*Dr. Rajeev Babel**

** FCS & IP*

[2018] 1 IBJ (Art.) 49

Insolvency Resolution by Operational Creditor : 'Demand Notice' and 'Financial Institution' under Judicial Scanner

In order to file insolvency resolution by the Operational Creditor under Section 8 of the Insolvency and Bankruptcy Code, 2016, demand notice of unpaid operational debt has to be served on the Corporate Debtor and the Operational Creditor has to ensure that no dispute exists before the issue of demand notice under clause (c) of sub-section (3) of Section 9. Operational Creditor is also required to submit a copy of the certificate from the financial institutions maintaining accounts of the Operational Creditor confirming that there is no payment of an unpaid operational debt by the Corporate Debtor. In this article, the author explains expressions 'demand notice' and 'financial institution' which have come under judicial scanner.

Insolvency resolution by Operational Creditor

Section 8 of the Insolvency and Bankruptcy Code, 2016 ('the Code') which deals with the insolvency resolution by Operational Creditor, provides that an Operational Creditor may, on the occurrence of a default, deliver a demand notice of unpaid operational debtor copy of an invoice demanding payment of the amount involved in the default to the Corporate Debtor in such form and manner as may be prescribed.

What is demand notice

1. The *Explanation* to Section 8 clarifies the meaning of the word, "demand notice", which means a notice served by an Operational Creditor to the Corporate Debtor demanding repayment of the operational debt in respect of which the default has occurred.

1.1 Rule 5 of the Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016 states that an Operational Creditor shall deliver to the Corporate Debtor: (*i*) a demand notice in Form 3 or, (*ii*) a copy of an invoice attached with a notice in Form 4. The demand notice or the copy of the invoice, demanding payment referred to in sub-section (2) of Section 8, may be delivered to the Corporate Debtor –

(*a*) at the registered office by hand, registered post or speed post with acknowledgment due; or

(*b*) by electronic mail service to a whole time director or designated partner or key managerial personnel, if any, of the Corporate Debtor.

Financial Institution

2. Application for initiation of Corporate Insolvency Resolution Process by Operational Creditor shall be supported with a copy of the certificate from the financial institutions maintaining accounts of the Operational Creditor confirming that there is no payment of an unpaid operational debt by the Corporate Debtor, as prescribed in clause (c) of sub-section (3) of Section 9 of the Code. In terms of clause (*14*) of Section 3 of Code, the 'Financial institution' means –

(*a*) a scheduled bank;

(*b*) financial institution as defined in Section 45-I of the Reserve Bank of India Act, 1934 ;

(*c*) Public financial institution as defined in clause (72) of Section 2 of the Companies Act, 2013 ; and

(*d*) such other institution as the Central Government may by notification specify as a financial institution.

2.1 In terms of the Section 2(e) of the Reserve Bank of India, Act, 1934, 'scheduled bank' means a bank included in the Second Schedule.

2.2 In terms of Section 45-I(c) of the Reserve Bank of India Act, 1934, 'financial institution' means any non-banking institution which carries on as its business or part of its business any of the following activities:

- The financing, whether by way of making loans or advances or otherwise, of any activity other than its own.
- The acquisition of shares, stock, bonds, debentures or securities issued by a Government or local authority or other marketable securities of a like nature.
- Letting or delivering of any goods to a hirer under a hire-purchase agreement as defined in clause (c) of Section 2 of the Hire-Purchase Act, 1972.
- The carrying on of any class of insurance business.
- Managing, conducting or supervising, as foreman, agent or in any other capacity, of chits or kuries as defined in any law which is for the time being in force in any State, or any business, which is similar thereto.
- Collecting, for any purpose or under any scheme or arrangement by whatever name called, monies in lump sum or otherwise, by way of subscriptions or by sale of units, or other instruments or in any other manner and awarding prizes or gifts, whether in cash or kind, or disbursing monies in any other way, to persons from whom monies are collected or to any other person.

But does not include any institution, which carries on as its principal business –

(*a*) agricultural operations ; or

(*aa*) industrial activity ; or

(*b*) the purchase or sale of any goods (other than securities) or the providing of any services ; or

(*c*) the purchase, construction or sale of immovable property.

so however, that no portion of the income of the institution is derived from the financing of purchases, constructions or sales of immovable property by other persons ;

"Industrial activity" means any activity specified in sub-clauses (i) to (xviii) of clause (c) of Section 2 of the Industrial Development Bank of India Act, 1964;

2.3 In terms of clause (72) of Section 2 of the Companies Act, 2013 ('the Act'), 'public financial institutions' are as follows:

- The Life Insurance Corporation of India, established under Section 3 of the Life Insurance Corporation Act, 1956.
- The Infrastructure Development Finance Company Ltd., referred to in clause (vi) of sub-section (1) of Section 4A of the Companies Act, 1956 so repealed under Section 465 of this Act.
- Specified company referred to in the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002.
- Institutions notified by the Central Government under sub-section (2) of Section 4A of the Companies Act, 1956 so repealed under Section 465 of the Act.

- Such other institution as may be notified by the Central Government in consultation with the Reserve Bank of India:

No institution shall be so notified unless (*a*) it has been established or constituted by or under any Central or State Act other than this Act or the previous company law; or (*b*) not less than fifty-one per cent of the paid-up share capital is held or controlled by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments.

Interpretation of the expressions 'demand notice' and 'financial institutions'

3. The various judicial pronouncements have more elaborately interpreted these expressions and with defined parameters.

Demand Notice and existence of dispute

3.1 Clause (*a*) of sub-section (2) of Section 8 provides that the Corporate Debtor shall, within a period of ten days of the receipt of the demand notice or copy of the invoice mentioned in sub-section (1), bring to the notice of the Operational Creditor existence of a dispute, if any, and record of the pendency of the suit or arbitration proceedings filed before the receipt of such notice or invoice in relation to such dispute. The Supreme Court in the case of *Mobilox Innovations (P.) Ltd. v. Kirusa Software (P.) Ltd. [2017] 1 IBJ (JP) 2* observed that the respondent Kirusa Software as an Operational Creditor issued a demand notice on appellant Mobilox, a Corporate Debtor, demanding payment of certain dues. Appellant responded to notice by pointing out that respondent had breached Non-disclosure agreement (NDA) between parties and divulged appellant's confidential information. According to appellant, breach of NDA amounted to a 'dispute' within meaning of clause (*a*) of sub-section (2) of Section 8, and, therefore, demand was not liable to be met. Respondent approached the National Company Law Tribunal ('NCLT') by filing application for insolvency resolution process against appellant under Section 9 and the said application was dismissed by the NCLT on grounds that a notice of dispute had been issued by appellant, hence, claim was hit by sub-clause (*d*) of clause (*ii*) of sub-section (5) of Section 9. Appellate Authority, however, allowed appeal of respondent holding that Adjudicating Authority had acted mechanically and rejected application under that sub-clause without examination. Once Operational Creditor has filed an application, which is otherwise complete, Adjudicating Authority must reject application under if notice of dispute has been received by Operational Creditor or there is a record of dispute in information utility. All that Adjudicating Authority is to see at this stage is whether there is a plausible contention which requires further investigation and that dispute is not a patently feeble legal argument or an assertion of fact unsupported by evidence, however, in doing so, Court does not need to be satisfied that defence is likely to succeed. The Supreme Court opined that the claim of Corporate Debtor, that there existed a dispute in relation to breach of non-disclosure agreement was sufficient to refuse entertainment of insolvency application by Operational Creditor. Appellate Tribunal was wholly incorrect in characterizing defense as vague, got-up and motivated to evade liability.

3.1.1 The National Company Law Appellate Tribunal ('NCLAT'), in the case of *Elecon Engineering Co. Ltd. v. Ducon Technologies (I) (P.) Ltd.* [Company Appeal (AT) (Insol) No. 14 of 2018] observed that where there was an 'existence of dispute' pending even before issuance of demand notice under sub-section (1) of Section 8, Adjudicating Authority rightly rejected application preferred by Operational Creditor to initiate insolvency resolution process.

3.1.2 The NCLAT, in the case of *Value Line Interiors (P.) Ltd. v. Rattan India Power Ltd.* [Company Appeal (AT) (Insol) No. 305 of 2017] observed that there was an 'existence of dispute' and a notice of dispute has been received by the 'Operational Creditor'. In the aforesaid background the Adjudicating Authority rightly rejected the application filed by the appellant under Section 9 of the Code.

3.1.3 The NCLAT, in the case of *Philips India Ltd. v. Goodwill Hospital & Research Centre Ltd.* [Company Appeal (AT) (Insol) No. 14 of 2017] held the same view and opined that where there was existence of dispute about claim of debt prior to issuance of notice under Section 8 by Operational Creditor, application under Section 9 for initiation of Corporate Insolvency

Resolution Process against respondent - Corporate Debtor was to be rejected.

3.1.4 The NCLAT, in the case of *Rajesh Arora v. M Y Agro (P.) Ltd.* [Company Appeal (AT) (Insol) No. 182 of 2017], observed that the demand notice under Section 8 was issued to the Corporate Debtor at its registered office and to directors at their address available on website of Ministry of corporate affairs was returned unserved except notices issued to their Company Secretary and to one ex-director, same could not be said to be complete.

Demand notice – Can it be issued by a Lawyer / Advocate

3.2 The Supreme Court in the case of *Macquarie Bank Ltd. v. Shilpi Cable Technologies Ltd. [2018] 1 IBJ (JP) 119*, opined that a demand notice under Section 8 of an unpaid operational debt can be issued by a lawyer/ advocate on behalf of Operational Creditor observed as follows:

> '33. Insofar as the second point is concerned, the first thing that is to be noticed is that Section 8 of the Code speaks of an Operational Creditor delivering a demand notice. It is clear that had the legislature wished to restrict such demand notice being sent by the Operational Creditor himself, the expression used would perhaps have been "issued" and not "delivered". *Delivery, therefore, would postulate that such notice could be made by an authorized agent*. In fact, in Forms 3 and 5 extracted hereinabove, it is clear that this is the understanding of the draftsman of the Adjudicatory Authority Rules, because the signature of the person "authorized to act" on behalf of the Operational Creditor must be appended to both the demand notice as well as the application under Section 9 of the Code. *The position further becomes clear that both forms require such authorized agent to state his position with or in relation to the Operational Creditor*. A position with the Operational Creditor would perhaps be a position in the company or firm of the Operational Creditor, but the expression "in relation to" is significant. It is a very wide expression, as has been held in *Renusagar Power Co. Ltd. v. General Electric Co. [1984] 4 SCC 679* and *State of Karnataka v. Azad Coach Builders (P.) Ltd. [2010] 9 SCC 524*, which specifically includes a position which is outside or indirectly related to the Operational Creditor. *It is clear, therefore, that both the expression "authorized to act" and "position in relation to the Operational Creditor" go to show that an authorized agent or a lawyer acting on behalf of his client is included within the aforesaid expression.*' [Emphasis supplier]

3.2.1 The NCLAT, in the case of *Macquarie Bank Ltd. v. Uttam Galva Metallics Ltd.* [Company Appeal (AT) (Insol) No. 96 of 2017], observed that the notice has been given by an advocate/lawyer and there is nothing on the record to suggest that the lawyer was authorized by the appellant, and as there is nothing on the record to suggest that the said lawyer/advocate hold any position with or in relation to the appellant company, the NCLAT opined that the notice issued by the advocate/lawyer on behalf of the appellant cannot be treated as notice under Section 8. And for the said reason also the petition under Section 9 was not maintainable.

3.2.2 The NCLAT, in the case of *Shriram EPC Ltd. v. Rio Glass Solar SA* [Company Appeal (AT) (Insol) No. 133 & 197 of 2017], held that where notice under Section 8 had not been issued by Operational Creditor but by an advocate for Operational Creditor in relation to whom no authorization had been produced by Operational Creditor, petition filed under Section 9 was not maintainable. A power of attorney holder is not empowered to file application on behalf of Operational Creditor.

3.2.3 The NCLAT, in the case of *Senthil Kumar Karmegam v. Dolphin Offshore Enterprises (Mauritius) (P.) Ltd.* [Company Appeal (AT) (Insol) No. 154 of 2017] held that where demand notice under Section 8 had been issued by an advocate of 'Operational Creditor' in relation to whom there was nothing on record to suggest that he hold any position with or in relation to Operational Creditor, instant application filed by Operational Creditor for initiating insolvency resolution process was to be dismissed. Where demand notice under Section 8 had not been issued in mandatory Form 3 or Form 4, as stipulated in Rule 5 of the Application to Adjudicating Authority Rules, 2016, application filed by Operational Creditor for initiating insolvency resolution process was to be dismissed.

Financial Institution

3.3 The NCLAT, in the case of *Macquarie Bank Ltd. v.*

Uttam Galva Metallics Ltd. [Company Appeal (AT) (Insol) No. 96 of 2017], held that Macquarie Bank Ltd is not a 'financial institution' observing that admittedly, Macquarie Bank, Australia is not a scheduled bank in India nor is a 'financial institution' as defined under Section 45-I of the Reserve Bank of India Act, 1934. Macquarie Bank, Australia also do not come within the meaning of 'public financial institution' as defined in clause (*72*) of Section 2 of the Companies Act, 2013. The Central Government has also not issued any Notification specifying 'Macquarie Bank' for the purpose of clause (*14*) of Section 3 read with Section 9. 'Macquarie Bank', Australia not being a 'financial institution' within the meaning of that clause, any certificate given by the said bank cannot be relied upon, to decide default of debt.

3.3.1 The same view was held by the NCLAT, in the case of *Shilpi Cable Technologies Ltd. v. Macquarie Bank Ltd.* [Company Appeal (AT) (Insol) No. 101 & 102 of 2017] and opined that Macquarie Bank Ltd., has not enclosed any certificate from 'financial institution' as defined under clause (14) of Section 3 and lawyer's notice as given has been deprecated by the 'Adjudicating Authority'. The Appellate Tribunal further observed that in effect order (s), if any, passed by the Adjudicating Authority appointing any 'interim resolution professional' or declaring moratorium, freezing of account and all other order (s) passed by Adjudicating Authority pursuant to impugned order and action, if any, taken by the 'interim resolution professional', including the advertisement, if any, published in the newspaper calling for applications all such orders and actions are declared illegal and are set aside. The Adjudicating Authority will now close the proceeding. The appellant company is released from all the rigour of law and is allowed to function independently through its Board of directors from immediate effect.

3.3.2 The NCLAT, in the case of *Achenbach Buschhutten CmbH & Co. v. Arcotech Ltd.* [Company Appeal (AT) (Insol) No. 97 of 2017] the NCLAT, New Delhi held that 'Sparkasse Siegen is not a 'financial institution' observing that the appellant is a company incorporated under the laws of Germany having its office at 'Siegener StraBe, 152, 57223, Kreuztal, Germany', claimed to be 'Operational Creditor' and filed an application under Section 9 to initiate Corporate Insolvency Resolution Process in respect of respondent- 'Corporate Debtor'. The respondent brought to the notice of the NCLAT that the appellant has not enclosed any certificate granted by the 'financial institution' as stipulated under clause (c) of sub-section (3) of Section 9. From the record, we find that the appellant has enclosed one letter relating to 'confirmation of receipt of payment' from foreign institution known as 'Sparkasse Siegen'. Referring to its earlier order in *Macquarie Bank Ltd. v. Uttam Galva Metallics Ltd.* (*supra*) wherein the NCLAT held that, after taking into consideration that the foreign bank was not incorporated under the Companies Act and the bank has no office in India nor any account with any of the bank or 'financial institution', the bank is not a 'financial institution' as defined under sub-section (14) of Section 3. The NCALT pointed out that the bank in question is not a scheduled bank, nor is a 'financial institution' as defined under Section 45-1 of Reserve Bank of India Act, 1934. The bank also do not come within the meaning of 'public financial institution' as defined in clause (*72*) of Section 2 of the Companies Act, 2013. The Central Government has also not issued any Notification specifying the bank in question for the purpose of clause (14) of Section 3 read with Section 9.

Summing up

4. The words' demand notice' and 'financial institution' have been well defined in the Code and the relevant Rule. The judicial pronouncements have more clarified on the issue. In order to file insolvency resolution by the Operational Creditor, a demand notice must be served on the Corporate Debtor. The format of the demand notice to be served should be in the prescribed format as mentioned in Rule 5 of the Application to Adjudicating Authority Rules, 2016. Further, the demand notice shall be issued by the Operational Creditor himself or by the authorized person. The Operational Creditor shall also ensure that no dispute exist before the issue of demand notice. If demand notice is not served as per the parameters prescribed under the Code and Rule, the same cannot be admissible under the law. Further, the financial institution which does not come within the defined boundaries of clause (14) of Section 3 cannot be treated as financial institution.

*Dr. Hemant Manuj**

**Associate Professor and Area Head – Finance at SPJIMR, Mumbai*

[2018] 1 IBJ (Art.) 54

Liquidation Value in Insolvency Resolution Process – How Relevant is it?

Ever since the Insolvency and Bankruptcy Code, 2016 was enacted, several issues were raised with regard to its implementation and were well responded by the Insolvency and Bankruptcy Board of India. One of the issues that have been of concern relates to the liquidation value of the insolvent debtor. In this article, the author examines this issue.

Introduction

1. It has been one year since the implementation of the Insolvency and Bankruptcy Code (IBC). The policy makers, especially the Insolvency and Bankruptcy Board of India (IBBI), deserve credit for being open to suggestions, criticisms, and potential solutions from the stakeholders as well as independent commentators. One of the issues that have been of concern for some time relates to the liquidation value (LV) of the insolvent debtors. It has often been highlighted by various commentators that the LV of the debtor is a conservative benchmark for valuation of a debtor. The computation of the LV assumes, ex-ante, that a firm is likely to be liquidated, which is not the true scenario under which bids for resolution of insolvency are invited. It is, therefore, argued that the disclosure of the LV at the stage of invitation for resolution artificially bids suppresses the bid values. Considering the views of various stakeholders, the requirement of disclosure of the liquidation value by the creditors has now been done away with, through an amendment to the IBC. However, the central assumption behind the debate on LV still needs to be debated more closely. Does the disclosure of LV, in itself, affect the bids? Let's examine the issue.

Disclosure of Liquidation Value

2. The bids for resolution are invited by the Insolvency Resolution Professional (IRP) in an open manner and are required to be evaluated on a competitive basis. In an ideal scenario of perfectly competitive markets, each bidder will put in her best estimate of the value that she would be willing to pay for the firm, in the same state as it is being bid for. Thus, the fair value of the debtor should get discovered through competitive bids. In such a scenario, the disclosure of LV should be just a matter of record, and of no importance. Irrespective of the LV disclosed or assumed by the creditors, the bidders would behave in their own best interests. However, we know that we are not in a perfectly competitive market. In that case,

the right approach would be to explicitly recognise and address the distortions around the competitive market for bidding. This holistic review should help in an efficient price discovery and make the disclosure of the LV irrelevant. Indeed, the debate on the lack of perfect competition does not seem to have received adequate attention of the policy makers or the commentators.

Bidding Process for Insolvency Resolution – Factors in the way of healthy competition therein

3. There are two factors in the way of a healthy competition in the bidding process for insolvency resolution. First, and most importantly, the creditors do not have any alternative to accepting the best bid for insolvency resolution, if they wish to avoid liquidation of the debtor. Why would the creditors wish to avoid liquidation of the debtor? If a debtor is to undergo liquidation, it requires maintenance and management on a going concern basis, till the liquidation process gets completed. However, unlike in many other developed markets, India does not have independent professional management entities to manage the insolvent debtor companies. As a result, a debtor company undergoing liquidation is highly likely to lose a lot of its intrinsic value with the passage of time. Thus, under the current process, the creditors suffer a perverse incentive to accept the best resolution bid, even if the valuation of the debt, as offered by the bidder, may be not matching with their own estimate of fair value of the debt.

3.1 A second factor that may suppress the insolvency resolution bid values in many cases is the lack of adequate interest or ability among the bidders to match the fair value of the debt. The former is more likely in the case of specialised or very small businesses. The latter could manifest in case of a demand of a large financial and/ or managerial commitment and inadequate availability of the same on the supply side.

3.2 In certain cases, there could also be a possibility of cartelisation among the prospective bidders. While this does not yet seem to be conclusively visible in cases of the large size insolvencies, one cannot rule out the possibility. The existing anti competition law mechanism should be referred to, along with the IBC, in a pre-determined rule based manner, applicable to all cases of insolvency.

3.3 In view of these factors, we need to strengthen our insolvency resolution framework with the central focus being on strengthening the infrastructure to encourage a healthy competition among the players in the process.

Fierce competition is a welcome sign

4. The fierce competition in the final bids for the first set of twelve large debtor accounts is a welcome sign that an open market based competition is working. The government and the regulators must now keep away from any kind of dispute resolution between the bidders, on a case-by-case basis. Instead, they should keep working on continuously improvising the infrastructure and the regulatory landscape. These include the establishment of specialised interim business management firms, encouraging interim high yield financing agencies, and deepening of bond markets, especially junk bond markets. The policymakers should stay resolutely focussed on making the markets transparent, efficient, and competitive, so that the market participants can then take care of micro issues like valuation benchmarks.

Conclusion

5.The process of insolvency resolution is a journey well begun, and we can make a true success of it, if and only if we stay disciplined and are steadfast with both the short term and long term imperatives of insolvency resolution process framework.

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