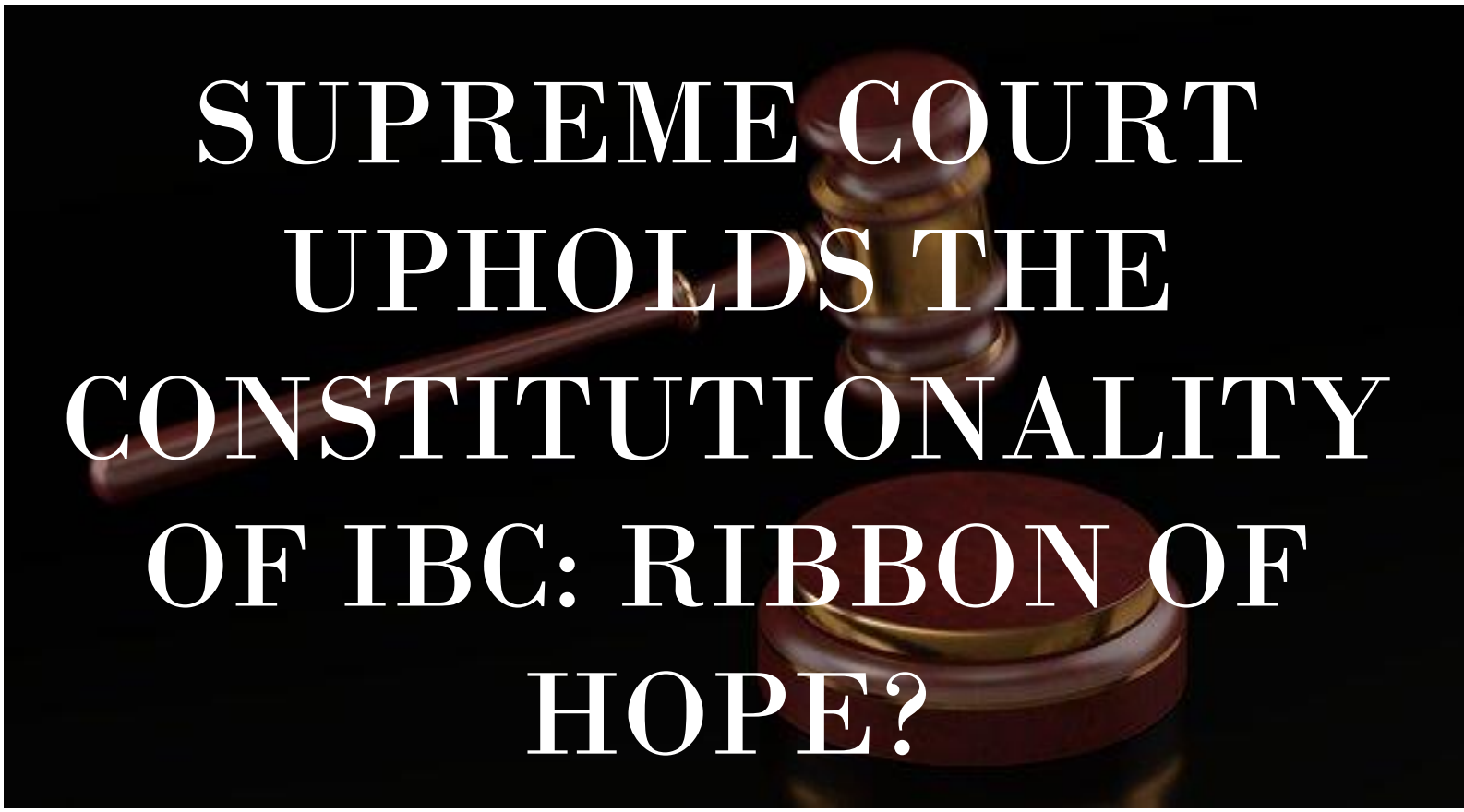

SUPREME COURT UPHOLDS THE CONSTITUTIONALITY OF IBC: RIBBON OF HOPE?

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Background

The constitutional vires of Part II of the Insolvency and Bankruptcy Code, 2016 ("**Code**") (*Insolvency Resolution and Liquidation for Corporate Persons*), substantial provisions of which were brought into force with effect from December 1, 2016, *vide* Notification S.O. 3594(E) dated November 30, 2016, has been subject to numerous challenges before various High Courts[1]. Such numerous attacks upon the vires of the Code, as well as the constitutional validity of National Company Law Tribunal ("**NCLT**"), prompted the Supreme Court to direct Gujarat High Court to "*not to enter into the debate pertaining to the validity of the Insolvency and Bankruptcy Code, 2016 or the constitutional validity of the National Company Law Tribunal*."[2]

Finally, all the various challenges mounted against the constitutionality of the Code seems to have been finally settled by the Supreme Court, vide its decision dated January 25, 2019, rendered in the case of *Swiss Ribbons Pvt. Ltd. v. UoI*[3].

Grounds for challenge

The Division Bench of Hon'ble Justice R. F. Nariman and Hon'ble Justice Navin Sinha heard together and decided various writ petitions challenging the vires of the Code. Primarily, the grounds on the basis of which the Code was sought to be challenged may be summarised as follows:

(a) Members of the NCLT and certain members of the National Company Law Appellate Tribunal, New Delhi ("**NCLAT**") have been appointed in a manner contrary to the judgment of the Supreme Court in *Madras Bar Association (III)*[4];

(b) Presence of a sole NCLAT in New Delhi, despite substituting the power of various High Courts, is violative of the order of the Supreme Court in Madras Bar Association (II)[5];

(c) The NCLTs and NCLAT are functioning under the Ministry of Corporate Affairs ("**MCA**") despite the order of the Supreme Court in Madras Bar Association (I)[6] requiring the Ministry of Law and Justice to govern the functioning of all Tribunals;

(d) The distinction between financial creditors and operational creditors as envisaged in the Code is violative of Article 14 of the Constitution of India[7] as there is no *intelligible differentia* between the two types of creditors. Further-
   (i) The financial creditors are unfairly exempted from the requirement to establish the absence of dispute placed on operational creditors under Section 7 of the Code[8];

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[1] See, *Sree Metaliks Limited v. UoI* [W.P. 7144 (W) OF 2017, decided on April 7, 2017 (Calcutta)]; *Anandram Developers Private Limited v. National Company Law Tribunal* [W.P.Nos.29084 and 29085 of 2017, decided on November 17, 2017 (Madras)] and *Akshay Jhunjhunwala v. UoI* [W.P. No. 672 of 2017, decided on February 2, 2018 (Calcutta)]

[2] See, *Shivam Water Treaters Private Limited v. UoI* [Special Leave to Appeal (C) No(s).1740/2018, order dated January 25, 2018 (SC)]

[3] *Swiss Ribbons Pvt. Ltd v Union of India* [Writ Petition (Civil) No. 99 of 2018, decided on January 25, 2019 (SC)]

[4] *Madras Bar Association v. Union of India*, (2015) 8 SCC 583

[5] *Madras Bar Association* v *Union of India* [(2014) 10 SCC 1]

[6] *Union of India* v *R.Gandhi, President, Madras Bar Association* [(2010) 11 SCC 1]

[7] Article 14 of the Constitution states that - *The State shall not deny to any person equality before the law or the equal protection of the laws within the territory of India Prohibition of discrimination on grounds of religion, race, caste, sex or place of birth.*

[8] Section 7 of the Code prescribes the conditions for admission and rejection of an insolvency application filed by a financial creditor against a corporate debtor.

(ii) There is hostile discrimination against operational creditors under Section 21[9] and Section 24[10] of the Code as they are barred from being represented and/or voting in the Committee of Creditors;

(e) The certificate of an information utility, as envisaged in Section 210 of the Code[11], is in the nature of a preliminary decree issued without any hearing and/or process of adjudication;

(f) Section 12A of the Code[12] derails the settlement process by requiring approval of at least ninety percent (90%) of voting share of Committee of Creditors;

(g) The powers of adjudication under the Code and regulations given to a resolution professional, being a non-judicial authority, is violative of basic aspects of dispensation of justice and access to justice;

(h) Section 29A of the Code[13] is *ultra vires* for the following reasons:

(i) the vested rights of erstwhile promoters to participate in the recovery process of a corporate debtor has been impaired retrospectively;
(ii) a blanket ban has been imposed on the participation of all promoters of Corporate Debtors without any mechanism to weed out those who are unscrupulous; and
(iii) the period of one year prescribed under Section 29A(c) of the Code is wholly arbitrary and without any basis in rationality and law;
(iv) persons who are relatives with no business connections to erstwhile promoters of corporate debtors may also be debarred under Section 29A (j) of the Code;

(i) Section 53 of the Code[14] is ultra vires as the position of operational creditor below other unsecured creditor is arbitrary.

Touchstone for examining constitutional validity of the Code

In its scrutiny of the issues, the Hon'ble Supreme Court analysed the jurisprudence of the United State of America, the rise and fall of the *Lochner Doctrine*[15], and the jurisprudence of India to determine the permissible extent of judicial intervention in the Code, which is an economic legislation. In the Indian context, it was observed that in various judgements the Supreme Court has held that '*the Court must defer to legislative judgment in matters related to social and economic policies and must not interfere unless the exercise of legislative judgment appears to be palpably arbitrary.*'[16]

The Statement of Objects and Reasons of the Code was also analysed by the Supreme Court. The Supreme Court has accordingly held in the Judgment that the '*The primary focus of the*

[9] Section 21 of the Code describes the composition of a committee of creditors.
[10] Section 24 of the Code describes the manner of conducting meeting of a committee of creditors.
[11] Section 210 of the Code prescribes the procedure for registering as an information utility.
[12] Section 12A of the Code states that "*The Adjudicating Authority may allow the withdrawal of application admitted under section 7 or section 9 or section 10, on an application made by the applicant with the approval of ninety per cent. voting share of the committee of creditors, in such manner as may be specified. describes the meeting of a committee of creditors.*"
[13] Section 29A of the Code lays down disqualification criteria for resolution applicants.
[14] Section 53 of the Code prescribes the distribution of assets from the proceeds of liquidation assets.
[15] The *Lochner Doctrine* established by the U.S. Supreme Court in *Lochner v. New York* [198 U.S. 45 (1905)], resulted in a large number of minimum wage laws, maximum hours of work in factory laws, child labour laws to be struck down as, according to the Court, such legislations did not square with property rights. However, the judicial trend shifted in 1937 and thereafter, the U.S. Supreme Court refused to sit as a '*Super Legislature to weigh the wisdom of legislation*' and '*strike down state laws, regulation of business and regular conditions, because they may be unwise, improvident, or out of harmony with a particular school of thought.*'
[16] *R. K. Garg v Union of India* [(1981) 4 SCC 675]; *Bhavesh D Parish v Union of India* [(2000) 5 SCC 471]; *DG of Foreign Trade v Kanak Exports* [(2016) 2 SCC 226].

Legislation is to ensure revival and continuation of the Corporate Debtor by protecting the Corporate Debtor from its own management and from a corporate debt by liquidation. The Code is thus a beneficial legislation which puts the Corporate Debtor back on its feet, not being a mere recovery legislation for creditors'. (emphasis supplied)

It is with this background, factual and legal, that the validity of the Code has been tested by the Hon'ble Supreme Court.

Decision

For sake of brevity and convenience, the Judgment has been summarised issue-wise.

Appointment of Member of NCLTs and NCLAT

It was argued before the Supreme Court that appointment of the members of NCLT and NCLAT was unconstitutional as the very subsistence of Section 412(2) of the Companies Act, 2013[17] was contrary to the decisions in *Madras Bar Association (I)* [18] and *Madras Bar Association (III),*[19] resulting in the judicial members of the Selection Committee to be outweighed by the three bureaucrats.

However, it was noted by the Apex Court that Section 412 of the Companies Act, 2013 has already been amended with effect from January 3, 2018, to align the constitution in accordance with the aforesaid directions of the Supreme Court. The Court also took note of an affidavit filed by the Ministry of Corporate Affairs that all appointments to the NCLT and the NCLAT had been made by a Selection Committee constituted in accordance with the aforesaid Supreme Court decisions and thus rejected challenge to the vires of the constitutionality of NCLT and NCLAT on this account.

Requirement of NCLAT circuit benches

It was alleged that whilst the powers of High Courts were taken away, NCLAT having been constituted only in Delhi, deprives the litigants of the convenience of approaching the jurisdictional High Court in a state. This was argued to be in contravention of the principle recognised in *Madras Bar Association (II)* [20], where the Supreme Court was of the view that *while vesting jurisdiction in an alternative court/tribunal, it is imperative for the legislature to ensure that redress should be available with the same convenience and expediency as it was prior to the introduction of the newly created court/tribunal*.

The grounds alleged were not heavily contested by the Government, with Attorney General assuring that circuit benches will be established as early as practicable and a direction was passed to set up circuit benches of the NCLAT within a period of 6 months from the date of the Judgment.

Ministry of Law and Justice should govern functioning of NCLTs and NCLAT

A reference was made to *Madras Bar Association (I)* [21] where the Supreme Court had observed that the administrative support of all tribunals shall fall under the exclusive purview of the Ministry

[17] Section 412 of the Code lays down the procedure for selection of members of tribunal and appellate tribunal.
[18] *Union of India* v *R.Gandhi, President, Madras Bar Association* [(2010) 11 SCC 1]
[19] *Madras Bar Association v. Union of India*, (2015) 8 SCC 583.
[20] *Madras Bar Association* v *Union of India* [(2014) 10 SCC 1]
[21] *Union of India* v *R.Gandhi, President, Madras Bar Association* [(2010) 11 SCC 1]

of Law and Justice. The management of the NCLTs and NCLAT by the Ministry of Corporate Affairs in terms of allocation of business rules was challenged on this ground.

The Supreme Court though recognised the mandatory nature of rule of business allocation set by it[22], directed the Union of India to follow the aforementioned judgment in both letter and spirit.

Arbitrariness in differentiating between Financial Creditor and Operational Creditor

The Supreme Court tested the Code for arbitrariness in its distinction between financial creditors and operational creditors on the anvil of Article 14 of the Constitution of India. It determined the presence of an intelligible differentia which separates the two kind of creditors. The Court observed that financial debt, being consideration for the time value of money, is clearly distinguishable from operational debt which is claims in respect of provision of goods and services.

Placing reliance on the Bankruptcy Law Reforms Committee ("**BLRC**") Report, and the Insolvency and Bankruptcy Bill, the Supreme Court also delved into the distinction between the financial creditors and the operational creditors. It was identified that financial creditors (generally secured) consist of banks and financial institutions and operational creditors (generally unsecured) consist of entities which supply goods and services. The nature of loan agreements with financial creditors who generally provide working capital loans, term loans etc. is also different from contracts with creditors for supply of goods and services. The resultant requirement for financial creditors to assess the viability of the corporate debtor while disbursing loans was also highlighted to clearly distinguishes them from operational creditors. Further, it was recognised that financial creditors have electronic records of the liabilities and incontrovertible event of default on any financial credit contract can be readily verifiable by accessing this system, while the event of default may either be in physical or electronic form for an operational creditor.

The Court also found the support for differentiation between financial and operational creditor basis the fact that a financial creditor has to prove default, whereas an operational creditor merely 'claims' a right to payment of a liability or obligation in respect of a debt which may be due.

In view of these differences, the Supreme Court held that the distinction that the Code carves out between operational creditors and financial creditors is not violative of Article 14 of the Constitution of India.

Notice, Set-Off and Counterclaim qua Financial Debts

It was argued before the Supreme Court that the absence of the requirement to serve notice and establish disputes as a defence for an application under Section 7 of the Code is inequitable, arbitrary, capricious and prevents and/or limits the corporate debtor from opposing the said application.

The Supreme Court, on a conjoint reading of Rule 4(3) of the *Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016*[23], Section 420 of the Companies Act, 2013[24] and Rules 11, 34, and 37 of the *National Company Law Tribunal Rules, 2016*[25], arrived at the

[22] *Delhi International Airport Limited* v *International Lease Finance Corporation and Ors.* [(2014) 10 SCC 1] states that once rules of business are allocated among various ministries, such allocation is mandatory in nature.
[23] Rule 4(3) of the *Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016* prescribes the manner of service of notice of the application on the financial creditor.
[24] Section 420 of the Companies Act, 2013 specifies that Tribunal is required to provide parties with a reasonable opportunity to be heard.
[25] Rules 11, 34, and 37 of the *National Company Law Tribunal Rules, 2016* specifies the inherent powers, general procedure and notice requirements followed by the NCLT.

finding that the corporate debtor is required to be served with a copy of the application filed with the Adjudicating Authority and has the opportunity to file a reply and be heard before an order is made admitting an application.

The Supreme Court also recognised that sections 65 and 75 of the Code[26] provide ample protection to the corporate debtor from being dragged into the corporate insolvency resolution process unnecessarily, by way of prescribing penalties for filing mala-fide proceedings and providing false information by a financial creditor. It was also held that a set-off/counter-claim may be considered at the stage of filing of proof of claims during the resolution process by the resolution professional, and there is nothing in the Code which interdicts the corporate debtor from pursuing counterclaims in other judicial fora.

The Supreme Court recognised that the Code has contributed to a complete transition of the legislative policy from the concept of 'inability to pay debt' to 'determination of default'. Such shift has enabled the financial creditor to prove, based upon solid documentary evidence, that there is an obligation to pay the debt and that the debtor has failed in such obligation rather than attempt to establish an abstract concept of inability to pay. This has resulted in predictability and certainty; safeguarding of the interest of the Corporate Debtor and an assurance that liquidation shall only initiate upon failure of the resolution process. On such ground, this issue was dismissed by the Supreme Court.

Operational Creditors vis-à-vis the Committee of Creditors

The Supreme Court was next concerned with the constitutionality of exclusion of operational creditors from the Committee of Creditors.

The Supreme Court distinguished between the qualifications of financial creditors and operational creditors to support the exclusion of operational creditors from the Committee of Creditors. The Court held that financial creditors like banks and financial institutions, being in the business of money lending, are best equipped to assess viability and feasibility of the business of the corporate debtor. Even at the time of granting loans, these banks and financial institutions undertake a detailed market study which includes a techno-economic valuation report, evaluation of business, financial projection, etc. and are thus in a good position to evaluate the contents of a resolution plan.

It was observed that operational creditors do not have the requisite expertise to determine the viability and feasibility of business as they are generally involved in the supply of goods and service.

In this regard, the Supreme Court placed reliance on the United Nations Commission on International Trade Law, in its Legislative Guide on Insolvency Law to highlight the importance of treating similarly placed creditors similarly.

The Supreme Court noted that the operational creditors or their representatives could be present in the meeting of the Committee of Creditors if the amount of their aggregate dues was not less than ten per cent of the debt. Further, it was observed that there is no conclusive data to suggest that operational creditors are adversely affected by being excluded from the Committee of Creditors. Further, it was noted that the NCLTs, while looking into the viability and feasibility of resolution plans always go into whether operational creditors are given roughly the same treatment as financial creditors, and if they are not, such plans are either rejected or modified so that the operational creditors' rights are safeguarded.

On such grounds, the constitutionality of the Code was upheld.

[26] Section 65 of the Code provides for a penalty upto Rs. 1 crore for fraudulent or malicious initiation of proceedings. Section 75 of the Code provides for a penalty of upto Rs. 1 Crore for providing false information in an application.

Legality of settlement under Section 12A of the Code

Section 12A of the Code[27] was assailed as it prescribes a very high threshold by requiring approval of ninety percent (90%) of the members of the Committee of Creditors to allow withdrawal of a corporate debtor from Corporate Insolvency Resolution Process.

In this regard, the Supreme Court recognised that the requirement of consent of the Committee of Creditors to allow withdrawal of the corporate debtor from the Corporate Insolvency Resolution Process stems from the fact that once a petition under Section 7 or Section 9 is admitted, the Corporate Insolvency Resolution Process becomes proceeding *in rem*, through which rights of the public in general are affected. Further, the requirement of approval of ninety percent (90%) of the members of the Committee of Creditors ensures that the liabilities of all the creditors are addressed in an omnibus settlement as most of the financial creditors have to grant their approval to the settlement proposal. In fact, the arbitrary rejection of a just settlement proposal by the Committee of Creditors may be appealed to the NCLT under Section 60 of the Code, and therefore Committee of Creditors does not have the last say in the subject.

Interestingly, the Supreme Court has also elaborated on the means of settlement available to a Corporate Debtor after admission to Corporate Insolvency Resolution Process but before formation of the Committee of Creditors. It has clarified that the NCLT may allow an application of withdrawal or settlement using its inherent powers under Rule 11 of the National Company Law Tribunal Rules, 2016[28], at any stage where the Committee of Creditors is yet to be constituted. However, the NCLT is required to hear all the concerned parties and considering all relevant factors before allowing such withdrawal/settlement.

Certification by Information Utility

The constitutionality of involvement of the private information utilities set up under the Code was assailed on the ground that they were not governed by proper norms. It was submitted that their certification cannot be conclusive evidence of default.

The Supreme Court placed reliance on Regulations 20 and 21 of the *Insolvency and Bankruptcy Board of India* (*Information Utility Regulation), 2017*[29] to hold that Information Utilities are in fact governed by stringent norms by the virtue of which the moment information of default is received, such information is communicated to all parties and sureties to the debt. Apart from this, the Information Utilities are required to expeditiously undertake the process of authentication and verification of information, which will include authentication and verification from the debtor who has defaulted.

The Supreme Court also noted that the certification of default by the Information Utilities is only *prima facie* evidence of default, which is rebuttable by the corporate debtor, and therefore a challenge to the same must fail.

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[27] 12-A. *Withdrawal of application admitted under Section 7, 9 or 10. – The Adjudicating Authority may allow the withdrawal of application admitted under Section 7 or Section 9 or Section 10, on an application made by the applicant with the approval of ninety percent voting share of the committee of creditors, in such manner as may be specified.*

[28] Rule 11. *Inherent Powers. - Nothing in these rules shall be deemed to limit or otherwise affect the inherent powers of the Tribunal to make such orders as may be necessary for meeting the ends of justice or to prevent abuse of the process of the Tribunal.*

[29] Regulation 20 of the *Information Utility Regulations, 2017* provides that upon acceptance of information, the Information Utility will notify user of unique identifier of the information, terms of verification/authentication and manner in which it may be accessed. Regulation 21 of the *Information Utility Regulations, 2017* provides that on receipt of information of default, the Information Utility shall communicate the information of default and status of authentication to the creditors, parties and sureties of debt.

Powers of a Resolution Professional

On the issue whether a resolution professional, being a non-adjudicatory authority under the Code, has been given powers of adjudication, the Supreme Court clarified that resolution professionals are given administrative powers as opposed to quasi-judicial powers. The Supreme Court has comparatively analysed the extent of power of a resolution professional vis-à-vis that of a liquidator to emphasise this.

The Court held that when the liquidator determines the value of claims admitted under Section 40 of the Code[30], such determination is decision, which is quasi-judicial in nature, and which can be appealed against to the Adjudicating Authority under Section 42 of the Code[31]. In contrast, no appeal lies against rejection of claims by resolution professionals.

It was also elucidated that even when the resolution professional is to make a determination under Regulation 35A of the *Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016*[32], the application to the Adjudicating Authority is only for appropriate relief, and no adjudication is made by the resolution professional.

Further, unlike the liquidator, the resolution professional cannot act, in most circumstances, without the approval of the Committee of Creditors, which retains the power to replace one resolution professional with another, by a two-thirds majority. Thus, the resolution professional has been recognised only as a facilitator of the resolution process, whose administrative functions are overseen by the Committee of Creditors and by the Adjudicating Authority.

Vires of Section 29A of the Code

Section 29A of the Code was first introduced by the *Insolvency and Bankruptcy Code (Amendment) Ordinance, 2017*, amending the Code and provides for which persons are ineligible to be resolution applicants in a Corporate Insolvency Resolution Process. The constitutional validity of various aspects of Section 29A, as dealt by the Supreme Court in the instant case, are categorised as follows:

(a) Retrospective Application – It was argued that Section 29A of the Code had retrospectively impaired the right of erstwhile promoters to participate in the recovery process for the corporate debtor. In this context, the Supreme Court observed that a statute is not retrospective merely because it affects existing rights. Noting that the resolution applicant has no vested right for consideration or approval of its resolution plan, the Court noted that Section 29A is not retrospective in nature.

(b) Section 29A(c) not restricted to malfeasance – It was argued that there is no reason to not permit an erstwhile manager not guilty of malfeasance or of acting contrary to the interest of

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[30] 40. (1) *The liquidator may, after verification of claims under section 39, either admit or reject the claim, in whole or in part, as the case may be:*
Provided that where the liquidator rejects a claim, he shall record in writing the reasons for such rejection.
(2) The liquidator shall communicate his decision of admission or rejection of claims to the creditor and corporate debtor within seven days of such admission or rejection of claims.

[31] 42- Appeal against the decision of liquidator. —*A creditor may appeal to the Adjudicating Authority against the decision of the liquidator accepting or rejecting the claims within fourteen days of the receipt of such decision.*

[32] 35A. Preferential and other transactions. —*(1) On or before the seventy-fifth day of the insolvency commencement date, the resolution professional shall form an opinion whether the corporate debtor has been subjected to any transaction covered under sections 43, 45, 50 or 66. (2) Where the resolution professional is of the opinion that the corporate debtor has been subjected to any transactions covered under sections 43, 45, 50 or 66, he shall make a determination on or before the one hundred and fifteenth day of the insolvency commencement date, under intimation to the Board. (3) Where the resolution professional makes a determination under sub-regulation (2), he shall apply to the Adjudicating Authority for appropriate relief on or before the one hundred and thirty-fifth day of the insolvency commencement date.*

the corporate debtor from taking part in the resolution process. Further, it was submitted that there was no reason why during liquidation, any person, including persons not eligible to be resolution applicants, should not be allowed to purchase properties sold by the liquidator by way of a public auction.

The Supreme Court, whilst reiterating the absence of a vested right of an erstwhile promoter of a corporate debtor to bid for property of the corporate debtor, clarified that malfeasance was not the only ground for disqualification under Section 29A of the Code, as Section 29A prescribed other grounds on the basis of which a person could be ineligible to submit a resolution plan. Hence, there was no question of treating unequals as equals. The Supreme Court further held that the principles of Section 29A further permeates to the process of liquidation, and there is no anomaly with the same. Consequently, the constitutionality of Section 29A of the Code was upheld on this count.

(c) Arbitrary period of 1 year in Section 29A(c) – Section 29A(c) of the Code[33] disqualifies a person in management or control of a corporate debtor which has remained classified as a Non-Performing Asset as per RBI guidelines for a period of one year. The period of one year prescribed in Section 29A(c) of the Code was challenged as arbitrary. The Supreme Court considered the applicable RBI guidelines and determined that as per Clause 4 of the RBI Master Circular on *Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances* ("**Master Circular**"), this policy could not be found fault with. The period of one year was held to have emerged from the provisions of the Master Circular, as during this period, a non-performing asset is classified as a substandard asset. As the ineligibility attaches only after the one-year period is over, when the non-performing asset is classified as a doubtful asset, the provision was held to be neither arbitrary, nor unconstitutional.

(d) Related Parties under Section 29A(j) – The constitutionality of Section 29A(j) of the Code[34] read with the definition of *related party* under Section 5(24A) of the Code[35] was assailed, based on apprehensions concerning the disqualification of relatives of persons disqualified as a resolution applicant, in spite of not having any business relationships with the disqualified persons *per se*.

The Supreme Court noted that all categories of persons mentioned in Section 5(24A) of the Code show that such persons must be connected with the resolution applicant within the meaning of Section 29A(j) of the Code. All categories persons in Section 29A(j) deal with persons, natural as well as artificial, who are connected with the business activity of the resolution applicant. This being the case, the Supreme Court held that the definition of "related party" contained in Section 5(24A) must be read *noscitur a sociis* with the categories of persons mentioned in Explanation I and shall *include only persons who are connected with the business activity of the resolution applicant*. The Court also held that in the absence of showing that such person is connected with the business of the activity of the resolution applicant, such person cannot possibly be disqualified under Section 29A(j).

(e) Exemption of Micro, Small and Medium Enterprises (**"MSME"**) from the purview of Section 29A – The fact that MSMEs are exempted from the application of Section 29A(c) and Section

[33] Section 29A(c) of the Code states that "*(c) has an account, or an account of a corporate debtor under the management or control of such person or of whom such person is a promoter, classified as non-performing asset in accordance with the guidelines of the Reserve Bank of India issued under the Banking Regulation Act, 1949 and at least a period of one year has lapsed from the date of such classification till the date of commencement of the corporate insolvency resolution process of the corporate debtor: Provided that the person shall be eligible to submit a resolution plan if such person makes payment of all overdue amounts with interest thereon and charges relating to non-performing asset accounts before submission of resolution plan;*"

[34] Section 29A(j) of the Code states that "*A person shall not be eligible to submit a resolution plan, if such person, or any other person acting jointly or in concert with such person – has a connected person not eligible under clauses (a) to (i).*"

[35] Section 5(24A) of the Code prescribes the definition of related party.

29A(h) of the Code was assailed on the ground of constitutionality. The Insolvency Law Committee's Report had suggested exempting MSMEs from the ambit of Section 29A(c) and 29A(h)[36] as the business of a MSMEs normally attracts interest primarily from promoters of the MSMEs, and not those from other industries. To ensure that there are ample opportunities to revive the companies, the MSMEs have been exempted from the application of Section 29A(c) and Section 29A(h) of the Code. The Supreme Court, whilst upholding the constitutionality of the exemption, has also welcomed the fact that the legislature is alive to serious anomalies that arise in the working of the Code and have taken proactive steps to rectify them.

Section 53 of the Code does not violate Article 14

The position of operational creditors in the waterfall provided under Section 53 of the Code was argued to be detrimental to their interest, as they rank below all other creditors, including unsecured financial creditors.

The Supreme Court, to uphold the constitutionality of Section 53 of the Code, delved into the nature of the debts, observing that repayment of financial debts infuses capital into the economy inasmuch as banks and financial institutions may further lend such money to other entrepreneurs for their businesses. The Court also recognised that workmen's dues are unsecured debts, however, traditionally their place is above most other debts.

The Supreme Court finally concluded that unsecured debts may be of various kinds, and when there is legitimate interest, in tandem with the object of the Code, sought to be protected, the same cannot be called unconstitutional. It has been held that Section 53 of the Code does not violate Article 14 of the Constitution of India.

Some Critical Observations

Whilst the Supreme Court has set at rest the various challenges to the constitutionality of the Code, in the course of doing the same, it may have given rise to certain new confusions, which are as follows:

(a) *Availability of Inherent Power of NCLT whilst acting as an adjudicating authority:* In paragraph 52 of the impugned decision, the Court had noted the availability of inherent power under Rule 11 of the *National Company Law Tribunal Rules, 2016* for effecting settlement, prior to constitution of the committee of creditors. This seems to be at variance with the earlier decision of the same Court in the case of *Lokhandwala Kataria Construction Private Limited v. Nisus Finance and Investment Managers LLP*[37], where it had upheld the decision of NCLAT regarding lack of such inherent power as a view, which *prima facie* appeared to be the *correct position of law*.

(b) *Availability of judicial fora for maintainability of counterclaims by corporate debtor*: In paragraph 36 of the impugned decision, the Court noted that *there is nothing in the Code which interdicts the corporate debtor from pursuing such counterclaims in other judicial fora*. Notably, in terms of Section 60(5)(b) of the Code, the NCLT has the jurisdiction to entertain or dispose of *any claim made by or against the corporate debtor or corporate person, including claims by or against any of its subsidiaries situated in India*. Further, in terms of Section 231 of the Code, the jurisdiction of *civil courts is barred in respect of any matter in which the Adjudicating Authority is empowered by, or under, this Code to pass any order*. In view of the statutory provisions, it is not clear on what basis did the Court come to the conclusion that corporate debtor is entitled to pursue any counterclaims in other judicial fora.

[36] Section 29A(h) of the Code states that *"(h) has executed an enforceable guarantee in favour of a creditor in respect of a corporate debtor against which an application for insolvency resolution made by such creditor has been admitted under this Code;"*

[37] *Lokhandwala Kataria Construction Private Limited v. Nisus Finance and Investment Managers LLP* [Civil Appeal No. 9279 of 2017, decided on July 24, 2017 (SC)]

(c) *Priority in waterfall: Related party unsecured financial creditor vis-à-vis operational creditor*: As has been noted, the constitutionality of Section 53 of the Code, and especially Section 53(1)(f), dealing with priority of debts owed to operational creditors, was upheld by the Court, upholding the rationale for differentiation between financial debts which are *secured* and operational debts which are *unsecured*. Whilst doing that, the Court failed to take note of Section 53(1)(d), under which *financial debts owed to unsecured creditors* also rank higher in the waterfall than *unsecured operational creditors*. It defies logic why any unsecured financial creditor (which would even include shareholder loan, loans from associate entities which may or may not be on arms' length) be offered priority over *operational debts*. The Court probably missed an opportunity to address the lacunae in the Code.

Conclusion

The decision of Supreme Court will helpfully put to rest some of the vexed questions surrounding the interpretation of the provisions of the Code, as well as clarify the roles of the machineries under the Code. The direction to set up circuit benches of the NCLAT in different cities is a definite welcome decision ensuring quicker disposal of appeals. Furthermore, the Supreme Court has recognised the effective working of the Code in the exponential increase of flow of financial resource to the commercial sector as a result of financial debts being repaid. Whilst a welcome decision, the Court probably could have avoided the issues identified herein above, had it been a bit more vigilant.

This note has been written by Pooja Chakrabarti (Partner) and Adheesh Agarwal (Associate).

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