

# Insolvency and Bankruptcy Hotline

May 07, 2021

## SUPREME COURT CLARIFIES THE EFFECT OF ACKNOWLEDGMENT OF DEBT UNDER INSOLVENCY CODE

- Balance sheet entries of a debtor company are considered as valid acknowledgment of debt to extended limitation period from the date of acknowledgement
- If Balance Sheet entries are qualified in Auditors Report or notes to Balance Sheet, then they may not be considered as a valid acknowledgement under Limitation Act.

### BACKGROUND

In the year 2017, Nishith Desai Associates filed an application under the Insolvency and Bankruptcy Code, 2016 ("IBC/Code") before the National Company Law Tribunal, Mumbai Bench ("NCLT") on behalf of foreign bondholders seeking initiation of insolvency proceedings of a pharmaceutical company. During arguments, it was claimed that the debt was time barred and hence the application was not maintainable. However, the NCLT took note of the specific entries in the books of accounts of the corporate debtor, indicating the existence and acknowledgment of a debt. Based on this, the period of limitation was deemed to be extended from the date of acknowledgment and the petition was admitted.

Fast forward to 2020, contrary to judicial precedents, after several controversial and contradictory orders were passed, a full bench of the NCLAT, in *V. Padmakumar v. Stressed Assets Stabilisation Fund*, held that entries made in balance sheets do not amount to acknowledgement under Section 18 of the Limitation Act, 1963 ("NCLAT Judgment").<sup>1</sup> This position would have created a significant amount of strain in the debtor-creditor relationship. The Supreme Court ("SC") in *Asset Reconstruction Company v. Bishal Jaiswal*, has reversed the position while holding that entries made in balance sheets amount to acknowledgment under Section 18 of the Limitation Act. Here are the key takeaways from the judgment.

### PROVISIONS OF LIMITATION ACT APPLY TO THE IBC

Section 238A of the IBC was inserted into the Code through the 2018 Second Amendment Act and stated that the provisions of the Limitation Act would apply to the IBC. The Court while referring to the Insolvency Committee Report of 2018, reaffirmed that the provisions of the Limitation Act would be applicable to the IBC unless a specific period of limitation was prescribed in the Code itself. The Court emphasized that the intention of the Code was not to reopen the rights of creditors who held time-barred debts in order to throw them a lifeline when they have failed to exercise their remedies in a timely fashion.

### ENTRIES MADE IN BALANCE SHEETS AMOUNT TO AN ACKNOWLEDGEMENT OF DEBT

The law provides for various limitation periods for different civil remedies. If a person fails to exercise its remedy within the prescribed limitation period, they are barred from making a claim post the expiry of the limitation period. However, Section 18 of the Limitation Act provides that calculation of the limitation period starts afresh each time there is an acknowledgement of debt i.e. from the date of acknowledgement, provided that the acknowledgement is made before the expiry of the original limitation period.

The question before the SC was whether entries made in balance sheets would amount to an acknowledgment of debt for the purpose of extending the period of limitation under Section 18 of the Limitation Act. After referring to multiple pronouncements of the SC as well as various High Courts, the SC laid down the following principles to determine as to what would constitute a valid acknowledgement:

1. The acknowledgement must refer to a present subsisting liability. The statement may not necessarily specify the exact nature of the said liability.
2. It must indicate a jural relationship such as that of a creditor and debtor between the parties.
3. An express or implied intention to show that jural relationship must be present.
4. The liability must give rise to an actionable claim to a creditor under the IBC.

It was contended that entries in balance sheets, were made under the compulsion of law, therefore, such an admission would not constitute an acknowledgement for the purpose of Section 18 of the Limitation Act.

The Calcutta High Court in *Bengal Silk Mills Co. v. Ismail Golam Hossain Ariff* had dealt with this issue and held that the mere fact that the admissions were made under compulsion of law does not disqualify them from being considered as valid acknowledgements of debts. While there is a compulsion of law to prepare a balance sheet, there is no compulsion to make any particular admission.

Affirming the Calcutta HC judgment, the SC perused the relevant provisions of the Companies Act and noted that the filing of balance sheets was indeed mandated by the law. The balance sheets that are prepared ought to be signed

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and approved by the Board of Directors. Later, along with the Director's report and Auditor's report, copies of the balance sheets are sent to the Registrar of Companies. However, to determine whether entries in balance sheet are unequivocal concerning the liability, the surrounding circumstances have to be respected. *First*, the notes annexed to or forming part of the balance sheets, which are statutorily recognized, have to be considered to understand whether any contingency has been highlighted with respect to a debt. *Second*, the observations made in the Auditor's report have to be checked for any specific comment on the entry reflecting the debt. A conjoint reading of these two factors would shed light on whether there was any indication that the entry would not amount to an acknowledgement of debt. In the absence of any indications to the contrary, the SC categorically held that entries made in balance sheets amount to acknowledgement of debt under Section 18 of the Limitation Act.

In the course of a creditor-debtor relationship, it is not always possible to make repayments of dues as per the agreed timelines, which gives birth to the concept of acknowledgement of debt which is due and payable. Debtors acknowledge the debt owed by them also to afford some assurance to their creditors as a promise of repayment. The NCLAT Judgment would have effectively put this arrangement in jeopardy, where creditors would not allow deferment of payments basis acknowledgments. The SC's reversal of this decision is a welcome move and allows debtors to acknowledge debts through their balance sheets and creditors an increased period to exercise their claim.

However, it will be important for creditors to ensure that (a) any written communication from a creditor satisfies the ingredients of a valid acknowledgement as enunciated by the SC and (b) an entry in the balance sheet of a creditor is not subject to qualifications in the notes to the balance sheet or Auditors Report, for the same to extend the period of limitation from the date of acknowledgement.

– Arjun Gupta & Sahil Kanuga

You can direct your queries or comments to the authors

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<sup>1</sup> Company Appeal (AT) (Insolvency) No. 57 of 2020 (decided on 12.03.2020).

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