

Distinction in Treatment of Financial Creditors vs. Operational Creditors

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Introduction

The Insolvency and Bankruptcy Code, 2016 (IBC) has consolidated and revised the laws governing the reorganisation and insolvency of corporate persons, partnership firms, and sole proprietorships. The primary purpose of this legislation is to assist the timely resolution of corporate insolvency.

The 2013 Companies Act simply introduced the phrase “creditors” without providing any clarification. The Insolvency and Bankruptcy Code, 2016 classifies creditors as ‘financial’ and ‘operational’ for the sake of transparency. In addition, this classification under the IBC has been utilised to place creditors on different tiers at each step of the proceedings; consequently, it is essential that creditors understand the scope of their rights under the Code.

Two fundamental components of the insolvency procedure under the IBC, 2016 are a financial creditor and an operational creditor. The 2016 Code distinguishes between financial and operational creditors. Financial creditors are those who have a purely financial contract with the entity, such as a loan or a debt security. Operational creditors are those whose obligation to the firm emerges from an operation-related transaction.

According to the study, the IBC also addresses circumstances in which a creditor has conducted both financial and operational transactions with an organization. Under these conditions, the creditor may be categorised as a financial creditor for the amount of the financial debt and an operational creditor for the amount of the operational debt.

Financial Creditor

[Section 5\(7\)](#) of the IBC defines a financial creditor as “a person to whom a financial debt is owed, including a person to whom such debt has been legitimately assigned or transferred.” To determine whether a person is a financial creditor, the debt owed to that person must come within the definition of “Financial Debt” as outlined in [Section 5\(8\)](#) of the IBC.

Under [Section 5\(8\)](#) of the IBC, a financial debt is defined as: “a debt together with interest, if any, that is distributed against the consideration for time worth of money and includes:

- a. money borrowed against interest payment.
- b. Any money raised through acceptance under an acceptance credit arrangement, or its dematerialized counterpart.
- c. Any sum raised by a note purchase facility or the issuance of bonds, notes, debentures, loan stock, or a comparable instrument.
- d. The amount of any liability related to a lease or hire purchase agreement that is deemed a

finance or capital lease under the Indian Accounting Standards or such other accounting standards as may be prescribed.

- e. Receivables sold or discounted, excluding those sold on a nonrecourse basis.
- f. Any sum raised through any other transaction, such as a forward sale or purchase agreement, that has the commercial impact of a loan.
- g. Any counter-indemnity duty relating to a bank or financial institution's guarantee, indemnity, bond, documented letter of credit, or other instrument.
- h. The amount of any responsibility relating to any guarantee or indemnification for any of the items listed in sub - clauses (a) - (h) of this clause “.

Operational Creditor

[Section 5\(20\)](#) of the IBC defines an operational creditor as “any person to whom an operational debt is owed, including any person to whom such debt has been legally assigned or transferred.” To determine whether a person meets the criteria of an operational creditor, the debt owed to that person must meet the definition of an operational debt under [Section 5\(21\)](#) of the IBC.

Under [Section 5\(21\)](#) of the IBC, an operational debt is defined as “a claim for the provision of goods or services, including employment, or a debt for the repayment of dues arising under any law for the time being in force and payable to the Central Government, any State Government, or a local authority.”

Treatment of Financial Creditors Vs. Operational Creditors

The Code establishes a number of distinctions in the treatment provided to them, including, but not limited to, (i) the right to apply to NCLT (scope of adjudication), (ii) the right to participate in the Committee of Creditors (the “CoC”), (iii) the right to receive funds under the Resolution Plan, and (iv) the right to benefit from the liquidation of the Corporate Debtor.

The distinction in treatment of financial creditors and operational creditors are mentioned below:

Financial Creditors

In accordance with [Section 7\(1\)](#), a financial creditor may file an application with the Adjudicating Authority to commence the corporate insolvency resolution procedure against a corporate debtor upon the occurrence of any event of default.

According to [Section 7\(3\)](#), the financial creditor must include the name of the resolution professional who will serve as an interim resolution professional with the application.

Operational Creditors

When a default occurs, the operational creditor has the right to send the corporate debtor a demand notice of unpaid operational debt copies of an invoice seeking payment of the defaulted amount. If the operational creditor does not receive payment from the corporate debtor or notification of the dispute under subsection (2) of [Section 8](#), they may submit an application after the lapse of 10 days from the date of delivery of the notice or invoice demanding payment under subsection (1) of [Section 8](#).

As per [Section 9\(4\)](#), An operational creditor may nominate a resolution professional to serve as an interim resolution professional.

[Section 21\(2\)](#) states that the committee of creditors must be wholly composed of financial creditors, including all financial creditors of the corporate debtor.

A financial creditor must disclose financial information as well as information regarding the assets over which a security interest has been formed, according to [Section 215\(2\)](#).

[Section 5\(28\)](#) - A financial creditor's voting rights are proportional to the amount owed to such financial creditor. The creditor committee must be approved by a vote of at least 75% of the voting shares.

Operational creditors shall not be a part of the committee of creditors

As per [Section 215\(3\)](#), an operational creditor may submit financial information to the information utility.

The operational creditor will have no voting rights at the meeting of the creditor's committee.

As we approach [Section 21](#) of the Code, the financial creditors have sufficient authority over the operational creditors. This is so that the Committee of Creditors, which is established by the Insolvency Resolution Professional after gathering all claims against the corporate debtor, can vote on an insolvency resolution scheme and repayment plan against the corporate debtor. This is because [Section 21](#) provides for the Committee of Creditors. It is important to remember that [Section 21\(2\)](#) clearly excludes operational creditors and includes all financial creditors as members of the CoC, with the exception of those categories of financial creditors or their representatives who are affiliated with the corporate debtor.

It is very clearly understood that an operational creditor is not eligible to join the CoC and is not given the aforementioned authority. Additionally, [Section 24\(3\)\(c\)](#) places restrictions on the right of an operational creditor to attend such a CoC meeting. It states that those operational creditors whose cumulative debts total at least 10% of the total debt due from the corporate debtor may attend the CoC meeting but not participate or vote as permitted by [Section 24\(4\)](#), and their absence will not have any bearing on the proceedings of the succeeding CoC meeting.

In addition, a specific order of priority has been enlisted under [Section 53](#) of the Code for the distribution of liquidation assets that are owed to the corporate debtor in line with such order. According to [Sections 53\(2\)\(b\)\(ii\)](#) and 53(2)(d), the secured financial creditor is given due prominence and importance, followed by the unsecured creditors, among both secured and unsecured financial and operational creditors, while obligations owed to operational creditors are impliedly interpreted as "any remaining debts and dues" and are given relatively less prominence under [Section 53\(2\)\(f\)](#).

The reasoning behind this wide gap of powers and priority treatment under the Code between the Financial Creditors and Operational Creditors is clarified by the Banking Law Reforms Committee in their report under Para 5.3.1, sub-para. 4:

"The Committee reasoned that members of the creditors committee must be creditors who are able to evaluate viability and who are willing to negotiate changes to the terms of current liabilities. Ordinarily, operational creditors are neither able nor willing to make decisions on the entity's insolvency or to incur the risk of delaying payments in exchange for the entity's

future prospects. The Committee concluded that the Code would stipulate that the creditors committee should be limited to only the financial creditors in order for the process to be quick and effective.”

The Banking Law Reforms Committee’s report justifies the disparity in their rights by stating that the drafter’s goal was to safeguard the interests of all stakeholders through a process that prioritises debt restructuring and business revival before attempting to liquidate all of the company’s assets if those efforts fail. Additionally, OCs are typically not interested in the company’s revival but are eager for its liquidation.

The Banking Law Reforms Committee explains why the Code distinguishes between financial and operational creditors in terms of powers and priority, but it is silent when we witness instances where such expansive powers granted to financial creditors are improperly used and fail to protect the interests of operational creditors by imposing an arbitrary resolution.

Priority given to Financial Creditor

In contrast to operational creditors, who are excluded from the committee of creditors, financial creditors have voting rights and are therefore given higher priority. Since the statute’s provisions protect financial creditors’ rights and interests, the basic issue is that some categories of operational creditors are subject to discrimination. This is backed by the fact that when the application is submitted by the operational creditors, the relevant class does not have the right to make any suggestions at the meeting of the creditor’s committee.

In the matter of *Swiss Ribbons Pvt. Ltd. and Ors. vs. Union of India* [\[2019\] ibclaw.in 03 SC](#), the Hon. Supreme Court of India was asked to rule on the differential treatment and preference given to “Financial creditors” over “Operational Creditors,” which was contested.

In the case of *Swiss Ribbons(supra)*, the Supreme Court specifically evaluated whether or not it violated Article 14 of the Constitution by not having organisational creditors represented on the CoC. (Protection from discrimination). The Bankruptcy Law Reforms Committee’s (hereafter “BLRC”) report, the predecessor to the IBC, served as the foundation for the Supreme Court’s reasoning for the exclusion of operating creditors from the CoC. A resolution plan’s viability could be assessed by financial creditors since staff members were qualified to do so, according to the BLRC.

Conversely, operational creditors are typically unable to assess a company’s profitability and viability; instead, they are simply concerned with collecting the money they are owed for their goods and services. Such a justification, though, appears tenuous. The BLRC posits that since financial creditors can assess a plan’s effectiveness and viability, they will do so and base their choice to approve or reject a plan primarily on those considerations.

The NCLAT has always considered whether operational creditors are treated roughly the same as financial creditors when evaluating the viability and feasibility of resolution plans that are approved by the committee of creditors. If they are not, such plans are either rejected or modified so that the rights of operational creditors are protected. As can be observed, a resolution plan is ineligible for approval under [Section 30\(2\)\(b\)](#) read in conjunction with [Section 31](#) unless a minimum payment is given to operational creditors that is not less than liquidation value. Regulation 38 was also changed on October 5th, 2018. By putting the notion of fair and equitable treatment of operational creditors’

rights, as well as priority in payment over financial creditors, into statute, the aforementioned Regulation significantly strengthens operational creditors' rights. Due to all of the aforementioned factors, the court does not believe that either the equal treatment of equals or the obvious arbitrariness provisions of Article 14 have been violated, nor does the court think that operational creditors are being discriminated against.

In this case, the Supreme Court upheld [Section 53](#) constitutional validity and rejected the argument that there should be a distinction between Financial Creditors and Operational Creditors on the grounds that doing so would violate Article 14 of the Indian Constitution and undermine the intent behind the Code.

Violation of Article 14 of the Constitution

The differentiation that leads to discrimination of operational creditors in the insolvency process is contrary to the Constitution's principles of natural justice and equality. The self-proclaimed purpose of the IBC is to "maximise the value of the corporate debtor's properties" while "balancing the interests of all stakeholders." In light of this, the full marginalisation and disregard for the interests of operational creditors appear unreasonable.

Unfortunately, rather than considering solutions to ensure that operational creditors are handled fairly, Parliament has attempted to limit their rights even further. This was achieved by include a statement stating that distribution in accordance with IBC [Section 30\(2\)\(b\)](#) would be regarded "fair and equitable." Though the BLRC's logic for distinguishing operational creditors is understandable, the divergence to the level of prioritisation under [Section 53](#) of the IBC is unreasonable.

Conclusion

The distinction between financial and operational creditors is crucial under the Code. When both Operational and Financial Creditors are unsecured, it is clearly a matter of discrimination as opposed to differentiation. The ultimate purpose of every creditor, whether financial or operational, is to maximise recovery. The IBC contains no incentive mechanism to encourage such a transition and ensure that financial creditors do not act only in their own self-interest.

Despite the fact that the current legal environment has been able to settle disputes in terms of prompt payment of resolution amount and discriminatory nature of the resolution, the war is far from finished. As we delve deeper into the scenario, we discover that neither clarity nor rule is available to help the IBC framework in answering issues about the procedure for distributing the resolution amount. (Unlike distribution of liquidation value, since [Section 53](#) cannot be relied upon in a resolution process) whether equally or pro-rata between the Financial and Operational Creditors or whether the Operational Creditors may also be conferred with the power to participate with the CoC (Financial Creditors) in granting certain [Section 28](#) approvals that would otherwise have a direct impact on the interest of the Operational Creditors had they been oppressed by the CoC. The end of the struggle of priority between Financial and Operational Creditors is a distant dream until these contradictory viewpoints are addressed with a suitable and clarified legal framework.

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