ESTABLISHING "PRE-EXISTENCE DISPUTES", UNDER THE IBC REGIME

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The Insolvency and Bankruptcy Code ("***Code***") was enacted to facilitate timely resolution to insolvency proceedings, maximisation of value of assets of the debtors, to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders. However, the Code is being weaponized to act as an alternative to traditional recovery proceedings. Liquid Companies under the threat of insolvency proceedings are forced to settle claims, both legitimate and fictitious. Anticipating such ill-motivated proceedings, the Code has inbuilt provisions to prevent such misuse.

In this article, we explore the concept of "pre-existing disputes" and how the courts have viewed "pre-existing disputes".

The Code was introduced in the year 2016, as an umbrella legislation for insolvency resolution of all entities in India, both corporate and individuals. The enactment of the Code resulted in repeal of the Presidency Towns Insolvency Act, 1909, and the Provincial Insolvency Act, 1920, and amendment to several laws, including the Companies Act, 2013, the Recovery of Debts Due to Banks and Financial Institutions Act, 1993, and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002. The Code is formulated in such a way that all routes available to resolve the insolvency must be explored, in a time bound manner, before liquidation, which should only be a last resort.

With regard to Corporate Insolvency, the Code has differentiated the creditors of corporates into financial and operational creditors. A combined reading of Section 5 (7) and Section 5 (8) of the Code gives us the definition of financial creditors as the creditors who have a purely financial contract with the entity, such as a loan or a debt security. Similarly, Section 5 (20) and Section 5 (21), when read in consonance define operational creditors as those creditors whose obligation to the firm emerges from an operation-related transaction, such as supply of goods or services.

The Code also lays down different procedures to be followed by each type of creditor, while initiating insolvency proceedings. The primary difference in the procedure to be followed by financial and operational creditors is the issuance of demand notice by operational creditors before initiating corporate insolvency resolution process against the debtor. As per Section 8(1) of the Code, operational creditors are required to send a demand notice of unpaid operational debt to the corporate debtor, before initiating insolvency proceedings under Section 9. Once the corporate debtor receives the demand notice, it must respond to the notice within a period of 10 days, either by sending proof of payment or by bringing to the knowledge of the operational creditor an "***Existing Dispute***"[1].

[1] Section 8 (2)(a) of The Insolvency and Bankruptcy Code, 2016

The Code mandates that the adjudicating authority should reject the application if there is a pre-existing dispute with regard to an operational debt[2]. Thus, the determination of what constitutes a "pre-existing dispute" becomes paramount for Operational Creditors under the IBC regime.

The statutory definition of "dispute" under Section 5 (6) of the Code, when interpreted literally, is a bit restrictive, as it only considers suits and arbitrations which are pending before a court of law or tribunal. However, the section has been liberally interpreted by the Hon'ble Supreme Court in ***Mobilox Innovations Private Limited Vs. Kirusa Software Private Limited***[3], wherein it has been held that the definition of "dispute" is an inclusive one and it is not intention of the legislators to limit the scope of disputes to only proceedings pending before a court of law or tribunal.

Relying on the judgment of the Hon'ble Supreme Court in the ***Mobilox*** case, the National Company Law Tribunal ("**NCLT**") (Ahmedabad Bench) in the case of ***Raghuvir Buildcon Private Limited Vs. Ketan Construction Limited***[4] has laid down that the parameter to ascertain as to whether there is a dispute or otherwise can be summarized as under

i) The dispute should be prima facie bona fide and exist naturally in a given fact.
ii) The grounds for alleging the existence of a dispute should not be spurious, hypothetical, illusory or misconceived.
iii) The existence of a dispute need not require further to be proved.
iv) The dispute should be natural and not a made to believe dispute.

While the liberal interpretation of the term "dispute", has been widely welcomed, the courts have also cautioned debtors against raising the plea of pre-existing dispute as a moonshine defence. At this point, it is pertinent to point out that in the first Insolvency and Bankruptcy Bill, 2015, Section 5(4) defined "dispute" as meaning a "***bona fide***" suit or arbitration proceedings…, however the 2016 Code, defines "dispute" under Section 5(6) and excludes the expression "bona fide". This point too was considered in ***Mobilox Innovations Private Limited Vs. Kirusa Software Private Limited*** (***supra***) and the Hon'ble Supreme Court has held that the exclusion of the phrase "bona fide" is significant and thus it would be difficult to judge whether a dispute exists or not. However, the court has gone on to hold that, if there is a contention of dispute raised, the adjudicating authority must examine whether the contention of "dispute" is a feasible argument or if it's a mere assertion lacking any corroborative evidence. The court has also cautioned that such examination must not turn into a probe into the merits of the case.

Similarly, the National Company Law Appellate Tribunal ("**NCLAT**") in the case of ***Soham Polymers Private Limited Vs. Flocksur India Private Limited***[5], has held that in proceeding under Section 9 of the Code, the Court has to be satisfied that dispute truly exists in fact and is not spurious, hypothetical or illusory. In the ***Raghuvir Buildcon*** case (supra), the Tribunal has clearly laid down that not every difference/disagreement can be held to constitute a dispute and that normally commercial/ legal differences *per se* are not dispute unless such differences are ascertained into a claim on which both the parties have opposite /different views and want to settle the same through some legal process or otherwise. Not every routine correspondence in commercial relationship can automatically or necessarily be considered and admitted as dispute unless certain stage is reached. On similar footing, the NCLAT in the case of ***Deepak Modi Vs. Shalfeyo Industries Private Limited***[6] has held that a "genuine" pre-existing dispute is a must in order to reject an application under Section 9 of the Code. The above findings given by various forums, make it clear that a "dispute" includes not only *Lis Pendens* before various forums, but also those legitimate and substantiated claims, which fall under the ambit of Section 5 (6) of the Code.

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[2] Section 9 (5)(ii)(d) of The Insolvency and Bankruptcy Code, 2016
[3] (2018) 1 SCC 353
[4] C.P (IB)No.57/9/NCLT/AHM/2019
[5] Company Appeal (AT) (Insolvency) No. 924/2021
[6] (2023) SCC Online NCLAT 169

For a dispute to be considered as "pre-existing", it should have existed prior to the receipt of the demand notice under Section 8 (1) of the Code. To drive home this point, one has to once again turn to the judgment of the Supreme Court in the ***Mobilox Innovations Private Limited Vs. Kirusa Software Private Limited*** (***supra***), wherein the court has held that in order to reject an application under Section 9 of the Code, the existence of the dispute and/or suit or arbitration proceedings must be pre-existing, meaning it must have existed before the receipt of the demand notice or invoice, as the case may be. In the case of ***G. T. Polymers [A Partnership Firm] Vs. Keshava Medi Devices Private Limited***[7], when a civil suit was filed after the receipt of the Section 8 demand notice, the NCLAT held that such suit does not constitute a pre-existing dispute.

The question that now remains is at what stage the existence of a pre-existing dispute must be brought to the knowledge of the operational creditor? Ideally, any dispute regarding commercial transactions has to be brought to the attention of the opposing party at the earliest. The Code also provides an opportunity to the corporate debtor to bring to the knowledge of the operational creditor, any existing disputes, in their reply to the demand notice issued to them. However, even if a corporate debtor fails to reply to the demand notice, it is not barred from establishing that there are pre-existing disputes even at the time of submitting their pleadings before the adjudicating authority. This point was substantiated by the NCLAT in the case of ***Brandy Realty Services Limited. v. Sir John Bakeries India Private Limited***[8], wherein the Tribunal has held that "*mere fact that a reply to notice under Section 8(1) having not been given within 10 days or no reply to demand notice having been filed by the corporate debtor does not preclude the corporate debtor to bring relevant materials before the adjudicating authority to establish that there are preexisting dispute which may lead to the rejection of Section 9 application.*" This proposition of law was upheld by the NCLAT in the case of ***Greymatter Entertainment Private Limited Vs. Pro Sportify Private Limited***[9], wherein the Tribunal explained that neither Section 8 nor Section 9 of the Code indicate that in the event a reply to the notice was not filed within 10 days, the corporate debtor is precluded from raising the question of dispute or pleading that there or no amount due and payable, the corporate debtor is not prevented from establishing by way of a reply and relevant documents, any "pre-existing dispute".

In summation, debtors have to be pro-active and vigilant while dealing with insolvency applications and should endeavour to establish the existence of pre-existing disputes at the first opportunity available to them. Remaining silent about a dispute in the face of repeated demands to make payment would be to its detriment. They should also establish the facts leading up to the dispute and use language which is indicative of such dispute being raised by them in their communications with the operational creditors. Though they are not precluded from raising this defence even at a belated stage in the process, demonstrating the existence of a pre-existing dispute at an early stage, will alleviate the apprehension that an attempt is being made to misguide the adjudicating authority by claiming there is a dispute only as a last-ditch effort.

Similarly, operational creditors should initiate steps to obtain confirmation of payments due to the extent possible in order to prevent debtors from claiming later on that there was a pending dispute.

From the above, it is amply clear that initiating a resolution process by an operational creditor will not be a cake walk though it would have contributed to the business of the corporate debtor equally like a financial creditor.

7 Company Appeal (AT) (Ins) No. 1266 of 2019

8 (2022) SCC Online NCLAT 290

9 (2023) SCC Online NCLAT 82