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FAILURE ATTEMPT OF ARBITRATION IN INDUS BIOTECH v KOTAK INDIA

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ABSTRACT

A Three-Judge Bench of the Hon'ble Supreme Court in *Indus Biotech v. Kotak India VenturesLtd*. While dealing with a Section 11 application under Arbitration and Conciliation Act,1996 ["Arbitration Act"] has finally decided the long-standing controversy between Insolvency and Bankruptcy Code, 2016 ["Code"] and Arbitration Act. Though the conclusion reached by the court wherein it allowed the arbitration between the parties is correct, however, the path taken by the court is unnecessarily convoluted and raises more doubts than it solves. The paper will seek to unravel some patent flaws in the reasoning of the court such as its misinterpretation of the scheme envisioned under the Code. The Code is a trailblazing piece of legislation that has employed rather unique approaches to expedite insolvency resolution. For initiation of CIRP, Code implements an ingenious measure to move away from the concept of the incapacity to honor debts to the concept of "*determination of default*". The reasons for this approach are very pertinent and integral to achieving the objective of this Code. However, according to the authors, an isolated interpretation of this rule without reconciling itwith the arbitration regime will create a fatal lacuna by providing an escape route to the unscrupulous litigants to subvert arbitration clauses by dressing up Section 7 applications initiating CIRP against another party.

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FAILURE ATTEMPT OF ARBITRATION IN INDUS BIOTECH v KOTAK INDIA

INTRODUCTION

In the case of *Indus Biotech v. Kotak India VenturesLtd*[1]*, a 3 Judge Bench was constituted in the Apex Court*, while dealing with a Section 11[2] application under "Arbitration and Conciliation Act, 1996"] has finally decided the long-standing controversy between Insolvency and Bankruptcy Code, 2016 ["Code"] and Arbitration Act. Though the conclusion reached by the court wherein it allowed the arbitration between the parties is correct, however, the path taken by the court is unnecessarily convoluted and raises more doubts than it solves. The paper will seek to unravel some patent flaws in the reasoningof the court such as its misinterpretation of the scheme envisioned under the Code.

In this case, the respondent was a subscriber of Optionally Convertible & Redeemable Preference Shares of the petitioner company. While the discussions were underway between the parties with regard to the quantum of conversion value of the said security, the redemptionvalue became due and payable back in 2018 pursuant to the Share Subscription Agreement. Asa result, the respondents moved a Section 7 application under the Code for initiation of corporate insolvency resolution process ["CIRP"] claiming to be a financial creditor of the petitioner company. Meanwhile, the corporate debtor raised an application under the Arbitration Act for reference of the dispute to the arbitration which was accepted by the NCLTMumbai in a previous order.[3] The matter went to the Hon'ble Apex Court after the petitioners approached it under Section 11 of the Arbitration Act for the appointment of an arbitrator.

In the judgment, the court firstly held that the Code shall override the provisions of the Arbitration Act and an application for initiation of CIRP u/s Section 7 of the Code would be given preference over the arbitration agreement of the parties. Settling the position of law on this issue, the court held that in case the corporate debtor raises an application under

[1] Indus Biotech v. Kotak India Ventures Ltd., 2021 SCC OnLine SC 268 (hereinafter 'Indus Biotech').
[2] Arbitration and Conciliation Act, 1996, § 11, No. 26, Acts of Parliament, 1996 (India).

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Section 8of the Arbitration Act during an ongoing legal proceeding under Section 7 of the Code, the court must first examine the merits of the Section 7 application before entertaining the questionof reference of the parties to arbitration. It held that parties can be referred to arbitration onlywhen the court is satisfied that no default occurred within the meaning of the Code.

The Code is a pioneering piece of law that has used somewhat unusual strategies to hasten the resolution of insolvency. In order to start CIRP, Code uses a clever technique to go from the idea of being unable to pay debts to the idea of "determination of default." The justifications for this strategy are crucial to reaching this Code's goal and are highly relevant.

STATEMENT OF PROBLEM

The author explains the anomalies underlying the two critical issues where the court erred – misinterpretation of the term "default" and failure of the court to reconcile the arbitration and insolvency regimes harmoniously – while analysing this decision with a primary focus on conducting an in-depth analysis of the competing interests between the arbitration and insolvency regime. The author goes deeper into the position of law in different jurisdictions about the choice of review standard to be used. Finally, the paper offers suggestions for ways to achieve a harmonious balance between these regimes and ensure that the intent and purpose associated with these regimes are preserved, including the adoption of a prima facie standard of review with provisions for fast-track arbitration and effective implementation of information utilities. As a result, the legal position established by Indus Biotech will be contrasted with the reconciliatory interpretation used in jurisdictions that encourage arbitration, such as Singapore and the UK.

RESEARCH QUESTIONS

a) Whether the disputes of Insolvency and Bankruptcy are arbitrable or not?
b) How the term ‘default’ is interpretated by the Court in order to reconcile the parties with the help of Arbitration?
c) What is the actual intent of the Legislature when it comes to the special position of financial creditors?

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RESEARCH OBJECTIVES

a) The IBC, 2016 is not implemented to hamper any other law.
b) With the help of case law, the reasons for failure in arbitration proceedings will also be analysed.
c) The clear intent of the Legislation for financial creditors will be analysed with the help of case laws will be known in the latter part of the part. Also, how the term 'default' was misinterpreted and had given perplexity for the same is also analysed, to resolve the perplexity.

ARBITRABILITY OF INSOLVENCY ISSUES

As we compare both the area of laws, the interests reflected by arbitration and insolvency regimes are poles apart. The arbitration regime seeks to provide the parties with the choice of a private forum for resolving their disputes.[3] On the other hand, the insolvency regime seeks to provide a central adjudication for creditors of the corporate debtor. Hence, the issue of arbitrability of insolvency disputes under Section 7 of the Code came for determination before the court.

Arbitration is a private adjudicatory process through which parties decide to forego their right to approach the courts in favor of arbitral tribunals. Hence it is necessary that it should be ousted in cases where *erga omnes* rights i.e., rights for and against everyone concerned are present.[4]

Since insolvency disputes relate to the rights of third parties' creditors who have an interest in liquidation or resolution of the corporate debtors, insolvency disputes were painted with a broad brush to be non-arbitrable in *Booze Hamilton*[5]. However, this position changed for good in *Vidya Drolia*[6] where a three-judge bench of the court opined that subject should not be declared non-arbitrable by laying bold expositions. Additionally, it advised the courts to

[3] Ajar Rab, *Defining the Contours of The Public Policy Exception – A New Test for Arbitrability in India*, 7 IND.JOUR. OF ARB. L. 161, 161 (2019).
[4] N. BLACKABY ET AL., REDFERN AND HUNTER ON INTERNATIONAL ARBITRATION ¶ 2.126 (6th ed. 2015).
[5] Booz Allen and Hamilton Inc. v. SBI Home Finance Ltd., (2011) 5 SCC 532.
[6] Vidya Drolia v Durga Trading Corporation, (2021) 2 SCC 1.

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find out the specific erga omnes rights involved in the case.

Keeping in mind these pronouncements, the court in *Indus Biotech* took a rather pragmatic approach while deciding the arbitrability of default under Section 7 of the Code. It observed that erga omnes rights of various creditors to the corporate debtor come into place only after aSection 7 application for initiation of CIRP is accepted by the NCLT. Thus, it declared that thedispute is non-arbitrable only after admission of the application under the Code, leaving the parties competent to raise an application for reference to an arbitrator before admission of the corporate debtor in CIRP.[33] This sensible approach provided a good start to the judgment whichwas in contrast to the inchoate tangle of a mess that followed soon.

TERM 'DEFAULT' INTERPRETATION

Apart from striking a blow to the arbitration regime, the court also created a gaping loophole by misinterpreting the term "*default*" as defined in the Code. The Hon'ble Supreme Court whileconsidering the issues held that non-payment of dues in the present case cannot be classified as default till the dispute between the parties concerning terms of payment is resolved[7].

This view adopted is contrary to the statutory provisions which define default as non-paymentof *debt* that has become due and payable under the law[8]. Further, the Code defines "*debt"* as a liability or obligation in respect of a claim which is due[9]. A "*claim"* is defined in Section 3(6) of the Code as a right to payment, whether or not such right is reduced to judgment, fixed,disputed, undisputed, legal, equitable, secured, or unsecured[10].

Hence the combined reading of the above-mentioned provisions points to the conclusion that even disputed claims can form the basis of default in the Code, for which CIRP can be initiated by a financial creditor. This intention was also identified in the *Innoventive Industries v. ICICIBank* [11], the first judgment which dealt with the Code.

[7] Supra Note at 1

[8] Insolvency & Bankruptcy Code, 2016, § 3(12), No. 31, Acts of Parliament, 2016 (India).

[9] Insolvency & Bankruptcy Code, 2016, § 3(11), No. 31, Acts of Parliament, 2016 (India).

[10] Insolvency & Bankruptcy Code, 2016, § 3(6), No. 31, Acts of Parliament, 2016 (India).

[11] Innoventive Industries Limited v. ICICI Bank, (2018) 1 SCC 407 30.

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However, the court ignored this mandatory and swift process enshrined in the Code to introducean unwarranted discretion on the courts to ascertain the existence of a default. This approach not only falls foul of statutory provisions but also the legal intent to reduce delays in the process and increasing uncertainty in the process. It is to be noted that an unwarranted effect of this judgment would be that even the parties which do not have arbitration agreements will have an option of raising the defense of dispute to derail the initiation of CIRP. Thus, the judgment erred for firstly not trying to reconcile the objectives of insolvency and arbitration regimes and secondly not interpreting the Code in line with the legislative intent.

DILUTING THE LEGISLATIVE INTENT BEHIND THE SPECIAL POSITION OF FINANCIAL CREDITORS

In misinterpreting the terms "financial debt" and "claim" as it appears in the code, the court contravenes the very clear legislative intent behind distinguishing the rights of operational creditors and financial creditors. The financial creditors can initiate CIRP based on the existence of a default irrespective of the presence of any dispute. On the other hand, the operational creditors can initiate CIRP only in the absence of any dispute raised by the corporate debtor[12]. The reason for such difference has been observed in *Swiss Ribbons*[13]. The Hon'ble Supreme Court observed that financial creditors are engaged in assessing the viability of the business from the very beginning, thus they are in a better position to identify the problems in the business and try to take corrective actions for the company. Moreover, unlike operational creditors they have huge sums invested in the business hence they are also more impelled to restructure the business of the corporate creditors when they see a problem in the acts of the promoter group.

However, by imposing the condition on the financial creditor to prove an undisputed debt before initiating the CIRP, it has placed financial creditors on the same footing as that of the operational creditor. Thus, the judgment smudges the difference between the two classes of creditors to a vanishing point and ends this objectivity in the process of initiating CIRP for

[12] Insolvency & Bankruptcy Code, 2016, § 9(3)(b), No. 31, Acts of Parliament, 2016 (India).
[13] Swiss Ribbons Pvt. Lmt. v. Union of India, 2019 SCC OnLine SC 73

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thefinancial creditors and replaces it with a rather vague and befuddled standard.

POSITION IN UK & SINGAPORE

Various jurisdictions across the globe have dealt with the conflict of centralization of dispute resolution in bankruptcy law and the party autonomy provided by arbitration law. In this section, the authors try to analyze the position of law adopted in other relevant common law jurisdictions.

Faced with the same conflict, in *AnAn (Singapore) Pte Ltd v VTB Bank*, the Singapore Court of Appeal ruled that the alleged debtor must dispute the debt in good faith on a prima facie basis for reference to arbitration[14]. This is because, when parties agree to settle conflicts by arbitration, one party should not be allowed to override the arrangement by pursuing the otherremedy for non-payment of a contested debt.

In this case, the court extensively relied on the approach in *Salford Estates (No 2) Ltd v Altomart Ltd* adopted by the English Court of Appeal which held that the courts ought to dismiss or stay the winding-up application except in wholly exceptional circumstances[15]. Thesewholly exceptional circumstances included the cases where the corporate debtor raises patentlysuperficial and futile defences to delay inevitable insolvency.

In the *AnAn* Case, the court was faced with a choice among the two standards of review to assess if the parties should be referred to arbitration. While according to the "*triable issue*" standard the parties had to prove an arguable case substantially on merit to dispute the validityof the debt to refer the parties to arbitration. However, the "*prima facie*" standard merely requires the parties to establish the existence of a bona fide dispute regarding the debt and a valid arbitration agreement.

The Singapore Court of Appeal drew attention to the incoherent standard adopted to review and refer debt proceedings to arbitration.[54] While the prima facie standard was applied in ordinary litigation, the triable issue standard was applicable on insolvency applications. It was of the opinion that there is no justification to apply different standards to the same disputed debt because it encourages the tactical use of winding up application.

[14] AnAn (Singapore) Pte Ltd v. VTB Bank (Public Joint Stock Company) [2020] SGCA 33.
[15] Salford Estates (No 2) Ltd v. Altomart Ltd (No 2) [2015] Ch 589.

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The judgment in AnAn endorsed the legislative policy to arbitrate the dispute between the parties before initiating insolvency proceedings. Subsequently, it highlighted as the primary principle, the intent of the insolvency regime to enable creditors to prefer an application to wind-up companies incompetent to honor their debts where no bona fide dispute regarding the existence and quantum of debt exists.[59] In doing so it unauthorized a state of affairs where thefinancial creditor could act without giving justifications for its inconsistent actions to the agreement. This is because in such situations the financial debtor lost their status as a rights- bearing entity and became subject to the whims of the financial creditor pending the dispute.

Thus, in the conflict between arbitration and insolvency, the insolvency regime does not applyuntil a debt is determined by arbitration. This is because the parties decided to settle disputes regarding the existence of debt itself through arbitration.

SOLUTIONS FOR BALANCING THE CONFLICT OF INTERESTS

INTRODUCTION OF PRIMA FACIE STANDARD

The earlier discussions in this article pose a very fascinating problem of how to discourage the strategic invocation of CIRP by financial creditors to subvert arbitration while maintaining allegiance to the legislative intent behind "*default rule*" enshrined in the Code. However, a solution to this conflict cannot be arrived upon without considering the interests involved in the Arbitration regime.

Arbitration agreements are binding contracts that are entered into for ousting the primary jurisdiction of the court and placing it in hands of a private adjudicatory body. The effective enforcement of these agreements lies at the very bedrock of modern international commercial transactions as it maintains predictability and reinforces the trust of the investors. These pivotal interests inextricably linked with our current conflict must not be glossed over. Thus, we lean in favor of the view where this binding arbitration agreement should not be thrown out of the window merely because of the invocation of Section 7 application for initiation of CIRP under the Code. Thus, the English "*prima facie*" standard

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where parties are referred to arbitration except in wholly exceptional cases should be preferred. This approach strikes the perfect balance between the competing interests as it upholds the sanctity of arbitration agreements without diluting the objective "*default rule*" enshrined in the Code for cases other than arbitration, which the current judgment fails to do.

FAST TRACK ARBITRATIONS

Though the "*prima facie*" standard is an effective way of upholding the sanctity of arbitration agreements without diluting the objectivity of default rule in cases other than arbitration, however, it comes with its own set of concerns. Value destruction caused by inordinate delay is the stumbling block of a successful resolution process[16]. If the valuable time elapses in a prolonged arbitration process, the objective of value maximization will be defeated. Such reduction in value can occur due to a variety of reasons such as market speculation or fraudulent trading by the promoter group. Thus, the time elapsed during the arbitration should be minimized and closely monitored.

The stated problem can be addressed by taking a resort to fast-track arbitration. Fast-track arbitration is a stringent time-bound sub-system of regular arbitration which cannot be delayed due to any reason. The fast-track arbitration regime, considering time as essence, allows the consenting parties to waive the conventional procedural and technical requirements to accelerate the dispute resolution process.

The process of expedited arbitration as prescribed under Section 29B of the Arbitration Act[17] prescribes mainly three stipulations which are as follows.

1. The Arbitral Tribunal consists of a sole arbitrator;
2. Waiver of formalities such as oral hearing; and
3. Compliance with a six months timeline.

[16] Ivo Welch, Arturo Welch & Ning Zhu, *The Costs of Bankruptcy: Chapter 7 Liquidation Versus Chapter 11 Reorganization, 61* JOURN. OF FIN. 1253, 1275 (2006).

[17] Arbitration and Conciliation Act, 1996, § 29B, No. 26, Acts of Parliament, 1996 (India).

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This fast-track arbitration provision is based on the mutual consent of parties providing no power to the courts to make an order for mandatory arbitration. However, it is suggested that the parties can be encouraged to adopt the procedure by mutual consent under Rule 11 of the NCLT Rules which provide the tribunals with the power to do complete justice[18].Alternatively, the legislature can also add an enabling clause to the Code empowering the tribunal to pass orders for mandatory arbitration.

EFFECTIVE IMPLEMENTATION OF INFORMATION UTILITIES

The problem of strategic dressing up of petition by the financial creditor in situations when the corporate debtor is financially viable can be solved by effective implementation of InformationUtilities. The Code envisages Information Utility as a data repository to provide core services such as accepting and safekeeping electronic submission of financial information. This information including the sum borrowed, default made, and other security interests of corporate debtors is kept and validated by Information Utility to deliver it to concerned stakeholders. The concept of Information Utility is visualized as one of the supporting pillars of institutionalinfrastructure under the Code as it speeds up the default authentication. The objective of proposing Information Utilities is to reduce information asymmetry and strengthen the systemof credit risk assessment to empower the creditors and lenders to make informed choices. Theambitious time limit prescribed in the Code is based on the belief that relevant evidence-basedinformation will be easily available to concerned stakeholders through Information Utility. Additionally, as evident from the observations of SC in *Swiss Ribbons* and *Innoventive Industries,* the "default rule" which provided different standards for Financial and Operational Creditors was premised on the assumption of effective working of InformationUtilities.

[18] National Company Law Tribunal Rules, 2016, GSR 716(E) 57.

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CONCLUSION

The solutions suggested in the article conspicuously provide that the competing interests are not irreconcilable. The competing interest can be solved by implementing arbitration clauses with full effect except in exceptional circumstances where it is apparent that the invocation ofarbitration is mala fide and dilatory. This provides a twin solution as it *firstly* thwarts the possibility of strategic use of arbitration to avert or delay insolvency and it *secondly* maintains the integrity of default rule in disputes between parties without an arbitration clause. However,the Hon'ble Supreme Court in *Indus Biotech* miserably fails to balance as it disturbs the integrity of the "*default rule*" and throws the door open for unscrupulous litigants to avert insolvency by raising futile defenses. Thus, failing on both accounts. Though referring the parties to arbitration may balance the competing interests between arbitration and insolvency, however, we must not lose sight of the fact that it comes with the problem of delay caused by long periods taken by the arbitration process to culminate between the parties. To resolve this issue, the authors have suggested several ways such as passing orders for fast-track arbitration and reinforcing institutional systems of the Code such as information utilities to ensure speedy adjudication of "defaults" at the stage of initiation of CIRP.