Luthra and Luthra
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# DISPUTE RESOLUTION NEWSLETTER

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It gives us immense pleasure to circulate the May 2024 edition of the Luthra and Luthra Law Offices India's Dispute Resolution Newsletter. In this edition, we have primarily focused on the recent legal developments in the field of Arbitration and Insolvency. Accordingly, we have covered key judgments passed by the Hon'ble Supreme Court, High Court(s), National Company Law Appellate Tribunal and National Company Law Tribunal for the period of March - April, 2024. We hope you enjoy reading our newsletter.

# SUPREME COURT

## Security Deposit may constitute a Financial Debt provided certain conditions are met

The Hon'ble Supreme Court in *Global Credit Capital Limited & Anr. v. Sach Marketing Pvt. Ltd. & Anr.*[1] ("**SC**") has upheld the view National Company Law Appellate Tribunal that 'Security Deposit' may also constitute 'Financial Debt', provided certain conditions are met.

Two Agreements were executed between Sach Marketing Private Limited ("**SMPL**") and Mount Shivalik Industries Limited ("**Corporate Debtor**" or "**CD**"), whereby the Corporate Debtor appointed SMPL as its 'sales promoter'. The terms of the Agreements stipulated that SMPL must deposit with CD a minimum-security deposit amount (Rs. 53,15,000/- in the first Agreement and Rs. 32,85,850/- in the second Agreement) on which interest at 21 % per annum would be levied. Further, it was also stipulated that INR 4,000/- every month would be paid to SMPL for its services. In 2018, CD was admitted to Corporate Insolvency Resolution Process ("**CIRP**"). SMPL filed its claim as 'Financial Creditor', which was rejected by Interim Resolution Professional ("**IRP**"). SMPL filed an application challenging the decision of IRP before the Adjudicating Authority ("**NCLT**"), which was partly allowed with the direction to admit the claim of INR 1.41 Cr as Financial Debt. NCLAT, in an appeal filed by SMPL impugning the order passed by NCLT, held SMPL to be a Financial Creditor.

In the appeal before the SC, the issue before the Hon'ble Court was to determine if the entire obligation, including the security deposit amount, should be categorized as financial debt in terms of Section 5(8) of Insolvency and Bankruptcy Code, 2016 ("**IBC**"). The terms of the agreements were carefully reviewed by the SC, and the Hon'ble Court laid down comprehensive test to determine as to when a debt qualifies as 'Financial Debt'. The SC observed that for a transaction to be classified as 'Financial Debt' in terms of Section 5(8) of IBC, it must first satisfy the test of being a debt, along with interest if any, which is disbursed against the consideration for time value of money. The Court also observed that transactions specified in Section 5(8)(a) to 5(8)(i) of IBC would only fall within the ambit of 'Financial Debt' if the initial requirement/requirements of principle clause were satisfied. In the case at hand, the SC specifically emphasized Section 5(8)(f) which pertains to an amount raised under

[1] *Global Credit Capital Limited & Anr v. Sach Marketing Private Limited & Anr*, 2024 SCC OnLine SC 649

transaction which has the commercial effect of borrowing. The Court summarised its legal conclusions with respect to 'Financial Debt' as follows:

> *"…*
>
> *b. The test to determine whether a debt is a financial debt within the meaning of sub-section (8) of section 5 is the existence of a debt along with interest, if any, which is disbursed against the consideration for the time value of money. The cases covered by categories (a) to (i) of sub-section (8) must satisfy the said test laid down by the earlier part of sub-section (8) of section 5;*
>
> *c. While deciding the issue of whether a debt is a financial debt or an operational debt arising out of a transaction covered by an agreement or arrangement in writing, it is necessary to ascertain what is the real nature of the transaction reflected in the writing; and …"*

In the facts of the case, the SC was of the opinion that Security Deposit paid by SMPL was not linked to the performance of the other terms of the Agreements or the services rendered by SMPL. Moreover, the Hon'ble Court noted that, as per Agreement, CD was required to refund the Security Deposits without any right of forfeiture and the said deposits were reflected as 'other long-term liabilities' in the financial statement of CD. Thus, the Hon'ble Court concluded that the transaction satisfied the initial requirements of Section 5(8) of IBC and had commercial effect of borrowing in terms of Section 5(8)(f) of IBC. Therefore, the Security Deposits were held to be 'Financial Debt'.

This judgment is of significant importance as it deals with appropriate classification of debt in the CIRP proceedings, which is crucial in classifying operational creditors and financial creditors, and the impact thereof on participation of such creditors in CIRP, voting rights as well as distribution of proceeds. Moreover, the tests prescribed in the judgment to guide the classification of Debt will help in avoiding disputes regarding the nature of debts and streamlining the insolvency resolution process.

# NCLAT

## New Resolution Applicants cannot participate in CIRP without issuance of fresh Form G[2]

The NCLAT though the bench comprising Justice Ashok Bhushan (Chairperson), Mr. Barun Mitra (Technical Member), and Mr. Arun Baroka (Technical Member) has held that when no fresh Form G has been issued, it is not open for new Resolution Applicants to submit application before the NCLT for being permitted to participate in the CIRP and submit Resolution Plan.

In the case at hand, an application was filed by new Resolution Applicant(s) before NCLT seeking direction for submitting fresh Resolution Plan (despite them not being part of list of Proposed Resolution Applicant) for consideration before the Committee of Creditors ("**CoC**"). The NCLT allowed the application and directed the CoC to consider the Resolution Plan with a fresh opportunity to revise the bid to all the Resolution Applicants.

In an appeal before the NCLAT against the order of the NCLT, the NCLAT while relying on Regulation 36A and 39 of the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 observed that new Resolution Applicants do not have any right to submit/file applications before NCLT and submit a resolution Plan without them being included in the list of Prospective Resolution Applicants. Moreover, the Hon'ble Tribunal observed that as per Regulation 36A of the CIRP Regulations the CoC retains the power to modify the Expression of Interest, and it is always open to CoC to take a decision to not proceed on the Applications, EOI received and take a decision for issuance of fresh Form G and permit other applicants to participate. Thus, the Hon'ble Tribunal observed that when no fresh Form G has been issued, it is not open for any new applicant to file an application before the NCLT for being permitted to participate in the CIRP and submit the Resolution Plan.

## Limited relief for MSME Promoters, Section 240A exemption inapplicable to Section 29A(b) of IBC[3]

The NCLAT has held that MSME promoters are exempt only from sub-sections (c) and (h) of Section 29A of IBC as per the exemptions provided under Section 240A of IBC. When the promoters of an MSME are identified as wilful defaulters as per the RBI guidelines, and there

[2] *Ashdan Properties (P) Ltd. v. Mamta Binani*, 2024 SCC OnLine NCLAT 386.
[3] *Namdev Hindurao Patil v. Virendra Kumar Jain and Others,* 2024 SCC OnLine NCLAT 543.

is no stay in favor of the promoter on such determination as on the date of plan submission, then such promoters are ineligible to be a resolution applicant under Section 29A(b) of IBC.

CIRP was initiated against the corporate debtor. An expression of interest was published by the Resolution Professional, with 23.01.2022 being the last date to submit resolution plans. Interestingly, the CoC refrained from voting on the plan of the Appellant, who was a suspended director and one of the resolution applicants of the corporate debtor. Given his status as a wilful defaulter, the CoC declared Appellant ineligible, which resulted in Liquidation of Corporate Debtor. Aggrieved by the same the Appellant filed an application before the NCLT against the actions of the CoC.

The Appellant alleged that he was wrongly declared a wilful defaulter and had already challenged this declaration before the appropriate court. Moreover, the resolution professional allowed the appellant to submit the plan subject to the outcome of the challenge by the Appellant. A stay was granted by the Civil Judge concerning the case of Appellant. The Appellant alleged that he wanted to help revive the corporate debtor, whereas the CoC wanted to liquidate the corporate debtor.

The Respondents contended that the Appellant was not eligible to submit the resolution plan for him being declared as a wilful defaulter, and thus, was disqualified under section 29(A) of IBC. Moreover, it was contended that the stay (ad-interim relief) granted in the case of the Appellant challenging the wilful defaulter title was a conditional relief, and interim relief was granted till the filing of the reply by the Defendant. Subsequently, the Reply was filed, and the stay / interim relief came to an end.

The Tribunal considered the issues of eligibility of the Appellant for submitting a resolution plan under Section 29A of IBC, and the extent of commercial wisdom of CoC. The Bench analysed Section 29A of IBC, which provides for a list of persons who are not eligible to be resolution applicants, and Section 240A of IBC, which deals with the application of the code to MSME. The Tribunal observed that Section 29A of IBC was added by the Amendment of 2021 with the intent that a person who adds to the default of the corporate debtor by his misconduct should be prevented from having control over the corporate debtor.

The Tribunal noted that the promoters of MSME are exempted only from sub-section (c) and (h) of Section 29A of IBC. Therefore, the exemption under Section 240A of IBC does not apply to Section 29A(b) of IBC. The Tribunal also observed that CoC has the duty to check the eligibility of the resolution applicant under Section 29A of IBC. The Tribunal also noted that the ineligibility of the resolution plan would be determined with reference to the date on which the resolution applicant submits his plan.

## Resolution Professional Cannot Inspect or Claim Possession of Third-Party Property, Post-Lease Expiry Under Section 14(1)(d) of IBC[4]

The NCLAT has held that the Resolution Professional cannot be said to have the right to inspect the subject property of a third party at a time when the lease period with respect to the subject property has already expired.

The Corporate debtor was admitted into CIRP on 20.07.2022. Thereafter, a notice was issued by the Resolution Professional wanting to inspect and access the subject property and the assets kept thereunder. The Appellant was the owner of the subject property and had leased the same. The lease was for 3 years and 5 months, deemed to have commenced on 01.06.2018. This deed was further assigned to Corporate Debtor through an Assignment Deed dated 06.08.2018. The original lease deed had expired till the time Corporate Debtor was admitted into CIRP, and there was no subsisting lease agreement with the Corporate Debtor. Considering the aforesaid, the Appellant filed an application before NCLT seeking to set aside the notice issued by the Resolution Professional, which was rejected by the NCLT.

An appeal was filed before NCLAT impugning the Order passed by NCLT. The Appellant *inter alia* contended that lease was not assigned to Corporate Debtor, the Appellant was kept uninformed of the assignment of leave and the assignment could not have been made to Corporate Debtor without written intimation to the Appellant. It was also contended that the original lease had expired prior to initiation of CIRP of the Corporate Debtor.

The NCLAT noted that the original lease had expired on 14.11.2021. Moreover, upon perusal of the lease deed and inspection notice, the Hon'ble Tribunal was of the opinion that the lease deed was not between the Appellant and the Corporate Debtor, and the lessor/assignor did not obtain the Appellant's permission to assign the lease deed.

The Hon'ble Tribunal relied on Section 18(1)(f) of IBC, which allows RP to take control of the assets of the Corporate Debtor and observed that Resolution Professional is required to take control and custody of any asset belonging to the Corporate Debtor. However, the Tribunal noted that said provision is subject to exclusion of assets owned by third party as specified in Explanation Clause. Therefore, the Tribunal held that the Resolution Professional does not have the right to inspect the subject property as there is no contract between the Appellant and the Corporate Debtor. This case brought out the position that assets owned by a third

[4] *Durdana Aabid Ali v. Vijay Kumar V Iyer*, 2024 SCC OnLine NCLAT 549.

party in possession of the Corporate Debtor are excluded from the scope of CIRP and moratorium.

## HIGH COURT

### Notarized Certified Copy of Arbitration Agreement adequate under Section 8(2) of Arbitration Act[5]

The High Court of Calcutta, adjudicating on a revisional application under Article 227 of the Constitution of India, held that an attested-notarized-certified copy of an original agreement fulfils the requirement of section 8(2) of the Arbitration and Conciliation Act, 1996 ("**Arbitration Act**"), and basis such a copy the parties can be referred to arbitration.

In the case at hand, the original Plaintiff/Respondent had filed a suit with a prayer for declaration, injunction, and consequential relief against the Petitioner. Upon receipt of summons, Petitioner entered appearance and filed an application under Section 8 r/w Section 5 of the Arbitration Act, for referring the matter for arbitration. The Trial Court rejected the application filed by the Petitioner. Aggrieved by the said Order, the Petitioner appeached the Hon'ble High Court under Article 227 of the Constitution of India.

The High Court while setting aside the order passed by the Trial Court observed that the Trial Court failed to appreciate the true scope and spirit as provided under Section 8 and Section 5 of the Arbitration Act. The High Court observed that the Trial Court erred in rejecting the application filed by the Petitioner on the ground that Petitioner failed to produce either the original or certified copy of the agreement as required under Section 8(2) of the Arbitration Act. The Court noted that certified copy of the agreement attested by the Notary Public (as the case in hand) fulfils the requirement of Section 8(2) of the Act i.e., if such copy of the Arbitration Agreement has been filed, it must be held that the mandatory requirement under the Act had been complied with.

## NCLT

### Resolution Professional must go beyond Corporate Debtor's Records for Claim Verification[6]

[5] *Fullerton India Credit Company Limited v. Manju Khati*, 2024 SCC OnLine Cal 3215.
[6] *K. Amutha v. Resolution Professional,* 2024 SCC OnLine NCLT 1987.

The Chennai Bench of the NCLT has held that the Resolution Professional can look beyond the books of the Corporate Debtor while verifying and admitting claims under CIRP proceedings. s where there is an irregularity in the books of the Corporate Debtor, claimants should not suffer due to such default.

The Applicant, in this case, was seeking relief before NCLT to direct the Resolution Professional to admit its complete claim along with the interest. The Applicant had booked an apartment in a Project promoted by the Corporate Debtor. An advance payment as per the booking form, was furnished by the Applicant. The payment was partly made by cheque and partly by cash. As there was no progress in the construction of the Project, a request for a refund was claimed by the Applicant. However, the Corporate Debtor refused to refund the advance booking amount. Instead, the Corporate Debtor, along with its parent company, provided commitments to the construction of the booked apartment.

In the meantime, the Corporate Debtor was admitted for CIRP, and an Interim Resolution Professional ("**IRP**") was appointed. Thereafter, the applicant submitted its claim to the IRP. However, after not receiving any response and with further inquiry from the Applicant, it was found that the IRP was replaced by the Respondent. The Applicant also realized that other members of the Association had filed their claims before the Respondent and were awaiting confirmation. Thus, the Applicant presumed that its claim would also be considered and admitted by the Respondent.

Subsequently, the Applicant's claim was only admitted to a small extent in the list of admitted claims published by the Respondent. This was challenged by the Applicant to be illegal and invalid. The Respondent contended that there was no entry in the books of the Corporate Debtor for the alleged cash payment. The Respondent relied on the landmark judgment of *Swiss Ribbons v. Union of India*,[7] and contended that he only had limited powers in the verification of claims. Further, it was contended that the Resolution Plan was approved by 95% of the CoC, and admitting the Applicant's claim at this stage would be prejudicial to other stakeholders.

The tribunal perused the payment receipts of the Applicant that indicated the complete amount of payment made to the Corporate Debtor, and the same was not reflected in

[7] *Swiss Ribbons v. Union of India*, 2019 SCC OnLine SC 73.

the books of the Corporate Debtor. The Tribunal relied on Section 8A of the CIRP Regulations which provides existence of debt may be proved by relevant documents, including 'receipt of the payment made.' Further, the Tribunal also relied on Regulation 13 of CIRP Regulations, which provides for 'verification of claims.' Thus, the Tribunal observed that said Regulations provide that Resolution Professionals must verify every claim, however, there is no compulsion on the resolution professional to strictly compare the claims of the claimants with the Corporate Debtor's books.

The Tribunal held that if the Resolution Professional only verifies the claims based on the Corporate Debtor's books and if there is an irregularity in maintaining these books, it would be detrimental to creditors. Thus, the Tribunal observed that the Applicant /creditors should not suffer on account of the improper maintenance of books by the Corporate Debtor. A Resolution Professional must verify the authenticity of supporting documents of the claimants by other means within the boundaries of the law.

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*This newsletter is only for general informational purposes, and nothing in this newsletter could possibly constitute legal advice (which can only be given after being formally engaged and familiarizing ourselves with all the relevant facts). However, should you have any queries, require any assistance, or clarifications with regard to anything contained in this newsletter (or Dispute Resolution in general), please feel free to contact the Dispute Resolution team at any of the contacts listed below.* 

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