Operational Debt or Financial Debt? A Discussion on the Position of Arbitral Awards Under the Insolvency & Bankruptcy Code, 2016

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The Insolvency and Bankruptcy Code, 2016 (**"IBC"**) was enacted to provide a smooth and efficient resolution in cases of corporate insolvency. It deals with situations where corporations commit default in the repayment of their debt obligations. One of the key developments in IBC is the categorization of debt into operational debt or financial debt. This distinction is not merely organizational or for the sole purpose of categorization of creditors, but the rights, obligations, and the procedure of their realization for a financial creditor and an operational creditor also differ thereunder.

Most corporations today, due to market competition and to achieve the goal of economic expansion, must undertake transactions underlying huge financial risk. Most of these transactions, whether in the nature of a term loan, debentures, arrangements for the supply or manufacturing of goods, provision of services etc. are governed by an underlying contract. These contracts will more often than not contain an arbitration clause which mandate the parties to refer any dispute arising out of or in relation to the contract to arbitration before seeking any other remedy available to them under the law. Once the arbitral proceedings conclude, an arbitral award will be passed awarding either one of the parties a monetary compensation. In a situation where the other party fails to pay such amount, a question arises as to what the nature of this amount awarded under an arbitral award be? Will it be categorized as a financial debt or an operational debt?

Before we go any further, a look at the definitions of operational debt and financial debt under IBC is warranted. Section 5(21) of IBC categorizes any "*claim in respect of the provision of goods or services*" as an operational debt[1]. An example of this would be if under a contract of supply of goods, after having supplied the goods, the creditor is not paid for those goods. Financial debt on the other hand, as per section 5(8) of IBC is a debt which is disbursed "*against the consideration for the time value of money*", along with any interest. However, it is important to note that a financial debt will not be such only if there is an interest component, only principal amount in itself can also qualify as financial debt.[2]

A demand notice under section 8 of IBC forms a prerequisite for initiation of corporate insolvency resolution process (**"CIRP"**) by an operational creditor. After having received the demand notice, the corporate debtor shall have a period of 10 days to respond to it, failing which CIRP may be initiated. Arbitral awards on the other hand may also be enforced under the Civil Procedure Code 1908 as a court decree is enforced[3]. It is also important to note here that section 8 read with section 9 of IBC establish that while a pre-existing dispute exists, CIRP cannot be initiated[4]. Even in cases where an arbitral award has passed, an appeal can be made, i.e., the aggrieved party may make an application to a court for setting aside of the arbitral award under section 34 of the Arbitration and Conciliation Act, 1996. A party may not use IBC prematurely or as a substitute for debt enforcement as an arbitral award does not by itself extinguishes the existence of a dispute until the time limit for challenge has passed or the appeal is done away with[5]. There have been cases

where the adjudicating authorities have dismissed CIRP application due to pending proceedings under section 34 of the Arbitration and Conciliation Act, 1996[6].

However, in case an arbitral award is granted and remains unpaid, the confusion arises as to whether the arbitral award itself creates a financial claim, or whether the underlying dispute from which the arbitral proceedings arose should be considered to determine whether the claim is in relation to a financial debt or an operational debt.

One of the key precedents in this regard is by the apex court in the case of *Dena Bank v. C. Shivakumar Reddy, (2021) ibclaw.in 69 SC* (**"Dena Bank Case"**). The Supreme Court stated, *"Final judgment and/or decree of any court or tribunal or any arbitral award for payment of money, if not satisfied, would fall within the ambit of a financial debt."* As one can see, the court has categorically stated that any such order or decree would come under the ambit of a financial debt. The court also stated that such an order or decree gives a fresh cause of action and therefore the limitation period is renewed. One may therefore also infer from this that since it's a fresh cause of action, the underlying dispute resulting in the arbitral award should not be of particular importance.

However, there also exists jurisprudence stating that the underlying dispute in the arbitral proceeding determines the nature of dues under the arbitral award. Which means, an arbitral award procured in pursuance to a dispute in relation to an operational debt, shall be considered as an operational debt[7]. One of the most recent cases in this regard is that of *HPCL Mittal Pipelines Ltd. v. Coastal Marine Constr. and Engineering Ltd., (2024) ibclaw.in 96 NCLT* (**"HPCL Case"**). In this case a similar question arose, and the tribunal took consideration of the Dena Bank Case as the same was also referred to by the creditor in HPCL Case, however, the tribunal reasoned that the Supreme Court was of such an opinion as the underlying dispute therein was a financial debt and therefore it held that the arbitral award should be considered a financial debt. One may say that the tribunal has erred in this understanding as the Supreme Court has quite axiomatically stated that arbitral awards should be considered a financial debt. The apex court's view in the Dena Bank Case was also similar to the stand taken by Supreme Court in the case of *Kotak Mahindra Bank Ltd. v. A. Balakrishnan, (2022) ibclaw.in 62 SC*.

References:

[1] Consolidated Constr. Consortium Ltd. v. Hitro Energy Solutions (P) *Ltd.,(2022) ibclaw.in 09 SC*.

[2] Orator Marketing (P) Ltd. v. Samtex Desinz (P) Ltd., (2023) 3 SCC 753.

[3] Section 36, Arbitration & Conciliation Act 1996.

[4] Transmission Corpn. of A.P. Ltd. v. Equipment Conductors & Cables Ltd., 2019 12 SCC 697; Kay Bouvet Engg. Ltd. v. Overseas Infra. Alliance (India) (P) Ltd., *(2021) ibclaw.in 147 SC*.

[5] K. Kishan v. Vijay Nirman Co. (P) Ltd., *(2018) ibclaw.in 01 SC.*

[6] CG Power & Industrial Solutions Ltd. v. ACC Ltd., CP No. 1681/IB &C/2017 *(2018) ibclaw.in 294 NCLT*.

[7] Sushil Ansal v.. Ashok Tripathi & ors., *(2020) ibclaw.in 43 NCLAT*; Cholamandalam Investment & Finance Company Ltd. v. Navrang Roadlines Pvt. Ltd., O.S.A. (CAD) No. 115 of 2022 *(2022) ibclaw.in 331 HC*.

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