

## Turning A Blind Eye To The Dues Of Operational Creditor

written by Gaurav Singh Gaur | May 24, 2022



### Dues of Operational Creditor Under IBC

The Insolvency and Bankruptcy Code, 2016, (hereinafter referred to as “Code”) was executed with the intent of collaborating, bringing the concept of insolvency under one single legislation, and for providing a single forum for the insolvency resolution process. The Code was also enacted in light of the failure of the existing legislation. It primarily aims to resolve and revive industries and if the same may not be possible, the Code provides the mechanism for payment of dues to the creditors.

In a recent judgment delivered by the Hon’ble National Company Law Appellate Tribunal, Chennai Bench, in the case of M/s. Genius Security & Allied Services v. Mr Shivadutt Bannanje & Ors., has addressed the issue of NIL payments to operational creditors under the resolution plan in detail, unlike other judgements that have not specifically dealt with this issue of Dues of Operational Creditor Under IBC to date.

### Creditors Under The Code

It is pertinent to note that the Code defines and differentiates various creditors based on the role they play in the functioning of the company while it is still solvent. The Code differentiates and demarcates a distinction between the financial creditor and the operational creditor.

As per Section 5(7) of the Code, the term “financial creditor” means and includes fiscal institutions that have provided financial assistance to the corporate debtor during its solvency and have the primary right over the dues, whereas as per Section 5(20) of the Code, the term “operational creditor” means and includes all creditors that have assisted in the operations of the corporate debtor and are owed an operational debt by the corporate debtor.

The Code also deals with the concept of a secured creditor, unsecured creditor and decree-holder and the dues payable to such entities. However, the financial and operational creditors are the key entities and highlights of the Code.

### Waterfall Mechanism: Violation Of Article 14?

The Code provides the order of priority for the distribution of sale proceeds from the liquidation assets of the Corporate Debtor under Section 53 of the Code. At this point, we must take into account the judgement delivered by the Supreme Court of India in the case of *Swiss Ribbons (P) Ltd v. Union of*

*India<sup>(11)</sup>* which emphasises the need for differentiation between the financial debts, which are secured, and operational debts, which are unsecured.

*"Repayment of financial debts infuses capital into the economy inasmuch as banks and financial institutions are able, with the money that has been paid back, to further lend such money to other entrepreneurs for their businesses."*

The Apex Court has, by the aforementioned rationale, created an intelligible differentiation between the payment to financial creditors over operational creditors. In the judgement, it was further contended that such differentiation between the creditors stood in clear violation of Article 14 of the Constitution of India.

However, the Hon'ble Court struck down the contention stating that Article 14 of the constitution of India is not breached by the distinction between various classes of creditors as long as the objective of the Code is unaffected and there is a legitimate interest to be protected in that regard. The Court dismissed the challenge to Section 53 of the Code and thereby confirmed the waterfall mechanism set up under the Code.

#### Resolution Plan And Committee Of Creditors

The Committee of Creditors (hereinafter referred to as "CoC") is the body set up for deciding the viability of the Resolution Plan (hereinafter referred to as "Plan") and only upon its approval can the Plan come into effect. The Plan – after initiation of the Corporate Insolvency Resolution Process (hereinafter referred to as "CIRP") – is put up before the CoC by the Resolution Applicant to settle the insolvency of the Corporate Debtor or liquidate the same in totality and distribute the funds raised after as per the mechanism under Section 53 of the Code discussed above.

For the Plan to be presented before the CoC, a Resolution Professional appointed for the process of CIRP must put the same to test as envisaged under Section 30 of the Code. Section 30(2)(b) looks after the interests of operational creditors to avoid misconduct on part of the Resolution Applicant and further specifies that the amount payable under the Plan shall not be less than the amount to be paid in the event of liquidation of the Corporate Debtor under Section 53 of the Code.

Now as we look at the Plan to be put before the CoC, we must understand the constitution of the CoC. The Code provides for the constitution of CoC under Section 21 (2) and as per the aforesaid statute, only financial creditors (and not operational) are a part of the CoC. The law is clear on this aspect and has reiterated that the understanding of terms and implications of financial actions rests better in the hands of fiscal institutions and therefore are better suited and placed in the CoC.

Operational creditors, on the other hand, only seek to recover the amount due to them for the services provided by them and are not concerned with the overall financial position of the Corporate Debtor.

Therefore, once the Plan is approved by the Resolution Professional, it is put before the CoC for approval and the same must be approved by a majority of not less than sixty-six per cent of the CoC. It is noted that once the CoC approves the Plan, the same becomes absolute and the Adjudicating Authority only stamps its approval on the same. It is an established position of law that the wisdom of the CoC cannot be questioned by the Adjudicating Authority unless any provisions or requirements under the Code have been contravened.

## Nil Payments To Operational Creditors: Whether Fair And Equitable?

In a recent judgement delivered by the Hon'ble National Company Law Appellate Tribunal, Chennai Bench, (*hereinafter referred to as "NCLAT"*) in the case of *M/s. Genius Security & Allied Services v. Mr Shivadutt Bannanje & Ors.*<sup>[2]</sup>, it has been held that a Plan passed by the CoC, where the Plan provides for nil payment to operational creditors, is valid and legal. An appeal was preferred against the judgment and order passed by the Hon'ble National Company Law Tribunal, Bangalore Bench (*hereinafter referred to as "NCLT"*) in IA No. 334/2020 in CP(IB) No. 132/07/BB/2017.

In the said appeal before NCLAT, the Plan came under scrutiny as the same mentioned the payment to the operational creditors as nil. It was contended that the claims of the operational creditors were disregarded in the formulation of the Plan and that the Plan ought not to have been approved by the Resolution Professional as it did not conform with Section 30(1) of the Code.

It is pertinent to note here that the Plan was approved by the CoC by a majority voting share of 95.07% as against the minimum requirement of 66% under the Code.

The NCLAT, while dismissing the appeal filed, observed that the Plan stood in conformity with the waterfall mechanism specified under Section 53(1).

Further taking note of the liquidation value of the Corporate Debtor and the categories of creditors, NCLAT observed that there was no discrimination in the Plan since the whole class of operational creditors were given no payments at all. It was concluded that there could only be alleged discrimination when and if certain payments were made to certain operational creditors while others were deprived of any payments under the Plan.

## Brief Look At The United States & United Kingdom Insolvency Law

It would be useful at this point to take a look at the provisions of insolvency law that exist in other countries to draw a comparison with the provisions of the Code and further, the concept of creditors and the payment plans as has been addressed in these regions.

- In the United States, the primary Act that governs the concept of bankruptcy is the Bankruptcy Code (*Title 11 of the United States Code*<sup>[3]</sup>). The key concepts that one must know about are as follows:
  - Concept of Automatic Stay: Much like the moratorium under Section 14 of the Code, Section 362 of the Bankruptcy Code comes into effect at the commencement of bankruptcy proceedings and is a statutory injunction that applies to all proceedings to deter creditors from filing individual claims against the debtor.
  - Rule of Absolute Priority: Similar to the waterfall mechanism as envisaged under Section 53 of the Code, the rule of absolute priority provides that the secured claims have to be paid in full before any general unsecured creditors receive money.
- In the United Kingdom, the primary Act that governs the insolvency law is the Corporate Insolvency and Governance Act, 2020 (*hereinafter referred to as "CIGA"*). The key concepts that one must know about are as follows:
  - Unlike Section 31 of the Code, where the Adjudicating Authority has limited power to approve the plan passed by the CoC, the courts in the UK under the CIGA have the authority to allow the resolution plan if it is "fair and equitable" which opens door to multiple interpretations, ambiguity and further actions before the courts.

- Unlike the moratorium as imposed under Section 14 of the Code, where the affairs of the company are vested with the Insolvency Resolution Professional, the day-to-day proceedings remain vested with directors of the debtor with the insolvency professional overseeing the affairs. Upon perusal of the above key concepts, it is visible that in the United States as well as the United Kingdom, the key intent of the insolvency law is to revive the dying and sick industries, and if the same may not be financially feasible, then to liquidate and distribute the recovered amount amongst the creditors. Concerning the distribution of the assets, it is always the financial institutions that are given priority over other creditors to strengthen the economy and sustain the flow of money back into the economy.

#### Conclusion

In view of the judgment delivered by NCLAT, the ratio developed in the case does establish intelligible differentiation between financial and operational creditors, even in the case of the award of claims under the Plan. The judgment of NCLAT essentially settled the conundrum regarding payments or NIL payments to the operational creditor by classifying and relying on the discrepancy created between the class of creditors.

Regarding current laws and legal precedents, it would not be out of place to state that the present case before the NCLAT has made it complicated for the operational creditor to support the CIRP. Because of NIL payments and the preference of other creditors over their financial interest, many operational creditors might shy away from initiating the insolvency proceedings for their debts to be paid by the Corporate Debtor.

This will result in many operational creditors not taking recourse or shelter under the Code because of the implication that their rights are not safeguarded or guaranteed under the Code. This may also result in the initiation of multiple proceedings by operational creditors against the Corporate Debtor such as recovery suit, proceedings under the Commercial Courts Act, 2015, and other legal alternatives.

Such an oversight might defeat the very purpose of the Code. The unresolved issue of protecting the rights of an operational creditor needs to be revisited by the legislation or the Supreme Court or it will result in setting up a dangerous precedent against the object and application of the Code.

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[1] (2019) 4 SCC 17

[2] *Company Appeal (AT) (CH) (Insolvency) No. 110 of 2021*

[3] 11 U.S.C. §§ 101–1532 (2012)

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