
BAFFLING CONUNDRUM BETWEEN FINANCIAL CREDITOR AND OPERATIONAL CREDITOR UNDER INSOLVENCY AND BANKRUPTCY CODE, 2016

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ABSTRACT

The jurisprudence on the Insolvency and Bankruptcy resolution in India has evolved quite a lot over the period, but there still exist certain grey areas. One of which is the tale of baffling conundrum between operational and financial creditors challenging constitutional validity. In this article author discusses the unsettled conundrum as to treatment by an unbiased code by ascertaining the aims and objectives of Insolvency and Bankruptcy Code. Followed by the analysis of financial and operation creditors in the light of the judicial pronouncement, and the psychological aspect for prioritising financial creditors considering the nature of credit and market play which creates the intelligible differentia and has a legitimate nexus with the objectives of the IBC.

Introduction

With the advent of major economic changes and regulations development since 1991 economic reform policies¹, the market structure has changed drastically. The stakeholder's participation in the companies have increased manifolds, leading to enhanced creditor role. The Debt Recovery laws have seen major changes in the past few years from enactment of a new Insolvency and Bankruptcy Code 2016 (herein after referred as, IBC), along with various amendments and judicial decisions have shifted the debt market from "Debtor Oriented" to "Creditor Driven" Market. In the former model the "Debtor" i.e. the company's management had full control over the companies affairs even after the repetitive defaults in repayment to stakeholders (creditors particularly), whereas, in the later model the managerial control of the company shifts from the hands of the existing board of directors of the company in the hands of creditors and they have the authority to accept new resolution plans as per their commercial wisdom. This paradigm shift of model has created a deterrent effect among the corporate debtors, allowing it to be concomitant to creditor's right.²

Creditors are considered to be major stakeholders of the company. The debt provided by them act as a food and fuel for a company alongside the capital of the company. In 2015, a committee headed by T. K. Viswanathan³ was formed to regularise and unify the Insolvency laws in India. The objective of the committee was unification of the laws by improving the powers of creditors. When a company is not able to pay the debt the first step should be resolution, i.e. promoting business survival and growth in a going concern manner. The resolution should negotiate creditor- debtor relationship, focusing on "avoid destruction of value of assets and drawing a line between malfeasance and business failure".⁴ Liquidation should be the last resort after proper external examination and supervisions of assets in the waterfall mentioned under the statute.⁵

The preamble of the code does speak about "maximisation of the value of assets of corporate debtors and the balancing of the interests of all stakeholders."⁶Categorization or classification

¹Pradeep Agarwal, Gokan Subir, Veena Mishra, Kirit Parick and Kunal Sen "India: Crises and Response," Economic Restructuring in East Asia and India London: Macmillan (1995)

²Shakti Deb and Idrajit Dube, "Insolvency and Bankruptcy Code 2016- Revisiting the Market Reality" International Journal of Law and Management, Emerald Publishing Limited 1754-243X DOI 10.1108/IJLMA 05-2020-0133

³Bankruptcy Law reforms Committee, the Interim Report of the Bankruptcy Law Reforms Committee (2015)

⁴ *ibid*

⁵ The Insolvency and Bankruptcy Code 2016(No 31 of 2016), Section 53

⁶ The Insolvency and Bankruptcy Code 2016(No 31 of 2016), Preamble

of creditors is not a novel concept, earlier the creditors were divided on the basis of securities associated with the debt i.e. Secured Creditor, Unsecured Creditor and Statutory Creditors. Now, the nature of debt or the purpose for which the debt is provided is distinguishing factor as Financial Creditor (FC), Operations Creditor (OC) and Other creditors. Earlier classification was easier to identify and understand, because of collateral's presence, tangible nature of the same did not lead to much confusion, but the purpose for that was to secure the debt/ repayment by the debtor. Whereas, under IBC, the aim is to resolve credit viability issue rather than security. Business running in a going concern manner is the need of all, large investments, huge employment and market competitiveness depends upon a company. A company being liquidated suffers more harm to the society at large than good to the creditors.

The paper will be focusing on the central argument of validity of priority given to FC than OC. The paper is focusing on critically analyse the definition of FC and OC along with the differential treatment for them under the code. The paper will further analyse various judicial jurisprudence laid on the compartmentalisation of the creditors.

Financial and Operational Creditors

A debate on compartmentalisation of creditors has been in discussion since the code came into effect, before going into the discussion of the same; there are certain general definitions that need to be understood in beforehand like creditor, debt and default. A "Creditor"⁷ has been 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". Further, "Debt"⁸ is defined as "a liability or obligation in respect of a claim which is due from any person and includes a financial debt and operational debt". Lastly under section 3(12) "Default" has been defined as "non-payment of debt when whole or any part or instalment 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".

A "Financial Creditor"⁹ is a person who owns a financial debt to the Debtor. Under section 5(8) of IBC the definition of "Financial Debt" a very extensive, interpretative and inclusive. The key takeaways from the definition are "time value of money" and "commercial effect of borrowing". The term "Time Value of Money" has been interpreted by the apex court as an

⁷ The Insolvency and Bankruptcy Code 2016(No 31 of 2016), Section 3(10)

⁸ The Insolvency and Bankruptcy Code 2016(No 31 of 2016), Section 3(11)

⁹ The Insolvency and Bankruptcy Code 2016(No 31 of 2016), Section 5(7)

debt were the value is added to the money either in the form of interest or any other mechanism and at the time of repayment the creditor gains such value.¹⁰ It acts as a kind of investment to the creditors, where the money appreciates in value from the time it has been given. The nature of debt is not the repayment for goods and services but actual market forces working together in appreciation of value of money. “Commercial effect of borrowing” means that the money which is borrowed by the debtor acts as a fuel to the company’s day to day working. The debt has been used to generate income for the company. The suitable example of the same is inclusion of home buyers with 2018 amendment under the ambit of FC.¹¹ In general a Real estate business is working on the regularly on continuous inputs received from the home buyers at various stages.¹²

An Operational Creditor¹³ is a person who owns operational debt against the corporate debtor. “Operation Debt¹⁴” 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.” The court has made it very clear that the definition of OC must not be used as a residuary provision.

Hence we could say that whenever the claim is in relation with repayment of goods and services, employment claims and statutory dues it is an OD hence the person can be an OC. Whereas, in case if the claim has “time value of money” or falls under any of the specified clauses of section 5(8) or has “commercial effect of borrowing”, in short if the claim is used to provide fuel for regular functioning of the business of the company than it is an FD and the person is FC.¹⁵ Such classification is made considering the aim and objective of the code, i.e. market development and better position of creditors.

Differential position of Financial Creditor and Operational Creditor

To understand the conflict between the FC and OC, it is essential that we look into the places where the difference lies:

¹⁰ Akshay Jhunjhunwala and Anr. Vs. Union of India, W.P. No. 672 of 2017

¹¹ The Insolvency and Bankruptcy Code, 2016 (No 31 of 2016), Section 5(8)

¹² Pioneer Urban Land and Infrastructure Limited and Anr. Vs. Union of India & Ors. WP (C) No. 43/2019

¹³ The Insolvency and Bankruptcy Code 2016 (No 31 of 2016), Section 2(20)

¹⁴ The Insolvency and Bankruptcy Code 2016 (No 31 of 2016), Section 2(21)

¹⁵ C. Scott Pryor; Risham Garg, "Differential Treatment among Creditors under India's Insolvency and Bankruptcy Code, 2016: Issues and Solutions," American Bankruptcy Law Journal 94, no. 1 (Winter 2020): 123-154

1. Filing of the Corporate Insolvency Resolution Process- for a FC to initiate a CIRP, it is essential that in case of default, the FC can make an application to the Adjudicating authority, name an Interim resolution professional along with default proof.¹⁶ For a OC the process is rather is two stages first the OC has to file a notice to the CD claiming the debt that has been defaulted and notice period of 10 days must be given to CD to repay the OC.¹⁷ On second stage if he does not pay or files for dispute than in such a situation the OC can file for initiation of CIRP against the Debtor.¹⁸
2. Member of Committee of creditors- As soon as the CIRP application is accepted by the Adjudicating Authority has three cause of action i.e. make public announcement, declare moratorium and appoint Interim Resolution Professional.¹⁹ The Interim resolution professional will form a Committee of Creditors after collating all the claims. In this COC only FC can be a member and all the OC has right to attend and speak in the meeting but not voting.
3. Voting Rights in Resolution Plans- Once the COC is formed, the voting rights regarding acceptance or rejection of the Resolution Plan is in the hands of the COC only i.e. indirectly in the hands of FCs. The commercial wisdom of the COC cannot be questions in court and hence the decision of the COC is final.

Judicial pronouncements

In the case of *Nikhil Mehta v. AMR Infrastructure Ltd.*²⁰ the definition of financial debt was analysed as follows “A financial debt must meet the first essential requirement of disbursing money against the consideration of time value of money, that is, the events listed in various sub-clauses. The key feature of financial transaction as postulated by section 5(8) is its consideration for time value of money. A financial transaction is one in which money is received today and has to be paid for over a period of time through a single or series of payments in the future. The legislature has included this type of financial transaction in the definition of "Financial Debt". It can also be an investment made today that is to be repaid over time through a series of payments to be made in the future. In Black's Law- Dictionary (9th edition) the expression 'Time Value' has been defined to mean

¹⁶ The Insolvency and Bankruptcy Code 2016(No 31 of 2016), Section 7

¹⁷The Insolvency and Bankruptcy Code 2016(No 31 of 2016), Section 8

¹⁸ The Insolvency and Bankruptcy Code 2016(No 31 of 2016), Section 9

¹⁹ The Insolvency and Bankruptcy Code 2016(No 31 of 2016), Section 13

²⁰*Nikhil Mehta v. AMR Infrastructure NCLAT, New Delhi, Company Appeal (AT) (Insolvency) No. 07/2017, Date of decision – 21 July, 2017.*

“The price associated with the length of time that an investor must wait until an investment matures or the related income is earned” In both the cases, the inflows and outflows are distanced by time and there is a compensation for time value of money...” Relying on the same judgement many cases have examined that an interest payable to OC for delayed payment is not converting the debt into and operational debt, the intent for which the debt is been given should be a deciding factor.²¹

It was for the first time in 2018, the constitutional validity on the distinction between FC and OC was challenged under article 14, 19 and 21 of the Constitution of India in the case of Swiss Ribbons (P) Ltd. v. Union of India,²² the SC declining the challenges stated that financial creditors have a better understanding of the viability and feasibility of a business than Operational creditors, the classification does not violate Article 14. While operational creditors, who only deal with goods and services and the fees associated with them, are unable to evaluate the business, financial creditors, such as banks and financial institutions, who lend money, are. The court analyzed the difference through various measures like, Nature of contracts being signed by the creditors, intent for providing debt, quantum of loan, time for debt repayment and overall outcome on the market and business structure of the debt that is being provided. The court emphasised that the focus of the code is resolution that promotes revival of business with different managerial control and continuation of the corporate debtor rather than going for liquidation. The code is for overall betterment of all the stakeholders of the company, not a mere recovery mechanism for creditors. the court pointed out that the debt secured from OC is of recurring nature and can be disputed on various ground level, which can lead to long civil court cases hampering the working of the company, on the other hand FC debts are usually on contractual basis with arbitration clauses that eliminates the scope of dispute of claim. in addition to the same court also mentioned that FC are assessing the viability of the company even before investing the money in corporate debtor hence they are very much aware about the market functioning, credit rating of the company, return ratios of their investment and competitors present in the same industry, hence are a better judge to the resolution plans proposed to them while being a member of Committee of Creditors. OC are generally small goods and service providers that facilitate in smoothing functioning of the business rather than actively participating in the business operation hence they are majorly concerned about their

²¹ DF Deutsche Forfait AG and Ors v. Uttam Galva Steel Ltd., C.P. No. 45/I&BP/NCLT/MAH/2017. Decision date- 10.04.2017

²²(2019) 4 SCC 17.

debt repayment rather than corporate debtor functioning. They are large in number hence their participation in the voting of Committee of Creditors can be biased towards their claims and not the corporate debtors overall development and also the majority accessibility is difficult task in timely manner.

Reinforcing the Swiss Ribbons decision, the Supreme Court did not place both financial and operational creditors on the same pedestal, as observed in *Essar Steel India Ltd. v. Satish Kumar Gupta*²³, where the Supreme Court clarified that the principle of equality cannot be applied between financial and operational creditors because financial creditors deal with public money, which has a direct impact on the country's economy. The financial creditors are primary investors in the company where as OC are secondary beneficiaries.²⁴

In *Binani Industries Ltd. v. Bank of Baroda*,²⁵ both the unsecured financial creditors and the operational creditors challenged the differential payments on grounds of discrimination being meted out based on their voting shares, when the I&B Code does not provide for such discrimination. In its ruling, the NCLAT stated that the I&B Code aims to maximise the value of the corporate debtor's assets for the purpose of establishing the law in this area. It is rather important to promote entrepreneurship, increase the access to finance, and strike a balance between competing interests, rather than maximising value for a single "stakeholder" or group of "stakeholders," such as creditors, the goal is to maximise value for all key stakeholders.

In *Maharashtra Seamless Ltd. v. Padmanabhan Venkatesh*²⁶, the Supreme Court held that it is not necessary for the resolution plan to match the maximum asset value of the corporate debtors while highlighting the object of the Code, i.e. "resolution before liquidation," while on the other hand, the Supreme Court refused to recognise the interests of operational creditors.

OC and FC might have different approach towards initiation of the CIRP process but the right associated with the claim of credit is not at distinguishing level. It has been clearly interpreted by the SC that in case of resolution the Committee of creditors will look into the claims of operational creditors first and must be at equitable level of liquidation value ought to be received by them.²⁷ In the case of *Rajputana Properties Pvt. Ltd. v Ultratech Cement Ltd. &*

²³(2020) 8 SCC 531.

²⁴ Saransh Jain, "Operational Creditors - The 'Outcast' of Insolvency and Bankruptcy Code", 3 INT'L J.L. MGMT. & HUMAN. 77 (2020).

²⁵2018 SCC OnLine NCLAT 521.

²⁶(2020) 11 SCC 467.

²⁷ Akshay Jhunjhunwala & Anr vs Union Of India, (2017) W.P. No. 672.

Ors²⁸ in 2018, the Supreme Court held that operational creditor dues are treated similarly to financial creditor dues. Dues of both the creditors are considered to be at par in case of resolution process. For instance if all the creditors are paid proportionally in respect of their debt than on the same equal level the debts of OC will also be treated.

Considering the current market economy 80% of the business market in India is being governed by MSMEs. MSMEs do not have huge capital inputs as compared with Multinational companies, they rely on credit availability equally to function. Creditors' acts as a backbone to such organisations, who can infuse money at any time. Considering the nature of credit given by FC, is more of investment purposes. A Financial creditor studies the market economy and then with a motive of earning returns of the debt given they provide debt to the corporate debtor. Whereas, in case of OC they are focussed on securing payment against the goods and services being provided by them, they neither aim at providing resources for running the company nor have any commercial effect on the company's business. Since FCs have studied the market before providing the debt they have a better understanding of the market forces and can judge that the non payment is either because of "Business failure" or "Financial failure". In case of financial failure, resolution can be the best manner to solve the issue as new resolution applicant can take in charge of the businesses and provide for finances and takeover the business in going concern manner. But, in case of business failure, the cost of running the business independently is more expensive than the cost of repayment of the debt.²⁹ Usually, FCs are huge investment companies like financial institutions and banks, that have access of resources and skilful team to look into the matters of the business and decide whether resolution can be best possible solution and even if it is which of the multiple resolutions plans received will be commercially viable option³⁰ Furthermore, the definition of "time value of money" and "commercial effect of borrowing" is an open ended concept. The legislators have deliberately not given any set definition for the same because of changing market structure and business. It is left open for the Adjudicating Authority to determine whether or not any particular debt falls under the FCs definition or not.

Psychologically, the FC's have debt investments for a longer period of time and their repayment dues and interest keep on increasing with time and because the quantum of money

²⁸Rajputana Properties Pvt. Ltd v. Ultratech Cement Ltd. & Ors, (2018) Company Appeal (AT) (Insolvency) No. 188

²⁹ Sudip Mahapatra; Pooja Singhania; Misha Chandna, "Operational Creditors in Insolvency: A Tale of Disenfranchisement," NALSAR Student Law Review 14 (2020): 78-93

³⁰ Col. Vinod Awasthy v. AMR Infrastructure Ltd., NCLT, Principal Bench, Delhi, (2017) CP No. (IB)-10(PB)

is more than the other creditors, and the returns is also not one time but rather in instalments, so in case of liquidation and winding up of the company their money is at loss, their return is not being paid out as per the investment plan. So, they will always try to keep the business running as they are looking at a more foresighted approach for their debt. Whereas, in case of OCs they are focused on securing their payment for the time being they are not concerned about the interest they earn from such debt.

Conclusion

Under the Code, the distinction between financial and operational creditors is fundamental and an economy is based on both the provision of goods and services, as well as the financial system. Therefore, in light of the above discussion, the Code's aim to protect the rights of all the stakeholders and to keep the Corporate Debtor as a going concern is achieved by the distinction made between FCs and OCs, which is valid and constitutional per Article 14 of the Indian Constitution. The reason for the same is that the demarcation between FC's and OCs based on the factors discussed in this article draws an intelligible differentia between both of them, and such a differentia has a legitimate nexus with the objectives of the IBC.