

# STATE OF PERPLEXITY – APPLICABILITY OF IBC ON NBFCs

*IBC acts as an invisible shield for NBFCs classified as FSPs*

- **Megha Mittal**

**Editor's Note:** This piece is an extension of the previous article. It analyses the ruling of NCLT in *HDFC Bank Ltd. vs RHC Holding Private Limited* in particular, and takes the discussion further in light of global practices.

## Background

In line with the order passed by the National Company Law Appellate Tribunal, (NCLAT) in the matter of [Randhiraj Thakur, Director Mayfair Capital Private Limited v. Jindal Saxena Financial Services Private Limited](#) in September 2018, the Principal Bench of National Company Law Tribunal (NCLT) dismissed an application filed for initiation of Corporate Insolvency Process against a financial services provider.

Vide its order dated 06.12.2018, NCLT in *HDFC Bank Ltd. vs RHC Holding Private Limited*, dismissed the application preferred by HDFC for initiation of Corporate Insolvency Process against RHC Holdings on the ground that the latter, a NBFC is a financial service provider and that the Insolvency and Bankruptcy Code, 2016 (hereinafter referred to as “Code”/ “IBC”) does not cover “financial service providers” in its ambit.

Hence, in light of the recent state of affairs, in this article, we shall analyze the stance/ interpretation of NCLT as well as NCLAT so as to understand the extent of immunity available to FSPs, and whether all NBFCs are FSPs. It must be noted that FSPs, colloquially known as entities that are “too big to fail”, is a significant sector of our economy, where public money is involved. In a situation where

these entities fall into bankruptcy, it will lead to a domino effect. Hence, to avoid failure of the economy which seems very probable if there is an increase in the number of failing FSPs, these entities have been excluded from the ambit of the Code.

## Understanding Terminologies

One of the major reasons for which the implementation of the Code was much anticipated was that the Code will emerge as a single-stop solution, consolidating various laws relating to reorganization and insolvency of corporate persons, partnership firms, Limited Liability Partnerships and individuals.

## Corporate Persons:

- Company, under sec 2(20) of the Companies Act, 2013
- LLP, under sec 2(1)(n) of the LLP Act, 2008
- Any other person incorporated with limited liability
- EXCLUDES, any financial service provider

In such a scenario, it is important to understand the reach of the Code, i.e. the entities to which the Code is applicable.

Section 3(7) of the Code, defines the term “Corporate Person” as

*“a company as defined in clause (20) of section 2 of the Companies Act, 2013 (18 of 2013), a limited liability partnership, as defined in clause (n) of sub-section (1) of section 2 of the Limited Liability Partnership Act, 2008 (6 of 2009), or any other person incorporated with limited liability under any law for the time being in force **but shall not include any financial service provider**”*

The definition being exclusive in nature, very clearly eliminates financial services providers from the purview of the Code.

Now the question arises as to what are “financial service providers?”

Section 3(17) of the Code defines “financial service provider” as a person engaged in the business of providing financial services in terms of authorization issued or registration granted by a financial sector regulator, like the Reserve of bank of India (RBI), Securities & Exchange Board of India (SEBI), the Insurance Regulatory and Development Authority of India (IRDAI) etc. Thus, a financial service provider must be one that provides financial services as defined in the Code **as well as** be regulated by or registered with a financial sector regulator.

Further, section 3(16) of the Code, defining “financial services” is *ad-verbatim* produced as follows:

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*“(16) financial service” **includes** any of the following services, namely:*

- a. accepting of deposits;*
- b. safeguarding and administering assets consisting of financial products, belonging to another person, or agreeing to do so;*
- c. effecting contracts of insurance;*
- d. offering, managing or agreeing to manage assets consisting of financial products belonging to another person;*
- e. rendering or agreeing, for consideration, to render advice on or soliciting for the purposes of*
  - (i) buying, selling, or subscribing to, a financial product;*
  - (ii) availing a financial service; or*
  - (iii) exercising any right associated with financial product or financial service;*
- f. establishing or operating an investment scheme;*
- g. maintaining or transferring records of ownership of a financial product;*
- h. underwriting the issuance or subscription of a financial product; or*
- i. selling, providing, or issuing stored value or payment instruments or providing payment services;”*

(emphasis given)

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The extant definition of “financial services” enlists services which shall tantamount to financial. It is important to note that, the definition being “inclusive” in nature,

- i. is not limited to the activities specified in the Code; and
- ii. is operated by the Rule of “*ejusdem-generis*”, which states that, in construction of laws, wills and other instruments, when certain things are enumerated and then a phrase is used which might be construed to include other things, it is generally confined to things *ejusdem generis*, i.e. of the same kind.

## ***EJUSDEM-GENERIS: of the same kind!***

Hence, while determination of a service as “financial service” under the Code, the service must be of the same nature/ kind as those enlisted in the Code.

Interestingly, the Code has refrained from the explicitly using the term NBFCs and as such it is imperative to identify whether NBFCs fall within the purview of Financial Service Providers.

NBFCs are financial institutions that offer various banking services, but do not have a banking license. Generally, these institutions are not allowed to take deposits from the public, which keeps them outside the scope of traditional oversight required under banking regulations.

In furtherance to our earlier articles, it is in light of the recent ruling and scenario that the author humbly attempts to provide a different opinion as outright rejection of NBFCs from the scope of the Code, as a class in entirety, does not seem justified.

### **Facts of the case**

Having understood the connotation of the various terms, let have an insight into the facts of the case in question i.e. HDFC Ltd. vs. RHC Holdings. In the instant case, the financial creditor i.e. HDFC Ltd. preferred an application before NCLT for initiation of corporate insolvency process against RHC Holdings u/s 7 of the Code. However, the application was denied and dismissed by the Hon’ble Bench on the ground that the Respondent i.e. RHC Holdings, an NBFC, is a financial service provider and as such beyond the jurisdiction of the Code.

The Respondent in this matter, is a non-deposit taking NBFC, the main object of which (as stated in para 27 the Order), is “*to lend and finance any persons, companies, corporations, firms or institutions by way of lending ....*” Therefore, the Respondent, evidently a non-deposit taking NBFC does in no manner involve public money or any such activity which might be substantive or crucial to the economy.

However, placing reliance upon the order of the Hon’ble NCLAT in *Randhiraj Thakur v. Jindal Saxena Financial Services*, NCLT held that the Respondent to be financial services provider and accordingly dismissed the application for initiation of its CIRP on grounds on maintainability.

## Rationale

One may argue that the Respondent was engaged in lending and financing companies, corporations, etc. and as such is a financial service provider. However, it is important to note that section 3(16) of the Code enlists those services as financial services which are intricately linked to the money market and/or capital market and might trigger systemic risk in the economy. **And, by the operation of Rule of ejusdem-generis, services like inter-corporate deposits shall not be construed as financial services.**

Inter-corporate deposits are borrowings by one corporate entity registered under the Companies Act from another. The corporate having surplus funds lends it to another corporate which is need of funds. Thus, it is clear that in case of inter corporate deposits, there is very little or no involvement of public's money and hence it does not pose a threat to the economy.

Hence, in the instant case, the Respondent, a non-deposit taking NBFC shall not be classified as a financial service provider and thus be covered under the Code.

It is often said that "finance is the life blood of an economy". FSPs include various entities/ participants, which play a key role in facilitating the smooth functioning of the economy.

The very reason for exclusion of FSPs from the purview of the Code was to avoid failure of the economy which seems very probable if there is an increase in the number of failing FSPs. These institutions are colloquially referred to as "too big to fail".

However, considering that out of the existing NBFCs only a meagre percentage is allowed to accept deposits, exclusion of NBFCs does not seem to be serving the purpose. On the contrary, exclusion of NBFCs that are not FSPs from the Code acts as an invisible shield guarding such entities from the provisions of insolvency law. In absence of an established legal framework, it gives such entities and undue leeway to escape insolvency procedures.

Hence, where on one hand, rationale behind the carve out given to financial service providers seems justified, it is crucial to note that not all NBFCs have the similar impact on the economy. NBFCs that are not financial service providers have the same standing as per the Code, as other non-financial companies, which too are mostly burdened with a pile of bank liabilities.

Owing to this systemic vacuum that exists with regard to bankruptcy situations in financial firms, the Union Cabinet Financial Resolution and Deposit Insurance (FRDI) Bill, 2017 was approved by the Union Cabinet to be introduced in the Parliament. While the Code dealt with companies under insolvency, the FRDI Bill was expected to provide a comprehensive resolution framework to deal with bankruptcy situations in financial sector entities such as banks and insurance companies. However, after over an year of being introduced in the Lok Sabha, followed by the Joint Parliamentary meeting, the FRDI Bill was withdrawn due to apprehensions raised by the stakeholders w.r.t the provisions of the FRDI Bill like the use of bail-in instrument to resolve a failing bank and the adequacy of deposit insurance cover.

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## **Global Scenario**

The insolvency Code in India has been drafted placing significant reliance on the UK Insolvency Act and then moulding the same as per the Indian scenario.

Under the UK Insolvency Act, 1986, if an insurance company (a FSP as per the Code), were to fail, procedures that apply to all insolvent companies would apply, subject to certain modifications to ensure protection of the policy-holders. As per the Financial Services and Markets Act 2000 (FSMA) of UK, Insurance companies are not entitled to enter into voluntary liquidation, but can be wound up by the UK Insolvency Act in the event of failure. Section 122 of the UK Insolvency Act sets out the circumstances in which a company may be wound up by the court and carves out no exception for insurance companies or any other systemically important industry, whatsoever. Considering the massive impact on admission of an insurance company for winding up, if the court does decide to wind up the insurer, the Insurers (Reorganisation and Winding Up) Regulations 2004 (the Reorganisation Regulations) of UK will apply.

Hence, despite the probable impact of failure of FSPs in major economies being in multiples as compared to the Indian economy, the insolvency law of other economies have laid down similar procedures to deal with insolvency of financial companies of systemic importance as for other companies.

Thus, where companies of major significance to the economies are also covered under the purview of insolvency law, exclusion of NBFCs from Code does not seem to be justified.

## **Alternate Remedy**

Now that it is established that the doors of the Code are closed for creditors who owe money from FSPs, what is the alternate remedy available to them?

Meanwhile, a separate legal framework is drawn and implemented, it is pertinent to note that section 277 of the Code interestingly bestows upon the Central Government the power to notify, in consultation with the appropriate financial regulators, financial service providers for the limited purpose of insolvency, which may be conducted under this Code. This provision on account of it being overriding in nature gives an extensive power to central government to notify the financial service providers under the Code.

However, despite there being a provision for inclusion of financial service providers in Code, owing to the economy sensitive and complex structure of the extant Financial Service Providers, it shall be best suited to have a separate legal framework dealing with the resolution and insolvency process of Financial Service Providers, especially those which are “systematically critical.”

## **Conclusion**

In light of the facts and circumstances discussed above, it can be construed that:

- a. Not all NBFCs can be classified as financial services providers and as such a deemed carve out of NBFCs from the Code shall not be prudent interpretation; and

- b. as much as exclusion of Financial Service Providers from the Code proves to be appropriate, the need of the hour is to introduce a separate framework dealing with matters of insolvency of financial service providers.

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