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ANALYSIS

Unlocking Value in Distress – The Evolution of Alternative Investment Funds in India’s Restructuring Landscape

1. THE CHANGING PARADIGM OF STRESSED ASSET RESOLUTION

The Indian financial system has long grappled with the burden of stressed loans, a challenge that consistently necessitates significant capital infusion into Banks and Non-Banking Financial Companies (NBFCs). As traditional lenders step back from direct turnaround operations due to their own regulatory constraints, a vacuum has emerged in the distressed asset market.

To release capital locked in these stressed loans and redirect it toward economic development, sophisticated and patient capital is required. While Asset Reconstruction Companies (ARCs) traditionally managed the buying of stressed loans, Alternative Investment Funds (AIFs) have emerged as powerful vehicles to supplement these efforts.

AIFs manage privately pooled funds from well-informed investors who possess the appetite for high-risk, high-reward turnaround investments.

2. THE STRATEGIC DEPLOYMENT OF CATEGORY II AIFS

Historically, Category II AIFs have been the primary and most legally robust vehicles for acquiring and restructuring stressed assets under the Corporate Insolvency Resolution Process (CIRP).

Regulatory Alignment: Under Regulation 17(a) of the SEBI (Alternative Investment Funds) Regulations, 2012, Category II AIFs are mandated to invest primarily in unlisted companies or listed debt securities rated 'A' or below. This perfectly aligns with the strategy of taking over distressed private entities or de-listed public targets.

Capital Pooling: The structure allows for the efficient pooling of domestic and offshore capital via the FDI route.

Instrument Flexibility: It enables deployment through a flexible mix of debt and equity instruments that traditional lenders cannot easily replicate.

When an AIF steps in as a Resolution Applicant under Section 5(25) of the Insolvency and Bankruptcy Code, 2016 (IBC), navigating the strict disqualification criteria of Section 29A becomes the primary legal hurdle. Section 29A acts as a gatekeeper to prevent defaulting promoters from regaining control.

For an AIF, it is critical that no sponsors, limited partners, or connected persons trigger disqualifications, such as under Section 29A(c), which bars entities managing an account classified as a Non-Performing Asset for over a year. Crucially, the IBC provides carve-outs for "financial entities," allowing specialized funds to participate without being hindered by the historical defaults of their broader portfolio, provided they are not related parties to the corporate debtor.

From a tactical standpoint, an AIF can aggregate debt from existing financial creditors pre-resolution to secure a controlling seat on the Committee of Creditors (CoC). Post-resolution, the fund can enforce strict governance mechanisms, including step-in rights and dedicated board seats, directly through the NCLT-approved resolution plan.

3. CONCLUDING THOUGHTS

The intersection of SEBI's evolving AIF framework and the IBC's time-bound, clean-slate resolution mechanism creates an unparalleled opportunity for value creation in the Indian market.

Whether utilizing the traditional flexibility of Category II structures, specialized funds are positioned to become the dominant force in clearing and revitalizing India's distressed assets. Proper structuring, rigorous due diligence under Section 29A, and strategic CoC maneuvering will dictate the success of these capital deployments in the years to come.



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