Between the lines...

VAISH ASSOCIATES ADVOCATES
New Delhi • Mumbai • Bengaluru
Celebrating over 45 years of professional excellence

October, 2018

Key Highlights

I. Supreme Court: CIRP cannot be initiated against the corporate debtor if the challenge to arbitral award is pending

II. Supreme Court: No stamping required in case of enforcement of foreign arbitral awards

III. NCLAT: Moratorium under Section 14 of IBC is not applicable to criminal matters

IV. ITAT Delhi: Long-term capital loss cannot be set-off against long-term capital gain if the transaction is a sham transaction

I. Supreme Court: CIRP cannot be initiated against the corporate debtor if the challenge to arbitral award is pending

The Hon'ble Supreme Court of India in the case of ***K. Kishan v. Vijay Nirman Company Private Limited*** *(decided on August 14, 2018)* held that the operational creditors cannot prematurely initiate the corporate insolvency resolution process (**"CIRP"**) against the corporate debtor, ruling that pendency of a challenge to arbitral award was itself proof that the debt was a disputed debt.

Facts

To undertake a construction project on behalf of M/s. Ksheerabad Constructions Private Limited (**"KCPL"**), M/s. Vijay Nirman Company Private Limited (**"Respondent"**) had entered into a sub-contract agreement with it on February 1, 2008. In relation to this project, a tripartite Memorandum of Understanding was also entered into amongst KCPL, the Respondent and M/s. SDM Projects Private Limited on May 9, 2008.

Disputes arose between the parties during the execution of the project and same were referred to arbitral tribunal. Arbitral tribunal decided the dispute by an award dated January 21, 2017 through which it allowed certain claims in favour of the Respondent.

The Respondent sent a notice dated February 6, 2017 under Section 8 of the Insolvency and Bankruptcy Code, 2016 (**"IBC"**) (which provides for delivery of demand notice by the operational creditor to the corporate debtor, demanding amount involved in the default) to KCPL for payment of a certain amount of money. This came to be disputed by KCPL on two grounds:

a. The amount demanded by the Respondent was the subject matter of arbitration proceedings; and

b. The Respondent was, on the other hand, liable to pay larger sums to KCPL.

KCPL proceeded to file a petition challenging the arbitral award. Thereafter, a petition under Section 9 of the IBC came to be filed by the Respondent on July 14, 2017. Section 9 of the IBC provides for initiation of CIRP against the corporate debtor by the operational creditor if the operational creditor does not receive payment or notice of the dispute from the corporate debtor within stipulated time period. It was submitted before the National Company Law Tribunal (**"NCLT"**) by the Respondent that the sum was awarded in favour of the Respondent by the arbitral tribunal and had become operational debt payable by the corporate debtor that is KCPL. KCPL had submitted that an application was filed challenging the arbitral award even before Section 9 application was filed and the same was sub-judice before a court at Hyderabad.

NCLT allowed the Section 9 IBC petition filed by the Respondent, on August 29, 2017, by observing:

a. The arbitral award recorded that KCPL had admitted the liability; and

b. There was no stay on the arbitral award.

The National Company Law Appellate Tribunal (**"NCLAT")**, upheld the decision of the NCLT and observed that:

a. The non-obstante clause contained in Section 238 of the IBC overrides the provisions of the Arbitration and Conciliation Act, 1996 (**"Arbitration Act"**). Section 238 of the IBC provides that the provisions of the IBC shall have effect, notwithstanding anything inconsistent therewith contained in any other law for the time being in force or any instrument having effect by virtue of any such law; and

b. Order of the arbitral tribunal was a record of operational debt as Form V of Part 5 of the Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016 required particulars of an order of an arbitral panel adjudicating on the default.

Issue

Whether the IBC can be invoked in respect of an operational debt where an arbitral award has been passed against the operational debtor, which has not yet been finally adjudicated upon?

Arguments

The appellant relied upon observations of the Supreme Court in ***Mobilox Innovations Private Limited v. Kirusa Software Private Limited [(2018) 1 SCC 353]*** ("**Mobilox Judgment**") and submitted that the object of the IBC was not to replace debt adjudication and enforcement under other laws including the Arbitration Act. It was contended that the NCLAT's findings on application of Section 238 of the IBC was erroneous as there was nothing inconsistent between the adjudication and enforcement process under the Arbitration Act and the application of Sections 8 and 9 of the IBC.

The Respondent referred to the law in the United Kingdom and Singapore and submitted that insolvency process does not get affected by an application pending for setting aside any judgment, order or decision.

Observations of the Supreme Court

The Supreme Court referred to Section 9(5)(ii)(d) of the IBC which states that:

"(5) The Adjudicating Authority shall, within fourteen days of the receipt of the application Under Sub-section (2), by an order-

(ii) reject the application and communicate such decision to the operational creditor and the corporate debtor, if-

(d) notice of dispute has been received by the operational creditor or there is a record of dispute in the information utility;"

The Supreme Court noted that the above provisions made clear that the application under Section 8 of the IBC had to be rejected if notice of a dispute was received by the operational creditor. It was observed that although as per the Respondent, there was admission of awarded amount and hence there was no dispute, counter claims by the appellant were also part of the challenge to the arbitral award which were of far greater amount.

Observations made in Mobilox Judgment were referred to by the Supreme Court. In the Mobilox Judgment, Notes on Clauses annexed to the Bill of the Insolvency Code were referred, relevant portion reads as under:

"This ensures that operational creditors, whose debt claims are usually smaller, are not able to put the corporate debtor into the insolvency resolution process prematurely or initiate the process for extraneous considerations."

Paragraph 51 of the Mobilox Judgment was also referred, which states that if a dispute truly exists in fact and is not spurious, hypothetical or illusory, the adjudicating authority has to reject the application. It was observed that there was a pre-existing dispute between the parties and the mere factum of challenge to the arbitral award was sufficient to state that the award was disputed. The Supreme Court added that the possibility of the appellant succeeding on the cross-claims was sufficient to conclude that the operational debt was a disputed debt. The Supreme Court noted, *"The alarming result of an operational debt contained in an arbitral award for a small amount of say, two lakhs of rupees, cannot possibly jeopardize an otherwise solvent company worth several crores of rupees."*

On Section 238 of the IBC, the Supreme Court observed that, in this case, this provision would apply only in case of inconsistency between the IBC and the Arbitration Act, which was absent.

Decision of the Supreme Court

Allowing the appeal, the Supreme Court reversed the judgment of the NCLAT.

VA View

The Supreme Court has negated the findings of the NCLAT and has rightly observed that there being no inconsistencies between the Arbitration Act and the IBC, Section 238 of the IBC is not applicable. Thus, this bars initiation of CIRP till the time arbitral award attains finality. The Supreme Court has taken the correct view considering that there were cross claims of larger amounts and if they were upheld in petition filed under Section 34 of the Arbitration Act, the operational creditor would have had no claim at all. Thus, the admission of CIRP would have been, indeed, premature and had to give way to pending challenge proceedings against the arbitral award. The operational creditors have been using the IBC as a tool for recovery of money and this decision of the Supreme Court will put a brake to such attempts of operational creditors.

II. Supreme Court: No stamping required in case of enforcement of foreign arbitral awards

The Supreme Court in the case of ***M/s. Shriram EPC Limited v. Rioglass Solar SA*** *(decided on September 13, 2018)* held that the expression "award" as provided in the Indian Stamp Act, 1899 ("**Stamp Act**") does not constitute foreign award and therefore foreign arbitral awards are not liable to be stamped before enforcement in India.

Facts

An appeal was filed against the order of the Madras High Court before the Supreme Court by M/s. Shriram EPC Limited (**"Appellant"**) concerning a foreign arbitral award.

Issue

Whether an unstamped foreign award could be enforced in India?

Existing Rulings

The jurisprudence on this issue has been inconsistent due to conflicting judgements from different High Courts. The Punjab and Haryana High Court in ***Gujrals Company v. M.A. Morris [AIR 1962 P&H 167]*** held Section 3 of the Stamp Act would apply before a foreign award is filed and made a rule of the Court in India, hence, the foreign award must be stamped. In ***Naval Gent Maritime Limited v. Shivanath Rai Harnarain (I) Limited [(2009) 163 DLT 391],*** the Delhi High Court held that the issue of stamp duty cannot stand in the way of deciding whether the award is enforceable or not. It relied heavily on the decision of the Supreme Court in ***M. Anasuya Devi & Another v. M. Manik Reddy and Others [(2003) 8 SCC 565],*** which held that at the time of deciding objections under Section 34 of the Arbitration and Conciliation Act, 1996 (**"Arbitration Act"**), the court cannot set aside the award for want of stamping and registration. In ***Narayan Trading Company v. Abcom Trading Private Limited [(2013) 2 MP LJ 252],*** Madhya Pradesh High Court held that the Stamp Act was not amended to bring within its scope the scheme of a foreign award, which was introduced by way of the Arbitration Act. Accordingly, it would not apply to a foreign award.

Arguments

The Appellant argued that a foreign arbitral award would fall within the scope of the Stamp Act. Aside from the above stated judgement of the Punjab and Haryana High Court, the Appellant relied heavily on the Gujarat High Court judgment in case of ***Orient Middle East Lines Limited, Bombay and Another v. Brace Transport Corporation of Monrovia and Others [AIR 1986 Guj 62].*** This judgement was interpreted by the Appellant to mean that New York Convention, which forms the basis of Part II Chapter I of the Arbitration Act recognizes that foreign awards may have to bear stamp duty for enforcement in the country in which they are sought to be enforced. The Appellant also pressed on the 194th Law Commission Report which suggested changes pertaining stamp duty in Part II of the Arbitration Act. Owing to these arguments, an unstamped foreign award cannot be enforced.

Rioglass Solar SA (**"Respondent"**) relied on the judgment of the Delhi High Court as well as the Madhya Pradesh High Court referred hereinabove. According to it, the expression "award" which occurs in Schedule I of the Stamp Act applies only to a domestic award and not a foreign award. It was argued that the Stamp Act was enacted in 1899, and since then "award" as it appears thereunder has never been enlarged so as to include foreign awards after the Arbitration (Protocol and Convention) Act, 1937 and/or the Foreign Awards (Recognition and Enforcement) Act, 1961 were enacted. Also, the only requirement for the enforcement of a foreign award is laid down in Section 47 of the Arbitration Act, which does not require the award to be stamped. A without prejudice argument was also made that under Section 48(2)(b) of the Arbitration Act, even if a foreign award were required to be stamped, but is not stamped, enforcement of such award would not be contrary to the fundamental policy of Indian law.

Observations of the Supreme Court

The Supreme Court taking a chronological approach looked at the state of arbitration law when the Stamp Act came into force. Arbitration law in 1899 was captured by way of Civil Procedure Code and Arbitration Act, 1899 which applied to British India. Arbitration Act, 1899 further applied only where the subject matter submitted to arbitration, if it were the subject of a suit, could be instituted in a presidency town. The "award" that is referred to in the Stamp Act refers to an award that is made in the territory of British India and not the princely states in India. An arbitration award made in the princely states therefore would be a foreign award in so far as British India is concerned. An award made in a princely state, or in a foreign country, if enforced by means of a suit in British India, would not be covered by the expression "award" contained in Article 12 of Schedule I of the Stamp Act. The scope of the term "award" continues to be the same regardless of numerous changes in the arbitration law in India pursuant to the Code of Civil Procedure, 1908, Arbitration (Protocol and Convention) Act, 1937, Arbitration Act, 1940 and the present-day Arbitration Act. Therefore, the Supreme Court was of the view that the expression "award" in the Stamp Act has never included a foreign award from the very inception till date. Consequently, a foreign award not being includible in Schedule I of the Stamp Act is not liable for stamp duty.

The Supreme Court rejected the interpretation of the Appellant of its reliance on the Punjab and Haryana High Court judgement by stating that since that judgement did not refer to the definition of the word "award" in the Stamp Act, it

was of no relevance. Further, the Supreme Court also stated that the Appellant incorrectly cited the Gujarat High Court judgement as it did not discuss the aspect of stamp duty at the time of enforcement of a foreign arbitral award.

The Supreme Court also criticized the assumptions made by the Respondent in their argument that Section 47 of the Arbitration Act requires three things and only three things to be produced before the court for enforcement of a foreign award namely: (a) the original award or a copy thereof; (b) the original agreement for arbitration or a duly certified copy thereof; and (c) such evidence as may be necessary to prove that the award is a foreign award. Since stamp duty is not one of the three things required, it cannot be a necessity before the enforcement of a foreign award. The Supreme Court held that Section 47 of the Arbitration Act does not interdict the payment of stamp duty if it is otherwise payable in law. Also, the argument of the Respondent that under Section 48(2)(b) of the Arbitration Act, even if stamp duty is payable on a foreign award, it would not be contrary to the public policy of India, was rejected. It has been previously held that any law dealing with the economy of the country would certainly come within the expression *"fundamental policy of Indian law"*. The Stamp Act being a fiscal statute which deals with the economy of India would be an act reflecting the fundamental policy of Indian law, therefore, non-payment of stamp duty, if the Stamp Act required it to be paid, would be against the public policy of India.

Decision of the Supreme Court

The Supreme Court rejected the appeal filed by the Appellant and held that foreign arbitral award is not liable to be stamped before enforcement in India.

VA View

Section 3 of the Stamp Act provides that the stamp duty mentioned in the Schedule I of the Stamp Act is chargeable to every instrument mentioned therein. With the surge of international commercial arbitrations and the enforcement of their resulting awards in India, the question whether the term "award" mentioned in Article 12 of Schedule I of the Stamp Act would include a foreign award or not, had been a subject of judicial discourse at the High Court level.

The Supreme Court has finally settled the law by holding that stamp duty is not required to be paid on foreign arbitral awards before its enforcement. This decision shall put an end to tenuous objections being made by the party against whom the foreign award has been passed at the final stage of enforcement. By this decision, the Supreme Court has further paved the way for India in becoming an arbitration friendly jurisdiction.

III. NCLAT: Moratorium under Section 14 of IBC is not applicable to criminal matters

The National Company Law Appellate Tribunal (**"NCLAT"**) in ***Shah Brothers Ispat Private Limited v. P. Mohanraj and Others*** *(decided on July 31, 2018)* held that the moratorium period provided under Section 14 of the Insolvency and Bankruptcy Code, 2016 ("**IBC**") will not cover any criminal matters.

Facts

Shah Brothers Ispat Private Limited (**"Appellant"**) had initiated the corporate insolvency resolution process against M/s. Diamond Engineering Chennai Private Limited (**"Corporate Debtor"**) and the moratorium provided for under Section 14 of the IBC came into force from June 6, 2017. Thereafter, the Appellant filed a complaint under Section 138 of the Negotiable Instruments Act, 1881 (**"NI Act"**), with the Metropolitan Magistrate, Mumbai. Mr. P. Mohanraj (**"Respondent"**) and two other persons, who were the directors of the Corporate Debtor, approached the National Company Law Tribunal, Chennai (**"NCLT"**) for stay of the proceedings before the Magistrate Court on the ground that the order of moratorium prohibits the filing of any proceedings before any authority. The NCLT, agreed with the contention of the directors and directed the Appellant to withdraw the complaint filed under Section 138 of the NI Act, failing which appropriate order would be passed for violation of the moratorium. The NCLT made further observations that the Appellant had deliberately attempted to misuse the process of law by suppressing material facts at the time of filing the Complaint before the Metropolitan Magistrate. The Appellant appealed against the NCLT order before the NCLAT and the following issue came up for determination:

Issue

Whether an order of moratorium under Section 14 of the IBC, covers a criminal proceeding initiated under Section 138 of the NI Act?

Arguments

The Appellant argued that it is at liberty to file proceedings under Section 138 of the NI Act as the said provision provides for imprisonment and the Corporate Debtor being a company cannot be imprisoned. Therefore, the punishment provided for under Section 138 of the NI Act cannot be imposed by a court of competent jurisdiction on the Corporate Debtor, if found guilty. Whereas it will be the directors of the Corporate Debtor who can be imprisoned or a fine may be imposed on them.

The Respondent argued that the proceedings under Section 138 of the NI Act is covered by Section 14(1)(a) of the IBC. Section 14(1)(a)of the IBC states that the adjudicating authority shall by order declare moratorium for prohibiting *"the institution of suits or continuation of pending suits or proceedings against the corporate debtor including execution of any judgment, decree or order in any court of law, tribunal, arbitration panel or other authority."* Therefore, proceedings against the Corporate Debtor, including execution of any judgement, decree or order in any court of law, tribunal, arbitration panel or other authority cannot proceed, in effect treating the same as a proceedings filed after the order of moratorium.

Observations of the NCLAT

The NCLAT observed that Section 138 of the NI Act is a penal provision which empowers the court of competent jurisdiction to pass an order of imprisonment or fine, which cannot be held to be proceeding or any judgement or decree of money claim. Neither the imposition of fine can be held to be a money claim or recovery against the

Corporate Debtor nor order of imprisonment, if passed by the court of competent jurisdiction on the directors can come within the purview of Section 14 of the IBC. In fact, no criminal proceeding is covered under Section 14 of the IBC.

Decision of the NCLAT

The NCLAT set aside the order of the NCLT with a finding that since the moratorium passed under the IBC would not apply to criminal proceedings, the court of competent jurisdiction could proceed under Section 138 of the NI Act even during the period of moratorium.

VA View

The order of the NCLAT clarifies a major area in the scope and applicability of the moratorium. A large number of companies, through their directors, are facing criminal prosecution and are also undergoing the corporate insolvency resolution process. Owing to there being no specific provision as to the applicability of the IBC to criminal proceedings, there was a question mark on the status of the criminal proceedings initiated before or during the moratorium period.

The NCLAT has rightly said that criminal proceedings attract penal provisions and the same cannot be forfeited under the provisions of the IBC. If the intent behind imposing the moratorium is looked at, it is very evident that proceedings attracting penal consequences would not be stayed during the moratorium period since in effect there is no civil claim that is being made against the company. This decision of the NCLAT that the moratorium under Section 14 of the IBC does not apply to criminal matters has been reiterated in the judgment of ***Tayal Cotton Private Limited v. The State of Maharashtra and Others*** *(decided on August 6, 2018)* passed by the Aurangabad Bench of the Bombay High Court.

While this decision clarifies the applicability of Section 14 of the IBC to criminal matters, a grey area remains as to whether IBC will prevail over other criminal laws such as the Indian Penal Code, 1860, Prevention of Money Laundering Act, 2002 and Maharashtra Protection of Interest of Depositors (in Financial Establishments) Act, 1999 in respect of attachment of properties by the authorities.

IV. ITAT Delhi: Long-term capital loss cannot be set-off against long-term capital gain if the transaction is a sham transaction

The Delhi Bench of the Income Tax Appellate Tribunal (**"ITAT"**) in the case of ***DCIT v. BS Info Solution Private Limited*** *(decided on August 23, 2018)* upheld the appeal preferred by revenue disallowing the claim of set off of capital loss arising on sale of shares against long term capital gains arising on sale of property by holding the transactions between inter-se group companies to be a sham transaction.

Facts

During the assessment year 2012-13, BS Info Solution Private Limited (**"Assessee"**) had incurred long term capital gains on sale of property to Q.A. Infotech Private Limited (**"QIPL"**) for which part consideration was received during the preceding assessment year 2011-12. During the assessment year 2011-12, the Assessee separately entered into a collaboration agreement with M/s Charmwood Realtech Private Limited (**"CRPL"**) (a group company of the Assessee) to develop the same property for which the Assessee had already taken part consideration as mentioned hereinabove. The Assessee received INR 9 Crores as refundable security deposit/ earnest money from CRPL. Out of INR 9 crores, the Assessee transferred INR 7.50 Crores immediately to VBPL (another group company of the Assessee) towards allotment of 3,75,000 shares of VBPL having face value of INR 10 per share at a premium of INR 190 per share.

During the assessment year 2012-13, the Assessee cancelled the collaboration agreement with CRPL and the amount of INR 9 crores was returned to CRPL. The said amount was partly funded by sale of shares of VBPL. The shares were sold at INR 82.50 per share as against the issue price of INR 200 per share. As a result, the Assessee incurred a capital loss of INR 5.18 crores on the sale of shares, which was set-off against the capital gains of INR 3.48 Crores arising on sale of property. The assessing officer examined the sequence of events and came to the conclusion that the purchase and sale of shares was nothing but a colourable device to generate loss to be set off against capital gain. On first appeal, the Commissioner of Income Tax (Appeals-2), New Delhi (**"CIT(A)"**) reversed the assessment order and allowed the Assessee's claim of capital loss.

Decision of the ITAT

ITAT examined the factual matrix and concluded that the share transaction was nothing but a sham transaction, a colourable device to avoid capital gains tax liability. Based on the evidences on record, it observed that the same property was the subject matter of two distinct transactions – one with QIPL and the other with CRPL, though ultimately the property was sold to QIPL. This means that when the Assessee received part consideration from QIPL, it was well aware that the transaction was going to result into capital gains and to avoid such capital gains liability the Assessee used CRPL and VBPL as conduits to generate loss in shares to be set-off against the capital gain income.

It further noted that the Assessee paid a hefty premium of INR 190 for the shares of VBPL which was incorporated only around three months back. It also remarked that though the premium was justified by a valuation report, the same appeared to be a self-serving document. It remarked that the value and the period within which the shares were subscribed and sold did not accord with human probabilities and commercial prudence.

VA View

Despite the transactions may be structured in a manner so as to fall within the four corners of law, yet time and again, there is something beyond which the courts have looked into. The Supreme Court has frowned upon colorable devices and since then the courts have given more weightage to the substance rather than what is apparent on the face of the transactions. In the present matter, the ITAT has denied the losses after testing the genuineness of the facts and evidences of the entire gamut of inter-se transactions.

It is pertinent to note that with the introduction of the provisions of General Anti Avoidance Rules (GAAR), the possibility of the revenue delving deep into such claims of tax reductions made by taxpayers in its return of income cannot be undermined. It is advisable that while planning or executing a transaction, one should be mindful that the transaction should accord with human probability and commercial prudence.

Contact Details :

www.vaishlaw.com

NEW DELHI
1st, 9th & 11th Floor
Mohan Dev Bldg. 13 Tolstoy Marg
New Delhi - 110001, India
Phone: +91-11-4249 2525
Fax: +91-11-23320484
delhi@vaishlaw.com

MUMBAI
106, Peninsula Centre
Dr. S. S. Rao Road, Parel
Mumbai - 400012, India
Phone: +91-22-4213 4101
Fax: +91-22-4213 4102
mumbai@vaishlaw.com

BENGALURU
565/B, 7th Main HAL
2nd Stage, Indiranagar,
Bengaluru - 560038, India
Phone: +91-80-40903588 /89
Fax: +91-80-40903584
bangalore@vaishlaw.com