

NCLAT: A written financial contract is not mandatory to prove the existence of financial debt under the IBC

In a significant decision, the NCLAT in the case of *Agarwal Polysacks Ltd. vs K. K. Agro Foods & Storage*¹ has recently held that a written financial contract is not the only basis for proving the financial debt. Financial debt can be proved from other relevant documents such as the balance sheet entries of the financial creditor, the corporate debtor's balance sheet and the Form 26AS showing TDS deductions on the interest.

Brief Facts

In 2017, one, M/s Agarwal Polysacks Limited ("**Financial Creditor**") had extended an unsecured loan to the tune of INR 75,00,000 (Indian Rupees seventy five lakh) to M/s K. K. Agro Foods and Storage Limited ("**Corporate Debtor**"). The term of the loan was "repayment on demand".

In 2019, the Financial Creditor filed an application under Section 7 of the Insolvency and Bankruptcy Code, 2016 ("**IBC**") against the Corporate Debtor on being aggrieved with the non-repayment by the Corporate Debtor.

By an order dated July 29, 2022, the NCLT, New Delhi, Bench – V ("**NCLT**") dismissed the petition under Section 7 of the IBC. The NCLT dismissed the petition primarily on the ground that the Financial Creditor had failed to demonstrate that the nature of the transaction, the loan amount and the default fell under the definition of a "financial debt" and hence, the Financial Creditor failed to satisfy the pre-requisite for triggering corporate insolvency resolution process ("**CIRP**") under IBC ("**NCLT Order**").

Aggrieved by the NCLT Order, the Financial Creditor filed an appeal before the NCLAT, New Delhi.

Issue

Whether a written financial contract is essential to prove a financial debt?

What are the (other) relevant materials to prove that the corporate debtor owes a financial debt?

Findings and Rationale

The NCLAT answered the first issue in the affirmative and accordingly, allowed the appeal, set aside the NCLT Order and directed the NCLT to pass an order admitting the Corporate Debtor into CIRP. On each issue, the NCLAT finds as under:

¹ Order dated 29.07.2022 passed by NCLT, New Delhi, Bench-V in IB-1705/(ND) /2019.

1. On a perusal of the definition of “Financial Contract”² and the applicable rules and regulations³, the Court finds that Regulation 8(2) of the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 (“**CIRP Regulations**”):
 - a) does not contemplate the existence of all documents as the use of word “or” in Regulation 8(2)(a) of the CIRP Regulations indicates that any of the documents referred under Regulation 8 (2) of the CIRP Regulations can prove the existence of debt.
 - b) A financial contract supported by financial statements as evidence of the debt is one of the documents contemplated in Regulation 8(2) of the CIRP Regulations but that is not exclusive requirement for proving existence of debt.

Thus, a Financial contract can very well be furnished to prove the financial debt, but a plain reading of Regulation 8(2) of the CIRP Regulations indicate that it is not mandatory that existence of financial debt has to be proved by a financial contract (for example, financial statements and records of information utility, etc.).

2. Therefore, the statutory scheme under the Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016 and CIRP Regulations makes it is clear that financial debt can be proved from other relevant documents and it is not mandatory that written financial contract can be only basis for proving the financial debt.
3. In the facts of this case, the NCLAT found that the financial documents placed on record sufficiently established the financial debt. The NCLAT observed that the balance sheet of the Corporate Debtor and the entries in the Financial Creditor’s financials corroborate the amount due on the Corporate Debtor. Further, Form 26AS which shows the payment of interest (while TDS deduction is not sufficient to conclude financial debt⁴, however when the Form 26AS entries corroborate to the entries in the Balance Sheet, the document can be used as a document to evidence financial debt).

Conclusion

This judgement is a step in the right direction to make the IBC regime all-inclusive and give a more expansion finding on the nature and validity of financial debts without formal loan agreements. While Courts have previously held that balance sheets, etc. are evidence of financial debt, this is one of the first findings on a Financial Creditor’s right to initiate insolvency proceedings for unpaid loans, in the absence of a written financial contract.

Informal loan documentation is not uncommon in India, especially in cases of unsecured loans. Hence, this decision has tested the documentation of financial debt on the 2 (two) essential conditions of financial debt with regard to time value for money, viz. disbursement and interest. This judgement clarifies that these tests need not necessarily only be satisfied by a written financial contract but can also established by *other* documentary evidence and thus, the absence of a written financial contract does not defeat a financial creditor’s right to trigger CIRP against an errant corporate debtor under IBC.

While as of today the position stands as such, with M/s K. K. Agro Foods and Storage Limited challenging this NCLAT decision before the Supreme Court, it is yet to be seen whether the Supreme Court would endorse such an expansive reading of the CIRP Regulations or take a more conservative view on this proposition.

² Under Section 3(1)(d) of the IBC, “financial contract” means a contract between a corporate debtor and a financial creditor setting out the terms of the financial debt, including the tenure of the debt, interest payable and date of repayment.

³ Rule 4 of the Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016 prescribes that an application by Financial Creditor is to be filed in Form 1, and be accompanied with several documents, records and evidence of default specified under Regulation 8(2) of the CIRP Regulations.

⁴ *Prayag Polytech Pvt. Ltd. vs. Gem Batteries Pvt. Ltd.*, Company Appeal (AT) (Ins.) No. 713 of 2019.

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