Non-Arbitrability of Infrastructure Debts: One Step Forward, Two Steps Back

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ABSTRACT

Infrastructure financing in India has been on the downturn since the IL&FS crisis struck in 2018, and has worsened with the Covid-19 pandemic. Infrastructure lenders are weary of financing Special Purpose Vehicles (SPVs) set up to construct large-scale infrastructure and projects, particularly because of the high investment values involved. To add fuel to the fire, lenders are frightened at the thought of loan defaults by such SPVs in the event the SPV is unable to generate sufficient cash-flows to repay its loans or due to cost overruns and delays. To secure lenders from this anomaly, the law provides for Debt Recovery Tribunals (DRTs) and civil courts which can attach and auction assets of the defaulter. Although the DRTs have proven to be gradualist in debt recoveries, this has, amongst other consequences, caused parties to be strongly driven to pursue other forms of dispute resolution like arbitration. This pursuit of alternative forms has been the case until the Supreme Court of India's (SC) recent ruling in Drolia[1], which came up with significant transformations on the issue of arbitrability of debt recovery disputes.

Key Words: Non-Arbitrability, Debt, Project Finance, Financial Bottlenecks

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

Introduction

Infrastructure development is the pivotal engine without which any national economy cannot be steered. Infrastructure like airports, roads, railways, energy, ports, telecom, etc. form a significant part of India's growth story. More importantly, financing such projects is a sine qua non in establishing sustainable economic growth. Realizing this, the Indian Prime Minister Narendra Modi unveiled the National Infrastructure Pipeline (NIP) for FY 2019-25, allocating an initial sum of INR 100 lakh crores to be expended on social and economic infrastructure projects across the country. Following this announcement in August 2019, the 2021 Budget saw the largest ever outlay being allocated to the infrastructure sector – with INR 5.54 lakh crores going as investments towards the capital-intensive sector.[2]

Evidently, there is an increased impetus in India for the development of the infrastructure sector. However, over the years, what has also followed along with the growth of this capital-intensive industry is the rise of disputes. More often than not, lenders and financial institutions who advance credit and assume significant financial risks are found struggling to recover their own legitimate dues owed to them by defaulting borrowers or SPVs. To insulate itself from these risks, lenders and institutions have adequate measures such as bank guarantees and collateral securities which form a standard part of project financing contracts. However, certain operational risks like operational & maintenance (O&M) issues or demand risks like reduced sales of off-take leading to reduced cash flows may hinder repayment obligations of the SPV, thus driving the matter into what is often a long-drawn dispute. The other principal cause of infrastructure disputes stems from construction delays which in turn leads to cost overruns, consequently diminishing investor returns for the lenders and institutions.

To tackle with these risks as a creditor, lenders are often not so stretched in terms of remedies available to them to recover their dues. Until now, lenders have had limited yet woefully lengthy remedies at their disposal – some of them include civil litigation, Debt Recovery Tribunals (DRTs) and on the other hand, quick resolution processes like arbitration too. Amongst these, lenders have a natural and increasingly strong inclination towards arbitration as a mode of resolving debt recovery disputes relating to the infrastructure sector. This is primarily because the DRTs and civil courts have been drowning in ever-increasing pendency, vacancies, lack of competent administrative and judicial staff, etc. However, this remedy of invoking arbitration has been altered in disputes involving debt recovery by the Supreme Court ruling of *Vidya Drolia v. Durga Trading Corporation*[3]. It is argued by the author that this alteration by the Hon'ble Court is tenuous and unfounded and needs reversal.

Arbitrability of Debt Recovery Disputes: Judicial History

Lenders generally have the option of recovering their dues under civil litigation vide one of two statutes – '*Securitisation & Reconstruction of Financial Assets & Enforcement Act, 2002'* (SARFAESI Act) or '*Recovery Debts due to Banks and*

[2] Abhishek Gupta, *Budget 2021: FM Nirmala Sitharaman gives boost to infrastructure sector*, CNBCTV18 (Feb. 10, 2021 at 06:45AM), https://www.cnbctv18.com/views/budget-2021-fm-nirmala-sitharaman-gives-boost-to-infrastructure-sector-8267831.htm (last visited on May 6, 2021 at 15:40PM)
[3] Vidya Drolia, *Supra* note 1.

Financial Institutions Act, 1993' (DRT Act). Albeit remedies under these Acts often turn out to be lengthy and cumbersome, therefore are not desired by lenders who now prefer to arbitrate.

Nonetheless, arbitration of debt recovery disputes comes with its own legal nuances. The issue of 'arbitrability of debt recovery disputes' stems from the concept of 'debt arbitration', which essentially refers to the process of recovering debt from the borrower, not through litigation under SARFAESI or DRT Acts, but via the alternate mode of dispute resolution, i.e. arbitration. Lenders prefer arbitrating rather than litigating because they would rather choose to amicably settle for a lower recovery amount than to let the borrower slip into bankruptcy and invite more complications the issue of whether such a type of dispute can be arbitrated upon has lingered on for some time now. Indian courts have had the seminal opportunity to clear the air on this issue on more than one occasion now. The issue first came up before the full bench of the Delhi HC in *HDFC Bank Ltd. v. Satpal Singh Bakshi*[4], where the court was tasked with deciding on the issue of arbitrability of debt recovery disputes subject to the exclusive scope and jurisdiction of DRTs established under the DRT Act. The court herein asserted that tribunalization of justice cannot curtail the principle of party autonomy. The court further stated that this exclusive jurisdiction granted to a specialized forum by means of a legislation only waives civil jurisdiction, and certainly does not imply non-arbitrability of such disputes as an automatic consequence. In holding so, the court reiterated that claims lacking the feature of public interest and instead arising out of disputes in personam would be capable of being arbitrated.

The Supreme Court has referred to the Delhi HC's decision in *HDFC Bank Ltd.* case in the case of *M.D. Frozen Foods Exports Private Limited v. Hero Fincorp Ltd.*[5] to hold those enforcement proceedings to recover debts under Acts like SARFAESI and DRT can run simultaneously with adjudicatory proceedings like arbitration.[6] Albeit, it may be pertinent to note that the Supreme Court did not explicitly deal with the issue of arbitrability of debt recovery disputes falling under the exclusive jurisdiction of either SARFAESI or DRT Acts.

Vidya Drolia: Unruly Horse in Chinatown

The Supreme Court was recently presented with deciding a similar issue again based on the arbitrability of, inter alia, debt recovery disputes under the DRT Act. In the case of *Vidya Drolia v. Durga Trading Corporation*[7], a tenant refused to vacate the premises of the landlord after the expiry of the lease period of 10 years, as agreed in the lease agreement which also consisted of an arbitration clause. Consequently, the landlord sent a notice to the tenant invoking arbitration proceedings u/S 11 of the Arbitration Act for the appointment of an arbitrator. The Calcutta HC refused to entertain the tenant's objections of landlord-tenant disputes being non-arbitrable and referred the matter to arbitration. At that time, in a separate case of *Himangni Enterprises*[8], the Supreme Court held that landlord-tenancy disputes governed by the '*Transfer of Property Act, 1882*' ("TPA") are non-arbitrable. Thereafter, the matter in *Vidya Drolia*

[4] 2013 (134) DRJ 566.
[5] (2017) 16 SCC 741.
[6] *Id.*at ¶33 and ¶34.
[7] Vidya Drolia, *Supra* note 1.
[8] Himangni Enterprises v. Kamaljeet Singh Ahluwalia, (2017) 10 SCC 706.

case was preferred to a two-judge bench of the SC, which in turn referred the case to a larger bench of the SC, citing its differences with the ruling in *Himangni Enterprises*.

Placed before a three-judge bench of the Supreme Court, the primary issue was whether landlord-tenant disputes subject to TPA could be arbitrated upon under the '*Arbitration and Conciliation Act, 1996*' (Arbitration Act). In its 243 page judgement, the court also oscillated on the issue of arbitrability of debt recovery disputes under the DRT Act. The Court first formulated a four-fold test of arbitrability, which would then be applied against the issue to decide whether a particular subject matter can be arbitrated upon or not.

The four-fold test holds that a dispute cannot be arbitrated upon when:
1. *"It relates to actions in rem;*
2. *it affects third party rights and requires centralized adjudication;*
3. *it relates to the inalienable sovereign and public interest functions of the state; and*
4. *it is expressly or by necessary implication non-arbitrable as per mandatory statute(s)."*

The court then referred to the Delhi HC ruling in *HDFC Bank Ltd* case[9] to hold that the Delhi HC did not pay heed to the fact that although disputes arising out of actions *in personam* could be arbitrated upon, non-arbitrability may surface where there exists implicit prohibition in the statute, which confers special rights to be adjudicated by the courts or public fora, whose enforcement would not be possible through arbitration. Furthermore, banks and financial institutions would be denied their statutory rights and modes of recovery accorded to them if claims under the DRT Act were held to be arbitrable. The Court concluded by holding that since the non-obstante clause of the statute had overwritten the parties' contractual right to arbitration, debt recovery claims covered under the DRT Act cannot be arbitrated upon as waiving off the jurisdiction of the DRT is prohibited by necessary implication.

Vidya Drolia: Critique Against Exclusivity

The *Vidya Drolia* judgement by the Supreme Court clears the air over certain practical issues of arbitrability which could expedite access to justice when it comes to landlord-tenancy arbitration.[10] However, the author points out how this could potentially pan out in a negative way for lenders when it comes to infrastructure debt recoveries.

It is argued that the four-fold test in *Vidya Drolia* is tenuous and questionably unconvincing in cases of debt recovery disputes.

Firstly, disputes involving debt recoveries are concerned with the lender(s) and one or more borrowers, thereby lacking any element of a public nature. Such disputes *in personam* can certainly be arbitrated upon. The same was also acknowledged by the court in *Vidya Drolia*.

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[9] HDFC Bank, *Supra* note 4.

[10] Jigar Parmar, *A Recent Judgment on Arbitration of Tenancy Disputes has the Potential to Expedite Access to Justice*, Vidhi Centre for Legal Policy (Jan. 22, 2021), https://vidhilegalpolicy.in/blog/a-recent-judgment-on-arbitration-of-tenancy-disputes-has-the-potential-to-expedite-access-to-justice/ (last visited on May 7, 2021 at 15:58PM)

Secondly, the judgment observed that factors like "*examining the text of the statute, its legislative history, or any inherent conflict between arbitration and the statute's underlying purpose*" need to be considered to determine 'necessary implication'[11] and to ensure that no repugnancy exists between the legislation and arbitration as an alternative. It is argued that the drafters of the DRT Act could not have possibly intended to oust the jurisdiction of arbitral tribunals, as the legislative object of the Act was to expeditiously adjudicate upon debt recovery disputes.

Thirdly, arbitration can, in fact, complement such modes of dispute recovery. It is also simultaneously argued that such legislation does not bestow any special rights or obligations, as the primary object of that legislation was to ensure effective and expeditious resolution of debt recovery disputes.[12] The fulfilment of this object, on its own, does not grant any special rights or obligations to the parties.

Fourthly, N.V. Ramana, J. held in a separate opinion that "The legislative intention of not arbitrating issues of public policy are intertwined with the fact that monopolies of the State activities should not be a subject matter of a private tribunal, as the concerns of the State cannot be dealt effectively."[13] However, it is again contended that since these disputes are of a personal nature and the DRT Act does not affect public welfare at large, such claims are arbitrable.[14]

It is not in dispute that the DRTs have been laggard as a mode of dispute resolution for debt recovery disputes, and more so in the infrastructure sector, for the following inter-connected reasons.

Burgeoning Pendency

The primary objective of the DRT Act was speedy disposal of debt recovery disputes. The Deshpande Committee Report directs that no more than 30 cases should be listed on board for any given day and no more than 800 cases should be pending at any given time before the Presiding Officer (PO) of DRTs.[15] Far from that, the pendency has only mushroomed over the years with thousands of cases pending before DRTs at any given time. In fact, DRT (Chennai) disposed of a 1997 debt recovery application in 2020, after an astonishing 23 years.[16]

Stalling by Large Borrowers

In the early years, DRTs showed efficacy in recovering considerable amounts of bad debts, but the progress faltered when it came to large, powerful and influential borrowers who delayed trials on several grounds, including res judicata defences against impending cases in civil courts.

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[11] Vidya Drolia, *Supra* note 1 at ¶34.
[12] Narsimham Committee-I Report (1991), Ministry of Finance – Govt. of India.
[13] Vidya Drolia, *Supra* note 1 at ¶50.
[14] In contrast, disputes under legislations like Hindu Marriage Act or Prevention of Sexual Harassment at Workplace Act are examples of welfare legislation over which the State has monopoly, and therefore cannot be privately arbitrated upon.
[15] N.V. Deshpande, Principal Legal Advisor of RBI, '*Working Group to Review the functioning of DRTs*' Report, p. 13.
[16] Law Commission of India, *Assessment of Statutory Frameworks of Tribunals in India*, Report No.272 (October 2017).

Lack Of Competent Appointments

Post judgements being passed by DRTs, security interest needs to be enforced by the Recovery Officers (RO). However, the lack of qualified ROs lacking competence and knowledge in due legal process is hurting enforcement proceedings.[17] This, coupled with adjudicatory and administrative vacancies across DRTs, has slowed down the dispute resolution process at DRTs.

Lack Of Timely Resolution

According to a 2019 World Bank report, the Indian judiciary takes an average time of 1.6 years to resolve an insolvency proceeding. In comparison, Japan takes 0.6 years and Singapore, 0.8 years.[18] Although the DRT Act stipulates that the tribunal shall make an endeavour to dispose of the applications within 180 days from its receipt,[19] it is rarely practised.

Asset Value Deterioration

Another fundamental cause of infrastructure disputes ending up in elongated litigations has been the continuous deterioration of the infrastructure assets' value. As endless proceedings take place to resolve debt, the net value of the assets (or national resources, in public projects) owned by the sponsor or the SPV unceasingly keep on diminishing with time and so much so that at times, it becomes an issue to run the SPV as a 'going concern'. In such circumstances, banks and financial institutions are advised to realise the 'going concern' value of the distressed assets in the initial stages, possibly through business mergers and acquisitions or the sale of the SPV itself.

Impact on Infrastructure Debt Recovery Claims: Hurting Lenders?

The consequences of this judgement by the Supreme Court could have ripple effects in the infrastructure financing industry. While the order explicitly bars lenders like banks and financial institutions from recovering their dues before an arbitral tribunal, the same also acts as an impediment categorically for infrastructure lenders from making a recovery claim before an arbitral tribunal and instead compels them to undergo traditional litigation under the DRT Act. In this regard, Justice N.V. Ramana observed:

"*To hold that the claims of banks and financial institutions covered under the DRT Act are arbitrable would deprive and deny these institutions of the specific rights including the modes of recovery specified in the DRT Act. Therefore, the claims covered by the DRT Act are non-arbitrable as there is a prohibition against waiver of jurisdiction of the DRT by necessary implication. The legislation has overwritten the contractual right to arbitration.*"[20]

[17] R.N. Pradeep, *Set right debt recovery tribunals*, Business Line (Nov. 14, 2012) https://www.thehindubusinessline.com/opinion/set-right-debt-recovery-tribunals/article22995923.ece (last visited on May 7, 2021 at 16:54PM)

[18] World Bank, Doing Business Report on '*Time to resolve Insolvency*' https://data.worldbank.org/indicator/IC.ISV.DURS?end=2019&most_recent_value_desc=false&start=207 (last visited on May 7, 2021 at 17:35PM)

[19] Recovery of Debts due to the Banks and Financial Institutions Act, 1993, §19(24), No. 51, Acts of Parliament, 1993 (India).

[20] Vidya Drolia, *supra* note 1.

Infrastructure lenders have two statutory remedies when it comes to recovering debt from SPVs or project sponsors – under the DRT Act and under the SARFAESI Act. In ordinary cases, lenders can attach movable or immovable property like cars or homes under these Acts, auction them and recover the money. However, when it comes to infrastructural assets and especially so in Public-Private Partnership (PPP) projects, lenders are faced with a stifling and fundamental concern.

In PPP projects, the government (also known as the 'concessioning authority') practically owns infrastructure assets like highways, ports and airports which are kept as security to the lenders. The concession agreements signed between the concessioning authority and the SPV (also known as the 'concessionaire') also explicitly indicate that the infrastructure assets are owned by the concessioning authority. Now, this is problematic for lenders in the event of a default because they are essentially unable to attach government property to recover their debts. Government assets like ports, highways and airports cannot be attached without difficulty and auctioned away. Therefore, the security created inside the government asset would virtually be left meaningless if lenders are not permitted to claim their dues through the attachment of secured assets.

To simplify this through a hypothetical yet relatable example, let us take the Coastal Road Project being built by Larsen & Toubro (L&T) on PPP basis with the Maharashtra Govt. on the shores of Mumbai to connect the city's north and south sides. Let us also assume that the project is being financed by a consortium of several banks, including a Mandated Lead Arranger. Here, the loans granted to the SPV formed on PPP basis are secured against the infrastructure asset of the SPV itself. Now, in the unfortunate event that the SPV is unable to pay back the loans due to, let's say, an inaccurate assessment of the environmental, demand or political risks – one might argue that the banks have granted secured loans, so the risk is fully minimized. However, it is pertinent to note that the coastal road is essentially a government-owned asset being built and to be operated and maintained by a partner like L&T. To attach the coastal road and auction it away would imply several obvious hurdles, starting with issues like whether the coastal road can even be sold, considering the ownership vests in the government? Similarly, auctioning few other public infrastructures built under concession agreements like metro and rail corridors, energy supply projects, etc. raises doubts on whether ownership of such public assets of the SPV can be transferred when auctioned, and if yes, would potential buyers be willing to invest in such large-scale distressed assets?

Further, it may also be pertinent to look back to a landmark project in the 1990s where the parties used court intervention to slow down the arbitration process affecting recovery claims. The 'Enron-Dabhol Power Project' was one of India's biggest foreign investments in the infrastructure sector in the 90s. However, when a dispute arose because the authorities halted the project and the foreign investor had already invested millions, both the central and the Maharashtra government rather fancied to avoid a settlement of the dispute by international arbitration, which was duly agreed to in the relevant agreements. At that time, India had even ratified the New York Convention and passed the 1996 Arbitration Act. Yet, this was apparently done by the governments to slow down the arbitration proceedings through court intervention. After a long

litigation battle of about 25 years, the Supreme Court eventually decided to close the petition.[21]

Conclusion

Whether it is private investments or PPPs, the principle of project maximization holds utmost relevance for investors, sponsors and lenders in the infrastructure sector. However, disputes due to cost escalations and delays are not an uncommon menace for investors and lenders alike. Thus, a resilient dispute resolution system for lenders like banks and financial institutions to recover their dues in a timely fashion is key to uphold and improve 'Ease of Doing Business' in India. With cumbersome and lengthy litigation before domestic tribunals without virtually any party autonomy, the pros of arbitration clearly outweigh those of DRTs and civil courts. Judicial intervention, delay and procedural rigidity of DRTs and civil courts have contracted its scope as the most effective mechanism in PPP disputes.[22]

The author concludes by reiterating that the Supreme Court's observations in *Vidya Drolia* with respect to restricting the arbitrability of debt recovery disputes to DRTs are unfounded and tenuous. For the already aforementioned reasons, DRTs are already burdened with tens of thousands of pending cases and the system is choking with bottlenecks. In light of this and all arguments presented in this article, it is contended that the Hon'ble Court could have gone with the alternative view of permitting debt recovery claims to be arbitrated upon, as they conform to the four-fold test laid down in this very judgement. India can take a step forward from "*being a jurisdiction where the term 'dispute' meant complex litigation procedures, confusion, and ambiguity surrounding the jurisdictional issues, a huge backlog of cases, etc., to an investment destination which has undertaken important steps towards improving quality of the judicial process and vows to effectively reduce time and cost of enforcing a contract.*"[23]

More importantly, it has been observed by this very Court that there lies a presumption in favour of the dispute's arbitrability.[24] All disputes are arbitrable until it is proven that the legislative intent is to oust the contractual freedom of parties to settle their disputes through arbitration or that there exists such fundamental conflict between the subject matter of dispute and the current understanding of public policy.[25]

It is finally and zealously argued that courts must uphold the principle of party autonomy and allow the parties to derive the advantages of such an alternate mechanism rather than precipitously snubbing it so as to conserve the jurisdiction of public fora. *The Courts mustn't take one step forward to go two steps back.*

[21] Centre of Indian Trade Unions v. State of Maharashtra, (2020) 13 SCC 741.
[22] K. Harisankar and G. Sreeparvathy, *Rethinking Dispute Resolution in Public–Private Partnerships for Infrastructure Development in India*, 5(1) Journal of Infrastructure Development 30 (2013).
[23] Amitabh Kant, *Effective Arbitration Process Can Make India A Sought After Business Destination*, The Economic Times (July 24, 2019), https://economictimes.indiatimes.com/news/economy/policy/view-how-properarbitration-mechanismcan-make-india-a-sought-after-businessdestination/articleshow/70368747.cms?from=mdr (last visited on May 8, 2021 at 6:22AM)
[24] Magma Leasing & Finance Ltd. v. Potluri Madhavilata, (2009) 10 SCC 103.
[25] Anand Kumar Singh, *Arbitrability of Disputes in India: The Changing Landscape of 'Exclusive Jurisdiction' Discourse*, 7(1) NLUJ Law Review 101 (2020).

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