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Equitable Classification of Creditors under the Insolvency Law

The Insolvency and Bankruptcy Code (2016) envisages a “creditor in control” regime where creditors, any financial or operational shall exercise a control through Insolvency professionals in the event of default in payments of loans or interest. What does this imply? The aforesaid code hereby ensures that stressed or distressed corporates need to honor an accurate cash flow forecasting mechanism to identify mismatch of inflows with due commitment timely in line with contractual relationships.

Classification of Debts under Insolvency Code

The new law has observed a bifurcated approach towards the eligibility of complainant to initiate a corporate insolvency resolution process. It majorly depends on the nature of the debt. The ‘Financial Debt’ under the code is defined as “a debt along with interest, if any, which is disbursed against the consideration for time value of money and includes:

- Money borrowed against payment of interest
- Any amount raised by acceptance under any acceptance credit facility or its de-materialised equivalent
- Any amount raised pursuant to any note purchase facility or the issue of bonds, notes, debentures, loan stock or any similar instrument
- 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 other such accounting standards as may be prescribed
- Receivable sold or discounted other than any receivable sold on non-recourse basis
- Any amount raised under any other transaction, including, any forward sale or purchase agreement, having the commercial effect of borrowing
- 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
- 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
- The amount of any liability in respect of any of the guarantee or indemnity for any of the items

referred to in sub clauses (a) to (h) of this clause”, and the person to whom such debt is owed and or has been legally assigned is called a ‘Financial Creditor.

Further, the ‘Operational Debt’ means “a claim in respect of the provisions of goods or services including employment or a debt in respect of the repayment 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” and “any person to whom an operational debt is owed and includes any person to whom such debt has been legally assigned or transferred” is identified as an operational creditor.

What differentiates the two class of Creditors?

The “Creditor in Control” regime establish a due procedure which shall be followed by the committee of creditors in case of default of a claim. The Corporate Insolvency Resolution Process under the Code is regulated by the Committee of Creditors, so it becomes really important to answer, Who shall be the part of such Committee of creditors? It has been laid out that a credit committee of creditors will be constituted to be of all financial creditors and a resolution plan can be implemented only if it has been approved by 66% of the creditors. The IBC limits the rights of the operational creditor and an additional pre-requisite need to be adhere to prior to initiating an insolvency process. An operational creditor must deliver a demand notice of unpaid operational debt to the corporate debtor and if within 10 days of demand of such notice, the due payment is not received, then operational creditor has all rights to initiate insolvency resolution process. Therefore, unlike financial creditors, the rights conferred on the operational creditors are subject to certain conditions which resultantly gives more weightage to the concerns of financial creditors by giving them total monopoly over the entire resolution process.

A bivolor approach on assignment of rights to creditors has been followed and the rationale behind such incoherent balance has been highlighted in the report of Bankruptcy Law Reforms Committee, which states that,

“members of the creditors committee have to be creditors both with the capability to assess viability, as well as to be willing to modify terms of existing liabilities in negotiations. Typically, operational creditors are neither able to decide on matters regarding the insolvency of the entity, nor willing to take the risk of postponing payments for better future prospects for the entity. The Committee concluded that, for the process to be rapid and efficient, the Code will provide that the creditors committee should be restricted to only the financial creditors”.

The framers of the code has created a bifurcation with a sole objective to protect the interests of the corporate debtor by treating as a going concern and provide for liquidation as a last resort when all efforts towards the resolution eventually fail.

Judicial Approach : Theory of Intelligible Differentia

The question, whether such unlike classification favoring financial creditors is violative of

principles of equality under Article 14 of the Indian Constitution or not has been raised repeatedly and the same has been put on rest by the Apex Court in a recent judgment of Swiss Ribbons Private Limited vs. Union of India, affirming that “equality is only among equals, no discrimination results if the Court can be shown that there is an intelligible differentia which separates two kinds of creditors so long as there is some rational relation between the creditors so differentiated, with the object sought to be achieved by the legislation”.

The bench of Honorable Justice R. Nariman in a 2019 judgment has held that the distinction between secured and unsecured creditors is a distinction which has obtained since the earliest of the Companies Acts both in the United Kingdom and in this country. Apart from the above, the nature of loan agreements with financial creditors is different from contracts with operational creditors for supplying goods and services. Financial creditors are, from the very beginning, involved with assessing the viability of the corporate debtor. They can, and therefore do, engage in restructuring of the loan as well as reorganization of the corporate debtor’s business when there is financial stress, which are things operational creditors do not and cannot do. Thus, preserving the corporate debtor as a going concern, while ensuring maximum recovery for all creditors being the objective of the Code, financial creditors are clearly different from operational creditors and therefore, there is obviously an intelligible differentia between the two which has a direct relation to the objects sought to be achieved by the Code. With regard to voting rights of the operational creditors, the Supreme Court observed that since the financial creditors are in the business of money lending, banks and financial institutions are best equipped to assess viability and feasibility of the business of the corporate debtor. On the other hand, operational creditors, who provide goods and services, are involved only in recovering amounts that are paid for such goods and services, and are typically unable to assess viability and feasibility of business. The Adjudicating Authority while looking into viability and feasibility of resolution plans, approved by the committee of creditors, always check whether operational creditors are given roughly the same treatment as financial creditors, and if they are not, such plans are either rejected or modified so that the operational creditors’ rights are safeguarded.

The said judgment has made the position very clear affirming that an unlike classification of creditors does not necessarily mean its inequitable. The insolvency law shall honor the respective contractual relationships and the deals which were made out between the creditors and debtors, when the latter was all healthy.

References:

1. Insolvency and Bankruptcy Code 2016, available at <https://www.mca.gov.in/Ministry/pdf/TheInsolvencyandBankruptcyofIndia.pdf>
2. Article published in ipleaders dated October 5, 2017, available at <https://blog.ipleaders.in/financial-creditors-vs-operational-creditors-better-off/>
3. Paragraph 5.3.1, The Report of the Bankruptcy Law Reforms Committee Volume 1: Rationale and Design published in November 2015, available at https://ibbi.gov.in/BLRCReportVol1_04112015.pdf
4. Swiss Ribbons Pvt. Ltd. v. Union of India, Writ Petition (Civil) No. 99 of 2018, decided on January 25, 2019

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