Set-Off Under IBC Regime

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Introduction

The Insolvency and Bankruptcy Code, 2016 ("the Code"), represents a groundbreaking legislation that heralded a seismic shift from a debtor-in-possession framework to a creditor-in-control paradigm. Prioritizing the interests of creditors as paramount, the Code delineates a bifurcated process for the rehabilitation of ailing companies while acknowledging that the demise of a company inflicts concomitant losses upon its creditors. Success and failure are inherent facets of business, and losses are an inevitable consequence of its unpredictable nature. When misfortune strikes with the force of a hurricane, it can drive businesses into bankruptcy. In such instances, the downfall of a Corporate Debtor invariably entails losses for its creditors as well. Consequently, the Code's structure is designed to mitigate such ripple effect adversely affecting the economy, thereby safeguarding the broader economic ecosystem.

To optimise outcomes in adverse circumstances, the Code delineates a two-pronged strategy to safeguard creditors' interests. Under the initial framework, i.e. CIRP ("Corporate Insolvency Resolution Process") the emphasis is placed not only on repaying the creditors' dues but also on the paramount objective of revitalizing the company. However, in scenarios where such revival is unattainable, the principal objective shifts to the equitable distribution of assets by maximizing the value of the Corporate Debtor's estate. Consequently, the Code establishes a time-bound process aimed at expediting the resolution of insolvency, whether through the rehabilitation of the company or its Liquidation. Therefore, at the outset, it is imperative to distinguish between the CIRP and the Liquidation process under the IBC. The CIRP aims to facilitate the rehabilitation, revival, and resolution of the Corporate Debtor. In contrast, the Liquidation process is concerned with the constellation of assets of the Corporate Debtor in Liquidation and the subsequent distribution and payment to creditors in accordance with the priority order established by the insolvency statute.

It is abundantly evident that the objective of the CIRP diverges significantly from that of Liquidation. Consequently, the Legislation deliberately refrains from imposing a statutory mandate, with respect to Set-offs, within the CIRP framework. However, the Supreme Court in *Bharti Airtel Ltd and Anr. v Vijaykumar V. Iyer and Ors.[1]* has carved out certain exceptions to this principle, which will be examined in detail. On the other hand, in the context of Liquidation, Regulation 29 of the Insolvency and Bankruptcy Board of India (Liquidation Process) Regulations, 2016, governs the process of set offs thereby allowing Set-offs only under Liquidation with a prerequisite that the case should fall under the category of mutual dealing between the parties.

Principles and types of Set Offs under the Indian regime

Set-off, in its broadest sense, acknowledges the debtor's right to offset a smaller claim owed to him against a larger claim due to his creditor. It is an adjustment of claims between two parties, effectively discharging reciprocal obligations. The objectives of Set-off are threefold. Firstly, it serves an economic purpose by stimulating trade and commerce, offering a degree of confidence to parties in their dealings. Secondly, it reduces litigation, promotes time economy, and provides an efficient method for resolving debts between parties. Thirdly, natural equity demands that cross-demands should mutually compensate, with the lesser sum being deducted from the greater. "Set-off" is defined in Black's Law Dictionary (7th Edn., 1999) inter alia as a debtor's right to reduce the amount of a debt by any sum the creditor owes the debtor: the counterbalancing sum owed by the creditor. The dictionary quotes Thomas W. Waterman from A Treatise on the Law of Set-Off, Recoupment, and Counter Claim as stating:

“Set-off signifies the subtraction or taking away of one demand from another opposite or cross-demand, so as to distinguish the smaller demand and reduce the greater by the amount of the less; or, if the opposite demands are equal, to extinguish both. It was also, formerly, sometimes called stoppage, because the amount to be set off was stopped or deducted from the cross-demand.”

In general under the common law, there are 4 different types of Set-offs, namely, Contractual Set-off, Statutory or Legal Set-off, Equitable Set-off and Insolvency Set-off. The different types of Set-offs are discussed hereinbelow -

1. Contractual Set Off

Contractual set-off operates exclusively through mutual agreement rather than as an independent application of set-off. The parties possess the liberty to concur on desired outcomes. This consensual nature allows for deviations from customary set-off rules concerning credit or debit mutuality, liquidation of debts, and interrelated debts, which are typically pertinent in statutory or insolvency-related set-offs. Nevertheless, the contractual arrangement must adhere to legal parameters and public policy. Furthermore, adherence to fundamental principles of contract law, such as the intent to establish a legal relationship, acceptance, consideration, among others, is essential to validate a contractual set-off.

2. Statutory or Legal Set-off

Statutory or Legal Set-off arises under specific statutes. For instance, Order VIII Rule 6 of the Code of Civil Procedure, 1908, provides that in a money recovery lawsuit, the Defendant may present its counterclaim against the Plaintiff’s demand for any established sum of money legally owed by the Plaintiff to the Defendant, not exceeding the court's jurisdictional limits. This procedure necessitates both parties occupying equivalent roles as they do in the Plaintiff's lawsuit. The Defendant is permitted, at the initial hearing of the case and not thereafter unless authorized by the court, to submit a written statement detailing the debts intended for set-off. To qualify for legal set-off, the obligations between the parties must consist of ascertainable monetary sums or money claims that are definite. Both debts must represent mutual obligations, i.e., reciprocal claims held by the parties under the same capacity.

3. Equitable Set-Off

Several judgments of Supreme Court and the High Courts have recognised the Defendant's ability to assert equitable set-off concerning both unascertained sums payable as damages and ascertained monetary amounts. Equitable set-off requires a nexus between the Plaintiff’s debt claim and the Defendant's set-off claim, rendering it unfair to compel the Defendant to pursue a separate legal action. It has been established that the set-off claim should arise from the same transaction or interconnected transactions treated as a single entity. Unlike Legal set-off, which is a statutory entitlement limited to ascertainable monetary claims, equitable set-off derives from common law principles. In *Maheswari Metals & Metal Refinery, Bangalore v. Madras State Small Industries Corporation[2]* it was held that, the claim for an Equitable Set-off must have a connection between the plaintiff's claim for the debt and the defendant's claim to set-off, which would make it inequitable to drive the defendant to a separate suit.

In *Union Of India Versus Karam Chand Thapar And Bros[3]* the Hon'ble Supreme Court observed that "What the rule deals with is legal set-off. The claim sought to be set off must be for an ascertained sum of money and legally recoverable by the claimant. What is more significant is that both the parties must fill the same character in respect of the two claims sought to be set off or adjusted. Apart from the rule enacted in Rule 6 abovesaid, there exists a right to set-off, called equitable, independently of the provisions of the Code. Such mutual debts and credits or cross-demands, to be available for extinction by way of equitable set-off, must have arisen out of the same transaction or ought to be so connected in their nature and circumstances as to make it inequitable for the court to allow the claim before it and leave the defendant high and dry for the present unless he files a cross-suit of his own. When a plea in the nature of equitable set-off is raised it is not done as of right and the discretion lies with the court to entertain and allow such plea or not to do so."

4. Insolvency Set-off

According to Rory Derham's analysis of Set-offs, Insolvency Set-offs should be distinguished from Equitable Set-offs. This observation reflects the evolution of UK law, which has led to the enactment of specific provisions governing Set-offs in Insolvency cases. Under UK law, Insolvency Set-off is permissible when there exist mutual debts, credits, and other reciprocal transactions between the parties at the relevant cut-off time, typically coinciding with the initiation of the Liquidation Process undertaken in India.

Set Off under IBC

The discussion below will elucidate the applicability of Set-off at 3 different stages delineated under the Code –

1. Pre-admission Stage

The Apex Court in umpteen number of judgements have laid down that the contours of Section 7 and Section 9 of the Code are very limited in nature. In the case of *Innoventive Industries Limited v. ICICI Bank[4]* the Supreme Court articulated that during the pre-admission phase, the Adjudicating Authority's role is limited to reviewing the records of the information utility or other evidence provided by the Creditor. This review is intended to ascertain the existence of a Debt and whether the Corporate Debtor has defaulted on repayment. Once it is established that there is both a debt and a default, the Adjudicating Authority is mandated to admit CIRP under the Code.

Therefore, it is not incumbent upon the Adjudicating Authority to cater to questions of Set-off at Pre-Admission Stage, the only question to be answered at this stage is whether there exists debt and default. In *Swiss Ribbons Private Limited and Another v. Union of India and Others[5]* the Hon'ble Apex Court clarified that it is not the case that a legitimate set off is not to be considered at all, per contra, such Set-off maybe considered at the stage of filling of proof of claims, during CIRP, by the Resolution Professional.

2. During CIRP-

In terms of Section 14 of the Code, moratorium is immediately effected upon the initiation of the CIRP. Interestingly, there is no express prohibition on the set-offs during CIRP, however, in general no Set-off are allowed during the

CIRP owing to the operation of moratorium. Keeping the same in mind the Hon'ble Supreme Court in *Bharti Airtel Ltd and Anr. v Vijaykumar V. Iyer and Ors. (Supra)* have carved out two exceptions –

a) Contractual Set-off - A party is entitled to Contractual Set-off on the date which is effective before or on the date CIRP is put into motion

This exception persists because the CIRP does not preclude the application of Contractual Set-off. During the moratorium period effected upon the initiation of the CIRP, activities such as recovery actions and legal proceedings are stayed or held in abeyance. Concurrently, the contractual terms remain binding and unaltered.

The basis of Contractual set-off mirrors that of equitable set-off, which centres on challenging ownership, albeit Contractual Set-off is established through mutual agreement permitting adjustment and set-off. Therefore, if a debtor's right to pursue legal action is impeached before the initiation of the CIRP, the same standard should apply to the Resolution Professional, who in terms of Section 25 of Code, is mandated to safeguard and manage the assets of the corporate debtor, including its ongoing business operations.

b) Equitable Set-off - A party is entitled to an Equitable Set-off in case the Set-off is arising out of the same transaction

The second exception arises in cases of 'Equitable Set-off' where the claim and counterclaim through Set-off are interlinked and stem from one or more transactions that can be considered a unified whole. This set-off must be substantiated by clear facts and legal grounds, ensuring that it would be unjust and inequitable to demand payment from the debtor without allowing for the warranted adjustment. The amount subject to adjustment must be quantifiable and indisputable, given the time-sensitive nature of the CIRP, which operates as an expeditious summary procedure. Unlike civil suits, the resolution process does not entail the adjudication of disputed legal and factual matters after evidentiary proceedings. Such a set-off does not necessitate formal legal proceedings and is limited to monetary claims, excluding assets. As an equitable entitlement, it may be denied if granting relief would undermine principles of fairness and justice.

It is equitable because the transactions are closely intertwined, giving rise to both claim and counterclaim. Fragmenting such connected transactions to enforce one party's claim without adjusting the amount owed to the other would be manifestly unjust. This approach does not conflict with the moratorium's effect as the transactions are treated as indivisible units. During the moratorium period, a claim for transactional set-off against a claim by the Resolution Professional serves as a defence to uphold legitimate expectations and maintain legal certainty.

Therefore, an Equitable Set-off during CIRP will be permissible only if the following prerequisites are fulfilled-

a) Undisputable claim

b) The amount should be quantifiable

c) The amount should be in monetary terms i.e. Set-off of assets is not permissible only money alone can be set-off

d) Should promote equity and should not be against principles of justice

3. Liquidation

As opposed to CIRP, Regulation 29 of the Liquidation Regulations governs the process of Set-off under Liquidation. Section 36(4) in Chapter III, Part II of the Insolvency and Bankruptcy Code (IBC) addresses the exclusion of certain assets from the Liquidation Estate. This Section authorizes the Insolvency and Bankruptcy Board of India (IBBI) to designate assets that can subject to Set-off due to mutual dealings between the Corporate Debtor and a Creditor and can be excluded from the Liquidation Estate. Assets excluded from the Liquidation Estate are not available for distribution during the liquidation process. Consequently, if a Creditor exercises and is permitted a set-off under Section 36(4) of the IBC, the said Creditor may receive a preferential status over other creditors, including secured Creditors, to the extent of the set-off value.

Despite the absence of a specific reference to Section 36(4) of the IBC in the Liquidation Regulations, Set-off due to mutual dealings is permitted under Regulation 29 of the Liquidation Regulations. The mutually owed sums can be Set-off to determine the net amount payable to the Corporate Debtor or to the Creditor. This exclusion will result in reduction of value of the Liquidation Estate, thereby impacting the distribution process under the Liquidation.

The High Court of Australia in *Gye v. McIntyre[6*] articulates that the term 'mutual' conveys the notion of reciprocity rather than mere correspondence. Mutuality requires that the demands must be between the same parties and held in the same capacity, right, or interest. Mutuality pertains to the status of the parties and their relationship with each other, rather than the nature of the claims themselves. There must be an identity between the persons beneficially interested in the claims and the person against whom the claim exists. Consequently, an obligation arising from an instrument may be set off against a simple contract debt, and a secured debt may be set off against an unsecured creditor. However, the court clarified that the requirement for the same parties means that A's right to sue B cannot be set off against A's debt to C, and a joint demand cannot be set off against a separate demand.

The term 'mutual dealings' constitutes the pre-requisite for Insolvency Set-off under Regulation 29 of the Liquidation Regulations. This concept extends beyond the scope of Statutory or Legal Set-off and Equitable Set-off under Indian Regime. Insolvency Set-off applies when there are reciprocal claims involving the same parties. It necessitates a shared identity between the claimant and the party against whom the claim is made. Even in cases involving multiple distinct and independent transactions, mutuality can exist if the parties act in the same capacity or right. Mutual dealings are primarily concerned with the relational aspect and the pertinent identities of the parties involved, rather than the specific nature of the claims themselves. This framework ensures that one party cannot enforce a claim without due consideration for counterclaims, thereby upholding principles of fairness and justice.

Conclusion

In conclusion, the Insolvency and Bankruptcy Code, 2016 represents a significant legislative advancement aimed at balancing the interests of creditors and debtors within India's Insolvency framework. The Code's provisions delineate a structured approach to insolvency resolution, emphasising either the revival of distressed companies through the CIRP or the efficient realization and distribution of assets in cases where revival is not feasible, as in liquidation.

The concept of set-off, being crucial in both the Resolution and Liquidation phases, plays a pivotal role in adjusting mutual debts and credits between parties involved in Insolvency Proceedings. While the Code does not expressly prohibits set-offs during CIRP, in general the set-offs are not given effect owing to the moratorium. While clarifying the conundrum Hon'ble Apex court in the case of Bharti Airtel Ltd and Anr. v Vijaykumar V. Iyer and Ors. (Supra) carved out certain exceptions, as discussed above, when the set-offs can be allowed during the CIRP especially in the cases where set-off emanates from the same transaction.

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1. AIR 1974 Mad 39
2. (2004) 3 Supreme Court Cases 504
3. (2018) 1 SCC 407

4. (2019) 4 SCC 17

5. (1991) 171 CLR 609

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