



## LexCognito

*This issue of LexCognito, which in Latin means 'awareness about law', seeks to provide you an insight into significant legal and regulatory developments that have taken place very recently in India.*

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### **Supreme Court on the conundrum of operational debt vis a vis financial debt under the Insolvency and Bankruptcy Code, 2016**

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The Supreme Court of India in a recent landmark judgment in the case of **Global Credit Capital Ltd. and Anr. Vs. Sach Marketing Pvt. Ltd. and Anr** (Civil Appeal No. 1143 of 2022) dealt with a vexatious issue of operational debt vis a vis financial debt under the Insolvency and Bankruptcy Code, 2016 (**IBC**). The Supreme Court in this case while explaining the concept of financial debt held that in a case where one party owes a debt to another and the creditor is making claim under a written agreement of service, the debt can be categorised as an operational debt only if the claim has some connection or nexus with the 'service', the subject matter of the transaction. The Supreme court further explained that the written document or agreement should not be taken on its face value and the real nature of the transaction must be ascertained after examining the agreements.

In the instant case, the issues revolved around Sales promotion agreements signed by the corporate debtor (**CD**) with the sales promotion agency/sales promoter (**Agency**) for promotion of sale of beer in the state of Jharkhand. The CD received security deposit from the Agency under the said agreements. The Supreme Court pointed out after examining the two agreements signed by the CD that although the clause in the agreement provided for the payment of the security deposit by the Agency, there was no clause for the forfeiture of the security deposit. The amount specified as security deposit had no correlation or nexus whatsoever with the performance of the other conditions of the contract by the Agency. The Supreme Court held that as there is no clause regarding forfeiture of the security deposit or part thereof, the CD was liable to refund the security deposit after the period specified therein was over with interest @21% per annum. Since the security deposit payment had no nexus or correlation with any other clause under the agreements, the Court held that the security deposit amounts represent debts covered by subsection (11) of Section 3 of the IBC and the right of the Agency to seek a refund of the security deposit with interest is a claim within the meaning of subsection (6) of Section 3 of the IBC.

The Supreme Court further dwelling upon the concept of financial debt explained that (a) under sub-section (8) of Section 5 of the IBC, in the facts of the case, there is no doubt that there is a debt with interest @21% per annum. The provision made for interest payment shows that it represents consideration for the time value of money. The condition for the

applicability of clause (f) of section 5 (8) of IBC is that the transaction must have the commercial effect of borrowing.

The Supreme court also took note of the financial statements of the CD and held that it is evident that the amount raised under the said two agreements has the commercial effect of borrowing as the CD treated the said amount as borrowed from the Agency. In the financial statement of the corporate debtor, the amounts paid by the Agency were shown as "other long-term liabilities". The Supreme court also took into account the letter written by the CD whereby the CD informed the Agency that for the financial year 2016-2017, the CD had provided the interest amounting to Rs.18,06,000/- in the books of the CD. Therefore, the Supreme court came to the conclusion that the amount raised under the said two agreements has the commercial effect of borrowing as the CD treated the said amount as borrowed from the Agency.

The Supreme Court summarised the underlying legal principles/conclusions as under :

- i. There cannot be a debt within the meaning of subsection (11) of section 5 of the IB Code unless there is a claim within the meaning of sub-section (6) of section 5 of thereof;
- ii. The test to determine whether a debt is a financial debt within the meaning of sub-section (8) of section 5 is the existence of a debt along with interest, if any, which is disbursed against the consideration for the time value of money. The cases covered by categories (a) to (i) of sub-section (8) must satisfy the said test laid down by the earlier part of sub-section (8) of section 5;
- iii. While deciding the issue of whether a debt is a financial debt or an operational debt arising out of a transaction covered by an agreement or arrangement in writing, it is necessary to ascertain what is the real nature of the transaction reflected in the writing; and
- iv. Where one party owes a debt to another and when the creditor is claiming under a written agreement/ arrangement providing for rendering 'service', the debt is an operational debt only if the claim subject matter of the debt has some connection or correlation with the 'service' subject matter of the transaction.

In the Instant case, the Supreme Court dissected the underlying transaction reflected in the agreements executed between the CD and Agency to arrive at the conclusion that security deposit paid by the sales promotion agency shall qualify as financial debt as defined under section 5 (8) (f) of the IBC and has laid down legal principles to determine the issue of operational debt and financial debt under the IBC.

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