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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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CRITICAL APPRAISAL OF ARBITRATION PROCEEDING IN CASE OF INSOLVENCY

AUTHORED BY - MAHEK SONI
CO-AUTHOR BY - MANU SHARMA

"At all events, arbitration is more rational, just, and humane than the resort to the sword."

- Richard Cobden

ABSTRACT

This paper deals with arbitration proceedings in matters relating to situations when parties to arbitration proceedings become insolvent. Parties can go for both arbitration and insolvency proceedings for dispute resolution but both proceedings cannot take place simultaneously.

Insolvency is a situation where an individual or company becomes unable to meet-up their financial obligations. It is a non-arbitrable dispute as the right being exercised involves a third party and they are the proceeding in rem. On the other hand, Arbitration is a formal dispute resolution mechanism used by parties to resolve their conflicts. As Arbitration is cost-efficient, time saving, and the award is final and having a binding effect upon the parties therefore parties opt for it. It is binding unless challenged by Section 34 of the Arbitration and Conciliation Act, 1996. It is also important to note that if parties to an arbitration agreement become insolvent, then the arbitration agreement will not become invalid on its own rather it will depend upon the facts and adoption of the contract by the receiver. Provisions relating to cases of insolvency of parties in an arbitration agreement are provided under Section 41 of the Arbitration and Conciliation Act, 1996. While considering the insolvency scenario, the following are circumstances to keep on a note and are the possible terms of the arbitration clause:

After the date of the insolvency order, After the commencement of insolvency proceedings, but before passing the insolvency order, Before the initiation of insolvency proceedings. It also indicates the role of The National Company Law Tribunal as an adjudicatory authority for insolvency and bankruptcy proceedings of companies and limited liability partnerships (LLPs)

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under the Insolvency and Bankruptcy Code, 2016.

The paper also highlights the effect of insolvency in arbitration agreements along with the needs and importance of the Arbitration and Conciliation Act.
The objective of this paper is to evaluate and examine the procedure of arbitration in matters when a party to the arbitration agreement becomes insolvent in the context of India by taking references from case laws. This paper is an attempt to find the answer to the question of in such a situation which legislation will prevail which is the Arbitration or Insolvency Act.

KEYWORDS – arbitration, arbitration agreement, arbitration proceedings, insolvency, insolvency proceedings

INTRODUCTION

Arbitration is one of the methods of dispute resolution outside the court. It is a procedure to determine the legal rights and obligations of the parties with binding effects which are enforceable by law. People prefer arbitration over court proceedings because it is flexible and time and cost efficient, moreover parties receive desired results and confidentiality is maintained. But there are certain categories of disputes that are non-arbitrable as those disputes involve the right in rem and affect the right of third party and insolvency is one of those categories. Bankruptcy portrays a circumstance where the indebted person is incapable of meeting his/her commitments, in other words, it could be a state when a person, organization, or other organization cannot meet its money-related commitments for paying obligations as they become due. Arbitration in insolvency cases presents a unique set of challenges and opportunities. This critical appraisal will explore the introduction and implications of arbitration proceedings in the context of insolvency, with a focus on its advantages, potential drawbacks, and overall effectiveness.

The introduction of arbitration in insolvency cases is a significant development in the legal landscape. Traditionally, insolvency matters are resolved through court proceedings, which can be time-consuming and costly. Arbitration offers an alternative dispute resolution mechanism that is often faster and more cost-effective. This can be particularly beneficial in the context of insolvency, where the preservation of the debtor's assets and the equitable distribution of assets to creditors are critical objectives.

One of the primary advantages of arbitration in insolvency cases is its efficiency. Insolvency

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proceedings require swift and effective resolution to maximize the value of the debtor's estate for the benefit of creditors. Arbitration, being a more streamlined process compared to traditional litigation, can help achieve this goal. Moreover, the parties involved can choose experienced arbitrators with expertise in insolvency matters, ensuring a better understanding of the intricacies of the case.

Arbitration also offers confidentiality, which can be essential in insolvency cases. In court proceedings, information about a company's financial distress becomes a public record, potentially harming its reputation and causing further harm to the business. Arbitration allows for a more discreet resolution, protecting the debtor's reputation and sensitive financial information. However, there are certain drawbacks to consider. The lack of an established body of case law in insolvency arbitration can lead to uncertainty and inconsistency in outcomes. In court proceedings, judges apply well-established legal principles, while arbitration decisions may vary based on the arbitrator's interpretation of the law and the specific terms of the arbitration agreement. This can lead to unpredictable results, which is not ideal for a system designed to provide fair and equitable resolutions.

Moreover, arbitration agreements are typically consensual. If one party refuses to participate or comply with the arbitration process, it can cause delays and complications. In insolvency cases, where time is of the essence, such challenges can hinder the effective resolution of the matter. In summary, the introduction of arbitration in insolvency cases offers several advantages, including efficiency, confidentiality, and the flexibility to choose arbitrators with relevant expertise. However, the lack of a consistent legal framework and potential challenges in enforcing arbitration agreements must be considered. The effectiveness of arbitration in insolvency cases depends on the willingness of the parties to cooperate and the expertise of the arbitrators involved. As the use of arbitration in insolvency cases continues to evolve, it is crucial to strike a balance between its benefits and potential drawbacks to ensure a fair and effective resolution process for all stakeholders involved.

NEEDS AND IMPORTANCE OF THE ARBITRATION AND CONCILIATION ACT,1996

In the phase of industrialization, there is rapid growth in the number of industries, which is beneficial for the economy of the country. Along with the benefits it also leads to an increase in disputes which seem to be a burden upon the Courts. Following are some of the key points that

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describe the need for propounding the Arbitration and Conciliation Act, of 1996

- **Increase in commercial disputes:** India is a developing country, and with the passage of time new industries are established and conflicts also increasing. So, to resolve those disputes, a dispute resolution mechanism is required as courts are becoming overburdened, therefore the Arbitration and Conciliation Act,1996 is introduced and arbitral tribunals are set up.
- **Reduce the court's burden:** Court proceedings are lengthy and time-consuming, and the number of cases is increasing rapidly therefore courts are overburdened. To reduce the burden of court, arbitration as an alternate dispute resolution mechanism is introduced.
- **Avoid the Complexity of Court Proceedings:** In comparison to arbitration proceedings, court proceedings are complex and time-consuming, which sometimes makes them costly. However, arbitration proceedings are flexible in nature and save time as well as money of parties as they resolve the disputes between 6 – 12 months.
- **Time and cost-efficient:** Arbitration proceedings are time and cost efficient and this unique feature keeps the hope in people regarding easy and early getting of justice.
- **Parties' autonomy:** In arbitration proceedings, parties are in an autonomous state as they are free to choose the arbitrator, language, and place of arbitration, but in court proceedings, the party cannot choose the Judge, language, or jurisdiction.

The importance of Arbitration can be understood for assorted reasons such as:

- **Arbitration is flexible in nature:** It is flexible as parties can choose the place, time as well as the language of the proceeding. This flexibility makes sure that parties to the dispute can settle their differences in a fashion that works for them.
- **Arbitration is a faster and more efficient way of resolving disputes:** In comparison to litigation, arbitration is faster as it resolves the disputes within 6-12 months, whereas in litigation, courts take years to resolve the disputes, and this is one of the reasons for overburdening of the court.
- **It is a confidential process:** Arbitration proceedings are not open to the public, which means details of the disputes are not disclosed to the public. This will help parties maintain confidentiality and their reputation gets protected.
- **It is a cost-efficient process**: The arbitration proceeding is cost-efficient in comparison to court proceedings because it is less formal than slick, and parties do not have to pay for court fees or legal representation.

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RESEARCH OBJECTIVE

- To better understand the concept of insolvency in relation to arbitration.
- To know if there is any contradiction between the Arbitration and Conciliation Act and the Insolvency and Bankruptcy Code.
- To find the answer that if any contradiction arises between both Acts, then which legislation will prevail?

STATEMENT OF PROBLEM

1. **Are the Arbitration Act and Insolvency and Bankruptcy Code contradictory?**
2. **If there is a contradiction between the Arbitration and Conciliation Act of 1996 and the Insolvency and Bankruptcy Code of 2016 then which legislation will prevail?**
3. **What is the international scenario of conflict between the Arbitration Act and the Insolvency Act?**

PROVISION IN CASE OF INSOLVENCY IN THE ARBITRATION ACT

If a party to an arbitration agreement becomes insolvent then section 41 of the Arbitration and Conciliation Act,1996 comes into the picture which deals with the provisions relating to this. This section goes hand in hand with the provisions of the Insolvency and Bankruptcy Code,2016 (IBC). Section 41 of the Arbitration and Conciliation Act,1996 states that

"(1)[1] Where it is provided by a term in a contract to which an insolvent is a party that any dispute arising thereout or in connection therewith shall be submitted to arbitration, the said term shall, if the receiver adopts the contract, be enforceable by or against him so far as it relates to any such dispute.

(2)[2] Where a person who has been adjudged an insolvent had, before the commencement of the insolvency proceedings, become a party to an arbitration agreement, and any matter to which the agreement applies is required to be determined in connection with, or for the purposes of, the insolvency proceedings, then, if the case is one to which sub-section (1) does not apply, any other party or the receiver may apply to the judicial authority having jurisdiction in the insolvency

[1] Section 41(1) of the Arbitration and Conciliation Act of 1996
[2] Section 41(2) of the Arbitration and Conciliation Act of 1996

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proceedings for an order directing that the matter in question shall be submitted to arbitration in accordance with the arbitration agreement, and the judicial authority may, if it is of opinion that, having regard to all the circumstances of the case, the matter ought to be determined by arbitration, make an order accordingly.

(3)[3] In this section, the expression "receiver" includes an Official Assignee."

Subsequent to the date of insolvency order - In this case, the arbitration agreement will become void. Once the party is declared bankrupt, the arbitration clause may not have a binding effect on the receiver.

Subsequent to the commencement of insolvency proceedings, but before passing the insolvency order - In these circumstances, the future dispute has been referred by the Arbitration clause, the receiver can enforce the arbitration clause, but the receiver adoption of the contract should take place. In this situation permission of NCLT is not required for both parties, but when the insolvent company would be replaced by the receiver handling the insolvency then it would not be applicable. If the recipient chooses not to abide by the contract of which the arbitration clause is a part, the party involved in the arbitration can apply to the NCLT to persuade it to go to arbitration proceedings. If the dispute is to be decided by arbitration, the decision will be that of the NCLT alone, considering the circumstances. NCLT will pass orders accordingly.

Before the initiation of insolvency proceedings. – In the event that the arbitration agreement is entered into before the insolvency proceedings come into existence; Then the resolution depends on the receiver. If the receiver accepts the contract, the party may enforce the agreement against the receiver.

If the recipient chooses not to accede to the contract, the party may apply to the NCLT for a reference to arbitration as explained under condition (b) given above.

ROLE OF RECEIVER

The receiver is an independent and impartial person, who plays a crucial role in assisting the court. The appointment of the receiver is done by the court. The receiver has to take possession of and sell or liquidate the assets secured by the security agreement so that the outstanding debt

[3] Section 41(3) of the Arbitration and Conciliation Act of 1996

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can be repaid. The Arbitration and Conciliation Act provides a significant responsibility to the receiver to decide whether to choose arbitration or not in cases of insolvency, and he can only choose to adopt the contract when it is beneficial for the insolvent party. If the receiver opts for the adoption of a contract, then he must adopt it completely and fully he cannot opt for it in parts means he cannot reject the dispute resolution clause. If he agrees to adopt the contract consisting of an arbitration agreement/ clause, then such contracts can be enforced against the insolvent party if in future any dispute arises.

INSOLVENCY OF PARTIES AND IMPACT ON ARBITRATION

Applications can be made for both arbitration and insolvency proceedings. Still, these two cannot exist together. Section 41 of the Arbitration and Conciliation Act of 1996 explains the provisions of an arbitration agreement when one of the parties is insolvent. When the party becomes insolvent, the question is whether the arbitration agreement would be valid or not. So, the answer is that it will not become invalid directly. It will be the decision of the receiver whether he wants to continue the contract or not. If the receiver adopts the contract, must adopt it completely, he cannot adopt the agreement in parts and he can choose to adopt the contract if it is beneficial for the insolvent person. If the receiver adopts any commercial contract containing arbitration agreement/ clause, then such arbitration agreement is enforceable against the insolvent if any dispute arises in the future. The contract can be adopted wholly and exactly. The receiver cannot reject the dispute resolution clause and adopt it partially.

The different decisions made by the national company law tribunal in different circumstances. If bankruptcy judgment has been declared earlier and after that parties signed an arbitration agreement, then the agreement would be null and void. After a decision has been taken that the company is insolvent then the arbitration clause would not bind any party or trust. If the trustee chooses to adopt the contract it can be enforced against him if Arbitration agreements are established before the decision given by bankruptcy award and after the filing of bankruptcy proceedings.

After that, the receiver or the party becomes insolvent and is not bound to obtain permission from the national company law tribunal. An insolvent Receiver can replace the insolvent party or company by accepting the contract or initiating arbitration. If the recipient refuses to accept the contract, then the insolvent party can approach the court. Further, it will be at the discretion of the national company law tribunal that the decision of dispute will be given by the Arbitration

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court or not. If the Tribunal or the National Company Law Appellate Tribunal directs not to consider the arbitration agreement due to the status of the insolvent company, the parties may litigate a civil action against the receiver.

Therefore, the existing arbitration agreement will affect the resolution of the bankruptcy proceedings. In India, insolvency is a dispute that cannot be referred to arbitration because enforceable rights are substantive and involve a third party. Arbitration and bankruptcy are two separate proceedings that cannot take place at the same time.

The timing of the formation of the arbitration agreement, the decision of the court-appointed receiver, and the order of the National Company Law Tribunal play an important role in deciding the procedure and law applicable to a dispute with an insolvent party.

DISPUTES RELATED TO INSOLVENCY: NON-ARBITRABLE

There are certain categories of disputes that are non-arbitrable, and insolvency is one among them. In the case of ***Himangini Enterprises vs Kamaljit Singh***[4] Supreme Court held that tenancy disputes where the Transfer of Property Act applies are non-arbitrable. This case is taken as a reference in ***Vidya Drolia vs Durga Trading Corporation***[5] in which the court states that the Himangini judgment was not reasonable here as the transfer of property act is not a special statute and dispute arising under this Act is arbitrable along with this Supreme Court also propounded a fourfold test to determine the arbitrability of a matter which are as follows:

- When the subject matter of the dispute and the cause of action relates to action in rem.
- When the cause of action of the dispute affects the right of the third party and mutual adjudication would not be appropriate.
- When the cause of action and subject matter of dispute relates to sovereign and public interest functions of the state.
- When the subject matter of the dispute is explicitly or by necessary implications non-arbitrable according to obligatory statute.

The court also introduced the following six categories that are non-arbitrable:

- Disputes arising out of the criminal offense.
- Matrimonial matters

[4] APPEAL No. 16850 OF 2017, (@ S.L.P.(c) No.27722/2017), (D.No.21033/2017)
[5] (2021) 2 SCC 1 : (2021) 1 SCC (Civ) 549]

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- Guardianship matters
- Insolvency and winding up matters.
- Testamentary matters
- Eviction and tenancy matters.

So, from this case, the picture becomes clear that disputes related to insolvency are non-arbitrable because the resolution of an insolvency dispute involves the rights of third parties. The Supreme Court also in ***A. Ayyasamy vs A. Paramasivam & Ors***[6] has observed that 'insolvency and winding-up matters' are not arbitrable. The order of moratorium is valid until completion of the CIRP.[7] ***Swiss Ribbons Private Limited v. Union of India***[8], ***P. Anand Gajapati Raju v. PVG Raju***[9]**,** and ***Booz Allen and Hamilton v. SBI Home Finance Limited***[10] are some of the examples of those cases where the court differentiated between right in rem (right against the whole world) and right in personam(right available against a particular person).

In other words, when the insolvency proceedings begin against a person, all the other legal proceedings against such person will have stayed till the disposal of the insolvency proceedings which includes any pending arbitration proceedings as well.

Apart from the moratorium's imposition, the statute has no provisions addressing how the bankruptcy process affects arbitrations. Comparably, the influence of the corporate insolvency resolution process (CIRP) on arbitrations is not covered by any provisions in the Arbitration and Conciliation Act, 1996.

It is also noteworthy to note that there are some overriding clauses in both the Arbitration Act of 1996 and the IBC of 2016. Given that they are both special statutes, it is now necessary to determine which statute will prevail. The newest ruling by the Supreme Court in the case of ***Indus Biotech Private Limited v. Kotak India Venture Fund*** [11]provides answers to all these questions.

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[6] (2016) 10 SCC 386

[7] Section 14(4) of the Code: The order of moratorium shall have effect from the date of such order till the completion of the corporate insolvency resolution process:
Provided that where at any time during the corporate insolvency resolution process period, if the Adjudicating Authority approves the resolution plan under sub-section (1) of section 31 or passes an order for liquidation of the corporate debtor under section 33, the moratorium shall cease to have effect from the date of such approval or liquidation order, as the case may be.

[8] AIR (2019) 4 SCC 17

[9] Civil Appeal No. 5251 of 1993, (2000) 4 SCC 539

[10] NO.5440 OF 2002

[11] Civil Appeal No.1070 /2021 @ SLP (C) NO. 8120 OF 2020.

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ARBITRATION ACT AND INSOLVENCY ACT: COLLUSION

Indus Biotech Pvt. Ltd. v. Kotak India Venture Fund (2021)[12]

In this case, Kotak Venture Fund had subscribed to Optionally Convertible Redeemable Preference Shares which were issued by Indus Biotech Pvt Ltd. After sometimes Kotak Venture Fund decided to convert the Optionally Convertible Redeemable Preference Shares into equity shares. A dispute arose between Kotak Venture Fund and Indus Biotech Pvt Ltd regarding the valuation and calculation for the same, due to which Indus Biotech referred the dispute for arbitration and Kotak Venture Fund has filed an application under Section 7[13] of the IBC initiating Corporate Insolvency Resolution Process(CIRP) before the NCLT against Indus and the same is challenged by Indus Biotech by contending that this matter falls within the scope of dispute resolution clause, arbitration was an appropriate stage in the process, it further argued that Kotak's application under Section 7 application is a "dressed-up" scheme to avoid the arbitration process and is intended only as a means of coercion to extract money from Indus.

In this case, the National Company Law Tribunal applies the test of arbitrability. After observing the dispute, the NCLT passed the order in favour of Indus and referred the matter to arbitration. Aggrieved by this Kotak Venture filed a Special Leave Petition before the Apex Court of India and Supreme Court allowing the same held that when the NCLT initiated CIRP under Section 7 of the IBC, from the same time the insolvency proceeding stops being arbitrable. The Court also mentions that there is nothing improper in dismissing the application of section 7 by the NCLT, and mere filing the petition and its pending status cannot be interpreted as starting an insolvency process to be treated as proceedings in rem. The matter only becomes non-arbitrable upon the admission of such an application.

The Supreme Court further mentioned that the NCLT's responsibility is to figure out whether the company has defaulted or has any debt that must be paid based on the information that is provided to it. If there is a default, then automatically the application under Section 7 of IBC will be admitted and the matter becomes non-arbitrable on the other hand if there is no default then the application will be dismissed, and the parties can opt for arbitration. Thus, in this case, the Supreme Court has upheld the dismissal of the Section 7 application by the NCLT but observed that the NCLT must first decide the admissibility of the Section 7 application without looking if

[12] AIR 2021 SUPREME COURT 1638, AIRONLINE 2021 SC 171
[13] Initiation of Corporate insolvency resolution process by financial creditor.

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a Section 8 application is pending or not and the admission or dismissal of the application under Section 7 will be evaluated on its own to determine whether or not the issue is arbitrable. As both are special statutes, the one that is enacted later will prevail over the other, the Supreme Court ruled in resolving the issue between the non-obstante clause under Section 5 of the Arbitration and Conciliation Act,1996, and the overriding effect under Section 238 of the IBC.

THE ARBITRATION ACT AND THE INSOLVENCY ACT: AN INTERNATIONAL SCENARIO

Elektrim v Vivendi[14], is a cross-border insolvency case with an arbitration clause, The Swiss courts followed Polish law because it is a Polish company that is insolvent. The Swiss Supreme Court ruled that *"the arbitration tribunal had no authority because the arbitration clause was considered ineffective upon the initiation of insolvency proceedings under Polish law."*

"Disputes concerning an insolvent corporation that occurs only upon the initiation of the insolvency process, such disputes, cannot undergo arbitration", according to Singaporean courts in the case of ***Larsen Oil and Gas Pte Ltd v Petroprod Ltd.***[15] However, where the issue concerns the company's interests before insolvency, it can be resolved by arbitration.

An insolvency proceeding would not exclude parties from pursuing arbitration in the United Kingdom. This position was founded in the case of ***Fulham Football Club v. Richards,*** where the appellate court found that "*a shareholder unfair discrimination lawsuit could be arbitrated. "The appellate court has observed that the arbitrability of insolvency law cases is contingent on its effect on third parties."*

SUGGESTIONS

The Indian legislative still must address several legal and policy difficulties, even though Indian courts have closed any legal loopholes and attempted to strike a compromise between the conflicting goals of arbitration and insolvency legislation. Arbitration proceedings against a CD cannot proceed after a moratorium has been placed on them, apart from actions that are for the CD's advantage, according to the legal precedent outlined in the analysis above. From the standpoint of a claimant in an arbitration procedure, who can be left without any recourse when

[14] [2007] EWHC 571 (Comm) (20 March 2007)
[15] [2011] SGCA 21

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an insolvency proceeding is initiated against a respondent in an arbitration proceeding, this leaves a lot to be desired.

To assess the arbitrability of insolvency issues, a consistent framework or model like the Legislative Guide is required because the lack of regulations results in diversity and unpredictability. For example, a list of core and non-core items could exist, like what the US Bankruptcy Code does; however, it would be challenging to incorporate such a list within Swiss substantive law.

It is contended that a Handbook would benefit national courts and international arbitral tribunals by promoting a more assured transboundary approach to the arbitrability of insolvency proceedings, even though such problems are thought to be overcome. The benefits to the global business community will include more predictability and certainty, fewer costs associated with arbitration and litigation, and increased clarity.

CONCLUSION

Arbitration is a procedure in which the dispute between the parties is submitted to an arbitral tribunal. The tribunal provides a decision known as an award on the dispute that is binding on the parties. Supreme Court in the case of ***Indus Biotech Pvt. Ltd. v. Kotak India Venture Fund***[16] makes it clear that once insolvency proceedings are admitted the dispute becomes non-arbitrable. Procedural and substantive are the two aspects of arbitrability. An arbitration agreement anticipates within its scope an arbitration of the dispute, while substantive arbitrability refers to whether the subject matter of the dispute is capable of arbitration as per public policy is known as Procedural arbitrability.

Thus, the Supreme Court has a significant role in this regard and as the law is dynamic in nature the possible recommendations must be implemented to bridge the gap between the idea and implementation.

[16] AIR 2021 SUPREME COURT 1638, AIRONLINE 2021 SC 171

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