



# INTERPRETATION OF FINANCIAL CREDITORS AND OPERATIONAL CREDITORS

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## ABSTRACT

*The Insolvency Resolution of India has gone through a structural change due to the economic impact when The Insolvency and Bankruptcy Code 2016 were enacted. The Code provides procedure for the insolvency resolution within a stipulated time frame. It made possible for the creditors and debtors to claim the debt and the concerned Authority would decide over the matter within the specified time period. The main object of this code is to save and to ease out the termination of firms from financial and economic condition.*

*The Economic and Financial subjects are the backbone of the code and the Adjudicating Authority, Appellate Authority and Judiciary have articulated applicable execution of the code and settled the hazy areas to give total lucidity, conviction and consistency for the stakeholders.*

*Through this paper, I aim to discuss the interpretation of financial creditors and operational creditors in relation with the relevant provisions and some judicial pronouncements which have helped in the legal development under the Insolvency and Bankruptcy Code, 2016.*

## INTRODUCTION

The bankruptcy Code is being an extensive reform of the different corporate insolvency frameworks. The Code becomes an operating tool to the creditors to lead through the insolvency resolution process when a debtor is unable to pay the debts and it has given the statutory rights to the creditors and streamlined the manner to assist its debts without dissolving the benefits of the creditors.

Bankruptcy Code was needed because of the multiple approach which created a hassle for the judge to interpret upon the non-performing assets and due to the abundance of enactment which deals with the insolvency and bankruptcy provisions, lead to chaos in the legal system.

Prior to Insolvency and Bankruptcy Code 2016 (IBC 2016), several statutory enactments such as, The Recovery of Debt Due to Banks and Financial Institution Act, Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, Sick Industrial Companies Act, The Companies Act, 2013 were in existence.

When the creditors have a debt, the person has the right to approach the court or tribunal i.e. civil court or arbitral tribunals for recovery of debts. The code has focused upon the relationship and interpretation between financial creditor and operational creditor. A financial Creditor is a person who has a relationship with the debtor and against the consideration of the time value of money<sup>2</sup>. Operational Creditor is a creditor who provides goods and services for the business transaction. The Code has defined the categories of creditors as financial creditors and operational creditors but even though it creates an issue while interpreting when the creditor is a financial creditor or an operational creditor. The interpretations are based on the literal and liberal rule of interpretation and arbitrary.

### SIGNIFICANT PROVISIONS AS PER THE INSOLVENCY AND BANKRUPTCY CODE, 2016

- **Claim**<sup>3</sup> is defined as, “it means –
  - (a) a right to payment, whether or not such right is reduced to judgment, fixed, disputed, undisputed, legal, equitable, secured, or unsecured;
  - (b) right to remedy for breach of contract under any law for the time being in force, if such breach gives rise to a right to payment, whether or not such right is reduced to judgment, fixed, matured, un-matured, disputed, undisputed, secured or unsecured.”
- **“Creditor**<sup>4</sup>” is defined as “any person to whom a debt is owed and includes a financial creditor, an operational creditor, a secured creditor, an unsecured creditor, and a decree-holder”.
- **“Debt**<sup>5</sup>” is “a liability or obligation in respect of a claim which is due from any person and includes a financial debt and operational debt”

<sup>2</sup> nishithdesai.com

<sup>3</sup> Section 3(1) of insolvency and Bankruptcy Code, 2016

<sup>4</sup> Section 3(10) of Insolvency and Bankruptcy Code, 2016

- Under Section 3(12) of the code, it deals with the definition of the word “**Default**”, which means that “non-payment of debt when whole or any part or installment of the amount of debt has become due and payable and is not paid by the debtor or the corporate debtor, as the case may be”.
- “**Financial Creditor**<sup>6</sup>” is defined as, “any person to whom a financial debt is owed and includes a person to whom such debt has been legally assigned or transferred to”.
- “**Financial Debt**<sup>7</sup>” is defined as a “debt along with interest, if any, which is disbursed against the consideration for the time value of money and includes—
  - (a) money borrowed against the payment of interest;
  - (b) any amount raised by acceptance under any acceptance credit facility or its dematerialized equivalent;
  - (c) any amount raised according to any note purchase facility or the issue of bonds, notes, debentures, loan stock or any similar instrument;
  - (d) the amount of any liability in respect of any lease or hire purchase contract which is deemed as a finance or capital lease under the Indian Accounting Standards or such other accounting standards as may be prescribed;
  - (e) receivables sold or discounted other than any receivables sold on non-recourse basis;
  - (f) any amount raised under any other transaction, including any forward sale or purchase agreement, having the commercial effect of a borrowing;
  - (g) any derivative transaction entered into in connection with protection against or benefit from fluctuation in any rate or price and for calculating the value of any derivative transaction, only the market value of such transaction shall be taken into account;
  - (h) any counter-indemnity obligation in respect of a guarantee, indemnity, bond, documentary letter of credit or any other instrument issued by a bank or financial institution;
  - (i) The amount of any liability in respect of any of the guarantee or indemnity for any of the items referred to in sub-clause (a) to (h) of this clause.”
- “**Operational Creditor**<sup>8</sup>” is defined as “a person to whom an operational debt is owed and includes any person to whom such debt has been legally assigned or transferred.”
- “**Operational Debt**<sup>9</sup>” is defined as “a claim in respect of the provision of goods or services including employment or a debt in respect of the payment of dues arising under any law for the time being in force and payable to the Central Government, any State Government or any local authority.”

<sup>5</sup> Section 3 (11) of Insolvency and Bankruptcy Code, 2016

<sup>6</sup> Section 5(7) of Insolvency and Bankruptcy Code, 2016

<sup>7</sup> Section 5 (8) of Insolvency and Bankruptcy Code, 2016

<sup>8</sup> Section 5(20) of Insolvency and Bankruptcy Code, 2016

<sup>9</sup> Section 5(21) of Insolvency and Bankruptcy Code, 2016

## EXPLANATION AND ITS JUDICIAL PRONOUCEMENT

The scheme of the code has changed the previous insolvency regime and in relation to the corporate entities. It has introduced with the category of creditors, and also minimized the scope for judicial interference. It was analyzed that the company had various stakeholders and creditors altogether the stakeholders of the company. Before the IBC 2016, a creditor was classified as a secured, unsecured and statutory creditor. The code has reclassified the creditors as financial and operational creditors. The distinction of secured, unsecured, and statutory creditors is not obviated in its entirety<sup>10</sup>.

The constitutional validity was challenged on various provisions; sections 7, 8, 9 of the code. The issue was raised regarding the differentiation between the two aforesaid types of creditors is based on the intelligible differentia.

“As the committee has deliberated upon the matters regarding insolvency that the creditor's committee have been given the power to ultimately keep the company as a going concern or liquidate it because the creditors have to be reasoned enough with the capability to access viability as well to modify the terms of the existing liabilities in negotiations. Even the operational creditors never decide to take the matter nor willing to take the risk of postponing payments for better future-oriented for the entity”<sup>11</sup>.

“The Bankruptcy Committee has given a rationale to the financial creditors being treated in a particular way vis-à-vis an operational creditor in an insolvency proceeding concerning a company. The rationale is a plausible view taken for an expeditious resolution of an insolvency issue of a company. Courts are not required to adjudge legislation based on possible misuse or the crudities or inequalities that may be perceived to be embedded in legislation<sup>12</sup>. The rationale of giving a particular treatment to a financial creditor in the process of insolvency of a company under the Code of 2016 cannot be said to offend any provisions of the Constitution of India”<sup>13</sup>.

When a liability or an obligation for the payment of the debt owed by a person is not repaid either on-demand or after the date of maturity then it becomes a default. The dispute is raised when the default was due to the non-payment of the debt. The Code has laid down a mechanism in favour of corporate debtor to raise a dispute. The prescribed time period under the code states that within ten days of the date of receipt of demand notice were issued by the operational creditor against the corporate debtor shall prove the existence of the dispute or if there are any proceedings pending for the same subject matter or the receipt<sup>14</sup>.

If the default is not clear as a dispute then the authority investigates upon the stated issue raised and they determine whether the dispute is reasonable enough to initiate the proceedings on that legal matter.

<sup>10</sup> Akshay Jhunjhunwala and anr. Vs. Union of India, W.P. No. 672 of 2017

<sup>11</sup> Bankruptcy Law reforms Committee, the Interim Report of the Bankruptcy Law Reforms Committee(2015)

<sup>12</sup> Sree Metaliks Limited & Anr. (supra), Innovative Industries Limited (supra) and Mobilox Innovations Private Limited (supra) W.P. 7144 (W) OF 2017

<sup>13</sup> Bankruptcy Law reforms Committee, the Interim Report of the Bankruptcy Law Reforms Committee(2015)

<sup>14</sup> Section 8 (2) of Insolvency and Bankruptcy Code, 2016

The NCLAT has provided with the interpretation of the phrases ,‘dispute’ and ‘existence of dispute’ and “held that the definition is inclusive and not exhaustive and includes mediation, conciliation, consumer court, labour court or any other proceedings pending or raised before the court”<sup>15</sup>.

The code has recognized three different types of creditors such as a financial creditor, an operational creditor, and other creditors. If a debt is along with the interest or assurances that were made for the repayment is to be made in near future along the interest is treated as financial debt and any person to who such financial debt is owned is a financial creditor. If a debt is owed due to the non-payment in respect of the goods and services rendered is termed as operational debt and any person to whom such operational debt is owned is an operational creditor.

“Financial creditors are those whose relationship with the entity is a pure financial contract, such as a loan or debt security. Operational creditors are those whose liability from the entity comes from a transaction on operations”<sup>16</sup>.

In *Swiss Ribbons and Anr. Vs. Union of India*<sup>17</sup> case, the issue was regarding the constitutional validity of the various provisions of Insolvency and Bankruptcy Code, 2016. A technical objection was raised stating that there is no real difference between financial creditors and operational creditors<sup>18</sup>. As both the type of creditors are related to the money in terms of a loan or terms of goods and services. The government was able to focus upon nonperforming assets crisis and depending upon the problems; the Supreme Court has made relevant points –

1. The distinction between the promoters or management and corporate debtor has been judicially recognized.
2. Supreme Court stated that IBC is a beneficial legislation and it would benefit the corporate debtor and their admission of a company into a corporate insolvency resolution process.
3. Supreme Court has upheld Section 29A regarding the related parties.

The Legislature has drafted legislation on economic matter subjects, in which they cannot anticipate all the possible issues which can be raised in near future and for that, a body is established where the authority can decide what exemptions, immunities, and restrictions shall be provided in the statute in compliance with the constitutional validity and it draws a thin line between the legislature and judiciary. Where the court has to power to the interpret the intent of the legislature and if there are any flaws or mischief in the provisions then the judiciary shall draw the conclusion and provide recommendations to resolve the mischief.

The Insolvency Law committee has observed that regulatory dues were intentionally not included under the definition of the operational debt. The home buyers were not included as a part operational creditor to initiate the insolvency resolution process or participate in the process as members of the committee of creditors<sup>19</sup>. As the interest of the home buyers were not adequately safeguarded. A petition was filed under IBC, 2016 on behalf of

<sup>15</sup> Kirusa Software Pvt. Ltd. Vs. Mobilox Innovations Pvt. Ltd., Civil Appeal No. 9405 of 2017

<sup>16</sup> Bankruptcy Law Reform Committee, Report of the Bankruptcy Law Reform Committee, Para 5.2.1 Vol. I (2015)

<sup>17</sup> 71(IBC)02/2019

<sup>18</sup> 71(IBC)02/2019

<sup>19</sup> Bankruptcy Law Reform Committee, Report of the Bankruptcy Law Reform Committee, Para 5.2.1 Vol. I (2015)



the aforesaid issue raised and to include a new category of financial creditor- Real Estate (Commercial) and Real Estate (Residential). This category is a distinct category from an organized sector of financial creditors like banks and other financial institutions. The issue was made in consonance with the principle of present and voting. According to the threshold limit, 75 percent of total voting share of the financial creditors in all cases as mentioned before the IBC (Second Amendment) Act, 2018<sup>20</sup>.

According to the purposive interpretation made, “the legislature has drafted the Code to promote resolution over liquidation”. The Principal Bench found that the home buyers would not be described as a financial creditor. The appellate tribunal carved out an exception on Real Estate (Commercial & Residential) that in a case where the assured return is provided with terms and conditions of the agreement then on default it shall constitute as a financial creditor.

After the Judicial Pronouncement, the legislature has expanded the expression of financial debt<sup>21</sup> under the clause (f) that “debt along with the interest if any which is disbursed against the consideration for the time value of money”.

The agreement between homebuyers and builders and along with terms and conditions for the utilization of disbursements made by the home buyers to the builders in the future after the construction. The code has also defined “allottees” as “a person has agreed to pay the total amount or has paid the total amount then allottee can allege default and if the payment has not been made then the allottee cannot allege the default”<sup>22</sup>. When the allottees came to know that the construction is not completed by the corporate debtor within the stipulated time as mentioned under the agreement then they can raise the claim on failure to refund the amount of allottees.

The court has focused “upon the distinction between the nature of agreement entered into with the financial creditor and operational creditor, where the former related to working capital or on a term loan and the latter where the agreement mostly related to the sale and purchase of goods and services. This distinction is based upon the intelligible differential with rational nexus to the objectives of the code”<sup>23</sup>.

Deferred payment does not constitute that debt should bear interest along with it and such interest is not an essential condition for a debt to be categorised as a financial debt. The court has also discussed the nature of transactions, as it includes a consideration borrowed against the rate of interest, the amount raised through commercial effect borrowing, and also includes sale and purchase of agreement<sup>24</sup>.

According to the definition of Operational Debt, it includes all debts other than financial debts. NCLT interpreted that the legislature has not considered “to include” within the expression<sup>25</sup>. Therefore, an operational debt would be related only to four categories like goods, services, employment, and government dues<sup>26</sup>.

<sup>20</sup> Nikhil Mehta & Sons Vs. AMR Infrastructure, CA. NO. 811(PB)/ 2018

<sup>21</sup> Section 5(8) of Insolvency and Bankruptcy Code, 2016

<sup>22</sup> Explanation under section 5(8) of Insolvency and Bankruptcy Code, 2016

<sup>23</sup> Understanding the Insolvency and Bankruptcy Code, 2016- Analysing the developments in jurisprudence

[https://ibbi.gov.in/webadmin/pdf/whatsnew/2019/Jun/190609\\_UnderstandingtheIBC\\_Final\\_2019-06-09%2018:20:22.pdf](https://ibbi.gov.in/webadmin/pdf/whatsnew/2019/Jun/190609_UnderstandingtheIBC_Final_2019-06-09%2018:20:22.pdf)

<sup>24</sup> Shailesh Sangani Vs. Joel Cardoso, CA (AT) No. 616 of 2018

<sup>25</sup> Col. Vinod Awasthy Vs. AMR Infrastructure Ltd. CA No. (IB)- 10 (PB)/ 2017

When the resolution process initiates then the Code shifts the control and management of the corporate debtor to the Financial Creditors represented as Creditors of the committee. Director and shareholders have the right to attend the board meeting but does not have the voting right. The Committee of creditors determines over the objective and implication of the Resolution Plan prepared by the Interim Resolution Professional (i.e. IRP). The code gives COC voting right depends upon the proportionate debt owed by the debtor. So, the financial creditors can access and modify the terms and conditions keeping in mind that the owned can be realized as per the accounting standards and should have bona fide intention to accept or reject the resolution plan in the Board Meeting. Whereas the operational creditor cannot attend the meeting of the creditors but does not have any voting right because the operational creditor can never take decisions while keeping the risk of delayed payments.

### **INSOLVENCY RESOLUTION PROCEEDING**

- A. Financial Creditor can initiate the application, either itself or jointly with other financial creditors or with any other person on behalf of the financial creditor before NCLT when a default has occurred<sup>27</sup>. During the adjudication process, a financial creditor does not require serving notice to the debtor within fourteen days from the date of applying, NCLT should determine the existence of debt and default either to admit or reject the application<sup>28</sup>.
- B. An Operational creditor would demand for the payment of the unpaid debt and in case of non-payment of an unpaid debt that would amount to be a default. The Corporate debtor may within 10 days from the date of receipt either has to pay the debt or pay the unpaid debt<sup>29</sup>. In the event, the corporate debtor does not pay the debt, the creditor may file an application to NCLT to initiate insolvency resolution process.
- C. The confirmation on the application initiated by a financial creditor or an operational creditor according to the moratorium which is pronounced on the continuation of the proceeding, and Interim Resolution Professional is given authority by the NCLT within 14 days from the bankruptcy initiation date.

During the time, Resolution Professional needs to decide the genuine monetary situation of the debtor by gathering the data on resources, funds, and activities. Accounting Standards in compliance with the records are required to be interpreted and then decide the estimation of the financial position of the Corporate Debtor. IRP needs to assess the parameters and those parameters must be affirmed by the panel of COC.

A decision of the Committee of Creditors would require to be approved by a minimum of 51% of voting shares of financial creditors. Every financial creditor is eligible to be a part of the Committee of Creditors and voting is done based on the share of financial creditors. Resolution professionals would assist in the formulation of a resolution plan. A Resolution plan would be a strategy for repayment of the debts after

<sup>26</sup> Mukesh Kumar Vs. AMR Infrastructure Limited, CA No. (IB) – 30(PB)/ 2016

<sup>27</sup> Section 7(1) of Insolvency and Bankruptcy Code, 2016

<sup>28</sup> Section 7(4) of insolvency and Bankruptcy Code, 2016

<sup>29</sup> Section 9 of Insolvency and Bankruptcy Code, 2016

an evaluation of the debtor's worth. The Resolution plan may have some eligibility criteria to be satisfied by a person to qualify a resolution applicant. Once a person meets all the eligibility criteria and submits a resolution plan, in the event the same is not approved by a committee of creditors or by NCLT, NCLT may direct the debtor to liquidate. If creditors who are aggrieved by non-implementation of a resolution plan approved by NCLT, can apply to NCLT and if the resolution applicant is not complying with the terms of the resolution plan, then the entire period is available to complete CIR process is exhausted by the time NCLT approves a resolution plan. If the resolution plan fails to implement then they have no time to look for other plans. The corporate debtor would be forced to liquidate.

### ANALYSIS

1. Secured creditors i.e. banks and financial institutions who are the financial creditors whereas the unsecured creditors are the operational creditors as payments of goods and services and payments made to the workers are not secured.
2. The Corporate Insolvency Resolution Process (CIRP) is instituted by the operational creditor and financial creditor and such classification is arbitrary and which guarantees fair and equitable treatment to operational Creditors and Financial Creditors.
3. The financial creditor has to prove that there is a default based on documentation or agreement made as to the terms and conditions.
4. The distinction made between the "dispute" or the "existence of a dispute" is based on the facts of the circumstances. In the provision, the Word 'or' is used between the aforesaid word because either of them can constitute a dispute for the initiation of the proceedings and it would resolve the issue regarding the interpretation of dispute with the word 'and'. If we used the word 'and' then both are inclusive and it becomes necessary to fulfill. Sometimes, the creditor does not any have sufficient time to issue a demand notice and after the reply is filed then the procedure is initiated. So, the word 'and' is not considered effective to dissolve the dispute initiated in the proceeding.
5. Financial debt is extended for the assurance of future payment of money. On the other hand, debt is an operational debt when it is regarding the goods and services, employment, and government dues.
6. The code provides liabilities to individuals-
  - a. When debtor have a mala fide intention to defraud creditors, shall be accountable to make contributions of the assets as a penalty.
  - b. When Director or Partner has no sufficient reason for avoiding the initiation of the insolvency process shall be accountable to make contribution to the assets.
  - c. If the officer has made any gifts or charge on the property, then such officer shall be held liable with imprisonment for a term not less than 1 year and with fine, shall not be less than 1 lakh rupees which may extend to 1 crore.
7. Insolvency Resolution Process has reduced overload of the assets from the banking system and while trying to improve the ease of doing the business.
8. The Limitation Act of 1963, shall apply on all proceedings and appeals made under IBC.



## CONCLUSION

The Code is based on the stipulated period for the resolution of the corporate debtors and it benefits of all stakeholders. The Adjudicating Authority must follow the principle of natural justice.

The operational creditor can claim to arise out of a business transaction and such creditor, they are not eligible for voting right in the committee of creditors' meetings. The experimentation on economic matters is permissible and misusing the enactment is not a ground to repeal such enactment. This legislation needs to be amended in such matters which are relevant to fulfill the objective of the statute as the legislature will not be able to forecast all the possibilities of socio-economic changes. While initiating the Resolution Process, the creditor has to fall under the ambit of financial creditor and operational creditor. NCLT appoints an Interim Resolution Process and they discharge the functions and duties to prepare the resolution plan and the Committee of Creditors conduct the board meeting and they approve or reject the resolution plan.

