Warranty comes to rescue of Corporate Debtor : 'Sale of Goods Act (SOGA)' Vs IBC

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The Hon'ble Supreme Court ("SC") verdict in ***Rajratan Babulal Agarwal vs Solartex India Pvt. Ltd. & Ors. (Civil Appeal No. 2199 of 2021)*** has held that the standard i.e., the reference to which a case of a pre-existing dispute under Insolvency and Bankruptcy Code, 2016 ("IBC") is determined cannot be equated with even the ***principle of preponderance of probability*** which guides a civil court at the stage of final decreeing a suit. The matter came up as an appeal arising out of National Company Law Appellate Tribunal ("NCLAT") order holding that there was no dispute within meaning of IBC. The SC placed reliance on *Mobilox Innovations Private Limited* vs *Kirusa Software Private Limited [2017] ibclaw.in 01 SC* (hereinafter referred to as "Mobilox" judgement) to observe that IBC does not enable the operational creditor to put corporate debtor into insolvency resolution process prematurely over small amounts of default.

DOCTRINE OF PREPONDERANCE OF PROBABILITY

The inference for the phrase 'preponderance of probability' in civil suits comes from Section 3 of the Indian Evidence Act which defines word "proved" as:

> *"A fact is said to be proved when, after considering the matters before it, the Court either believes it to exist, or considers its existence so probable that a prudent man ought, under the circumstances of the particular case, to act upon the supposition that it exists."*

The majority view in Rishi Kesh Singh and Ors. vs The State, AIR 1970 All 51 referred to the aforementioned section to state that:

> *"When the evidence is of an overwhelming nature and is conclusive, there shall exist no dispute, nor shall there be any doubt and the Court can say that the fact does exist, but in criminal trials, where the accused claims the benefit of the Exception, there cannot be any evidence of such a nature. Very often there is oral evidence which may be equally balanced. In the circumstances, the case of the prosecution or of the defence has to be accepted or rejected on the basis of probabilities. Section 3 of the Evidence Act by itself lays down that a fact is said to be proved when, after considering the matters before it, the Court considers its existence so probable that a prudent man ought, under the circumstances of the particular case, to act upon the supposition that it exists. This is what is meant by the "test of probabilities" or the "preponderance of probabilities." The decision is taken as in a civil proceeding."*

The present case refers to the doctrine of preponderance of probabilities to hold that the standard of determining pre-existing dispute under IBC cannot be equated with the principle. The principle is important as the Apex court has cleared the air on the presumption theory and have set out the principle of dispute to be limited at threshold.

FACTUAL BACKGROUND

There was an agreement wherein first respondent/Operational Creditor ("OC") for supply of 500 metric tonnes coal to second respondent/Corporate Debtor ("CD") and to its sister-concern. The

purchase order w.r.t CD was dated 27.10.2016, and CD was supplied 412 metric tonnes between 28.10.2016 and 02.11.2016. Appellant is the ex-director of CD. Correspondence was made between CD and OC via emails on 30.10.2016 and 03.11.2016, with CD mentioning about the inferior quality of supplied coal. The OC replied to CD's 03.11.2016 email on- 04.11.2016 stating that further supply has been stopped. Notice was raised by the OC for Rs. 21,57,700 against which CD demanded Rs. 4.44 crores due to coal not being of promised quality. The CD also filed a civil suit claiming damages against OC. Pursuant to this, the National Company Law Tribunal ("NCLT") on 28.05.2020, admitted the application filed by OC under Section 9 of the IBC, dismissing CD's reply which stated that there was pre-existing dispute and so application should be dismissed. The matter went in appeal before the NCLAT where it was rejected thereby affirming NCLT's order, and hence the matter came up before SC.

ISSUE

Whether the Appellant raised a dispute that is 'pre-existing' as elaborated by SC in *Mobilox* judgement?

CONTENTIONS BY PARTIES

The Appellant submitted that the 30.10.2016 email contained reference of not just the purchase order of 27.10.2016 but also with regard to supply of coal to CD, and the 03.11.2016 email mentioned the inferior quality of supplied coal. He contended that as per Section 12 of the Sales of Goods Act, 1930 ("Act"), in a contract of sale of goods, a term may be a condition or a warranty, and that he treated the condition relating to quality of goods as a warranty, as per Section 59 of the Act which declares remedies open for such buyer. Section 12 of the Act reads as:

> "***12. Condition and warranty.*** *– (1) A stipulation in a contract of sale with reference to goods which are the subject thereof may be a condition or a warranty.*
>
> *(2) A condition is a stipulation essential to the main purpose of the contract, the breach of which gives rise to a right to treat the contract as repudiated.*
>
> *(3) A warranty is a stipulation collateral to the main purpose of the contract, the breach of which gives rise to a claim for damages but not a right to reject the goods and treat the contract as repudiated.*
>
> *(4) Whether a stipulation in a contract of sale is a condition or a warranty depends in each case on the construction of the contract. A stipulation may be a condition, though called a warranty in the contract.*"

Doctrine of Election : Condition or Warranty ?

Section 59 of Act contemplates suit for damages as well as setting up extinction of the price. Section 59 of the Act has been reproduced below for reference:

> "***59. Remedy for breach of warranty.*** *– (1) Where there is a breach of warranty by file seller, or where the buyer elects or is compelled to treat any breach of a condition on the part of the seller as a breach of warranty, the buyer is not by reason only of such breach of warranty entitled to reject the goods; but he may—*

(a) set up against the seller the breach of warranty in diminution or extinction of the price; or

(b) sue the seller for damages for breach of warranty.

(2) The fact that a buyer has set up a breach of warranty in diminution or extinction of the price does not prevent him from suing for the same breach of warranty if he has suffered further damage."

The OC on the other hand, submitted that there were only three emails prior to the date of notice under IBC and the documents do not show that there is dispute. He stated that CD consumed the supplied coal even after alleged deficiency existed. He said that the 03.11.2016 email provided that for any further damage, same would be debited in account of OC, and CD continued to consume the coal until that date. There was no further damage. It was contended that the claims were not genuine and not supported with evidence.

The Appellant further contended that if the OC treats contravention of a condition as a violation of warranty, rights under Section 59 would come into play, which would include the right to sue not merely for damages but to extinguish price of goods as well. The consumption of 412 metric tonnes should be treated as 'acceptance' of goods within ambit of Section 42.

Section 42 which discussed "**Acceptance**" of the Act reads as:

"The buyer is deemed to have accepted the goods when he intimates to the seller that he has accepted them, or when the goods have been delivered to him and he does any act in relation to them which is inconsistent with the ownership of the seller, or when, after the lapse of a reasonable time, he retains the goods without intimating to the seller that he has rejected them."

The appellant contention that matter should be proceeded with limited scrutiny as to whether there is a dispute. Further referring to the *Mobilox* judgement, the court considered if the dispute was bona fide, but for an application under Section 9 of IBC, existence of bona fide dispute is not required.

SC OBSERVATION

SC analysed provisions of the Act to state that in a contract of sale of goods, breach of condition entitles buyer to treat the breach of condition as breach of warranty under Section 13. Section 13 talks about when condition to be treated as warranty:

"(1) Where a contract of sale is subject to any condition to be fulfilled by the seller, the buyer may waive the condition or elect to treat the breach of the condition as a breach of warranty and not as a ground for treating the contract as repudiated.

(2) Where a contract of sale is not severable and the buyer has accepted the goods or part thereof, the breach of any condition to be fulfilled by the seller can only be treated as a breach of warranty and not as a ground for rejecting the goods and treating the contract as repudiated, unless there is a term of the contract, express or implied, to that effect.

> *(3) Nothing in this section shall affect the case of any condition or warranty fulfilment of which is excused by law by reason of impossibility or otherwise*."

Further, SC analysed Section 15 that deals with "sale of specific goods by description" and it was observed that the only requirement for an implied condition to arise with regard to goods being merchantable is that the seller must deal with those particular goods. Section 15 states that "*where there is a contract for the sale of goods by description, there is an implied condition that the goods shall correspond with the description; and, if the sale is by sample as well as by description, it is not sufficient that the bulk of the goods corresponds with the sample if the goods do not also correspond with the description*".

Section 55 of the Act provides for a right to sue the seller for the price of the goods, reaffirming the principle that the property can pass without there being delivery-

> *"(1) Where under a contract of sale the property in the goods has passed to the buyer and the buyer wrongfully neglects or refuses to pay for the goods according to the terms of the contract, the seller may sue him for the price of the goods.*
>
> *(2) Where under a contract of sale the price is payable on a day certain irrespective of delivery and the buyer wrongfully neglects or refuses to pay such price, the seller may sue him for the price although the property in the goods has not passed and the goods have not been appropriated to the contract."*

The Mobilox judgement essentially provided the non-requirement of the dispute being "bona fide" to decide if a dispute exists or not. The adjudicating authority only needs to see is if there is a plausible contention which requires further investigation and that the "dispute" is not a feeble legal argument or assertion of fact unsupported by evidence.

The SC perused the purchase order, which mentioned that coal must be of a certain quality in terms of its characteristics. It was stated that the transaction could be treated as a 'sale of goods by description' as the contract for sale related to 500 metric tonnes of Indonesian coal. SC said that there indeed was an email dispatched to the OC on 30.10.2016 which was wrongly brushed aside by the NCLAT on two grounds: that there was no reference to purchase order dated 27.10.2016 and the concern raised in the email was qua purchase order dated 11.10.2016 which related to the sister concern of CD; and secondly, that there is no reference to the 30.10.2016 email in reply to the statutory notice under IBC. SC stated that express reference was made to the CD in the email and only thereafter were the issues relating to inferior quality of coal given; CD itself ventilated the complaint about inferior quality of coal via 03.11.2016 email.

The SC stated that the transaction should be treated as sale of goods as the contract gleaned from purchase order that related to goods sold by description, i.e., Indonesian coal (as also mentioned in email of 03.11.2016 about poor quality of 'Indonesian coal'). It was stated that Appellant's case is anchored by Section 13(2) of the Act, which states that 'in a contract of sale, breach of any condition to be treated as breach of warranty and not as a ground to reject the goods', since the quality of coal as well as its details were expressly enumerated in the purchase order, with reference to a certain objective criterion and was understood as a condition that was not fulfilled by the OC. It was, therefore, the case of the Appellant that acceptance of goods under Section 42 may not detract from Section 13(2) of the Act being applicable to facts. Section 59 of the Act gets attracted which would

permit the CD to treat the breach of the condition (of specific coal quality) when there is acceptance of goods as only a breach of a warranty.

On the objection raised by the OC that even though there was guarantee under the purchase order, CD was not prevented from rejecting the order, SC observed that it is oblivious to the CD's suit seeking damages; that the same cannot be considered to decide if there is a pre-existing dispute under IBC. This is because the suit was not filed before the receipt of demand notice under Section 8 of IBC.

For the purpose of deciding if there was a pre-existing dispute, SC also observed that as per Section 55(2) a certain day must be fixed in the contract for payment of price which, in this particular case, states 'within seven days of delivery'. SC stated that as per law, buyer has the right to resist the suit on the basis that the refusal to pay the price is not wrongful. Section 59 gives CD the right to set up a breach of warranty and seek at least the diminution of the price if not extinction of the same. CD has a right to seek damages even on the same breach.

As per SC, it was observed in the *Mobilox* judgement that one of the objects of IBC in regard to operational debts is to ensure that the amount of such debts which is usually smaller than the financial debts does not enable the operational creditor to put the Corporate Debtor into insolvency resolution process prematurely, the same being enough to state that dispute exists between the parties. The *Mobilox* judgement also provided that Section 5(6) of IBC excludes the expression 'bona fide', and that the only requirement is existence of a plausible contention, which must be investigated.

'Pre-existing dispute'* and *'Preponderance of Probability'

The SC did not find the dispute projected by the Appellant non-existent. SC stated that the standard i.e., the reference to which a case of a pre-existing dispute under IBC must be employed, cannot be equated with even the principle of preponderance of probability which guides a civil court at the stage of finally decreeing a suit. It held that the NCLAT erred in holding that there was no dispute within the meaning of IBC.

The present case did not involve a dispute as regards the delivery of goods and acceptance of goods through their usage by the CD, and therefore to determine pre-existing dispute, the impact of Section 13(2) read with Section 59 cannot be ignored. SC clarified that Section 13 of the Act permits the buyer to waive a condition, and therefore it would be upon OC to persuade the appropriate court that CD has waived the alleged condition. SC thus allowed Appellant's appeal on the basis that pre-existing dispute existed under IBC thereby rejecting the Section 9 Application filed by the OC against CD.

Conclusion

The Apex court has set benchmark higher for the judicial scrutiny in insolvency cases wherein sale of goods especially for operational creditors wherein the concept of sale by description and sample shall become relevant and disputes may arise even after accepting goods but the condition and warranty aspect will now be open for agitation by corporate debtor. Balancing equities, SC said that all defenses shall be available under law to operational creditor which may be related to acceptance of goods, passage of time in raising disputes, payment terms etc.

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