The Lending and Secured Finance Review

Sixth Edition

Editor
Azadeh Nassiri

The Law Reviews

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CONTENTS

PREFACE

This sixth edition of *The Lending and Secured Finance Review* contains contributions from leading practitioners in 25 different countries, and I would like to thank each of the contributors for taking the time to share their expertise on the developments in the corporate lending and secured finance markets in their respective jurisdictions, and on the challenges and opportunities facing market participants. I would also like to thank our publishers without whom this review would not have been possible.

I hope that the commentary that follows will serve as a useful source for practitioners and other readers.

Azadeh Nassiri
Slaughter and May
London
June 2020

Chapter 11

INDIA

L Viswanathan and Dhananjay Kumar[1]

I OVERVIEW

The Indian lending market continues to be dominated by banks (government-owned and private). However, the government's measures to reduce the pressure on bank funding to corporates has met with some success. Foreign portfolio investors (FPIs) and alternative investment funds (AIFs) invested close to 1,370 billion rupees in 2019. Their investments have been slightly tempered by the tax surcharge introduced for FPIs functioning as trusts in India vide the Finance (No. 2) Act of 2019.[2] The non-banking financial companies (NBFC) market remains muted after the IL&FS crisis. In order to meet the demand for liquidity in the power sector, government-owned lenders Power Finance Corporation Limited, Rural Electrification Corporation Limited and Indian Renewable Energy Development Agency have made large advances to corporates in the power sector. India saw a credit growth of approximately 6.3 per cent in the last fiscal year. NBFC borrowing from banks continued to grow; however, corporate borrowing in general saw a decline.

The past year in India saw several developments aimed at attracting foreign investment (debt and equity) into the country. The Ministry of Finance notified the Foreign Exchange Management (Non-debt Instruments) Rules, 2019. The demarcation of the regulatory oversight of the Reserve Bank of India (RBI) and the Ministry of Finance into debt and equity has become more pronounced. The government also announced mergers of multiple 'public sector' or government-owned banks, allowing capital to be freed up.[3] These mergers are intended to reduce operational redundancies and increase productivity, and over 700 billion rupees will be allocated to these merged banks, collectively for their recapitalisation.[4]

The (Indian) Insolvency and Bankruptcy Code, 2016 (Insolvency Code) was a gamechanger for corporate debt, but excluded financial services sector entities from its scope. The Financial Resolution and Deposit Insurance Bill 2017 (the Bill) intended to address this lacuna, was withdrawn from the Indian Parliament. Given the fallout of the IL&FS crisis and the resultant contagion in the NBFC sector, in November 2019, the central government

1 L Viswanathan and Dhananjay Kumar are partners at Cyril Amarchand Mangaldas. The authors acknowledge the help received from Surya Sreenivasan and Gautam Sundaresh.

2 www.financialexpress.com/economy/foreign-investors-return-to-india-in-2019-fpi-shoots-up-amid-slow-economic-growth/1808860/.

3 Oriental Bank of Commerce and United Bank of India are to be merged into Punjab National Bank, Syndicate Bank is to be merged with Canara Bank, Indian Bank merged with Allahabad Bank, and Union Bank, Andhra Bank and Corporation Bank are also to be merged.

4 www.moneycontrol.com/news/business/markets/analysts-give-thumbs-up-to-mega-merger-of-public-sector-banks-4391061.html.

instituted an interim framework for the insolvency and resolution of certain categories of financial service providers. The Insolvency and Bankruptcy (Insolvency and Liquidation Proceedings of Financial Service Providers and Application to Adjudicating Authority) Rules, 2019 (FSP Rules) was notified. The FSP Rules subsume the insolvency resolution process for certain notified categories of NBFCs and housing finance companies (having asset size of 5 billion rupees and above) under the Insolvency Code framework as an interim measure, until a comprehensive framework is introduced. The central government has the power to extend the applicability of the FSP Rules to further categories of financial service providers through notification.

The Insolvency Code also saw an increase in its scope, with the notification of the provisions for the insolvency resolution and bankruptcy for individuals, to the extent these are applicable to personal guarantors.[5] The urgent government intervention required to rescue one of the largest private banks in India (YES Bank Limited) has brought the focus back on the regime for financial sector resolution.

Of course, the covid-19 pandemic has completely changed this outlook, and has forced the government and regulators to take various sweeping steps with respect to the lending market in India. This includes, among others, a temporary (and optional) moratorium on repayment by borrowers (discussed in Section II), exclusion of the lockdown period from the Insolvency Code timelines, extension of the timelines for restructuring outside the Insolvency Code framework, and reduction in the case reserve ratio of banks for a one-year period to free up funds.[6] Certain public sector banks have also recently been discussing an 'omnibus inter-creditor agreement' to institute a uniform framework for lenders to deal with the likely surge in out-of-court debt restructurings as a result of the pandemic.[7] The government has also taken a decision to suspend fresh filings for the initiation of a corporate insolvency resolution process under the IBC for a period of one year, for defaults directly caused by and related to the covid-19 outbreak, to prevent companies from being forced into insolvency proceedings solely on account of the current economic situation.[8]

II LEGAL AND REGULATORY DEVELOPMENTS

i Regulation of lenders

Banks in India are heavily regulated, with RBI guidelines governing interest rates, the extent of exposure to corporate groups (which has been temporarily relaxed until 30 June 2021 because of the pandemic), information sharing and reporting requirements, and other prudential aspects. Indian regulations permit NBFCs to engage in the lending business if they register with the RBI, although NBFCs are subject to lesser scrutiny. The RBI has introduced several measures aimed at reducing regulatory arbitrage between banks and NBFCs.[9] The RBI and the Securities and Exchange Board of India have introduced lightly

5 Vide notification dated 15 November 2019 issued by the Ministry of Corporate Affairs, reference No. S.O. 4126(e).

6 RBI Circular on Maintenance of Cash Reserve Ratio dated 27 March 2020, reference No. RBI/2019-20/191 DOR.No.Ret.BC.49/12.01.001/2019-20.

7 www.moneycontrol.com/news/business/sbi-proposes-uniform-inter-creditor-agreement-norms-for-faster-loan-restructuring-report-5285041.html.

8 While not yet notified, an ordinance is expected to be notified shortly.

9 RBI, Report on Trend and Progress of Banking in India 2015-16.

regulated investment vehicles such as AIFs and FPIs to widen the Indian investment market. The RBI has now permitted commercial banks and NBFCs to allow a moratorium of six months on the repayment of instalments for terms loans and interest amounts for working capital facilities outstanding as of 1 March 2020.[10]

ii Restructuring schemes

On 7 June 2019, the RBI introduced a new 'Prudential Framework for Resolution of Stressed Assets', to replace an earlier framework that was struck down by the Supreme Court. The circular mandates lenders to enter into an intercreditor agreement and agree on a plan for debt restructuring or resolution immediately on the occasion of a payment default and gives benefits to lenders who refer borrowers under the Insolvency Code. Decisions are made by a specified majority of lenders and bind all lenders. Under the covid-19 related relaxations granted by the RBI, the lockdown period has been excluded from the 'review period' that is mandated under the framework for accounts under review as on 1 March 2020, and the timelines have been extended by 90 days where the review period (but not the outer 180 day timeline) had expired by this date.[11]

iii Insolvency Code

The Insolvency Code was introduced in 2016, and over 3,300 companies were undergoing a resolution process under the Code as of March 2020. The RBI has also been given the power to issue directions to banks to initiate insolvency resolution in respect of borrowers.[12]

Several important positions have already been taken by courts since the commencement of the Insolvency Code. One such recent decision pertains to the *Essar Steel*[13] case, where the Supreme Court held that the ultimate wisdom to decide and approve the commercial aspects and distribution mechanics under a resolution plan lies with the committee of creditors, and also that differential payment to different classes of creditors is permissible under a resolution plan. Similarly, in another important decision by the Supreme Court in the *Jaypee*[14] matter, it was held that a creditor who only has security over the corporate debtor's assets (for loans availed by a third party) will not be considered a financial creditor of that company (unless the security is also provided in the form of a guarantee).

Several amendments have been made to the Insolvency Code since inception to address the various issues that have cropped up during its implementation. One significant change

10 RBI Circular dated 17 April 2020 entitled 'COVID-19 Regulatory Package – Review of Resolution Timelines under the Prudential Framework on Resolution of Stressed Assets', reference No. DOR No. BP.BC.62/21.04.048/2019-20 read with RBI notification dated 23 May 2020 entitled 'COVID-19- Regulatory Package', reference No. RBI/2019-20/244.

11 RBI Circular dated 17 April 2020 entitled 'COVID-19 Regulatory Package – Review of Resolution Timelines under the Prudential Framework on Resolution of Stressed Assets', reference No. DOR No. BP.BC.62/21.04.048/2019-20.

12 Although these powers were first exercised by the RBI in June 2017 to refer 12 companies to insolvency proceedings under an ordinance (i.e., an executive order), an amendment to the Banking Regulation Act 1949 was formally notified on 25 August 2017.

13 *Committee of Creditors of Essar Steel India Limited v. Satish Kumar Gupta & Ors.* (Civil Appeal No. 8766-67 of 2019).

14 *Anuj Jain (Interim Resolution Professional for Jaypee Infratech Limited) v. Axis Bank Limited & Ors.* (Civil Appeal Nos. 8512–8527 of 2019).

was the inclusion of Section 29A,[15] which introduced stringent eligibility criteria in respect of prospective resolution applicants to a distressed company.[16] The last year has seen several important amendments to the Insolvency Code. One such important amendment relates to a prohibition on termination or suspension of arrangements relating to government conferred rights (such as concessions and licences) on account of insolvency during the moratorium period, as long as payment are up to date in this respect.[17] This is intended to protect lenders to companies implementing projects on the basis of a concession from the government (because the terms of such concession typically allow the government to terminate if the entity goes into insolvency) and telecom companies. Under another important amendment, immunity is granted to successful resolution applicants from criminal action initiated against the corporate debtor upon implementation of a resolution plan.[18]

The economic and social implications of the covid-19 pandemic have also resulted in important changes in the Insolvency Code framework, to protect against 'unnecessary hardship' to companies and promoters during this period. This includes raising the default threshold for initiation of insolvency proceedings from 100,000 rupees to 10 million rupees (with effect from 27 March 2020) and a recent announcement by the finance ministry to suspend fresh filings for a period of one year (for defaults directly related to and stemming from the consequences of the pandemic) and to introduce a separate framework for the insolvency of micro, small and medium enterprises.[19] Further, as per the directions passed by the NCLAT in its *suo moto* order in Company Appeal (AT) (Insolvency) No. 01 of 2020, the lockdown period is also to be excluded for purposes of determining the outer timeline applicable to an insolvency resolution process (i.e., 180 days extendable to a maximum of 270 days). This exclusion has also been captured by way of amendment to the regulations under the Insolvency Code applicable to insolvency resolution[20] and liquidation,[21] with respect to any activities that could not be carried out on account of the lockdown.

The treatment of convertible and structured instruments in an insolvency proceeding remains to be tested (in a decision of the Principal Bench of the NCLT[22], however, FCCDs (fully and compulsorily convertible debentures) were held to be in the nature of debt instruments up until their conversion into equity). Further, the provisions of the Insolvency

15 By way of the Insolvency and Bankruptcy Code (Amendment) Ordinance 2017, which was subsequently replaced by the Insolvency and Bankruptcy Code (Amendment) Act 2017.

16 The disqualification criteria set out under Section 29A include, inter alia: (1) being an undischarged insolvent or wilful defaulter; (2) having an account, or being the promoter of a company that has an account that has been declared to be a non-performing asset under the guidelines of the Reserve Bank of India, with a period of one year having elapsed from the date of such classification; (3) being convicted for an offence punishable with imprisonment of two years or more; (4) being prohibited by the Securities and Exchange Board of India from trading or accessing the securities market; and (5) having executed an enforceable guarantee in respect of a corporate debtor against whom proceedings have been initiated under the Insolvency Code.

17 Explanation to Section 14(1) of the Insolvency Code.

18 Section 32A of the Insolvency Code.

19 While not yet notified, an ordinance is expected to be notified shortly.

20 Regulation 40C of the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016.

21 Regulation 47A of the Insolvency and Bankruptcy Board of India (Liquidation Process) Regulations, 2016.

22 SGM Webtech Pvt. Ltd. v. Boulevard Projects Pvt. Ltd., (CA No. 1340 (PB)/ 2019 in (IB)-967 (PB)/ 2018).

Code that allow operational (trade) creditors to file proceedings against borrowers for smaller defaults have caused many creditors to strengthen cross-default clauses in loan documents, while also imposing stricter covenants on borrowers with respect to trade creditors.

iv Constitution of the NCLT

The NCLT and the National Company Law Appellate Tribunal (NCLAT) were constituted in June 2016. These are meant to be solely responsible for all company law disputes, assuming powers previously exercised by high courts, the Company Law Board and the Board of Industrial and Financial Reconstruction. The NCLT also functions as the adjudicating authority for all matters under the Insolvency Code (with the NCLAT functioning as the appellate authority). Apart from the NCLAT bench at New Delhi, the central government has also recently notified the constitution of another bench at Chennai with effect from 18 March 2020, which is to have jurisdiction over the states of Karnataka, Tamil Nadu, Kerala, Andhra Pradesh, Telangana, Lakshadweep and Puducherry.

v Basel III

Basel III implementation has commenced in a staged manner in India, with full implementation expected by 1 January 2022. Though it is generally expected that implementation of Basel III may increase lending rates, unlike LMA and APLMA jurisdictions, domestic creditors have not introduced a concept of 'increased costs' for Basel III implementation in loan documentation. Foreign creditors in India, however, adopt the LMA standard of reserving a right to claim increased costs from the borrower, subject usually to negotiated caps.

vi Sanctions and anti-corruption laws

In recent times, based on recommendations of the Financial Action Task Force (FATF) and the Basel Committee, the RBI has issued various guidelines on compliance by banks with these standards[23] in respect of monitoring accounts and reporting of suspicious activity. SEBI regulations also require FPI entities to be registered in jurisdictions that are FATF compliant. The notification of Mauritius in the FATF 'grey list' raised concerns around the large number of FPIs registered in Mauritius; however, SEBI clarified that these FPIs would continue to be eligible, albeit with increased monitoring.[24]

Banks are also now subject to enhanced 'know your customer' (KYC) requirements, which are tailored to meet these guidelines. Most domestic banks require borrowers and security providers to complete a comprehensive KYC process as a condition precedent to disbursement. International banks, as well as domestic banks with a presence in the United States and the European Union (EU), may additionally require borrowers to comply with requirements of the Office of Foreign Assets Control regime or the relevant EU regime. Typically, creditors do not look to extend compliance requirements beyond these regimes (except in transaction-specific cases).

23 Consolidated in the RBI Master Direction – Know Your Customer (KYC) Direction, dated 25 February 2016, as amended from time to time.

24 www.sebi.gov.in/media/press-releases/feb-2020/inclusion-of-mauritius-in-the-fatf-list-of-jurisdictions-under-increased-monitoring-_46073.html (last accessed 25 May 2020).

Given the spate of financial frauds,[25] the government introduced the Fugitive Economic Offenders Act 2018, which came into force on 21 April 2018. The legislation is intended to lay down measures to empower Indian authorities to attach and confiscate properties and proceeds of crime (in or outside India) associated with economic offenders who have left India or are refusing to return to India to avoid prosecution. The efficacy of these measures is currently being tested.

vii Marginal cost of funds-based lending rate

While RBI guidelines permit banks and NBFCs to determine interest rates linked to market-determined external benchmarks (such as the London Interbank Offered Rate), most domestic lenders adopt the 'marginal cost of funds-based lending rate' (MCLR). In April 2016, the RBI replaced the existing interest rate system with the MCLR. Under the MCLR, the lending rate is also pegged against changes in rates and costs of borrowing by banks, including the repo rate. The final lending rate offered to individual borrowers includes a 'spread' over and above the MCLR.

III TAX CONSIDERATIONS

i Withholding tax

An Indian borrower is required to withhold tax payable by a non-resident creditor on interest. Interest payable on a foreign currency-denominated loan is subject to a withholding tax of 20 per cent (plus applicable surcharge and cess),[26] whereas interest on a rupee-denominated loan is subject to withholding tax of 40 per cent (plus applicable surcharge and cess). A lower withholding tax rate of 5 per cent (plus applicable surcharge and cess) may be available where an Indian company avails itself of a long-term foreign currency loan, or issues long-term foreign currency- or rupee-denominated bonds, subject to fulfilment of certain prescribed conditions linked to the Indian exchange control regulations.[27] Interest on loans to Indian borrowers outside India for their offshore businesses is not subject to withholding tax in India, whereas loans taken out in India are subject to withholding tax.

Indian tax laws also offer lower withholding tax rates to certain foreign investors who qualify as FPIs. Generally, FPIs suffer a withholding tax of 20 per cent (plus applicable surcharge and cess) in the case of interest from any securities. However, a lower withholding tax rate of 5 per cent (plus applicable surcharge and cess) applies in the case of payment of interest on rupee-denominated bonds of an Indian company.[28]

Non-resident creditors and FPIs may also be eligible to avail themselves of beneficial tax rates available under India's vast array of double tax avoidance agreements (DTAAs). Certain DTAAs exempt interest income from tax, should the interest be paid to certain specified

25 Such as the US$2 billion fraud involving diamantaire Mr Nirav Modi and Punjab National Bank.

26 Surcharge may be zero per cent, 2 per cent or 5 per cent depending on the income thresholds. Rate of cess will be 4 per cent.

27 This reduced rate of withholding tax is applicable where the specified loans and bonds are issued on or before 30 June 2023.

28 Subject to fulfilment of certain conditions. Also, this reduced rate of withholding tax is applicable where interest is paid on specified bonds on or before 30 June 2023.

creditors (such as the government, specified governmental agencies, financial institutions, and statutory or local authorities). The rate of withholding tax on interest varies from 7.5 per cent to 40 per cent as per the DTAAs executed by India.

The Indian government has also notified Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent BEPS (the MLI), which would apply and modify DTAAs that have been notified by both the countries, being parties to the tax treaty, as a Covered Tax Agreement (CTA).The MLI, inter alia, seeks to introduce anti-avoidance provision in the CTAs, which provides that if one of the main purposes of a transaction arrangement is to obtain tax benefit, then the benefit of the tax treaty may be denied.

The introduction of the Goods and Services Tax in India may impact the cost of lending, as increased service tax will be leviable on banking services.

ii Documentary and transfer taxes

Documentary (or stamp) tax is payable on every document signed in India or signed outside India but brought into India (including, in some states, in electronic form). Therefore, if creditors anticipate a document being brought into India (i.e., for enforcement), stamp duty is usually paid at the time of signing. Rates of stamp duty on most documents are determined by the respective state governments for where the document is to be executed or for the location of the immovable property concerned. The rate of stamp duty payable on various types of security interests also varies significantly and is a consideration for creditors while choosing their security package. Following a 2015 judgment of the Supreme Court,[29] although collateral is created in favour of a single agent or trustee in consortium lending, security documents are required to be stamped as though executed separately in favour of each creditor.

Loan trading transactions attract stamp duty. Though novation of commitment may attract a nominal stamp duty (because stamp duty is already paid on the loan agreement), stamp duty on an agreement for assignment of a loan and receivables (being treated as a conveyance of movables) attracts stamp duty ranging from 3 per cent to 14 per cent of the loan amount being assigned. To boost the securitisation market, however, the legislature has exempted securitisation transactions involving the transfer of rights or interest of banks or financial institutions in financial assets from stamp duty incidence.

Debentures are a popular fundraising instrument for Indian corporates. Debentures are required to be stamped under the provisions of the Indian Stamp Act, 1899 (a central legislation) and not the respective state stamp legislations. The Finance Act, 2019 proposed several amendments to the manner of stamping of debentures, at the time of issuance and transfer.[30] Historically, transfer of dematerialised securities (including debentures) was not subject to stamp duty, as no 'instrument' was executed. Importantly, the depository (which handles dematerialised securities) is now legally required to collect stamp duty on such transfer of dematerialised securities and pay such amounts to the relevant government. While stamp duty on the issuance of debentures was earlier subject to a cap of 25 million rupees, this cap has now been removed, although the rate of stamp duty has reduced from 0.25 per cent of the face value of the debenture to 0.005 per cent.[31]

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29 *Chief Controlling Revenue Authority v. Coastal Gujarat Power Limited & Ors*, Civil Appeal No. 6054 of 2015 (arising out of SLP (C) No. 32319 of 2013).

30 These amendments also cover issue and transfer of dematerialised securities in general.

31 These amendments are not yet made applicable.

Typically, the adequacy of stamp duty on instruments is tested when: (1) they are sought to be registered or otherwise presented to a public authority that has the authority to impound such documents under the stamp laws; or (2) they are sought to be enforced or relied on as evidence (in court proceedings or private dispute resolution proceedings such as arbitration).

Documentation is structured in a manner that minimises stamp duty incidence (such as by executing in states that have a lower stamp duty rate and agreeing to the jurisdiction clauses of such state).

Further, any gains arising to a non-resident from a disposal or transfer of asset (including debt instruments), held as capital assets, will generally be chargeable to capital gains tax in India, if such assets are regarded as property situated in India. The rate at which such gains would be taxed depend on the period of holding of the asset. For different assets, long-term capital gains may arise if the asset is held for a period of more than one to three years. Conversely, short-term capital gains may arise if an asset is held for a period less than one to three years. The long-term capital gain is taxed at rates ranging from 10 to 20 per cent (plus applicable surcharge and cess), while short term capital gains is taxed at rates ranging up to 40 per cent (plus applicable surcharge and cess). In case of any capital gains arising to a non-resident, tax would also be required to be withheld by the buyer at the applicable rates. In case of a non-resident, these rates are subject to beneficial tax provisions available under India's vast array of DTAAs.

iii FATCA and the CRS

In 2015, the Foreign Account Tax Compliance Act (FATCA) and the Common Reporting Standard (CRS) became applicable in India, under the intergovernmental agreements executed by the Indian government. These arrangements have been implemented by requiring financial institutions to share relevant data with the Central Board of Direct Taxes, which will then transmit this information to the relevant offshore authorities. The RBI has also modified its KYC and reporting guidelines applicable to lending institutions to incorporate the FATCA and CRS requirements. Creditors typically address FATCA compliance by requiring the borrower and other creditors to confirm their FATCA status, and each party bears its own FATCA deductions, with no gross-up (similar to the LMA arrangements on FATCA).

IV CREDIT SUPPORT AND SUBORDINATION

i Security

Types of security interests

Creditors can choose from a variety of security options to safeguard their exposure to borrowers and minimise risks associated with lending in India. Typically, high-value transactions involve the creation of multi-layered security packages. Though creditors may have preference for the type of security that is to be created, industry and company-specific diligence plays a key role in charting out the strategy for assets to be secured as well as the type of security interest to be created, to ensure the highest degree of protection. The *Jaypee* judgment in the context of the Insolvency Code is also likely to change lenders' approach to third-party security (which is fairly common in Indian lending transactions) to require third parties to also provide a guarantee along with the asset security.

Mortgages

A mortgage is a transfer of interest in immovable property to secure an existing or future debt or the performance of an engagement that may give rise to a pecuniary liability. Although there are different types of mortgages that may be created in India (such as usufructuary mortgage or mortgage by conditional sale), in secured lending transactions involving immovable property as security, typically a mortgage in the English form or by deposit of title deeds is created. Many traditional lending institutions in India still require a borrower to mortgage some immovable property for any lending, as this is seen to provide a greater assurance than security over movable or financial assets. Working capital is typically secured by receivables and the stock-in-trade of the borrower.

A mortgage in the English form is the preferred form of security, as it involves a complete transfer of property to the creditor subject to the right of redemption of the mortgagee. It is typically associated with ease of enforcement, because a creditor has private remedies available (such as appointment of a receiver for the property) under law and does not have to rely on a court process for protection or enforcement of security. There is ambiguity regarding whether these remedies are available to foreign creditors, however. Legal structuring of a mortgage in the English form allows borrowers to charge or assign movables, contracts and other assets along with the immovable property, affording the benefit of private remedies and ease of mortgage enforcement to all such assets. A mortgage in the English form can, thus, effectively secure all assets of the borrower.

A mortgage by deposit of title deeds requires the deposit of title deeds of the property with the creditor with an intention to create security over the property (usually demonstrated by a declaration issued by the borrower at the time of deposit of the title deeds). The mortgage can be created only over immovable property and, therefore, does not afford the convenience of stapled security, unlike a mortgage in the English form.

Pledges and liens

A pledge is a special form of 'bailment' under law and, therefore, requires actual or constructive delivery of possession of the assets being pledged. Because transfer of possession restricts the ability of the borrower to use the secured assets, a pledge is usually created over shares and financial assets, which are not required for day-to-day operations. The pledge is created by handover of the share or security certificates to the creditor, or if the securities are in electronic form, by the marking of a pledge over the securities in the records of the depository,[32] which 'locks' the securities and does not permit any transaction without the consent of the creditor. Pledges are usually accompanied by a power of attorney in favour of the creditor (or the trustee) for exercise of rights in respect of the securities on the occurrence of a default.

Pledges are taken as security in all kinds of financing, including project financing and mezzanine or structured financing, because they allow borrowers to leverage financial securities held by them and provide ease of enforcement. Upon a default by the pledgor, a sale of the pledged assets can be effected without court intervention, and the proceeds can be used by the pledgee to discharge the pledgor or borrower of its obligations.

Indian law also recognises retention of title clauses and provides for security in the form of a lien to unpaid sellers.

32 A depository is an entity registered with the Securities and Exchange Board of India to hold dematerialised securities in its system and maintain records for the beneficial owners of the securities.

Charges and hypothecations

Although movable assets are frequently 'stapled' with immovable property in an English mortgage (see 'Mortgages' in Section IV.i), where immovable property is not available or is being secured by a mortgage by deposit of title deeds, creditors require the borrower to charge its movable assets (physical, financial and non-physical assets) under a hypothecation document. Though a stand-alone mortgage over movable properties has also been recognised, this is not the usual route adopted by creditors in India. A hypothecation is recognised in Indian law as a charge on existing or future movable property without delivery of possession. It is a contractual creation of a special property in assets, entitling the creditor to take possession of those assets in a default and sell them for realisation of outstanding debt. Both fixed and floating charges are recognised in India.

Substitution rights

In most public–private partnership projects (e.g., roads and airports), the government continues to own the project asset, with a concession being granted to the borrower to develop and operate the asset. Similarly, several assets such as telecom assets, spectrum and mining rights are owned by the government and licensed to private parties. These assets cannot be charged directly to creditors. Therefore, government authorities enter into tripartite arrangements with creditors, under which they allow the creditors a right to substitute the borrower with an eligible third party (subject to certain conditions). However, the sanctity of these arrangements is unclear.

Common methods of taking security

The most common types of security interests associated with certain types of assets are:

a real estate: by way of a mortgage over immovable property, which may also encompass all other assets of the borrower under a stapled security structure;

b tangible movable property: by way of a mortgage (if stapled with land) or a hypothecation;

c financial securities: usually by way of a pledge, delivering possession to the creditors; and

d contractual rights, receivables, intellectual property, etc.: by way of a mortgage (if stapled with land) or a hypothecation.

Additional perfection rights may be required depending on the nature of the asset (e.g., creation of charge over aircraft is required to be endorsed on the certificate of registration with the Directorate General of Civil Aviation). With respect to intellectual property, creation of any security interest is required to be notified to the relevant registration authorities.

Foreign creditors also require a no-objection certificate from the relevant authorised dealer[33] prior to the creation of security over any Indian assets in their favour.

Common methods of enforcement

Enforcement of a security interest may be done either privately or through court intervention. A typical private enforcement process would take about two to four years, whereas a court process may extend to about 10 to 12 years. A mortgagee has the right to file a suit for

33 Authorised dealer banks are banks that are authorised by the RBI to deal in foreign exchange in India.

foreclosure or sale on default in repayment; however, these rights have not been extended to foreign creditors under the Indian transfer of property regime. Thus, although foreclosure is not an option for mortgages in the English form or foreign creditors, creditors holding a mortgage in the English form are permitted to effect a private sale of the property or appoint a private receiver without approaching a court. The enforcement of a charge over movable assets requires the intervention of courts unless the terms of the underlying contract expressly provide for it. For a pledge, a creditor may simply sell the pledged assets in accordance with the terms of the underlying contract and after giving reasonable notice to the pledgor. Creditors have a duty to maximise recovery from secured assets.

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (the SARFAESI Act) provides creditors private remedies to enforce any security interest (except a pledge on movable assets or a lien). Where a substantial part of the business is held as collateral by the creditors (such as in a project financing), they are also permitted to take over the management of the borrower. In the case of consortium lending, approval of 60 per cent of the creditors in value is required for the exercise of powers under the SARFAESI Act, and the approval is binding on all creditors (including dissenting creditors). Remedies under the SARFAESI Act are also available to the listed bond market in India and to non-banking financial companies with an asset size exceeding 1 billion rupees.

Debt recovery tribunals (DRTs) were established in India under the Recovery of Debts Due to Banks and Financial Institutions Act 1993. Creditors (including secured creditors who have not received full repayment from enforcement of security) may apply to the DRTs for recovery of debt. Recovery officers of the DRT are empowered to, inter alia, attach property of the borrower (even property that is not offered as collateral) and require third-party debtors of the borrower to repay debt amounts to the officer. The efficacy of approaching the DRTs to seek recovery of debt is severely hampered by an immense backlog of cases. It is estimated that there are over 100,000 cases pending before the various DRTs.[34] In an attempt to reduce the load on DRTs, the government has increased the minimum loan size for which cases may be filed to 20 million rupees.

Under extant foreign exchange regulations, foreign creditors require authorised dealer approval for enforcement of security and repatriation of proceeds. Further, enforcement would also need to comply with generally applicable foreign exchange restrictions, including that the sale of immovable property can only be to a resident and any invocation of pledge is to be in accordance with the foreign investment policies.

Formalities and registration

Board approval

Any creation of security over a company's assets needs the approval of the board of directors of the company by way of a physical meeting. Creation of security over assets exceeding specified valuation thresholds or of third-party security for a loan to a group company also requires approval of three-quarters of the shareholders of a company. In the case of third-party security, additionally, the loan for which security is provided is required to be used for the principal business activities of the borrower.

34 www.livemint.com/Industry/kljsixs5Uor7G4MBSWLVMN/Nearly-1-lakh-pending-cases-in-DRTs-data-shows.html (last accessed 10 June 2018).

Registration

All charges (including mortgages, pledges and liens) created over the property and assets of a company are to be registered with the Registrar of Companies within 300 days of the date of creation of the charge for the security interest to be enforceable as regards the company's creditors and its liquidator, for a fee ranging between US$3 and US$9.

Mortgages over immovable property (other than by way of deposit of title deeds) are also required to be registered with the sub-registrar of assurances in whose jurisdiction the property is situated. The registration fee varies across various states and may either be a capped amount (US$461 in Maharashtra) or *ad valorem* in respect of the amount secured. Mortgages by deposit of title deeds are required to be noted in the land registry in certain states.

Creditors are required to file details of mortgages created in their favour with the Central Registry of Securitisation Asset Reconstruction and Security Interest of India (CERSAI) under the SARFAESI Act. Additionally, specific assets may also require additional registration (i.e., the assignment or transmission of rights in relation to patents is required to be filed in the register of patents). While financial creditors have already been mandated by the RBI to submit information relating to their borrowers' accounts to information utilities,[35] as per a recent notification by the NCLT dated 12 May 2020, it is now also mandatory to file the default record from the information utility along with new petitions being filed under Section 7 of the IBC (and prior to the next date of hearing, for petitions that are pending admission).

Particular challenges

Some of the specific challenges faced by creditors in the creation and enforcement of security are as follows:

a requirement of government consent for creation and enforcement of security. Consent of local authorities may be required in some states for mortgaging land, particularly if the creditor is not a recognised or notified creditor. Certain assets (such as production-sharing contracts or mining leases) require government approval for creation and enforcement of any security, and enforcement is also possible against a limited number of entities. Similarly, forest land cannot be mortgaged, as it belongs to the government and approval is required even for the removal of immovable plant and machinery located on it (which may itself be charged to the creditor). Securing government approvals may require approval of the relevant authority, and any transfer on enforcement may only be in favour of a similarly qualified entity;

b transaction costs remain high because of stamp and registration duties;

c private enforcement is limited to only certain types of creditors, and enforcement proceedings through the court process are highly protracted, resulting in a diminution in the value of the assets over time; and

d under Indian transfer of property laws, there may be dual ownership over fixed assets and the land on which such assets are located. This creates complications for the purposes of enforcement of security by creditors.

35 RBI notification dated 19 December 2017 entitled 'Submission of Financial Information to Information Utilities', reference No. RBI/2017-18/110.

ii Guarantees and other forms of credit support

Corporate guarantees are usually sought by creditors from the parent or from associated companies of the borrower entity. Although guarantees are executed as deeds (and, therefore, do not require consideration to pass to the guarantor), most creditors require the guarantor to demonstrate consideration in the form of a corporate benefit accruing to it.

Given India's traditionally promoter-driven corporate market, creditors have historically required individual promoters to provide personal guarantees for corporate loans. Creditors also require promoters to provide personal guarantees as a condition of restructuring loans, on the principle that shareholders should bear the first loss. In view of the burgeoning NPA problem (see Section I), the RBI in 2014 allowed banks to classify guarantors who refuse to honour guarantees as 'wilful defaulters', restricting access to capital and debt markets. With the increasing focus on guarantors by both banks and regulators, many corporate groups resist guarantees by individual promoters. Creditors as beneficiaries of guarantees are also able to take the guarantor (following invocation) to a corporate insolvency resolution proceeding under the Insolvency Code.[36] While this was earlier possible only for corporate guarantors, the provisions of the Insolvency Code applicable to the insolvency resolution and bankruptcy of personal guarantors were also notified with effect from 1 December 2019, as mentioned above.

Group company guarantees require a host of corporate compliance criteria to be met, including approval of the shareholders of the guarantor and a condition that the loan should be used by the borrower company for its principal business activities only.

iii Priorities and subordination

Secured creditors continue to have better protection and preferential access to borrower assets than unsecured creditors.[37] Certain encumbrances created under law also have priority over secured creditor rights (such as banker's lien and an unpaid vendor's lien). Because these rely on a preferential status because of possession, priority rules gain significance in the context of non-possessory securities (such as charges and mortgage).

In the absence of contractual provisions to the contrary, the following rules of priority are applicable under Indian law:

a between two registered charges, the charge registered prior in time will have priority;

b an equitable mortgage takes effect against any mortgage deed subsequently executed and registered in relation to the same property;

c a mortgage of movables with possession has priority over a prior mortgage without possession;

d a mortgagee of movable property without possession that comes to court first will have priority over subsequent such mortgagees that approach the court;

e a fixed charge has priority over a floating charge;

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36 See *Vishnu Kumar Agarwal v. Piramal Enterprises Ltd* (Company (AT) (Insolvency) Nos. 346 and 347 of 2018); *Rai Bahadur Shree Ram and Company Pvt Ltd v. Rural Electrification Corporation & Ors*, Civil Appeal No. 001484 of 2019; *Axis Bank Limited v. Edu Smart Services Limited* (Company Appeal (AT) (Insolvency) No. 304 of 2017); and *ICICI Bank Limited & Ors v. CA Ritu Rastogi & Ors* (CA 366 (PB)/2017 and (IB)-102(PB)/2017).

37 Under the Insolvency Code, secured creditors have the option of enforcing their security interests without relinquishing the same to the liquidation estate. In this scenario, the unpaid debt of secured creditors ranks at par with government dues and below unsecured financial creditors under the liquidation waterfall.

f between two floating charges, the one created earlier in time will have priority; and
g the registration and fulfilment of perfection requirements of a charge give it priority over a non-registered and non-perfected charge, notwithstanding when the charge was created.

Contractual priorities in security are usually set out in an intercreditor or subordination agreement between the creditors. Intercreditor arrangements are fairly standard and are afforded sanctity by courts as well as participating lending institutions. It remains to be tested whether turnover subordination provisions will be binding on a liquidator appointed under the Insolvency Code or the Companies Act 2013 (this seems to be the position taken in a recent decision[38] of the Ahmedabad bench of the NCLT, however).

Typical LMA and APLMA provisions requiring majority creditor consent for enforcement or other action against a borrower or obligor are viewed as unenforceable under Indian law, as the Indian Contract Act 1872 holds contracts restraining legal proceedings to be void. Therefore, enforcement priority in India is maintained by imposing wait periods (up to a year) on subordinated creditors for enforcement.

An intercreditor arrangement may become problematic where different types of creditors are party to it, as all creditors do not have equal access to special enforcement mechanisms. For instance, remedies under the SARFAESI Act are not available to foreign creditors who are not registered in India and to certain NBFCs. The imposition of wait periods for access to remedies under the SARFAESI Act also entitles some creditors to invoke remedies under the SARFAESI Act before others. Though an intercreditor arrangement may address these issues by requiring creditors who have the benefit of these regimes to share recoveries with other creditors, this results in an unsatisfactory situation where the notified creditors cannot then recover their dues as they have (notionally) already received full payment from the borrower.

V LEGAL RESERVATIONS AND OPINIONS PRACTICE

i Limitations on the validity and enforceability of guarantees and securities

Although India broadly adopts a pro-creditor approach in ensuring the least possible hindrance in the enforcement of security interests and guarantees, there are certain limitations to enforceability that find their origin in law and apply in a universal fashion. These include the necessity of demonstrating a corporate benefit, aspects pertaining to financial assistance and the existence of clawback risks in the context of insolvency. These issues have been elaborated upon in more detail below.

ii Corporate benefit

A corporate benefit is required to be demonstrated in different ways, depending on the type of transaction being entered into, and the person or entity to whom loans are being advanced or on behalf of whom security interests are being created (e.g., in favour of lenders). There applies a blanket prohibition on loans being advanced or securities being created by a company in favour of its own directors or persons in whom the directors are interested. Exceptions to

38 *Technology Development Board v. Anil Goel & Ors.* (IA 514 of 2019 in C.P. (I.B) No. 4/NCLT/AHM/2017).

this rule include the provision of loans or securities as part of the service ordinarily extended by the company to its employees or pursuant to a scheme expressly approved by the members of the company.

Financial assistance

The Companies Act 2013 restricts public companies from giving loans or guarantees, or providing security or any financial assistance in connection with the purchase or subscription of shares by any person (including any shares in its holding company).

Clawback risks

As the insolvency regime applicable to corporate entities is spread over the provisions of the Companies Act 2013 and the Insolvency Code, there are several clawback risks that apply depending on the framework under which the relevant antecedent transaction is being scrutinised. These have been set out in the table below.

Antecedent transaction	Counterparty to the transaction	Effect	Look-back period	Consequence	Who may apply
Fraudulent preference under the Companies Act 2013	Creditor, surety or guarantor	Puts person in better position in liquidation than would have been if no preference had been given The preference would involve the transfer of property or delivery of goods, payment, execution made, taken or done by or against the company	Six months prior to making of winding-up application	The NCLT may restore position to what it would have been if no preference had been given	*Suo moto*
Transfers not in good faith under the Companies Act 2013	A purchaser or encumbrancer in good faith and for valuable consideration	A transfer of property or delivery of goods not being a transfer or delivery made in the ordinary course of business	One year before presentation of a petition for winding up by the NCLT	The NCLT would deem the transfer or delivery void against the company liquidator	*Suo moto*
Creation of a floating charge under the Companies Act 2013	Any person	Creation of a floating charge on the undertaking or property of the company, unless it is proved that the company was solvent immediately after the creation of the floating charge	One year before presentation of a petition for winding up by the NCLT	The NCLT would deem the floating charge invalid except to the extent of any money paid in consideration for the charge together with interest on this amount	Suo moto

Antecedent transaction	Counterparty to the transaction	Effect	Look-back period	Consequence	Who may apply
Extortionate credit transaction under the Insolvency Code	Any person other than financial service companies	Requires the company to pay exorbitant payments for credit provided or is unconscionable under laws of contracts	Two years from insolvency commencement date	Set aside the transaction, restore the position as it existed prior to the transaction, modify the transaction or pass any other order under Section 51(1) of the Code	Liquidator or resolution professional
Extortionate credit transaction under the Insolvency Code	Any person other than financial service companies	Requires the company to pay exorbitant payments for credit provided or is unconscionable under laws of contracts	Two years from insolvency commencement date	Set aside the transaction, restore the position as it existed prior to the transaction, modify the transaction or pass any other order under Section 51(1) of the Code	Liquidator or resolution professional
Preferential transactions under the Insolvency Code	Creditor, surety or guarantor	Transfer of property or an interest thereof because of an antecedent financial liability, operational debt or other liability owed by corporate debtor having an effect of putting person in a better position than under waterfall mechanism under Section 53	Related party: during the two years preceding insolvency commencement date Other than related party: during the one year preceding insolvency commencement date	Avoidance of preferential transactions or any other order made by the tribunal under Section 44 of the Code	Liquidator or resolution professional
Undervalued transactions under the Insolvency Code If the transaction was deliberately entered into by the company to keep assets beyond the reach of creditors or adversely affect a person's claims, the transaction can be treated as a transaction defrauding creditors	Any person	A gift is made to a person; or a transaction is entered into that involves transfer of one or more assets or consideration that is significantly less than the value of consideration provided by corporate debtor	Related party: during the two years preceding insolvency commencement date Other than related party: during the one year preceding insolvency commencement date No look-back period is applicable in respect of transactions defrauding creditors	Undervalued transactions: declaration of transaction as void or reversal of effect of transaction (as provided under Section 48), and release of security created or return of benefits Transactions defrauding creditors: restoration of the position as it existed before the transaction, as if the transaction had not been entered into; and any other order to protect the interests of the persons who are victims of the transaction	Liquidator, resolution professional, creditor, or member or partner of the corporate debtor

iii Legal opinions practice

The issuance of legal opinions is standard practice for the purposes of Indian lending. Opinions usually contain statements regarding the capacity of the counterparty to execute the necessary documentation and to enter into the transaction. For the purposes of secured lending, these opinions also explicitly comment on the validity of the security interest being created. It is the creditors' counsel who usually delivers the opinions. However, in some cases, opinions are sought from the borrower's counsel along with a supporting confirmation from the creditors' counsel.

iv Choice of law

Decrees passed by courts of a 'reciprocating territory' may be executed in India as Indian decrees, except in certain limited circumstances (e.g., where the judgment has not been pronounced by a court of competent jurisdiction, where it has not been given on the merits of the case or where it appears on its face to be founded on an incorrect view of international law). The government notifies jurisdictions that qualify as reciprocating territories by way of notification in the Official Gazette. So far, only 12 jurisdictions have been notified as reciprocating territories, and this list does not include several key jurisdictions, including the United States. Judgments or decrees of courts in non-reciprocating territories can be enforced only by filing a lawsuit in an Indian court for a judgment based on the foreign judgment.

Pursuant to certain changes to the framework governing domestic and international arbitration, the scope for challenging a foreign award on the basis of violation of public policy has been narrowed, and awards have been prohibited from being set aside merely on the ground of an erroneous application of the law or by way of re-appreciation of evidence.

VI LOAN TRADING

Loan trading is common, with most documentation structures providing for loan trading without borrower consent by way of novation (usually of undisbursed commitment) and assignment (of a disbursed facility). Large loans involve agent and security trustee structures, allowing new creditors the benefit of existing collateral without requiring action on the part of the borrower. In the event of trading of bilateral loans, however, a release and recreation of security with the cooperation of the borrower is inevitable, which also has its own stamp tax and registration cost implications. See Section III.

Sub-participation and risk participation without a change to the creditor on record have seen an increase in Indian markets in light of the NPA issue, with the market having seen a lifetime high of transactions between April and December of 2018.[39] This has encouraged banks to trade stressed assets. Securitisation (i.e., assignment of loans and receivables to asset reconstruction companies (ARCs) that issue security receipts to holders) is governed by the SARFAESI Act, which contemplates transfer of stressed assets to ARCs, which would then undertake recovery measures against the borrower. There has been a big push to promote these entities by the RBI and the Indian government recently, including by liberalising foreign investment in such companies.[40] Foreign investment by eligible FPIs is also now permitted in securitised debt instruments issued by ARCs.

In September 2016, the RBI permitted banks to sell their stressed assets to other creditors, NBFCs and financial institutions. As per these guidelines, 'scheduled commercial banks' are required to identify assets for sale on an annual basis and periodically review the classification of their financial assets. Banks are also required to invite public bids for the

39 www.thehindubusinessline.com/money-and-banking/securitisation-market-volumes-touch-all-time-high-of-144-lakh-cr-icra/article25933831.ece (last accessed 19 April 2019).

40 Press Note No. 4 of 2016 issued on 6 May 2016 by the Department of Industry Policy and Promotion, Ministry of Commerce and Industry, government of India.

same, to attract more buyers and improve the price discovery mechanism. Banks have also now been permitted to buy back financial assets that have been successfully restructured by ARCs (other than those that were sold by the banks themselves).

The Insolvency Code and its time-bound mechanism for acquisition of distressed assets has seen great interest from global distressed assets funds. Many funds with an India focus have raised a significant amount of capital recently to acquire debt positions from stressed banks looking to offload non-performing and stressed assets.[41]

Because a resolution process under the Insolvency Code requires 66 per cent positive votes from creditors, loan trading has assumed greater significance for companies that are in the middle of a corporate insolvency resolution process. The Indian Banks Association has therefore requested its member banks not to sell stressed assets of companies undergoing insolvency resolution proceedings without informing other lenders in the consortium.[42]

VII OTHER ISSUES

The covid-19 situation has also resulted in the introduction of a spate of other measures apart from those discussed above. The finance ministry recently announced a large stimulus package, which provides for, among other things, the introduction of special liquidity schemes and credit backed schemes for NBFCs (under which the first 20 per cent loss will be borne by the government as guarantor). The package also accords permission to NBFCS to defer the commissioning date for real estate projects for delays beyond the control of the promoter without treating this as a 'restructuring' (and the attendant consequences). Further, while the market for debt mutual funds was growing at a healthy rate so far, the redemption and liquidity issues that have arisen as a result of the pandemic have resulted in volatility in this sector, with Franklin Templeton announcing the winding down of six of its debt funds in India.[43] In light of these, lenders will need to consider the implications of these measures before advancing funds to borrowers.

VIII OUTLOOK AND CONCLUSIONS

With the economic and social disruption caused by covid-19, the Indian lending market is in an uncertain stage. State-owned banks continue to be seen as a primary source of funds, especially for mid- to large-scale projects as well as playing a big role in stimulus for the battered Indian industries. Global debt funds (through AIFs and FPIs) seem to be adopting a 'wait and watch' approach. The government's measures to provide relief to borrowers and the proposed suspension of the Insolvency Code are far-reaching measures, and their true impact can be assessed only once the economy slowly reopens after the various 'lockdown' measures imposed to curb the spread of covid-19.

41 https://smartinvestor.business-standard.com/market/ipoNews-552281-IBC_accounts_for_143_bn_worth_of_distressed_assets_in_MA_space_Kroll.htm.

42 https://economictimes.indiatimes.com/markets/stocks/news/collective-action-on-stressed-assets-sales-by-banks-needed/articleshow/62847064.cms (last accessed on 10 May 2018).

43 https://thewire.in/business/franklin-templeton-debt-schemes-coronavirus.

Appendix 1

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Viswanathan has acted on a number of landmark transactions, including advising: the Indian lenders on the restructuring of the Dabhol power project; the syndicate of lenders and other national and international financial banks and agencies in the 4000 MW Mundra Ultra Mega Power Project; the syndicate of lenders in the refinancing of the acquisition financing obtained by Tata Motors; clients with respect to several road projects in India, including the KMP Expressways Limited; and the developers with respect to the privatisation and modernisation of the Mumbai International Airport, and the syndicate of lenders financing the Delhi International Airport.

Lauded for his 'fantastic understanding of complex matters' and his 'thoughtful, innovative approach' by *Chambers Global*, Viswanathan has been included among the top project finance, and banking and finance lawyers in India by several leading international legal publications. *IFLR1000* 2014 named him as a leading lawyer for energy and infrastructure. *Chambers Asia-Pacific* 2018 states that 'whenever there was an issue that neither side could resolve, everyone would turn to Viswanathan to see what he felt. His views were seen as that of a senior authority, and both sides were happy to trust his judgement' and that he is 'one of the top lawyers in terms of reputation and seniority'. *Who's Who Legal* notes that he is 'recommended without hesitation' by clients.

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