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April 2023

Financial debt and default thereto - Is it sufficient to trigger insolvency proceedings

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The decision on admission of an application preferred by a financial creditor under section 7 of the Insolvency and Bankruptcy Code, 2016 ('IBC') has by large been dependent only on two aspects – existence of a financial debt and default in relation thereto. Any other extraneous factors being contended by a corporate debtor has at best served limited purpose of deferring the inevitable.

However, two recent judgments on the subject matter are likely to have far reaching implications on the way an application under section 7 has to be dealt with by the Adjudicating Authority going forward.

This article deals with the key observations made while denying initiation of Corporate Insolvency Resolution Process pursuant to section 7 application in N.S. Engineering Projects Private Limited and the stay on commencement of insolvency proceedings in the case of Vidarbha Industries Power Limited.

Hon'ble National Company Law Tribunal, Kolkata Bench in State Bank of India, Punjab National Bank Vs N. S. Engineering Projects Private Limited (Corporate Debtor)

The Corporate Debtor ("CD") had availed Term Loan Facilities and Working Capital Facilities and the said facilities were restructured upon approval of CDR package. Upon the account being declared non-performing asset, State Bank of India followed by Punjab National Bank filed an application u/s 7 of Insolvency and Bankruptcy Code, 2016 ("Code") before the Hon'ble NCLT Kolkata Bench against the CD.

The contentions on behalf of the CD were prevailed:

- the agreed contract [being the master restructuring agreement pursuant to approved restructuring package under Corporate Debt Restructuring (CDR) mechanism] consisted of reciprocal promises to be performed by both the parties, whereby on default of one party, the other party will not only be required to not perform its obligations but will also be discharged and further entitled to compensation.
- In view of the position of dominance that banks have over industries, the CD could not have terminated the contract and was obliged to wait for the banks to perform their obligations. Owing to the failure on part of the banks to fund and perform their obligations on time, the CD was unjustly prevented from running its unit and performing its obligations.

Key observations of the Adjudicating Authority

1. The Lenders' Independent Engineer (LIE)'s Report commissioned by the Financial Creditor (FC) does not point to any failure on the part of the CD or its promoters to perform its obligations in terms of the sanction letter. Therefore, there seemed no reason whatsoever for the FC not to disburse the amounts in terms of the sanction letters.
2. The whole gamut of the economics of an enterprise is dependent upon the lender and the borrower alike, therefore, FC should not plead innocence on either the failure or the below-par performance of a commercial endeavour and lay the entire blame at the door of the entrepreneur.
3. Section 7(5)(a) of the Code stipulates that where the AA is satisfied that a default has occurred, it may by order admit such application however, it cannot be extended to a fact situation where the FC, by its own acts of omission and commission, contributes to the default on the part of the CD.

The moot question addressed by the Adjudicating Authority was is it bound to admit an application under section 7 of the Code when it is alleged that there is contributory negligence arising out of non-disbursement of the amounts in terms of the sanction letters.

The Adjudicating Authority disagreed with the submissions of the financial creditor that it is imperative for the AA to consider whether there is a debt in respect of which there is a default or not and determination of counterclaim, set-off etc., comes in later.

With the above observations, the application of the financial creditor was rejected stating that the same was not a fit case for initiating CIRP against the CD.

Hon'ble Supreme Court of India in Vidarbha Industries Power Limited vs. Axis Bank Limited

An appeal under Section 62 of the Insolvency and Bankruptcy Code 2016 ("Code") was preferred against a judgment and order dated 02.03.2021 passed by the National Company Law Appellate Tribunal (NCLAT), New Delhi whereby the learned Tribunal refused to stay the proceedings initiated by the Axis Bank Limited (Financial Creditor/ FC) against Vidarbha Industries Power Limited (CD) for initiation of the Corporate Insolvency Resolution Process (CIRP) under Section 7 of the IBC.

The main contention of the CD was that it had applied for stay of the proceedings before NCLT, Mumbai in extraordinary circumstances, where the CD had not been able to pay the dues of the FC, only because an appeal filed by Maharashtra Electricity Regulatory Commission (MERC) against an order dated 03.11.2016 passed by Appellate Tribunal for Electricity (APTEL) in favour of the CD, was pending before the Supreme Court and resultantly, the CD was unable to realize a sum of Rs.1,730 Crores, which is due and payable to it in terms of the order of APTEL.

It was submitted that considering the special nature of the business of the CD of production of electricity, tariff whereof is regulated by MERC and APTEL, the application under Section 7 of the IBC should not have been admitted.

Key observations of the Hon'ble Supreme Court

1. The new Insolvency and Bankruptcy framework has been designed, inter alia, to facilitate the assessment of viability of an enterprise at a very early stage, and to ensure a time bound Insolvency Resolution Process to preserve the economic value of the enterprise.
2. There can be no doubt that a CD who is in the red should be resolved expeditiously, following the timelines in the Code. No extraneous matter should come in the way. However, the viability and overall financial health of the CD are not extraneous matters.
3. Both, the NCLT and the Appellate Tribunal (NCLAT) proceeded on the premises that an application must necessarily be entertained under Section 7(5)(a) of the Code, if a debt existed and the CD was in default of payment of debt.
4. An award of the APTEL in favour of the CD, cannot be completely disregarded by the Adjudicating Authority (NCLT), when it is claimed that, in terms of the said award, a sum of Rs.1,730 crores (which far exceeds the claim of the FC), is realisable by the CD.
5. The Appellate Authority (NCLAT) erred in holding that the Adjudicating Authority (NCLT) was only required to see whether there had been a debt and the Corporate Debtor had defaulted in making repayment of the debt, and that these two aspects, if satisfied, would trigger the CIRP. The existence of a financial debt and default in payment thereof only gave the financial creditor the right to apply for initiation of CIRP.
6. The Adjudicating Authority (NCLT) was required to apply its mind to

relevant factors including the feasibility of initiation of CIRP, against an electricity generating company operated under statutory control, the impact of MERC's appeal pending for disposal, order of APTEL and the overall financial health and viability of the CD under its existing management.

7. The fact that Legislature used 'may' in Section 7(5)(a) of the IBC but a different word, 'shall' in the otherwise almost identical provision of Section 9(5)(a) shows that 'may' and 'shall' in the two provisions are intended to convey a different meaning. It is apparent that Legislature intended Section 9(5)(a) of the IBC to be mandatory and Section 7(5)(a) of the IBC to be discretionary.
8. It is certainly not the object of the Code to penalize solvent companies, temporarily defaulting in repayment of its financial debts, by initiation of CIRP. Section 7(5)(a) of the IBC, therefore, confers discretionary power on the Adjudicating Authority (NCLT) to admit an application of a Financial Creditor under Section 7 of the Code for initiation of CIRP.
9. The Adjudicating Authority (NCLT) has to consider the grounds made out by the CD against admission, on its own merits. When admission is opposed on the ground of existence of an award or a decree in favour of the CD, 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) of the IBC to keep the admission of the application of the Financial Creditor in abeyance, unless there is good reason not to do so.
10. The Adjudicating Authority (NCLT) has simply brushed aside the case of the CD that an amount of Rs.1,730 Crores was realizable by the CD in terms of the order passed by APTEL, with the cursory observation that the said disputes, if any, were inconsequential.

With the above observations, the appeal was allowed and NCLT directed to re-consider the application of the CD for stay of further proceedings on merits in accordance with law.

In the light of the above judgments, the Adjudicating Authority would expectedly exercise their discretion while determining admissibility of a Section 7 application by considering factors beyond debt and corresponding default and accord fair share of consideration to the reasons resulting in inability of the CD to cure the default.

The above judgments render a whole new perspective by bringing in an element of subjectivity to the initiation of insolvency proceedings by financial creditors. Notwithstanding the underlying rationale, these precedents are bound to create ripples in the ecosystem with the rules of the game undergoing changes and the consequent impact on the nascent insolvency regime for all to witness in the times to come.

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