

'Operational Debt' cannot be converted into 'Financial Debt' through an agreement

In the matter of *Mr. Santosh Mate (Prop. of Mahalaxmi Traders) vs. M/s Satyam Transformers Private Limited*¹, the Mumbai bench of the National Company Law Tribunal ("NCLT Mumbai") held that the conversion of an operational debt into financial debt through an agreement is invalid and impermissible as it would defeat the very objective of the Insolvency and Bankruptcy Code, 2016 ("IBC") and have the effect of rewriting it.

Brief Facts

1. Mr. Santosh Mate (Prop. of Mahalaxmi Traders) ("**Applicant**") filed an application ("**Application**") for initiation of the corporate insolvency resolution process ("**CIRP**") against M/s Satyam Transformers Private Limited ("**Corporate Debtor**") before the NCLT for resolution of a purported financial debt of INR 1,69,00,000 (Indian Rupees one crore sixty nine lakh only) ("**Debt**").
2. Since 2014, the Applicant had supplied goods and rendered services to the Corporate Debtor, for which the Corporate Debtor was indebted to the Applicant for the Debt. Due to the Corporate Debtor's inability to repay the Debt on account of financial stress, the Applicant agreed to enter into an agreement in 2019 ("**Debt Conversion Agreement**"), which had the effect of converting the Debt from an operational debt to a financial debt.
3. A summary of the terms of the Debt Conversion Agreement are set out below:
 - a) The Applicant and the Corporate Debtor agreed to convert the Debt into a loan of a principal amount not exceeding INR 1,69,00,000 (Indian Rupees one crore sixty nine lakh only) in accordance with the terms and conditions of the Debt Conversion Agreement.
 - b) The date of loan conversion was agreed to be April 1, 2019, and the loan was payable on or before the expiry of 24 (twenty four) months from the conversion date.
 - c) The Corporate Debtor agreed to pay the Applicant, as a lender, an interest of 12% per annum on a compounding basis, calculated monthly from the date of conversion and till the final settlement date.
 - d) The due date for making the repayment of the entire amount of the loan, along with interest, was on or before March 31, 2021. If there was a default in the repayment of the outstanding loan or the interest on the due date, it would result in an event of default with attendant consequences of such default (one such consequence was payment of an additional 2% per month on the amount of loan, or interest thereon).
 - e) The Corporate Debtor agreed to bear legal fees, stamp duty and all other expenses incurred in connection with execution of the Debt Conversion Agreement. The Debt Conversion Agreement was to come into force on the date of execution and for a term of 24 (twenty four) months from the loan conversion date.

¹ CP (IB) No. 253 of 2023 (NCLT, Mumbai)

Issue before NCLT Mumbai

Whether the parties under an agreement can convert an ‘operational debt’ into a ‘financial debt’, and file an application under Section 7 of the IBC on the basis of such agreement?

Findings of NCLT Mumbai

1. NCLT Mumbai noted the scope of the definition of ‘financial creditor’ under IBC, which means any “*person to whom a financial debt is owed*”, and which also includes a person to whom such debt has been legally assigned or referred to.
2. NCLT Mumbai further referred to the various categories of a ‘financial debt’ codified in its definition under IBC and noted that the claim of the Applicant, i.e. the Debt, does not fall under any stipulated categories of ‘financial debt’ under IBC. Consequently, the Applicant does not fall within the meaning of a ‘financial creditor’ under IBC.
3. Noting the lack of any authoritative rulings of the Supreme Court of India or a higher forum on the subject issue, it was also observed that if NCLT Mumbai were to recognise the Debt Conversion Agreement as valid and permissible, it would “*defeat the very object of the Code and would lead to rewriting the Code*”.
4. The conduct and manner of the parties, along with the terms and conditions of the Debt Conversion Agreement raised suspicion on the genuineness of the Debt Conversion Agreement and a collusion between the parties to the Application could not be ruled out.

In view of the aforesaid reasons, NCLT Mumbai rejected the Application of the Applicant and classified it as a misuse and abuse of the process of the tribunal and IBC.

Conclusion

The constitutionality of the distinction between an operational creditor and financial creditor under IBC was upheld by the Supreme Court of India in the ***Swiss Ribbons case***² due to existence of an intelligible differentia between the two, which as per the Supreme Court, “*has a direct relation to the objects sought to be achieved by the Code*”.

In the said case, the Supreme Court also referred to the ‘Notes’ on Clause 8 of the bill which introduced IBC in the Parliament. The ‘Notes’ attributed the distinction between the process for initiating CIRP by an operational creditor and a financial creditor to, amongst other things, operational debts being usually smaller in amount and recurring in nature. It is further evident from the ‘Notes’ that a stated objective was to prevent the operational creditors from putting the corporate debtors into CIRP prematurely or for extraneous considerations.

NCLT Mumbai has implicitly recognised the aforesaid objectives of IBC in differentiating between a ‘financial creditor’ and an ‘operational creditor’ and consequently between a ‘financial debt’ and an ‘operational debt’ under IBC. It has also applied a long-established judicial principle of interpretation that statutory provisions override a contractual agreement between parties to a contract if such a contract has terms and conditions contrary to a statute.

This is not the first attempt in India to convert an operational debt into a financial debt through a contract to gain certain advantages in the CIRP under IBC. Similar instances can be seen in the matters of *Jambudwip Exports and Imports Limited vs. UP Bone Mills Private Limited*³ and *Step Stones Infrass Private Limited vs. Yes and Yes Infracon (P) Limited*⁴ wherein the parties entered into similar agreements to effectively convert their outstanding operational debt into financial debt. Such attempts were also thwarted by the Delhi and Chennai benches, respectively, of the National Company Law Tribunal.

² Writ Petition (Civil) No. 99 of 2018 (Supreme Court of India)

³ (IB)-447(ND)/2021 (NCLT, New Delhi)

⁴ IBA/403/2020 (NCLT, Chennai)

Accordingly, the suppliers of goods and services need to recognise that any attempt of conversion of operational debt into financial debt through an agreement does not satisfy the legal ingredients of a 'financial debt' under IBC as there is no disbursement of money against the time value of money.

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