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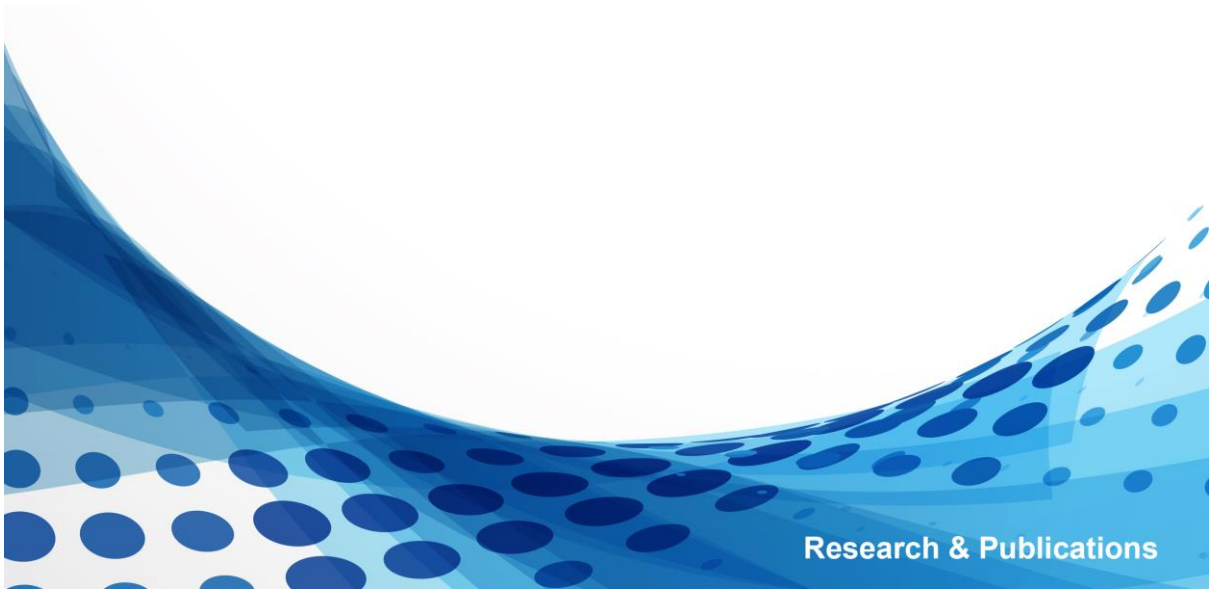

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Abstract:

The overarching objective of the Insolvency and Bankruptcy Code, 2016 (IBC) is to foster rescue culture in India and facilitate the reorganization, restoration and resolution of the corporate debtor rather than its liquidation. However, liquidation has been the most prevalent outcome so far for corporate debtors who have entered into the insolvency resolution process. The liquidation process under the IBC entails an orderly distribution of sale proceeds of the liquidation estate or the unsold assets of the corporate debtor where each creditor receives a proportionate amount of their claims based on their place in the distribution hierarchy of the liquidation process. A creditor's ability to set off a debt by-passes this orderly scheme of distribution and allows the creditor exercising the set off to be preferred over others to the extent of the set off value. Despite this manifestation of the right to set off, it is preserved in the insolvency and bankruptcy regimes of the US and the UK, the latter making it mandatory. India recognized set offs under insolvency law prior to the enactment of the IBC. After the IBC's enactment, an indebted creditor's right to set off during the insolvency resolution process has become ambiguous. The IBC's protective moratorium during the insolvency resolution process has been used to deny indebted creditors of their ability to exercise set offs against the corporate debtor. This paper analyses the evolution in the Indian position on insolvency set offs and compares it with the treatment of set offs in the UK and the US. The paper finds that set offs are not inherently antithetical to insolvency law and that they can be embraced by the IBC.

Keywords: Bank set-offs; insolvency set offs; IBC 2016; *pari passu* principle; moratorium; liquidation

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I. Introduction

A set off, at its essence is an adjustment of mutual debts between a debtor and creditor.[1] Insolvency set off comes into the existence when both the debtor and the creditor have a claim against each other and to avoid multiplicity of proceedings for recovery, the mutual debts are treated as cancelled to the extent of the smaller debt. A bank's right to set off allows it to adjust its customer's deposits with the debts they owe to the bank. In the United Kingdom , bankers' set off was a part of the law merchant and has now become a part of the common law.[2] Unless a contract specifically excludes a bank's right to set off, there is a presumption in favour of its existence.[3] The right to set off can come into existence as a result of statute, principles of equity, or contracts.[4] A set off gives the creditor and debtor the right to adjust their debts against one another and pay the balance that remains due. An insolvency set off refers to the recognition of the debtor's and creditor's right to set off during the insolvency process.[5] When any insolvency law provides for a right to set off, it is effectively protecting the pre-insolvency right to set off held by the debtor and creditor. This would allow the debtor which is going into liquidation and creditor to set off the debts they owe to one another.[6] Thereafter, only the balance of the debts (after being adjusted against each other) would be paid to either the debtor's estate or the creditor depending on the person to whom it falls due.[7]

If the treatment of a bank's right to set off upon the commencement of liquidation proceedings against its depositor were to be traced, one would find that it is preserved in the United States and the United Kingdom. In the US, a bank's right to set off during liquidation or reorganization

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[1] New South Wales Law Reform Commission, Report 94, at 4 (February 2000); John McCoid II, *Set Off: Why Bankruptcy Priority?*, 75 VIRGINIA LAW REVIEW, 15, 19-20 (1989); RORY DERHAM, DERHAM ON THE LAW OF SET-OFF ¶1.01 (2015).

[2] Thomas G. Dobyns, *Banking Set off – A Study in Commercial Obsolescence*, 23 HASTINGS L.J 1585, 1586 (1972).

[3] National Westminster Bank v. Halesowen Presswork and Assemblies (1972) AC 785, 819-20 (House of Lords). See *Bank Accounts: Right to set off* Financial Ombudsman Service (UK) (Jun. 8, 2019), https://www.financial-ombudsman.org.uk/businesses/complaints-deal/banking-and-payments/bank-accounts-right-set-off.

[4] *See* The New South Wales Law Reform Commission, *supra* note 1, Samuel R. Maizel, *65. SETOFF AND RECOUPMENT IN BANKRUPTCY – SETOFFS (CONT'D), RECOUPEMENT,* United States Department of Justice (Jan. 16, 1996), https://www.justice.gov/jm/civil-resource-manual-65-setoff-and-recoupment-bankruptcy.

[5] Gerard McCormack, *Set off under the European Insolvency Regulation*, INSOL INTERNATIONAL, 100, 103, 105 (2020); Venessa Finch, Principles of Corporate Insolvency Law 614 (2d ed); DERHAM, *supra* note 1, at ¶1.02.

[6] McCormack, *supra* note 5, at 103, 105; VENESSA FINCH, PRINCIPLES OF CORPORATE INSOLVENCY LAW 614 (2d ed); DERHAM, *supra* note 1, AT ¶1.02.

[7] McCormack, *supra* note 5, at 103; FINCH, *supra* note 6, at 614; DERHAM, *supra* note 1, at ¶1.02.

is not created by virtue of bankruptcy law.[8] However, pre-existing set offs created through contracts or State law are preserved under the US Bankruptcy Code.[9] The US Bankruptcy Code's preservation of the right to set off has been recognized through judgments.[10] The judgments concluded that the code does not create an independent federal right of setoff, but merely preserves such right that exists under other applicable laws. In the UK, set offs are preserved by virtue of the Insolvency Act, 1986 and the Insolvency (England and Wales) Rules, 2016 (replacing the Insolvency Rules 1986) which use mutual dealings between a creditor and the corporate debtor undergoing liquidation to arrive at the final amount due.[11] If the creditor owes the debtor any dues, these need not be paid to the debtor.[12] Instead, they are reduced from the total amount that is owed from the debtor to the creditor.[13] In the US the amount subject to set off automatically becomes secured upon the commencement of bankruptcy.[14] This change in the nature of the creditor's right allows unsecured creditors to be paid in the same priority as secured creditors to the extent of the value of their debt that can be subject to set off.[15] In both the UK and the US, the right to set off is retained even after the corporate debtor enters into liquidation.[16]

India's insolvency regime which is contained in the Insolvency and Bankruptcy Code, 2016[17] (IBC) does not offer similar protections to the right to set off in the context of corporate insolvency. In the case of partnerships and individual bankruptcies, set offs have been mandated in the text of the IBC, but no analogous provision exists for companies.[18] This is an important shift from the corporate insolvency regime that was in place before the IBC was

[8] Maizel, *supra* note 4.
[9] *See e.g.* Copley v. United States, 959 F.3d 118 (2020), at 122; Stewart v. Army & Air Force Exch. Serv. (In re Stewart), 253 B.R. 51 (2000), at 53; United States v. Continental Airlines (In re Continental Airlines), 134 F.3d 536 (1998), at 541.
[10] Dobyns, *supra* note 2. See e.g. Texas Finance Code §34.307 (2017); Alabama Code § 5-24-27 (2013); New York Banking Law § 9-G (2015), California Financial Code § 1411 (2019).
[11] UK Insolvency Act 1986 c.45, §323, Sch B1 ¶65; Insolvency (England and Wales) Rules 2016, 1024, rr. 14.24-14.25.
[12] UK Insolvency Act §323, Sch B1 ¶65; Insolvency (England and Wales) Rules rr. 14.24-14.25; Bresco Electrical Services (In liquidation) v. Michael Lonsdale [2020] UKSC 25, ¶27.
[13] UK Insolvency Act §323, Sch B1 ¶65; Insolvency (England and Wales) Rules 2016 rr. 14.24-14.25. *See* Bresco Electrical Services, *supra* note 12.
[14] U.S.C Title 11 § 553 [Hereinafter US Bankruptcy Code]; Jeanne L. Schroeder & David Gray Carlson, *Three Against Two: On the Difference Between Property and Contract and the Example of Deposit Accounts in Bankruptcy,* 35 EMORY BANKRUPTCY DEVELOPMENTS JOURNAL 417, 482 (2019).
[15] Schroeder & Carlson, *supra* note 14, at 482.
[16] *See* Bresco Electrical Services, *supra* note 12; Schroeder & Carlson, *supra* note 14; DERHAM, *supra* note 6, at ¶10.54.
[17] Insolvency and Bankruptcy Code, No. 31, Acts of Parliament, 2016 [Hereinafter IBC].
[18] *Id.* § 173.

enacted as the previous regime under the Companies Act, 2013[19] and Provincial Insolvency Act, 1920[20] gave effect to an indebted creditor's right to set off against the corporate debtor.[21] Unlike the regime that preceded it, the present IBC does not provide a clear framework for set off during liquidation. While it has been remarked that the insolvency framework does not have any mandatory provision for insolvency set off, this is not an accurate characterization of the problem.[22] Under the IBC, set offs are given effect during the insolvency resolution process only while making a distribution and there are separate regulations that refer to set offs at the stage of liquidation. Thus, the IBC offers some protections for the right to set off through its framework. But a lack of an express mandate for the right to set off in the text of the IBC dealing with corporate insolvency has led to decisions by the adjudicating authority that prevent the creditor from claiming set offs.

Uncertainty with regards to the right to exercise set off during insolvency will have an effect on different types of unsecured creditors, but banks in particular are likely to feel the brunt of this policy change. This is because the right to set off has become almost ubiquitous in India through its inclusion in terms and conditions that banks routinely include in transactions with customers. If the right to set off is not preserved during liquidation, then a bank's position becomes worse than it would have been prior to the commencement of insolvency proceedings. Under the Indian Contract Act, 1872,[23] the bank can retain the possession of a fixed deposit receipt. However, since the IBC requires the resolution professional to take control and custody of the assets of the corporate debtor,[24] a bank cannot withhold the possession of fixed deposit receipts, during the liquidation process. The only instance in which a bank can stake a claim over a customer's deposits during liquidation proceedings is if a charge with respect to them has been registered, i.e., the deposits are made a security for loans owed to the bank.[25] In the absence of such a secured claim, banks in India seem to be in a precarious position in the event of the liquidation of one of their depositors.

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[19] Companies Act, No. 18, Acts of Parliament, 2013 § 325 [Hereinafter Companies Act 2013].
[20] Provincial Insolvency Act, No. 5, Central Government Act, 1920 §46.
[21] *See* Official Liquidator of the High Court of Karnataka v. V. Lakshmikutty, (1981) 3 SCC 32; Bank of Maharashtra v. Official Liquidator, Navjivan Trading Finance, 1998 SCC OnLine Guj 370.
[22] Shishir Mehta et al., *Restructuring and Insolvency in India: Overview*, THOMSON REUTERS (Oct. 1, 2017), https://content.next.westlaw.com/6-506-0854?__lrTS=20210212032453871&transitionType=Default&contextData=(sc.Default)&firstPage=true.
[23] Indian Contract Act, No. 9, Central Government Acts, 1872 §§ 171-173.
[24] IBC §§ 18(f), 238.
[25] *See* Companies Act § 77; IBC § 52.

This paper explores the evolution of the right to set off in India in the context of insolvency law. Since the IBC shares several features of the UK's and the US' insolvency and bankruptcy laws, this paper turns to these jurisdictions to understand how they have addressed the concept of set offs in insolvency especially with regards to deposits left with banks. Part II engages in a conceptual discussion about the role of set offs during insolvency and Part III explains how set offs operate within the provisions of the IBC and the Indian Companies Act, 2013 (which replaced the Companies Act, 1956). Part III also uses case law from before and after the enactment of the IBC to compare how set offs operate during insolvency and liquidation proceedings. Part IV surveys the approaches of the UK and the US and engages in a thematic discussion about the role of set offs. In doing so, it explains how these jurisdictions have resolved the apparent tension between insolvency law's impetus of orderly distribution and the possibility of set offs to act as a preference to some creditors. Thereafter, Part V concludes and suggests that India should exclude money subject to set offs from the liquidation estate or afford it protections that do not risk diluting this right.

II. Understanding the role of set offs in insolvency law

The implications of a set off are vastly different once one of the parties involved becomes insolvent.[26] If both parties are able to pay their debts to each other and neither is insolvent, then the rationale behind set off is straightforward. If A owes 100 USD to B and B owes 60 USD to A, A may simply pay B 40 USD to settle the entire debt between the parties.[27] This avoids the multiple transactions involved in the alternate scenario where A first pays B 100 USD, and then B pays 60 USD to A.[28] Using the set off means that A need not part with 100 USD at once, but can satisfy their debt with B by simply paying the balance of the amounts due between them or 40 USD. The situation becomes markedly different if B becomes insolvent and faces liquidation.

Under regular circumstances, a set off pits the right of a debtor against that of the creditor who is also indebted to them. But in the context of liquidation this right of an indebted creditor to exercise set off influences how effectively other creditors are able to realize their debts through the liquidation process.[29] This nature of insolvency proceedings which cause a change in the effects of a set off is what makes their retention or exclusion from the insolvency framework a

[26] McCoid, *supra* note 4, at 15.
[27] *Id.*
[28] *Id.*
[29] *Id.* at 18.

critical policy decision. A common feature of liquidation in India and other jurisdictions is that creditors are seldom paid in full because corporate debtors do not have the assets required to fully pay all the claims against them.[30] For instance, if the total claims against a creditor are to the tune of 100 USD, but the liquidation estate only amounts to 60 USD, this means that creditors will not receive the entire proportion of their debt. Instead, creditors will receive 60 cents on the dollar, their claims being reduced (during payment) proportionately to the insufficiency of the liquidation estate.[31] Unsecured creditors are most affected by this type of ratable distribution since they do not have the ability to dispose of any security to realize a part of their claim. In case a secured creditor had a debt of 250 USD against the debtor which was secured by an asset worth 200 USD, then they would be in a position to realize this security and be subject to ratable distribution for the remainder of the debt.[32] Keeping this in mind, the application of the set off rule has two important consequences.

The first is that set offs can often operate as a preference.[33] The portion of the claim that a creditor is able to set off against the claim of the corporate debtor, will effectively be paid in full to the creditor.[34] For instance, if the creditor has a claim of 700 USD against the debtor but owes the debtor 450 USD, based on the rules of set off, the creditor needs to only claim 250 USD from the debtor.[35] This will mean that to the extent of 450 USD the creditor using the set off provisions has been given a preference, as this debt is paid (or rather, adjusted) before any other creditors are paid from the liquidation estate.[36] In the absence of a set off provision, the creditor would have to pay 700 USD into the liquidation estate and wait in the queue along with other creditors to receive a ratable distribution.

A corollary implication of the application of set offs during liquidation is that it reduces the total funds available to the other creditors awaiting distribution.[37] In the example above, when set off is applied, the creditor only pays 250 USD into the liquidation estate. However, when no set off is applied, the entire sum of 700 USD is paid into the estate. Since the liquidation estate is treated as a common pool of assets, all creditors benefit from an increase in the liquidation estate as they stand to gain more when it is distributed. In this regard, a set off

[30]Rizwan Jameel Mokal, *Priority as Pathology: The Pari Passu Myth*, 60 CAMBRIDGE L.J. 579, 588 (2001).
[31] McCoid, *supra* note 4, at 17-18;
[32] *Id.*
[33] *Id.*; Finch, 614-15; Rizwan Jameel Mokal, *supra* note 30, at 585-86 (2001).
[34] *Id.*
[35] *Id.*
[36] *Id.*
[37] McCoid, *supra* note 4, at 17-18.

mimics the characteristics of secured debt, though it is a right that is actually exercised by unsecured creditors. In the example regarding the secured creditor, they would be able to realize their security worth 200 USD but this amount would be removed from the liquidation estate, thus reducing sum available for distribution. Set offs have the same effect, if one were to claim a set off of 200 USD, then an unsecured creditor would be able to effectively remove that sum from the liquidation estate and apply it to satisfying their debt. A set off's capacity to allow the same treatment for unsecured and secured creditors during liquidation has raised questions about its compatibility with the principle of creditor equality under insolvency and bankruptcy law.[38]

A. Pari Passu and objections to insolvency set offs

The *pari passu* principle is considered one of the key features of modern insolvency and bankruptcy law.[39] At its simplest and strongest application, the principle requires that unsecured creditors be given equal treatment.[40] This would mean that all unsecured creditors, irrespective of the other characteristics of their debt should obtain a proportionate distribution from the liquidation estate to satisfy their debt.[41] India prioritizes workers' wages for up to two years over other unsecured debts.[42] Similarly, the UK has classes of preferred employees whose claims are prioritized over those of other unsecured creditors.[43] Even within this "weak" application of the pari passu principle,[44] there is a requirement that unsecured creditors within the classes created by insolvency legislation are treated equally.[45] The pari passu principle has not been explicitly mentioned under the IBC, however, it is the key conceptual opposition to allowing set offs during insolvency.[46] Further, section 53 containing the liquidation hierarchy states that debts within each class will be ranked equally among each other, thus making it an expression of the pari passu principle.

The reason why set offs can militate against the pari passu principle is quite intuitive. As discussed above, the set off can manifest as preference for the portion of the debt that is adjusted. While other unsecured creditors need to wait for ratable distribution for the entirety

[38] *Id.* at 18.
[39] Mokal, *supra* note 30 at 581; Finch, at 599.
[40] FINCH, *supra* note 6, at 599.
[41] *Id.*
[42] IBC § 53.
[43] FINCH, *supra* note 6, at 599.
[44] *Id.*
[45] *Id.*
[46] Mokal, *supra* note 30, at 585.

of their debt, those that exercise their set off are able to retain the full portion of their claim to the extent of the set off amount. Moreover, in retaining sums form the liquidation estate while exercising set off, the total assets available for collective distribution are reduced. This is because what would have been turned over to the liquidation estate is being applied to reduce one creditor's indebtedness to the corporate debtor.

This apparent conflict between insolvency set offs and one of the corner stones of modern insolvency law (the pari passu principle) need not, however, come in the way of recognizing insolvency set offs. For instance, the UNCITRAL Model Law on Cross Border Insolvency's Legislative Guide also provides for the right of set off as an exception to the principle of pari passu distribution.[47] Under the European Union Insolvency Regulations, set off becomes a guarantee governed by law applicable to the insolvent debtor's claim.[48] This exception under Article 9 acts as an exception to the common principle of pari passu and was inserted with an intention to protect a creditor from lack of set off rights.[49]

Scholars writing about insolvency law often recognize the two opposing truths of how the pari passu rule is applied – it is considered a fundamental rule of insolvency law in almost all jurisdictions, but it actually applies to only a small portion of creditors.[50] This paradoxical situation is a result of the various exceptions to the pari passu rule that insolvency law has created. Some of these exceptions have been discussed above, such as preferential payments to workers and employees who are unsecured creditors but treated differently from general unsecured creditors during liquidation. Other examples include debts created after the commencement of insolvency proceedings which are also prioritized over those of other unsecured creditors.[51] Given its various exceptions, the pari passu rule properly applies only to general unsecured creditors whose debts have not been granted any preference by the insolvency statute.[52] The pari passu principle alone, thus cannot be the justification for denying set offs during insolvency. This is mainly because governments have taken policy decisions to create hierarchies in liquidation priority that did not exist before the commencement of insolvency and liquidation proceedings. The decision on whether or not to allow set offs must

[47] United Nations Commission On International Trade Law - Legislative Guide on Insolvency Law, UNCITRAL, https://uncitral.un.org/en/texts/insolvency/legislativeguides/insolvency_law (last visited May 31, 2021).
[48] McCormack, *supra* note 4, at 100, 101–102.
[49] Miguel Virgos & Etienne Schmit, *Report on the Convention on Insolvency Proceedings*, EU Council Doc 6500/96 ¶ 109 (1996).
[50] Mokal, *supra* note 30, at 582-83, 587; FINCH, *supra* note 6, at 628.
[51] *Id. See* IBC § 52.
[52] *Id. See* IBC § 52.

also be seen as such because there appears to be nothing inherently incompatible with set offs and orderly distribution during liquidation. The next parts survey how India, the UK, and the US have each preserved the right to set off. Specifically, the paper turns to an analysis of what happens to the right to set off during three stages of the insolvency proceedings, commencement, resolution proceedings as under their respective legislations, and finally, liquidation.

III. Evolution of India's position on insolvency set offs

The insolvency regime preceding the IBC was similar to that which is currently prevalent in the UK. Before the IBC was enacted, India's insolvency law for corporations was contained in the Provincial Insolvency Act, 1920[53] and the Companies Act, 1956 which was subsequently replaced by the Companies Act, 2013. Prior to the enactment of the IBC, a company would be liquidated subsequent to a winding up order passed by a High Court.[54] This winding up process could be started by a company's creditor if a company was unable to pay its debts.[55] Thereafter, the court may make an order for winding up and appoint an official liquidator to gather the assets and sell. The sales proceeds are distributed among the creditors of the company.[56] The Companies Act, 1956 and 2013 both provided for this mode of winding up in similar way; after the enactment of the IBC the Provincial Insolvency Act, 1920 was repealed and the Companies Act, 2013 was amended to remove a company's inability to pay debts as a basis for winding up.[57] In order to understand the treatment of the right to set off prior to the IBC, the following discussion examines case law related to insolvency set off before the IBC was enacted.

A. Treatment of insolvency set offs before the IBC

As mentioned above, the winding up provisions under the Companies Act, 1956 and Companies Act, 2013 are similar to one another in that both allow for the creditor to initiate winding up when a company cannot pay its debtors.[58] Further, under both Companies Acts, liquidation subsequent to the winding up order was required to be carried out in accordance

[53] Provincial Insolvency Act, No. 5, Central Government Act, 1920.
[54] Companies Act 2013 § 271; Companies Act, No. 1, Acts of Parliament, 1956 § 433(e) [Hereinafter Companies Act 1956].
[55] The Companies Act 2013 § 271.
[56] *Id.* §§ 271, 273, 275.
[57] IBC § 243. For amended Companies Act 2013 for position after the enactment of the IBC, *See The Companies Act 2013*, MINISTRY OF CORPORATE AFFAIRS, http://ebook.mca.gov.in/default.aspx (last visited Jun. 8, 2021).
[58] Companies Act 2013 § 271; Companies Act 1956 § 433(e).

with the insolvency law in force (Provincial Insolvency Act, 1920).[59] The Provincial Insolvency Act contained a provision on mutual dealings (section 46) and mandated that debts arising from mutual dealings between the debtor and the creditor had to be set off against each other.[60] This meant that only the amount due after claims were set off against one another would have to be paid to either the debtor or creditor, depending on where the balance was owed. The wording of section 46 is similar to the UK's insolvency law as found in the UK's Bankruptcy Act, 1914[61] and the Insolvency Rules 2016 which is the insolvency law currently applicable to corporations in the UK.[62] Under all three pieces of legislation, an account needs to be taken of sums due from one party to the other (the parties being the debtor and the creditor) and these sums due need to be set off against one another.

The operation of the winding up provisions under India's company law and section 46 of the Provincial Insolvency Act firmly embedded the right to set off during corporate liquidations in India. This position has been reflected in case law prior to the enactment of the IBC. The Supreme Court of India broadly identified the rationale for set offs in *Official Liquidator of the High Court of Karnataka v. Lakshmikutty*.[63] In this short decision, the Supreme Court did not look into the facts of the case; since it was deciding an appeal. The court simply upheld the High Court's decision and explained the legal position with regards to insolvency set offs. In doing so, the Supreme Court reconciled the Companies Act's provision on preferential payments in the event of winding up and the right to set off. The Companies Act, 1956 contained a provision on preferential payments under section 530 which required certain dues, such as those owed to central and state governments or employees' compensation, to be paid in preference to all other debts.[64] Section 530 however, was subject to section 529A which prioritized dues owed to workmen and secured creditors and ensured that these debts ranked equally.[65] These provisions had to be harmonized with section 46 of the Provincial Insolvency Act which provided for set off, thus allowing an unsecured creditor to adjust their payments to the company's liquidation estate based on the dues the creditor owed to the company. The Supreme Court held that all of these provisions had to be read together to give effect to the

[59] Companies Act 2013 § 324; Companies Act 1956 § 529.
[60] Provincial Insolvency Act § 46. *See* Official Liquidator of the High Court of Karnataka v. V. Lakshmikutty (1981) 3 SCC 31, ¶1.
[61] Bankruptcy Act 1914, Ch. 59 § 31.
[62] Insolvency Rules 2016 rr. 14.24, 14.25.
[63] Official Liquidator of the High Court of Karnataka v. V. Lakshmikutty (1981) 3 SCC 31.
[64] Companies Act 1956 § 530.
[65] *Id.* §539A.

liquidation framework in force. The court found that while preferential payments were mandated under section 530, this order of distribution would not come in the way of a creditor exercising their right to set off.[66] The Supreme Court reasoned that the creditor cannot be expected to pay all of its dues to the company (without set off) while only being entitled to a ratable distribution of what they are owed from the company.[67] Following the precedent of English courts and noting the similarity between the set off provisions of Indian insolvency law and English insolvency law at the time, the Supreme Court held that only the balance amount after set off needs to be paid into the liquidation estate by the creditor.[68]

A more detailed examination of set offs was carried out by the Gujarat High Court in *Bank of Maharashtra v. Official Liquidator*.[69] In this case, a company had created fifty fixed deposits in the Bank of Maharashtra and had availed of an overdraft facility from the same bank. The fixed deposit receipts (FDRs) were pledged as security for the overdraft account held by the company. However, some FDRs were pledged as security for the overdraft account once winding up proceedings against the company had commenced. The validity of these FDRs as security was at risk because the Companies Act, 1956 required dispositions of property after the commencement of winding up proceedings to be validated by the court, without this validation, any disposition of the company's property would be considered void.[70] Much like the IBC, then existing Companies Act, 1956 allowed a secured creditor to decide whether they would prefer to surrender their security to the liquidation estate and obtain a portion of the distribution from it or realize the value of their security in lieu of ratable distribution.[71] Further, secured creditors ranked higher in the liquidation distribution hierarchy than unsecured creditors under the winding up schemes of the Companies Acts of 1956 and 2013.[72] If the bank could have had the pledged FDRs validated by the court, then its claim with respect to the overdraft account held by the company would no longer be an unsecured debt, rather, it would be secured by the FDRs.[73] In the alternative, the bank argued that it was entitled to retain the FDRs and not surrender them to the liquidation estate by virtue of its right to set off.[74] The

[66] Official Liquidator of the High Court of Karnataka v. V. Lakshmikutty (1981) 3 SCC 31, ¶2.
[67] *Id.*
[68] *Id.* The Supreme Court referred to the House of Lords Decision in *National Westminster Bank Ltd. v. Halesowen Presswork & Assemblies Ltd*., [1972] 1 All ER 641.
[69] Bank of Maharashtra v. Official Liquidator, 1998 SCC OnLine Guj 370.
[70] *Id.* ¶ 3; Companies Act 1956 §536.
[71] See Provincial Insolvency Act §§28(6), 47; Companies Act 1956 § 529.
[72] IBC § 53, Companies Act 1956 §§ 529-530; Companies Act 2013 §§ 325-326.
[73] Bank of Maharashtra, *supra* note 69, ¶8.
[74] *Id.*

High Court of Gujarat which heard this case finally decided in favor of the bank based on the second argument.[75]

The High Court referred to the standards applicable for deciding whether a disposition of property ought to be validated after winding up is commenced but it concluded that its decision on whether or not to validate the security would not make a difference in the outcome of the case.[76] This was because it emphasized on the bank's right to claim set off under the Companies Act 1956 read with section 46 of the Provincial Insolvency Act.[77] The High Court noted that even if the FDRs lost the characteristics of a security (if they were not validated by the court), they can still be set off against the debt owed by the company to the bank. This would mean that the bank need not relinquish all the FDRs to the liquidation estate.[78] The High Court ultimately ordered the liquidator to set off the amounts due with respect to the overdraft facility with those held by the bank through the company's FDRs.[79] If the bank owed anything to the company after the set off, only this amount could be included in the liquidation estate of the company. Importantly, the High Court held that set off under the Companies Act,1956 read with the Provincial Insolvency Act was mandatory.[80] This case gives a lucid vindication of the bank's (and company's) right to claim set off in the event of liquidation prior to the enactment of the IBC.

The enactment of the IBC did not affect set offs as a result of any explicit provision. Rather, the addition of different insolvency procedures and provisions have each had distinct effects on the right to set off. The discussion of set offs under the IBC has been categorized based on three important stages of the insolvency resolution process, i.e., the commencement of the resolution process, the resolution process itself, and finally, liquidation.

B. Treatment of set offs after the IBC

The IBC consolidated insolvency laws prior to it and created a comprehensive piece of legislation for corporate insolvency and individual bankruptcy.[81] The IBC allows creditors to

[75] *Id.* ¶61.
[76] *Id.* ¶62.
[77] *Id.* ¶66.
[78] *Id.* 61.
[79] *Id.*
[80] *Id.* ¶66.
[81] IBC Preamble; *Understanding the IBC: Key Jurisdictions and Practical Considerations – A Handbook*, INSOLVENCY AND BANKRUPTCY BOARD OF INDIA, at 14, https://ibbi.gov.in/uploads/whatsnew/e42fddce80e99d28b683a7e21c81110e.pdf (last visited Jun. 8, 2021).

initiate insolvency proceedings against the corporate debtor if it commits a default exceeding INR 10,000,000.[82] Creditors are divided into four categories based on the nature of their relationship with the corporate debtor.[83] The first comprises of those creditors who have a purely financial relationship with the corporate debtor (such as a bank providing a loan) are classified as financial creditors.[84]

The IBC further classifies the financial creditors on the basis of their security interest as secured and unsecured creditors. The second category of creditors is operational creditors. These creditors have a claim against the corporate debtor on account of goods or services provided to it or in the form of government dues.[85] The third category of creditors are workmen and employees, whose wages or salary are outstanding in the accounts of corporate debtor. The fourth category comprises of those creditors, who are not covered under above three categories such as preference shareholders or guarantors. Financial creditors are at the helm of the decision-making process under the IBC because they form the Committee of Creditors (CoC) which is the key decision-making body in the insolvency resolution process. The insolvency resolution process is facilitated by a resolution professional (appointed by the CoC) who takes over the management of the corporate debtor during the insolvency resolution process, collects claims from creditors, and invites proposals for a resolution plan.

1. Set Offs and the Moratorium

Once an insolvency petition against a corporate debtor is accepted by the court, a moratorium against all individual claims falls into place. The moratorium stays the commencement and continuation of all legal proceedings against debtor and it also prevents secured creditors from taking any steps to realize their security against the corporate debtor.[86] This moratorium remains in place until the National Company Law Tribunal (NCLT)[87] confirms the resolution plan approved by the CoC or until the NCLT passes a liquidation order requiring the assets of the corporate debtor to be gathered and distributed among its creditors[88] The moratorium is a crucial feature of the IBC in that it forces the creditors to work collectively to decide the future

[82] IBC § 4(1). *See* Notification S.O. 1205(E), Ministry of Corporate Affairs (Mar. 2020).
[83] IBC §§ 5(7), 5(20).
[84] *Id.* §§ 5(7)-5(8).
[85] *Id* §§ 5(20)-5(21)
[86] *Id.* §14(1)(c)
[87] The National Company Law Tribunal is the Adjudicating Authority under the IBC which needs to confirm a resolution plan before it can take effect. *See* IBC §5(1).
[88] IBC § 14(4).

of the corporate debtor. The moratorium under section 14 of the IBC is analogous to the automatic stay under US Bankruptcy Law and the moratorium that falls into place under UK insolvency law.[89]

Section 14 of the IBC has been used to prevent banks and other creditors from setting off any amounts they owe to the debtor against their own claims. The IBC also allows the resolution professional to take control and custody of the debtor's property[90], and this has been held to include amounts that can be subject to set off by the creditor. This means that even if there are mutual dealings between the debtor and creditor, the resolution professional will control all assets of the debtor. The following discussion explains the IBC's position on set offs and interpreted by the NCLT and the National Company Law Appellate Tribunal (NCLAT) in the context of the corporate insolvency resolution process.

A recent decision of the NCLT in *Interim Resolution Professional v. ICICI Bank*[91] provides a starting point for discussions on how the section 14 moratorium of the IBC affects set offs. In this case, ICICI Bank had debited money from the corporate debtor's current account after insolvency proceedings against it had commenced.[92] In this case, insolvency proceedings were commenced by another financial creditor of the corporate debtor. On learning about these proceedings, ICICI Bank debited sums from the corporate debtor's current account to adjust it against the debtor's unpaid loans to the bank.[93] The interim insolvency resolution professional of the corporate debtor filed an application with the NCLT to order it to return the money debited from the corporate debtor's current account.

It may be noted that moratorium provisions of section 14 of the IBC prevent the commencement and continuation of legal proceedings against the corporate debtor. Exercising the right to set off, however, does not require legal proceedings.[94] The terms and conditions of most banks that customers agree to before opening an account give the bank the right to set off.[95] ICICI Bank, instead, chose to base its arguments on another feature of the section 14

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[89] US Bankruptcy Code § 365, UK Insolvency Act § *see Infra*, Part IV.
[90] IBC § 25(2)(a).
[91] 2018 SCC OnLine NCLT 21931;
[92] *Id.* ¶2.
[93] *Id.*
[94] *See e.g.* Syndicate Bank v. Vijay Kumar (1992) 2 SCC 330, [7]; Canara Bank v. Messrs Taraka Prabhu Publishers (1990) SCC OnLine AP 122, [10]; Bank of Baroda v. Messrs Samrat Exports (1997) SCC OnLine Kar 303, [14]; Canara Bank v. Roop Dutt (2009) SCC Online HP 2018.
[95] *See e.g.* ICICI Bank, Terms and Conditions of Current Account, [19], https://www.icicibank.com/ebor/personal-banking/deposits/accounts/TC_for_CA.pdf.; Terms and Conditions for Savings Account, ICICI Bank, [26], https://www.icicibank.com/terms-condition/savings-terms-

moratorium. The bank argued that section 14 is specific in preventing certain actors from carrying out particular actions against the corporate debtor.[96] For instance, *secured creditors* are not allowed to foreclose or recover any security and the *owners* or *lessors* of any property occupied by the corporate debtor cannot take any action to recover their property.[97] For each action that is prohibited under the moratorium, an actor has been identified under section 14. Similarly, the prohibition on encumbering or disposing off any asset or legal right of the corporate debtor is specifically imposed on the corporate debtor themselves. The bank used this provision to argue that only the corporate debtor, and not the bank was prohibited from alienating or encumbering the assets (which in this case referred to the current account) of the corporate debtor. The NCLT was not persuaded by this line of reasoning. It held that the bank's right over the current account was not one of ownership but that right which flowed from its position as the creditor to the corporate debtor, i.e., the right to recovery. This right to realization was barred by the section 14 moratorium and thus the bank would not be allowed to act on it.

In its decision, the NCLT recognized that the outcome would have been different were the right to set off recognized in India as it is in other jurisdictions.[98] But since this right has not been recognized in India in the context of the IBC, ICICI Bank was ordered to deposit the money it had debited back into the corporate debtor's account.[99] In another matter, *State Bank of India v. Debashish Nanda*[100] the NCLAT used the moratorium to prevent the bank from debiting amounts from the corporate debtor's account. Though the NCLAT allowed the financial creditor to record the debited amount in a separate ledger, it did not allow the amount to be adjusted. The NCLAT further observed that the bank cannot freeze the account nor can it prohibit the corporate debtor from withdrawing the amount, for its day-to-day functioning.

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conditions.page#tc24; HDFC Bank, General Terms and Conditions, [1.28], https://www.hdfcbank.com/personal/useful-links/terms-and-conditions; State Bank of India, Terms of Use (Terms & Conditions), 13, https://www.onlinesbi.com/sbijava/Terms_of_Use.html; Kotak Mahindra Bank, Terms & Conditions, 2, https://www.kotak.com/en/customer-service/terms-and-conditions.html#2; Bank of Baroda, Terms & Conditions, 2.1, https://www.bobibanking.com/terms.html.

[96] 2018 SCC OnLine NCLT 21931, ¶7.

[97] IBC § 14(1)(c)-(d).

[98] *Id.* ¶¶12-13, The NCLT held, "*Of course, doctrines like set-off, reclamation, withholding recognised under insolvency jurisprudence of USA, UK and Germany are not available in the Code, under those jurisprudences, there is a possibility to set off or withhold funds of insolvent, creditor is entitled to exercise any of the doctrines mentioned above to arrest onslaught against creditors. But the same not yet being applied to our Law…once moratorium is kicked in, the creditor will have no right to exercise its right of lien upon the asset of the Corporate Debtor*."

[99] *Id.*

[100] Company Appeal (AT) (Insolvency) No. 49 of 2018, order dated 21.03.2018

The most important part of the resolution process after an application is admitted is the confirmation of the insolvency resolution plan. This process is facilitated by a resolution professional who is appointed by the financial creditors of the corporate debtor who comprise the Committee of Creditors. The resolution professional invites bidders to submit resolution plans and the CoC may approve a resolution plan with a sixty-six percent majority. Thereafter, the NCLT confirms the resolution plan, making it binding on all creditors and the corporate debtor.

2. Set offs and distribution under insolvency resolution plans

Any distribution made under an insolvency resolution plan follows the distribution order that is applicable in instances of liquidation. Section 53 of the IBC contains the liquidation waterfall which provides the order in which claims ought to be paid. In this order, secured creditors' claims (only to the extent that they are secured) are ranked second, pari pasu with workmen's dues for up to two years.[101] Thus, should a secured creditor choose to relinquish their security, their debts would rank second in priority. Unsecured creditors' claims are ranked fourth and sixth depending on whether they are financial or operational creditors respectively.[102] Since a bank's relationship with a company to which it loans money is purely financial, a bank's unsecured debt will be a financial debt and liable to be paid fourth in the event of liquidation. Sums owed to secured creditors in excess of the value of their security are paid fifth and are ranked equally with dues owed to the Central and State governments.[103]

The discussion on the moratorium and set offs explained how section 14 prevented the exercise of set offs during the insolvency resolution process. The text of the IBC does not have any reference to set offs during distribution of assets under an insolvency resolution plan, but some guidance can be found in the Schedules of the IBC's regulations. The Insolvency and Bankruptcy Board of India (Insolvency Resolution for Corporate Persons) Regulations, 2016[104] contains forms in which all the creditors need to submit their claims, including details about mutual dealings with the corporate debtor which may be set off.[105] Form B requires operational

[101] *Id.* §53(1)(b).
[102] *Id.* §53(1)(d),(f).
[103] *Id.* §53(1)(e).
[104] Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons), IBBI/2016-17/GN/REG004.
[105] *Id.* regs. 7–8.

creditors to disclose any mutual dealings that can be subject to set off and Form C does the same for financial creditors.

Authors were not able to find any case law in which these set offs claims were approved, however, the NCLT has held that the appropriate stage to exercise the right to set off would be while filing claims. In *Re: State Bank of India*, the corporate debtor claimed that it was owed a sum of money by the financial creditor (a bank). The corporate debtor attempted to use this obligation of the financial creditor as a means to dispose of the insolvency application. The NCLT held that since the corporate debtor had committed a default, the insolvency application of the bank had to be admitted. The NCLT then remarked that any counterclaims or set offs would have to be disclosed under Form C (or Form B, in case of an operational creditor) and that the insolvency resolution process of the IBC provided for a mechanism to deal with this situation. This decision did not involve the actual exercise of set off as it was made at the stage of admitting an application.

Another important decision when discussing set offs under the insolvency resolution process is *Vijay V. Iyer v. Bharti Airtel*.[106] Though this case pertains to a set off claimed by an operational creditor, the rationale for rejecting the claim (application of section 14 moratorium) can be applied to both financial and operational creditors. The *Bharti Airtel* case involved the insolvency resolution proceedings of Aircel Ltd. and Dishnet Wireless (Aircel entities) which had entered into a spectrum transfer agreement with Airtel Ltd. and Hexacom Ltd. (Airtel entities).[107] The spectrum transfer agreement allowed Airtel entities to use the 2300 MHz band spectrum for a consideration payable to Aircel entities.[108] This spectrum transfer approval required the sanction of the Department of Telecommunications (DoT); the DoT required Aircel Entities to submit a bank guarantee as a condition to granting approval.[109] Aircel Entities approached Airtel Entities to provide the bank guarantee on their behalf as the former did not have sufficient funds. Airtel Entities agreed to do so and retained a sum of INR 4,537,300,000 (value of the bank guarantee) to be adjusted against the total consideration for the spectrum transfer owed to Aircel Entities.[110] In the meantime, Airtel Entities entered into operational service agreements with Aircel Entities for which Airtel Entities were owed payments. When

[106] 2020 SCC OnLine NCLAT 584 [Bharti Airtel NCLAT].
[107] Bharti Airtel Ltd. & Anr. v. Vijay V. Iyer & Anr., MA 230/2019 in C.P. No. 302/IBC/NCLT/MB/MAH/2018 [Bharti Airtel NCLT].
[108] *Id.*
[109] *Id.* at 2-3.
[110] *Id.*

Aircel Entities entered the insolvency resolution process, Airtel Entities refused to surrender the entire amount held by them pursuant to the bank guarantee. Airtel Entities set off the amounts owed to them by Aircel Entities on account of operational service agreements and returned only the remaining amount that was withheld by it on account of providing the bank guarantee.[111] The resolution professional refused to recognize this set off on the grounds that it resulted in giving a preference to Airtel Entities over other operational creditors. Airtel Entities had retained a sum of INR 1,120,000,000.[112]

The decision of the resolution professional was contested by Airtel Entities before the NCLT (Mumbai Bench).[113] The NCLT recognized the right to set off during the insolvency resolution process and held that Airtel Entities were entitled to retain the amounts payable to them on account of unpaid amounts with respect to operational services given. In response to the resolution professional's contention that this would result in a preference over other operational creditors, the NCLT noted that the option to exercise set off was available to all operational creditors in case they had any pre-existing right to set off.[114] The NCLT was also unpersuaded by the argument that the moratorium barred set offs during the resolution process. The NCLT characterized amounts subject to set off as being held by the corporate debtor under a contractual obligation by the corporate debtor. The Tribunal likened assets subject to set off to assets of a third party held in trust or under a contractual obligation. Under section 18 of the IBC, such assets are excluded from the control and custody of the resolution professional. Based on this reasoning, the NCLT held that the moratorium did not prevent the application of set offs.[115]

The decision of the NCLT was appealed by the resolution professional and Aircel Entities (corporate debtors) in the National Company Law Appellate Tribunal (NCLAT), the appellate tribunal of NCLT.[116]The NCLAT disagreed with the NCLT and upheld the resolution professional's decision. The NCLAT held that allowing the operational creditor to retain any amount due to the corporate debtor on account of a set off would be antithetical to the IBC.[117] Even in this case, the NCLAT held that allowing the set off would be contrary to the

[111] *Id.* at 6.
[112] *Id.* at 7.
[113] Bharti Airtel NCLT, *supra* note 107, at 7.
[114] *Id.* at 35.
[115] *Id.* at 33–34.
[116] Bharti Airtel NCLAT, *supra* note 104.
[117] *Id.* ¶¶8, 14.

moratorium imposed under section 14 of the IBC.[118] Unfortunately, the NCLAT did not provide a detailed refutation of the NCLT's rationale but asserted the overarching nature of the section 14 moratorium and that it would supersede any accounting practices that allowed for the set off of claims.[119]

In the absence of an overarching mandate for set offs under the IBC during the insolvency resolution process, unsecured creditors need to rely on Forms B and C of the Insolvency Proceedings Regulations. The case law with regards to how creditors may use these forms to claim set offs casts doubts on the operation of set offs. In *Swiss Ribbons*,[120] the Supreme Court did not directly deal with set offs but held that they were a "rarity" and that when they occurred, they would need to be considered.[121] The NCLT decision in *Re: State Bank of India* encourages the use of the forms under the Insolvency Proceedings Regulations to claim set offs, however, this case involved a set off that would result in a payment to the corporate debtor and did not involve a claim of set off over its existing assets. Finally, the NCLAT decision in *Bharti Airtel* suggests that notwithstanding the forms in the Insolvency Proceedings Regulations, section 14 would come in the way of exercising the right to set off under the IBC. The NCLAT decision has diluted the provisions contained in the Insolvency Proceedings Regulations and for this reason, should be revisited. Having examined how set offs operate during the insolvency resolution process, the next section turns to the operation of set offs during liquidation.

3. The subsumption of set offs under the liquidation process

Though IBC's framework emphasizes the rehabilitation of the corporate debtor and treats liquidation as an option of the last resort, a majority of the cases that have been disposed under the IBC have resulted in liquidation rather than rehabilitation or reorganization.[122] A study published in 2020 found that over half the cases admitted under the IBC were still undergoing resolution proceedings or had been withdrawn.[123] Out of the total number of admitted cases,

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[118] *Id.*
[119] *Id.* at ¶14.
[120] Swiss Ribbons v. Union of India, Swiss Ribbons v. Union of India, (2019) 4 SCC 17. In this case, the constitutional validity of the IBC's distinction between financial and operational creditors was challenged. The main ground for this challenge was that by distinguishing between operational and financial creditors, the IBC was discriminating between different types of creditors thus violating the principle of equal and non-arbitrary treatment enshrined in Article 14 of the Constitution of India. The Supreme Court ultimately upheld this distinction and the scheme of the IBC as constitutionally valid.
[121] *Id.* ¶61.
[122] Samrat Sharma, *Bankruptcy resolution: In IBC, liquidation and overwhelming outcome rather than revival*, Financial Express (Mar. 27, 2020), https://www.financialexpress.com/economy/bankruptcy-resolution-in-ibc-liquidation-an-overwhelming-outcome-rather-than-revival/1972086/.
[123] *Id.*

24 percent had ended in liquidation while only 6 percent resulted in the corporate debtor's reorganization.[124] The treatment of set offs during liquidation thus remains as important under the IBC as it was under the previous insolvency regime. This issue is particularly relevant to unsecured creditors as they cannot realize their debt outside the IBC's liquidation process. Secured creditors, however, have the option of opting out of the IBC's liquidation process and may choose to realize the value of their security.[125] This is permitted by virtue of section 52 of the IBC which allows secured creditors to remove their security from the collective liquidation process by informing the liquidator.[126] In the alternative, a secured creditor may relinquish their security and participate in the liquidation distribution provided for under section 53 of the IBC.[127] The distribution order has already been discussed; to briefly reiterate, the debt remaining payable to a secured creditor after their security is realized is paid fifth. In the case that the secured creditors release their security to the liquidation estate, their dues are paid second in priority ranking equally with workmen's wages.[128]

The provisions of the IBC that provide for the creation of the liquidation estate out of which distributions are made to creditors suggest that any amount subject to set off needs to be made a part of the liquidation estate.[129] This would mean that if a creditor is in possession of any money that can be set off against the dues owed to them by the corporate debtor being liquidated, this money would have to be paid into the liquidation estate. Section 36 of the IBC describes what constitutes the liquidation estate. Under this section, the liquidation estate includes all assets of the debtor including the debtor's rights and interests as demonstrated from its balance sheet.

The assets included in the liquidation estate also extend to assets that are not in the possession of the debtor and encumbered assets. Section 36 also contains a list of items that will not be included in the liquidation estate.[130] These include assets held in trust of a third party, sums due to workmen from the provident fund, gratuity fund, and pension fund, and personal assets of any shareholder.[131] The NCLAT affirmed this by holding that that the provident fund, the pension fund and the gratuity fund do not come within the meaning of liquidation estate for the

[124] *Id.*
[125] *Id.* §52.
[126] *Id.*
[127] *Id.*
[128] *Id.* §53(1)(b),(e).
[129] IBC §36.
[130] *Id.* §36(4).
[131] *Id.*

purpose of distribution of assets under Section 53.[132] The list of excluded assets concludes by giving the Insolvency and Bankruptcy Board of India (IBBI) the power to specify other assets that can be excluded from the liquidation estate.[133] This provision also mentions the types of assets whose exclusion may be specified by the IBBI and assets which could be subject to set off are included here.[134] Section 36 thus suggests that assets subject to set off are to be made a part of the liquidation estate, however, the IBBI has the power to exclude them from the liquidation estate. If the IBBI were to exercise its power and allow for the exclusion of money subject to set offs from the liquidation estate, this would alter the status quo and ensure that any amount that can be subject to set off will be retained by the creditor instead of being turned over to the corporate debtor's liquidation estate.

While the provisions under section 36 seem straightforward, there is some room for confusion in the IBBI's Liquidation Regulations.[135] These regulations provide for set offs and state that mutual debts arising from mutual dealings shall be set off against one another.[136] However, this may refer to assets subject to set off that are not in the possession of the creditor when the liquidation estate is being created. The Liquidation Regulations also account for the payment of debts that fall due in the future i.e., after the date of liquidation.[137] The set off provision in regulation 29 can be applied to debts that are owed to the corporate debtor by its creditor in the future. The application of section 36 of the IBC (the parent legislation of the Liquidation Regulations) makes it clear that money subject of set off before the commencement of insolvency proceedings cannot be automatically set off during liquidation. If a creditor possesses such sums, it needs to be surrendered to the liquidation estate.

In terms of liquidation process under IBC, Regulation 29 of the Liquidation Regulations adds a layer of complexity to the treatment of set offs by requiring mutual dealings between the debtor and the creditor to be set off against each other. Since the operation of section 36 of IBC requires all assets of the corporate debtor to be made a part of the liquidation estate and this extends to any sums subject to set off. For instance, a bank has control over the debtor's deposits and is in a position to pay them into the liquidation estate. Regulation 29 could not

[132] State Bank of India v.. Moser Baer Karamchari Union & Anr., Company Appeal (AT) (Insolvency) No. 396 (2019)
[133] *Id.* §36(4)(e).
[134] *Id.*
[135] Insolvency and Bankruptcy Board of India (Liquidation Process) Regulations, IBBI/2016-17/GN/REG005, 2016. [Hereinafter IBC Liquidation Regulations].
[136] *Id.* reg. 29.
[137] *Id.* reg. 28.

apply in this case as there would be no amount to set off since the creditor will have already parted with it by virtue of section 36. Since the Liquidation Regulations allow for the payment of debts that fall due after the date of liquidation, regulation 29 may find an application by allowing the set off of future debts due from the corporate debtor to the creditor and vice versa. This means that when a creditor possesses an asset of the corporate debtor that could be subject to set off, it will have to be turned over to the liquidation estate. In this situation, regulation 29 is most likely to apply to debts that fall due in the future, the means of payment for which are neither in the possession of the debtor nor the creditor.

While claims that are filed during the resolution process can provide information about set offs, *Bharti Airtel* shows that the resolution professional is at the liberty to deny this set off. In the context of liquidation, set offs are militated against by including all of the debtor's assets in the liquidation estate under section 36, even those which are subject to set off. Though the IBBI has the power to exclude assets subject to set off from the liquidation estate, it has not exercised this power yet. Fixed deposit receipts, for instance would have to be surrendered to the liquidation estate as they are technically assets of the debtor. Unless the financial creditor has a charge over these fixed deposit receipts (making them a security), they cannot be set off by the bank against the debtor. In order to better understand the concept of insolvency set offs better and the possible justifications in retaining it within insolvency law, the approaches of the UK and the US have been examined in the following discussions. These jurisdictions are of particular relevance as the IBC borrows features from both of them.[138] Importantly, until the IBC was enacted, India's jurisprudence on insolvency set offs was influenced by that of the UK.

IV. Tracing Insolvency set offs in the UK and the US: A Comparison with India

A. Insolvency set offs in the UK

The UK's experience with set offs during its administration process is of particular value for India because the UK has provisions that are similar to India's insolvency resolution process and moratorium. Administrators who facilitate the administration process in the UK have

[138] Himani Singh, *Pre-packaged Insolvency in India: Lessons from the UK and the US*, Harvard Law School Bankruptcy Round Table (Apr. 28, 2020), 2, https://blogs.harvard.edu/bankruptcyroundtable/tag/himani-singh/; Namrata Kishnani, *Insolvency and Bankruptcy code 2016 – A critical review for resolving NPA's in Banking Industry*, 7 INTERNATIONAL JOURNAL OF MONEY BANKING AND FINANCE 100, 104 (2018); Krishn A. Goyal & Ravinder Kumar, *"Bankruptcy Code for Corporate Failure in SAARC Countries" (A Comparative Study)* 59 PRODUCTIVITY, 275, 278 (2020)

powers that are similar to the resolution professional in India. During an administration, directors of a debtor entity cannot make any decisions or take any actions that may interfere with the functions of the administrator.[139] The UK Insolvency Rules (England and Wales), 2016 give the administrator the power to make a distribution to unsecured creditors during administration (with the permission of the court) and also provide for the rules applicable in the event of a company's liquidation through winding up.[140] A company can be liquidated after entering into administration through a procedure known as creditors' voluntary winding up.[141] Creditors' voluntary liquidation can be initiated by the administrator if they believe that secured creditors' claims will be paid in full and leave something in the liquidation estate for the payment of unsecured creditors.[142] Administrators can also initiate creditors' voluntary liquidation after making a distribution to secured and preferential creditors or unsecured creditors (with court approval). The details of each type of winding up are not germane to the present discussion.

What is important to note is that the moratorium in place during administration is similar to the section 14 mortarium under the IBC that facilitates the insolvency resolution process in India. As discussed above, this moratorium under section 14 of the IBC remains in place until a liquidation order is passed. Even once a liquidation order is passed creditors are stayed from taking recourse to legal proceedings in order to realize their claim.[143] Their remedies continue to be determined by the provisions of the IBC. The same applies to liquidation and distributions in the UK. Once liquidation commences, creditors are stayed from taking individual actions outside insolvency law to realize their claims against the corporate debtor.[144]

A significant difference in the treatment of set offs under the insolvency law of the UK and India is that the UK's jurisprudence has consistently upheld the right to set off in the event of liquidation.[145] The mandatory nature of set off was highlighted in the landmark decision of *National Westminster Bank v. Halesowen Pressworks*.[146] Though this case dealt with the Bankruptcy Act, 1914 (which was replaced by the Insolvency Act, 1986), it remains precedent and has been cited by recent cases to underscore the mandatory nature of the UK's present set

[139] Insolvency Act 1986, Sch. B1, ¶64.
[140] Insolvency Rules 2016, r. 14.25.
[141] Insolvency Act 1986, Sch. B1, ¶83.
[142] FINCH, *supra* note 6, at 390.
[143] IBC §34.
[144] FINCH, *supra* note 6, at 529, Insolvency Act 1986 §§126-128.
[145] FINCH, *supra* note 6, at 614.
[146] [1972] AC 785

off provisions.[147] Insolvency set off in the UK thus cannot be contracted out of by parties. This right to set off is able to coexist with the mortarium during administration because of the time at which dues owed to each party are calculated.[148] When an administrator announces their intention to make a distribution among creditors thus triggering rule 14.24 (set off of mutual debts), the dues are calculated as on the date of the announcement.[149] The set off thus does not automatically occur once a company enters into the administration process; however, it automatically applies once the intention to distribute is announced by the administrator. Thereafter, only the sums due at the balance of the account between the debtor and the creditor are payable to either party.

The case of *Kaupthing Singer*[150] decided by the Court of Appeal (Chancery Division) is useful to explain how insolvency set offs operate in the UK when a bank's deposits are involved. *Kaupthing Singer* was decided under the Insolvency Rules 1986, but since the set off provisions remain largely the same, it remains relevant in the context of the current insolvency rules as well.[151] In this case, a bank, Kaupthing Singer & Friedman Limited (KSF) had entered into administration. It was accepted by the joint administrators appointed for the company and the creditors that a set off had to take place, but the case required the adjudication of a more specific question regarding the calculation of set off amounts. The creditors in this case were depositors of KSF to whom the bank owed the deposits it held. These creditors however were indebted to the bank as well because they had taken loans from the bank. Both the loans and the deposits were payable at a future date. Since the set off would happen before the actual date of repayments, the amounts due would have to be discounted as they were being paid at an earlier date (rule 2.105 of the Insolvency Rules 1986).[152] The question before the court was whether the amount that will be repayable from the indebted creditor to the debtor at future date (after extinguishing the portion of set off during insolvency) will also have to be discounted. The court answered this in the negative and held that while discounting would be applicable to ascertain the amounts subject to set off.[153] The remaining portion of the debt that continues to remain due at a future date will not have to be discounted.[154]

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[147] *See e.g.* Barclays Bank Plc. v. Jonathan Edward Marsden, 2019 WL 07763848 (Westlaw), *See* FINCH, at 618–619.
[148] DERHAM, *supra* note 1, ¶6.124.
[149] *Id.*
[150] [2010] EWCA Civ 518.
[151] *See* Bresco Electrical Services, *supra* note 12, ¶1.
[152] Insolvency Rules 1986, r. 2.105.
[153] *Id.* ¶35
[154] *Id.*

A two-fold justification for the policy can be culled out from scholarship and case law to defend insolvency set offs. The first is that it contributes to a quick settling of accounts between the debtor and the creditors and does away with the need for multiple transactions to settle a mutual debt.[155] Second, and more pertinent to the context of UK insolvency law, requiring the creditor to accept a ratable distribution while allowing the debtor to recover a full sum form the indebted creditor would be unfair if mutual debts exist between the two.[156] This line of reasoning was referred to in *Bank of Maharashtra* case in India as well.[157] A broader policy justification of the insolvency set off, especially in the context of banks is that it would simply reduce their exposure.[158] A bank that is able to apply the FDRs it owed to reduce its claim against the corporate debtor will be subject to ratable distribution during liquidation only for the remaining amount that the set off could not adjust.

The discussion above demonstrates how both, the inclusion and exclusion of set offs can be justified under insolvency law. Importantly, there is nothing in the scheme of orderly distribution during liquidation that prevents the application of set offs. There is also nothing inherently incompatible between set offs and a moratorium, if anything the moratorium only pauses the exercise of the right to set off in the UK but does not completely do away with it. There is no reason why this cannot be adopted under the IBC as well. The provision under the IBC that explains the constituents of the liquidation estate allows the government to exclude money subject to set off from it. While it is true that set offs operate as preferences and have the potential to bypass the pari passu rule, this is not a wholly radical idea in the context of insolvency. Governments routinely set preferences for certain types of unsecured debt, recognizing set offs would not be very different from this. Should India decide to implement mandatory set offs in its insolvency regime, it has the option of falling back on the position that existed before the IBC (which was similar to the current practice in the UK). In the alternative it can retain set offs through other changes to the IBC which may allow for greater flexibility than mandatory set offs as seen in the UK. One such approach has been adopted by the US Bankruptcy Code and has been discussed below.

[155] Bresco Electrical Services, *supra* note 12, ¶27.
[156] *Id.* ¶28.
[157] Bank of Maharashtra, *supra* note 69, ¶38.
[158] FINCH, *supra* note 6, at 619.

B. Bankruptcy Set offs under the US Bankruptcy Code

The US Bankruptcy Code does not create a right to set off, rather it preserves any existing right to set off granted through contract or under State law.[159] When a bankruptcy petition is filed, the portion of a creditor's claim which can be set off is converted into a secured debt.[160] Once the bankruptcy petition is filed, Bankruptcy Code prevents the bankruptcy trustee from paying debts using funds which can be subject to a set off.[161] The scheme of the US Bankruptcy Code thus ensures that a bank's right to set off is not extinguished by withdrawals from the debtor's account (section 542(b)).[162] A bankruptcy trustee is allowed to call upon the bankrupt debtor's creditors to pay their debts as and when they fall due, however, portions of the debt that can be subject to set off are not required to be paid by creditors indebted to the bankrupt. This is in stark contrast to the position in India wherein the right to set off held by banks of deposit accounts is extinguished when assets are being gathered to create the liquidation estate.[163] The US Bankruptcy Code's position on bankruptcy set off puts erstwhile unsecured bankers on par with secured creditors, making an exception to the rule that all creditors must be treated on par with like creditors.[164]

Another important implication of the US' approach is that the nature of the money subject to set off is changed by a bankruptcy filing. The right to set off has been described as "use it or lose it."[165] This refers to the depositor's ability to withdraw the amount from banks, thus depriving the bank of the set off right by simply removing money that can be subject to set off from its account. Creating a secured interest in favour of the bank to the extent of the set off amount fixes the interest of the bank in the value of the set off amount. If the debtor withdraws the set off amount after it is treated as a security, then the proceeds from that money would also carry a secured interest in favour of the bank.[166] For instance, if a debtor were to buy property using the money from the bank account after the bankruptcy petition is filed, the secured

[159] 11 U.S.C. § 553(a) (2020). *See* Citizens Bank of Maryland v. Strumpf 516 U.S. 16 (1995) (US Supreme Court); Benjamin Weintraum & Alan Resnick, *Freezing the Debtor's Account: A Banker's Dilemma Under the Bankruptcy Code*, 100 BANKING LAW JOURNAL 316, 317 (1983); Schroeder & Carlson, *supra* note 14, at 486.
[160] Schroeder & Carlson, *supra* note 14, at 482; 11 U.S.C. § 506(a) (2020).
[161] 11 U.S.C. § 542 (b) (2020).
[162] Schroeder & Carlson, *supra* note 14, at 483.
[163] IBC § 36; *See supra* Part II.1.B.
[164]McCoid, *supra* note 1, at 16.
[165] Schroeder & Carlson, *supra* note 14, at 436.
[166] *Id.*

interest would attach to a property.[167] This is an important distinction between the right to set off and having a security interest in deposit account. A right to set off is contingent on the amount of money remaining in the deposit account. Once the money is withdrawn, the bank's ability to set off does not travel with the money beyond the deposit account.[168] The implication being that the right to set off will exist for the benefit of the bank only so long as the customer does not withdraw the sums deposited in the bank account.[169] This is unlike the case of a secured interest where the charge would extend to the "proceeds" of the security interest as explained in the example above.[170]

The bankruptcy trustee in the US is empowered to use and dispose of the bankrupt's assets in the ordinary course of business. Even when doing so, the right to set off cannot be altered to disadvantage the unsecured creditor. Secured interests need to be adequately protected when the trustee is carrying out transactions in the ordinary course of business. The unsecured creditor will thus also have to be adequately protected in case their right to set off is impinged by any of the transactions for the day-to-day business of the debtor.[171] There is no definition for adequate protection under the US Bankruptcy Code, however, some examples of adequate protection are given in section 361. For instance, adequate protection can include periodic cash payments to the secured creditor or granting another security in lieu of the one disposed.[172] The US Bankruptcy Code thus not only preserves the right to set off as it is but transforms it (into a security) so that the process of bankruptcy does not erode it. Importantly, while preserving the right to set off, it does not allow the creditor to immediately use it because of the operation of the automatic stay.[173]

An automatic stay over debt collection by individual creditors falls in place under the US Bankruptcy Code once a bankruptcy petition is filed.[174] This automatic stay is similar to the moratorium imposed under the IBC during the insolvency resolution process or during the administration process under the UK Insolvency Act. The automatic stay under the US Bankruptcy Code even goes to the extent of specifically barring the exercise of any set off

[167] U.C.C. § 9-315(a)(2). See, Schroeder & Carlson, *supra* note 14, at 436.
[168] Schroeder & Carlson, *supra* note 14, 435-436.
[169] *Id.*at 436.
[170] *Id.*
[171] *Id.* at 483.
[172] US Bankruptcy Code §361; *Adequate Protection and The Automatic Stay Under The Bankruptcy Code: Easing Restraints On Debtor Reorganisation*, 131 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 423, 427–428 (1982).
[173] US Bankruptcy Code §362(a)(7).
[174] US Bankruptcy Code §362; *Adequate Protection and The Automatic Stay Under The Bankruptcy Code: Easing Restraints On Debtor Reorganisation*, 131 University of Pennsylvania Law Review 423 (1982).

rights when it is in force.[175] Should the creditor wish to exercise their right to set off prior to distribution, they would have to file an application with the Bankruptcy Court.[176] The US Bankruptcy Code thus preserves the right to set off in substance but also creates procedural tools to ensure that creditors do not resort to individual actions while the stay is in place.

The operation of the automatic stay takes effect once the bankruptcy petition is filed but a creditor can exercise the right to set off only by filing for a relief from the automatic stay before the bankruptcy court. There is thus a risk that in the meantime, a debtor can make withdrawals from their account, consequently taking away the indebted creditor's right to set off. This situation was discussed in the case of *Citizens Bank of Maryland v. Strumpf*[177] which continues to be used as precedent. In *Strumpf*, a bank filed a motion for relief from the automatic stay under the Bankruptcy Code so that it could exercise its right to set off against the debtor.[178] The bank had also announced its intention to freeze the debtor's account until the court decided on this motion. During proceedings, the key question before the Supreme Court of the United States and those which dealt with the case before it was whether a freeze on the debtor's account would violate the automatic stay under the US Bankruptcy Code. The Supreme Court in *Strumpf* held that a freeze would not violate the automatic stay.

The Supreme Court reasoned that set offs refer to adjustments that are permanent settlements of a party's obligation to one another.[179] An administrative freeze by a bank over its account does not have the same effect as it is a temporary measure.[180] However, section 362(b) specifically prohibits an entity from exercising control over the debtor's property.[181] At first blush, it would appear that section 362(b) would prohibit any freeze on the debtor's account as the bank would be exercising control over it. In order to harmonise its decision with section 346(b) which imposes the automatic stay, the Supreme Court in *Strumpf* distinguished between contract and property in the context of bankruptcy.[182]

The Supreme Court reasoned that by refusing to honour a cheque (on account of the administrative freeze) drawn on the debtor, the bank was not controlling the property of the

[175] *Id.* §362(a)(7).
[176] Schroeder & Carlson, *supra* note 14, at 483.
[177] See Citizens Bank of Maryland v. Strumpf 516 U.S. 16 (1995) (US Supreme Court).
[178] Schroeder & Carlson, *supra* note 14, at 483.
[179] *Id.* at 485.
[180] *Id.*
[181] *Id.* at 487.
[182] *Id.*

debtor; rather the bank was in breach of its contractual duty. According to the Supreme Court, the administrative freeze did not allow the bank to control the debtor's property nor make any disposals of it.[183] The relationship between the bank and the debtor was best described as a promise (or contract) and thus the bank's refusal to pay the debtor would be a breach of that promise and not an appropriation of the debtor's property.[184] This relationship exists in a "two-person universe" i.e., where the parties involved are the bank and the debtor.[185] However, if a third party (such as a garnishor) who attempts to take control of the account, then the character of the account would be one of property and such garnishment would violate the automatic stay.[186] Courts in the US continue to refer to *Strumpf* in order to ascertain the nature of the right to set off against a bankrupt debtor. For instance, the Bankruptcy Court for the District of Columbia, in *Re Randolph Towers Coop Inc*.[187] referred to *Strumpf* to hold that a debit restraint placed on the deposit account of the debtor who has filed for bankruptcy will not amount to a violation of the automatic stay.[188]

The US Bankruptcy Code thus recognizes pre-existing rights to set off and preserves them. This is done by allowing the creditor to apply for relief from the automatic stay in order to set off their debt and by requiring that trustees adequately compensate creditors if they use money subject to set offs to run the debtor's day to day business.[189] Further, when creditors file claims against debtors for distribution, that portion of unsecured debt that is subject to set off is treated as a secured claim.[190] These protections were buttressed by *Strumpf* which interpreted protective steps taken by creditor banks (administrative freezes, for instance), as conforming to the provisions of the automatic stay. The UK Insolvency Act and Insolvency Rules offer a more limited form of set off. Creditors are entitled to a mandatory set off under insolvency law, however, this right becomes active only during distribution (in case of administration) or during liquidation leading to winding up proceedings. Creditors do not have the right to petition for a relief from the moratorium in order to exercise their right to set off.

[183] *Id.* at 487-88.
[184] *Id.*
[185] *Id.*
[186] *Id.*
[187] 2011 Bankr. LEXIS 2784.
[188] *Id.*
[189] US Bankruptcy Code §361; Schroeder & Carlson, *supra* note 14, at 483.
[190] US Bankruptcy Code §506(a); Schroeder & Carlson, *supra* note 14, at 482.

C. Options available to India for recognizing set offs

India's IBC borrows features of insolvency laws in the UK and the US.[191] As discussed earlier, the IBC implemented several changes to how a company and creditors were treated during insolvency proceedings. One important change that seems to have gone under the radar is the treatment of the creditor's right to set off, especially in the context of a bank's right to offset deposits against the corporate debtor's unpaid loans. This position does not seem to be envisioned as a permanent one since the IBC itself allows money subject to set offs to be excluded from the liquidation estate through notification by the IBBI. The IBBI's ability to exclude money subject to set offs from the liquidation estate vindicates the notion that there is nothing inherently incompatible between set offs and the objectives of Indian insolvency law. The decision about whether or not to recognize it is essentially a policy decision.

The manner in which set offs have been given a space to operate during insolvency proceedings in the UK and the US show the diversity of routes India can take to implement set offs under the IBC should it decide to. If the government is unwilling to allow the moratorium to be lifted in way that corresponds the treatment of the automatic stay under the US Bankruptcy Code, then it can adopt stronger protections for set offs during distribution. Money subject to set off can either be excluded from the liquidation estate or they can be given the status of secured credit. If debts are secured to the extent that they can be set off, then creditors may choose whether they want to realize this secured portion of their claim against the debtor or surrender it to the liquidation estate.

V. Conclusion

The change in the treatment of set off rights under Indian insolvency law after the enactment of the IBC has largely gone unnoticed. Banks and creditors who have attempted to assert their right to set off have been denied by the NCLT on account of the moratorium imposed under section 14. Once liquidation commences any of a debtor's deposits that a bank holds (or any other sum held by a creditor that is subject to set off) needs to be turned over to the liquidation estate. The COVID-19 pandemic has strained banks to the extent that they are not allowed to

[191] Himani Singh, *Pre-packaged Insolvency in India: Lessons from the UK and the US*, Harvard Law School Bankruptcy Round Table (Apr. 28, 2020), 2, https://blogs.harvard.edu/bankruptcyroundtable/tag/himani-singh/; Namrata Kishnani, *Insolvency and Bankruptcy code 2016 – A critical review for resolving NPA's in Banking Industry*, 7 INTERNATIONAL JOURNAL OF MONEY BANKING AND FINANCE 100, 104 (2018); Krishn A. Goyal & Ravinder Kumar, *"Bankruptcy Code for Corporate Failure in SAARC Countries" (A Comparative Study)* 59 PRODUCTIVITY, 275, 278 (2020).

commence fresh insolvency proceedings against defaulting customers until the moratorium on such proceedings imposed by the government has been be lifted. With the existence and continuance of this pandemic, it is the correct time for the IBBI to adopt set offs either by exercising their powers under section 36 or by amending the Liquidation Regulations. Since the government has the power to protect set offs from the regular liquidation process, this would be a good time to use it in order to reduce the exposure of banks and unsecured creditors. Notably, recognizing the right to set off in the context of liquidation would not harm the debtor's access to the IBC's rehabilitative process. Creditors will still have the opportunity to consider plans for the debtor's resolution and exit from insolvency under the IBC and liquidation will continue to be the last resort.