



A CRITICAL EVALUATION OF ASPECTS AFFECTING 'OPERATIONAL CREDITORS' UNDER THE INSOLVENCY AND BANKRUPTCY CODE, 2016

Susheel Kumar Bhandari

susheel.bhandari@law.christuniversity.in

Abstract-- In the Indian legal framework, the Insolvency and Bankruptcy Code 2016 has brought about a significant change in the way insolvency and bankruptcy of companies, individuals and partnership firms are managed and processed, marking a new beginning in the Indian economy.

The researcher, in the present article focuses on the Operational Creditors of the Corporate Debtors, wherein the latter owes a debt to the former, which is known as the Operational Debt. "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. "Operational Creditor" means a person to whom an operational debt is owed and includes any person to whom such a debt has been legally assigned or transferred¹. Therefore, it is evident that Operational Creditors are those whom the company owes a debt as a result of a transaction of operations e.g. trade supplier-creditors, employees, workers, utilities etc. "Financial Creditor" means any person to whom a financial debt is owed and includes a person to whom such debt has been legally assigned or transferred to². Therefore, financial creditors are those who have a financial contract with the company, for example, those who have advanced loans to the company.

Through this research and study, the researcher has been able to make it apparent that the Operational Creditor has not been made part of the Insolvency and Bankruptcy Code 2016 in the same way as the Financial Creditors and there is a certain differential or unfair treatment meted out to the Operational Creditors. Operational Creditors need to be given a better footing in the execution of the Insolvency and Bankruptcy Code 2016 and thus be successful in its objective of releasing the obstructed funds back into the markets, thus boosting the economy altogether. The researcher makes an attempt to examine the issues and challenges affecting the interests of Operational Creditors in the entire gamut of the laws, rules and execution of the Code of 2016 as laid down in the code itself, dealing with corporate debtors and corporate insolvency and bankruptcy. It is pertinent to mention that so far the Insolvency and Bankruptcy Code 2016, deals with corporate insolvency only and the part that deals with individual insolvency is not yet enforced as it is yet to be notified. This research critically examines the interests of Operational Creditors under the Insolvency and Bankruptcy Code 2016, brings to the fore the challenges Operational Creditors are facing in the Code of 2016 and discusses whether the Code is prejudicial to the interests of Operational Creditors.

Keywords: *Insolvency, Bankruptcy, Operational Creditors, Financial Creditors, Committee of Creditors, Insolvency Resolution Process, Information Utilities, Insolvency Resolution Professional, Individual Insolvency, Corporate Insolvency*

INTRODUCTION

Lord Ellenborough said: "The principle of bankruptcy laws is to prevent persons craftily obtaining into their hands great substance of other men's goods, and at their own wills and pleasures consuming the substance obtained by credit of other men, and it is always to be remembered that it is the **protection of persons who have so given credit** which is the professed object of bankruptcy laws."³

James LJ, said: "The bankruptcy law is a special law having for its object the distribution of an insolvent's assets equitably amongst his **creditors** and persons to whom he is under liability, and upon this cessio bonorum, to release him under certain conditions from future liability in respect of his debts and obligations."⁴

Bankruptcy is a process of law through which the debtor's property is taken for payment to creditors, by a designated or appointed officer, and wherein the property thus taken is distributed amongst creditors by way of priorities and proportionately. Halsbury's Bankruptcy Law states in its 3rd Edition on page 1 that "The chief aim of every system of Bankrupt Law should be to combine and regulate two great objects: First, the

¹LLM, Christ (Deemed to be University), Bengaluru.

²Section 5(20) of the Insolvency and Bankruptcy Code, 2016.

³Section 5(7) of the Insolvency and Bankruptcy Code, 2016.

⁴Sutton v Weeley, (1806) 7 East 442, 3 Smith K.B, 445, 103 ER 171 (K.B.), at pp 173-174

⁴In Re Levy, Ex Parte Walton (1881) 17 Ch D 746, CA.



distribution of the effects of the debtor in the most expeditious, the most equal, and the most economical mode and secondly, the liberalisation of his person from the demands of his creditors when he has made a full surrender of his property".⁵

The Operational Creditors have not been given an equal footing as compared to the Financial Creditors, within the Insolvency and Bankruptcy Code, 2016. The interests of the Operational Creditors are inadequately protected in the Code, and they are also subjected to an improper treatment, as they are not represented properly. There is also as a general rule no representation of the Operational Creditors in the Committee of Creditors which is the *iudicium facere corpus* (decision making body), when the company which owes the debts called as the Corporate Debtor is under Insolvency Resolution Process.

The lacunae in the code is also visible when one sees that the Operational Creditors are given 'observer status' in the Committee of Creditors, only if they meet a certain threshold in terms of the monetary value or financial quantum within the overall outstanding of the corporate debtor on it being liquidated or subjected to a resolution plan, as the case may be. The questions that arise are whether the Operational Creditors should be given an equal footing in the Code of 2016, and whether they are represented sufficiently or they need better representation in the Code. It is the need of the hour that the concerns of the Operational Creditors are brought under the lens, to see how the Operational Creditors are prejudiced and affected by this statute, and their interests must be protected too. In the spirit of Article 14 of the Constitution of India, the law making authorities of India should look into the shortcomings of the Code, and enable the Operational Creditors equally as the Financial Creditors.

In the United Kingdom, the Cork Committee of 1982 headed by Sir Kenneth Cork, studied the then insolvency regime of the United Kingdom, and had expressed that a business concern has a lot of stakeholders like creditors, employees among others who depend on such businesses for their sustenance and livelihood, and therefore liquidation of such business concerns leads to a chain reaction which can have unforeseen consequences on a society. Subsequently, the Insolvency Act of 1986 in the United Kingdom included suggests based on Cork's report, called the 'Report of the Review Committee on Insolvency Law and Practice' (Cmnd 8558, 1982). The insolvency process is called as 'Administration' in the United Kingdom, whereas in India, it is called as 'Corporate Insolvency Resolution' under the Insolvency and Bankruptcy Code, 2016.

Similar to the expression in the Cork Report, Operational Creditors are also stakeholders and many of them depend on the business concerns, with whom they deal, for their sustenance and livelihood. There are various types of Operational Creditors, in terms of the scale, some are small scale suppliers of goods, vendors, contractors, service providers and some are medium or large scale too but they in turn support other smaller businesses and individuals too. It is a chain indeed, made up of various persons and entities who are in turn affected whenever a business faces insolvency or bankruptcy.

ANALYSIS OF THE ROLE OF OPERATIONAL CREDITORS IN THE INSOLVENCY AND BANKRUPTCY CODE, 2016

If one delves closely into the reasons why the Code was made in the first place, it is apparent that the earlier laws⁶ dealing with insolvency and bankruptcy of companies were not able to achieve the expected results in terms of helping the economy or boosting the business environment because it was not able to curtail the accumulation of non-performing assets, loans, the subsequent repercussions on the financial institutions and banks, ultimately harming the society and economy at large. Hence, the Code was made to consolidate and amend the laws relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals, in a time bound manner for maximisation of value of assets of such persons, to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders including alteration in

⁵ Avtar Singh, *Law of Insolvency*, 1 (4th ed.2004).

⁶ The Sick Industrial Companies (Special Provisions) Act, 1985 (SICA); The Recovery Of Debts Due To Banks And Financial Institutions Act, 1993 (51 of 1993); Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 (54 of 2002), also known as the SARFAESI Act.



the order of priority of payment of Government dues and to establish an Insolvency and Bankruptcy Board of India and for related matters.

In Part II of the Code of 2016, which provides for the Insolvency and Resolution and Liquidation for Corporate Persons, Operational Creditor⁷ is defined as a person to whom an operational debt is owed and includes any person to whom such debt has been legally assigned or transferred; and the definition of Operational Debt⁸ is given as a claim in respect of the provision 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. Whenever there is a default or non-payment of debt towards the Operational Creditor, the latter can initiate action under the Code against the Corporate Debtor.

A corporate insolvency resolution process may be initiated by a financial creditor, an operational creditor or the corporate debtor itself⁹. The Code lays down the procedure of initiating the insolvency process by an Operational Creditor¹⁰, which states that the operational creditor may, on the occurrence of a default, deliver a demand notice of unpaid operational debt or copy of an invoice demanding payment of the amount involved in the default to the corporate debtor in the prescribed form and manner.¹¹ The corporate debtor shall within a period of ten days of the receipt of the demand notice or copy of the invoice, bring to the notice of the operational creditor regarding the existence of a dispute, if any, or regarding the pendency of any suit or arbitration proceedings filed before the receipt of such notice or invoice, and provided such suit or arbitration proceeding is related to the dispute. The corporate debtor alternatively or additionally may also inform the operational creditor that payment has been made, and a proof of electronic transfer or a record or details of or copy of a cheque encashed by the creditor, as an attested copy shall be sent by the corporate debtor to such creditor. This ensures that there are no trivial or unsupported claims pushing corporate debtors to insolvency resolution processes. An opportunity to settle the debt related dispute, outside the court or judicial proceedings, is provided under the Code.

The Insolvency and Bankruptcy Code, 2016 provides for the manner in which the application for initiation of corporate insolvency resolution process by operational creditor may be filed¹². The application is filed before the Adjudicating Authority i.e., the National Company Law Tribunal. The application may be filed after the expiry of a period of ten days from the date of delivery of the notice or invoice demanding payment and only if in such period of ten days the operational creditor has neither received the payment from the corporate debtor nor any notice about existing dispute. The application has to be filed in the prescribed form and manner with the prescribed fee¹³. The application shall be accompanied with a copy of the invoice demanding payment or demand notice sent by the operational creditor to the corporate debtor, along with an affidavit stating that there is no notice given by the corporate debtor relating to any dispute of the unpaid operational debt, with a copy of the certificate from financial institutions maintaining accounts of the operational creditor confirming that there is no payment of an unpaid operational debt by the corporate debtor, if available, a copy of any record with information utility confirming that there is no payment of the debt by the corporate debtor, if available, and any other evidence showing that there is no payment of the debt by the corporate debtor.

The Operational Creditor initiating the process of corporate insolvency resolution may also propose a resolution professional to act as an interim resolution professional. The Adjudicating Authority shall have to, within fourteen days of the receipt of the application, either admit the application or reject the application and communicate such decision to the operational creditor and the corporate debtor, such decision based on the information available at hand regarding the default, payment or non-payment, existence of dispute or otherwise among other factors. Before rejecting an application, a notice to the applicant to rectify the defect in his

⁷Section 5(20) of the Insolvency and Bankruptcy Code, 2016.

⁸Section 5(21) of the Insolvency and Bankruptcy Code, 2016.

⁹Section 6 of the Insolvency and Bankruptcy Code, 2016.

¹⁰Section 8 of the Insolvency and Bankruptcy Code, 2016.

¹¹Rule 5 of Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules (2016).

¹²Section 9 of the Insolvency and Bankruptcy Code, 2016.

¹³Section 9(2) of the Insolvency and Bankruptcy Code, 2016.



application shall be given, within seven days of the date of receipt of such notice from the Adjudicating Authority. The corporate insolvency process begins from the date of the admission of the application.

Thereafter, the Insolvency Resolution Professional, is bound to receive and collate all the claims from various creditors, and proceed to make a Committee of Creditors¹⁴. This Committee shall consist of all the financial creditors¹⁵.

During the submission of a resolution plan, a minimum payment to the Operational Creditors should be included in the resolution plan¹⁶. A resolution applicant may submit a resolution plan, along with an affidavit stating that he is eligible¹⁷ to be a resolution applicant, which should be submitted to the resolution professional. However, the resolution professional must examine each resolution plan received by him to ensure that such plan provides for the payment of the debts of Operational Creditors in such manner as may be specified by the Board which shall not be less than such amount that would have been paid to the Operational Creditors had there been a liquidation of the corporate debtor¹⁸. The resolution applicant may attend the meeting of the Committee of Creditors in which the resolution plan of the applicant is considered, provided that the resolution applicant shall not have a right to vote at the meeting of the committee of creditors unless such resolution applicant is also a financial creditor¹⁹. If the resolution plan meets the requirements as per the Code, then it shall be approved by the Adjudicating authority, and such approved plan shall be binding on the corporate debtor, its employees, members, creditors, guarantors and other stakeholders involved in the resolution plan. Alternatively, if the plan does not meet the requirements, it may be rejected.

The distribution of assets are done as given for in the relevant section²⁰, if the company goes into liquidation. The expenditure or costs of the insolvency resolution process or liquidation, as the case may be, shall be borne first, along with the interim finance procured if any. Thereafter, debts payable to secured creditors in case such creditor/s have relinquished security interests, and then the dues payable to workmen for the last twelve months counted backwards from the date of the commencement of liquidation shall be paid off. Afterwards, the wages and outstanding dues towards employees for the preceding twelve months shall be paid. Subsequently, debts of financial nature payable to unsecured creditors shall be paid, followed by dues if any towards the State Government and/or Central Government for the preceding two years shall be paid, and then the debts due to secured creditor/s after the enforcing of security interest are paid off. Remaining debts or outstanding owing shall be paid at the end and any surplus money remaining shall be given to the shareholders or the partners of the corporate debtor.

The principle that lies beneath the distribution of assets in such manner is that the order of liabilities should remain the same as before the commencement of liquidation, so that only those claims that are on record as financial debts or operational debts will be cleared during the Insolvency Resolution Process. The workmen's dues are given highest importance and treated equal to secured creditors because the workmen are badly affected when a company turns insolvent or is declared bankrupt.

CHALLENGES FACED BY THE OPERATIONAL CREDITORS IN THE IBC, 2016

Before the recent amendment²¹ which was brought into effect from 6th June, 2018, Operational Creditors were subjected to difficulties due to the requirement under the Code that they had to furnish a certificate from a financial institution maintaining accounts for such operational creditor/s, in order to substantiate the claim that no payment has been made by the corporate debtor towards the debt²². Obtaining certificates and records was

¹⁴Section 21 of the Insolvency and Bankruptcy Code, 2016.

¹⁵Section 21(2) of the Insolvency and Bankruptcy Code, 2016.

¹⁶Section 30(2)(b) and Section 31 of the Insolvency and Bankruptcy Code, 2016.

¹⁷Section 29A of the Insolvency and Bankruptcy Code, 2016.

¹⁸Section 53 of the Insolvency and Bankruptcy Code, 2016.

¹⁹Section 30(5) of the Insolvency and Bankruptcy Code, 2016.

²⁰Section 53 of the Insolvency and Bankruptcy Code, 2016.

²¹IBC (Second Amendment) Act, 2018 (No.26 of 2018).

²²Section 9(3)(c) of the Insolvency and Bankruptcy Code, 2016.



complicated and delayed the resolution as there could be several bank accounts or financial institutions involved. Foreign banks or non-scheduled banks were also not included in such institutions' definition²³, which defines Financial Institution as a scheduled bank, or a financial institution as defined in the RBI Act 1934²⁴, or a public financial institution as defined in the Companies Act, 2013²⁵, or such other institutions as the Central Government may notify. There was also no prescribed form in which the submission was to be made, and no system in place to prove that the records are referring to the same debt which is the subject matter of the claim. It was observed by the apex court²⁶ that the Code must specify precisely either by explanation or by amendment that whether the aforementioned certification and proof from financial institutions were mandated or optional. After the amendment of 2018, it has now become optional by the insertion of 'if available' after the phrase 'by the corporate debtor' in the relevant part of the Code²⁷.

With reference to the Committee of Creditors, the Code does not make it clear what would be the course of action if there were to be only a sole financial creditor but it does have a way out if there were no financial creditors at all. If there were no financial creditors at all, which means that there is no financial debt owing or the financial creditors are related parties of the corporate debtor, the Committee of Creditors in such a scenario shall consist of²⁸:

- a) Eighteen largest operational creditors by value or all operational creditors if there are lesser than eighteen.
- b) One representative elected from the workmen.
- c) One representative elected from among the employees.

Operational Creditors are provided improper or conditional representation in the Committee of Creditors, which needs to be changed by the lawmakers of India. Operational Creditors being excluded from the Committee of Creditors is unfair. This was also discussed in the Swiss Ribbons' case²⁹. In this case, on the issue that operational creditors have no vote in the Committee of Creditors, it was observed that since financial creditors are in the business of advancing or lending money are better positioned to see if the business of a corporate debtor is viable or otherwise. These institutions or financial creditors also perform a detailed analysis before advancing loans, hence they must evaluate a resolution plan, hence their representation is necessary in the Committee of Creditors as compared to Operational creditors who are only keen on the recovery of their money for the goods supplied or services rendered. It was observed that the same treatment is meted out to operational creditors and financial creditors.

However, that's not the case really, if we have a close look at the law. There is an arbitrary distinction between Operational Creditors and Financial Creditors. Operational Creditors must be allowed representation in the Committee of Creditors equally if they are indeed treated equally, so that they can take decisions along with the Financial Creditors to ensure that resolution plans or liquidation, as the case may be, are effected transparently and with their active participation. With their participation and voting, decisions will be taken to the best advantage of all the stakeholders because there will be more minds working on the resolution and operation of the insolvency resolution process. Day to day operations will be handled with more persons involved thus reducing the burden on fewer financial creditors or only the financial creditors.

Moreover, the Operational Creditor's submission of a petition to initiate the insolvency resolution process may meet difficulties when a Corporate Debtor evokes claims of existence of a dispute, though the Financial Creditor's submission of such petition does not meet the same challenge, because there is no opportunity for the Corporate Debtor to raise an existence of dispute claim at all. Merely substantiating the claim with an

²³Section 3(14) of the Insolvency and Bankruptcy Code, 2016.

²⁴Section 45-I of the Reserve Bank of India Act, 1934

²⁵Section 2(72) of the Companies Act, 2013

²⁶Macquarie Bank vs Shilpi Cable (2018) 2 SCC 674.

²⁷Section 9(3)(c) of the Insolvency and Bankruptcy Code, 2016.

²⁸Regulation 16 of the IBBI (Insolvency Resolution Process for Corporate Persons) Regulations 2016.

²⁹Swiss Ribbons Pvt. Ltd. and Anr. vs. Union Of India and Ors. (25.01.2019 - SC Order) : MANU/SCOR/03383/2019



appreciable proof that there is a default in payment is enough for a Financial Creditor to proceed with the initiation of action under the Code.

Though the Supreme Court of India expressed in the Swiss Ribbons' case that there is 'intelligible differentia' at the helm of the different treatment to both types of creditors, i.e., Financial and Operational, they are not rightly treated if their voting and participation in the Committee of Creditors is not made equal. In fact, this is the very reason why the National Company Law Appellate Tribunal and the National Company Law Tribunal often checks during proceedings whether the Operational Creditors are treated on par with the Financial Creditors or not, and if not, such plans are not approved. This effort by the NCLT or NCLAT could be saved if their participation and voting in the Committee of Creditors is made mandatory, thus making it implied that the Operational Creditors have approved decisions and were part of the decision making process at all stages.

CONCLUSION & SUGGESTIONS

In the United Nations Commission on International Trade Law's (UNCITRAL) - Legislative Guide on Insolvency Law³⁰, there is no term as "Operational Creditor", however there are 'secured creditors'³¹ and 'unsecured creditors'³², the former being those holding a secured claim, and the latter being those creditors who have no security interest. This Legislative Guide also provides for the Principle of Pari Passu³³, thus making it necessary to treat similarly situated creditors equally and proportionally to their claim out of the assets of the estate available for distribution.

Hence, this very Pari Passu principle should also be applied for the treatment of Operational Creditors in India, for their positioning in the Committee of Creditors a crucial decision making body and the managing body of a corporation under the insolvency resolution process. For this purpose and to this effect, it is suggested that necessary amendments to the law of insolvency should be made and the Insolvency and Bankruptcy Code of 2016 should accommodate the Operational Creditors in the Committee of Creditors at the earliest.

³⁰Legislative Guide on Insolvency Guide, United Nations Commission On International Trade Law, (Jan.22, 2020,8.44 PM), https://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf.

³¹Id. in Article 12(oo)

³²Id. in Article 12(tt)

³³Id. in Article 12(cc)