Between the lines...

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Key Highlights

I. Supreme Court: Arbitrary conditions in a clause that requires a security deposit before invoking arbitration are contrary to Article 14 of the Indian Constitution

The Supreme Court in case of ***M/s. ICOMM Tele Limited v. Punjab State Water Supply and Sewerage Board and Another*** *(decided on March 11, 2019)* ruled on a clause in an agreement that required the deposit of security before initiating arbitration. The clause mandated that at the time of the refund of the security deposit, in the event the claimant succeeds, deposit shall be refunded in proportion to the amount awarded with respect to the amount claimed and the balance, if any, would be forfeited and paid to the other party. The Supreme Court held that such a clause is in violation of Article 14 of the Indian Constitution.

Facts

After making a successful bid in a tender process initiated by Punjab State Water Supply & Sewerage Board, Bhatinda (**"Respondent"**), M/s. ICOMM Tele Limited (**"Appellant"**) entered into a contract with the Respondent for extension and augmentation of water supply, sewerage scheme, pumping station and sewerage treatment plant for various towns in the State of Punjab. One of the important clauses of the tender documents was the arbitration clause, which provided that in order to avoid frivolous claims, the party invoking the arbitration clause shall furnish a "deposit-at-call" for 10% of the amount claimed. If the award was passed in favour of the claimant, the deposit shall be refunded to him in proportion to the amount awarded with respect to the amount claimed and the balance, if any, would be forfeited and paid to the other party (**"Impugned Clause"**). When the Appellant wanted to invoke arbitration, it made a request to the Respondent to waive off the 10% deposit fee. When it received no response from the Respondent, it filed a writ petition before the Punjab and Haryana High Court which was dismissed on the grounds

that the condition of the 10% deposit fee to invoke arbitration was not arbitrary or unreasonable. A similar decision was passed by the division bench of the Punjab and Haryana High Court. The Appellant, aggrieved by the said decision, took the matter before the Supreme Court and the following issues came up for determination:

Issues

1. Whether the Impugned Clause resulted in a contract of adhesion?
2. Whether the Impugned Clause was arbitrary or discriminatory and violative of Article 14 of the Indian Constitution and therefore should be struck down?

Arguments

The Appellant argued that the concerned arbitration clause was a contract of adhesion, that is a contract in which there is unequal bargaining power between the parties, are liable to be set aside on the ground that they are unconscionable. The Appellant cited the case of ***Central Inland Water Transport Corporation v. Brojo Nath Ganguly [(1986) 3 SCC 156]*** *(where it was held that the courts will strike down an unfair and unreasonable contract entered into between the parties who are not equal in bargaining power)* to support the aforesaid proposition. Further, Appellant argued that a condition of 10% deposit would clog the alternative dispute resolution process. Claims may ultimately be found to be untenable but need not be frivolous and frivolous claims by one party can be compensated by heavy costs. The Appellant emphasized that even if the award was passed in favour of the claimant, what could be refunded to him, would only be in proportion to the amount awarded and the rest would have to be forfeited. This onerous condition was even more arbitrary.

The Respondent argued that as the arbitration clause would apply to both the Respondent and the Appellant equally, it could not be struck down as discriminatory under Article 14 of the Indian Constitution. Further the principle laid down in the case of ***Central Inland Water Transport Corporation*** *(supra)* could not be applied to commercial contracts.

Observations of the Supreme Court

The Supreme Court agreed with the Respondent on the count that the principle laid down in the case of ***Central Inland Water Transport Corporation*** *(supra)* would not apply in a commercial contract where both parties were businessmen. However, it held that even in the contractual sphere, the requirement of Article 14 of the Indian Constitution to act fairly, justly and reasonably by persons who are "state" authorities or instrumentalities continued. The Supreme Court agreed with the Respondent that since the Impugned Clause applied to both the parties, it was not discriminatory. However, violation of Article 14 of the Constitution has also to be examined from the facet of arbitrariness.

Examining that, the Supreme Court stated that the intent of the Impugned Clause was to avoid frivolous claims and it is well settled that frivolous claims can be dismissed with exemplary costs. Further even punitive damages follow when a court is approached with a frivolous litigation. The important principle is that unless it is first found that the

litigation is frivolous, exemplary costs or punitive damages do not follow. The Supreme Court held that the 10% deposit fee is obviously without any direct nexus to the filing of frivolous claims, as it applies to all claims (frivolous or otherwise) made at every threshold. Further, a 10% deposit has to be made before any determination that a claim made by the party invoking arbitration is frivolous. Additionally, even where a claim is found to be justified and correct, as per the Impugned Clause, the amount that is deposited need not be fully refunded to the successful claimant. The deposit would be refunded to him in proportion to the amount awarded with respect to the amount claimed. For example, if a claim made by a party succeeds and of the damages claimed of say one crore, the arbitrator grants only ten lakhs, only one tenth of the deposit made will be liable to be returned to the successful party. The party who has lost in the arbitration proceedings will be entitled to nine-tenths of the deposit made despite the fact that the aforesaid party has an award against it. This would be wholly arbitrary and such a clause should be struck down.

The Supreme Court also held that arbitration is an important alternative dispute resolution process which is to be encouraged because of high pendency of cases in courts and cost of litigation. Deterring a party from an arbitration by a pre-deposit of 10% would discourage this process, contrary to the object of de-clogging the court system, and would render the arbitral process ineffective and expensive.

Decision of the Supreme Court

The Supreme Court held that the Impugned Clause violated Article 14 of the Indian Constitution on account of being arbitrary and was therefore struck down.

VA View

The courts have actively participated, or abstained from participating in matters concerning arbitration, to encourage the alternate dispute process. This is a case in which the Supreme Court has stepped in to strike at an arbitrary clause which could defeat the purpose of arbitration. Even though the Supreme Court has stated in some judgements that costs and damages can be imposed in case of frivolous claims, it has shown disinclination towards pre-deposit clauses as a solution to such frivolous claims on the ground that they are in violation of Article 14 of the Indian Constitution. Having said that, it is to be noted that this case involved a private and a state entity. As Article 14 of the Indian Constitution only applies to state entities, this ratio cannot be applied per se to disputes between two private entities. Nevertheless, if the courts take a more aggressive pro-arbitration approach and resolve to end the pre-deposit clauses in Indian arbitrations altogether, this case shall form a firm basis for such an endeavour.

II. Supreme Court: Arbitration clause in standard terms and conditions is deemed to be incorporated by reference

The Supreme Court in the case of ***Giriraj Garg v. Coal India Limited and Others*** *(decided on February 15, 2019)* held that in a contract between parties, the arbitration clause in standard terms and conditions is deemed to be incorporated by reference.

Facts

Coal India Limited (**"Respondent"**) issued a scheme in 2007 (**"Scheme"**) by which coal distribution was to be conducted via e-auction. The Scheme contained an arbitration clause specifying the seat of arbitration and appointment of arbitrator, which read as follows:

11.12 "...All disputes arising out of this scheme or in relation thereto in any form whatsoever shall be dealt exclusively by way of arbitration in terms of the Arbitration and Conciliation Act, 1996. The arbitration shall be conducted at Kolkata at a place to be notified by CIL....."

Giriraj Garg (**"Appellant"**) participated in the e-auction for the purchase of coal, and as a registered buyer under the terms and conditions of the Scheme, was issued several sale orders. The Appellant deposited the earnest money with the Respondent, in compliance with the terms and conditions of the Scheme. The Appellant, for certain reasons was unable to lift the coal within the stipulated time period, due to which Respondent forfeited the earnest money deposit. The consequent disputes that arose led to the invocation of the arbitration clause under the Scheme. The Respondent failed to appoint an arbitrator because of which the Appellant had to file an application for appointment of an independent arbitrator under Section 11 of the Arbitration and Conciliation Act, 1996 (**"Arbitration Act"**) before the High Court of Jharkhand. The High Court of Jharkhand by an Order rejected the application on the grounds that the individual sale orders neither contained an arbitration clause, nor made reference to the applicability of terms and conditions of the Scheme, and therefore held that the arbitration clause could not be incorporated by reference. Aggrieved by the aforesaid Order of the High Court of Jharkhand, the Appellant filed the present appeal and the following issue came up for determination:

Issue

Whether the arbitration clause contained in the Scheme would be deemed to be incorporated by reference in the individual sale orders?

Relevant Provisions

Section 7(5) of the Arbitration Act reads as follows:

7. Arbitration agreement.—

(5) The reference in a contract to a document containing an arbitration clause constitutes an arbitration agreement if the contract is in writing and the reference is such as to make that arbitration clause part of the contract.

Observations of the Supreme Court

The Supreme Court examined the UNCITRAL model laws and the position of English law on the issue. The Supreme Court observed that the principle of incorporation by reference of an arbitration clause, from another document or contract is a well-established principle in arbitration jurisprudence as evinced by ***Clements v. Devon Country Insurance Committee [(1918) 1 KB 94].*** Under Indian law, this principle has been given statutory recognition in Section 7(5) of the Arbitration Act. Arbitration can be invoked by way of an arbitration clause in an agreement, being part of an independent agreement, incorporated by reference to a parent agreement or a standard from of contract. Statutory provisions in foreign legislations such as Article 7(2) of the UNCITRAL model law *(prior to the 2006 amendment)* and Section 6(2) of the English Arbitration Act, 1996, are inclusive of the principal of incorporation of an arbitration clause by reference. These provisions state that specific mention of the arbitration clause is not necessary and it is sufficient if the reference simply refers to the document that contains an arbitration clause.

The Queen's Bench Division in the landmark case of ***Habas Sinai Ve Tibbi GazlarIsthisal Endustri AS v. Sometal SAL [(2010) EWHC 29 (Comm)],*** drew a distinction between a 'single contract case' and a 'two-contract case'. A 'single contract case' is the one where an arbitration clause is contained in a standard form contract to which there is a general reference in the contract between parties and a 'two-contract case' is the one wherein the arbitration clause contained in some other contract to which a reference is made, is incorporated in the contract between two parties. The Supreme Court observed that Clause 7 of the sale orders falls under the 'single contract case' where the arbitration clause is contained in a standard form document that is the Scheme, to which there is a reference in the individual sale orders issued by the Respondent.

Several judgements of the Supreme Court such as ***M. R. Engineers & Contractors Private Limited v. SomDatt Builders Limited [(2009) 7 SCC 696]; Inox Wind Limited v. Thermocables Limited [(2018) 2 SCC 519],*** have been relied upon, in which the Supreme Court has held that even if a contract between the parties does not contain a provision for arbitration, an arbitration clause contained in an independent document would be incorporated into the contract by reference, if the reference was such that the arbitration clause forms a part of the contract. The Supreme Court further opined that a general reference to a standard form contract of one party, along with those of trade associations, and professional bodies would be sufficient to incorporate the arbitration clause.

The Supreme Court also considered the ambit of the expressions such as "arising out of", or "in respect of", or "in connection with", or "in relation to". The Supreme Court held that such expressions are of the widest amplitude and content, and must be construed accordingly. The sale orders specifically state that they would be governed by the guidelines, circulars, office orders, notices, instructions, relevant law, etc. issued from time to time by the Respondent. Hence, the arbitration clause in the Scheme would stand incorporated in the sale orders issued under the Scheme.

Decision of the Supreme Court

The Supreme Court held that the arbitration clause as contained in the Scheme stands incorporated in the individual sale orders.

VA View

This judgement has reinforced the age-old principle of the doctrine of incorporation, to make it at par with international standards. The Supreme Court has relaxed the incorporation of such clauses by a specific reference, as was the case in previous precedents, and has held the impugned incorporation to be sufficient enough to be a binding arbitration agreement. In an ingenious move to reinforce its view, the Supreme Court has tactfully relied upon judgements on interpretation of statutes that give a wide amplitude to certain expressions, holding them to be sufficient enough for incorporation. This judgement not only strengthens the doctrine of incorporation, but clears a huge void in the domain of arbitration and government tenders.

III. Supreme Court strikes down the RBI Circular dated February 12, 2018 which dealt with the revised framework for resolution of stressed assets

The Supreme Court in the case of ***Dharani Sugars and Chemicals Limited v. Union of Indiaand Others*** *(decided on April 2, 2019)* struck down the circular issued on February 12, 2018 (**"Circular"**) by the Reserve Bank of India (**"RBI"**) by which the RBI promulgated a revised framework for resolution of stressed assets.

Facts

The RBI issued the Circular under Section 35-A of the Banking Regulation Act, 1949 (**"Banking Act"**) read with the Central Government's circular dated May 5, 2017, Sections 35-AA and 35-AB of the Banking Act, and Section 45-L of the Reserve Bank of India Act, 1934 (**"RBI Act"**). The salient features of the Circular included restructuring in respect of borrower entities *de hors* the Insolvency and Bankruptcy Code, 2016 (**"Code"**) can only occur if the resolution plan that involves restructuring is agreed to by concurrence of 100% of the lenders. Secondly, in respect of debts with an aggregate exposure of INR 2,000 crores and more, if default persists for 180 days from March 1, 2018, or if the date of first default is after March 1, 2018, lenders shall file applications singly or jointly under the Code within 15 days from the expiry of the aforesaid 180 days.

Issues

Issue 1–Whether Sections 35-AA and 35-AB introduced by the Banking Regulation (Amendment) Act, 2017 are constitutionally valid?

Issue 2–Whether RBI has the power to issue circulars for stressed assets?

Issue 3–Whether the Circular issued by RBI is constitutionally valid?

Relevant Provisions

For a better understanding of the issues, it is pertinent to reproduce Sections 21, 35-A, 35-AA and 35-AB of the Banking Act:

"21. Power of Reserve Bank to control advances by banking companies.—

(1) Where the Reserve Bank is satisfied that it is necessary or expedient in the public interest or in the interests of depositors or banking policy so to do, it may determine the policy in relation to advances to be followed by banking companies generally or by any banking company in particular, and when the policy has been so determined, all banking companies or the banking company concerned, as the case may be, shall be bound to follow the policy as so determined.

(2) Without prejudice to the generality of the power vested in the Reserve Bank under sub-section (1) the Reserve Bank may give directions to banking companies, either generally or to any banking company or group of banking companies in particular, as to—

(a) the purposes for which advances may or may not be made,

(b) the margins to be maintained in respect of secured advances,

(c) the maximum amount of advances or other financial accommodation which, having regard to the paid-up capital, reserves and deposits of a banking company and other relevant considerations, may be made by that banking company to any one company, firm, association of persons or individual,

(d) the maximum amount up to which, having regard to the considerations referred to in clause (c), guarantees may be given by a banking company on behalf of any one company, firm, association of persons or individual, and

(e) the rate of interest and other terms and conditions on which advances or other financial accommodation may be made or guarantees may be given.

(3) Every banking company shall be bound to comply with any directions given to it under this section."

"35-A. Power of the Reserve Bank to give directions.—

(1) Where the Reserve Bank is satisfied that—

(a) in the public interest; or

(aa) in the interest of banking policy; or

(b) to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company; or

(c) to secure the proper management of any banking company generally, it is necessary to issue directions to banking companies generally or to any banking company in particular, it may, from time to time, issue such directions as it deems fit, and the banking companies or the banking company, as the case may be, shall be bound to comply with such directions.

(2) The Reserve Bank may, on representation made to it or on its own motion, modify or cancel any direction issued under sub-section (1), and in so modifying or cancelling any direction may impose such conditions as it thinks fit, subject to which the modification or cancellation shall have effect."

"35-AA. Power of Central Government to authorise Reserve Bank for issuing directions to banking companies to initiate insolvency resolution process.—

The Central Government may, by order, authorise the Reserve Bank to issue directions to any banking company or banking companies to initiate insolvency resolution process in respect of a default, under the provisions of the Insolvency and Bankruptcy Code, 2016.

Explanation.—For the purposes of this section, "default" has the same meaning assigned to it in clause (12) of Section 3 of the Insolvency and Bankruptcy Code, 2016."

"35-AB. Power of Reserve Bank to issue directions in respect of stressed assets.—

(1) Without prejudice to the provisions of Section 35-A, the Reserve Bank may, from time to time, issue directions to any banking company or banking companies for resolution of stressed assets.

(2) The Reserve Bank may specify one or more authorities or committees with such members as the Reserve Bank may appoint or approve for appointment to advise any banking company or banking companies on resolution of stressed assets."

Section 45-L of the RBI Act reads as under:

"45-L. Power of Bank to call for information from financial institutions and to give directions. —

(1) If the Bank is satisfied for the purpose of enabling it to regulate the credit system of the country to its advantage it is necessary so to do, it may—

(a) require financial institutions either generally or any group of financial institutions or financial institution in particular, to furnish to the Bank in such form, at such intervals and within such time, such statements, information or particulars relating to the business of such financial institutions or institution, as may be specified by the Bank by general or special order;

(b) give to such institutions either generally or to any such institution in particular, directions relating to the conduct of business by them or by it as financial institutions or institution.

(2) Without prejudice to the generality of the power vested in the Bank under clause (a) of sub-section (1), the statements, information or particulars to be furnished by a financial institution may relate to all or any of the following matters, namely, the paid-up capital, reserves or other liabilities, the investments whether in Government securities or otherwise, the persons to whom, and the purposes and periods for which, finance is provided and the terms and conditions, including the rates of interest, on which it is provided.

(3) In issuing directions to any financial institution under clause (b) of sub-section (1), the Bank shall have due regard to the conditions in which, and the objects for which, the institution has been established, its statutory responsibilities, if any, and the effect the business of such financial institution is likely to have on trends in the money and capital markets."

Arguments

Issue 1–The petitioners argued that the Sections 35-AA and 35-AB of the Banking Act are unconstitutional on two grounds: (i) that the Sections introduced are manifestly arbitrary; and (ii) that they suffer from absence of guidelines. However, none of the petitioners were able to point out as to how either of these provisions is manifestly arbitrary. On the other hand, the respondents argued that great leeway must be given to parliament to deal with the problems which affect the national economy as a whole.

Issue 2–The petitioners argued that Section 35-A of the Banking Act was introduced by an Amendment Act of 1956 and cannot, therefore, be used to empower the RBI to relegate companies to insolvency under the Code as it did not exist at the time, or to give directions for resolution of stressed assets. Whether or not to invoke the Code was certainly not in parliament's contemplation when it enacted Section 35-A of the Banking Act, and for this reason, Section 35-A of the Banking Act cannot possibly be looked at as a source of power authorising the RBI to issue the impugned Circular. The respondents stated that if a specific provision of the Banking Act makes it clear that the RBI has a specific power to direct banks to move under the Code against debtors in certain specified circumstances, it cannot be said that they would be acting outside the four corners of the statutes which govern them, namely, the RBI Act and the Banking Act. Further, discretionary powers given to the RBI under the Banking Act generally, and under Section 35-A, in particular, are broad and expansive, and have been expansively expounded upon by the Supreme Court. Section 35-AB uses the words "without prejudice" to indicate that the power granted under the said Section was to be read in addition to other powers granted by Sections 35-A and 35-AA of the Banking Act.

Issue 3–The petitioners argued that Section 35-AA is applicable to only specific defaults and not to the issuance of directions to banking companies generally, as has been done by the Circular. The respondents argued that "specific cases" would include specification by category or class. Further, to apply a 180 days limit to all sectors of the economy without going into the special problems faced by each sector would treat unequals equally and would be arbitrary and discriminatory, and therefore, was violative of Article 14 of the Indian Constitution.

Observations of the Supreme Court

Issue 1–The Supreme Court observed that the amendments are in the nature of amendments which confer regulatory powers upon the RBI to carry out its functions under the Banking Act, and are not different in quality from any of the Sections which have already conferred such power. Further, Section 21 of the Banking Act makes it clear that the RBI may control advances made by banking companies in public interest, and in so doing, may not only lay down policy but may also give directions to banking companies either generally or in particular. Similarly, under Section 35-A of the Banking Act, vast powers are given to issue necessary directions to banking companies in public interest, in the interest of banking policy, to prevent the affairs of any banking company being conducted in a manner detrimental to the interest of the depositors or in a manner prejudicial to the interest of the banking company, or to secure the proper management of any banking company. When it comes to lack of any guidelines by which the power given to the RBI is to be exercised, guidance can be obtained not only from the statement of objects and reasons and the preamble to the Banking Act, but also from its provisions. Sections 22, 25, 29, 30, and 31 of the Banking Act give guidance as to how the RBI is to exercise these powers under the newly added provisions. There is no dearth of guidance for the RBI to exercise the powers delegated to it by these provisions. Therefore, Sections 35-AA and 35-AB of the Banking Act which give the RBI certain regulatory powers cannot be said to be constitutionally invalid.

Issue 2–Section 35-AA of the Banking Act makes it clear that the Central Government may, by order, authorise the RBI to issue directions to any banking company or banking companies when it comes to initiating the insolvency resolution process under the provisions of the Code. The Central Government is either to exercise powers along with the RBI or by itself. Therefore, without such authorisation of the Central Government, the RBI would have no such power to issue directions. In other words, if a statute confers power to do a particular act and has laid down the method in which that power has to be exercised, it necessarily prohibits the doing of the act in any manner other than that which has been prescribed.

The RBI can only direct banking institutions to move under the Code if two conditions precedent are specified, namely, (i) that there is a Central Government authorisation to do so; and (ii) that it should be in respect of specific defaults. Section 35-AA of the Banking Act, therefore, by necessary implication, prohibits this power from being exercised in any manner other than the manner set out in Section 35-AA.

The power to issue directions given by Section 35-AB has to be read in conjunction with Section 35-A. The power under Section 35-AB, read with Section 35-A, is to be exercised separately from the power conferred by Section 35-AA. When one section of a statute grants general powers, as opposed to another section of the same statute which grants specific powers, the general provisions cannot be utilised where a specific provision has been enacted with a specific purpose in mind. When resolution through the Code is to be effected, the specific power granted by Section 35-AA can alone be availed by the RBI. When resolution *de hors* the Code is to be effected, the general powers under Sections 35-A and 35-AB are to be used. Any other interpretation would make Section 35-AA otiose.

Issue 3–Section 35-AA of the Banking Act enables the Central Government to authorise the RBI to issue such directions in respect of "a default". "Default" would mean non-payment of a debt when it has become due and payable and is not paid by the corporate debtor. Therefore, it is a particular default of a particular debtor that is the subject matter of Section 35-AA. Further, the expression *"issue directions to banking companies generally or to any banking company in particular"* occurring in Section 35-A is conspicuous by its absence in Section 35-AA. Thus, the Supreme Court observed that directions that can be issued under Section 35-AA can only be in respect of specific defaults by specific debtors. Any directions which are in respect of debtors generally, would be ultra vires Section 35-AA. Section 35-AA makes it clear that the power to be exercised under the authorisation of the Central Government requires *"due deliberation and care"* to refer to specific defaults.

There is nothing to show that the provisions of Section 45-L(3) of the RBI Act have been satisfied in issuing the Circular. The Circular nowhere says that the RBI has had due regard to the conditions in which and the objects for which such institutions have been established, their statutory responsibilities, and the effect the business of such financial institutions is likely to have on trends in the money and capital markets. Further, the Circular applies to banking and non-banking institutions alike. It is very difficult to segregate the non-banking financial institutions from banks so as to make the Circular applicable to them even if it is *ultra vires* insofar as banks are concerned.

Decision of the Supreme Court

The Supreme Court declared the Circular as *ultra vires* as a whole, and to be of no effect in law. Consequently, all actions taken under the Circular, including actions by which the Code has been triggered must fall along with the Circular. As a result, all cases in which debtors have been proceeded against by financial creditors under Section 7 of the Code, only because of the operation of the Circular will be proceedings which, being faulted at the very inception, are declared to be non-est.

VA View

With the quashing of the Circular, the bankers are at liberty to successfully restructure the loans of a company even after 180 days of the default having occurred. The corollary being that the bankers are not required to wait until the expiry of 180 days after a default for proceeding against a corporate debtor under the Code. Despite quashing of the circular, banks will continue to have the option of referring such defaulting borrowers under the Code, in case the resolution plan fails. The promoters will be able to resolve the default accounts faster, as long as 66% of the consortium agrees to the settlement, compared to 100% voting required under the scrapped RBI Circular.

By declaring the insolvency proceedings which were initiated by operation of the Circular void, the corporate debtors will now have to prove that the financial creditor had proceeded against it only by virtue of the Circular. The issuance of the Circular had created an uproar amongst the foreign investors since debts which were restructured pursuant to foreign investment being brought in the Indian company continued to hold the NPA tag. RBI held that such restructuring does not amount to 'change in management and ownership'. Therefore, the corporate debtors and its investors seem to have benefited with the quashing of the Circular.

IV. NCLAT: Statutory dues such as taxes are operational debts under the Insolvency and Bankruptcy Code

The National Company Law Appellate Tribunal (**"NCLAT")** in case of ***Principal Director General of Income Tax (Admn. & TPS) v. M/s. Synergies Dooray Automotive Limited and Others*** *(decided on March 20, 2019)* has held that statutory dues including income tax and sales tax are operational debts as per the Insolvency and Bankruptcy Code, 2016 (**"Code"**).

Facts

The Principle Director General of Income Tax and the Principle Commissioner of Income Tax (collectively, **"Income Tax Department"**) have filed appeals in the NCLAT against the following orders:

(I) Order dated August 2, 2017, passed by the National Company Law Tribunal (**"NCLT"**) Hyderabad under Section 31 of the Code approving the resolution plan of 'Synergies Dooray Automotive Limited', where the resolution plan provided huge income tax benefits to the resolution applicant without impleading the Income Tax Department in the proceedings.

(ii) Order dated April 19, 2018, passed by the NCLT Mumbai, under Section 31 of the Code approving the resolution plan in the corporate insolvency resolution process (**"CIRP"**) initiated against 'Raj Oil Mills Limited', where the income tax liability of the corporate debtor amounting to INR 338 crores was settled for 1% of the crystalized demand at a maximum of INR 2.58 crores against the mandate of the Income-tax Act, 1961 (**"Income-tax Act"**).

The Sales Tax Department, State of Maharashtra (**"Sales Tax Department"**) has filed the appeals in the NCLAT challenging the following orders:

(i) Order dated April 19, 2018, passed by the NCLT Mumbai, approving the resolution plan in the CIRP initiated against 'Raj Oil Mills Limited'. The Sales Tax Department contended that sales tax and value added tax do not come within the ambit of 'operational debt' and therefore the Sales Tax Department could not be considered to be an operational creditor.

(ii) Order dated July 13, 2018, passed by the NCLT Mumbai, approving the resolution plan in the CIRP initiated against 'Yashraj Ethanoll Processing Private Limited', where the sales tax liabilities were reduced to 1% of the dues.

(iii) Order dated October 22, 2018, passed by the NCLT Mumbai, which approved the resolution plan in the CIRP initiated against 'Parte Casters Private Limited' which reduced the Sales Tax Department's claim by 80%.

Since the questions of law being addressed in these appeals filed by the Income Tax Department and the Sales Tax Department (**"Appellants"**) were similar in nature, they were clubbed together for adjudication.

Issues

The issues in this case were:

(I) Whether the 'income tax', 'value added tax' or other statutory dues, such as 'municipal tax', 'excise duty', etc. come within the meaning of the term 'operational debt' as defined under the Code?

(ii) Whether the Central Government, the State Government or a legal authority having statutory claim, come within the meaning of the term 'operational creditors' as defined under the Code?

Relevant Provisions

Sections 5(20) and 5(21) of the Code read as follows:

5. Definitions. –

"(20) "operational creditor" means a person to whom an operational debt is owed and includes any person to whom such debt has been legally assigned or transferred;"

"(21) "operational debt" means a claim in respect of the provision of goods or services including employment or a debt in respect of the payment of dues arising under any law for the time being in force and payable to the Central Government, any State Government or any local authority;"

Arguments

The Income Tax Department argued that as per the definition of 'operational debt' under Section 5(21) of the Code, income tax cannot be considered to be in the nature of 'operational debt', as income tax, being a statutory liability under the Income-tax Act is binding on every citizen, including a resolution applicant. It was submitted that the order granting approval of the resolution plan is in contravention of Sections 220 *(When tax payable and when assessee deemed in default)* read with Section 156 *(Notice of demand)* of the Income-tax Act, which provides for collection and recovery of tax. A similar plea was taken by the Sales Tax Department by relying on Section 37 *(Liability under this Act to be the first charge)* of the Maharashtra Value Added Tax, 2002. The Appellants submitted that the liability of paying statutory first charge has been adjudicated on by the Supreme Court in the case of ***Central Bank of India v. State of Kerala and Others [(2009) 4 SCC 94],*** where it was held that banks cannot claim priority of dues if there is a statutory first charge created in favor of the State. Several judgements were referred to by the Appellants for the interpretation of the word 'or' before the expression *'a debt in respect of the payment of dues'* in the definition of 'operational debt' under Section 5(21) of the Code. The Appellants argued that the word 'or' should have the connotation of the word 'and' and therefore be construed to be conjunctive and not disjunctive. It was submitted that the claim under Section 5(21) of Code should be related to either supply of goods or for rendering services to the corporate debtor. Since tax is not related to supply of goods or services rendered to the corporate debtor, it cannot be treated to be the operational debt.

On the other hand, one of the resolution applicants argued that the statutory dues including the 'income tax' and the 'sales tax' come within the meaning of Section 5(20) read with Section 5(21) of the Code as the provisions suggest that the term 'operational debt' also included debts arising under any law payable to the Central Government and the State Government.

Observations of the NCLAT

The NCLAT observed that there is no ambiguity in the interpretation of the word 'or' and the legislature has intended the meaning of the word 'or' to be as it is before the expression *'debt in respect of the payment of dues'* under Section 5(21) of the Code. The question of payment of statutory dues arises when a company is operational, creating a direct nexus between payment of such dues and the operation of a company. Therefore 'operational debt' in the normal course would be the debt owed by the corporate debtor in relation to running the operations of the company as a going concern, and since payment of statutory dues such as income tax and sales tax are required in order to keep the company functioning, such dues would be operational debts.

Decision of the NCLAT

The NCLAT disposed all the appeals and stated that since statutory dues including income tax, value added tax, etc., come within the meaning of 'operational debt', therefore, the Income Tax Department of the Central Government, Sales Tax Department of the State Government and local authorities are 'operational creditors' as per the Code and are entitled to their dues arising out of the existing law.

VA View

This judgement clarifies the meaning and scope of the term 'operational debt' under the Code and conclusively states that all statutory dues including income tax dues and sales tax dues would come under the ambit of 'operational debt'. By stating that all such dues would come under the ambit of 'operational debt', the NCLAT has also held that statutory authorities such as the Income Tax Department and the Sales Tax Department are operational creditors within the Code, and has stymied all attempts that the government departments have been taking in various cases to circumvent the provisions of the Code and to step outside the CIRP process to be paid their dues separately and in priority.

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