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INTERPLAY BETWEEN ARBITRATION AND INSOLVENCY/ BANKRUPTCY PETITIONS: INDIA AND OTHER REGIMES

By Nikita Thapar

1. Introduction: What's the conflict?

Despite setting out the mode to be adopted for resolution of dispute and differences under the contract as and when they arise, the parties are often confronted with a common issue: what if a party under the contract chooses a different forum not contemplated in the contract for adjudication of dispute that has arisen? Can a creditor invoke the jurisdiction of National Company Law Tribunal (NCLT), in case a debtor defaults in repayment of debt by initiating insolvency proceedings (under Section 7 or Section 9 of Insolvency & Bankruptcy Code, 2016) where the petition debt arises from an agreement containing an arbitration clause? Here, I will discuss as to how the Indian Courts have tried to resolve the conflict between IB Code, 2016 and Arbitration & Conciliation Act, 1996 ("Act 1996") through interpretation and precedents and which law will prevail in such a scenario. We will also briefly see the approach of US, UK and Honk Kong courts in this regard.

2. What does the law say: Indian perspective?

Insolvency & Bankruptcy Code, 2016:

We all know the IB Code, 2016 was enacted looking at the spiraling non-performing assets, lowest recovery rates in India especially for unsecured small creditors with no one forum as well as law looking after the insolvency and bankruptcy cases of companies, partnership firms and individuals. The Bankruptcy Law Reforms Committee, 2015 ("BLRC Report") in its report published in November 2015 recommended drafting of a comprehensive, unified insolvency & bankruptcy framework that gives lenders more power and say in the recovery of debts through resolution/reorganization of defaulting companies in a time bound manner

so as to minimize losses to creditors in recovery process[1]. The IB Code is therefore clear and precise in its approach.

Typically, on failure of a debtor (corporate entity under Part II of IB Code) to repay the debt or to pay for the goods or services hired by it when the amount becomes due and payable, a creditor can initiate insolvency proceedings against such debtor and seek to recover its dues by timely resolution of the assets of such corporate debtor. Depending on the nature of debt i.e., if it's a 'financial debt'[2], a creditor can file an application under Section 7 of the IB Code for initiating Corporate Insolvency Resolution Process against a 'corporate debtor' before the Adjudicating Authority when a 'default' has occurred. The provision, therefore, contemplates that in order to trigger a Section 7 application or qualify as a "financial debt" there should be in existence four factors[3]: (i) there should be a 'debt' which is disbursed against the consideration for the time value of money, (ii) 'default' should have occurred, (iii) debt should be due to 'financial creditor', and (iv) such default which has occurred should be by a 'corporate debtor': On such application being filed with the compliance required under sub-section (1) to (3) of Section 7 of IB Code, a duty is cast on the Adjudicating Authority (National Company Law Tribunal) to ascertain the existence of a default if shown from the records or on the basis of other evidence furnished by the financial creditor, as contemplated under sub-section (4) to Section 7 of IB Code, 2016.

Similarly, if it's an 'operational debt'[4], the Operational Creditor can file an application under Section 9(1) of IB Code complying with the sub-section (3) of Section 9 of IB Code after ten days from the date of delivery of the demand notice under Section 8 of IB Code, 2016, if no payment or notice of an existing dispute[5] is received from the corporate debtor. There is a similar duty cast on the Adjudicating Authority under Section 9 sub-section (5) of IB Code to decide the application of operational creditor within 14 days of its receipt after being satisfied of the conditions laid therein.

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[1] See, 'Objectives' under 'Features of the proposed Code', Sr no. 3.4.1 at Pg. 29 of BLRC Report, 2015
[2] Section 5(8) of IB Code, 2016

[3] Indus Biotech Private Limited vs. Kotak India Venture (Offshore) Fund: (2021) 6 SCC 436; Para 14

[4] Section 5(21) of IB Code, 2016

[5] For definition of pre-existence of dispute, please refer Paras 44, 48, 51 and 54 in Mobilox Innovations Private Limited v. Kirusa Software Private Limited [(2018) 1 SCC 353]

Arbitration & Conciliation Act, 1996:

Arbitration is the most sought-after alternate mode of dispute resolution by the parties while entering into a contract mainly due to (i) sheer flexibility/autonomy parties have in deciding the procedure to be adopted by Arbitrator in resolving the dispute, (ii) it is less tedious than court proceedings, (iii) privacy of the proceedings, and (iv) it being a time bound process, ensures much quicker resolution of disputes. Above all, the arbitral award is enforceable in the same manner as if it were a decree of the Court thereby giving it judicial recognition and binding force.[6] Usually and unless otherwise agreed by the parties, an arbitral proceeding is deemed to commence on the date when a request for referring the dispute to arbitration is received by the other party.[7]

The preamble of the 1996 Act reads that Arbitration is a right *in personam* and binds two parties agreeing to opt for such mechanism to resolve their dispute. In case of a right *in personam*, an interest is protected against a specific individual, and can be referred to arbitration. However, insolvency and/or winding up matters are non-arbitrable. Keeping that in mind, where a party to the contract makes an application under Section 8(1)[8] of Arbitration & Conciliation Act, 1996 before the judicial authority (NCLT in this case) where such insolvency proceedings are pending, for referring the dispute between parties to arbitrator as the same is within the scope of their arbitration agreement, the other party can take up a plea as to the arbitrability of the dispute itself i.e., whether or not a dispute can be submitted to arbitration. This plea can be taken up before the Court of law/judicial authority at the referral stage (while filing a Section 8 or a Section 11 application); during the arbitral proceedings before the Arbitral Tribunal which has statutory powers under Section 16 to deal with and decide jurisdictional issues of non-arbitrability or even in the post-award challenge proceedings instituted under Section 34 of the Arbitration & Conciliation Act, 1996. The reason why question of arbitrability of a dispute cannot be ignored by courts is because the

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[6] Section 36 of Arbitration & Conciliation Act, 1996

[7] Section 21 of Arbitration & Conciliation Act, 1996

[8] As per Section 8(1), a party has to take a plea before the judicial authority before which an action is brought that the dispute be referred to arbitration not later than when submitting its first statement on the substance of the dispute.

said question goes to the root of validity of any arbitration agreement and may render arbitration proceedings initiated by a party invalid.

The Apex Court has held in the case of *Vidya Drolia and Others Vs. Durga Trading Corporation*[9] that a dispute is said to be non-arbitrable when a cause of action and subject matter of the dispute relates to actions *in rem*. An action *in rem* is defined by R.H. Graveson (Conflict of Laws 98, 7th ed. 1974), which reads as under:

> "*An action in rem is one in which the judgment of the Court determines the title to property and the rights of the parties, not merely as between themselves, but also as against all persons at any time dealing with them or with the property upon which the Court had adjudicated.*"

Actions *in personam* refer to actions determining the rights and interests of the parties between themselves in the subject matter of the case. Thus, in cases of insolvency and bankruptcy proceedings once the Corporate Debtor is adjudged insolvent by the competent court under IB Code, a debtor is declared insolvent against the whole world i.e., third-party right is created in favor of all creditors of that corporate debtor and not just against a specific person or individual.

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IBC v. Arbitration

With the enactment of the IB Code, 2016, a new debate arose about whether a party having an arbitration clause in their agreement, could approach the NCLT for adjudication or filing of its petition debt under IB Code, 2016.

Although, the courts[10] have well established that there are certain categories of cases/disputes such as, insolvency/winding up/bankruptcy proceedings, criminal matters, matters relating to intellectual property rights, etc., which are exclusively reserved for public forums, be it a court or a forum created or empowered by the State to the exclusion of private forum, there may be more conflict when I will tell you that sometimes there's a thin line to differentiate the nature and scope of dispute for the courts. One principle can be that there are certain cases which are not capable of resolution by arbitration owing to the basic principle that the jurisdiction of an arbitral tribunal is excluded (expressly by a statute or by implication) as a

[9] (2021 2 SCC 1): Para 76
[10] Booz Allen and Hamilton Inc. v. SBI Home Finance Ltd., (2011) 5 SCC 532

matter of public policy. To add to this, overriding have been powers given to IB Code under Section 238, as a result of which an inevitable question that may arise is, can the corporate debtor file a Section 8 application under the 1996 Act before NCLT during the pendency of an insolvency petition for referring the dispute between the parties to Arbitral Tribunal because of the underlying arbitration clause? What will be the course adopted by the NCLT in such a scenario?

Indus Biotech Private Limited v. Kotak India Venture (Offshore) Fund (earlier known as Kotak India Venture Limited) & Ors.: (2021) 6 SCC 436

The above question was answered by the Hon'ble Supreme Court in this case while considering a Section 11 application of Indus Biotech Ltd. for appointment of arbitrator. The Hon'ble Court recognizing the overriding effect of IB Code, 2016 over all other laws to the extent the latter is inconsistent with the former, as provided under Section 238 of the Code, held that the NCLT is duty bound to first decide the Section 7 application of the creditor examining the material placed before it by the financial creditor and on merits record a satisfaction as to whether there is a 'debt' and 'default' or not, notwithstanding the fact that the alleged Corporate Debtor has filed an application under Section 8 of the Arbitration & Conciliation Act, 1996. The Hon'ble Apex Court went on to further hold as under:

"*29. ...it is clarified that in any proceeding which is pending before the Adjudicating Authority under Section 7 of IB Code, if such petition is admitted upon the Adjudicating Authority recording the satisfaction with regard to the default and the debt being due from the corporate debtor, any application under Section 8 of the Act, 1996 made thereafter will not be maintainable. In a situation where the petition under Section 7 of IB Code is yet to be admitted and, in such proceedings, if an application under Section 8 of the Act, 1996 is filed, the Adjudicating Authority is duty bound to first decide the application under Section 7 of the IB Code by recording a satisfaction with regard to there being default or not, even if the application under Section 8 of Act, 1996 is kept along for consideration. In such event, the natural consequence of the consideration made therein on Section 7 of IB Code application would befall on the application under Section 8 of the Act, 1996.*"

The Hon'ble Court clarified the legal position that mere filing of Section 7 petition and its pendency before admission cannot be construed as an action *in rem*. Thus, if the conclusion is that there is default and the debt is payable, due to which the NCLT proceeds to pass the order as contemplated under subsection 5(a) of Section 7 of IB Code to admit the application, the proceedings would then get itself transformed into a proceeding *in rem* having *erga omnes* effect due to which the question of arbitrability of the so-called *inter se* dispute sought to be put forth would not arise.[11]

Jasani Realty Pvt. Ltd. v. Vijay Corporation: 2022 SCC OnLine Bom 879

Recently, a similar question came up for consideration before the Hon'ble High Court of Bombay in an application filed before it under Section 11 of Arbitration & Conciliation Act, 1996. The question being, whether mere filing of a proceeding under Section 7 of the Insolvency and Bankruptcy Code, 2016, would amount to any embargo on the Court considering an application under Section 11 of the Arbitration and Conciliation Act, 1996, to appoint an arbitral tribunal?

The Hon'ble High Court of Bombay relying upon the *Indus Biotech* case (supra) observed that in the instant case the insolvency proceedings before NCLT as initiated by the Respondent under Section 7 of IB Code had not reached the stage of admission and therefore, mere filing of the proceedings under Section 7 of the IBC cannot be treated as an embargo on the Court exercising jurisdiction under Section 11 of the Arbitration Act, 1996 and appointed the Arbitral Tribunal to decide the disputes and differences that had arisen between the parties under the agreement.[12]

Millennium Education Foundation Vs. Educomp Infrastructure and School Management Limited: 2022 SCC OnLine Del 1442

Pertinently, sub-section (3) of Section 8 of Arbitration & Conciliation Act, 1996 establishes primacy of arbitration according to which, "*Notwithstanding that an application has been made under sub-section (1) and that the issue is pending before the judicial authority, an arbitration may be commenced or continued and an arbitral award made.*". In a way, it is a

[11] Para 28: (2021) 6 SCC 436
[12] Para 21: 2022 SCC OnLine Bom 879

guiding principle for courts to decide Section 11 applications. In a recent arbitration petition filed under Section 11 of Arbitration & Conciliation Act, 1996, the Hon'ble High Court of Delhi, allowing the said Section 11 petition, relied upon the judgment in *Indus Biotech Pvt. Ltd.* (supra) and held that the proceedings under IBC shall take precedence over Arbitration agreement,

> "*16. ... and any moratorium issued therein would automatically bind the proceedings under the Arbitration Act.*"

However, until the Section 9 petition is admitted by NCLT and moratorium is commenced, mere pendency of said Section 9 petition will not be a bar on the right of a creditor to commence proceedings under 1996 Act and refer disputes and appoint an Arbitral Tribunal.

3. USA: The Federal Arbitration Act vis-à-vis Bankruptcy Code

Even the courts in US are faced with the anomaly of giving precedence to arbitration agreements over insolvency/ bankruptcy petitions which emerge under the statute or vice-versa.

Section 2 of The Federal Arbitration Act ("FAA") provides that the arbitration agreements "*shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.*" The FAA further provides under Section 3 that the court where any suit or proceedings is brought relating to an issue which is referable to arbitration under a written agreement then, the Court "*upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement.*"

On the other hand, Title 11 of the United States Code (the "Bankruptcy Code") provides that the filing of a bankruptcy petition in the United States immediately triggers a stay of most civil actions or proceedings against the debtor and the debtor's property, without any further action on the part of the creditor. This mechanism, aptly termed the "automatic stay" and encoded by statute in Section 362(a)(1) of the Bankruptcy Code, applies to the commencement and continuation of arbitral proceedings as well against the debtor "*that was or could have been commenced before the commencement of the case under this title.*" Thus, it means that the automatic stay applies to arbitrations that are pending when the bankruptcy

petition is filed and arbitrations to be commenced during the course of a bankruptcy proceeding.

Unlike in India where there is no provision in IB Code, 2016 for stay on commencing or continuing the arbitration proceedings the moment an insolvency petition is filed (except upon its admission by NCLT and commencement of moratorium against Corporate Debtor under Section 14), the US Bankruptcy Code's automatic stay of claims against a debtor or a debtor's property is triggered by mere filing of a voluntary petition under Chapter 11 of the Bankruptcy Code for a reorganization of the debtor, a voluntary petition under Chapter 7 of the Code for liquidation of the debtor, or by an involuntary petition against a debtor under Section 303 of the Bankruptcy Code. In fact, the debtor is not required to take any step/ action to give effect to the stay or to provide notice of the stay to claimants or potential claimants against the debtor or its property.[13] The automatic stay of arbitration proceedings against the debtor under the U.S. Bankruptcy Code ordinarily end when a bankruptcy proceeding is closed or dismissed.[14]

It is important to note that the bankruptcy court may even declare an award issued in contravention of such stay as void and the same may be vacated or denied enforcement by United States ("U.S.") courts.[15] Therefore, Section 3 of FAA comes into play here which is co-terminus with Section 362(d) of Bankruptcy Code and a party to an arbitration or potential arbitration with the debtor will have to file a motion with the court for relief from the automatic stay. Bankruptcy courts, after hearing the parties, typically grant relief from stay with respect to arbitration proceedings unless the matter is "core" to the bankruptcy proceeding and/or because allowing the arbitration to proceed would inherently conflict with the purposes of the Bankruptcy Code. Section 157(a) and 157(b) of the Bankruptcy Code define core insolvency proceedings as those "arising under the Bankruptcy Code" and those that "arise in a bankruptcy case". The goal here is to centralize pure bankruptcy issues, the need to protect creditors and reorganizing debtors from piecemeal litigation.

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[13] Impact of National Insolvency on Domestic or Foreign Arbitration: National Report of the USA, https://www.ibanet.org/MediaHandler?id=8A157F9D-7590-4CF4-B7F4-EB2CDDF3AA20

[14] Section 362(c), Bankruptcy Code

[15] Page 2, ibid

4. UK: Arbitration Act, 1996 vis-à-vis Insolvency Act, 1986

Under Section 9 of the Arbitration Act, 1996, a party to an arbitration agreement against whom legal proceedings are brought (whether by way of claim or counterclaim) in respect of a matter which under the agreement is to be referred to arbitration may (upon notice to the other parties to the proceedings) apply to the court in which the proceedings have been brought to stay the proceedings so far as they concern that matter. Further, Section 9 sub-section (4) of the Arbitration Act mandates that on an application being filed under this section, the court "shall" grant a stay unless it is satisfied that the arbitration agreement is null and void, inoperative, or incapable of being performed. Legal proceedings herein include insolvency or winding up petitions under Insolvency Act, 1986.

Section 122(1) of the Insolvency Act 1986 ("IA 1986") provides that a company may be wound up by the court on one or more of the several grounds mentioned there. The ground stated in Section 122(1)(f) is that the company is unable to pay its debts.

In a famous case of *Salford Estates (No 2) Ltd v Altomart Ltd (No 2)* [2015] Ch 589[16], the issue before the English Court of Appeal was whether, and if so in what way, the stay provisions in section 9 of the Arbitration Act 1996 apply to a petition to wind up a company on the ground of its inability to pay its debts where the debt on which the petition is based arises out of contract containing an arbitration agreement. The Appeal Court held that even though S. 122(1) of Insolvency Act confers on the court a discretionary power to wind up a company, it is entirely appropriate that the court should, save in wholly exceptional circumstances, exercise its discretion consistently with the legislative policy embodied in the Arbitration Act, 1996 which is to exclude court's jurisdiction. Interestingly, the Court of Appeal discouraging frivolous insolvency petitions only to coerce the debtor to settle quickly observed that:

> "*40. Exercise of the discretion otherwise than consistently with the policy underlying the 1996 Act would inevitably encourage parties to an arbitration agreement – as a standard tactic – to by-pass the arbitration agreement and the 1996 Act by presenting a winding up petition. The way would be left open to one party, through the draconian threat of liquidation, to apply pressure on the alleged debtor to pay up immediately or face the*

[16] https://www.bailii.org/ew/cases/EWCA/Civ/2014/1575.html

burden, often at short notice on an application to restrain presentation or advertisement of a winding up petition, of satisfying the Companies Court that the debt is bona fide disputed on substantial grounds. That would be entirely contrary to the parties' agreement as to the proper forum for the resolution of such an issue and to the legislative policy of the 1996 Act."

5. Hong Kong: Arbitration Ordinance vis-à-vis Bankruptcy Ordinance

Insolvency and bankruptcy proceedings against a debtor are governed by Bankruptcy Ordinance in Hong Kong. The principle in Hong Kong is that the court has a discretion whether to dismiss or stay an action brought in breach of an exclusive jurisdiction clause to refer disputes to a foreign court or pending the determination of dispute by Arbitrator. However, that discretion should be exercised by granting a stay unless there is a strong cause for not doing so. The approach adopted by the courts here is similar to the English courts so as to compel the parties to resolve their dispute over the debt by their chosen method of dispute resolution rather than require the court to investigate whether or not the debt is bona fide disputed on substantial grounds. A debtor can apply under Cap. 6A Bankruptcy Rules for adjournment of bankruptcy proceedings and to refer the dispute to arbitration if he satisfies the court that there is an arbitration agreement in existence between the parties.

A recent Hong Kong Court of Appeal (HKCA) decision examined a creditor's right to commence bankruptcy/insolvency proceedings where the petition debt arises from an agreement containing an exclusive jurisdiction clause in favour of a foreign court: *Guy Kwok-Hung Lam v Tor Asia Credit Master Fund LP* [2022] HKCA 1297[17]. In this case, the HKCA also discussed the effect of arbitration clause on winding up petitions while referring to a landmark case, *Lasmos Ltd. v. Southwest Ltd Pacific Bauxite (HK) Ltd.* [2018] HKCFI 426 (more commonly known as "Lasmos") where the underlying contract contains an arbitration clause. The *Lasmos* case held that if,

(1) a company disputes the debt relied on by the petitioner;

(2) the contract under which the debt is alleged to arise contains an arbitration clause that covers any dispute relating to the debt; and

[17] https://www.hklii.org/cgi-bin/sinodisp/eng/hk/cases/hkca/2022/1297.html?stem=&synonyms=&query=title(%222022%20HKCA%201297%22)

(3) the company takes the steps required under the arbitration clause to commence the contractually mandated dispute resolution process and files an affirmation confirming this;

then the petition should generally be dismissed, unless there are strong reasons to the contrary. Examples of "strong reasons" include (among others): (i) the debtor may be incontestably and massively insolvent quite apart from the disputed petition debt; (ii) there may be a need to investigate potential wrongdoings; or (iii) dismissal or stay of the petition would be to deprive the petitioner of a real remedy or would otherwise result in injustice.

6. Conclusion:

With this deadlock surfacing between IB Code, 2016 and Arbitration & Conciliation Act, 1996, other serious questions of judicial over-lapping, forum-shopping and parallel proceedings have cropped up.

At least with the decision of Hon'ble Supreme Court in *Indus Biotech Pvt. Ltd.* (supra), this issue has been addressed by the Hon'ble Apex Court which may have given some clarity to National Company Law Tribunals when faced with this unique situation relating to insolvency petitions arising under the agreement comprising arbitration clause. It is clear that the Indian Courts do not want to interfere with matters/ issues arising purely under IB Code 2016 as the decisions so far reinforce the overriding powers of National Company Law Tribunals by virtue of Section 238 of Insolvency & Bankruptcy Code, 2016 to first hear and decide the insolvency petition irrespective of the arbitration agreement executed between the parties to refer their potential disputes and differences to. This is similar to the position adopted in US where bankruptcy courts have wider discretionary powers under the Bankruptcy Code such as, automatic stay of any civil action, judicial proceedings including arbitration the moment a bankruptcy petition is filed and enforce its own orders. Under Section 105 of the Bankruptcy Code, the bankruptcy courts are endowed with a broad equitable power to "*issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Code]*".

On the other hand, countries like UK and Hong Kong have taken a complete opposite stand in resolving the tussle between arbitration clauses and insolvency petitions by holding parties to their bargain under the contract executed by them and staying or dismissing the insolvency petition until the adjudication of dispute through arbitration. It tells us that in these countries

the modern approach to stay of legal proceedings in favour of arbitration is heavily influenced by the legislative policy of promotion of arbitration as an alternative dispute resolution mechanism.

To my opinion, the *Indus Biotech Pvt. Ltd.* case (supra) also has a flip side to it as it dilutes the stand of India in promoting arbitration as the preferred mode of dispute resolution and may lead to more confusion and anomaly in future as a creditor may try to create undue pressure on the debtor to settle or repay the debt by filing an insolvency petition under IB Code, 2016 and by-pass the arbitration clause under the contract.