BAR & BENCH

Supreme Court strikes down the **RBI circular** on the resolution of stressed assets: **Analysis and Implications**

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In an unprecedented development, the Supreme Court has set aside the Reserve Bank of India (RBI) circular issued on 12 February 2018, which stipulated a framework for the resolution of stressed assets. More particularly, in *Dharani Sugars and Chemicals Ltd v. Union of India & Ors* the Supreme Court examined the constitutional validity of Sections 35 AA and 35 AB of the Banking Regulation Act, 1949 ("Banking Regulation Act") and the RBI circular under challenge.

While upholding the constitutional validity of the provisions under challenge, the Court has struck down the impugned circular as *ultra-virus* and opined that it has no effect in law, and all actions taken thereunder (including initiation of insolvency proceedings) under the Insolvency

and Bankruptcy Code, 2016 ("Insolvency Code") must fall. As a consequence of the ruling, all proceedings where the debtors have been proceeded against by financial creditors under the Insolvency Code under the guise of the impugned circular will not be maintainable.

By way of background, the impugned circular was issued under Section 35AA, Section 35AB, and Section 35A of the Banking Regulation Act, 1949 and Section 45L of the RBI Act, 1934. The circular prescribed that unless a debt with exposure of more than INR 2,000 is restructured and fully implemented (approved by all the lenders) within 195 days from 1 March 2018 or the date of default, the lenders were mandated to initiate proceedings under the Insolvency Code as the financial creditor.

Sections 35AA and 35AB have been inserted by the Banking Regulation (Amendment) Act, 2017. Section 35AA authorised RBI to issue directions to the banking companies and initiate proceedings under the Insolvency Code, if: (i) there is a Central Government authorisation to do so; and (ii) it is in respect of specific default. Whereas, Section 35 AB allowed RBI to issue directions to any banking company or banking companies for resolution of stressed assets. Section 35 A is a more generic provision which allows the RBI to issue directions to the banking companies on issues which constitutes public interest, or which are in the interest of banking policy.

Section 35 AA and 35 AB were challenged on the premise that they are manifestly arbitrary and suffer from the absence of guidelines. The Supreme Court referred to the recent judgment of *Swiss Ribbons* wherein the constitutional validity of the Insolvency Code was upheld and observed that economic legislations are to be viewed with greater latitude, and opined that the impugned sections are not excessive, lack any guiding principles or manifestly arbitrary and on the contrary, confer regulatory powers on the RBI in the same manner as the other sections under the Banking Regulation Act. The Supreme Court referred to their earlier judgment in *Harishankar Bagla v. State of MP* and observed that the guidelines on the exercise of power under the impugned sections can be derived from the statement of objects and reasons, the preamble and other provisions of the Banking Regulation Act.

Since the impugned circular concerned proceedings under the Insolvency Code, the Supreme Court held that the circular must be in accordance with Section 35AA which alone allowed RBI to issue directions in relation to the Insolvency Code proceedings. The Supreme Court observed that there must be a Central Government authorisation to the RBI for issuance of the directions pursuant to Section 35AA in respect of specific defaults by a specific debtor, and any directions regarding the debtors generally, including those under the impugned circular, would be *ultra vires* Section 35AA. The Supreme Court also observed that Section 45L of the RBI Act permits the RBI to give directions to financial institutions, after having due regard to the conditions in which and the objects for which the institution has been established, etc. Since the RBI Circular does not reflect the satisfaction of the prerequisites stipulated under Section 45L, the impugned circular would be *ultra vires* as regards the non-banking and banking financial institutions as well.

The Supreme Court's decision has severe implications. First, the RBI may now issue specific directions or circulars under Section 35 AA identifying specific defaults by the companies and

accordingly the corporate insolvency process may be initiated under the Insolvency Code. Second, the RBI circulars on the resolution of stressed assets which had been issued prior and had been annulled by the impugned circular, such as the joint lender's forum as an institutional mechanism for resolution of stressed accounts may come back in operation and RBI may issue fresh directions in this regard. Third, it will be practically difficult to identify the insolvency proceedings which have been initiated pursuant to the impugned circular, as the lenders are likely to contend that such proceedings were commenced generally under the Insolvency Code and to that extent there may be a difficulty in enforcement of this judgment.

Another submission that was canvassed by the Counsel was the requirement to adopt sector-specific measures to address the issues relating to stressed assets, but there has been no finding on this submission. Overall, this is a bold judgment by the Supreme Court which has clarified the ambit of RBI's power under Section 35 AA and will compel the RBI to issue circulars only for specific defaults by specific debtors. Shortly after the judgment, the RBI governor has issued a statement acknowledging the Supreme Court's judgment and assured that RBI will take necessary steps including the issuance of a revised circular for expeditious and effective resolution of stressed assets, and it remains to be seen the measures RBI adopts in this regard.

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