Supreme Court's Practical View On Reference To Arbitration In Insolvency Proceedings

written by Amiy Kumar | May 28, 2021

In this Article Amit Kumar (Arbitration Law Firm) analyses Arbitration In Insolvency Proceedings. It has been observed that conflict arises when the provision related to *"reference to arbitration"* under Section 8 of the Arbitration and Conciliation Act, 1996 ("ACA") collides with insolvency proceedings under the Insolvency & Bankruptcy Code, 2016 ("IBC"). Both acts are considered special laws and are enacted in different ways in different fields of law. As far as ACA is concerned, there is no specific provision which excludes any particular set of disputes as non-arbitrable.

However, it has been settled through *Booz Allen Hamilton Inc. v. SBI Home Finance ltd*[1] that while there are certain categories of cases that are non-arbitrable, the Hon'ble Supreme Court has recognized the disputes as non-arbitrable when related to action in rem. A right in rem refers to legal rights outside the contract; it is available against the public at large and a right in personam is available within the contract and against a particular individual only.

It has been further settled in the said judgment of the Apex Court that "…. *a right in rem is a right exercisable against the world at large, and is not amenable to arbitration, whereas a right in personam, in which an interest is protected against specific individuals. It was also stated that disputes relating to subordinate rights in personam arising from rights in rem have always been considered to be arbitrable."* The Hon'ble Supreme Court has also labelled winding up and insolvency proceedings matters as non-arbitrable.

Further, in the case of *Vidya Drolia & Ors Vs Durga Trading Corporation*[2], the Hon'ble Supreme Court had mentioned that "…*when cause of action and subject matter of the dispute affects third party rights; have erga omnes effect; require centralized adjudication, and mutual adjudication would not be appropriate and enforceable."*

Therefore, it is to be noted that if the cause of action and the subject matter of the dispute affects the right and liabilities of the third parties, it becomes a matter of action in rem and that cannot be arbitrable and adjudicated by the private forum mutually chosen by the parties. It requires adjudication by the special forum or authority which is exclusively established for that particular set of disputes requiring expert adjudication in the interest of third-party rights.

Overriding effect

Section 238 of IBC provides that the provisions of IBC will override all the other laws and by virtue of Section 8 of the ACA, the judicial authorities are bound to refer the parties to arbitration[3], in case a valid arbitration agreement exists. Further, it is settled as per the rule of interpretation of statutes that in the event of a conflict between the non obstante clauses of two special statutes, the later statute must prevail.

However, in the matter of "Indus Biotech"[4], the Hon'ble National Company Law Tribunal ("NCLT"), Mumbai has allowed an application filed under Section 8 of ACA by the corporate debtor and dismissed the original petition filed by the financial creditor under Section 7 of IBC. The Hon'ble Supreme Court, in its recent Judgment dated 26.03.2021, upheld the decision of NCLT made in the "Indus Biotech" (Arbitration Petition)[5].

The Indus Biotech Case before NCLT

1. A company petition under Section 7 of IBC was filed before NCLT, Mumbai, by Kotak India Venture Fund ("Financial Creditor") seeking initiation of Corporate Resolution insolvency proceedings against the Indus Biotech Private Limited ("Corporate Debtor") on the grounds that the Corporate Debtor failed to redeem the Optionally Convertible Redeemable Preference Shares ("OCRPS") in terms of the Share Subscription and Shareholders Agreement ("SSSA") signed between the parties and accordingly, the Financial Creditor alleged that there was a default on the part of the Corporate Debtor in redeeming the OCRPS.
2. The parties had agreed to go for an IPO and the main dispute that arose between the parties was related to the calculation and conversion formula adopted for converting the preference share into the equity share of the Corporate Debtor.
3. The Corporate Debtor had filed an application under Section 8 of ACA before NCLT, seeking to refer the parties of the main petition to arbitration for settling their disputes.
4. The NCLT held that in any Section 7 petition, there has to be a judicial determination by the Adjudicating Authority as to whether there has been a "default" within the meaning of Section 3 (12) of the IBC.
5. The NCLT observed that no default occurred on the part of the Corporate Debtor within the meaning of IBC and the Corporate Debtor is a debt-free and profit-making company. Therefore, it will not serve any meaningful purpose to push such a company into insolvency proceedings. Also, the subject matter of the disputes is arbitrable. Considering all the aforesaid reasons, the NCLT allowed the Section 8 application and accordingly dismissed the said company petition.

The Indus Biotech Case: Supreme Court's Observation - Arbitration In Insolvency Proceedings

1. The Corporate Debtor had filed an arbitration petition before the Supreme Court under Section 11 of ACA seeking the appointment of arbitrators as the dispute had qualified for international arbitration. Along with the said arbitration petition, the Supreme Court considering the special circumstances, entertained the petition and examined the case on merits, to arrive at a conclusion on the correctness of the impugned order passed by the NCLT.
2. Referring to the Booz Allen Judgement, the Financial Creditor submitted that the proceedings under Section 7 of IBC are action in rem and as such,

insolvency proceedings and winding up matters are non-arbitrable.

3. Supreme Court held that an application under Section 7 becomes a proceeding in rem on the date of admission of the application, upon the occurrence of default. Thus, from that point onwards the matter would not be arbitrable.
4. Supreme Court observed that the trigger point for a proceeding to become a proceeding in rem would not be at the time of filing of Section 7 application, but when the same reaches the stage of proceedings in rem upon admission of the application. Therefore, on determination of default upon admission of the application, it automatically creates third party rights of all the creditors of the corporate debtor who are not bound by the arbitration agreement.
5. In the present case, Supreme Court observed that the petition under Section 7 of IBC was yet to be admitted and therefore, it was not qualified to the status of a proceeding in rem. Also, it was observed that no default occurred on part of the Corporate Debtor. NCLT had duly recorded that from the material available on record, the Adjudicating Authority was not satisfied that a default had occurred. However, in any case, wherein the company petition filed under Section 7 of IBC is yet to be admitted, and if in such proceedings any application under Section 8 of ACA is filed, then the Adjudicating Authority must decide the application under Section 7 of IBC as lead consideration, even if the Section 8 application is filed simultaneously.
6. Supreme Court upheld the decision of the NCLT that there no default occurred and hence the dismissal of the Section 7 petition at that stage was justified. Further, it was observed that the Section 8 application, though allowed by the NCLT, was subject to consideration before the Supreme Court in the petition filed under Section 11 of ACA.

Conclusion

The Supreme Court has rightly settled about Arbitration In Insolvency Proceedings that the application under Section 8 of ACA would not be maintainable after admission of the company petition filed under IBC seeking initiation of Corporate Insolvency Resolution Process as it becomes a proceeding in rem and creates third-party rights after admission of the petition. The Supreme Court has answered a much-awaited question as to when the disputes actually become non-arbitrable; this is going to help in deciding similar matters in future.

As far as insolvency proceedings are concerned, it is very clear now that the insolvency proceedings become in rem only upon admission of the application. Now Operational or Financial Creditor cannot avoid “reference to arbitration” by merely filing an insolvency application; instead, the NCLT would have to determine first the existence of default under IBC and if such default is not established, only then can the matter be referred to arbitration.

The Supreme Court has settled as to when the insolvency proceedings create third party rights and when they become a proceeding in rem. It is very clear now that admission of insolvency application affects the rights of the third party and reaches the stage of proceedings in rem after which an application under Section 8 of ACA would not be maintainable.

However, if the Adjudicating Authority is satisfied with the non-existence of default before admission of the insolvency application, then the matter can be settled through arbitration. The Supreme Court has very correctly pointed out that the natural consequence of consideration made in insolvency

application of IBC would befall the application under Section 8 of ACA.

- *[1] (2011) 5 SCC 532*
- [2] Civil Appeal No. 2402 OF 2019, SC.
- [3] (2000) 4 SCC 539
- [4] IA 3597 OF 2019 IN CP (IB) No.3077 OF 2019, NCLT MUMBAI
- [5] ARBITRATION PETITION (CIVIL) No. 48 OF 2019, SC
- [6]insolvency proceedings

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