maharashtra & Ors.,* [(2016) (4) Mh.L.J.249] as passed by the High Court of Calcutta, and the judgment in *Nag Leathers Pvt Ltd* v. *J.L.Sobhana,* [Crl OP No.8869 of 2018], of the High Court of Judicature at Madras.

Further, in *JIK Industries Limited vs. Amarlal V.Jumani* [(2012) 3 SCC 255], the Supreme Court held that sanction of a scheme under Section 391 of the Companies Act, 1956 will not lead to any automatic compounding of offence under Section 138 of the NI Act without the consent of the complainant. Neither Section 14 nor Section 31 of the Code can produce such a result. The binding effect contemplated by Section 31 of the Code is in respect of the assets and management of the corporate debtor. Further, no provision of the Insolvency and Bankruptcy Code bars the continuation of the criminal prosecution initiated against the corporate debtor or its directors and officials.

Whether, on account of the taking over of the management of the Corporate Debtor by the resolution applicant be a ground for quashing of the criminal complaint filed against the Petitioner as well as the Corporate Debtor?

Held: No. As held by the Hon'ble Supreme Court in *Aneeta Hada v. Godfather Travels & Tours (P) Ltd., (2012) 5 SCC 661*, when a new management takes over, it will have to make arrangements for representing the company and if the company is dissolved as a result of the resolution process, obviously proceedings against it will have to be terminated. But even then, its erstwhile directors may not be able to take advantage of the situation. Thus, where the proceedings under Section 138 of the Act had already commenced and during the pendency, the company gets dissolved, the directors and the other accused cannot escape by citing its dissolution or takeover in management. Post-conviction, while the process for recovery of fine/ compensation from the Corporate Debtor shall be as per the Code, the officials of the Corporate Debtor can be proceeded against directly. The present petition seeking quashing of prosecution against the Corporate Debtor, too, cannot be maintained since the management has been handed over to the resolution applicant.

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Judgment:

All the criminal original petitions for quashing of criminal proceeding under Section 138 of Negotiable Instruments Act, 1881 stand dismissed, along with connected miscellaneous petitions. [*Ajay Kumar Bishnoi* v. *Tap Engineering* - CRL.OP No. 34996 of 2019, Judgment dated 09th January 2020, High Court of Judicature at Madras.]

Note: This judgement does not deal with Section 32A of the Code inserted *vide* Insolvency and Bankruptcy Code (Amendment) Ordinance, 2019

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News Nuggets

Companies (Accounts) Amendment Rules, 2020 notified: The MCA vide its notification dated 30th January 2020 has published the Amendment Rules to amend Rule 12 of Companies (Accounts) Rules, 2020 in order to insert a sub-rule (1A) which states that every non-banking financial company that is required to comply with the Indian Accounting Standards (IND AS) shall file the financial statements together with Form AOC-4 NBFC (Ind AS) and the consolidated financial statement, if any, with Form AOC–4 CFS NBFC (Ind AS). Both Form AOC -4 NBFC (Ind AS) and AOC – 4 CFS NBFC (Ind AS) are also attached under the Amendment Rules.

Scope of interference in international commercial arbitration in India is narrow under Section 34 of Arbitration and Conciliation Act, 1996: The Delhi High Court *vide* judgement dated 07th January 2020 has held that subsequent to the Arbitration and Conciliation (Amendment) Act, 2015, the scope of interference under Section 34 has been narrowed down and even patent illegality is no longer a ground available to challenge International Commercial Award passed inIndia. In the background, the Court relied on the Apex Court judgement in *Ssangyong Engineering & Construction Co. Ltd. v. NHAI*.

SEBI penalty order cannot be sustained on account of inordinate delay: The Securities Appellate Tribunal ("SAT") vide order dated 21st January 2020 has struck down the penalty orders issued by SEBI under SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 ('PFUTP Regulations') on the ground of inordinate delay in issuance of show cause notices. The period of alleged violations under PFUTP Regulations relates to January 4, 2010 to January 10, 2011 while a show case notice was issued in November 2017. SAT noted that there is no period of limitation prescribed in the SEBI Act or the PFUTP Regulations for issuance of a show cause notice or for completion of the adjudication proceedings, however, when the period of limitation is not prescribed, such power must be exercised within a reasonable time.

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CCI directs investigation against alleged anti-competitive practices of two major e-commerce players: The CCI vide order dated 13th January 2020, has issued directions under Section 26(1) of the Competition Act, 2002 to the Director General to investigate the alleged anti-competitive practices by Flipkart Internet Private Limited and Amazon Seller Services Private Limited. The order is based on a complaint from Delhi Vyapar Mahasangh under Section 19 of Competition Act, 2002. The Informant alleged that there are instances of several vertical agreements between (i) Flipkart with their preferred sellers on the platform and (ii) Amazon with their preferred sellers, respectively which have led to a foreclosure of other non-preferred traders or sellers from these online marketplaces.

Investment by Foreign Portfolio Investors in Debt: RBI *vide* notification dated 23rd January 2020 has amended the directions issued on investment by Foreign Portfolio Investors in Debt. Accordingly, short-term investments by an FPI in 20% of Central Government Securities (including Treasury Bills) or State Development Loans is now revised to 30% from existing 20%. FPI investment in corporate bonds with minimum residual maturity of above one year is hereby increased from 20% to 30%. Short-term investment limit and the issue limit as applicable to Security Receipts issued by Asset Reconstruction Companies is now applicable to debt instruments issued by an entity under the Corporate Insolvency Resolution Process as per the resolution plan approved by the National Company Law Tribunal under the Insolvency and Bankruptcy Code, 2016.

NCLT, Ahmedabad Bench to exercise jurisdiction over State of Madhya Pradesh: The MCA *vide* its Notification #S.O. 484(E) dated 31st January 2020, in exercise of the powers conferred by Section 419(1) of the Companies Act, 2013 has notified that the jurisdiction of State of Madhya Pradesh shall be exercised by the National Company Law Tribunal ("NCLT") bench at Ahmedabad till the operation of Indore Bench of NCLT is commenced.

Debts Recovery Tribunals and Appellate Tribunals Electronic Filing Rules, 2020 ("E-Filing Rules"): The Ministry of Finance (Department of Financial Services) vide its notification dated 22nd January 2020 had notified the new E-filing Rules, with effect from the date of notification. The E-filing Rules are applicable to e-filing, display of orders passed by the Tribunals under Recovery of Debt and Bankruptcy Act, 1993 and Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002, on the common website in the e-DRT system and also to the electronic issuance and e-service of intimations. The e-filling of pleadings is optional. Where the pleading is filed in electronic form and in paper form by the applicant, before the Registry, the date of filing of the pleadings in the Tribunal shall be the date of submission of the last page of a pleading through the e-DRT system. Further, the E-filing Rules also prescribe the detailed rules in relation to the procedure for e-filing the pleadings and also for regular uploading of the information on the common website by the Tribunals.

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European Data Protection Board ("EDPB") adopts final version of Guidelines on processing of Personal Data through Video Devices: The EDPB in its seventeenth plenary held between 28-30 January 2020 has adopted the Guidelines with aim to clarify how the GDPR applies to the processing of personal data when using video devices and to ensure the consistent application of the GDPR in this regard. The Guidelines cover both traditional video devices and smart video devices. The Guidelines address, *inter alia*, the lawfulness of processing, including the processing of special categories of data, the applicability of the household exemption and the disclosure of video footage to third parties

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