THE INSOLVENCY AND BANKRUPTCY CODE, 2016: IMPACT OF MORATORIUM ON PRE-EXISTING CONTRACTUAL ARRANGEMENTS AND EXCEPTIONS TO STATUTORY MORATORIUM

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ABSTRACT

The aim of this research paper is to evaluate the implication of statutory moratorium upon pre-existing contractual arrangements. The evaluation of the moratorium's impact involves appreciating the fundamentally distinct rationales which form the basis of insolvency law and contract law. Multifarious views have emerged to resolve this conflict. The Indian insolvency regime, in light of introduction of the Insolvency and Bankruptcy code, 2016, prima facie adheres to the view that bankruptcy law has an overriding effect over the prevailing laws. This helps in achieving the insolvency law's objective of collectivity among creditors in the administration and distribution of assets. However, it blatantly ignores the importance of certainty in mutually beneficial exchanges, which forms the basis of contract law and is essential for expediting commerce. Accordingly, by extinguishing pre-insolvency obligations the moratorium can prejudice the interests of contract vendee. The author, while analysing such alteration in pre-existing contractual relations, tends to focus on the bankruptcy law's objective of maintaining

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the corporate debtor as a going concern. The present code has a single-minded focus upon value maximization of assets, without being cognizant of the highly specialized operations of some corporate debtor. This undermines the new code's objective of effectively reviving stressed assets. The author also puts forth the suggestion of granting exemption from the moratorium to certain category of debts. Mature insolvency law jurisdictions have acknowledged the special nature of certain debts and have accordingly exempted them from the moratorium. The author undertakes a comparative analysis of such exceptions and studies their feasibility in the Indian Context.

1. INTRODUCTION

Investors and creditors seek to maximize the return on investments and attempt to funnel their funds into enterprises which they believe would yield a return greater than the prevailing market rate of interest. But the recovery of principal and anticipated returns on these funds is uncertain due to prevailing macro dynamics of the economy[1]; sector specific return fluctuations, and fundamentals of the business concern which has been the recipient of the inflow. The debtor may make repayments as promised, or he may default and not make the payment. Such a debtor is then classified as insolvent. The insolvency proceedings hence triggered should ideally harmonize two conflicting interest. Firstly,

[1] Roger Backhouse, *Methodology of Macroeconomics*, J. ECON. METHODOLOGY 159, 160 (1999).

facilitating the recovery of creditor's funds and secondly, financial rearrangement to preserve the economic value of the debtor's business.[2]

The Insolvency and Bankruptcy Code, 2016 (IBC) aims to streamline the insolvency proceedings in India and seeks to achieve the aforementioned goals. However, the code being nascent, fails to address certain pertinent business considerations that arise due to effectuation of its provisions. Once a petition under the IBC is admitted against the Corporate Debtor, an absolute moratorium under Section 14 of IBC[3] follows in favour of Corporate Debtor. The moratorium under IBC kicks in following admission of the insolvency petition[4] and is in force till the Corporate Insolvency Resolution Process (CIRP) period and during such period no judicial proceedings for recovery, enforcement of security interest, sale or transfer of assets and beneficial interest, or termination of essential contracts can take place against the Corporate Debtor. Although the statutory moratorium provides immunity to the bankrupt entity, it prejudices the enforcement of pre-existing contractual arrangements, between the corporate debtor and creditor or between the corporate debtor and a third party to CIRP. The benches of National Company Law Tribunal (NCLT), National Company Law Appellate Tribunal (NCLAT), High Courts (HC) and Supreme Court (SC) have not enunciated any relief

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[2] KENNETH CORK, INSOLVENCY LAW AND PRACTICE: REPORT OF THE INSOLVENCY LAW REVIEW COMMITTEE (June 12, 2015), *available at* https://trove.nla.gov.au/version/32035648.

[3] Insolvency and Bankruptcy Code, 2016, No. 31, Acts of Parliament, 2016, § 14 [hereinafter IBC].

[4] IBC, § 7 & § 8.

mechanism for parties to contract prejudiced by such an absolute moratorium. This paper seeks to study whether any relief is available to the parties whose pre-existing contractual arrangements are adversely affected by moratorium. The scope of analysis includes the relevant dictums of competent authorities dealing with situations involving pre-existing contractual arrangement, provisions of IBC, and jurisprudence from mature insolvency jurisdictions.

2. Problems Emerging Due to Imposition of Moratorium

The jurisprudence examining the relationship between pre-existing contractual arrangements and the statutory moratorium is scarce. The researcher through the following hypotheticals, portrays the conundrum that a moratorium can trigger.

2.1. Illustration 1

The purchaser negotiated a favourable purchase price for a commercial property. The seller, a corporate entity, refused to close. The purchaser hired a lawyer who commenced proceedings in court to compel specific performance. Multiple motions for specific performance were made and denied due to infirmities in the purchaser's papers. Nearly five years after the contract was signed, the purchaser's motion for specific performance remained unresolved. Financial Creditors of the seller submitted a petition for insolvency as per Section 7, which was later on accepted and resulted in imposition of moratorium under Section 14. The state court proceedings were stayed and the purchaser lost its right to compel specific performance. The purchaser also does not have a right to institute a suit for damages as Section 14(1)(a) categorically bars initiation of any suits against the corporate debtor. The purchaser owned the adjoining property and had planned to initiate a real estate project and benefit from soaring real estate prices.

2.2. ILLUSTRATION 2

Company X holds 70% and Company Y holds 30% equity in a business concern. The business concern deals with highly specialized technology, requiring long term investments. As per the shareholder agreement, fellow shareholder has a pre-emptive right to purchase the shares at book value if any proceedings analogous to winding-up proceedings are begun in any jurisdiction against a shareholder. The clause analogous to winding up of proceedings can be interpreted to be wide enough to include CIRP. Company Y defaulted and subsequently the CIRP was initiated by its creditors, resulting in imposition of moratorium. Hence, any sale of shares owned by company Y is not possible, in view of the moratorium imposed in respect of transferring or disposing any of its assets or legal right or beneficial interest. Due to CIRP, the shares of company Y may be sold to some third party, in accordance with the approved resolution plan by the committee of creditors, without giving a pre-emptive right to company X. Company X would be adversely affected as the third party acquiring the shares might not have the requisite level of expertise for managing the niche and highly technical operations of the business concern. Such a concern has also been statutorily recognized. Illustration c of Section 12 of the Specific performance Act of 1877[5] provides that "A contracts to sell and B contracts to buy, a certain number of railway shares of a particular description. A refuses to complete the sale. B may compel A specifically to perform this agreement, 'for the shares are limited in number and not always to be had in the market, and their possession carries with it the status of a shareholder, which cannot otherwise be procured'.

Hence, it can be clearly seen in the hypotheticals that nothing except performance of pre-existing contractual arrangement would have restituted the parties, prejudiced due to the imposition of moratorium. The hypotheticals succinctly illustrate the manner in which the bankruptcy code can dramatically alter the rights of a contract vendee.

3. CONFLICTING POLICY CONSIDERATIONS

The nascent Indian insolvency regime has been categorically branded as creditor friendly by the Apex Court in its very first decision pertaining to the insolvency and bankruptcy code,[6] and it gradually seeks to incorporate international best practices. In line with the practice in UK and USA,[7] the policy intent of the moratorium under Section 14 is to keep

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[5] Specific Relief Act, 1877, No. 56, Imperial Legislative Council, § 12.
[6] Innoventive Indus. v. ICICI Bank, A.I.R. (2017) S.C. 4084.
[7] *In re* Smith Corset Shops, 696 F.2d 971, 977 (1982).

the corporate debtor's assets intact during the insolvency resolution process and expedite its orderly completion.[8]

IBC, by providing for a moratorium, promotes insolvency law policy's cardinal objective of collectivity among creditors in the administration and distribution of assets.[9] However, such a moratorium prima facie conflicts with the policy considerations of the contract law, which are rooted in high public regard for certainty in mutually beneficial exchanges.[10] Jurisprudence across matured insolvency jurisdictions has reiterated that it is imperative that a balance be struck between the policy objectives of contract law and those of insolvency law.[11] An approach aimed at shielding debtors and using the insolvency law as a redistributive platform will be detrimental to trade and commerce. United Nations Commission on International Trade Law Working Group V has rightly proposed in its draft legislative guide on insolvency law that,[12]

> *Although insolvency law generally forms a distinctive regime, it ought not to produce results that are fundamentally in conflict with the premises upon which the general law is based. Where the insolvency law does seek to achieve a result that defers or fundamentally departs from the general law, it is highly desirable that that result be the product of careful consideration and conscious policy in that direction*.

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[8] AES Barry Ltd. v. TXU Eur. Energy Trading, 2 B.C.L.C. 22, 25(2005).
[9] *In re* BNT Terminals, 125 B.R. 963, 971 (1991).
[10] Goetz & Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261, 1263 (1980).
[11] U.N. Comm'n for Int'l Trade Law (UNCITRAL), *Legislative Guide on Insolvency Law*, 9 (2004).
[12] *Id.*

4. MECHANISM AVAILABLE WITHIN THE EXISTING LEGAL FRAMEWORK TO SEEK REMEDY FOR THE PREJUDICED VENDEE

Following admission of the insolvency application, NCLT appoints IRP within 14 days .The IRP exercises control over the management and assets of the corporate debtor. Accordingly, the powers of the board of directors are suspended. It is pertinent to recognize that the statutory moratorium does not extinguish the substantive law rights of creditors.[13] The mechanism is procedural in nature and merely suspends such rights during the duration of the procedure.[14]

Subsequently, IRP appoints the committee of creditors (CoC) comprising of all financial creditors of the corporate debtors, which will further appoint a resolution professional. Section 25(1)[15] stipulates that the Resolution Professional shall "preserve and protect" the continued business operations of the Corporate Debtor, i.e., run the defaulting corporate entity as a going concern. Also, section 28 explicitly mandates the approval of the CoC, in order for the Resolution Professional to carry out any action that might affect the capital structure, ownership or management of the Corporate Debtor, or the rights of the creditors. In light of the aforementioned statutory limitations, following are the means by

[13] IAN FLETCHER & JOHN HIGHAM, CORPORATE ADMINISTRATIONS AND RESCUE PROCEDURES 50 (2d ed. 2004).
[14] Jack William, *Application of the Cash Collateral Paradigm to the Preservation of the Right to set off in Bankruptcy*, 7 BANKER DEV. J. 27, 30 (1990).
[15] IBC, § 25(1).

which an affected vendee can seek performance of the pre-existing contract.

4.1. OVERRIDING PROVISIONS OF THE COMPANIES ACT, 2013

Regulation 39(6) of the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016[16] (CIRP Regulations), specifically dispenses with the requirement of shareholders' approval for finalization of a resolution plan. However, Section 30(2)(e),[17] of the IBC clearly stipulates that any resolution plan must be in compliance with the provisions of any law in force. .In absence of any clarification regarding the interpretation of Section 30(2)(e), it cannot be construed narrowly.[18] Consequently, Regulation 39(6) does not in any way eliminate the requirements of shareholder approvals as per the Companies Act, 2013. Accordingly, shareholders' approvals to sell, lease, or otherwise dispose of the whole or substantially the whole of the undertaking of the company, as required under the section 180(1)(a)[19] cannot be dispensed with. Prima facie, IBC has an overriding effect and Regulation 39(6) is an attempt to re-enforce this position. But Section 30(2)(e) is a categorical requirement of the IBC itself, which cannot be

[16] Insolvency & Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016, IBBI/2016-17/GN/REG004, regulation 39(6) [hereinafter CIRP Regulations].
[17] IBC, § 30(2)(e).
[18] U.P. State Elec. Board v. Hari Shanker Jain, A.I.R. 1979 S.C. 65; Rohit Pulp & Paper Mills v. Collector, Cent. Excise, A.I.R. 1991 S.C. 754.
[19] Companies Act, 2013, No. 16, Acts of Parliament, 2013, § 180(1)(a) [hereinafter Companies Act].

overlooked as the National Company Law Tribunal (NCLT) can reject a Resolution Plan, if the same does not comply with provisions of any law in force.

Such a legal ambiguity can be utilized by the party seeking contractual performance during the moratorium. For example, in hypothetical 2, the shareholders of corporate debtor can stop the transfer of shares to 3rd party and instead insist on the shares being acquired by Company X, as it has the requisite technical expertise. The existing jurisprudence purports that the primary burden will to be establish that such a transfer is beneficial for the corporate debtor as it will ensure its continuance as a going concern. This requirement is in line with the Delhi High Court's dictum in *Power Grid Corporation of India Ltd. v. Jyoti Structures Ltd.*,[20] that Section 14 of the Code would be inapplicable to the proceedings which are beneficial for the corporate debtor. Since the word 'proceedings' under section 14(1)(a) is not preceded by the word 'all', the provisions of moratorium would not apply to all the proceedings against the corporate debtor. The aforementioned dictum creates a dichotomy of pre-CIRP proceedings involving the corporate debtor: The proceedings yielding post-CIRP monetary benefit and the post-CIRP proceedings not providing any monetary benefit to the corporate debtor. Hence, an exemption from the moratorium was provided to allow the corporate debtor to extract monetary benefit which entailed to Pre-CIRP affairs. It follows that even the enforcement of pre-existing contractual

[20] Power Grid Corp. of India v. Jyoti Structures Ltd., (2018) 246 D.L.T. 485.

arrangements which would ensure continuance of corporate debtor as a going concern and help in realizing enhanced returns from the stressed assets is exempted from the statutory moratorium. Additionally, it should be noted that Section 20(2)(e) of the IBC,[21] which allows resolution professional to take all necessary steps to keep the corporate debtor a going concern, is broadly framed and execution of such pre-existing contracts should reasonably fall within the terminology "all necessary steps". However, to give a practical effectuation to such an interpretation, it is vital that the resolution professionals appreciate that core strengths, operational synergy and efficient allocation of resources,[22] not solely the monetary realization, are essential for keeping corporate debtor a going concern.

4.2. PREJUDICED PARTY CAN RECLAIM THE AMOUNTS BY ESTABLISHING THAT THE MORATORIUM ADVERSELY AFFECTED ITS INTEREST.

The contract vendor has an option of establishing that amount due to it were prejudicially affected on account of the moratorium imposed under Section 14(1)(d) of IBC. According to Regulation 31(b) of CIRP Regulations,[23] the cost of the insolvency resolution includes the amounts due to the person whose rights are prejudicially affected on account of the

[21] IBC, § 20(2)(e).
[22] Credit Suisse Fides Trust S.A. v. Cuoghi [1997] 3 All E.R. 724, 730; PRINCIPLES OF INTERNATIONAL INSOLVENCY 124 (Sweet & Maxwell, 1996).
[23] CIRP Regulations, regulation 31(b).

moratorium imposed. An application needs to be filed under Section 60(5) of IBC, with a prayer to direct the resolution professional to consider the claim of the applicant as insolvency resolution process cost, as the applicant has been prejudiced due to imposition of statutory moratorium. The jurisprudence on this has been limited with only one order dealing with the Section 31(b).

In *JAS Telecom Private Limited v. Eolane Electronics Bangalore Private Ltd.*,[24] the operational creditor was the landlord of the corporate debtor. The corporate debtor had not been paying rent for five months. A suit was filed by the operational creditor for eviction and recovery of rent. The corporate debtor filed an application under Section 10 of IBC, read with Section 7 to initiate CIRP. Subsequently, the application was admitted and a statutory moratorium was imposed, suspending the proceedings for eviction and recovery. A letter was addressed to the RP stating that rent due to landlord, whose rights are prejudicially affected on account of moratorium imposed should be included in Insolvency Resolution Process cost. The resolution professional argued that rent is a direct cost in manufacturing and does not appear in essential supplies list which is enumerated from Section 31-34 of the CIRP regulations. Moreover, rent had not been paid much prior to the order of the Moratorium. It was submitted that such a default in payment of rent cumulates in operational debt and does not amount to cost of CIRP. NCLT, Bengaluru Bench, upheld that such a cost is not to be included

[24] JAS Telecom Pvt. Ltd. v. Eolane Elec. Bangalore Pvt. Ltd., 65/BB/2017 I.N. L.A. 161/2017, ¶ 19 (NCLT Bangalore 2017).

within the insolvency resolution process cost. Following appeal, NCLAT affirmed the NCLT's order.

In *Jas Telecom*, NCLT provided a criterion to classify the amount claimed as the cost of the insolvency resolution process. It upheld that the amount should become due or prejudiced solely at the commencement of the moratorium period. The tribunal's dictum seeks to convey that an amount whose recovery is prejudiced at the very moment when moratorium is enforced will be covered within the ambit of section 31(b) of CIRP regulations. A party is estopped from claiming an amount which became due prior to the commencement of the moratorium. As Regulation 32 separately defines essential goods, the party affected doesn't necessarily need to be affected solely in relation to essential goods. Contractual damages suffered by the vendee, due to non-performance which has its origin at the point of time of enforcement of the moratorium can be claimed as a part of cost of CIRP. The aforementioned is one of the possible ways for the contract vendee to recover amount paid when the moratorium has been imposed.

Classification of a claim as the cost of CIRP provides it a preference of payment over all other debts and dues. Regulation 38 of CIRP Regulations categorically provides that payment of CIRP Costs takes precedence over any other payments. If an application for recognition of claim as the cost of CIRP is not filed, it would ordinarily be recognized as an operational debt which is lower down the hierarchy of preference, which has been provided in Section 53 of IBC. Consequently, operational creditors, who are generally unsecured in nature, are not able to recover anything from the liquidation proceeds. Hence, the aforementioned methods can be employed to gain preference of payment.

4.3. PRAYING FOR EQUITABLE RELIEFS.

Section 424 of the Companies Act, 2013 stipulates that tribunal shall be guided by the principles of natural justice. Moreover, Rule 11 of the NCLT Rules, 2016,[25] and the NCLAT Rules, 2016,[26] provide 'inherent powers' to the Tribunals to make such orders or give such directions as may be necessary for meeting the ends of justice or to prevent abuse of process of the Tribunal. These provisions affirm the power of NCLT and NCLAT to grant performance of a pre-existing contract as an equitable relief.

4.3.1. Analysis of decisions granting equitable reliefs

The power of NCLT to grant equitable reliefs has been discussed in *Lokhandwala Kataria Construction Pvt. Ltd. v. Nisus Finance & Investment Managers LLP*.[27] The primary issue was, whether a financial creditor can withdraw an application for initiation of CIRP post admission of such an application. It is pertinent to note that Rule 8 of the Insolvency & Bankruptcy (Application to Adjudicating Authority) Rules, 2016 allows

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[25] Nat'l Co. Law Trib. Rules, 2016, G.S.R. 716(E), rule 11 [hereinafter NCLT Rules].
[26] Nat'l Co. Law Appellate Trib. Rules, 2016, G.S.R. 717(E), rule 11 [hereinafter NCLAT Rules].
[27] Lokhandwala Kataria Construction Pvt. Ltd. v. Nisus Finance & Inv. Managers L.L.P., (2017) 140 C.L.A. 215.

withdrawal only up to admission. Following declaration of moratorium, parties approached NCLT with a plea to set aside order and to allow withdrawal of application as the parties have reached upon settlement. The plea was denied by the NCLT. Subsequently parties pleaded the NCLAT to allow withdrawal, in light of Rule 11 of NCLAT Rules which bestowed it with equitable power. The NCLAT also upheld that the application cannot be withdrawn once the order for admission is issued and Moratorium is declared. The order was appealed to the SC highlighting that NCLAT could utilize the inherent power recognized by Rule 11 of the NCLAT Rules, 2016 to allow a compromise between the parties after admission of the matter. SC reiterated that the Rule 11 of the NCLAT Rules, 2016 was not notified as on the date of order passed by the NCLAT. However, the Hon'ble Supreme Court utilized its powers under Article 142 of the Constitution of India, which states that Supreme Court in the exercise of its jurisdiction may pass such order or decree as is necessary for doing complete justice. The Hon'ble Supreme Court while exercising its powers allowed the parties to withdraw the application.

The equitable powers of the NCLT and NCLAT were implicitly acknowledged by the Supreme Court. NCLAT did not allow withdrawal simply because the NCLAT Rules, 2016 were not adopted as on the date of adjudication of the matter. Accordingly, if the imposition of the moratorium is prejudicing a party due to non-performance of a pre-existing contract, NCLT or the NCLAT can order performance of obligations under such contract, in order to meet the ends of justice.

Argument may be made that withdrawal of application is a procedural issue whereas equitable remedy of performance despite the imposition of moratorium is a substantive issue. However, the NCLT and NCLAT Rules, 2016 give discretionary power to grant equitable remedy to meet ends of justice. As will be discussed in subsequent sections, equitable remedy of performance has been granted for substantive matters as well.

Interestingly enough, NCLT bench in Kolkata, in one of the orders, permitted execution of a pre-existing contract of sale during the moratorium period. In *State Bank of India v. Gujarat NRE Coke Limited*,[28] the applicant on behalf of the committee of creditors filed an application under Section 60(5) of IBC for approval of sale transaction of windmill assets belonging to the corporate debtor. Section 60(5) provides NCLT with jurisdiction over any application or proceeding by or against the corporate debtor or corporate person. The transaction of sale of windmill assets was contemplated under the Master Restructuring Agreement, which was agreed upon prior to admission of the insolvency petition. Following a bidding process Sun Pharmaceuticals Ltd. and United Technologies Ltd. emerged as successful bidders. Consequently, the prospective buyers made payment of an amount equal to 25% of the total consideration. Subsequently, CIRP was initiated for Gujarat NRE Coke Limited. The maintenance of windmill assets was carried out by Suzlon Global Service Ltd. However, Suzlon has terminated the operation and maintenance contract due to non-payment of their outstanding dues.

[28] State Bank of India v. Gujarat NRE Coke Ltd., C.A. (IB) No. 326.KB/2017 in C.P. (IB) No. 182.KB/2017, ¶ 23 (NCLT Kolkata, 2017).

Subsequently, the value of the windmill asset was depleting due to non-maintenance. The committee of creditors unanimously decided to execute the sale transaction.

Through the sale of non-core windmill assets the debt burden of the corporate debtor was to be reduced. The tribunal took cognizance of the fact that sale of asset would benefit the corporate debtor. However, Section 14 of IBC categorically bars transfer or disposal of assets of the corporate debtor during the duration of CIRP. The tribunal invoked Regulation 29 of CIRP Regulations 2017[29] which empowers the resolution professional to sell unencumbered assets of the corporate debtor, if he believes that such a sale is necessary for a better realization of value under facts and circumstances. The caveat under Regulation 29 is that the book value of assets sold shall not be more than 10% of the total claims admitted. Additionally, consent of committee of creditors is also required. As the sale of asset was compliant with the regulations, it was allowed. The Tribunal noted that:

> *In the interest of justice, keeping the windmills idle without maintenance and without disposing of it for a value which would be procured reasonably it would cause national waste as well as economic loss to the corporate debtor. Denial of approval may cause economic loss to both, corporate debtors and creditors*.[30]

Accordingly, the sale of assets under Regulation 29 of will be permitted by the tribunal if the applicant is able to establish that, in the

[29] CIRP Regulations, regulation 29.
[30] State Bank of India v. Gujarat NRE Coke Ltd., ¶ 29.

given facts and circumstances, such a sale is for the benefit of the corporate debtor. However, the use of phrase, "better realization of value" suggests that Regulation 29 seeks to focus solely on value maximization of the assets. An essential question which arises is whether it is economically sustainable to limit the meaning of the term "for the benefit of corporate debtor" to merely value maximization of the assets. Such a restricted interpretation can substantially prejudice the policy objective of maintaining the firm as a going concern. The existing legal framework is based on the assumption that a corporate person capable of coughing out the highest bid will be efficient in managing a business concern. It ignores the precarious situation of certain sectors where special expertise and operational synergies are vital to ensure maintenance of a business as a going concern.

The aforementioned decision also triggers an interesting debate concerning the power of the CoC to approve execution of a pre-existing contract. NCLAT in its recent decision in *Darshak Enterprises v. Chapparia*,[31] endorsed a laissez faire approach once a resolution plan has been approved by the CoC. It was upheld that adjudicating authority should interfere only in cases of discrimination or perverse decision making. Decision by NCLT Allahabad in *Vivek Vijay Gupta v. Steel Konnect*,[32] reaffirmed the approach stipulated by the appellate tribunal.

[31] Darshak Enter. v. Chapparia, Company Appeal (AT) (Insolvency) No. 328 of 2017, ¶ 6.
[32] Vivek Vijay Gupta v. Steel Konnect, IA No. 9/2017 C.P IB No. 5/7, ¶ 16, NCLT Ahemdabad.

The Bench categorically stated that no provision in the code empowers adjudicating authority to interfere in the rejection of the resolution plan. The dictum of both NCLT and NCLAT portray existence of a presumption that rejection or approval of a plan is contingent on interest of the company and relevant stake holders. Such a presumption can be extended to decisions of CoC which seek to execute a pre-existing contract. This assertion primarily relies on the fact that CoC aims at effectively rehabilitating the corporate debtor. Accordingly, the aforementioned presumption should be deemed to exist unless there exists a conclusive evidence of perverse decision making or discrimination by CoC in approving the execution of contract.

4.3.2. Consideration of operational synergies in the evaluation matrix

At this juncture it is essential to appreciate the concept of Evaluation Matrix.[33] Evaluation matrix means ,parameters to be applied and the manner in which such parameters are to be applied for the purpose of evaluating resolution plans. Such a matrix needs to approved by the CoC and subsequently notified to the Resolution Applicants. The Resolution Plan hence arrived at has to meet the end of achieving a fair-value for the creditors, which refers to market value of assets in an arms-length transaction.[34] Acknowledging the diverse nature of corporate

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[33] Insolvency & Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) (Amendment) Regulations, 2018, IBBI/2017-18/GN/REG024, regulation 2(ha).

[34] Jorio Alberto, *An Overview of the Insolvency Procedures and Proposed Reforms, in* CORPORATE RESCUE: AN OVERVIEW OF RECENT DEVELOPMENTS FROM SELECTED COUNTRIES 117 (2004).

debtors, The IBBI does not provide for a standardized evaluation matrix. Committee of creditor exercises the discretionary power of defining a matrix as per the nature of corporate debtor. Moreover, IBC code empowers the resolution applicants to challenge the Evaluation Matrix.[35] Hence, the resolution applicant can challenge the resolution plans which are plagued with the creditor's single mindedness towards value maximization and ignore other essential industrial dynamics.[36]

It is vital to note that while Regulation 29 talks about sales of assets, it is silent on the sale of equity shares. Based on the above analysis it appears that sale of shares can be approved by obtaining a consent of CoC followed by filing an application under Section 60(5) , pleading for the equitable relief of permitting sale of shares.

5. COMPARATIVE REVIEW OF EXCEPTIONS TO MORATORIUM

It is apparent from the legislative debates concerning the IBC that the Bankruptcy Law Report formed an essential *traveux preparatoires* for the current code.[37] The report relies heavily on insolvency law practices prevalent in mature jurisdictions such as UK, USA, and Australia and emphasizes that mechanisms evolved in such jurisdictions have expedited

[35] IBC, § 60(5).
[36] *Evaluation Matrix: A Discussion*, MINISTRY OF CORPORATE AFFAIRS, GOVT. OF INDIA, http://www.mca.gov.in/ministry/pdf/monthly_newsletter_feb_2018.pdf (last visited June 10, 2018).
[37] *Lok Sabha Debate, Archive from Thursday, May 05, 2016/Vaisakha 15, 1938 (Saka*), LOK SABHA, http://164.100.47.194/Loksabha/Debates/uncorrecteddebate.aspx (last visited June 13, 2018).

corporate restructuring.[38] Taking such practices into consideration, the Bankruptcy Law Reforms Committee decided to move away from the existing 'debtor in possession' regime to a 'creditor in control' bankruptcy regime, which is prevalent in mature jurisdictions. However, IBC is not a mere legal transposition as it takes cognizance of unique challenges posed by gigantic non-performing asset problem in India[39] and accordingly moulds foreign practices.

This section seeks to evaluate the jurisprudence of mature jurisdictions regarding statutory moratorium and examine its feasibility in context of the Indian insolvency law landscape. Unlike IBC, American and English Bankruptcy regime provide for certain exceptions to the statutory moratorium. Lawmakers have decided that certain debts are very significant and deserve to be granted priority over the policy objectives of the automatic stay. Following is an analysis of such statutorily accepted exceptions to the moratorium and their feasibility in Indian context.

5.1. RETROACTIVE PERFECTION OF INTERESTS.

The American Bankruptcy Code's moratorium does not suspend the right of creditors to perfect an interest in property of the bankruptcy estate. Such a perfection of interest has to be achieved during the

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[38] REPORT OF THE JOINT COMMITTEE ON THE INSOLVENCY AND BANKRUPTCY CODE ¶ 23, Gazette of India, Extraordinary Part-II, ¶ 2 (Dec. 17, 2015).
[39] MINISTRY OF CORPORATE AFFAIRS (GOVT. OF INDIA), BANKRUPTCY LAW COMM. REPORT, *available at* http://www.mca.gov.in/Ministry/pdf/ILRReport2603_03042018.pdf (last visited May 11, 2018).

statutorily prescribed grace period.[40] For example, a lien that arises pre-petition but is not perfected prior to initiation of the moratorium, can be perfected if the applicable non-insolvency law permits a later perfection against any party who has acquired an interest in the property.[41] Hence, such an exception enables retrospective perfection of interest despite the moratorium.

Retrospective perfection of interest can be illustrated through *In Re, 229 Main Street Ltd.*[42] In that case C notified the owner of a property of his intention to file lien against his property under a relevant non-bankruptcy statutory provision. Subsequently, the owner filed for bankruptcy before C could register the lien. The Court held that the bankruptcy code preserved C's statutory right to perfect his interest and allowed C to acquire the complete interest in the property.

The moratorium under the English insolvency regime does not restrain steps taken to create or perfect security and unlike the American code does not require a non-bankruptcy statute granting grace period.[43] Under Indian securitization law, mere creation of security by a company in favour of lender does not validate a charge over secured assets. In order to perfect the charge created, company is required to register the charge by filing Form CHG-1 under Companies Act, 2013 with the concerned

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[40] Bankruptcy Reform Act, 11 U.S.C. §§ 95-598 (1978) [hereinafter Bankruptcy Code]; *In Re*, New England Carpet Co., 26 B.R. 934 (Bankr. D. Vt. 1983).
[41] *Id*.
[42] *In Re*, 229 Main Street Ltd., 262 F.3d 1 (1st Cir. 2001).
[43] Bankruptcy Code, § 43(2).

Registrar of Companies with thirty days of creation of charge.[44] In line with the English insolvency regime, IBC does not envisage a restriction on perfection of interest and as per *lex lata*, the interest in a security can be perfected even during the statutory moratorium. This ensures that the vendee is able to perfect his interest in the insolvency estate. To such an extent, the vendee's right is not prejudiced.

5.2. COMPLEX MARKET CONTRACTS

The English Insolvency Regime exempts market charges from the ambit of statutory moratorium.[45] Similarly several complex market related contracts are exempted from the moratorium imposed under the American bankruptcy code. Contracts with commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency come within the ambit of such.[46] As Derivative contracts are exempted from the statutory moratorium, this permits counterparties to terminate derivatives contracts with a corporate debtor and seize underlying collaterals. Reason for treating derivatives contracts differently arises emanates from the economic theory underlying the automatic stay. The policy objective of the moratorium is to ensure survival of the firm as a going concern. Assets are needed to preserve going-concern status as they add value to the operation of the firm. However, the value adding dimension is absent in derivatives contracts,

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[44] Companies Act, § 77.
[45] Insolvency Act, 1986, c. 45, § 173 [hereinafter English Code].
[46] Bankruptcy Code, § 362(b)(6).

which are mere speculative risk management arrangements. As reported in legislative history, Congress believed this exemption from the automatic stay was necessary to prevent the insolvency of one commodity or security firm to send tremors of instability across the economy.[47] The statutory exemption hence ensures that derivatives counterparties can minimize their losses arising from the insolvency of a debtor.[48]

In Indian Context, section 5(8)(g) provides that financial debt shall include "Any derivative transaction entered into in connection with protection against or benefit from fluctuation in any rate or price". Hence, IBC does not confer any exception from moratorium upon derivative contracts or any other complex market contracts. An evaluation of the Indian markets, it can be seen that following Over the Counter (OTC) Margin Reforms most of the derivatives are traded in OTC rather than stock exchange.[49] A counterparty insolvency can trigger a systemic meltdown in the OTC derivatives market or even the exchange traded derivatives market. This huge derivatives market is dominated by a few large international banks and securities firms. This raises the possibility that a problem (such as insolvency) with a major derivatives-dealer (*i.e.*, a commercial or investment bank) could reverberate throughout the entire

[47] SALLY MCDONALD HENRY, THE NEW BANKRUPTCY CODE: CASES, DEVELOPMENTS, AND PRACTICE INSIGHTS SINCE BAPCPA 766.
[48] Michael Krimminger, *Insolvency in the Financial Markets: Banks, Hedge Funds, and Other Complications*, 34 BANKING POL. J. 123 (1996).
[49] Shyamala Gopinath, *Over-the-Counter Derivative Markets in India: Issues and Perspectives*, RESERVE BANK OF INDIA, https://www.rbi.org.in/scripts/FS_Speeches.aspx?Id=514&fn=2757 (last visited June 9, 2018).

OTC derivatives market and cause financial distress far beyond derivatives markets.

5.3. RECOUPMENT AND SET-OFF

5.3.1. Doctrine of Set-Off

The doctrine of setoff allows entities to apply their mutual debts against each other, thus "avoiding the absurdity of making A pay B when B owes A".[50] The American insolvency regime does not confer a right but reserves the rights of setoff that is conferred by applicable insolvency law. For exercising such a statutory right creditor is required to file a motion for stay on moratorium.[51] The creditor must demonstrate that both claims arose prior to bankruptcy and that they are unsettled between the parties. Even when a creditor meets the requirements for setoff, the decision to allow setoff is the discretionary power of the court.[52] It is pertinent to note that post-petition debts are not available for set-off as the moratorium effectively results in ceasing of mutuality between the parties.[53]

Moreover, there exists an implicit requirement that the debts be owed between the same parties, giving rise to mutuality.[54] For example, a

[50] Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, 18 (1995).
[51] *In re*, *Bennett Funding Group, Inc.,* 146 F.3d 136, 140 (2d Cir. 1998).
[52] Local Loan Co. v. Hunt, 292 U.S. 234, 240 (1934).
[53] *In re*, Smart World Techs., 423 F.3d 166, 184 (2d Cir. 2005).
[54] *Id*.

subsidiary's debt may not be set off against the credit of a parent or other subsidiary, due to absence of mutuality.

The position of the American insolvency regime on the set-off eligibility of post-petition debt was clarified in *In re, Lehman Bros. Holdings, Inc.*[55] In *Lehman Bros.* a bank creditor failed to set-off the amount transferred to creditor's account post-bankruptcy. The initial transfer instructions were issued on the business day prior to the bankruptcy petition date and the party that gave the transfer instructions maintained the right to change or reverse the transfer until three hours after the debtor filed for bankruptcy. However, the transfer was not completed and the actual book entry reflected a pre-petition debt that cannot be set-off.

5.3.2. Doctrine of Recoupment

Doctrine of Recoupment allows a creditor to reduce the amount of a debtor's claim by stating a claim against the debtor which arose out of the same transaction to arrive at a balance due to debtor.[56] The key ingredient to exercise the right of recoupment is that the claim and debt should arise from the same transaction. The landmark case of *Ashland Petroleum Co. v. Appel*,[57] succinctly explains the notion of recoupment. In this case, parties entered into an oil division contract that gave Ashland the right to purchase unspecified amounts of crude oil produced by B&L.

[55] *In re*, Lehman Bros. Holdings, Inc. 404 B.R. 752, 759 (Bankr. S.D.N.Y. 2009).
[56] Rakozy v. Reiman Construction, 42 B.R. 627, 628 (Bankr. D. Idaho 1984).
[57] Ashland Petroleum Co. v Appel, 782 F. 2d 155 (10th Cir. 1986).

Subsequently, Ashland overpaid B&L on two occasions. Within the following 3 months of overpayment, B&L filed for bankruptcy. Ashland sought to balance the amount payable for post-petition deliveries against pre-petition over payments. The US Court of Appeals upheld that Ashland validly withheld the payment and the moratorium doesn't prejudice such equitable interests emanating from pre-existing arrangements.

The doctrine of recoupment is alien to UK insolvency law. Pre-petition claims are subject to set-offs.[58] Insolvency set-off rights in English insolvency law are self-executing[59] and are not subject to the moratorium.[60] The objective of mandatory insolvency set-off is to do substantial justice between contracting parties.[61]

In the Indian Context, Section 173 of IBC deals with mutual credits and set-off. The bankruptcy trustee shall take an account of what is due from each party to the other in respect of the mutual dealings and the sums due from one party shall be set off against the sums due from the other. Only the balance shall be the bankruptcy debt. The IBC also incorporates the dictum from *In re, Lehman Bros.*, whereby, it is necessary to establish that the debt or claim was incurred pre-petition. Section 173(2) stipulates that Sums due from the bankrupt to another party shall not be included for set-off, if that other party had notice at the time they became due that an application for bankruptcy relating to the bankrupt was

[58] M.S. Fashions Ltd. v. Bank of Credit and Commerce Int'l, (1993) 3 All E.R. 769.
[59] Mersey Steel & Iron Co. v. Naylor, Benzon & Co., (1882) 9 Q.B.D. 648.
[60] IAN FLETCHER, CORPORATE ADMINISTRATIONS AND RESCUE PROCEDURES 57.
[61] Forster v. Wilson, (1843) 12 M&W 191, 204.

pending. Hence, there is a statutory recognition of set-off, provided that, both the debts arose prior to initiation of CIRP.

5.3.3. Governmental Actions taken in public interest.

The Bankruptcy Code exempts government agencies from the ambit of the statutory moratorium when the agencies are carrying out their regulatory functions. In American insolvency regime, the purpose of the § 362(b)(4) exception is aimed at preventing the statutory moratorium from transforming into an asylum for law-breakers. Jurisprudence in this regard has led to the evolution of the 'Public Policy Test'.[62] The public policy test provides that, a court must determine whether the government action will further public interest or merely accomplish the pecuniary interests of government. The moratorium will not bar a governmental action aimed at effectuating public policy. The accepted standard is that, when a governmental unit goes beyond preventing a prohibited or restricted activity and attempts to extract monetary benefit, the stay on moratorium is not available. The primary function of the aforementioned exception is to allow the state to take action against those who seek to abuse the bankruptcy law regime for escaping liability. *U.S.A. v. Nicolet, Inc.*,[63] illustrates an attempt to abuse the statutory moratorium to avoid liability for environmental damage. In *Nicolet*, it was upheld that moratorium did not bar the government's action to recover the clean-up costs and fine from a corporate debtor for causing an oil spill.

[62] U.S. v. Nicolet, Inc., 857 F.2d 202 (C.A.3 (Pa.) 1988).
[63] *Id.*

There is no similar exception under the UK insolvency law regime. Hence, the English regime does not differentiate between governmental actions taken in pursuit of fulfilling pecuniary interest and those actions initiated to preserve public interest. The Indian position is in line with UK. Although there exists no statutory provision granting a stay on moratorium when proceedings affect the public interest, recent decision by the apex court seeks to incorporate such an exception in the Indian insolvency Regime.

The Supreme Court recently stayed the order of the NCLT which initiated insolvency proceedings against Jaypee Infratech Ltd.[64] Following admission of the insolvency application by the Allahabad Bench of the NCLT, the statutory moratorium came in effect. This adversely affected thousands of home buyers who hadn't been allotted their flats. The moratorium barred the aggrieved home buyers from initiating proceedings under the Real Estate Regulatory Authority Act, 2016 or The National Consumer Dispute Redressal Commission. The stay on CIRP was a relief as it allowed initiation of fresh proceedings by the home buyers. It is pertinent to note that status of home buyers as financial creditors is now settled.[65]

Though this instance does not deal with a governmental action, it affirms that stay on moratorium is contingent on public interest being

[64] Chitra Sharma v. Union of India, (2018)145 S.C.L. 425.

[65] Insolvency and Bankruptcy Code (Ordinance) Amendment, 2018; *President Approves Promulgation of the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2018*, PRESS INFO. BUREAU, http://pib.nic.in/newsite/PrintRelease.aspx?relid=179805 (last visited Aug. 19, 2018).

prejudicially affected. Accordingly, government's actions for preservation of public interests are likely to be exempt from the statutory stay. The domain covered under the notion of public interest, as per the common law tradition, will be limited to exercise and implementation of governmental policies in sectors that are sensitive for the public, such as health, education, immigration and public infrastructure.[66]

6. CONCLUSION

The position of pre-existing contracts during the statutory moratorium remains largely unsettled. The author has attempted to frame out various mechanisms through which the prejudiced party can recover their interest and demand performance during the moratorium. However, the author is cognizant of the discretionary power of the court involved in obtaining some of the suggested reliefs and is of the view the view that legal regime related to the moratorium needs a legislative revamp, with introduction of certain exceptions to the statutory stay. The absolute moratorium implies a conflict between the policy objectives of contract law and those of insolvency law. As noted by UNCTAD, the moratorium should not generate legal implications which are fundamentally in conflict with the premises upon which the general law is based.

The comparative review of statutorily prescribed prescriptions clearly portrays the need to evolve certain exceptions to the moratorium for preservation of certain pre-existing contractual relations and

[66] O'Flynn, *Deliberating About the Public Interest*, 16 RES PUBLICA 299, 313 (2010).

governmental actions. Consider a scenario where National Green Tribunal (NGT) order imposing fine for causing river pollution is imposed during the petition period. There exists no categorical authority which would exempt such a fine from the stay imposed by moratorium. However, the public interest consideration taken by the apex court in *Chitra Sharma,*[67] is capable of emanating judicial decisions and subsequent legislative actions which exempt such NGT fines from the moratorium. Hence the author is hopeful that coming years would witness certain legislative reforms aimed at striking an equilibrium between policy rationale of contract law and insolvency law.

[67] Chitra Sharma v. Union of India, (2018) 145 S.C.L. 425.