USING GAME THEORY TO UNDERSTAND FLAWS IN REMEDIES OF THE IBC THROUGH P. MOHANRAJ & ORS. V. M/S SHAH BROTHERS ISPAT PVT. LTD.

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ABSTRACT

In 2020 the Supreme Court of India in P.Mohanraj v SBIPL reversed a NCLAT (National Company Laws Appellate Tribunal) Decision by not allowing for criminal complaints to subsist against a company during the IBC moratorium arising out of a bounced cheque being presented by P.Mohanraj to the victims SBIPL prior to being declared insolvent. The Issue that arose was that the statute of S.138 NI makes the presentation of a bounced cheque a criminal offence. In common law such an act would be a mere civil breach of contract. However such a statute raises a question of whether the act of the government can be justified through tools of economic analysis as a rational manner of enforcement of contract as well as criminal law. However the paper differs from the scarce legal discussion by analysing the issue from the perspective of the victim and not from that of the criminal/breacher or society/state.

The Paper first identifies how choices with regard to breach of contract are made and discusses using legal literature and other sources why contracts ought to be enforced . The paper then in brief explains how the State has attached through law a social significance to the aspect of insolvency and economic stability and thus justifies the criminalization of S.138.

Secondly the paper uses tools of economic analysis such as game theory to explain how all the stakeholders prefer settlement however the complex legal mechanisms such as moratoriums make such an option hollow. The paper will then use the economic comparison between fines and imprisonment to show how , separation of directors from the corporate personality in the SBIPL case actually disadvantages the victim most.

The focus of the paper is to use Literature as well as tools to analyse the victims perspective and choices in the case study and matter at large to show, to what extent is the current system of quasi criminal laws under IBC, leaving the victim without the optimal choice , as well as to what extent does the criminalization of breach of contract achieve the goals of the society, state and victim.

INTRODUCTION

The Non Performing Asset problem has long plagued the Indian Economy, especially in relation to Public Sector Banks. The underlying cause of this issue is bad loans given to companies that end up winding up and effectively become unable to return the money. This in turn directly impacts the society as Foreign direct investments decrease along with dwindling business confidence. The state has in turn double downed by steering fiscal policy to prioritize solving the NPA issue and creating business confidence. The state achieved this through the introduction of Legislations such as the Insolvency Bankruptcy Code of 2016 as well as the Debt Recovery Tribunal, aimed at steering sinking companies towards restructuring and continuation rather than winding up. The aim of these laws is to prioritize returning of debt by allowing the company to continue working and repayment of financial creditors such as banks and NBFCs. The state here has continued to adopt the practice of treating insolvency as a public issue or of a right in rem rather than that of private parties contracting with the company i.e a right in personam. This approach prioritizes a utilitarian approach of prioritizing the macro economy over micro contract relations. The State has achieved its goal of reduction in NPAs from 2016 to 2021[1]. However such a reduction has not come efficiently as it has complicated and elongated the legal process leading to a blur between rights in rem and rights in personam. It prioritizes the states objective while depreciating the value and legitimacy of legal remedy available to parties harmed by defaulting companies. A prime example of this and the focus of this paper is the analysis of the above mentioned critique through the case of P.Mohanraj v Shah Brothers Ispat pvt Ltd. (2021) SCC OnLine SC 152[2]. The paper will then analyse the various remedies under contract law and criminal law to understand whether the remedy given in the above mentioned case is efficient and whether all stakeholders are better off and whether the state is actually meeting the goal it set out.

THE CASE

The case at hand was an appeal from an NCLAT decision of the same parties. The Apellant P.Mohanraj had issued 15 cheques as payment for goods delivered to SBIPL the respondent. The Respondent on deposit of these cheques was informed that they were returned due to insufficient balance of the Appellant account. The Repsondent then within 15 days of the same

[1] Press Trust of India, BANKS' NPAS DECLINE TO RS 8.34 TRILLION AT MARCH-END 2021: MINISTER BUSINESS STANDARD (2021), https://www.business-standard.com/article/finance/bad-loans-decline-to-rs-8-34-trillion-at-march-end-2021-minister-121072600778_1.html (last visited Nov 27, 2021).
[2] P. Mohanraj & Ors. V. M/S Shah Brothers Ispat Pvt. Ltd., (2021) S.C.C OnLine S.C 152.

sent a notice under S.138 of the negotiable Instrument Act. However Parallel to this the Appelant's company was declared insolvent and a moratorium was declared. [3]

The definition of the word 'moratorium' is "*a legally authorized period of delay in the performance of a legal obligation or the payment of a debt*."[4] Essentially, it gives a grace period to anyone who owes something. Interestingly enough, this word is also a principle under corporate law. Under the IBC, it refers to a period of time where no judicial proceedings for recovery of debts, enforcement of security interests, termination of essential contracts, or a sale or transfer of assets can be enacted against a corporate debtor upon the commencement of the process of insolvency, until it is concluded.[5] A moratorium thus acts as a protective shield around the corporate debtor while undergoing insolvency. Barring a writ petition, no other category of suits can be instituted against a debtor when the provisions of section 14 are applied.[6] The object of enacting this provision of moratorium is to ensure that the corporate debtor does not lose all valuable assets during the process of insolvency, and to "*ensure revival and continuation of the corporate debtor by protecting the corporate debtor and its management from a corporate death by liquidation.*"[7] The second essential aspect of this case is the quasi criminal offense of dishonouring a cheque covered under S.138 of the Negotiable Instruments Act which adds a criminal punishment of imprisonment and a fine to a person who issues and presents such a cheque to the aggrieved.

The court in this case held that the director and a quasi criminal case is to be treated as a criminal proceeding that comes under the ambit of moratorium and therefore the remedy is only available against the directors , however the company shall be left unscathed during the period of the moratorium. The court was of the opinion that should the quasi criminal action go through , its objective is contravening that of the IBC as the fine imposed would be twice as much as the debt owed which could leave the Appellant insolvent and unable to revive the company. [8] The respondent here was an operational creditor who is not included in the committee of creditors and therefore has no precedence or say in the debt recovery process. The only options presented to the Respondent by the state were either to wait and take a chance on the fact that the appellant company would have enough resources to pay them back after the

[3] Id
[4]Definition of *MORATORIUM*, Merriam-webster.com (Jun. 28, 2021), https://www.merriam-webster.com/dictionary/moratorium.
[5] Insolvency and Bankruptcy Code, 2016, No. 31, Acts of Parliament, 2016 (India).
[6] Canara Bank v. Deccan Chronicle Holdings Limited, (2017) S.C.C OnLine N.C.L.A.T 225.
[7] Swiss Ribbons Pvt. Ltd. v. Union of India, (2019) 4 S.C.C 17.
[8] P. Mohanraj & Ors. V. M/S Shah Brothers Ispat Pvt. Ltd., (2021) S.C.C OnLine S.C 152.

financial creditors and employees have taken their shares , or to pursue criminal action against the director P Mohanraj who is now no longer part of the company. The following part of the paper shall analyse the economic efficiency of these options in comparison to the multiple remedies under contract and criminal law that exist.

EFFICACY OF THE MORATORIUM UNDER THE IBC

In *Rakesh Malhotra v Rajendra Malhotra*,[9] and *Haryana Telecom v Sterlite*,[10] while discussing the arbitrability of S.242 and 243 of *The Companies Act, 2013* i.e., oppression and mismanagement, the courts have characterised them as non arbitrable, since orders of winding up are not contained merely between two parties in dispute, rather are inclusive of the employees, shareholders, and third parties. The issue cannot be seen as private enforcement of a contract but a public issue, for which only the NCLT may issue a decree. Furthermore, the courts in a recent judgement of The *Directorate of Enforcement v. Sh. Manoj Kumar Agarwal and Ors* held that S.14 moratorium of the IBC includes properties attached under the *Prevention of Money Laundering Act ('PMLA')* by the Enforcement Directorate. The NCLAT held that as per S.238 of IBC, the effects of the PMLA should not hinder the process of the Insolvency/Resolution Professional from exercising power. The NCLAT further held that even in the event of a conflict between provisions of IBC and that of the act, the properties should be made available for liquidation under the IBC. Therefore, even in extreme criminal charges of corruption the court has opted to promote the goal of the IBC to protect the company over the social requirement of punishing a crime.[11] This is further actuated through the Reports of the Reliance Infratel resolution process, where the consortium led by SBI agreed to remove charges of fraud evident in a forensic audit, before the NCLT. This was done solely to ensure purchase by Reliance Jio once the process is over.[12]

Prior to delving into remedies under law , it is essential to see whether the IBC can be economically justified as beneficial or not. The IBC prioritizes the creditors as stake holders and within those creditors it prioritizes secured creditors. In order to determine its efficiency, the paper must first explore the case of the IBC not having being introduced in the given case.

[9] Rakesh Malhotra v Rajendra Malhotra, (2015) 2 CompLJ 288 (Bom).
[10] Haryana Telecom v Sterlite Ltd., (1999) 5 S.C.C 688.
[11] The Directorate of Enforcement v. Sh. Manoj Kumar Agarwal and Ors., (2019) CA-AT (Ins) No. 575.
[12] Mayur Shetty, *Reliance Infratel 'fraud' tag to go after sale: Lenders - Times of India*, THE TIMES OF INDIA, (Jun. 30, 2021), https://timesofindia.indiatimes.com/business/india-business/reliance-infratel-fraud-tag-to-go-after-sale-lenders/articleshow/83383382.cms.

If that were the case , then the matter would become one of multiple parties suing for their right in personam of not having a debt returned. In such a case there would be a marginal diminishing utility of the courts ability with each successive suit.

Now assuming that the Appellant company had 10 Cr as assets left , and each party demanded 5 Cr as compensation , with each successive suit the courts ability to enforce would reduce. Once all assets are liquidated , the court would now be faced with a situation where each subsequent suit increases the burden of having to either deny enforcement or somehow find more Assets to liquidate. This would be a greater burden on the court and would impact its time being wasted.

Number of Suit (Chronologically)	Assets available for liquidation (Cr)	Ability of Court to award damages
1	10	5
2	5	5
3	0	-5
4	0	-10

As each suit is successful the ability to compensate each consequent party decreases. This also adds further pressure in the legal system as it has to deal with competing interests of each aggrieved party while at the same time ensuring that there remains an ability to remedy the wrongs suffered by each party. Here there is no social benefit arising as the administrative costs of lengthy legal battles takes away the courts time as well as costs involved in enforcement. In status quo , the government justifies the stance by claiming it to be a method of allowing the equitable distribution of the company's assets while ensuring that any opportunity to continue operations after restructuring is taken. Since in status quo all parties are cooperating , or seem to be cooperating through collective decision making , the likelihood of a mutually beneficial solution with maximum satisfaction is most likely, along with that since the Insolvency Professional is paid through the restructuring process , the amount of welfare loss is also at a minimum. However on the contrary since the breach is also seen as one that is criminal in

nature , mere imprisonment while in the letter of the law under S.138 NI [13]may be justified by the court on a commercial or business standpoint as stated by Justice Nariman in this case does not meet the goal of the victim , who only seeks compensation. The court infact goes ahead to state that taking a sole criminal perspective dilutes the goal of the victim but at the same time states that the mere occurrence of a crime means that it is the duty of the state to punish those who are responsible. Here Justice Nariman calls for a balanced approach , but does not explain what this approach could be.

REMEDIES IN A QUASI CRIMINAL CASE

The case at hand is one of a quasi criminal nature. That is that the offence is civil but the remedy available is criminal in nature. This is because the Negotiable instrument act supersedes the Contract Act , by making the dishonouring of a cheque a criminal offence punishable by imprisonment or fine. Therefore it is essential to discuss how the remedies available actually meet the goals of the victim as stated by Justice Nariman. He states "*the real object of the provision is not to penalise the wrongdoer for an offence that is already made out, but to compensate the victim*." [14] Therefore the paper will now analyse whether traditional remedies under contract law may achieve the victims goal or whether criminal remedies do the same , especially given the said case of insolvency.

CONTRACTUAL REMEDIES

Shavell states that there would be no need for contract enforcement in a perfect world as there would be sufficient resources to ensure that the contract would never be breached. However the lack of resources being status quo there is a need to remedy a breach of contract.[15] As per Cooter and Allen , Remedies to contractual breach can be calculated as per Expectation damages , opportunity cost or reliance damages[16].

Expectation Damages refers to liquidated damages , which are usually determined within the contract as a result of the breach of the contract.[17] These would ideally be determined prior to the execution of the contract and is enshrined in S.73 of the Indian contract act. The Parties

[13] The Negotiable Instruments Act, 1881, No. 26, Acts of Parliament, 1881 (India) s.138.
[14] P. Mohanraj & Ors. V. M/S Shah Brothers Ispat Pvt. Ltd., (2021) S.C.C OnLine S.C 152.
[15] Steven Shavell , *ECONOMIC ANALYSIS OF CONTRACT LAW*, NATIONAL BUREU OF ECONOMIC RESEARCH (2003).

[16] Cooter, Robert and Ulen, Thomas, "LAW AND ECONOMICS, 6TH EDITION" Berkeley Law Books. Book 2. (2016).
[17] Id

enter into the contract aware of the risk of the breach however the pre determined damages covers the same. In the given case the IBC prefers expectation damages as it allows the structure of the council of creditors to efficiently determine the extent of damages and the manner of distribution of assets. The only issue here is the same as mentioned above , with regards to the defaulter/insolvent no longer possessing the same assets as those borrowed , creating scarcity and therefore causing competing interests to arise. The victim SBIPL in this case is an operational creditor who is not given preference as financial creditors are given preference over operational creditors (i.e those companies that were actually engaged in trade). This is highly inequitable and inefficient as the operational creditor would now have to await the moratorium to end in order to recover the said goods. Here the financial creditors , mainly banks are better off , the state is better off as there is no additional legal proceedings required , however the operational creditors and service providers are left to salvage any leftovers , making them worse off , and decreasing their business confidence.

Opportunity Cost : refers to the restitution of the party against whom the breach has been caused to be restored to the same position as they were prior to entering the contract. In this case the cost would amount to the costs sunk into delivery of goods and cost of goods.[18] In the given case this could be an ideal remedy in the case of operational creditors who have provided non perishable goods to the Insolvent company , SBIPL a steel trader could have ideally been returned the goods taken , however such a remedy is not being applied in status quo with immediate effect as it decreases the assets that lie with the insolvent to be used for the restricting process and hamper the states goal of continuation of business. Here the state and financial creditors may be worse of , but the operational creditor or the victim is atleast partly better off as the goods are returned , but the other intangible costs may not be remedied. This solution does not work for Service Providers or suppliers of perishable goods.

Pursuant to the Opportunity Cost , Reliance Damages may be used as a method of making up for time lost between breach and remedy.[19] While this is a rather subjective measure of damages , it essentially states that damages would amount to the difference between the (cost of goods in the original contract – the price at which the goods are sold to a third party) , it is assumed that the time has caused a depreciation in value of the goods and therefore the difference is the price that the operational creditor relied on the insolvent to pay. Such a method will only work

[18] id
[19] id

if first the goods are returned in a timely manner. Once returned this is a far more efficient system as it reduces the burden on the insolvent and vis a vis CoC to pay damages to the operational creditor. Here the Insolvent is better off , the Society is better off as goods are put back in the market , however the Victim is only better off if the goods are sold at a price reasonably similar to the original price.

CRIMINAL REMEDIES

The quasi criminal nature of S.138 NI comes from the enforcement of punishments, here being imprisonment for a period of one to two years or a fine which is double of the amount dishonoured via the cheques.[20] However the States addition of the moratorium excludes the director from the company and thus the company no longer being a defendant is not liable to pay the fines arising out of any conviction. The director is made solely responsible, and the victim is free to explore any remedies against the director. [21]

The first solution is imprisonment which can be seen either as a retributive measure , that is due to the insolvents actions affection the state as a whole making this an issue of a right in rem , or as a deterrent measure that is to prevent other companies and their directors from engaging in dishonouring of cheques as a method to avoid the situation as a whole. The issue here is that the victim itself is not satisfied with the imprisonment itself. The victim does not in this case , as stated earlier by Justice Nariman benefit from any form of imprisonment , however the only benefit is gained by the state in terms of imprisonment , which in itself has costs attached to it.

The second solution here is for the court to impose a fine , however even here the accused's capacity to pay has already been minimized to the extent that , even if they are willing they are unable to pay the fine resulting in contempt and eventual imprisonment. The state here knowingly or unknowingly has created a no win situation for SBIPL as it will not be satisfied unless it has some form of compensation. Here the state explores the opportunity for a settlement where the victim will agree to some form of monetary compensation even if megre as opposed to the contrary measure of retributive justice by sending the accused to prison.

[20] The Negotiable Instruments Act, 1881, No. 26, Acts of Parliament, 1881 (India) s.138.
[21] P. Mohanraj & Ors. V. M/S Shah Brothers Ispat Pvt. Ltd., (2021) S.C.C OnLine S.C 152.

In the given case assuming that the accused is worse off in any manner , we can measure the benefits of each solution between the victim that is the private party as opposed to the state who is the public in this case.

1. If the victim settles for the highest possible amount that the accused is able and willing to pay prior to trial.
    - Here the Victim is only better off if the amount is sufficient , however in most cases it is not possible for the individual to have more resources than a company hence , this is at most utopian. Victim is essentially given a band aid over a gaping wound.
    - State is better off as there is no trial or imprisonment or enforcement cost therefore resources are saved, however state fails to enforce a crime hence no deterrent.
2. If the victim pursues criminal action and allows for the trial to continue.
    - Victim is worse off as the penalty is greater than the amount sought in the contract itself as stated by Justice Nariman in the case where he states that the criminal fine would amount to double of what the amount sought was. [22]
    - State is worse off since the trial continues and state will have to bear costs of imprisonment and or enforcement of a fine that is not payable. Society is better off as a deterrent is formed however efficacy is questionable.

Therefore in conclusion the optimal solution here which is unscathed by the utopic idea of the accused being able to pay off all debts in a settlement , would be to allow for a blurring between the right in rem and right in personam. The first action would be to allow for the company to be made part of the trial , and allow recovery of goods by the victim which then allows for opportunity cost and reliance damages to be calculated , once that is done the court ought to calculate the fine as per the reliance damages that accrue. In any event the prosecution must not stop in terms of imprisonment however compensation must be granted as per contractual remedy and not criminal remedy in order to ensure that the victim is not disadvantaged in this whole process. The reason why the perspective of the victim is essential as the victim is another company and not a financial institution , the alienation of the victim from his remedy essentially creates a possibility of another insolvency of the victim itself and allows the chain to continue. The victim represents the commercial stakeholders of India being mid to small companies that

[22] P. Mohanraj & Ors. V. M/S Shah Brothers Ispat Pvt. Ltd., (2021) S.C.C OnLine S.C 152.

engage in trade rather than simply being money lenders , it is them who actually carry out the business for which the confidence is being built , therefore the States attitude of pandering to the financial creditors by deeming them essential for society is myopic and elitist and is not going to solve the problem at hand.