THE FRENZY OF PRIVATE SETTLEMENT UNDER THE INSOLVENCY AND BANKRUPTCY CODE

INTRODUCTION

The Insolvency and Bankruptcy Code, 2016[1] creates a time bound, specialized resolution mechanism in order to better preserve the economic value of an entity and facilitate a better and faster debt recovery mechanism.[2] The Code respects the right of all stakeholders equally and ensures a collective and inclusive insolvency resolution process.[3] To that effect, the National Company Law Tribunal mandates public announcement to be made for the initiation of corporate insolvency resolution process (CIRP) to ensure that all financial creditors are a part of the committee of creditors.[4] In light of this, the Code does not allow an individual creditor to settle with the debtor once the CIRP machinery is put in force as the same would defeat the object of the Code.

While this is so, the Supreme Court decision in *Lokhandwala Kataria Construction Limited v. Nisus Finance and Investment Managers, LLP*[5] (which represents the central point of contention of this essay) allowed a settlement by entering into consent terms by the parties after the insolvency proceedings under section 7 of the Code had been admitted. The novel question that had to be answered by the Court was whether the Appellate Tribunal could use its inherent power to allow a compromise. The Apex Court, while observing that the Tribunal does not have such a power, invoked its discretionary power under Article 142 to put a quietus to the matter.

The aim of this essay is to delve into how the Supreme Court decision is against the letter and spirit of the Code and how settlements under the current insolvency mechanism can lead to consequences not contemplated by this Code. At the same time, the essay would look at the pros and cons of including a settlement procedure in the Code. The objective is to make the

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[1] *Hereinafter,* referred to as the Code.
[2] Ministry of Finance, Government of India, *The Report of Bankruptcy Law Reform Committee, Volume I: Rationale and Design*, http://ibbi.gov.in/BLRCReportVol1_04112015.pdf, last seen on 31/01/2017.
[3] *Ibid.*
[4] S.15, the Insolvency and Bankruptcy Code, 2016.
[5] Lokhandwala Kataria Construction Limited v. Nisus Finance and Investment Managers, LLP, Civil Appeal No. 9279 of 2017 (Supreme Court, 20/11/2017).

Code more perceptive to the current needs and circumstances in a way that does not disturb its underlying intent and purpose.

WITHDRAWAL OF AN INSOLVENCY APPLICATION UNDER THE CODE

Rule 8 of the Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016, which is concerned with withdrawal of an application, provides that-

"The Adjudicating Authority may permit withdrawal of the application made under rules 4, 6 or 7, as the case may be, on a request made by the applicant before its admission."[6]

In the matter of *Mother Pride Dairy India Pvt. Ltd. v. Portrait Advertising & Marketing Pvt. Ltd.,*[7] the National Company Law Tribunal (NCLAT) interpreted the intent and object behind the provision. While dismissing the application, the Tribunal observed that-

" .....once an application is admitted, it cannot be withdrawn even by the Operational Creditor, as other creditors are entitled to raise claim pursuant to public announcement under Section 15 read with Section 18 of the I&B Code, 2016."

In other words, after an application is admitted, it acquires a representative character[8] as all creditors become eligible to join the insolvency resolution process and hence, one creditor cannot individually settle with the debtor. In substance, the position of the NCLT and the NCLAT has been that as long as the application is complete and without any defect, the parties are not at liberty to withdraw the application.[9]

While the provision is unambiguous and the approach adopted by the tribunals uniform, certain recent orders of the Supreme Court such as those in *Lokhandwala Kataria Construction Limited v. Nisus Finance And Investment Managers, LLP*[10] and *Mother Pride Dairy India Pvt. Ltd. v. Portrait Advertising & Marketing Pvt. Ltd.*[11] have posed a vexing question as to whether the Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016 should be

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[6] Rule 8, the Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016.
[7] Mother Pride Dairy India Pvt. Ltd. v. Portrait Advertising & Marketing Pvt. Ltd., Company Appeal (AT) (Insolvency) No.94 of 2017 (NCLAT, 27/06/2017).
[8] Re Parker Hannifin India Private Ltd I.A. No. 226/KB/2017 C.P. (IB) No. 150/KB/2017(NCLT, Kolkata Bench, 29/05/2017).
[9] West Bengal Essential Commodities Supply Corporation Ltd. v. Bank of Maharashtra Company Appeal (AT) Insolvency No. 90 of 2017 (NCLAT, 29/05/2017).
[10] *Supra* 5.
[11] Mother Pride Dairy India Pvt. Ltd. v. Portrait Advertising & Marketing Pvt. Ltd., Civil Appeal No. 9286 of 2017 (Supreme Court, 24/07/2017).

amended to allow settlement between an individual creditor and the debtor *after* the insolvency application has been admitted.

AN ANALYSIS OF THE LOKHANDWALA DECISION

The NCLT in the matter of *Lokhandwala Kataria*[12] admitted the application under section 7 of the Code by a financial creditor against the defaulting debtor. However, on account of a settlement between the parties including part repayment of the debt, the financial creditor preferred an appeal before the NCLAT for withdrawal of the application. While dismissing the application, the NCLAT opined that such a settlement cannot interfere with the impugned order in the absence of any other infirmity. For this purpose, the Appellate Tribunal cannot use its inherent powers under rule 11 of the NCLT Rules, 2016 in the absence of any merit.

In the appeal made in this behalf, the Supreme Court took the view that the inherent power could not be so utilized. It nevertheless used its inherent power under article 142 of the Constitution to put a quietus to the matter. The order gives no reasoning as to why the inherent power was so utilized.

In consideration of similar appeals being preferred to the Supreme Court, the following observations were made in the matter of *Uttara Foods and Feeds Private Limited v. Mona Pharmachem*[13]:

"We are of the view that instead of all such orders coming to the Supreme Court as only the Supreme Court may utilise its powers under Article 142 of the Constitution of India, the relevant Rules be amended by the competent authority so as to include such inherent powers. This will obviate unnecessary appeals being filed before this Court in matters where such agreement has been reached."

The essay will now scrutinize three significant issues-

a) Whether the Supreme Court was correct in invoking its discretionary power under article 142 of the Constitution of India to allow for withdrawal of application?

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[12] *Supra* 5.
[13] Uttara Foods and Feeds Private Limited v. Mona Pharmachem , Civil Appeal No. 18520 OF 2017 (Supreme Court, 17/11/ 2017).

b) Whether the NCLAT was justified in refusing to exercise its inherent power under rule 11 of the NCLT Rules, 2016 to dismiss the application filed for withdrawal of the insolvency application?
c) Whether the relevant rules should be amended by the competent authority to include such inherent powers as would allow withdrawal of an application *after* it has been admitted?

WHETHER THE SUPREME COURT WAS CORRECT IN INVOKING ITS DISCRETIONARY POWER UNDER ARTICLE 142?

Article 142 of the Constitution of India gives the power to the Supreme Court to pass such orders as are necessary for doing *complete justice.*[14] A significant issue that deserves consideration is whether this provision can be adverted to in order to defeat statutory provisions.

The position of law has been quite tempestuous with respect to this issue. In its initial series of cases, the court took a cautious approach. A classic example of this is the case of *Prem Chand Garg v. Excise Commr., U.P., Allahabad*,[15] wherein it was held that-

"An order which this Court can make in order to do complete justice between the parties, must not only be consistent with the fundamental rights guaranteed by the Constitution, but it cannot even be inconsistent with the substantive provisions of the relevant statutory laws."

This view was confirmed in the cases of *Naresh Shridhar Mirajkar v. State of Maharashtra*[16] and *A.R. Antulay v. R.S. Nayak*[17] decided by larger benches.

However, the position of law has changed after the year 1989 and the current position of law can be best summarized by referring to the following observations made in the case of *Supreme Court Bar Assn. v. Union of India*[18]-

[14] Art.142, the Constitution of India.
[15] Prem Chand Garg v. Excise Commr., U.P., Allahabad, 1963 SCR Supl.(1) 885.
[16] Naresh Shridhar Mirajkar v. State of Maharashtra , 1 1966 SCR (3) 744.
[17] A.R. Antulay v. R.S. Nayak, 1988 SCR Supl. (1) 1.
[18] Supreme Court Bar Assn. v. Union of India, AIR 1998 SC 1895.

"Indeed, these constitutional powers cannot, in any way, be controlled by any statutory provisions but at the same time these powers are not meant to be exercised when their exercise may come directly in conflict with what has been expressly provided for in a statute dealing expressly with the subject."

What is apparent is that the decision of the Apex Court in *Lokhandwala* clashes with the provisions of the Insolvency Code. Hence, the Supreme Court has not acted in accordance with the current position of law. Moreover, the Apex Court has done *complete injustice* to the other creditors instead of doing *complete justice* as contemplated by article 142 of the Constitution.

The approach of the Supreme Court can also be seen in a more optimistic light. In its recent order in the matter of *Uttara Foods and Feeds Private Limited*, it assigned the Ministry of Law and Justice the task of examining the relevant amendments that ought to be made to the Code to allow for a settlement procedure. Now this can be seen as an attempt to adjust the Code to include settlements and allow for more flexibility without disturbing its inherent structure.

WHETHER THE NCLAT WAS JUSTIFIED IN REFUSING TO EXERCISE ITS INHERENT POWER?

As discussed above, rule 11 of the NCLT Rules, 2016 reads as follows-

"11. Inherent powers - Nothing in these rules shall be deemed to limit or otherwise affect the inherent powers of the Appellate Tribunal to make such orders or give such directions as may be necessary for meeting the ends of justice or to prevent abuse of the process of the Appellate Tribunal."

The rule recognizes the principle of equity and natural justice that the Tribunal may utilize in disposing of matters. The idea is to prevent abuse of process and to do justice to the parties before it. However, rule 11 has not been adopted yet for the purpose of the Code and, therefore, the Appellate Tribunal in the *Lokhundwala* matter could not utilize its inherent powers as there existed none.

WHETHER THE RELEVANT RULES SHOULD BE AMENDED TO ALLOW THE WITHDRAWAL OF AN APPLICATION *AFTER* IT HAS BEEN ADMITTED?

In the matter of *Uttara Foods and Feeds Private Limited,*[19] the bench comprising of Justice R.F. Nariman and S.K Kaul opined that-

"instead of all such orders coming to the Supreme Court as only the Supreme Court may utilize its powers under Article 142 of the Constitution of India, the relevant Rules be amended by the competent authority so as to include such inherent powers. This will obviate unnecessary appeals being filed before this Court in matters where such agreement has been reached."

The current issue has been taken note of by the government, which has formed a fourteen-member committee to look into the same.[20] There is still some speculation as to what the committee report may contain, and the concerned stakeholders in the process keenly await it. This essay will now go on to analyze the pros and cons of the inclusion of a settlement process in the Code and further make suggestions as regards increasing the overall efficiency of the regime.

Pros

One of the pros of the inclusion of a settlement provision will inevitably be that it will obviate unnecessary appeals before the Apex Court. While there is skepticism that a settlement provision would jeopardize the collective interest of the creditors at the cost of an individual settlement procedure, it is submitted that, as opposed to the current scenario wherein a withdrawal is permitted on the ground of a private settlement between the parties, the Code may allow for a settlement procedure without the company going into the corporate insolvency resolution process which would ensure that the settlement offer is non-exclusionary; this is because the settlement would be under the supervision of the NCLT as opposed to a private settlement between one creditor and the corporate debtor without due knowledge of the other creditors. Further, the provision would prevent companies from losing investor confidence as the possibility of it going into liquidation would lead to significant value reduction. Also, since shareholders are placed at the bottom of the pyramid, pessimism looms in as regards them recovering any value from the already battered up shares. The inclusion of a settlement procedure could, therefore, bring in some level of certainty in the minds of the investors. An

[19] *Supra* 13.

[20] Constitution of Insolvency Law Committee, MCA (16/11/2017), http://www.mca.gov.in/Ministry/pdf/constitutionOrder_17112017.pdf, last seen on 16/02/2018.

example could be the withdrawal of the insolvency application against HDIL by Andhra Bank, which was followed by Morgan Stanley buying 29.18 shares of HDIL during that week.[21]

The corporate insolvency resolution process endeavors to reach a resolution plan for the settlement of dues; settlement, on the other hand, reaches the same end without the risk of the company going into liquidation. Therefore, settlement would allow for more convenient and flexible means of settlement of the dues. Another advantage of allowing settlements between creditors and debtors is the encouragement of debtor-creditor discourse which helps to rebuild confidence in one another. This would be conducive to healthy business relationships. An example of such practice is the newly established insolvency regime in Italy[22] which, in order to increase access to credit to troubled companies, promotes an agreement with the creditors even after the restructuring process has begun.

Cons

After the admission of an insolvency application, the same acquires a *representative* character [23] as opposed to an *individual enforcement action* provided under the Code of Civil Procedure, 1908 or under the Recovery of Debts due to Banks and Financial Institutions Act, 1993 (RDDBFI Act) and the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act); hence, withdrawal of the application by one creditor would be unfair to the other creditors. This might also lead to misuse of the provisions of the Code as creditors may rush to the NCLT merely for the sake of entering into individual compromises and with no intent to undertake the insolvency resolution process whatsoever. A situation may arise where the NCLT would be overburdened with matters which will in turn affect the speedy disposal of matters.

It is also pertinent to note that the Code sets out the *priorities* with respect to the distribution of assets by the liquidator.[24] However, allowance of private settlement would disrupt this order and substitute it with a mechanism wherein priority is given to the creditor who first approaches the Tribunal. One of the objectives of the Code is to maximize the value of the assets;[25] however, individual settlement would be antecedent to the said objective as companies eager

[21] *Morgan Stanley buys 29.18 shares of HDIL*,https://www.moneycontrol.com/news/business/stocks/morgan-stanley-buys-29-18-lakh-shares-of-hdil-2441773.html, last seen on 31/01/2017.
[22] Law no. 134, Conversion of the Law Decree No. 83/2012 (Italy).
[23] *Supra* 8.
[24] S. 53, the Insolvency and Bankruptcy Code, 2016.
[25] *Ibid,* Preamble.

to retain the management of the company would be in an unequal bargaining position with respect to the creditors.

Suggestions

Recently, the Reserve Bank of India has implemented a revised framework for the *Resolution of Stressed Assets.*[26] The framework mandates early identification and reporting of stress in defaulting bank accounts. According to the circular, when a default takes place, all lenders, singly or jointly, would formulate a resolution plan which would essentially involve debt repayment or restructuring of the account. If the said plan is not implemented within 180 days of its formation, only then would the insolvency application be admitted. This means that even before the insolvency application is filed, the banks endeavor to reach a compromise with the corporate debtor. This procedure should be followed with greater commitment to the process instead of reaching a stage where the insolvency application is to be filed. This is beneficial to the creditors as well as the debtors because the creditors do not have to give substantial haircuts and the debtors get to retain the management of the company.

The debt recovery mechanism in India gives the option of individual enforcement actions to the creditors; this includes provisions in the Code of Civil Procedure, 1908, the RDDBFI Act and the SARFAESI Act. In situations where the creditor is not prepared to face the consequence of the insolvency proceedings, the creditor should seek a remedy in the above mentioned statutes instead of the Code.

Since it is a generally accepted principle of insolvency law that collective action is more efficient, it requires all like creditors to receive the same treatment.[27] Also, it is recognized that there may be situations wherein the debtor wishes to benefit certain creditors at the expense of others.[28] The Code, if amended to include a settlement provision, should make the settlement process all-inclusive. The compromise on the table should not only include the creditor who instituted the insolvency proceedings, but also include all creditors to whom the corporate debtor owes claims. In order to ensure that the small creditors do not get an unfair bargain and

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[26] *Resolution of Stressed Assets Revised Framework*, RBI Notification No. RBI/2017-18/131 DBR No. BP.BC. 101, (21.04.02017), https://rbi.org.in/Scripts/BS_CircularIndexDisplay.aspx?Id=11218, last seen on 4/02/2018.
[27] UNICITRAL Legislative Guide on Insolvency Law; page 136, para 151.
[28] *Ibid.*

the entire process is fair and equitable, it should be monitored by the Insolvency Resolution Professional.

CONCLUSION

The Supreme Court decision in the *Lokhandwala* case[29] is contrary to the provisions contained in the Code and the Court has complete cognizance of the same as is clear from the order in the above mentioned case as well as that of *Uttara Foods and Feeds Private Limited.*[30] Despite that, the Court has chosen to put a rest to the matter by forming a committee to examine the matter, and rightly so, in light of the greater number of matters on the same issue reaching the Hon'ble Court.

That being said, for a law to be a good law, it has to mold itself to fresh situations and dynamism should be its inherent quality. The need of the hour is hence to strike a balance between allowing for a compromise and not disturbing the inherent structure of the newly enacted code. The essay, therefore, puts forward a suggestion that withdrawal of the application should be allowed only to the extent that the CIRP would not begin; however, the compromise should be made all inclusive, failing which the matter comes back to the NCLT. Additionally, the essay also highlights the importance of the RBI guidelines on *Resolution of Stressed Assets*[31] as a means of nipping the evil in its bud by establishing discourse between the creditors and the debtors even before the stage of filing an insolvency application is reached. Furthermore, the creditors are advised to follow individual enforcement actions in situations where they are not prepared to bear the brunt of insolvency proceedings.

[29] *Supra* 5.
[30] *Supra* 13.
[31] *Supra* 26.