

Supreme Court: The classification of “financial debt” and “operational debt” under IBC can only be determined upon ascertaining the real nature of the transaction.

The Hon’ble Supreme Court of India (“**Supreme Court**”) in *Global Credit Capital Limited & Anr Vs SACH Marketing Pvt. Ltd & Anr*, has established the following principles on classification of a debt under the Insolvency and Bankruptcy Code, 2016 (“**Code**”):

1. debt cannot exist without a corresponding “claim”;
2. the true nature of the transaction under an agreement must be analysed to determine whether the debt is to be categorized as a “financial debt” or an “operational debt”;
3. the test for determining whether a debt falls under the definition of “financial debt” within the Code is based on the presence of a debt along with any interest disbursed for the time value of money; and
4. debt will be an “operational debt” in an “agreement relating to services” only if the “claim” has a correlation with the “service” of the transaction.

This judgement is a significant precedent for debt classification and creditor rights under the Code. It particularly goes a long way in addressing the characterization of financing agreements between closely associated entities as “service agreements”, in case of insolvency claims.

Background

1. SACH Marketing Pvt. Ltd. (“**SMPL**”) entered into agreements with Mount Shivalik Industries Limited (“**MSIL**”), on April 1, 2014, and April 1, 2015 (“**Agreements**”), whereby SMPL was appointed as “Sales Promotor” for promoting the beer manufactured by MSIL over 12 (twelve) months, for which INR 4,000 (Indian Rupees four thousand) per month was agreed to be paid to SMPL.
2. The terms of the Agreement dated April 1, 2014, were nearly identical to those of the Agreement dated April 1, 2015, except for an additional requirement of Security Deposit under the latter agreement.
3. Under the Agreements, it was agreed that SMPL would deposit a minimum security of INR 53,15,000 (Indian Rupees fifty-three lakhs fifteen thousand) (“**Security Deposit**”) with MSIL, which will carry interest @ 21% per annum for which MSIL would pay interest on INR 7,85,850 (Indian Rupees seven lakhs eighty-five thousand eight hundred and fifty) at the same rate.
4. In an independent proceeding, MSIL was admitted into Corporate Insolvency Resolution Process (“**CIRP**”) by an order of the National Company Law Tribunal, Jaipur (“**NCLT**”). Consequently, the NCLT imposed a moratorium, and appointed an Interim Resolution Professional (“**IRP**”/ “**RP**”).

5. In the CIRP of MSIL, SMPL filed a claim for INR 1,58,341 (Indian Rupees one lakh fifty-eight thousand three hundred and forty-one) as “operational debt” (arising out of its monthly remuneration as a “sales promoter”) and INR 1,41,39,410 (Indian Rupees one crore forty-one lakhs thirty-nine thousand four hundred and ten) as financial debt (arising out of the interest from the security deposit).
6. The RP reclassified the claim for “financial debt” as “operational debt”, stating that SMPL could not be considered a “financial creditor”.
7. Challenging the said classification, SMPL filed an application before the NCLT (“**Application**”).
8. During the pendency of the Application, the committee of creditors (“**CoC**”) of MSIL approved a resolution plan submitted by a bidder. Thereafter, the RP filed an application seeking approval of this resolution plan before the NCLT.
9. The NCLT rejected the Application filed by SMPL and allowed the application seeking approval of the resolution plan. SMPL filed an appeal before the National Company Law Appellate Tribunal (“**NCLAT**”) against the rejection. By judgment and order dated October 7, 2021 (“**Impugned Order**”), NCLAT held that SMPL was a financial creditor and not an operational creditor.
10. Aggrieved by the Impugned Order, Global Credit Capital Limited and other members of the CoC (“**Appellants**”) preferred an appeal before the Supreme Court on the following grounds (supported by the RP):
 - a) SMPL's role was to provide services promoting MSIL's beer manufacturing. Therefore, the Security Deposit paid to MSIL constituted operational debt and not funds extended to MSIL for financial purposes.
 - b) MSIL had no intention of availing any financial facility. The mere payment or accrual of interest should not determine the classification of the debt as financial debt under the Code.
11. SMPL contested the appeal on the following grounds:
 - a) The essence of the transaction needed to be scrutinized to determine the nature of the debt.
 - b) The criteria for defining financial debt—such as disbursement, time value of money, and the commercial impact of borrowing under the Code were all met.
 - c) The money was repayable under the Agreements without any deductions or provisions for forfeiture, and the interest rate of 21% per annum was the consideration for the time value of money.

Findings of the Supreme Court

1. The Supreme Court interpreted the words of “debt”, “claim” and “financial debt” as defined under the Code laid down as follows:
 - a) Both financial debt and operational debt must stem from a liability or obligation associated with a claim.
 - b) Cases falling within the categories outlined in the definition of financial debt must meet the criteria specified earlier in Section 5(8), namely, there must be a debt with any applicable interest disbursed as consideration for the time value of money.
 - c) In situations where one party owes a debt to another party under a written agreement or arrangement involving the provision of ‘service’, the debt qualifies as an operational debt only if the claim (which is the subject matter of the debt) is connected with or correlated to the service (that is the subject matter of the transaction).
 - d) The wording of the written document cannot be taken at face value. Thus, it is essential to discern the true nature of the transaction by examining the agreements.
2. Applying the above principles, the Supreme Court held the following as regards the clauses in the Agreement:

- a) A nominal amount of INR 4000 (Indian Rupees four thousand) per month was paid to SMPL for its role as a sales promoter, and this sum was the only correlation for the services provided.
- b) SMPL was not entitled to any commission based on sales volume.
- c) There was no provision for the forfeiture of the Security Deposit.
- d) The payment of the Security Deposit was unrelated to the performance of other conditions by SMPL.
- e) Funds were arranged to be transferred to SMPL, resembling a form of commercial borrowing, given the treatment of interest on the Security Deposit as long-term loans/liabilities and interest revenues in the financial statements of MSIL and SMPL.

Consequently, the Supreme Court determined that the Security Deposit specified in the Agreements constitutes a financial debt owed to MSIL, classifying SMPL as a financial creditor under the provisions of the Code.

Conclusion

The principles laid down by the Supreme Court on classification of a debt highlights the criticality of the Adjudicating Authority ascertaining the true nature of the underlying transaction as well as provides guidance on the reference, interpretation, and reliance on the contractual terms to determine the qualification of “financial debt” or “operational debt” under the Code.

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