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FROM PRECISION TO CONFUSION: THE FALLOUT OF LITERAL INTERPRETATION IN VIDARBHA VERDICT

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The Supreme Court in an order dated 12 July, 2022 ruled out that the use of the word 'may 'for S.7(5)(a) of Insolvency and Bankruptcy Code, 2016, hereinafter referred as IBC provides the adjudicating authority with discretionary power to admit or reject an application made by the financial creditor for initiation of CIRP with the reasoning that the establishment of 'debt 'and 'default 'merely gives right to the financial creditor to file an application under the concerned provisions but doesn't mandatorily necessitates the admission of such application by the adjudicating authority.

This article aims to examine the question of whether the proceedings under S.7 of IBC, even after fulfilling the test by establishing a 'debt' and 'default', for a financial creditor, shall remain pending until there is a resolution granted to the related disputes. The article aims to critique the decision of Supreme Court as being violative of the objectives of IBC and analyse the legal reasoning and its impact on the CIRP.

Background:

Vidarhbha Industries Power Limited is a company which generates electricity using Coal-Fired Thermal Power Plant in Maharashtra. Through a bidding process, Vidarhbha Industries Power Limited won a contract to set up a power project, later converted into an independent power project. The Maharashtra Electricity Regulatory Commission (MERC) approved the Power Purchase Agreement (PPA) between Vidarhbha Industries Power Limited and Reliance Industries Limited which allowed Reliance Industries Limited to buy power from Vidarhbha Industries Power Limited.

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In 2015, MERC set final tariffs for Vidarhbha Industries Power Limited power plant for the financial year 2014-2015 and 2015-2016. MERC capped the tariffs for the years 2016-2020 even after the request to adjust for the increased cost of coal by Vidarhbha Industries Power Limited. The Appellate Tribunal of Electricity (APTEL) awarded Vidarhbha Industries Power Limited a sum of Rs.1730 Crores in 2016 which was never receieved by Vidarhbha Industries Power Limited as MERC challenged the award in Supreme Court, for which the appeal is pending, leaving Vidarhbha Industries Power Limited without funds and unable to clear the dues pending to its creditors.

Axis Bank Limited, the financial creditor of Vidarhbha Industries Power Limited filed an application to initiate CIRP under S.7(2) of IBC before the National Company Law Tribunal (NCLT), Mumbai for which Vidarhbha Industries Power Limited filed a Miscellaneous Application before NCLT seeking stay on the proceedings, until the delivery of the judgement of the appeal filed by MERC in the Supreme Court, giving reasoning that Vidarhbha Industries Power Limited is financially healthy and it is only because of the pending appeal, the debts are due and could not be paid at that moment. However, NCLT rejected the application seeking stay, holding S.7 as mandatory and holding that, the appeal pending would have no impact on the proceedings of CIRP under S.7 of IBC. Vidarhbha Industries Power Limited approached NCLAT, which held that the there is no justification to stall the CIRP process, therefore, the appeal stands dismissed.

In 2021, Vidarhbha Industries Power Limited filed an appeal before Hon'ble Supreme Court and the question of whether the Adjudicating Authority can decline to admit an application under S.7(5)(a) even after fulfilling the test by establishing a 'debt 'and 'default' for a financial creditor was brought into limelight.

The Supreme Court ruled out that the use of the word 'may' for S.7(5)(a) of IBC does provide the adjudicating authority with discretionary power to admit or reject an application made by the financial creditor for initiation of CIRP with the reasoning that the establishment of 'debt' and 'default' merely gives right to the financial creditor to file an application under the concerned provisions but doesn't mandatorily necessitates the admission of such application by the adjudicating authority.

The decision provided by the Supreme Court lacks some issues identified in this judgement.

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Issues:

1. *Whether the Adjudicating Authority can decline to admit an application under S.7(5)(a) even after fulfilling the test by establishing a 'debt' and 'default' for a financial creditor?*
2. *If the Adjudicating Authority declines to admit an application under S.7(5)(a) even after fulfilling the test by establishing a 'debt' and 'default' for a financial creditor, is it not violative of the objectives of IBC?*
3. *Can a pending proceeding, be a ground to reject an application under S.7(5)(a) for a financial creditor? Did the judgement give rise to ambiguity for the grounds of the adjudicating authority having a discretionary power to admit the application under S.7(5)(a) for a financial creditor?*

The Discretionary power of Adjudicating Authority

NCLT when looked into the matter, emphasised on the importance of IBC

"19. The Code is a special legislation. The chief object of which is to decide the Petition in a time bound manner and take adequate steps to see that the Corporate Debtor remains a going concern even during the process of CIRP.

20. The Hon'ble Apex Court in ***Swiss Ribbons v. Union of India & Anr. : (2019) 4 SCC 17*** *have set the tone for the proceeding before the Adjudicating Authority in order to make all endeavour to dispose of the matter in a time bound manner.*

The observation of the Hon'ble Court may profitably be quoted as under:

"As is discernible, the Preamble gives an insight into what is sought to be achieved by the Code. The Code is first and foremost, a Code for reorganisation and insolvency resolution of corporate debtors. Unless such reorganisation is effected in a time-bound manner, the value of the assets of such persons will deplete.

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Timely resolution of a corporate debtor who is in the red, by an effective legal framework, would go a long way to support the development of credit markets.

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The timelines within which the resolution process is to take place again protects the corporate debtor's assets from further dilution, and also protects all its creditors and workers by seeing that the resolution process goes through as fast as possible so that another management can, through its entrepreneurial skills, resuscitate the corporate debtor to achieve all these ends."

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21. The observation would indicate that no other extraneous matter should come in the way of expeditiously deciding a Petition either under Section 7 or under Section 9 of the Code. The inability of the Corporate Debtor in servicing the debts or the reason for committing a default is alien to the scheme of the Code. The averments made in the instant Application would indicate that various factors apparently hindered the Corporate Debtor from carrying on its business. There were disputes between the Corporate Debtor and the recipient of the energy as well as the change in supply chain management of the recipient of the energy may also have contributed to the lack of confidence between the entities. Be that as it may, the dispute of the Corporate Debtor with the Regulator or the recipient would be extraneous to the matters involved in the Company Petition. The decision in the matters pending before the Hon'ble Apex Court and other authorities would hardly have any bearing and impact on the issues involved in the present Company Petition under Section 7 of the Code.

22. This Authority is required only to see whether there has been a debt and the Corporate Debtor defaulted in making the repayments. These two aspects when satis^ed would trigger Corporate Insolvency. Therefore, the decision of the Authorities as well as of the Hon'ble Apex Court would not affect the proceedings before this Authority one way or the other. Therefore, we are of the considered opinion that this Authority need not stay its hands from considering the Company Petition as prayed for. As it is, there has been a considerable delay in disposal of the Company Petition. It will accordingly be appropriate that the Company Petition is disposed of as expeditiously as possible. Hence ordered. The Application be and the same is rejected on contest. There would however be no order as to costs."

After passing this judgement, when brought up in the appellate court, NCLAT held:

"On consideration of the issues raised in this Appeal we are of the considered opinion that the Appellant has no justification in stalling the process and seeking stay of CIRP, which in essence has manifested in blocking the passing of order of admission of Application of Respondent under Section 7 of I&B Code. There is no merit in Appeal as we find no legal infirmity in the impugned order. The Adjudicating Authority is conscious of the mandate of law and the course it has to take as per I&B provisions, which practically stands stalled. This is impermissible. The now of legal process cannot be permitted to be thwarted on considerations which are anterior to the mandate of Section 7(4) & (5) of I&B Code. The Appeal being devoid of merit is dismissed. However, we do not propose to impose any costs."

The Supreme Court held:

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The language of S.7(5)(a) of IBC compared to S.9(5) of the IBC, it can be clearly observed that the use of word 'may' in S.7(5)(a) and the use of word 'shall' in S.9(5) serves different purposes for both provisions. Therefore:

"*89. In this case, the Adjudicating Authority (NCLT) has simply brushed aside the case of the Appellant that an amount of Rs.1,730 Crores was realisable by the Appellant in terms of the order passed by APTEL in favour of the Appellant, with the cursory observation that disputes if any between the Appellant and the recipient of electricity or between the Appellant and the Electricity Regulatory Commission were inconsequential.*

90. We are clearly of the view that the Adjudicating Authority (NCLT) as also the Appellate Tribunal (NCLAT) fell in error in holding that once it was found that a debt existed and a Corporate Debtor was in default in payment of the debt there would be no option to the Adjudicating Authority (NCLT) but to admit the petition under Section 7 of the IBC.

*91. For the reasons discussed above, the appeal is allowed.****"***

Breakdown of S.7 IBC

S.7(5)(a) of IBC, 2016 says that

"*Where the Adjudicating Authority is satisfied that—*

(a) *a default has occurred and the application under sub-section (2) is complete, and there is no disciplinary proceedings pending against the proposed resolution professional, it may, by order, admit such application***"**

This implies that once twin test of debt and default has been establishedn and the adjudicating authority is satisfied that the default has occurred then it may admit the application of the financial creditor. The use of the word 'may' gives a discretionary power to the adjudicating authority which was brought up in this case.

It has become evident from a closer examination of S.7(5)(a) that the adjudicating authority only needs to satisfy itself to the extent of occurrence of default, the completion of the application and credentials of the proposed resolution professional. The criteria to trigger the CIRP is the occurrence of default. As per ***Innoventive Industries Ltd. V. ICICI Bank and Anr.,*** the Supreme Court interpreted the provisions of S.7(5)(a) focusing on the process and criteria for the admission of application to initiate CIRP and observed that the adjudicating authority has been granted the freedom to withhold the admission of CIRP only until the procedural requirements are satisfied. It stated that "*The moment the adjudicating authority is satisfied that a default has occurred, the application must be admitted unless it is incomplete,*

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in which case it may give notice to the applicant to rectify the defect within 7 days of receipt of a notice from the adjudicating authority."

"30. On the other hand, as we have seen, in the case of a corporate debtor who commits a default of a financial debt, the adjudicating authority has merely to see the records of the information utility or other evidence produced by the financial creditor to satisfy itself that a default has occurred. It is of no matter that the debt is disputed so long as the debt is "due" i.e. payable unless interdicted by some law or has not yet become due in the sense that it is payable at some future date. It is only when this is proved to the satisfaction of the adjudicating authority that the adjudicating authority may reject an application and not otherwise."

"59. The obligation of the corporate debtor was, therefore, unconditional and did not depend upon infusing of funds by the creditors into the appellant company."

In this perspective, the SC made it obligatory for adjudicating authority to admit the application and along with that declared that the adjudicating authority can reject the creditor's application only if it isn't convinced that the default has occurred based on the evidence provided and not otherwise. It also states that irrespective of any additional financial support, the Corporate Debtor has an unconditional obligation to repay debt. The same was reiterated in the case of ***E.S. Krishnamurthy V. Bharath Hi-Tech Builders Pvt. Ltd.*** and it was also held that the adjudicating authority cannot force the involved parties to negotiate a settlement. Therefore, the interpretation of SC in ***Vidarhbha Industries Power Limited V. Axis Bank Limited*** for S.7(5)(a) of IBC appears to be incorrect and goes against the legislative intent.

Intention of IBC

The SC in Innoventive Industries case held that the focus needs to be triggering of CIRP by establishment of default and not on the disputes raised by the Corporate Debtor. In the Swiss Ribbon's case, it was highlighted that the primary objective of IBC is the resolution in a time bound manner. The judgement laid down in this case, deviates from the foundational principles laid out in the Bankruptcy Law Reforms Committee (BLRC) report which says that **"***The Committee set the following as objectives desired from implementing a new Code to resolve insolvency and bankruptcy:*

1. *Low time to resolution.*
2. *Low loss in recovery.*
3. *Higher levels of debt financing across a wide variety of debt instruments.***"**

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IBC aims to initiate CIRP quickly to prevent the economic value of the assets from depleting and to maximise returns to the creditors. The SC also held that the 14-day timeline to determine the admissibility of a CIRP application, if extended, must record the reasons for the breach of timeline. Despite this clear intent, as provided in BLRC report that *"The Code will ensure a time-bound process to better preserve economic value."* The case was delayed for more than an year since the application fir CIRP was filed and due to the pendency of the appeal, no action was taken. In contrast with the timelines of IBC, the judgement in this case held that there's no fixed time limit within which the application under S.7 must be admitted. This judgement therefore, undermines the legislative intent, increases delays and violates the objectives of IBC.

Chaos in Courts

While relying on this judgement, in the case of ***Bank of Maharashtra V. Newtech Developers & Developers Pvt. Ltd.,*** NCLT exercised its discretionary power to reject the application by giving the reasoning that even after the establishment of 'debt' and 'default', which according to the BLRC report and intention of IBC is enough to trigger the CIRP and admit the application, would have negatively impacted the interests of homebuyers who had invested in the projects.

However, a contrasting judgement passed in the case of ***Indusland Bank Ltd. V. Hacienda Projects Pvt. Ltd.***, wherein the corporate debtor pleaded that despite the 'debt' and 'default', the overall financial health of the company was good and still viable, since it has almost completed the Project, NCLT while admitting the application for CIRP, held that if the company would have been financially sound, it wouldn't have defaulted in the payment of its debt. Therefore, the sole parameter of completion of Project can't judge the overall health and viability of the company.

In another case of ***Central Bank of India V. Simplex Infrastructures Limited,*** NCLT held that "*it is seen that the Corporate debtor is undergoing a transient insolvency due to a financial failure and it is a matter of time that it is able to liquidate these awards and payoff the creditors in good time which is in any case not going to be short, even if the management of the enterprise is changed, the business model of the Corporate Debtor being prudent."*

"7. (xv) Furthermore since the business model of the Corporate Debtor is not a faltered one- it works as a construction company on EPC and other form of contracts - the larger issue of the quality of the tender documents, the competition in the sector, the delay in the execution of

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the works due to various hinderances – both attributable to the owner and attributable to the Corporate Debtor and also various permutations thereof – remains unchanged even after the change of management through the resolution process."

(xvi) As such we are not satisfied in terms of Section 7 (5)(a) that this application needs to be admitted for if that was done it might create a larger harm to the Corporate Debtor."

In the case of ***State Bank of India V. Krishidhan Seeds Pvt Ltd,*** NCLT held that "*the facts which are placed before us by the corporate debtor make us think that it is not proper for us to admit the corporate debtor in CIRP at once. We do not wish to reject this application also. In our considered opinion, the management of the corporate debtor is trying hard to take the company out of the debt trap. We must give them some time. We believe their intention to settle the dues with other creditors. Hence, instead of admitting the corporate debtor in CIRP or rejecting this application, we think it proper to keep this proceeding in abeyance for six months from today. We make it clear that if the corporate debtor fails to settle the due debts, we will pass further orders. We further direct the Corporate Debtor not to sale the mortgaged assets of the Corporate Debtor to SBI without consent of the State Bank of India."*

In the case of ***HDFC Bank Ltd. V. John Energy Ltd.***, NCLT held that "*We put on record that the other lenders are ready to cooperate with the Corporate Debtor to pull itself out of the debt trap. Only HDFC Bank wants us to admit the Corporate Debtor in CIRP for their own reasons which we do not wish to endorse.*

22. So, on considering all the above facts, and more particularly, the Corporate Debtor has in its hand the contracts worth of Rs.711.18 Crores whereas total debt payable to HDFC Bank is Rs. 86.21 Crores and other lenders are ready to restructure the loan, we hold that it is not proper on our part to admit the Corporate Debtor in CIRP at once at this stage."

Since the discretionary power being established in Vidarbha judgement, the trend of citing this judgement has introduced a broader array of considerations. It has led to NCLT keeping the application at abeyance on the ground that it believes that the company's management is trying to fix its financial standing and therefore are willing to give the company some time to settle debts.

The Supreme Court's judgement in the case of ***M. Suresh Kumar Reddy V. Canara Bank & Ors.***, held that *"it was clarified by the order in review that the decision in the case of Vidarbha Industries was in the setting of facts of the case before this Court. Hence, the decision in the case of Vidarbha Industries cannot be read and understood as taking a view which is contrary*

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to the view taken in the cases of Innoventive Industries and E.S. Krishnamurthy . The view taken in the case of Innoventive Industries still holds good."

This Supreme Court judgement for holding S.7(5)(a) as mandatory is at complete odds with the Vidarbha verdict which holds it to be discretionary. However through this ruling, it has been made clear that the discretionary power of the Adjudicating authority cannot be entertained in the cases of established defaults. The reliance of Vidarbha Industries was placed as:

"86. Even though Section 7(5)(a) IBC may confer discretionary power on the adjudicating authority, such discretionary power cannot be exercised arbitrarily or capriciously. If the facts and circumstances warrant exercise of discretion in a particular manner, discretion would have to be exercised in that manner.

87. Ordinarily, the adjudicating authority (NCLT) would have to exercise its discretion to admit an application under Section 7 IBC and initiate CIRP on satisfaction of the existence of a financial debt and default on the part of the corporate debtor in payment of the debt, unless there are good reasons not to admit the petition.

88. The adjudicating authority (NCLT) has to consider the grounds made out by the corporate debtor against admission, on its own merits. For example, when admission is opposed on the ground of existence of an award or a decree in favour of the corporate debtor, and the awarded/decretal amount exceeds the amount of the debt, the adjudicating authority would have to exercise its discretion under Section 7(5)(a) IBC to keep the admission of the application of the financial creditor in abeyance, unless there is good reason not to do so. The adjudicating authority may, for example, admit the application of the financial creditor, notwithstanding any award or decree, if the award/decretal amount is incapable of realisation. The example is only illustrative."

Despite this Supreme Court judgement, the grounds for the discretionary power to be exercised by NCLT is still ambiguous. The ruling clarified that the discretion is limited and he application must be generally be admitted if there's an established default. However, it didn't provide a clear framework for what constitutes as valid grounds for the rejection of the application. It's been made quite clear that the NCLT may refuse admission if there are substantial reasons not to do so, but it doesn't specify definite set of criteria for such rejection. Additionally, both the Supreme Court's judgement deviated from the foundational principles laid out in BLRC report, which clearly states that:

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"1. The law must explicitly state that the viability of the enterprise is a matter of business, and that matters of business can only be negotiated between creditors and debtor. While viability is assessed as a negotiation between creditors and debtor, the final decision has to be an agreement among creditors who are the financiers willing to bear the loss in the insolvency.
2. The legislature and the courts must control the process of resolution, but not be burdened to make business decisions.
3. The law must set up a calm period for insolvency resolution where the debtor can negotiate in the assessment of viability without fear of debt recovery enforcement by creditors."

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"*8. The law must ensure that time value of money is preserved, and that delaying tactics in these negotiations will not extend the time set for negotiations at the start*."

Further the BLRC in its 2015 report in clause 3.2 has defined the insolvency of two types:
"Financial failure – a persistent mismatch between payments by the enterprise and receivables into the enterprise, even though the business model is generating revenues, or
Business failure – which is a breakdown in the business model of the enterprise, and it is unable to generate sufficient revenues to meet payments."

Not only this, the BLRC report also explains the role of the adjudicator as :
"The Committee recommends that the role of the Adjudicator needs to be carefully laid out so as to both minimise undue burden on the judiciary while simultaneously ensure the fairness and efficiency of insolvency resolution. This is done through two sets of recommendations from the Committee. The Committee recommends that the Adjudicator will focus on ensuring that all parties adhere to the process of the Code. For matters of business, the Committee recommends that Adjudicator will delegate the task of assessing viability to a regulated Insolvency Professional (Burman and Roy, 2015). The Adjudicator will be more directly involved in the resolution process once it is determined that the debt is unviable and that the entity or individual is bankrupt."
"Resolution phase I: A calm period for insolvency resolution
The Committee recommends two phases of resolution, once a procedure of default resolution has been triggered. The first phase is a collective negotiation to rationally to assess the viability of the debt. The Committee recommends that the assessment must be ensured a calm period where the interests of the creditors can be protected, without disrupting the running of the

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enterprise. This calm period is implemented in two orders passed by the Adjudicator. One is an order passing a moratorium on all recovery actions or filing of new claims against the enterprise. The other is by putting in place an insolvency professional who has the powers to take over the management and operations of the enterprise.

Resolution phase II: Bankruptcy as an outcome of insolvency resolution

The Committee recommends that bankruptcy is an outcome of resolving insolvency. If the debtor and creditors agree to change the terms of their contract during the negotiations to keep the enterprise as a going concern, then the enterprise is viable, and the insolvency resolution process is closed. If the negotiations fail to deliver a solution, then the enterprise is unviable, and is deemed bankrupt. The Code then specifies that bankruptcy resolution is immediately triggered."

The BLRC report clearly outlines that the viability of an entity shall not be a question of judicial discretion but rather a business decision between creditors and the corporate debtor. This implies that the role of the adjudicator is limited to ensuring all parties adhere to the process laid down in the code. For the case of determining financial viability, the adjudicator shall delegate it to the Insolvency Professional. It shall only be after the determination of the debt as unviable by Insolvency Professional, the adjudicator can be more directly involved for resolution process. In order to evaluate the viability, the first phase shall be managed by the Insolvency Professional which is appointed by the adjudicator. However, the adjudicating authority in Vidarbha judgement, made an early decision by assessing the debtor's viability by acknowledging that the financial problems are temporary and the business plan is sound. The decision of the tribunal to deny the application shall have been limited to keeping the attention on procedural matters rather than get unduly involved in the business decisions.

Vidarbha judgement by interpreting S.7(5)(a), allowed judicial discretion in assessing the viability of the entity which evidently implied for a violation of the principles of BLRC report. The objective of IBC to provide for a time-bound and predictable insolvency resolution process, preserving the economic value of the assets of the corporate debtor for its maximisation and ensuring equal rights to all creditors is compromised by such discretion. This has clearly upheld the legislative intent of IBC.

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Conclusion

The decision of the Supreme Court in Vidarbha Industries case, prioritises the Corporate Debtor over the legislative intent of the code and its objectives i.e. resolution of insolvency in a time bound manner, maximisation of the economic value of assets, promotion of entrepreneurship, availability of credit and equal rights to all creditors. This verdict gave rise to the existing management to keep the control to itself rather than promoting financial discipline brought by IBC to prevent from defaulting. The objective of IBC is to increase availability of credit but the cost of credit increases if it's stuck with sick units. It created a new category of default for all the debtors to seek shelter under the new found ground of 'temporary default'. The BLRC report clearly emphasised on the role of the adjudicator to be limited to overseeing proceedings and not involved itself in business decisions.

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