

Insolvency and Bankruptcy Hotline

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IMPLICATIONS OF THE INDUS BIOTECH RULING FOR IBC AND INVESTOR PROTECTION IN INDIA

The National Company Law Tribunal ("NCLT"), recently, in Indus Biotech Private Limited ("Indus/corporate debtor") v. Kotak India (Offshore) Fund ("Kotak/financial creditor") & Ors. decided there existed an arbitrable dispute between Kotak who held Optionally Convertible Redeemable Preference Shares ("OCRPS") and Indus. The NCLT negated Kotak's right to redemption of the OCRPS and refused to classify the failure of the Company to repay the redemption value as a default under Section 7 of the Insolvency and Bankruptcy Code, 2016 ("IBC/Code").

These contentions were presented before the Supreme Court by way of appeal. The findings of the NCLT were approved, making them the law of the land. We have dealt with the issues arising from these two judgements below:

I. BRIEF FACTUAL BACKGROUND

Kotak had subscribed to equity shares and OCRPS issued by Indus in 2007-2008. Indus wished to make a Qualified Initial Public Offering ("QIPO"). In light of regulation 5(2) of the Securities and Exchange Board of India (Issue of Capital & Disclosure Requirements) Regulations 2018, Kotak opted to convert its OCRPS into equity shares of Indus prior to the QIPO. During discussions between both parties, a dispute arose pertaining to the calculation and conversion formula to be followed while converting the OCRPS into equity shares. While the dispute was ongoing, Kotak invoked the provisions of the Share Subscription and Shareholders Agreement ("Agreement") seeking redemption of the OCRPS at the 'redemption value'.

Notably, the Agreement prescribed the procedure for the redemption of the OCRPS, including the 'redemption value', the time period within which said 'redemption value' would need to be paid to Kotak after it became due, and the circumstances in which Kotak could require Indus to redeem the OCRPS (such as, for instance, upon the occurrence of an exit event like a QIPO or upon the expiry of December 31, 2018, being the original tenure of the OCRPS). The Agreement further provided that the 'redemption value' would constitute a debt owed by Indus to Kotak from the due date till it was repaid in full. When Indus failed to redeem the OCRPS as per the prescribed timeline under the Agreement, Kotak interpreted the failure to mean a default under the Code and approached the NCLT under Section 7 of the IBC seeking initiation of insolvency proceedings of Indus. On the other hand, Indus filed an interim application under Section 8 of the Arbitration & Conciliation Act, 1996 before the NCLT and requested the tribunal to refer the disputes to arbitration which was the dispute resolution mechanism under the Agreement.

II. REASONING OF THE NCLT & THE SUPREME COURT

The NCLT, as well as the Supreme Court sided with the corporate debtor's contentions and held the Section 7 application to be inadmissible until the dispute between the parties is settled through arbitration. The primary reasons for their complementary decisions are explored below:

a. Existence of Default

Placing reliance on Section 7(5) of the IBC and previous Supreme Court judgements, the NCLT held that for an application under Section 7 to be admitted, the adjudicating authority must be satisfied of the existence of a default. The Supreme Court upheld this position and observed that an objective assessment by the adjudicating authority must yield satisfaction as to the existence of a default for admission of an application.

The main issue that arose in this case was with respect to the appropriate formula to be applied for the conversion of the OCRPS held by Kotak in Indus on account of the QIPO being evaluated. The Agreement provided that the range of conversion would be between 10 to 30 percent, depending on the valuation of the OCRPS, the mechanism for which was provided in the Agreement. Kotak claimed that it would be entitled to equity shares constituting 30 percent of the total paid-up share capital upon conversion, whereas Indus countered that Kotak would be entitled to equity shares up to 10 percent of the total paid-up share capital upon conversion. As noted by the Supreme Court, both parties unsuccessfully conducted multiple meetings and exchanged numerous correspondences for resolution of this issue. Upon failure of these discussions to resolve the dispute amicably, Kotak moved to redeem its OCRPS as per the procedure provided under the Agreement by requiring Indus to redeem the OCRPS within 15 (fifteen) days of the redemption date. Indus resisted the redemption notice issued by Kotak and made no payment of the redemption value to Kotak.

The NCLT, held that the determination of existence of default centred around three things - (1) the valuation of Kotak's OCRPS; (2) the right of Kotak to redeem such OCRPS when it had participated in the process to convert its OCRPS into equity shares of Indus; and finally, (3) the unilateral fixation of the QIPO date. It concluded that these three issues had to be conclusively determined in order to ascertain as to whether a default had been committed by Indus in not paying the redemption value to Indus. Thus, without a resolution of the dispute between parties, the existence of default could not be conclusively determined. The Supreme Court agreed with the findings of the NCLT, relying specifically on the intention of the parties to convert the OCRPS into equity shares as evident from the meetings and correspondence.

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Considering that the right of an OCRPS holder to redeem the OCRPS is distinct from the right of such OCRPS holder to convert the OCRPS into equity shares, it is possible that any dispute pertaining to the modalities of conversion might have been the subject matter of a separate trial and adjudication. The disputes cited with regards to the conversion of OCRPS and the conversion formula to be applied were wholly extraneous to the determination of whether (a) Kotak had correctly sought redemption of the OCRPS (b) any amount was due and payable as redemption value by Indus (c) such redemption value could be classified as financial debt and (d) there was a default in making payment of the redemption value by Indus. If on a consideration of these limited parameters, it was concluded by the NCLT that there was no debt due or that there was no default on the debt due, such a finding would be within the scope of adjudication of an application under Section 7 of the IBC as has been traditionally understood. In the present case, however, the SC and the NCLT have imputed that Kotak was not entitled to initiate a redemption of the OCRPS, since it had already initiated the process for conversion of the OCRPS into equity shares, which conversion was the subject matter of a parallel dispute between the parties. From a bare reading of the judgement, the Agreement does not seem to have envisaged such a stipulation on Kotak; therefore, it appears that this requirement or restriction has been read into the contractual obligations of Kotak by the adjudicatory forums. In doing so, the courts have adopted an expansive approach in its consideration of whether a 'debt' or a 'default' was being claimed by the applicant-party (being Kotak) pre-maturely. This approach may be problematic as we have observed subsequently.

b. Solvency of the Corporate Debtor

Another aspect which was considered important by both NCLT as well as the SC was the solvency of the corporate debtor. The NCLT in its concluding observations stated that Indus is a solvent, debt-free and profitable company and such an application would unnecessarily send such a company into CIRP, which would not be a desirable result. This emphasis on the solvency of the company and the presumption that solvent companies cannot commit any default runs contrary to and in conflict with the Supreme Court ruling in *Swiss Ribbons v. Union of India* (2019 SCC OnLine SC 73) which was recently reiterated by NCLAT in *Monotrone Leasing Pvt. Ltd. v. P M Cold Storage Pvt. Ltd.* (2020 SCC OnLine NCLAT 581). In the aforementioned cases, it was stated that the NCLT has to only make a factual determination on whether there exists a debt and default and not look into any other extraneous factors or circumstances revolving around the relationship between the creditor and debtor. It was also observed that the debtor can contest the application only by proving that the claim amount was not payable under law or contract thereby negating the existence of the default.

The Courts of Singapore have in the past considered factors such as abuse of process (*AnAn Group v. VTB Bank* [2020] SGCA 33) and solvency of a company (*BNP Paribas v Jurong Shipyard Pte Ltd* [2009] 2 SLR(R) 949) when adjudicating upon admission of a compulsory insolvency/winding up application by a creditor. However, this test is subsumed under the discretionary power of the Singapore Courts as per the applicable insolvency law. The same is not the case in India, where the NCLT must merely adopt an objective assessment for satisfaction under Section 7 of the IBC.

Analysis

The IBC has introduced templated forms which have to be filled up with necessary particulars by creditors seeking initiation of insolvency proceedings against borrowers. This is clear indication of the fact that parties are being persuaded to move away from the erstwhile winding-up regime where one would have to prove an "*inability to pay*" on the part of the borrower. Under the new IBC regime, the question as to whether the borrower has the ability to pay or not is of no significance, the creditor has to factually prove through documentary evidence the existence of debt and default. Consequently, the NCLT can only conduct a factual determination on whether under law and contract (a) an amount is due from the borrower and (b) the same has been paid.

As in the present judgment of the SC and the NCLT, if we start discussing and attributing importance to extraneous factors such as solvency of the borrower, then the same might encourage NCLT's to refuse admission of applications basis such circumstances which are completely outside the scope and object of the IBC. This might lead to incongruous findings of different NCLT's on the same point of law which will require further clarifications from the SC.

III. TAKEAWAYS

One can only hope that the rulings by the NCLT and the Supreme Court do not set precedent in relation to interpretation of provisions relating to investor's exit rights and price protections under investment documents. These are sacrosanct to the investment thesis and any dilution of these rights may impact India's standing as a destination for foreign and domestic capital. Neither the NCLT order nor the judgement of the Supreme Court, elaborates upon the manner in which the wordings of the Agreement was interpreted. However, there are certain key takeaways with respect to significant investor rights enshrined in the investment documentation.

a. Procedural provisions, especially exit provisions, to be watertight

1. The key findings in both the rulings hinges on the procedural provisions of the Agreement. It was found that, having initiated the process for the conversion of the OCRPS which process was held up owing to dispute around, inter alia, valuation, Kotak could not have initiated a separate right for the redemption of the very same OCRPS during the pendency of the dispute.
2. It is imperative that procedural provisions of investment documents align with the commercial requirements of investors and enable investors to resort to a parallel stream of rights available in the document. For the purpose, it is crucial that precise parties are subject to clear timelines for the completion of actions requirement under the relevant document.
3. This becomes all the more crucial in the case of the investor's exit rights; sufficient flexibility should be built into drafts to ensure that the investor is not denied a favourable exit and to secure the investor protection as to pricing of its securities.

b. Dealing with valuation provisions and commercial formulae

1. The Agreement provided that the range of conversion would be between 10 to 30 percent, depending on the

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valuation of the OCPRS.

2. In order to pre-empt disputes with respect to valuation matters, as in this case, parties may consider providing for an arrangement whereby valuation matters may be resolved without the need to invoke dispute resolution mechanism under the investment agreement.
3. For instance, parties may choose to allow valuation mismatches within a small range (say, a 2% range of variation) to be resolved by settling upon the mean between the two numbers arrived at, or by agreeing to the higher of the two valuation numbers.
4. An alternative mechanism may involve the appointment of a neutral accountant or valuation expert to review the valuation methodology adopted by the parties and to deliver a final valuation to the parties, which number shall be final and binding. In such cases, it is imperative that the parties agree upon the scope of the expert's review in the investment documents itself.
5. Finally, where relevant, the investment documents should carry sufficient illustrations and working examples to mitigate against any contrary interpretations being lent to ambiguity of commercial terms used in the formulae.

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