

INDUS BIOTECH V. KOTAK INVESTMENT - RECONCILING ARBITRATION AND INSOLVENCY

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FACTS

The Optionally Convertible Redeemable Preference Shares (OCRPS) issued by Indus Biotech Private Limited (Indus) were acquired by Kotak India Venture Fund (Kotak). Kotak had intentions to proceed with a Qualified Initial Public Offering (QIPO) in 2018, aiming to convert OCRPS into equity shares. However, a dispute arose between the two parties regarding the method for calculating and effecting this conversion¹. The terms for conversion and redemption of OCRPS were initially outlined in the Share Subscription and Shareholders Agreement (SSSA), which also included an arbitration provision. According to Kotak's proposed formula, they were entitled to approximately 30% of Indus' fully paid subscribed capital of shares. On the other hand, Indus maintained that it was obligated to provide only 10% of its entire paid-up share capital. This disparity in interpretation and application of the conversion formula led to the dispute.

To commence the corporate bankruptcy proceedings against Indus, given their refusal to acknowledge the 30% share claim, Kotak initiated a formal application with the National Company Law Tribunal located in Mumbai (NCLT). This move invoked the provisions of Section 7 of the Insolvency and Bankruptcy Code, 2016 (IBC). In response, Indus invoked the arbitration clause outlined in the Share Subscription and Shareholders Agreement (SSSA), requesting the tribunal to divert the matter to arbitration in accordance with Section 8 of the Arbitration & Conciliation Act, 1996 (Arbitration Act). Additionally, Indus submitted a formal plea seeking the dismissal of the Section 7 IBC proceedings, arguing that they were unsustainable.

On June 9, 2020, the NCLT issued a ruling stating that when a Section 7 application is filed, the tribunal must assess the corporate debtor's "default," as defined by Section 3(12)² of the IBC. After a comprehensive examination, the NCLT determined that Indus remained a viable

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¹ Sehar Sharma, 'Case Analysis Of Indus Biotech Private Limited v/s Kotak India Venture (Offshore) Fund' (*Legal Service India*) <<https://www.legalserviceindia.com/legal/article-11155-case-analysis-of-indus-biotech-private-limited-v-s-kotak-india-venture-offshore-fund-.html>> accessed 18 August 2023

² Insolvency and Bankruptcy Code, 2016, s 3(12)

and financially stable entity, concluding that no state of "default" existed. Consequently, the insolvency petition was dismissed, allowing the parties to turn to arbitration, as the dispute was fundamentally contractual in nature. According to this ruling, the provisions of the Arbitration Act would take precedence over the IBC. The NCLT further clarified that the concepts of insolvency, i.e., the inability to pay debts, and default are distinct elements, assessed through separate standards, as established in the case of *Monotrone Leasing v. PM Cold Storage*³. The decision regarding the acceptance or rejection of an application to initiate the Corporate Insolvency Resolution Process (CIRP) under the IBC, the NCLT ruled, does not hinge on the applicant's inability to meet financial obligations⁴.

Dissatisfied with this outcome, Kotak filed a petition before the Supreme Court under Special Leave Petition (SPL) in accordance with Article 136⁵ of the Constitution, challenging the NCLT's decision. Kotak contended that the subject matter of the case pertained to an issue in rem, thereby rendering it unsuitable for arbitration. Kotak's argument regarding the non-arbitrability of insolvency matters found support in the Supreme Court's ruling in the case of *Swiss Ribbons vs. Union of India*. Conversely, Indus aligned with the NCLT's stance, asserting that the matter should be referred to arbitration due to the absence of an insolvency-related default in accordance with Section 3(12)⁶ of the IBC

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The issues before the apex court are:

1. Is the IBC entitled to supersede the Arbitration Act?
2. Whether and when bankruptcy issues become inarbitrable.

ANALYSIS

Two legal proceedings unfolded at the Supreme Court: (i) a combined plea advanced by Indus representing the four Special Situation Strategic Advisors (SSSA) under Section 11 of the Arbitration Act, urging the nomination of an Arbitral Tribunal; and (ii) a special leave petition (distinct from an appeal) initiated by Kotak challenging the directive of the NCLT. The matter

³ *Monotrone Leasing (P) Ltd. v. P.M. Cold Storage (P) Ltd.*, 2020 SCC OnLine NCLT 16696

⁴ Renu Gupta, 'All that is not right with Indus Biotech v. Kotak | Indus Biotech (P) Ltd. v. Kotak India Venture (Offshore) Fund : A case comment' (*SSC Online*, 12 June 2021) <<https://www.sconline.com/blog/post/2021/06/12/indus-biotech-v-kotak/>> accessed 16 August 2023

⁵ Constitution of India, art 136

⁶ Insolvency and Bankruptcy Code, 2016, s 3(12)

titled *Indus Biotech Private Limited vs. Kotak India Venture (Offshore) Fund & Ors.*⁷ Was adjudicated by the apex court on March 26, 2021. Supreme Court reaffirmed the decision in *KSL Industries v. Arihant Threads*⁸ that when two special laws run contrary to each other, the one that came into existence later shall prevail. As per the Court's construal, notwithstanding the concurrent filing of a petition under Section 8⁹ of the Arbitration Act, the Adjudicating Authority is obligated to scrutinize the inquiry delineated in Section 7¹⁰ of the IBC through an examination of the presented evidence and render a decision on the presence of a default. The Supreme Court cited *Vidya Drolia vs. Durga Trading Corporation*¹¹, ruling that upon the approval of an application pursuant to Section 7 of the IBC, the insolvency contention assumes a status of non-arbitrability due to the incorporation of a third party, leading to an *erga omnes* effect. Furthermore, the disagreement is now classified as *in rem*, which means that the parties to the dispute cannot arbitrate it and that the adjudicating body has to get involved in the insolvency situation. According to the guidelines set down in *Vidya Drolia*, a dispute would be regarded as inarbitrable under the following situations:

1. When it relates to issues involving actions *in rem* or actions that do not stem from subordinate personal rights originating from rights *in rem*.

Explanation: This criterion applies in situations where the dispute involves broader legal interests or claims over specific property rights rather than individual contractual rights.

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2. When reaching a mutually agreed settlement would not be suitable or enforceable, and the matter has a widespread impact, necessitating a centralized adjudication process, or both.

Explanation: This condition comes into play when resolving the dispute through negotiation or agreement between the parties is impractical or unenforceable, and the issues at hand have implications that extend beyond the immediate parties involved, requiring a centralized legal resolution.

3. When it pertains to the fundamental sovereign and public interest functions of the state.

⁷ MANU/SC/0231/2021

⁸ *KSL and Industries Ltd. v. Arihant Threads Ltd.*, (2008) 9 SCC 763

⁹ Arbitration and Conciliation Act 1996, s 8

¹⁰ Arbitration and Conciliation Act 1996, s 7

¹¹ MANU/SC/0939/2020

Explanation: This criterion applies when the dispute is directly related to matters of paramount importance to the state, its governance, or public welfare, highlighting the need for state intervention and oversight.

4. When it is explicitly or implicitly barred from arbitration due to mandatory legal prerequisites.

Explanation: This condition arises when applicable laws expressly or implicitly prohibit the resolution of a particular type of dispute through arbitration, making it legally impermissible to use arbitration as a dispute resolution mechanism in such cases.

DIVERSE PERSPECTIVES ON THE CASE INCLUDE

In the landmark case of *Swiss Ribbons v. Union of India*, the highest court elucidated that the legislative intent aims to shift away from the concept of 'incapacity to discharge debt' and instead focus on the assessment of the 'occurrence of default.' This shift empowers financial creditors to assert their rights under the Insolvency and Bankruptcy Code (IBC) by substantiating their claims with evidentiary proof. It is crucial to underscore that the valuation of the redemption does not in any way impinge upon the determination of default on the part of the corporate debtor. Simply put, if a debt remains unpaid beyond its designated payment date, it unequivocally qualifies as a default. Once the adjudicating authority has duly identified such a default, initiating an arbitration petition cannot be exploited as a tactic to protract or hinder the legal proceedings. This underscores the principle that arbitration should not be misused as a tool for unwarranted delays in resolving disputes under the IBC framework. The court must focus on the facts and not on the reasons for the default¹². Additionally, the plea put forth by Indus under section 11¹³ of the Arbitration Act is untimely due to Indus lacking the authority to designate an arbitrator as stipulated by the SSSA agreement, thus lacking the requisite *locus standi* (legal standing). The court ought to have rendered a determination on the matter of whether a party bereft of the entitlement to appoint an arbitrator can initiate a petition under section 11 or not.

The mere presence of indebtedness should not automatically be equated with a default, a principle that offers a safeguard to businesses adept at managing their financial obligations

¹² Renu Gupta, 'All that is not right with Indus Biotech v. Kotak | Indus Biotech (P) Ltd. v. Kotak India Venture (Offshore) Fund : A case comment' (*SSC Online*, 12 June 2021)

<<https://www.sconline.com/blog/post/2021/06/12/indus-biotech-v-kotak/>> accessed 16 August 2023

¹³ Arbitration and Conciliation Act, 1996, s 11

alongside their operational activities. This fundamental tenet finds expression in the ruling of the case *Duncans Industries Ltd. v. AJ Agrochem*¹⁴, where it was observed that the overarching objective of the Insolvency and Bankruptcy Code (IBC) is not solely to extract overdue payments from the corporate debtor. Rather, the IBC endeavors, whenever feasible, to preserve the corporate entity itself and prevent its premature dissolution. This underscores a broader aim of corporate rehabilitation and continuity, aligning with the ethos of ensuring that businesses are provided with opportunities to rectify their financial difficulties and continue as viable entities within the framework of the IBC.

The jurisdiction of arbitral tribunals by means of arbitration agreements is not to be jeopardized by provisions in the Code. Such an extremely stringent interpretation of the Code, separated from interests at stake in arbitral proceedings, can have devastating consequences. Shivankar and Devang, the authors, contend that by affording an avenue for insubstantial claimants to evade arbitration provisions by presenting Section 7 petitions instigating CIRP proceedings against the opposing party, an insular construal of this principle devoid of harmonization with the arbitration framework would engender a critical lacuna¹⁵.

The National Company Law Tribunal (NCLT) fell short of conducting a thorough and exhaustive examination as mandated by Section 7 of the Insolvency and Bankruptcy Code (IBC). Instead, it prematurely arrived at a decision based on a petition brought under Section 8 of the Arbitration and Conciliation Act. Regrettably, the NCLT's assessment lacked the requisite depth, as it only briefly alluded to the issue of default, focusing its attention predominantly on the subject matter presented in the Section 8 application. This approach overlooked the multifaceted aspects of the insolvency petition, leading to an incomplete evaluation of the situation at hand.

There is a well-recognized consensus within the legal sphere that an arbitration agreement functions as a legally binding contract meticulously crafted to reallocate the conventional jurisdictional control vested in the court to an impartial private arbitrator. This pivotal concept lies at the heart of contemporary international trade dealings, bestowing upon them a sense of reliability and bolstering the trust of investors and stakeholders alike. It is imperative to emphasize that this perspective should not undermine the interplay between the arbitration

¹⁴ MANU/SC/1385/2019

¹⁵ Shivankar Sukul & Devang Bansal, 'Indus Biotech v. Kotak India Venture – Failed Attempt to Reconcile Insolvency and Arbitration Regime' (2021) 8 The GNLU Law Review 274

agreement and the insolvency framework, especially in the context of debt determination through a mutually agreed-upon method. This method effectively operates as a distinct legal system instituted by the involved parties themselves, with the explicit objective of resolving disputes pertaining to indebtedness. Such a mechanism is a testament to the parties' autonomy and their commitment to finding a tailored solution to their debt-related disagreements, bolstering the overall effectiveness of dispute resolution processes.

CONCLUSION

The judiciary has provided significant clarification on when insolvency proceedings grant rights to third parties and genuinely take on the character of having an in rem effect. This stance is in line with the principle that disputes should only be considered non-arbitrable when they have an impact on everyone involved, rather than simply arising from rights in rem. By stating that an insolvency proceeding only achieves an in rem status upon its acceptance, the Court's decision in the Indus Biotech case arguably establishes a framework that effectively prevents the manipulation of remedies in insolvency disputes. The Arbitration Act serves as a mechanism to limit judicial interference in overseeing conflicts, thereby upholding the fundamental goal of using arbitration for dispute resolution, with a specific emphasis on party autonomy. However, it is crucial to strike a balanced approach between the Insolvency and Bankruptcy Code (IBC) and the Arbitration Act. This balance ensures the peaceful coexistence of both statutory regimes, free from conflicts or contradictions. Such harmonious coexistence ultimately enhances efficient, impartial, and fair dispute resolution within the Indian legal system.

To elaborate further, it is important to acknowledge that judicial pronouncements have significantly contributed to defining the scope of rights granted by insolvency proceedings, especially concerning third parties. The determination that insolvency proceedings attain an in rem status only upon acceptance represents a significant shift in jurisprudence, one that limits the potential manipulation of legal remedies in insolvency disputes. This legal development aligns with the overarching principle that disputes should only be considered non-arbitrable when they affect the rights of all parties involved, rather than simply arising from rights in rem. On the other hand, the Arbitration Act plays a vital role in the realm of dispute resolution, aiming to minimize judicial intervention and empower parties to choose arbitration as a means of resolving conflicts. The Act's primary objective is to expedite dispute resolution through arbitration and discourage undue judicial interference, except when necessary.

Nevertheless, achieving a delicate balance between the IBC and the Arbitration Act remains crucial. Both legal frameworks have distinct roles and purposes, and it is essential to ensure their harmonious coexistence within the Indian legal landscape. This synergy between the two statutes not only prevents conflicts and contradictions but also enhances the effectiveness and fairness of the dispute resolution process, ultimately serving the interests of justice.

