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Between the lines...

A BRIEFING ON LEGAL MATTERS OF CURRENT INTEREST

KEY HIGHLIGHTS

* **Supreme Court**: Secured creditor not categorized as either financial creditor or operational creditor is entitled to retain security interest in pledged shares.

* **Supreme Court** upholds the constitutional validity of Section 140(5) of the Companies Act, 2013, which *inter alia* imposes statutory bar on the auditor(s) for a period of five years.

* **NCLAT** upholds the insolvency proceedings against Go First.

* **NCLT**: Land owners entering into joint development agreements for sharing of profits do not come within the ambit of operational creditors.

I. Supreme Court: Secured creditor not categorized as either financial creditor or operational creditor is entitled retain security interest in pledged shares.

The Supreme Court, by a judgment pronounced on May 4, 2023, in the matter of ***Vistra ITCL (India) Limited and Others v. Mr. Dinkar Venkatasubramanian and Another [Civil Appeal No. 3606 of 2020]***, has held that by virtue of a security created by a corporate debtor in favor of a lender to secure the loan facility advanced to a third-party, even though the lender would be considered as a secured creditor of the corporate debtor, however the lender would not be considered as a financial creditor and would not form part of the Committee of Creditors ("**CoC**") of the Corporate Debtor. Nonetheless, in the present case, the Supreme Court has directed that the Appellants will be entitled to retain the security interest in the pledged shares, in order to secure the ends of justice.

Facts

Amtek Auto Limited ("**Corporate Debtor**") approached KKR India Financial Services Limited ("**Appellant No. 2**") and L&T Finance Limited ("**Appellant No. 3**") to extend a short-term loan facility of INR 500 Crores to its group companies namely, Brassco Engineering Limited ("**Brassco**") and W.L.D. Investments Private Limited ("**WLD**"), for the ultimate end use of the Corporate Debtor. As per the Appellants, it was an understanding that the Corporate Debtor will create a first ranking exclusive security by way of pledge over 16,82,06,100 equity shares having face value of INR 2/- each of JMT Auto Limited ("**JMT**") held by the Corporate Debtor.

A security trustee agreement was executed on December 28, 2015, between Vistra ITCL (India) Limited ("**Appellant No. 1**") and WLD for an amount of INR 1,50,00,00,000/-. Further, a security trustee agreement was executed between Appellant No. 1 and Brassco for INR 1,50,00,00,000/-. Thereafter, another security trustee agreement was executed between Appellant No. 1 and Brassco for INR 2,00,00,00,000/-. Thereafter, an amended and re-instated pledge agreement was executed on July 05, 2016 ("**Pledge Agreement**"), between the Corporate Debtor, WLD, Brassco and Appellant No. 1, whereby the Corporate Debtor pledged 66.77% of its shareholding in JMT to secure the term loan facilities availed by WLD and Brassco from Appellant No. 2 and Appellant No. 3.

On July 24, 2017, Corporate Insolvency Resolution Process ("**CIRP**") was initiated against the Corporate Debtor under the provisions of the Insolvency and Bankruptcy Code, 2016 ("**IBC**") wherein Mr. Dinkar T. Venkatasubramanian ("**Respondent No. 1**") was appointed as the interim resolution professional and he was subsequently confirmed as the resolution professional.

On November 2, 2017, Appellant No. 1 filed its claim as a secured financial creditor of the Corporate Debtor for a principal amount of INR 500 Crores. However, the aforesaid claim was rejected by the Respondent No. 1 in 2017 and such rejection was not challenged by the Appellants before the National Company Law Tribunal, Chandigarh ("**Adjudicating Authority**").

Further, the Respondent No. 1 had received two resolution plans from entities namely, Liberty House Group Private Limited ("**LHG**") and Deccan Value Investors ("**DVI**") respectively. However, DVI withdrew its resolution plan and the revised resolution plan submitted by LHG was approved by the CoC of the Corporate Debtor on April 2, 2018, with majority voting shares of 94.20%. Thereafter, the aforesaid resolution plan submitted by LHG was approved by the Adjudicating Authority on July 25, 2018. However, thereafter, LHG failed to fulfil its obligations as committed in terms of the approved

resolution plan and the Adjudicating Authority passed an order directing the CoC to reconsider the resolution plan of DVI.

Thereafter, the Appellants filed an application before the Adjudicating Authority claiming their right on the basis of pledged shares. However, the Adjudicating Authority dismissed the aforesaid application filed by the Appellants. Thereafter, upon approaching the National Company Law Appellate Tribunal, New Delhi ("**Appellate Authority**"), the Appellate Authority dismissed the appeal. While dismissing the appeal, the Appellate Authority observed that the claim form submitted by Appellant No. 1 as a secured financial creditor was rejected by Respondent No. 1 in 2017 and it was not challenged before the Adjudicating Authority at that time and therefore, the Appellants are not entitled to raise the same issue in 2020. Further, the Appellate Authority had also observed that the Appellant No. 1 has not lent any money to the Corporate Debtor and reiterated the view of the Adjudicating Authority that the Appellant would not come within the purview of financial creditor.

Aggrieved by the aforesaid decision of the Appellate Authority, the Appellants preferred a civil appeal before the Supreme Court.

Issue

Whether in case of third-party security created by a corporate debtor, the lender who is a secured creditor qua the corporate debtor but neither considered as financial nor operational creditor qua the corporate debtor, would be entitled to retain the security interest in the asset created by the corporate debtor.

Arguments

Contentions of the Appellants:

The Appellants contended that the observation made by the Appellate Authority, that the Appellant have challenged the rejection of claim by Respondent No. 1 after a delay of nearly three years, is erroneous since it is a case of continuing cause of action. It was further contended that no limitation is prescribed for challenging the categorization of the creditors in a wrongful category.

Further, the Appellants contended that they had challenged their non-inclusion in the CoC as secured financial creditor on February 11, 2020, which is nearly five months prior to the date of approval of resolution plan by the Adjudicating Authority (that is, July 09, 2020).

Further, the Appellants contended that there exists a creditor-debtor relationship between the appellants and the Corporate Debtor. It was submitted that debt arising out of pledge of shares amounts to financial debt by virtue of the definition of "security interest" envisaged under Section 3(31) of the IBC.

Contentions of the CoC:

CoC raised the issue of the Appellants challenging the rejection of claim by Respondent No. 1 by approaching the Adjudicating Authority after a delay of nearly three years and further submitted that even in the numerous correspondences addressed to Respondent No. 1, Appellant No. 1 never raised the aforesaid grievance, but merely requested to Respondent No. 1 to ensure that the pledged shares are not dealt with in any manner without the prior written consent of Appellant No. 1. CoC further submitted that the Appellants had filed the application before the Adjudicating Authority on February 11, 2020

not to challenge the claim rejection, but for seeking admission into the CoC.

Further, the CoC placed reliance on judgment delivered by the Supreme Court in the matter of ***Anuj Jain Interim Resolution Professional for Jaypee Infratech Limited v. Axis Bank Limited [(2020) 8 SCC 401]*** ("**Anuj Jain Case**") and ***Phoenix ARC Private Limited v. Ketulbhai Ramubhai Patel [(2021) 2 SCC 799]*** ("**Phoenix Case**") to substantiate its contention that the Appellants cannot be considered a financial creditors of the Corporate Debtor by virtue of a third-party security created by the Corporate Debtor in the form of pledged shares with respect to the amounts advanced by Appellant No. 2 and Appellant No. 3 to the group companies of the Corporate Debtor.

Observations of the Supreme Court

The Supreme Court observed that in Anuj Jain Case the court held that even though the lenders of Jaypee Associates Limited are secured creditors of Jaypee Infratech Limited ("**JIL**") within the realms of IBC, they cannot be considered as financial creditors of JIL and would not form part of the CoC of JIL merely by virtue of third-party security creation. Further, relying upon its previous judgment in the matter of Anuj Jain Case, the Supreme Court in Phoenix Case held that Phoenix ARC Private Limited cannot be considered a financial creditor of Doshion Limited and Doshion Veolia Water Solutions Private Limited by virtue of third-party security creation. The Supreme Court observed that even in the present case, the liability to repay the financial facility was on the group companies of the Corporate Debtor who had availed the facility and not on the Corporate Debtor.

Thereafter, the Supreme Court examined whether the resolution plan can dilute, negate or override the Pledge Agreement because a resolution plan to such effect has been approved by the CoC. In this regard, Supreme Court observed that certain amendments were made in Section 30(2) of the IBC to secure the interests of operational creditors and dissenting financial creditors. However, in so far as creditors like Appellant No. 1, who are secured creditors but neither financial creditors nor operational creditors, a highly peculiar situation would arise wherein such creditors will be left remediless in terms of the amounts allocated to them upon implementation of an approved resolution plan since such creditors would neither avail the benefit available to the financial creditors nor the benefit available to the operational creditors. Hence, the Supreme Court observed that Appellant No. 1, not being a secured financial creditor is neither in a position to opt to realize its security interest in terms of Section 52(1)(b) (*Secured creditor in liquidation proceeding*) of the IBC nor it is in a position to receive sale proceeds at a relatively higher priority in the event of relinquishment of security interest to the liquidation estate.

In view of the above-mentioned issue, the Supreme Court considered two possible solutions. The first was to treat the secured creditor as a financial creditor of the Corporate Debtor to the extent of the estimated value of the pledged share on the date of commencement of the CIRP, which would make it a member of the CoC and give it voting rights equivalent to the estimated value of the pledged shares. However, this would lead to reconsideration of the earlier judgments in the matters of Anuj Jain Case and Phoenix Case and require reference to a larger bench of the Supreme Court. In view of the aforesaid reason, the Supreme Court observed that the first solution is not feasible.

Therefore, Supreme Court decided to treat Appellant No. 1 as a secured creditor in terms of Section 52 read with Section 53 of the IBC. The Supreme Court gave the option to DVI to treat Appellant No. 1 as a secured creditor, who will be entitled to retain the security interest in the pledged shares and would be entitled to retain the security proceeds on the sale of the said pledged shares under Section 52 of the IBC read with Rule 21A of the Insolvency and Bankruptcy Board of India (Liquidation Process)

Regulations, 2016. The Supreme Court further clarified that the aforesaid direction would not be a ground for DVI to withdraw the resolution plan which has already been approved by the Appellate Authority as well as the Supreme Court. The Supreme Court further observed that the aforesaid recourse would be equivalent in monetary terms for Appellant No. 1 and would be a fair and just solution in the interest of justice.

Decision of the Supreme Court

In view of the above-mentioned findings, the Supreme Court partly modified the impugned judgment of the Appellate Authority, holding that Appellant No. 1 would be entitled to all rights and obligations as applicable to a secured creditor in terms of Sections 52 and 53 of the IBC and in accordance with the Pledge Agreement. Accordingly, the Supreme Court disposed of the present appeal without any order as to costs.

VA View:

By way of the present judgment, the Supreme Court has settled a highly pertinent question of law. As such, lenders to group company having security over assets of corporate debtor are left remediless since such lenders would neither be able to avail the benefit available to the financial creditors nor the benefit available to the operational creditors.

In order to address this peculiar situation as evident from the facts of the present case, the Supreme Court directed that such lenders will be entitled to retain the security interest in the asset created by the corporate debtor. By providing an out of the box solution, the Supreme Court has endeavored to strike a fine balance to secure the ends of justice and equity.

II. Supreme Court upholds the constitutional validity of Section 140(5) of the Companies Act, 2013, which *inter alia* imposes statutory bar on the auditor(s) for a period of five years.

The Hon'ble Supreme Court of India ("**Supreme Court**"), in the case of ***Union of India v. Deloitte Haskins and Sells LLP and Another [Criminal Appeal Nos. 2305-2307/2022]*** ("**Judgement**"), has upheld the constitutionality of Section 140(5) (*Removal, resignation of auditor and giving of special notice*) of the Companies Act, 2013 ("**Companies Act**"), which *inter alia* renders the auditor(s) ineligible from acting as auditors for any company for a period of five years.

Facts

The Department of Economic Affairs, Ministry of Finance issued an office memorandum dated September 30, 2018 ("**Office Memorandum**") requesting the Ministry of Corporate Affairs ("**MCA**") to take actions against IL&FS Financial Services Limited ("**IL&FS**") under the Companies Act against the alleged series of defaults with an aggregate debt burden of more than INR 91,000 Crores. The MCA directed the Serious Fraud Investigating Officer ("**SFIO**") to conduct the investigations. SFIO submitted its interim-report to the MCA on November 1, 2018 ("**Interim Report**").

The National Company Law Tribunal ("**NCLT**"), on a petition filed by the MCA under Section 130 (*Re-opening of accounts on court's or Tribunal's orders*) of the Companies Act basis the Interim Report, directed the re-opening and recasting of the accounts of IL&FS. The auditors BSR & Associates LLP ("**BSR**") and Deloitte Haskins and Sells LLP ("**Deloitte**") (collectively referred to as "**Respondents**") were given notice of the said petition.

Meanwhile, the Reserve Bank of India also initiated an inspection of the IL&FS group, and submitted its inspection report dated March 22, 2019, to the new board of directors of IL&FS. Subsequently, SFIO completed its investigation and submitted its final report to the MCA, on the basis of which MCA filed a petition under Section 140(5) of Companies Act on June 10, 2019 before NCLT against BSR & Deloitte *inter alia,* for their removal, and barring them to take up audit activities of any company for next five years ("**Petition**"). The NCLT upheld the maintainability of Petition.

Thereafter, BSR filed a writ petition before the High Court of Bombay ("**High Court**") *inter alia* challenging the constitutionality of Section 140(5) of the Companies Act and challenging the maintainability of the Petition. The High Court upheld the constitutionality of Section 140(5) of the Companies Act, however it set aside the order of NCLT to the extent it had held that the Petition was maintainable against the auditors, primarily on the ground that once the auditor resigns as an auditor or is no more an auditor on his resignation, the proceedings against such auditors stands terminated.

Being aggrieved by the order of High Court, Union of India ("**Appellant**") preferred the present appeal before the Supreme Court.

Issues

1. Whether Section 140(5) of the Companies Act is constitutional.

2. Whether a petition under Section 140(5) of the Companies Act is maintainable against an auditor who is no more an auditor of a company.

Arguments

Contentions of the Appellant:

The Appellant submitted that the purpose and legislative intent behind Section 140(5) of the Companies Act was based on the recommendation of the J.J. Irani Committee and the Parliamentary Standing Committees' Reports and it was to make the role of an auditor more independent, yet accountable. The Appellant relied on the judgement of the Supreme Court in ***Devas Multimedia Private Limited v. Antrix Corporation Limited and Another [(2023) 1 SCC 216]***, to contend that the public policy behind Section 140(5) of the Companies Act is to prevent an auditor who has been found to perpetrate fraud or colluding from undertaking statutory audits for a period of five years.

It was also submitted that the second proviso to Section 140(5) of the Companies Act was a substantive provision which is automatically activated on the final order by the NCLT's satisfaction of fraud or collusion by the auditor company. Yet, in case the NCLT did not find any element of fraud or collusion by the auditor company in its final order, the auditor could be re-instated. It was further submitted that in case Section 140(5) of the Companies Act would cease to apply in case of resignation by the auditor,

the entire scheme of Section 140(5) of the Companies Act and Chapter X (*Audit and Auditors*) of the Companies Act would become nugatory, which was not the legislative intent.

Contentions of the Respondents:

The Respondents submitted that Section 140(5) of the Companies Act was meant to only ensure that a recalcitrant auditor resigns and thus when the auditor had so resigned, the Petition was subsequently not maintainable against such auditor.

It was also contended that the second proviso to Section 140(5) of the Companies Act was arbitrary, harsh and burdensome and ought to be read down as being violative of Articles 14 and 19 of the Constitution of India ("**Constitution**"). In this regard, it was also contended that the ineligibility to act as an auditor of any company prescribed under the second proviso to Section 140(5) of the Companies Act could only extend to the audit partners concerned and not to the entire firm and the other audit partners who were not connected with such fraudulent acts.

Observations of the Supreme Court

The Supreme Court observed that Chapter X of the Companies Act is a special provision through which the legislators intended to make the provisions for the auditors more stringent and for removal of auditor by the NCLT where there is a fraud committed by such auditor and contemplated that such auditor shall not be eligible to be appointed as an auditor of any company for a period of five years.

The Supreme Court further observed that the power of NCLT under Section 140(5) of the Companies Act is *quasi-judicial* in nature and it would have the power of a civil court to examine the role of the auditors and adjudicate on their role, more particularly whether it was fraudulent or not. The first proviso to Section 140(5) of the Companies Act provides power to the NCLT to, *suo-moto* or an application made by the central government, remove such auditor and appoint a new auditor. The measure was in the nature of *pro-tem* or interim order, based upon the NCLT's satisfaction that there is a fraud that has been perpetrated and the circumstance requires substitution of the auditor.

The Supreme Court observed that the second proviso to Section 140(5) of the Companies Act was a substantive provision which gets triggered automatically when a final order has been passed by the NCLT after a detailed enquiry to the effect that the auditor of a company has, directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its director or officers. To the corollary, it also observed that the High Court had erred in its interpretation of Section 140(5) of the Companies Act when it held that the proceedings under the section was not maintainable once the auditor had resigned or was no more an auditor for any reason. The Supreme Court also cautioned that such interpretation would have the consequence where every auditor would resign in order to save itself from the stringency of Section 140(5) of the Companies Act and continue perpetrating fraud.

With regards to the constitutionality of Section 140(5) of the Companies Act, the Supreme Court observed that the provision was not discriminatory against the auditors since the role of an auditor is vital in the affairs of the company and therefore, they have to act in larger public interest. In so far as the contention that the 'automatic effect' of penalty envisaged under the section was concerned and the contention that it was highly disproportionate, Supreme Court took the view that it was for the legislative wisdom to decide upon the quantity of penalty and how it would take effect. The Supreme

Court also observed that Section 140(5) of the Companies Act did not fall within the purview of Article 19 of the Constitution since an auditor's and its partners' fundamental right to carry on its profession could not be permitted where it had acted fraudulently, whether directly or indirectly. Such a fraudulent act was a serious misconduct which has to be dealt with sternly and therefore, automatic penalty under Section 140(5) of the Companies Act was a natural consequence of indulging into such misconduct.

Decision of the Supreme Court

The Supreme Court held that resignation of the auditors did not terminate the power of NCLT to take action against them and from attracting penalty envisaged under Section 140(5) of the Companies Act read with Section 447 of the Companies Act. The Supreme Court also upheld the constitutional validity of Section 140(5) of the Companies Act vis-à-vis Articles 14 and 19 of the Constitution.

VA View:

The Supreme Court has rightly upheld the vires of Section 140(5) of the Companies Act. It has given a purposive interpretation to the section in consonance with the legislative intent, that resignation of an auditor or its partner, could not terminate the proceeding under Section 140(5) of the Companies Act if the final order to the NCLT's satisfaction found element of fraud or collusion, whether directly or indirectly.

The Supreme Court has rightly trisected Section 140(5) of the Companies Act into: (i) the quasi-judicial power of NCLT to adjudge on the role of the auditor; (ii) the power of NCLT to remove the auditor in case of a *prima facie* satisfaction of fraud, in the nature of an interim order; and (iii) upon a detailed enquiry, if the NCLT finds commission of fraud, to debar the auditor from undertaking audit for a period of five years.

This is a forward looking judgement which will instill confidence in the stakeholders, especially the investors and will act as a deterrent for the defaulting auditors.

III. NCLAT upholds the insolvency proceedings against Go First.

The National Company Law Appellate Tribunal ("**NCLAT**"), collectively in the matters of:

SMBC Aviation Capital Limited v. Interim Resolution Professional of Go Airlines (India) Limited, Abhilash Lal [Company Appeal (AT) (Insolvency) No. 593 of 2023],

SFV Aircraft Holdings IRE 9 DAC v. Interim Resolution Professional of Go Airlines (India) Limited, Abhilash Lal [Company Appeal (AT) (Insolvency) No. 603 of 2023],

GY Aviation Lease 1731 Company Limited and Others v. Interim Resolution Professional of Go Airlines (India) Limited, Abhilash Lal [Company Appeal (AT) (Insolvency) No. 604 of 2023],

Engine Leasing Finance B.V. v. Interim Resolution Professional of Go Airlines (India) Limited,

Abhilash Lal [Company Appeal (AT) (Insolvency) No. 615 of 2023],

upheld the initiation of Corporate Insolvency Resolution Process ("**CIRP**") of Go Airlines (India) Limited ("**Corporate Applicant/ Respondent**") under the Insolvency and Bankruptcy Code, 2016 ("**IBC**").

Facts

Pratt & Whitney ("**P&W**") supplied faulty engines to the Corporate Applicant, owing to which the Corporate Applicant suffered losses and had to cancel several flights. After multiple attempts to resolve the issue amicably with P&W, an emergency arbitration was filed before the Singapore International Arbitration Centre against P&W, wherein the arbitrator passed arbitration awards requiring P&W to provide replacement engines which were not complied by P&W. Consequently, Corporate Applicant initiated enforcement proceedings against P&W in Delaware, U.S. and other relevant jurisdictions where engines were located.

The Corporate Applicant had committed a default of INR 2,660 Crores toward aircraft lessors, INR 1,202 Crores towards operational creditors (*including dues towards its vendors*) and default of INR 11.03 Crores (*towards interest dues of the Financial Creditors, which did not exist on the date of filing the application*). SMBC Aviation Capital Limited, GY Aviation, SFV Aircraft Holdings and Engine Leasing Finance B.V. ("**Lessors/ Appellants**") had leased aircraft(s) to the Corporate Applicant.

Consequently, the Corporate Applicant sought for initiation of CIRP against itself and filed an application under Section 10 (*Initiation of corporate insolvency resolution process by corporate applicant*) of the IBC ("**Application**"). The New Delhi Special Bench of the National Company Law Tribunal ("**NCLT**") admitted the Application by its order dated May 10, 2023 and initiated CIRP against the Corporate Applicant which resulted in a moratorium ("**Impugned Order**") owing to which, the possession of the aircraft could not be taken by the lessors. NCLT also passed an order for suspension of the Corporate Applicant's board of directors and ex-management. Mr. Abhilash Lal was appointed as an Interim Resolution Professional ("**IRP**") by NCLT to keep the Corporate Applicant as a going concern and run its services smoothly and to check that retrenchment of employees is not resorted to.

Aggrieved by the Impugned Order, Appellants filed the present appeal before the NCLAT.

Issues

1. Whether issuance of a notice to the creditors is necessary for granting hearing or opportunity of hearing, before admission of Application.

2. Whether the adjudicating authority is required to give an opportunity to the creditor to file an application under Section 65 (*Fraudulent or malicious initiation of proceedings*) of the IBC before admitting the application under Section 10 of the IBC, where the creditors have an objection to the said application for being filed fraudulently with malicious intent.

3. Whether moratorium will be applicable to the assets in case where the Lessors have terminated the lease agreement prior to the admission of Application.

4. Whether the Appellants are entitled to claim possession of the aircraft(s) and export the aircraft(s) as per the lease agreement where the Appellants have terminated the lease agreement prior to admission of the CIRP.

Arguments

Contentions of the Appellants:

The Appellants contended that the Impugned Order violates the principles of natural justice, since NCLT did not take into consideration the time period sought by the Appellants for filing an application under Section 65 of the IBC. Additionally, the Impugned Order has been passed without serving the copy of Application on the Appellants.

The Appellants also contended that there were objections raised against the Corporate Applicant's fraudulent and malicious intent and it should have been taken into consideration and an opportunity to file an application under Section 65 of the IBC ought to have been granted before the admission of the Application.

The Appellants placed reliance on judgment of the NCLAT in ***Wave Megacity Centre Private Limited v. Rakesh Taneja and Others [Company Appeal (AT) (INS.) No. 918 of 2022]***, wherein the order of the adjudicating authority was challenged by the corporate applicant, as a result of which the application under Section 10 of the IBC was rejected and the application under Section 65 of the IBC was allowed.

Additionally, the Appellants contended that the lease agreement executed in favour of the Corporate Applicant was terminated prior to the admission of the Application. Therefore, the Corporate Applicant has no legal right in respect to the aircraft's possession, therefore moratorium under Section 14 (*Moratorium*) of the IBC is not applicable on the assets of the Appellants.

Contentions of the Respondent:

The Respondent contended that the moratorium has been imposed under Section 14 of the IBC by which the Appellants are prohibited from recovering the assets. Consequently, the Appellants cannot recover any property, which is in possession of the Corporate Applicant. As the Corporate Applicant has the possession of the aircraft(s), it is also registered in their name and the said registration has not yet been cancelled, the Corporate Applicant is entitled to retain the possession.

The Respondent contended that the termination of lease took place after the Application. It was also contended by the Respondent that the principles of natural justice are not violated by the Impugned Order as there exists no requirement that the creditors should be heard before admission of an application under Section 10 of the IBC.

The Respondent submitted that there is no mandatory requirement to issue a notice to the creditors at the pre-admission stage under Section 10 of the IBC. It is a discretion which is exercised on a case-to-case basis on valid grounds. Here, in this case, the Application was accepted by the NCLT. Further, no application under Section 65 of the IBC was filed or put forth before the NCLT for consideration. Filing and decision of an application under Section 65 of the IBC can take place even after the admission of application under Section 10 of the IBC.

Observations of the NCLAT

It was observed by the NCLAT that there is no obligation on the Corporate Applicant to issue a prior notice to the creditors for initiation of the CIRP under IBC. However, during the admission proceedings NCLT must hear the objectors and accordingly take an appropriate decision. Further, NCLAT observed that the Corporate Applicant has not violated the principles of natural justice in the present case by merely not issuing a notice to the creditors, more so when objectors were heard by NCLT. Furthermore, NCLAT held that the application by the Corporate Applicant was not fraudulent with malicious intent and Appellants have the liberty to file an application under Section 65 of the IBC even after Application has been admitted.

NCLAT also granted liberty to the IRP and the Appellants for advancing appropriate application before NCLT for the purpose of declaring the applicability of the moratorium on the aircraft(s) regarding which leases in favour of the Corporate Applicant were terminated prior to admission of Application and it would to be decided by NCLT as per the provisions of law.

Decision of the NCLAT

The NCLAT disposed of the appeal filed by the Lessors and upheld the Impugned Order. Further, the NCLAT ordered the Lessors to file applications before the NCLT for the purpose of declaration on the moratorium's applicability and make claims regarding the leased aircraft(s).

VA View:

It can be observed that this is a landmark case where a creditor did not file the application for insolvency, rather the CIRP commenced due to an application of the Corporate Applicant filed directly with the NCLT. The Application was a move to prevent the lessors from seizing the aircraft's possession from the hands of the Corporate Applicant and an attempt by the Corporate Applicant to safeguard itself from further financial distress thereby resulting in a breach of its obligations towards the creditors.

This case may establish a new trend for further insolvency cases against the legislative intent wherein the Corporate Applicant may follow the similar shorter roadmap for obtaining a temporary monetary ease by directly approaching NCLT and filing an application for its insolvency to dispose of its liabilities in the event of business downturns.

IV. NCLT: Land owners entering into joint development agreements for sharing of profits do not come within the ambit of operational creditors.

The National Company Law Tribunal, Principal Bench, New Delhi ("**NCLT**") has, in its order dated May 12, 2023 ("**Order**"), in the matter of ***Mrs. Jesleen Kaur Papneja v. Raheja Developers Limited [Company Petition (IB)/392(PB)/2019]***, held that an agreement in the nature of a joint development agreement, for sharing of profits in an agreed upon ratio, does not come within the ambit of an operational debt and that the land owners entering into such joint development agreements do not come within the ambit of operational creditors.

Facts

M/s Raheja Developers Limited ("**Corporate Debtor**") was a real estate developer company engaged in the development and construction of integrated residential/ commercial plotted colonies/ group housing apartments, etc. Mrs. Jesleen Kaur Papneja ("**Applicant**") along with three land owners (collectively, "**Land Owners**") and the Corporate Debtor had entered into a collaboration agreement dated August 13, 2012, which was subsequently amended by a supplementary collaboration agreement dated June 25, 2013 ("**Collaboration Agreement**"), for the development of certain land admeasuring 24.1563 acres ("**Total Land**") in which the Land Owners had an undivided share. Out of the Total Land, the Corporate Debtor had procured a license for 12.48675 acres ("**Licensed Land**") from the Directorate of Town and Country Planning for the development of a residential group housing project namely 'Raheja Vanya' ("**Project**"). The balance land admeasuring 11.6695 acres remained unlicensed.

A memorandum of understanding dated October 7, 2016 ("**MoU**") was entered into between the Corporate Debtor and the Land Owners wherein the Land Owners permitted the Corporate Debtor to construct, develop, maintain, and sell the Land Owners' share, subject to the terms and conditions of the MoU. Under the MoU, the Land Owners agreed to provide the Corporate Debtor with the following:

1. An exclusive right to develop and construct the Licensed Land;
2. An exclusive and absolute right to sell the flat units and other saleable area of the Project;
3. The right to convey and transfer the title and interest in the Project; and
4. Exclusive and irrevocable rights with respect to the development of the Project.

In consideration of the abovementioned rights, the Corporate Debtor had agreed to develop the Project at its own cost and pay certain amounts to the Land Owners under various heads as agreed upon under the terms of the MoU, including 'revenue sharing'.

Subsequently, an agreement dated October 25, 2016 ("**Agreement**") was entered into by and amongst the Corporate Debtor, Mr. Navin M. Raheja (personal guarantor), Raheja SEZs Limited (mortgagor No. 1) and Enkay Buildwell Private Limited (mortgagor No. 2) (collectively, "**Raheja Group**") and the Land Owners. Since the Project was given as cross collateral for other project loans, the Raheja Group had, agreed to ensure the payment of the Land Owners' entitlement under the MoU by providing security/ mortgage/ hypothecation, etc., on a second charge basis certain mortgaged properties and receivables, subject to the terms and conditions of the Agreement. Under the terms of the MoU and the Agreement, the Land Owners were entitled to payments towards the Total Land purchase with development rights by the Corporate Debtor. Further, as per the MoU, the Land Owners were also entitled to 23.5% of the amounts received from the customers of the Project and such amount was to be disbursed by the Corporate Debtor in the manner provided in the MoU and the Agreement.

The total collection from the Project till September 2017 was INR 71.3 Crores, out of which the Land Owners' share of 23.5% amounted to INR 16.7 Crores. From the total amount of INR 16.7 Crores payable by the Corporate Debtor, a balance of INR 9.10 Crores remained unpaid to the Land Owners.

Consequently, the Applicant served a demand notice dated December 7, 2018, under Section 8 (*Insolvency resolution by operational creditor*) of the Insolvency and Bankruptcy Code, 2016 ("**IBC**") demanding the payment of INR 9.10 Crores ("**Demand Notice**") as a share in contravention of Clause

5.5.1 of the MoU. The Applicant had also claimed that the default amount payable by the Corporate Debtor was approximately INR 1,51,70,000/- due as on September 30, 2018.

Owing to the above, the Applicant had filed an application under Section 9 (*Application for initiation of corporate insolvency resolution process by operational creditor*) of IBC read with Rule 6 (*Application by operational creditor*) of the Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016, for initiating corporate insolvency resolution process against the Corporate Debtor ("**Application**").

Issue

Whether the dues to land owners entering into joint development agreements for sharing of profits can be treated as 'operational debt' within the provisions of the IBC.

Arguments

Contentions of the Applicant:

The Applicant contended that the lender of the Corporate Debtor, namely L&T Financial Services, had by its e-mail dated October 24, 2018 informed the Land Owners for the first time about the total collection from the Project as on September 2017.

The Applicant further submitted that land and construction over that land was the main component for development of any real estate project. The Licensed Land and the development rights over such land were directly related to the units/ product which were being developed, marketed and sold by the Corporate Debtor for its commercial operation/ production. Moreover, real estate companies generally treated land and building as 'stock in trade' in their books of accounts. Therefore, the Land Owners of the Licensed Land were ought to be treated as operational creditors of the Corporate Debtor.

Contentions of the Corporate Debtor:

The Corporate Debtor denied all the averments made by the Applicant and submitted that the Application was not maintainable considering that the debt claimed by the Applicant did not fall within the purview of operational debt under the IBC. Moreover, no goods or services were supplied/ rendered to the Corporate Debtor.

The Corporate Debtor contended that the Land Owners had executed a Collaboration Agreement for the development of a residential group housing colony over the Licensed Land, wherein the parties were to make payments towards external development charges and infrastructure development charges in proportion to their respective shares. Hence, the Land Owners and the Corporate Debtor were in joint collaboration. Further, a backup security agreement dated October 25, 2016 had been executed by and amongst the Land Owners and the Corporate Debtor, under the terms of which a net amount of INR 130 Crores was payable to the Land Owners as minimum security, which was inclusive of the amounts previously paid to the Land Owners and the alleged debt of INR 9.10 Crores, that had been claimed by the Applicant in the Demand Notice.

The Corporate Debtor contended that it had made a payment of INR 3 Crores towards pass through charges in compliance with Clause 5.5.1 of the MoU, which specifically provided that the first charge

on receivables was towards 'pass through charges' and not towards payments to Land Owners. However, the Applicant objected such payment of INR 3 Crores towards pass through charges. Consequently, the Corporate Debtor preferred an application under Section 9 (*Interim measures, etc., by Court*) of the Arbitration and Conciliation Act, 1996. The Corporate Debtor submitted that the said matter was taken up in arbitration by the Corporate Debtor prior to the Demand Notice. However, the arbitration application was subsequently dismissed by the adjudicating authority.

The Corporate Debtor also submitted that the Demand Notice was an afterthought, despite knowledge of the pre-existing arbitration application. The Applicant, instead of filing her reply to the arbitration application preferred by the Corporate Debtor, chose to send the Demand Notice. Moreover, the claims under the Demand Notice had jeopardised the development of the entire Project.

The Corporate Debtor concluded its arguments by stating that the Land Owners could not claim to be considered as operational creditors as they had neither supplied any goods nor rendered any services to the Corporate Debtor.

Observations of the NCLT

The NCLT observed that upon perusal of the definition of the term 'operational debt' under Section 5(21) of the IBC, it was clear that the definition is comprehensive in nature and has to be understood within the four corners of the IBC. Operational debt means a '*claim in respect of the provision of goods and services*'.

The NCLT perused the terms of the Collaboration Agreement, the MoU and the Agreement and observed that the transactions involved in the instant case were in the nature of a joint development agreement wherein the Corporate Debtor, being the developer, was to develop the land and the profits arising therefrom were to be shared amongst the Land Owners and the Corporate Debtor as per the agreed terms of the said Collaboration Agreement, the MoU and the Agreement.

The NCLT observed that it had been reiterated in several cases, both by the NCLT and the National Company Law Appellate Tribunal, that joint development agreements do not come within the ambit of 'financial debt' as defined under the IBC, and therefore, the question to be deliberated upon was whether such agreements and claims arising therefrom could be characterised as a 'operational debt'.

The NCLT observed that the Applicant in her submissions before the NCLT was suggesting that there was a direct nexus between the units sold by the Corporate Debtor and the Licensed Land, the ownership of which belonged to the Land Owners and so, the Land Owners were to come within the ambit of operational creditors. The NCLT further observed that the Applicant was attempting to give a very wide interpretation to Section 5(21) of the IBC which was not the legislative intent of the IBC.

Reasonably, while the Land Owners and the Corporate Debtor had, by way of entering into various agreements, shared a legal and binding relationship with mutual financial obligations towards each other, the transactions were not in the nature of 'operational debt'. Therefore, the agreements entered into between the Corporate Debtor and the Land Owners could neither be considered within the ambit of 'operational debt' under Section 5(21) of the IBC, nor could the Land Owners be treated as 'operational creditors' under Section 5(20) of the IBC and thereby under Section 9 of the IBC.

Decision of the NCLT

The NCLT opined that the nature of the agreement entered into between the Corporate Debtor and the Land Owners was that of a joint development agreement for development of the Project with the motive of sharing profits in an agreed upon ratio.

Therefore, the agreements were not to be read in isolation and were rather to be seen collectively as a whole, and since the joint development agreements were entered into with a motive for the development of the Project and sharing of the proceeds therefrom, rather than as a provision of goods or services, there was no case for the Application to be covered and admitted under Section 9 of the IBC. The NCLT did not find any merit in the Application and therefore dismissed the same.

VA View:

It has been observed in several judicial precedents that the rights of land owners under joint development agreements have not been favoured and such land owners have not been regarded as operational or financial creditors within the provisions of the IBC. The NCLT, through this Order has clarified that the legislative intent of the IBC is to safeguard the interests of legitimate third-party creditors who must not be affected by *inter-se* disputes between the land owners and the developer.

The NCLT has reiterated that in order to be considered as an operational creditor under Section 5(20) of the IBC, one must be entitled to an 'operational debt', that is, claims relating to the provision of goods or services. Since a joint development agreement is entered into with the intent of sharing profits and not for the provision of goods or services, land owners who enter into such joint development agreements cannot be considered as operational creditors within the ambit of the IBC.

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