Vidarbha Industries v. Axis Bank: An Unsettling Literal Interpretation

On July 12, 2022, the Supreme Court of India ("**Supreme Court**") in *Vidarbha Industries Power Limited v. Axis Bank Limited*[1] ("**Vidarbha**"), held that Section 7(5)(a) of the Insolvency and Bankruptcy Code, 2016 ("**IBC**") confers a discretionary power on the National Company Law Tribunal (the "**NCLT**") to admit an application of insolvency after the financial creditor has proved the existence of default. This judgment marks a significant departure from previous judgements of the Supreme Court where it has held that the NCLT needs to restrict its analysis to: (1) the existence of debt and (2) default in payment of debt. On September 22, 2022, the Supreme Court dismissed a petition for review of this judgment.

Section 7(5)(a) of the IBC reads: "*Where the Adjudicating Authority is satisfied that—a default has occurred and the application under sub-section (2) is complete, and there is no disciplinary proceedings pending against the proposed resolution professional, it* ***may****, by order, admit such application.*"

The Supreme Court in *Vidarbha* applied the literal interpretation test and held that the use of the word "may" confers upon the NCLT the discretion to admit the application after it is satisfied of the existence of debt. Further, it held that Section 9(5) of the IBC by using the word "shall" in the context of an application made by an operational creditor, highlights a deliberate legislative intent to differentiate between applications made by financial creditors and operational creditors.

In the review petition, reliance was placed on the Supreme Court's judgment in *E S Krishnamurthy & Ors. v. Bharath Hi-tech Builders Pvt. Ltd.*[2] in which the Supreme

[1] 2022 SCC OnLine SC 841.

[2] (2022) 3 SCC 161.

Court held in the context of Section 7(5) of the IBC that *"…The Adjudicating Authority is empowered only to verify whether a default has occurred or if a default has not occurred. Based upon its decision, the Adjudicating Authority must then either admit or reject an application respectively. These are the only two courses of action which are open to the Adjudicating Authority in accordance with Section 7(5)…"*

The Supreme Court however rejected the review petition on the basis that the question whether the power under Section 7(5) was mandatory or directory was not in issue in the judgments cited before the court.

OBJECTIVES OF THE IBC

Prior to the enactment of the IBC, insolvency and bankruptcy law in India was governed by a plethora of legislations including the Presidency Towns Insolvency Act 1909, the Provincial Insolvency Act 1920, Companies Act 2013, the Recovery of Debt Due to Banks and Financial Institutions Act 1993, Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 and most importantly, the Sick Industrial Companies (Special Provisions) Act 1985 ("**SICA**").

The Bankruptcy Law Reforms Committee ("**BLRC**") in its report dated November 4, 2015 (the "**BLRC Report**") highlighted that these prior legislations have convoluted the insolvency process and have resulted in a lack of clarity and jurisdiction. Further, by allowing authorities to venture into the merits of the dispute and the solvency of the debtor, there have been prolonged delays and uncertainty of outcomes. Before the enactment of the IBC, the average time to resolve insolvency in India was far longer than most other countries. As a result, the IBC was enacted with the intention of promoting a consolidated, transparent, predictable and efficient insolvency law in India.

INTERPRETATION OF SECTION 7

The IBC promotes a party driven insolvency resolution process. Section 7 of the IBC allows a financial creditor to initiate an insolvency resolution process against the corporate debtor upon showing a default in debt owed by the corporate debtor. In *Innoventive Industries Limited v. ICICI Bank*[3] ("**Innoventive**") the Supreme Court held that the scheme of the IBC is to ensure that when a default takes place, the insolvency

[3] (2018) 1 SCC 407.

resolution process begins. The Supreme Court held that the moment the NCLT is satisfied that a default has occurred, the application **must** be admitted.

Further, in *Swiss Ribbons Private Limited v. Union of India*[4] ("**Swiss Ribbons**"), the Supreme Court expanded on the decision laid down in *Innoventive* and held that the trigger under the IBC, is non-payment of dues owed to creditors. It further held that the legislative policy in India has shifted from the concept of "inability to pay debts" to "determination of default". This shift enables the financial creditor to initiate the insolvency resolution process, the moment there is evidence of a default.

This shift is highlighted in the BLRC Report[5] as the committee was against introducing a test of solvency under Section 7 of the IBC. The reasoning behind this approach was that there exists no standardized, indisputable way to establish insolvency. Rather, the IBC presumes that creditors only file an application for insolvency after failing to resolve conflicts through negotiation. In this context, the BLRC specified that the trigger for the insolvency resolution process is the evidence of default.

ANALYSIS

In *Vidarbha*, the Supreme Court has laid down a new approach to admission of claims. It has directed the NCLT to apply its mind to relevant factors and to ensure that solvent companies, temporarily defaulting in repayment of financial debts are not penalized by an insolvency resolution process. In our view, however, this approach is not sound.

1. Conflict with established rule of law

The Supreme Court in *Vidarbha* did not adequately differentiate application of this new test from the tests laid down previously. The twin test of "debt" and "default" laid down in *Innoventive* advocated for a binary approach of only inquiring the existence of a debt to admit an application. In *Vidarbha*, the Supreme Court stated that the NCLT cannot ignore relevant surrounding factors of the case. It was held that where the realizable dues of the corporate debtor were more than the payable dues, the NCLT must exercise its discretion in not admitting the petition. The Supreme Court has however failed to outline to extent of the discretion exercisable by the NCLT apart from stating that it must not be arbitrary. Not only does this approach run contrary to the *Innoventive* judgment, but it also goes against the

[4] (2019) 4 SCC 17.

[5] 5.2.2, Bankruptcy Law Reforms Committee Report, November 4, 2015.

recommendations of the BLRC. In the BLRC interim report dated February 10, 2015, the committee recommended the following:

"The rules for operationalization of the NCLT should specify that, whenever a company is given an opportunity to file a reply before admission of a petition, the NCLT should not hear the matter on merits at that stage"

In the final BLRC Report of November 2015, the committee further stated that due to the unreliable nature of the solvency test in India, the insolvency resolution process should be triggered upon existence of default. This approach was cited in *Swiss Ribbons* as well whereby it was held that "*Legislative policy now is to move away from the concept of "inability to pay debts" to "determination of default". The said shift enables the financial creditor to prove, based upon solid documentary evidence, that there was an obligation to pay the debt and that the debtor has failed in such obligation.*"

2. Counterintuitive to the objectives of the IBC

The Supreme Court in *Vidarbha* held that the objective of the IBC is not to "*penalize solvent companies, temporarily defaulting in repayment of its financial debts, by initiation of CIRP.*" While this is not disputed, it is also true that the IBC was designed to expediate insolvency disputes in a transparent and predictable manner.

An important aspect behind the failure of SICA was the significant degree of court involvement in the rescue process.[6] The BLRC noted that it took five to seven years for a sick industrial company to be revived under the previous legislations due to routine challenges to the appellate courts on the merits of insolvency in the process. As a result, the IBC has always advocated for a minimum judicial intervention approach. It is evident from the BLRC Report and the cited Supreme Court judgements that the NCLT should not look into the merits of the case and must restrict its analysis to the existence of default. This "hands-off" approach is not restricted to the stage of admission. In *Committee of Creditors of Essar Steel India Limited v. Satish Kumar Gupta*, the Supreme Court held that the NCLT must not question the commercial wisdom of the committee of creditors and must restrict its analysis to ensuring that the process laid down in the IBC has been followed.

[6] 4.1, Bankruptcy Law Reforms Committee Interim Report, February 10, 2015.

3. Dilution of the power of the committee of creditors

The committee of creditors is empowered to file an application of withdrawal and end the process of resolution under Section 12A of the IBC. This provision, which requires an approval of 90% of the voting share, can be perceived as an existing failsafe in the IBC, which prevents abuse of the insolvency process. Ultimately, this decision is left to the commercial wisdom of the committee of creditors and not the NCLT to decide.

CONCLUSION

The decision of the Supreme Court will undoubtedly be taken into serious consideration by the Union Government, which is reportedly considering a fresh set of reforms to the IBC in 2022. Presently, this judgement stands in stark contrast to the BLRC Reports and the previous judgements of the Supreme Court in *Innoventive* and *Swiss Ribbons*.

The authors submit that *Vidarbha* judgement has not given any compelling reasons why the test laid down in *Innoventive* is not to be followed or why the BLRC guidance should be ignored. Without a timely intervention in the form of a legislative amendment or reconsideration by the Supreme Court in an appropriate case, this judgement exposes the IBC to the risk of suffering the fate suffered by the previous insolvency regime in India.

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