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Avinash Kumar



Avinash Kumar has completed his Ph.D. in International Investment Law from the Dept. of Law & Governance, Central University of South Bihar. His research work is on "International Investment Agreement and State's right to regulate Foreign Investment." He qualified UGC-NET and has been selected for the prestigious ICSSR Doctoral Fellowship. He is an alumnus of the Faculty of Law, University of Delhi. Formerly he has been elected as Students Union President of Law Centre-1, University of Delhi. Moreover, he completed his LL.M. from the University of Delhi (2014-16), dissertation on "Cross-border Merger & Acquisition"; LL.B. from the University of Delhi (2011-14), and B.A. (Hons.) from Maharaja Agrasen College, University of Delhi. He has also obtained P.G. Diploma in IPR from the Indian Society of International Law, New Delhi. He has qualified UGC – NET examination and has been awarded ICSSR – Doctoral Fellowship. He has published six-plus articles and presented 9 plus papers in national and international seminars/conferences. He participated in several workshops on research methodology and teaching and learning.

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PROBLEMATIC APPROACH TO PUBLIC EQUITY SHAREHOLDERS: SEBI V. IBC

AUTHORED BY - HANAH VARGHESE

Abstract

This paper investigates the evolving role of the Securities and Exchange Board of India (SEBI) in protecting retail investors amid corporate insolvency, with particular emphasis on the consultation paper issued on November 10, 2022. This consultation paper proposes significant measures aimed at safeguarding retail shareholders. Specifically, it suggests ensuring these investors receive fair value for their shares during their exit from the company and offers them the opportunity to acquire equity in the restructured entity following insolvency. The necessity for SEBI's intervention is highlighted by major defaults such as Dewan Housing Finance Limited (DHFL) and Ruchi Soya, where retail investors experienced severe financial losses due to delisting and value erosion.

While SEBI's proposed measures are designed to address these investor concerns, they raise critical issues regarding the potential overreach of SEBI's authority, especially with the Insolvency and Bankruptcy Code (IBC). The IBC prioritizes creditor interests and focuses on the revival of the corporate debtor, establishing a framework where creditor claims are settled before any consideration is given to equity shareholders. The paper argues that while SEBI's initiatives are well-intentioned, they risk disrupting the delicate balance of the IBC's creditor-driven structure.

The discussion emphasizes the need for a careful alignment between SEBI's investor protection efforts and the objectives of the IBC to ensure a fair and coherent insolvency process. It advocates for regulatory measures that honour IBC's supremacy while also addressing the legitimate concerns of retail investors. The paper concludes by recommending that SEBI's approach be integrated thoughtfully within the IBC framework, ensuring that investor protections do not undermine the Code's primary goals of maximizing asset value and facilitating corporate revival.

Introduction

Since the inception of the Securities and Exchange Board of India (“SEBI”) in 1992, it has sought to protect the interests of investors. Particularly, retail investors like the common man who is likely to suffer in case of default by the company. The Dewan Housing Finance Limited (“DHFL”) case¹ is a prime example where retail investors suffered when the company underwent insolvency. The paid-up share capital was reduced to almost zero thereby inviting losses to the public equity shareholders who had to exit the company upon delisting.

SEBI’s consultation paper² dated 10th November, 2022 seeks to protect retail investors. It compels the Corporate Debtor (“CD”) to provide shareholders a fair value in proportion to their shareholding during their exit. Further, when the new entity is formed, retail investors of the erstwhile CD are invited to acquire a minimum of 5% of the fully diluted capital structure.

This paper dwells upon the merits and demerits of the consultation paper. It focuses on the jurisdictional tussle between SEBI and IBC and whether the former had the requisite authority to pass the paper. Finally, it addresses the concerns of retail investors during insolvency proceedings.

Highlights of the paper

The paper was passed in the backdrop of numerous defaults such as DHFL. In this case, retail investors purchased shares of DHFL after the restructuring in the expectation that it would remain listed. However, to their dismay, the company delisted following their resolution plan. In another case, Ruchi Soya maintained a low public shareholding of 0.097% post CIRP and the share price showed an increase of 8764% within 5 months upon listing³. Low public shareholding makes the scrip susceptible to manipulation which the SCRA seeks to avoid.

SEBI passed the paper when it received numerous complaints and grievances from companies that were delisted following the approval of the resolution plan. Among the primary concerns raised are:

¹ Dewan Housing Finance Corporation v. Union of India W.P. 3157 of 2021 (Ind)

² Securities and Exchange Board of India, Framework for protection of interest of public equity shareholders in case of listed companies undergoing Corporate Insolvency Resolution Process (CIRP) under the Insolvency and Bankruptcy Code (IBC) (Nov. 10, 2022), <https://www.sebi.gov.in/reports-and-statistics/reports/nov-2022/framework-for-protection-of-interest-of-public-equity-shareholders-in-case-of-listed-companies-undergoing-corporate-insolvency-resolution-process-cirp-under-the-insolvency-and-bankruptcy-code-ibc-64850.html>.

³ DBS Bank Ltd Singapore v. Ruchi Soya Industries Ltd and another, CIVIL APPEAL NO. 9133 OF 2019 (Ind)

- a. They believe that SEBI should step in to ensure that retail investors are allotted shares in the new entity that emerges after the debtor company is taken over by a new promoter through the NCLT resolution process.
- b. SEBI should be responsible for determining the fair value of the debtor company and ensuring that all small stakeholders receive an appropriate value for their shareholding, as currently, only major investors acquire shares of the distressed company at low prices, leaving retail shareholders without any compensation for their shares.
- c. A resolution process that culminates in the equity shares of a company being rendered worthless overnight as a consequence of delisting, following the approval of a resolution plan, without prior notice to public shareholders or allowing them to be heard before the Committee of Creditors (“CoC”), is procedurally untenable and contrary to principles of fairness⁴.

Assuming jurisdiction on the matter, SEBI proposed that the public equity shareholders of the CD should be provided an opportunity to acquire equity of the fully diluted capital structure of the new entity up to minimum public shareholding (“MPS”) percentage, on the same pricing terms as agreed upon by the resolution applicant. This allows retail investors who were part of the insolvent company a chance to be a part of the new management. The Primary Markets Advisory Committee (“PMAC”) proposed that post-Corporate Insolvency Resolution Process (“CIRP”) companies should have at least 5% public shareholding at the time of relisting⁵. Such companies have also been granted a time relaxation to achieve the MPS percentage (25%) within 36 months of relisting.

Further, suppose the new entity failed to maintain a minimum of 5% public shareholding. In that case, the company shall be delisted following the cancellation of the offer⁶. This forces public participation in the new entity to achieve the minimum shareholding. In light of recent cases, SEBI seems to have taken a more cautious role in ensuring that retail investors are not harmed.

⁴ Securities and Exchange Board of India, Framework for protection of interest of public equity shareholders in case of listed companies undergoing Corporate Insolvency Resolution Process (CIRP) under the Insolvency and Bankruptcy Code (IBC) (Nov. 10, 2022), <https://www.sebi.gov.in/reports-and-statistics/reports/nov-2022/framework-for-protection-of-interest-of-public-equity-shareholders-in-case-of-listed-companies-undergoing-corporate-insolvency-resolution-process-cirp-under-the-insolvency-and-bankruptcy-code-ibc-64850.html>.

⁵ Securities and Exchange Board of India, Recalibration of threshold for Minimum Public Shareholding norms, enhanced disclosures in Companies which undergo Corporate Insolvency Resolution Process (CIRP) (https://www.sebi.gov.in/sebi_data/meetingfiles/dec-2020/1608621922552_1.pdf)

⁶ Ibid at 4

The proposal reduces the burden of the new management post-restructuring to achieve the minimum public float as existing shareholders can participate in proportion to their shareholding and be a part of the new management. However, this approach to the Code appears to disrupt the nexus of the IBC.

Disrupting the nexus of IBC

The Insolvency and Bankruptcy Code (“IBC”) deals with CD's reorganization and insolvency resolution. The objective of the Code is threefold; "The top priority is to achieve a resolution, followed by maximizing the value of the CD's assets. The third objective focuses on supporting entrepreneurship, ensuring the availability of credit, and balancing the interests involved. This order of objective is sacrosanct⁷." The Code is beneficial, as it seeks to place the CD on its feet, and not just as a recovery legislation for creditors. It aims to balance the interests of the CD and the creditors.

In numerous instances, the apex court has held that the Code focuses on the revival of the CD and to make it a going concern and every attempt should be made to renew it with liquidation being the last resort⁸. Therefore, the resolution applicant should undertake all possible measures to revive the CD. It is only when the CIRP process fails to find a resolution, the distribution of proceeds from the sale of liquidation of assets under section 53 is triggered⁹.

The waterfall mechanism under section 53 contains a ‘non obstante clause’ meaning it shall take precedence over any other conflicting provisions. It puts forth the order of priority of the distribution of assets. The list places equity shareholders as the last priority in the event of liquidation. Therefore, minority equity shareholders shall only be entitled to compensation if any surplus remains after the debt is paid to persons ranking higher in the list. The limited liability company is a contract between equity and debt. As far as the debt obligations are met, equity owners have complete control, and creditors have no say in how the business is run¹⁰. So, the shareholders profit from their investment when the company performs well. However, in the event of default, control is transferred to the creditors, and equity owners have no say¹¹.

⁷ Binani Industries Limited Vs. Bank of Baroda & Anr (2018) SCC Online NCLAT 521 (Ind)

⁸ K. N Rajakumar v. V. Nagarajan & Ors CIVIL APPEAL NO.2901 OF 2021 (Ind)

⁹ Insolvency and Bankruptcy Code, No. 31 of 2016, § 53 (Ind).

¹⁰ Bankruptcy Law Reforms Committee, Report of the Bankruptcy Law Reforms Committee, Volume I: Rationale and Design (Nov. 4, 2015), https://ibbi.gov.in/BLRCReportVol1_04112015.pdf.

¹¹ Id

In the case of Jaypee Kensington Boulevard Apartments Welfare Association & Ors. V. NBCC (India) Ltd. & Ors¹² SC clarified the role of minority shareholders in insolvency proceedings. It has been held that the commercial wisdom of the CoC is not subject to judicial review. Commercial wisdom shall mean the decisions as to the amounts to be paid to different classes or subclasses of creditors per the provisions of the Code, which is not subject to judicial scrutiny¹³. The resolution plan (“RP”) accepted by the requisite creditors/ members of the CoC upon voting, is binding on all creditors¹⁴. Further, as per the Explanation of 30(2)(e) of the Code, the approval by the shareholders shall be deemed to be given for the implementation of the RP¹⁵. Therefore, the minority shareholders shall be subject to the decision of the CoC as this flows from the very objectives of the Code.

At the outset, it may appear problematic and unfair to the minority shareholders because one of the likely outcomes is that the retail investors do not get the right value at the time of liquidation in proportion to their contributions. They shall only receive if any surplus remains in the hierarchy of distribution. In the case of DHFL, delisting procedures were undertaken and retail investors received nothing in exchange for their shares¹⁶. Another case of Patanjali’s acquisition of Ruchi Soya¹⁷ comes to mind when it was relisted at Rs 17/share with its public shareholding as low 0.97%. Therefore, SEBI’s intent behind introducing the consultation paper can be traced here.

The SC in the Essar Steel case delineated specific criteria under which a decision of CoC may be subjected to judicial review.¹⁸ It has been held that the ultimate business decision lies with the CoC. However, the Adjudicating Authority should ensure that CoC decisions do not supersede the objectives of the Code. These include: (i) the CD should continue as a going concern during the resolution process (ii) value of the assets of the CD should be maximised and (iii) interests of all the stakeholders should be balanced¹⁹. Therefore, the CoC shall be subjected to judicial review only if it departs from the very objective of the IBC. There is no scope for interference except when ensuring that the resolution plan meets the requirements of the Code. Therefore, only the most exceptional circumstances warrant the questioning of the CoC. The commercial wisdom of

¹² Kensington Boulevard Apartments Welfare Association & Ors. V. NBCC (India) Ltd. & Ors (Ind)

¹³ India Resurgence ARC Private Limited v. Amit Metaliks Limited & Another, 2021 SCC Online SC 409 (Ind)

¹⁴ DBS Bank Ltd Singapore v. Ruchi Soya Industries Ltd and another, CIVIL APPEAL NO. 9133 OF 2019 (Ind)

¹⁵ Insolvency and Bankruptcy Code, No. 31 of 2016, § 30 (2) (e) (Ind)

¹⁶ Dewan Housing Finance Corporation v. Union of India W.P. 3157 of 2021 (Ind)

¹⁷ Ibid at 15

¹⁸ Committee of Creditors of Essar Steel India Limited (through authorized signatory) v. Satish Kumar Gupta and Others (2020) 8 SCC 531 (Ind)

¹⁹ Rajat Sethi and Aditi Agarwal, Case Note: Judgement of the Supreme Court in the Essar Steel Case, SR Insights, SNRLaw.

the CoC is required to be honoured in letter and spirit and to be granted paramount supremacy²⁰.

Overreach by SEBI

SEBI's intention behind passing the consultation paper is honorable. It seeks to protect retail investors during the CIRP process. However, a question of jurisdiction over the IBC may have a potentiality of being questioned on its overreach.

In *Shobha Limited v. Pancard Clubs Limited*²¹ the jurisdictional tussle between SEBI and IBC was dealt with. In this case, the debtor company launched and promoted holiday plans which were Collective Investment Schemes (CIS) without valid registration. The defaulting company raised more than Rs 7000 crores through its investors. The admissibility of the petition was probed in the suit. To this effect, the test laid down in *Kishorebhai Khamanchonil Goyal vs State of Gujarat*²² was applied. The necessary questions raised in the test include:

1. If there is a direct conflict between the two provisions
2. If the legislature intended to lay down an exhaustive Code in respect of the subject-matter replacing the earlier law.
3. If the two laws occupy the same field²³.

The inquiry pertains to determining whether there exists a direct conflict between the provisions, whether the legislature intended to establish an exhaustive Code that supersedes the prior law, and whether the statutes govern the same subject matter.

Based on the test, the apex court held that no conflict exists between the SEBI Act and IBC because SEBI deals with investor protection issues whereas IBC deals with creditor issues. SEBI deals with the investors and the company, whereas IBC deals with the creditors and the debtor. The overriding effect of Code shall only apply when the operation of some other provision is inconsistent to the Code itself. Therefore, if any regulation breaches the non-obstante clause, it shall be deemed invalid.

In *Bhanu Ram v. HDN Diaries and Allied Limited*²⁴, a similar tussle between SEBI and IBC arose. Regarding the overriding effect of section 238, NCLT held that it should only take effect when

²⁰ *Bank of India v. Pradeep Kumar Goenka (RP) Comp.App.(AT)(Ins) 342/2022 (Ind)*

²¹ *Shobha Limited v. Pancard Clubs Limited*

²² *Kishorebhai Khamanchonil Goyal vs State of Gujarat (2003) L2 SCC 274 (Ind)*

²³ *Id*

²⁴ *Bhanu Ram v. HDN Diaries and Allied Limited CP No. IB 547 (PB)/2018 (Ind)*

the other laws are inconsistent with the IBC, since the SEBI Act has been dealing with investor protection issues, not with creditor and debtor issues, though Section 238 is an exhaustive mode in respect of the subject matter of creditor and debtor issues, it has no overlapping or overriding effect over investor protection issues dealt with under SEBI Act²⁵.

Based on the precedence laid down in the above judgments, we can infer that if any provision disrupts the objectives of IBC, such provision shall be invalid. The consultation paper proposes changes that breach the order of priority u/s 53²⁶. It requires the CoC to allocate a portion to minority shareholders during liquidation, potentially at the expense of other creditors who hold a higher priority. Therefore, the consultation paper is an overreach by SEBI to the extent of the minimum public shareholding.

Shareholder involvement in IBC

It is a settled provision of law that the shareholders are the real owners of the company. However, in the event of bankruptcy or when the firm defaults on its debt, the control of the company should shift to its creditors²⁷. This is the fundamental basis for the Code. The RP, appointed by the CoC, is responsible for managing the insolvency process, which includes gathering and presenting all necessary information to stakeholders, including shareholders. The RP facilitates a transparent negotiation process between creditors and debtors, ensuring that all parties, including minority shareholders, have an opportunity to submit resolution plans²⁸.

In *Arcelor Mittal India Private Limited v. Satish Kumar Gupta*²⁹, the SC observed that “the CD consists of several employees and workmen whose daily bread is dependent on the outcome of the CIRP. If there is a RP who can continue to run the CD as a going concern, every effort must be made to try and see that this is made possible³⁰.” In another case, the SC reaffirmed that the IBC is designed to balance the interests of all stakeholders, emphasizing that the Code's primary focus is on the revival of the CD. This case underlined that while the IBC is creditor-driven, the resolution process must ensure fairness to all parties involved, including shareholders, albeit within the confines of creditor priority³¹. Therefore, despite the Code being creditor-driven, all efforts

²⁵ Id

²⁶ Insolvency and Bankruptcy Code, No. 31 of 2016, § 53 (Ind).

²⁷ The report of the Bankruptcy Law Reforms Committee Volume 1: Rationale and Design (November 2015) https://ibbi.gov.in/BLRCReportVol1_04112015.pdf

²⁸ Insolvency and Bankruptcy Code, No. 31 of 2016, § 29A (Ind).

²⁹ *Arcelor Mittal India Private Limited v. Satish Kumar Gupta* (2019) 2 SCC 1 (Ind)

³⁰ Id

³¹ *Swiss Ribbons Pvt. Ltd. v. Union of India* [2019] 3 S.C.R. 535 (Ind).

must be taken to ensure the best price and outcome for the members involved or affected by the proceedings. Precedent therefore dictates balancing the interest of all the persons and not just the creditors.

Conclusion and way forward

While SEBI's efforts to protect retail investors are well-intentioned, they must be balanced against the established framework and objectives of the Insolvency and Bankruptcy Code (IBC). The IBC's supremacy as the comprehensive legislation governing insolvency ensures that the interests of all stakeholders, including creditors and shareholders, are aligned with the goal of corporate revival and maximizing asset value. Any regulatory intervention, including SEBI's, must respect the IBC's priority structure and overarching principles to maintain the integrity of the insolvency process. The current legislative framework has distinctly held IBC primacy in matters of insolvency.

However, the interests of minority shareholders, who often bear the brunt of insolvency resolutions, must not be overlooked. The DHFL case, where minority shareholders were blindsided by an overnight change in their shareholding status, underscores the need for greater transparency and inclusion. To prevent such scenarios, the insolvency regime should incorporate stricter controls and ensure that all stakeholders, including minority shareholders, are duly informed and considered in the decision-making process.

Furthermore, SEBI's proposal to allow minority shareholders of the erstwhile CD to participate in the public shareholding of the restructured entity is a step in the right direction. This proposal merits serious consideration within the framework of the IBC, as it offers a more inclusive approach to corporate restructuring. By integrating minority shareholders into the post-restructuring shareholding, the Code can better balance the interests of all parties involved, fostering a more equitable and transparent insolvency process.

In conclusion, while maintaining the supremacy of the Code, there is also a need to evolve the insolvency framework to ensure that minority shareholders are not marginalized. A collaborative approach, where SEBI's proposals are integrated within the IBC framework, can lead to a more balanced and just outcome for all stakeholders.