Jus Corpus Law Journal
Open Access Law Journal – Copyright © 2022 – ISSN 2582-7820
Editor-in-Chief – Prof. (Dr.) Rhishikesh Dave; Publisher – Ayush Pandey

The Interplay of Arbitration and Insolvency

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Received 18 September 2022; *Accepted* 27 September 2022; *Published* 05 October 2022

Insolvency refers to when a person or company can no longer meet its financial obligations to lenders. Before a company or person gets involved in these proceedings, they will typically be involved in informal arrangements with creditors - such as setting up alternative payment arrangements. Arbitration is can be a method where alternative dispute resolution (ADR), defined as "a legal process that allows parties to resolve their conflict outside of court through an independent third party" is used. Based on this, the NCLAT has ruled that money awarded in an arbitral award cannot be considered money that the Award-holder/creditor initially disbursed to the Award-debtor and that is due from the latter. According to Vijay Nirman Company Ltd., awards for which there is a possibility of setting them aside would not be deemed "final," and the debts would instead be regarded as challenged until the relevant court resolved those processes. Therefore, when setting aside actions that are open or pending, debts under awards cannot be used to start an insolvency proceeding. Kishan explained that where the setting-aside procedures have been refused or the time limit to launch such proceedings has passed, insolvency may be started based on an award.

Keywords: *insolvency, arbitration, arbitral award, adjudicating authority.*

INTRODUCTION

Insolvency (or being insolvent) is a condition in which the court considers that a person cannot repay their debts. Insolvency has two separate meanings depending on how it is used. The first

meaning refers to companies and means that the company cannot pay or won't pay its debts when due. The second meaning refers to individuals and means that the individual cannot pay the money owed to creditors when they are due. Under the Insolvency Act 1986, firms may be declared insolvent by either a court or government agency if they meet certain conditions – such as being unable to pay debts or being unable to continue trading reasonably – for an extended period. The company can then be made to liquidate (break up) and the assets distributed to a creditor.

Transactions of parties in the courts below have different rules governing them. For accidental matters, an agreement is necessary between the parties regarding their mutual rights and obligations before either party can submit any motion or address the court below. Arbitration is a method where alternative dispute resolution (ADR), defined as "a legal process that allows parties to resolve their conflict outside of court through an independent third party" is used. This dispute resolution process is used in cases that have to do with a financial nature wherein the parties have no recourse to sue each other for any wrongdoing.

Insolvency and arbitration have a very different relationship because while insolvency seeks to consolidate all legal actions against a debtor under one jurisdiction, giving those actions legal force and establishing third-party rights, arbitration advocates a decentralized strategy and encourages party autonomy, leading to personal proceedings.[1] Arbitration is based on the principle of freedom of contract in which parties can agree on any terms or conditions amongst themselves. Parties that intend to enter into an arbitration agreement should be aware that they are setting their rights and obligations under laws that are different from those of the state where they originated from. Usually, arbitration agreements in writing, explicitly state their enforceability under the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958 lists arbitration as one of the acceptable methods of resolving disputes and provides for the enforcement of arbitration awards. In the U.S., both state and federal

[1] Sanskar Modi, 'A Tale of Two Proceedings: Revisiting the Intersection of Insolvency and Arbitration' (*Law School Policy Review & Kautilya Society*, 14 July 2021) <https://lawschoolpolicyreview.com/2021/07/14/a-tale-of-two-proceedings-revisiting-the-intersection-of-insolvency-and-arbitration/> accessed 17 September 2022

agencies and courts typically enforce arbitration awards. A party that does not want to be bound by the decision, however, may challenge the validity of an award in a court.

Arbitration is a recognized system for solving disputes. The parties can choose to settle any disputes on their own or hire an independent party that serves as an arbitrator to assist them in settling their dispute. Arbitration is usually private and confidential, thus speeding up the process of adjudication. Arbitrators (also known as arbiters or umpires) are individuals appointed by the contract between parties that will decide disputes they cannot resolve themselves through further negotiations. Arbitration is a type of alternative dispute resolution process in which parties have a strong input on the outcome. The process is typically much faster and more efficient than going to court. Arbitration awards may be enforced through the court system or may be binding depending on the contract language.

Arbitration can take place within a business setting, between two businesses, or even between an individual and a business entity. It can also take place in different formats such as by telephone or online. It may be binding or non-binding.[2] In the United States, there are three major types of arbitration: litigation, statutory and contractual. Litigation arbitration is used when the parties agree to submit all disputes to a federal or state court. Statutory (or administrative) arbitration is generally used for employment and consumer claims, where a statute requires that specific claims be the subject of binding arbitration. Contractual arbitration allows parties to agree on the terms of an arbitrator to resolve a dispute that is covered by a written contract or agreement.

There is a wide range of reasons an individual or business might be interested in arbitration. Conditions have changed since the days when attorneys were routinely used to settle disputes. These include: The arbitration may be used in a variety of alternative dispute resolution settings including as follows: as part of a labour agreement, contract, as part of sale or purchase agreement, and part of an alternative dispute resolution procedure (ADR) process under Title

[2] 'LA Reference Guide' (*Lease Accelerator,* 1 March 2022) <https://community-leaseaccelerator.force.com/SuccessAndSupport/s/article/LA-Reference-Guide-Leasing-Terms> accessed 17 September 2022

VII of the Civil Rights Act, which allows private individuals to sue employers for discriminatory practices.

A CASE THAT SHOWS THE INTERPLAY OF ARBITRATION AND INSOLVENCY.

Indus Biotech Private Limited v Kotak India Venture Fund[3]

The Supreme Court in this case (a.k.a. "Indus Biotech Case"), has addressed the scope of insolvency issues' arbitrability and attracted the interest of academics and arbitration practitioners by laying out the relationship between insolvency & arbitration proceedings under the Indian legal system. With the development of a new insolvency regime in India, the discussion of the confluence between arbitration and insolvency is of utmost importance.

AnAn (Singapore) Pte Ltd v VTB Bank (Public Joint Stock Company),[4]

The Singapore Court of Appeal (the Singapore Court) recently had to deal with a significant issue where a creditor wants to recover a debt arising under a contract with a clause mandating arbitration for dispute settlement (arbitration agreement). If it can be demonstrated that a disputed debt resulted from a contract with an arbitration clause, the court will stay court actions related to the debt. In AnAn, the Singapore Court took this into account when deciding whether it would be appropriate to delay or dismiss court proceedings related to the same disputed debt that was initiated following the filing of a winding-up motion. The Singapore Court concluded that the answer is basically "yes."

INITIATING INSOLVENCY PROCEDURES BASED ON AN ARBITRAL AWARD

1. "Does an Award constitute a Financial Debt or Operational Debt?"

Taxes and financial obligations are inevitable in India.[5] To facilitate fiscal responsibility, debts must be paid back in a timely fashion. Operational debt is handled differently under the Code

[3] Sanskar Modi (n 1)
[4] *AnAn (Singapore) Pte Ltd v VTB Bank (Public Joint Stock Company)* [2020] SGCA 33
[5] Avani Mishra, 'Basic tax obligation in India' (*Vakil Search*, 29 April 2019) <https://vakilsearch.com/advice/basic-tax-obligations-in-india/> accessed 17 September 2022

than financial debt. Operational Creditors are mostly given low priority in payments and no power to vote on whether the debtor's settlement plans are approved.

In most cases, an award that is recognized as a debt by its creator does not count as an operational creditor. As such, the creator's intent does not have to be considered or any other legal or statutory standards applied. The Board generally considers a debt to be an award if the creditor has a right to participate in the debtor under U.S. bankruptcy laws and the terms of the debt entitle it to participate in the administration and rehabilitation of the debtor. Whether or not a debt is recognized as an obligation and whether or not it falls into one of these categories is determined on a case-by-case basis by an examination of each debt. The Code specifies that financial debts include "any judgment, decree, Writ, Award, Order, Decree and lien," which can be collected under applicable laws including tax liens. According to the National Company Law Appellate Tribunal (NCLAT), a financial debt includes both the initial flow of funds and the subsequent obligation to repay them, as well as the time value of those funds.[6] Based on this, the NCLAT has ruled that money awarded in an arbitral award cannot be considered money that the Award-holder/creditor initially disbursed to the Award-debtor and that is due from the latter.[7] Because these are amounts decided by an arbitral tribunal, they cannot be categorized as financial debt and are instead operational debt.

2. The power to appeal an arbitral award and how that affects Code-governed processes.

Arbitration is a way of resolving disputes outside court. One of the advantages of arbitration is that it has its own set of rules and proceedings - and one such proceeding is that applications to set aside an arbitral award must be filed within three months from the date when the party was notified about the making of the award. If you need to file for this, you only have three months to do so. But what does this mean in practical terms? Well, as per The Arbitration Act, 1950 (Act 10) - a setting aside application cannot be filed once three months have lapsed or after rejection by the tribunal. The application must be filed within three months. But one should note that if the setting aside application is rejected, it will not matter whether the proceedings within three

[6] *Sushil Ansal v Ashok Tripathi & Ors* Company Appeal (AT) (Insolvency) No 452 of 2020
[7] *Ibid*

months or after rejection, or even after the expiry of three months, the award cannot be treated as final - and it will always be treated as capable of initiating insolvency proceedings. One should also note that in the case of setting aside an award under Section 50(1) of the Act, this time limit is extended to six months - which means a party has six months to apply for setting aside an award under Section 50(2). In the United Kingdom, it is prudent to understand the intricacies of arbitration law in the UK. The Arbitration Act 1971 governs the enforcement of arbitral awards made outside England and Wales and those awards are enforced on similar principles as court judgments. There are several defences against enforcement in addition to just challenging an award. For example, you can argue that the tribunal was not properly constituted or that there are deficiencies with the notice of proceedings.

The Supreme Court in *K. Kishan* v *Vijay Nirman Company Ltd.*[8] has ruled that until those procedures are resolved by the appropriate court, awards against which proceedings are pending for setting aside the award would not be 'final,' and the debts would be regarded as contested. As a result, when setting aside proceedings are ongoing or accessible, debts covered by awards cannot be used to start an insolvency process. In K. Kishan, the Court made it clear that where either the setting-aside procedures have been dismissed or the time limit to bring such proceedings has passed, insolvency may be started based on an award.[9] It is also pertinent to note in this connection that the deadline for bringing procedures to set aside arbitral judgements has been extended from March 2020 until further instructions from the Supreme Court due to the pandemic and the country's current circumstances[10]. Thus, arbitral awards made just before and within this time frame might not be able to start insolvency procedures.[11]

3. The interplay between initiation of insolvency proceedings and enforcement proceedings in respect of an award

[8] *K Kishan v Vijay Nirman Company Pvt Ltd* Civil Appeal No 21824 of 2017
[9] *Ibid*
[10] *In Re Cognizance for Extension of Limitation* Miscellaneous Application No 665/2021 in SMW(C) No 3/2020
[11] Puneeth Ganapathy, 'Contractual claims, Arbitration and the Insolvency Code – The interplay and fault lines' (*Lakshmikumaran & Sridharan Attorneys* , 21 July 2021) <https://www.lakshmisri.com/insights/articles/contractual-claims-arbitration-and-the-insolvency-code-the-interplay-and-fault-lines/#> accessed 17 September 2022

Section 65 of the Code accordingly provides: 'If any person initiates the insolvency resolution process or liquidation proceedings …for any purpose other than for the resolution of insolvency, or liquidation, as the case may be, the Adjudicating Authority may impose upon such person a penalty which shall not be less than one lakh rupees, but may extend to one crore rupees'

Whether an application to initiate insolvency would constitute genuine debt resolution or a purpose other than resolution (i.e. debt recovery) would appear to be purely based on the factual matrix of a given case, and the extent to which the true motivations of the parties can be ascertained.

Although the existence of the debt serves as the foundation for both categories of acts, "debt resolution" is to be regarded differently from "debt recovery" under the Code. The award-holder typically has two alternatives I commence insolvency proceedings against the award-debtor and (ii) initiate enforcement procedures for the award, under the Arbitration Act when a debt is due and unpaid under an arbitral judgement that has not been set aside and has become final. The Award-holder chooses this. As a result, this judgement might not be contestable if the Award holder decides to start insolvency procedures rather than enforcement proceedings.[12] avoid violating Section 65, the NCLAT determined that starting insolvency proceedings based on an award amounted to little more than a forceful attempt at debt recovery.[13]

However, the recent consistent trend of decisions by the NCLAT demonstrates that any parallel invocation of insolvency will be regarded as being for a "purpose other than resolution," and therefore barred by Section 65, where the Award-holder has already turned to enforcement proceedings about a decree or award.[14]

[12] M/s *Ugro Capital Limited v Bangalore Dehydration and Drying Equipment Co Pvt Ltd* Company Appeal (AT) (Insolvency) No 984 of 2019
[13] *HDFC Bank Ltd v Bhagwan Das Auto Finance Ltd* Company Appeal (AT) (Insolvency) No 1329 of 2019
[14] *International Asset Reconstruction Co Pvt Ltd v Jayant Vitamins Ltd* Company Appeal (AT) (Insolvency) No 1472 of 2019

THE INSOLVENT COMPANY CLAIMS THAT CAN BE MADE IN ARBITRATION PROCEEDINGS

While an insolvent firm cannot initiate or continue arbitration procedures against it, it may initiate or continue claims against third parties. In *P. Mohanraj and Ors.* v *Shah Brothers Ispat Pvt. Ltd.*[15], the Supreme Court has made it clear that continuing claims and counterclaims in an arbitration involving a bankrupt corporation would be an erroneous implementation of the Code's provisions because doing so could unavoidably result in a judgement against the debtor and cause asset depletion. In *Committee of Creditors of Essar Steel India Limited Through Authorised Signatory* v *Satish Kumar Gupta & Ors.*[16], it would seem that the goal is for the Resolution Professional to "maximise" the value and assets of the insolvent company while acknowledging that the insolvent company's assets cannot be allowed to run out.

CREDITORS' STRATEGIC CONSIDERATIONS (CLAIMANTS AND AWARD HOLDERS)

It is often the case where creditors of an insolvent company will pursue a claim to lessen the chance of being obliged to take part in insolvency procedures, and arbitration proceedings against several parties in the same arbitration, whenever possible. According to recent developments in Indian arbitration law, non-signatories are now more frequently included as parties to arbitrations based on ideas of "group of companies," "alter-ego," or "network of agreements." Given the recent case law developments, and in the context of a restructuring or insolvency situation, Creditors (Claimants and Award Holders) may wish to consider pursuing claims in an arbitration against several parties under one arbitration award. The same can apply when there are several separate disputes between the same set of parties. Such strategy may also be useful for Claimants/Award Holders where one party is a Subsidiary or Associate of another and both are joined as parties to an arbitration. These strategies will have particular relevance when pursuing claims in the commercial context and may have limited application to other dispute contexts such as contentious domestic matters.

[15] *P Mohanraj v M/S Shah Brothers Ispat Pvt Ltd* [2018] SC 10355
[16] *Committee of Creditors of Essar Steel India Limited v Satish Kumar Gupta & Ors* [2019] SC 8766-67

In India, there are a variety of legal issues Creditors (Claimants and Award Holders) may wish to consider when contemplating filing claims in arbitration. For starters, the parties must understand the relevant rules of arbitration. One such key point is that different matters between a set of parties may be governed by differing provisions in the arbitration statute. Hence, before commencing proceedings under an arbitration statute, which may be either Indian or foreign law depending on the facts of each case, Claimants should be familiar with the procedural or substantive provisions applicable to them in their jurisdiction. "Where multiple parties have joint liability to pay sums due under an award, the insolvency of one party may accordingly not hamper the chances of recovery against the other parties. Parties who are non-signatories to the contract can be brought into the fold of arbitration proceedings. Award holders and claimants, usually seen as Operational Creditors, do not in most circumstances recover even a fraction of their dues, where the creditor has genuinely turned insolvent."[17]

CONCLUSION

Arbitration is a method where alternative dispute resolution (ADR), defined as "a legal process that allows parties to resolve their conflict outside of court through an independent third party" is used. In the U.S., both state and federal agencies and courts typically enforce arbitration awards. Arbitration awards may be enforced through the court system or may be binding depending on the contract language. Litigation arbitration is used when the parties agree to submit all disputes to a federal or state court. The Supreme Court in this case (a.k.a. "Indus Biotech Case"), has addressed the scope of insolvency issues' arbitrability and attracted the interest of academics and arbitration practitioners by laying out the relationship between insolvency & arbitration proceedings under the Indian legal system. When a creditor seeks to recover a debt arising under a contract with a clause mandating arbitration for dispute resolution, the Singapore Court of Appeal (the Singapore Court) recently had to deal with a crucial issue (arbitration agreement). Initiating insolvency procedures based on an arbitral award.

[17] Puneeth Ganapathy (n 11)

Based on this, the NCLAT has ruled that money awarded in an arbitral award cannot be considered money that the Award-holder/creditor initially disbursed to the Award-debtor and that is due from the latter. One of the advantages of arbitration is that it has its own set of rules and proceedings - and one such proceeding is that applications to set aside an arbitral award must be filed within three months from the date when the party was notified about the making of the award. According to Vijay Nirman Company Ltd., awards for which there is a possibility of setting them aside would not be deemed "final," and the debts would instead be regarded as challenged until the relevant court resolved those processes. Therefore, when setting aside actions that are open or pending, debts under awards cannot be used to start an insolvency proceeding. Kishan explained that where the setting-aside procedures have been refused or the time limit to launch such proceedings has passed, insolvency may be started based on an award.