Dispute Resolution Hotline

January 23, 2024

ARBITRABILITY OF DEBT AGREEMENTS: IMPACT ON INVESTORS

- Financial institutions governed by the Recovery of Debts and Bankruptcy Act, 1993 ("**RDB Act**") cannot opt for arbitration as a mechanism for adjudication of claims in relation to the determination of debt due.
- Claims of financial institutions governed by the RDB Act can only be adjudicated by the Debt Recovery Tribunal ("**DRT**").
- Debenture trustees being financial institutions under the RDB Act, are precluded from initiating arbitration proceedings to recover amounts payable to debenture holders under debenture subscription agreements.
- Non-Banking Financial Companies ("**NBFCs**") if notified as financial institutions under the RDB Act, will also be precluded from arbitrating their claims pertaining to the determination of debt due under investment agreements.

INTRODUCTION

The Bombay High Court ("**the Court**") in a recent judgement in the case of *Tata Motors Finance Solutions Ltd. v. Naushad Khan*[i] held that a financial institution as defined under the RDB Act will compulsorily have to approach the DRT for the adjudication and crystallisation of the debt recoverable from the borrower. However, a financial institution as defined under the SARFAESI Act can choose to arbitrate for the determination of the amount of debt due.

FACTUAL BACKGROUND

Tata Motors Finance Solutions Limited ("**the Lender**") had entered into Loan-cum-Hypothecation-cum-Guarantee Agreements ("**the Agreements**") with Naushad Khan and Parveen Travels Pvt. Ltd. ("**the Borrower**") for the purchase of vehicles. The loan under the Agreements, was secured by hypothecation of the vehicles. The Respondents defaulted on the repayment and sold one of the vehicles. Hence, fearing that the other vehicles would be also disposed off, the Lender filed an application under Section 9 of the Arbitration and Conciliation Act, 1996 ("**Arbitration Act**") seeking interim reliefs against the Respondents. Simultaneously, the Lender also filed an application under Section 11 of the Arbitration Act, seeking the appointment of an arbitrator.

ISSUE

The Respondents had contended that the Lender has a statutory remedy under the SARFAESI Act to approach a special tribunal i.e., the DRT for the determination of the amount of debt due. Therefore, the Lender cannot resort to arbitration proceedings, notwithstanding the existence of an arbitration clause in the Agreements.

JUDICIAL REASONING

As per the Supreme Court in *Vidya Drolia*,[ii] if a special statute provides a prescribed mechanism for the resolution of disputes pertaining to a specific subject matter, parties would lose their ability to arbitrate disputes pertaining to such a subject matter. There cannot be an inconsistency between the mechanism prescribed under a special statute and the choice of arbitration as an alternative dispute resolution mechanism.[iii] Hence, in the present case the Court examined the relevant provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ("**SARFAESI Act**") and the RDB Act to adjudicate on the abovementioned issue.

The Court examined the definition of 'financial institution' under the SARFAESI Act to hold that the Lender qualified as a financial institution. Further, the Court observed that there is a distinction between the definition of 'financial institution' under the SARFAESI Act and the RDB Act. The Lender did not qualify as a financial institution under the RDB Act.

The SARFAESI Act only provides for an enforcement mechanism for the recovery of dues, the quantum of which has already been determined. It does not provide for a mechanism for the adjudication and determination of debt recoverable by lenders. Hence, a lender / financial institution would be required to *first*, adjudicate the debts recoverable through arbitration or court proceedings and *second*, take steps to recover such adjudicated debts through the SARFAESI Act.

Contrary to the scheme of the SARFAESI Act, the RDB Act prescribes a mechanism for the adjudication of amounts recoverable by a financial institution and is a special act in this regard. Therefore, a financial institution as defined under the RDB Act is precluded from initiating arbitration for the determination of debt due.

In this case, the Lender not being a financial institution under the RDB Act was entitled to initiate arbitration proceedings for determination of debt due.

Research Papers

FAQs on Setting Up of Offices in India
December 13, 2024

FAQs on Downstream Investment
December 13, 2024

Gaming Law 2024
December 12, 2024

Research Articles

The Revolution Realized: Bitcoin's Triumph
December 05, 2024

The Bitcoin Effect
November 14, 2024

Acquirers Beware: Indian Merger Control Regime Revamped!
September 15, 2024

Audio

Securities Market Regulator's Continued Quest Against "Unfiltered" Financial Advice
December 18, 2024

Digital Lending - Part 1 - What's New with NBFC P2Ps
November 19, 2024

Renewable Roadmap: Budget 2024 and Beyond - Part I
August 26, 2024

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

Click here to view Hotline archives.

Video

"Investment return is not enough" Nishith Desai with Nikunj Dalmia (ET Now) at FII8 event in Riyadh
October 31, 2024

Analysing SEBI's Consultation Paper on Simplification of registration for FPIs

CONCLUSION & ANALYSIS

The decision of the Court in the present case disentitles all financial institutions governed by the RDB Act from choosing arbitration as a mechanism for the resolution of their disputes. This can have a significant impact on all lending agreements entered into by such financial institutions, that have an arbitration clause.[iv] Notably, the RDB Act identifies (a) debentures as debt and (b) debenture trustees as financial institutions. Hence, debenture trustees will have to compulsorily file an application before the DRT for the determination of claims due to the debenture holders under a debenture subscription agreement. Debenture trustees are not only appointed for representing Indian investors but also foreign investors investing in debt instruments such as non-convertible debentures. Investment agreements with such foreign investors often have arbitration clauses. However, the ruling in the present case might renders arbitration clauses contained in debenture subscription agreements ineffective to the extent of disputes relating to the determination of debt due.

The RDB Act assigns a wide and inclusive definition to 'debt'.[v] Any liability along with interest, that is due from any person and is claimed by any bank or financial institution during the course of the business activity undertaken by it, can be referred to as debt. Debt securities are also considered to be debt under the RDB Act.[vi] This has the potential to extend the application of the RDB Act and prevent entities from opting for arbitration as a mode of dispute resolution. Further, the Central Government has the power to notify additional institutions as financial institutions under the RDB Act. NBFCs if notified as financial institutions under the RDB Act should also be prevented from arbitrating their claims. Hence, the claims arising out of investment / loan agreements entered into by such NBFCs should be non-arbitrable to the extent that they pertain to the determination of debt due under these agreements.

A parallel can be drawn to the Micro, Small and Medium Enterprises Development Act, 2006 ("**MSMED Act**"). The MSMED Act allows parties limited autonomy to arbitrate their disputes. This is because under the MSMED Act, only the Micro and Small Enterprises Facilitation Council is empowered to either arbitrate disputes by itself or appoint an arbitral institution.[vii] Hence, even for entities governed by the MSMED Act, an arbitration clause expressing the parties' choice of mechanism for dispute resolution could be ineffective.[viii]

– Shruti Dhonde, Arjun Gupta and Vyapak Desai

You can direct your queries or comments to the authors.

[i] 2023 SCC OnLine Bom 2716.

[ii] *Vidya Drolia v. Durga Trading Corporation,* (2021) 2 SCC 1.

[iii] *Vidya Drolia v. Durga Trading Corporation,* (2021) 2 SCC 1, 55.

[iv] Recovery and Debt and Bankruptcy Act, 1993, s. 2(h)(ib).

[v] *Eureka Forbes Ltd. v. Allahabad Bank*, (2010) 6 SCC 193.

[vi] Recovery and Debt and Bankruptcy Act, 1993, s. 2(g).

[vii] Micro, Small and Medium Enterprises Development Act, 2006, s. 18.

[viii] *Gujarat State Civil Supplies Corpn. Ltd. v. Mahakali Foods (P) Ltd.*, (2023) 6 SCC 401.

September 26, 2024

Scope of judicial interference and inquiry in an application for appointment of arbitrator under the (Indian) Arbitration and Conciliation Act, 1996

September 22, 2024