Insolvency and Bankruptcy Hotline

September 10, 2018

INSOLVENCY AND BANKRUPTCY: WHETHER CHALLENGE TO AN ARBITRAL AWARD IS AN 'EXISTING DISPUTE' UNDER THE CODE?

Supreme Court has held that:

- application for initiation of corporate insolvency resolution process by the operational creditor is liable to be rejected in the presence of a 'pre-existing dispute' as to the debt;
- pendency of challenge to an arbitral award qualifies as 'pre-existing dispute' for the purposes of initiating corporate insolvency resolution process by the operational creditor;
- the Code should not be used inappropriately as a substitute for debt adjudication and enforcement procedures under other statutes.

INTRODUCTION

Recently, the Supreme Court of India ("**Supreme Court**") in *K. Kishan v. M/s Vijay Nirman Company P. Ltd.*[1], has considered whether the Insolvency and Bankruptcy Code, 2016 ("the **Code**") can be invoked in respect of an operational debt where the arbitral award passed against the operational debtor creating such debt, is pending challenge under Section 34 of the Arbitration and Conciliation Act, 1996 **("Act")**.

BRIEF FACTS

M/s Vijay Nirman Company Pvt. Ltd ("**Respondent**") and M/s Ksheerabad Constructions Pvt. Ltd. **("KCPL")** entered into an agreement on 1 February 2008 for construction and widening of the existing two-lane highway. Subsequently, disputes and differences arose between the parties and the same was referred to arbitration proceedings which finally culminated into an award dated 21 January 2017 ("**Award**"). In the Award, amongst other reliefs, a sum of INR 1,71,98,302 was granted in favour of the Respondent in relation to certain interim payment certificates. There were certain cross claims which were rejected in the Award.

Subsequently, on 6 February 2017, the Respondent issued a demand notice (under Section 8[2] of the Code) on KCPL. KCPL disputed the demand notice within 10 days on the premise that the claimed amount was subject matter of an arbitration proceeding.

Thereafter, on 20 April 2017, KCPL challenged the Award under Section 34 of the Act. On 14 July 2017, an application under Section 9[3] of the Code was filed by the Respondent stating that amount granted in favor of the Respondent was an 'operational debt' and non-payment of the said debt was a ground for initiation of the corporate insolvency resolution process ("**CIRP**") under the Code **("Section 9 Application")**.

On 29 August 2017, the National Company Law Tribunal ("**NCLT**") admitted the Section 9 Application, and observed that pendency of a Section 34 challenge was irrelevant as there had been no stay of the Award, and moreover the claim amount stood admitted during the arbitral proceedings. On appeal, the National Company Law Appellate Tribunal ("**NCLAT**") affirmed the ruling of the NCLT basis the reasoning that order of the Arbitral Tribunal adjudicating on the default, would be treated as "a record of an operational debt". The decision of the NCLAT was subsequently assailed before the Supreme Court.

CONTENTIONS:

Appellant:

Relying on the decision of the Supreme Court in *Mobilox Innovations Private Limited v. Kirusa Software Private Limited*[4] (2018) 1 SCC 353 (**"Mobilox"**), it was contended that the object of the Code is not to replace debt adjudication and enforcement under other acts (including the Act), and the moment there is a real dispute between the parties which need not be a 'bonafide dispute', which is likely to succeed in law, CIRP process cannot be initiated against the operational debtor. It was contended that the very fact that a Section 34 challenge is pending is reflective of a real dispute which was pre-existing, and which culminated into the Award and has been challenged.

There were cross claims rejected by the Arbitral Tribunal, which exceed the amount awarded to the Respondent.

Contrary to the finding of the NCLAT, there is nothing inconsistent between the adjudication and enforcement process under the Act and application of Section 8 and 9 of the Code, and as long as the existence of dispute is established, the Act will apply.

Respondent:

Reliance was placed on the insolvency laws in the UK and Singapore to contend that once there is a primary

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adjudication that indicates existence of a debt, any further dispute which may be pending in appeal or otherwise over the debt could not be said to be bona fide dispute by the debtor.

NCLAT has correctly applied Section 238 of the Code as there would be an inconsistency between applicability of the Code and Section 34 proceedings.

JUDGMENT

The Supreme Court relied on Section 9 (5) (ii) (d) of the Code and observed that an application under Section 8 of the Code must be rejected when a notice of dispute had been received by the operational creditor. The Supreme Court noted the following facts: (a) the basis of the demand under Section 8 stems out of the Award granted in favour of the Respondent, but the demand notice setting out the details of debt was disputed in the reply; (b) counter-claim exceeding the claim awarded was rejected by the Arbitral Tribunal (and while two counter-claims were rejected for lack of evidence, the third counter-claim amounting to INR 19,88,20,475 was rejected on the basis of a price adjustment claim on merits)**.** Thereafter, the Supreme Court observed that the subject matter was pending a challenge under Section 34 of the Act, and it could not be stated that no dispute existed between the parties. In this light, challenge to the Award was held to be a 'pre-existing dispute' which culminates at the first stage of the proceedings in an Award, continues even after the Award, at least till the final adjudicatory process under Section 34 and Section 37 of the Act is complete.

The Supreme Court did not accept the Respondent's submission that the debt set out in the demand notice has been admitted by the Appellant during the arbitral proceedings. It was observed that cross claims which were rejected by the Arbitral Tribunal, were subject matter of challenge under Section 34 of the Act, and the mere possibility that the Appellant would succeed in the cross claims, was sufficient to state that the operational debt in the present case could be said to be an undisputed debt.

The Supreme Court placed reliance on *Mobilox*, which had settled the '*disputed debt*' conundrum under the Code. It re-affirmed that if there is '*existence of a dispute*' between the parties or pending suit or arbitration proceedings before the demand notice was sent to the operational debtor, CIRP cannot be initiated by the operational creditor and the application under Section 8 of the Code would thus have to be rejected. The Supreme Court thereafter held that the operational creditor cannot use the Code either prematurely or for extraneous considerations or as a substitute for debt enforcement procedures.

The Supreme Court also observed that: (a) in instances where a challenge petition under Section 34 of the Act may be clearly and unequivocally barred by limitation, in such cases CIRP may be put into operation; (b) CIRP cannot be initiated by an operational creditor during the pendency of an application for exclusion of time under Section 14 of the Limitation Act, 1963[5].

The Supreme Court additionally observed that there is no inconsistency between the adjudication and enforcement process under the Act and Section 8 & 9 of the Code and therefore Section 238 of the Code would have no application in the present case.

Further, the Supreme Court affirmed that even though Arbitral Awards are valid records of an operational debt, the same would have to be undisputed as per the parameters discussed in this judgement and *Mobilox*, to enable initiation of the CIRP by operational creditors.[6]

ANALYSIS

The judgment of the Supreme Court is praiseworthy and provides clarity on what constitutes existence of dispute under the Code. In crux, it has emphasized that a debt is not crystalized till the Arbitral Award containing such debt attains finality. This judgement has amplified the scope of previous judgements in *Mobilox* and *Annapurna* to include challenge to Arbitral Awards within the meaning of *'existence of dispute'* under Section 9 the Code.

However, it remains to be seen how courts will look at similar situations where financial creditors are involved. The ratio of *Mobilox* cannot *per se* be applied onto financial creditors because the adjudicating authority, at the stage of admission of an application to initiate CIRP, is required to only satisfy itself of the occurrence of default and to ensure that the application is complete and no disciplinary proceedings are pending against the proposed resolution professional and is not required to delve into the aspect of 'existence of a dispute'.

Further, in the present case, the Award under challenge was a domestic award challenged under Section 34 of the Act. It will be interesting to see the treatment of a foreign award being resisted enforcement, which per se does not qualify as a challenge to an Arbitral Award. Perhaps, it would still be brought within the ambit of 'existing dispute' till such time the Award is finally enforced in India.

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You can direct your queries or comments to the authors

[1] Civil Appeal No. 21825 of 2017. Click here to read the judgment.

[2] Section 8 of the Code sets out the insolvency resolution process for an operational debt.

[3] Section 9 of the Code specifies the details to initiate CIRP against an operational debtor.

[4] Please find our analysis of this case in a previous hotline here.

[5] Section 14 of the Limitation Act relates to exclusion of time for proceeding bona fide in a court without competent jurisdiction.

[6] Click to see the discussion on Arbitral Awards being a valid record of an 'event of default' in *Annapurna Infrastructure P. Ltd v. Soril Infra Resources Ltd.* Company Appeal (AT) Insolvency No. 32 of 2017.

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