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Bondholders under IBC: Unravelling no action clauses

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"*The lack of power in the hands of a bondholder has been one (though not the only) reason why the corporate bond market has not worked*." – Bankruptcy Law Reforms Committee, 2015

When the ability to recover dues is strewn with difficulties, creditors will be reluctant to lend. Hence, substantial lending has traditionally been restricted to few kinds of lenders that lend only to a few large groups in India. With the advent of the Insolvency and Bankruptcy Code, 2016

(**IBC**), it is expected that India's debt regime will take a new turn and offer a more robust, diversified and level playing field to both lenders and borrowers. In fact, the Finance Minister in his budget speech of 2018-19, indicated a move towards creating an environment that encourages corporates to meet a significant part of their financing needs from the bond market. It has been felt that the bond market in India could offer a great source of finance but has not been sufficiently utilized due to the erstwhile unfavorable debt regime.

Classification under IBC

Bonds are financial instruments that represent a plain vanilla debt obligation. They are issued by companies at a fixed rate of interest with an obligation to pay the principal amount along with interest within a stipulated time period. Under IBC, any amount raised pursuant to issue of bonds is classified as a "financial debt" and any person to whom a financial debt is owed is classified as a "financial creditor". The term "person" as defined in IBC includes a person resident outside India. Accordingly, Bondholders, whether Indian or foreign, are treated as financial creditors under the IBC.

Typically, bonds are listed and tradable on an exchange. The tradability of bonds enables Bondholders to exit the investment without getting 'locked-in' till their maturity so long as there are buyers. Corporate bonds issued by Indian Companies to foreign Bondholders are governed by the Reserve Bank of India (**RBI**) regulations on External Commercial Borrowings (**ECBs**). Like any other fundraising under the ECB route, bonds are also subject to certain conditions, including eligible borrowers, eligible lenders, minimum maturity, all-in-costs ceilings, etc.

Framework for Bondholders

The issuance of bonds is usually coordinated with the involvement of a trustee, who acts on behalf of the individual Bondholder. This simplifies the administration of a large number of individual Bondholders and avoids difficulties which may arise if Bondholders were able to enforce their rights as individual creditors of the issuing company.

In the international context, where an Indian company issues bonds to foreign Bondholders, a principal trust deed is executed between the issuer and the trustee which outlines the rights and obligations of each party. Once the principal trust deed is executed, an offering memorandum is published and circulated to potential investors (i.e. potential Bondholders) which contains the terms of the deed, some background information about the issuer and terms under which the bonds are issued. The potential Bondholders then purchase bonds of a particular value and an agreement is established by way of an offer (the offering memorandum) and acceptance (the purchase of bonds). The rights and obligations of the issuer, trustee and Bondholders are

exhaustively laid down in the trust deed. Certain matters under the trust deed are directly controlled by Bondholders, i.e. matters in which trustee can act only as per the decision of Bondholders (either majority or a specified number of Bondholders), however, some matters are delegated to the trustee by Bondholders to be performed on their behalf like power to waive minor breaches or agree to minor modifications in terms of issue that will not prejudice the Bondholders etc.

No Action Clause

One of the key terms in a trust deed is a "no action clause" which is usually worded as follows:

"At any time after the bonds become due and payable, the trustee may, at its discretion and without further notice, institute such proceedings against the issuer as it may think fit to enforce the terms of the trust deed and the notes, but it need not take any such proceedings unless (a) it shall have been so directed by an extraordinary resolution or so requested in writing by bondholders holding at least one-fifth in principal amount of the notes outstanding, and (b) it shall have been indemnified to its satisfaction. No Bondholder may institute proceedings directly against the issuer unless the trustee, having become bound so to proceed, fails to do so within a reasonable time and such failure is continuing."

The above clause has many variations and is generally tweaked to suit the requirements of the parties. In some cases, 2/3rd majority decision of Bondholders is required to instruct the trustee while in some cases the reasonable period for acting on Bondholders' instructions is thirty (30) days. These clauses however, in all cases, restrict a Bondholder from acting against the issuer individually.

Problems faced by Individual Bondholders

No action clauses sometimes become a roadblock for individual Bondholders who may want to independently initiate proceedings against defaulting companies due to the following reasons:

1. <u>Interest of minority bondholders may not be aligned with the majority</u>

Many a times majority Bondholders, owing to their bigger risk appetite, are not in favor of initiating proceedings against the issuer at the time of default. They prefer to wait until the company starts showing signs of recovery, which puts minority Bondholders at their mercy. It may also happen that the risk assessment of a particular Bondholder is different as it may have purchased the bonds at a higher price than others and may need to seek some recourse to minimize its losses.

2. <u>Prior indemnification of the Trustee</u>

In most cases, trustees of bonds are not obliged to take any action against the company unless they have been first indemnified and/or secured and/or pre-funded, by the Bondholders, to their satisfaction. This further adds to the woes of Bondholders who are suffering losses because of defaulted bonds and may not want to incur additional expenses.

It is, therefore, not surprising to see the enforceability of these clauses being challenged in courts. While courts in the US and UK have been reluctant to entertain attacks on their enforceability, Indian courts appear to have taken a different approach. In the past, Indian courts have allowed individual debenture-holders or note-holders to initiate winding up proceedings against companies despite having similar no action clauses in agreements (*see for example Gramercy Emerging Market Fund v. Essar Steel Limited, (2002) 111 Comp Cas 1, BNY Corporate Trustee Services v. Wockhardt Ltd, (2014) 187 Comp Cas 301).* It is pertinent to note that while IBC does not define either debentures or bonds, it adopts the definitions provided in the Companies Act. Under the Companies Act, debentures include bonds or any other instrument of a company evidencing a debt. Hence, the court rulings in the context of debentures may hold equally good for the bonds as well.

Ability of individual Bondholder to initiate CIR Process under IBC

With the change in regime from winding up to IBC, the question arises as to whether a no-action clause will bar individual Bondholders to initiate CIR Process under IBC. Based on available jurisprudence and the provisions of the IBC, it can be argued that individual Bondholders can initiate CIR Process despite having a no-action clause.

Few key reasons are provided hereunder:

1. <u>Express language of the provisions and limited scrutiny by NCLT</u>

As mentioned above, Bondholders come within the category of financial creditors. Under IBC, it is categorically provided that a financial creditor can, either by itself or jointly with other financial creditors, file an application for initiating CIR Process when a default has occurred. The Adjudicating Authority i.e. the National Company Law Tribunal ("**NCLT**") has to admit such an application if it is satisfied that, (1) a default has occurred, (2) the application of financial creditor is complete and (3) there is no disciplinary proceedings pending against proposed resolution professional. Given the statutory right of the creditor, it can be argued that NCLT cannot reject the application merely because the terms of the trust deed are not adhered to by the financial creditor.

2. <u>Bondholder in initiating proceedings under IBC is not enforcing the terms of the trust deed</u>

Typically, no action clauses only restrict Bondholders from initiating proceedings to enforce the terms of the trust deed. The nature of IBC proceedings is different from mere enforcement of payment of dues under the trust deed. IBC proceedings are *in rem* proceedings based on

statutory grounds. Accordingly, such proceedings cannot be said to be hit by a no-action clause in a trust deed. Similar views were also expressed by Bombay High Court in *BNY Corporate Trustee Services Ltd. v. Wockhardt Ltd.*, (2014), in the context of winding up under Companies Act, 1956 whereby the court also held that conditions in trust deed against express provisions of the Companies Act would be void.

In contrast, English and US judges appear to have read the no-action clause widely, implying that they may apply to all actions that could be pursued by a Bondholder. Therefore, in both jurisdictions, no-action clause may prevent Bondholders from bringing tort actions, or commencing insolvency and administration proceedings (*See In the Matter of Colt Telecom Group plc [2002] EWHC 2815(Ch); In the US see, Elliott Assoc, LP v Bio-Response, Inc, 1989 WL 55070, 5-7 (Ct Ch Del, 1989)*).

3. Bondholders are beneficiaries under the Trust Deed

It is trite law that under a trust, a beneficiary always has right to enforce a contract which benefits him. The same has also been upheld by the Supreme Court in the case of *M. C. Chako v. State Bank of Travancore (AIR 1970 SC 504).* In fact, in *Narotamdas Trikamdas Toprani v. Bombay Dyeing and Manufacturing Co. Ltd. & Ors.*, the Bombay High Court held Debenture Holders to be beneficiaries under the trust deed. It further held that although the remedy to enforce these securities may vest in the trustees, debenture-holders, as beneficiaries, would be entitled to enforce covenants which are for their benefit even if they may not directly be parties to the covenants.

Conclusion

While the jurisprudence so far has tilted in favor of individual Bondholders, there still remains a case to be made in favor of enforcing a no-action clause. It can be argued that no-action clauses seek to achieve a legitimate purpose and their non-enforcement may create impediments to the development of a corporate bond market.

Nevertheless, the mechanism prescribed under IBC brings on board all the stakeholders in the CIR Process. Once initiated, all stakeholders (whether financial creditors or operational creditors) are dealt with in accordance with law. No stakeholder is at an advantage merely by initiating the CIR Process. Therefore, the question whether CIR Process is initiated by an individual Bondholder or trustee on behalf of majority Bondholders becomes moot.

Pertinently, the Bankruptcy Law Reforms Committee in its November 2015 report, observed that, "*the natural financing strategy in all countries is for large companies to obtain all their debt financing from the bond market. This channel has been choked off in India, partly owing to the fact that corporate Bondholders obtain particularly bad recovery rates under the present arrangement. Bankruptcy reform would yield higher recovery rates for corporate bondholders, and remove one barrier that impedes the corporate bond market. It is important to emphasise, however, that this is*

not the only barrier which holds back the corporate bond market." It has been rightly pointed out by the Committee that the reform in the regime has not removed all the barriers in the corporate bond market. There continues to remain other aspects of enforcement of Bondholders/issuers rights which need to be dealt with by Indian courts. We only hope that, in time, the new regime matures into an eco-system where the corporate bond market can thrive in India as well.

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