

De Jure

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RBI permits ARCs to act as a Resolution Applicant under IBC

**ASSET RECONSTRUCTION
COMPANY**



**INSOLVENCY
AND
BANKRUPTCY
CODE**



BRIEF RECAP ABOUT ARC

The concept of Asset Reconstruction Companies ("**ARC**") was essentially introduced on the recommendation of the Narasimham Committee-II to form a special category of companies who would help banks relieve their stress by acquiring their distressed accounts/ bad debts at a lower value and recover the proceeds from realizing the assets of such NPA's. This helped the concerned banks to clean up their books in the process and enabled them to start on a clean slate. Prior to the introduction of the Insolvency and Bankruptcy Code, 2016 ("**Code**"), the mechanism for resolution of debts or reconstruction of debts was governed by Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ("**SARFAESI**").

ISSUE AT HAND

The issue of ARC being eligible to act as Resolution Applicant and present a Resolution Plan under the Code has been a contentious one for some time now. This issue came into limelight when Reserve Bank of India ("**RBI**") opined, in one of the cases, that ARCs cannot submit a Resolution Plan and act as Resolution Applicant under the Code since the same is outside the purview of SARFAESI as regards the powers granted to an ARC under SARFAESI.

While at one side, SARFAESI did not specifically permit ARCs to act as Resolution Applicants under the Code. Section 29A of the Code provides several filters for an entity to be eligible to act as a resolution professional. In fact, Section 29A of the Code provides reference to a financial entity (which includes an ARC), not being a related party of the Corporate Debtor to act as a Resolution Applicant. This resulted in divergent views on the concerned subject matter. Also, under the RBI norms,

ARCs can acquire upto 26% shareholding of the borrower/ defaulting entity (after conversion of the debt) which can be enhanced to more than 26% subject to fulfilment of certain conditionalities.

The issue came into the limelight in the case of UV Asset Reconstruction Company Limited wherein it proceeded ahead in acting as a Resolution Applicant in the matter of Aircel Limited and its subsidiaries, which was under the corporate insolvency resolution process under the Code and then, after being declared as a Successful Resolution Applicant, UV Asset Reconstruction Company Limited sought approval of the RBI for acting as a Resolution Applicant. However, RBI issued a show cause notice seeking the grounds as to why its certificate of registration should not be cancelled since acting as Resolution Applicant by an ARC fall outside the purview of the SARFAESI and thereby violating the provisions of SARFAESI. UV Asset Reconstruction Company Limited challenged the show cause notice before the Delhi High Court and the Delhi High Court vide its order dated November 27, 2020, has stayed the show cause notice of the RBI. The matter is sub judice now. The Delhi High Court had remarked that the regulatory authorities need to take a harmonious view on the subject matter.

This is not to say that none of the ARCs have acted as Resolution Applicants under the Code. Such ARCs have acted as Resolution Applicants under the Code but post seeking approval of the RBI as required under Section 10(2) of the SARFAESI. ACRE ARC acting as Resolution Applicant along with Reliance Industries Limited is case in point.

Considering the above, a need was felt that RBI itself brings out a clarification/amendment on this aspect, especially considering the growing cases under the Code and the need to find suitable and credible/ financially competent Resolution Applicants, especially the ones having specialized mandate in resolution of stressed assets.



GO AHEAD BY RBI, ALBEIT WITH RIDERS

The RBI, vide its notification dated October 11, 2022¹ has inter alia permitted ARCs to act as Resolution Applicant under the Code, albeit subject to certain conditions.

The RBI notification has provided the much need comfort to the plaguing uncertainty and approvals for ARCs to act as a resolution applicant under the corporate resolution insolvency process under the Code.

The RBI notification has essentially revamped the regulatory framework for the ARCs which included conditionally permitting ARCs to act as Resolution Applicant under the Code.

¹ RBI/2022-23/128. DoR.SIG.FIN.REC.75/26.03.001/2022-23

The RBI notification states that ARCs play a vital role in the management of distressed financial assets of banks and financial institutions. Considering their critical role, a need was felt to review their functioning and operating framework. Accordingly, as part of the Statement on Developmental and Regulatory Policies released along with the Monetary Policy Statement on April 7, 2021, the RBI had set up a Committee to undertake a comprehensive review of the working of ARCs and recommend suitable measures for enabling them to function in a more transparent and efficient manner. The Committee had submitted its report in September 2021 which was published by the RBI on its website on November 02, 2021.

The Committee in its report had suggested for allowing ARCs to act as Resolution Applicant under the Code. Following is the extract of the report on this aspect:

"The Committee recognises that in the interest of better value realization for originators and enhancing the effectiveness of ARCs in recovery, even the equity pertaining to a borrower company may be allowed to be sold by lenders to ARCs which have acquired the borrower's debt. The Committee recommends that ARCs may be allowed to participate in the IBC process as a Resolution Applicant either through a SR trust or through the AIF sponsored by them"

"While ARCs as secured creditors are allowed to resolve their financial assets through the IBC process, the current regulatory and legal framework does not allow them to act as Resolution Applicants (RA) under IBC. The fundamental reason behind the same is that the legal and regulatory design of ARCs is focused on recovery of debt from the borrower and not on resolution of the borrower's insolvency. At the same time, the Act does provide tools to ARCs which could be used for insolvency resolution (e.g. change in/takeover of management, debt to equity conversion, etc). However, as mentioned earlier, ARCs, in

general, have not been using these tools. Envisaging ARCs as a prime vehicle for resolution of stressed assets, the regulations should allow ARCs to also use the IBC framework for this purpose. This can be facilitated by allowing ARCs to participate as a RA. Expertise acquired through IBC in resolving borrower insolvency will help ARCs in maximising recovery of dues. However, the ARC should remain asset-light in order to avoid conflict of interest in resolution of assets acquired in the trusts managed by them vis-à-vis acquired in their own balance sheet. Therefore, the Committee recommends that ARCs may be allowed to participate as RA, only in their capacity as SR trustees, or through their sponsored AIFs.

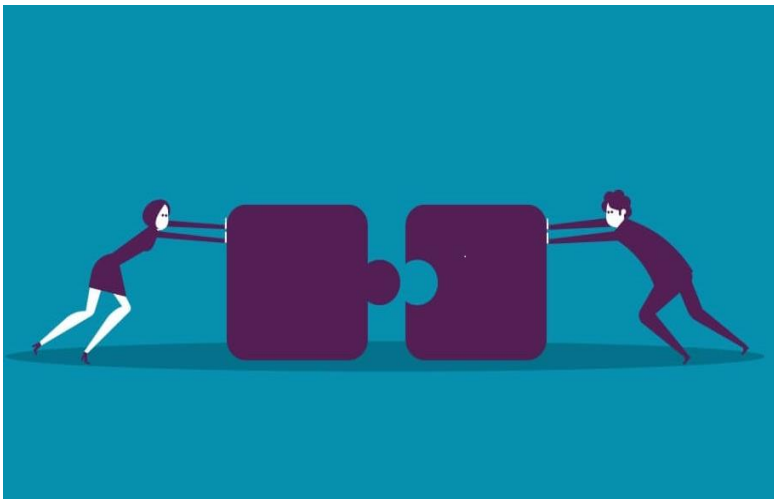
While permitting ARCs to set up AIFs for enhancing asset recovery and participate in insolvency resolution under IBC it would be necessary to ensure that they continue to focus on financial asset reconstruction as envisaged under the Act. Accordingly, a principal business requirement (PBR) should be made applicable to ARCs. PBR should be in terms of AUM by ARCs wherein AUM by the ARC acquired through AIF and IBC should not together exceed the AUM acquired via SR issuance at any time. "

RBI concurring with the view of the committee, has now permitted the ARCs to act as Resolution Applicant under the Code in terms of the said RBI notification dated October 11, 2022. However, such permission to ARCs have been granted by the RBI subject to following conditions:

- (i) The ARC has a minimum Net Owned Funds of ₹1,000 crore.
 - (ii) The ARC shall have a Board-approved policy regarding taking up the role of Resolution Applicant which may inter alia include the scope of activities, internal limit for sectoral exposures, etc.
 - (iii) A committee comprising of a majority of independent directors shall be constituted to take decisions on the proposals of submission of resolution plan under IBC.
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- (iv) The ARC shall explore the possibility of preparing a panel of sector-specific management firms/ individuals having expertise in running firms/ companies which may be considered for managing the firms/ companies, if needed.
- (v) In respect of a specific corporate insolvency resolution process (CIRP), the ARCs shall not retain any significant influence or control over the corporate debtor after five years from the date of approval of the resolution plan by the Adjudicating Authority under IBC. In case of non-compliance with this condition, the ARCs shall not be allowed to submit any fresh resolution plans under IBC either as a resolution applicant or a resolution co-applicant.
- (vi) The ARC shall make additional disclosures in the financial statements with respect to assets acquired under IBC in addition to the existing disclosure requirements. These would include the type and value of assets acquired under IBC, the sector-wise distribution based on business of the corporate debtor, etc.
- (vii) The ARC shall disclose the implementation status of the resolution plans approved by the Adjudicating Authority on a quarterly basis in their financial statements.

CONCLUSION



This move of RBI is laudable since it gives ARCs a chance to acquire the corporate debtor subject to complying with the aforementioned conditions. While this clarification by the RBI was keenly awaited by the industry players and would certainly be welcome. It would be interesting to see the unfolding of the impact of this RBI notification as to whether ARCs would now clamour to act as Resolution Applicants under the Code or whether the ARCs would find the conditions, to be stiff and daunting enough (especially the condition of minimum net owned fund of Rs.1,000 crores) to be eligible to act as

Resolution Applicants. It would also be interesting to see whether RBI still keeps an approval window open for such ARCs who are not able fulfil such conditionalities on a standalone basis and especially where the ARCs are desiring to act as Resolution Applicants along with other lead Resolution Applicants to acquire a Corporate Debtor under the Code. The conditions with respect to corporate governance and disclosure norms are expected to improve the functioning of the ARCs. Having said so, this step by RBI is likely to bring in fold the large ARCs to participate under the Code as Resolution Applicants who were till now *sitting* on the fence and awaiting regulatory clarity. One can hope that with this step, there could be more credible and financially strong Resolution Applicants, add to that the specialized and more pertinent skill set of the ARCs, for acquiring the Corporate Debtors under the Code with improved possibility of realizing one of the cardinal objectives of the Code i.e., maximization of value. This should act as a big boost to the regime under the Code by possibly accelerating the resolution processes under the Code and relieve the numerous pending cases, especially the insolvency cases going into liquidation stage. For now, the ball seems to be in ARCs court as to how they accept this opportune 'festive' offering by the RBI.

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