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# Status Quo of Operational Creditors under IBC – A Judicial Analysis

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## ABSTRACT

*The Insolvency and Bankruptcy Code, 2016 (the "Code"/ "IBC") was enacted with the purpose of consolidating, bringing the concept of insolvency under one single piece of legislation, and establishing a single venue for insolvency settlement. The Code was also enacted as a result of prior legislation's failure. The Code's primary purpose is to resolve and revive industries, but if that isn't possible, it provides a way for creditors to be paid. In addition to this, the IBC aimed to bring about a paradigm change away from the idea of the debtor being in control and toward a process that was led by the creditors. When a debtor is unable to pay its debts, the Code becomes an operational tool for the creditors to guide them through the insolvency resolution process. It has provided the creditors their statutory rights and streamlined the manner to aid the debtor without destroying the creditors' benefits.*

*The Code has been utilised by creditors as a means of recovery, and corporate borrowers have also been led astray by the creditors' recovery strategies out of concern that an insolvency petition will be admitted against the corporate debtors and the repercussions that will follow from this. The most recent events and decisions made by the Apex Authority, on the other hand, have had the consequence of putting the Operational Creditors in a disadvantageous position. In the event that a creditor's claim is contested, the operational creditors are forced to consider whether it is in their best interest to present the claim to the Resolution Professional or to proceed with the adjudicatory process that is being handled by the Judicial Bodies in light of the moratorium being lifted.*

*This article makes an effort to study the recent judgments that have been handed down by the courts, as well as the mechanism in the Insolvency and Bankruptcy Code 2016, and it also makes an effort to put forward the present posture of operational creditors in accordance with the Code.*

## I. INTRODUCTION

A noteworthy and commendable feature of the Code was the introduction of a new class of creditors by categorising creditors based on debt into financial and operational creditors. This

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was the first time that creditors were classified solely on the basis of debt, rather than on the basis of security, into secured and unsecured creditors.

As per Section 5(21)<sup>2</sup> of the Code, a claim linked to the provision or supply of goods or services is referred to as operational debt, and it comprises employment dues and statutory dues owing to the Central or State Governments, or any municipal government, under any existing law. In accordance with Section 5(20)<sup>3</sup> of the Code, operation creditors were defined as those to whom financial debt was owed, as well as people to whom such obligation had been legally assigned or transferred. Even though the Code has defined the types of creditors as financial creditors and operational creditors, it still presents a challenge when attempting to determine whether a certain creditor falls into the category of financial creditor or operational creditor. The interpretations are founded on the rule of interpretation that is both literal and liberal, and they are arbitrary.

During the CIRP, there is no differentiation made between the financial creditors and the operational creditors; rather, they are both handled in the same manner. However, the only person who has voting rights is the company's financial creditor. Simply putting in a claim does not guarantee that an individual will be granted voting rights<sup>4</sup>.

The Supreme Court in *Essar Steel India Limited v. Satish Kumar Gupta & Ors.*<sup>5</sup> has discovered that in a resolution plan, operational and financial creditors do not have to be treated equally. Furthermore, if the action was successful, the corporate debtor's pre-insolvency liabilities would be dismissed. The ruling of the Supreme Court appears to have significant significance for secured financial creditors and resolution applicants. Simultaneously, operational creditors, especially those with disputed claims, are likely to be treated unfairly. Financial creditors, for example, have a completely financial arrangement.

## II. TREATMENT OF OPERATIONAL CREDITORS UNDER THE CODE

The IBC's stated goal and purpose is to balance the interests of all stakeholders and maximise asset value. According to the Code's long title, it is an act to streamline, harmonise, and amend existing laws on the reorganisation and insolvency resolution of corporations, partnership

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<sup>2</sup> The Insolvency and Bankruptcy Code, 2016; S. 5(21).

<sup>3</sup> The Insolvency and Bankruptcy Code, 2016; S. 5(20).

<sup>4</sup> 'XI ANNUAL NATIONAL LAW SCHOOL OF INDIA REVIEW SYMPOSIUM on the INSOLVENCY and BANKRUPTCY CODE on JSTOR' (*Jstor.org*2018) <  
[https://www.jstor.org/stable/26743941?searchText=dues+of+operational+creditors+ibc&searchUri=%2Faction%2FdoBasicSearch%3FQuery%3Ddues%2Bof%2Boperational%2Bcreditors%2Bibc%26so%3Drel&ab\\_segments=0%2F5YC-6427%2Ftest&refreqid=fastly-default%3Aaffa6e8dbf4cf13f207e41d5cd41c427&seq=22](https://www.jstor.org/stable/26743941?searchText=dues+of+operational+creditors+ibc&searchUri=%2Faction%2FdoBasicSearch%3FQuery%3Ddues%2Bof%2Boperational%2Bcreditors%2Bibc%26so%3Drel&ab_segments=0%2F5YC-6427%2Ftest&refreqid=fastly-default%3Aaffa6e8dbf4cf13f207e41d5cd41c427&seq=22) >  
accessed 14 June 2022.

<sup>5</sup> *Essar Steel India Limited v. Satish Kumar Gupta & Ors.*, (2020) 8 SCC 531.

firms, and individuals to maximise the value of their assets while also fostering innovation and access to capital for all parties involved. It also aims to balance the competing interests of all parties involved by altering the order of priority for government obligations to be paid, among other things.

In light of the long title of the Code, as stated above, as well as the binding nature of a resolution plan under section 31<sup>6</sup> of the Code, the adjudicating authority must determine whether all stakeholders' interests have been balanced before approving a resolution plan. If the adjudicating authority is not satisfied, the resolution plan may be rejected, and the corporate debtor may be forced to liquidate. Even if other creditors do not have explicit rights and privileges, the Committee of Creditors (CoC) must consider their interests in the resolution plan to the extent necessary to balance the interests of stakeholders.

The Insolvency Law Committee<sup>7</sup> noted how if the Code does not allow operational creditors to express their dissatisfaction with a resolution plan that fundamentally alters their contractual rights, it could lead to a lack of trust and confidence in the CIRP's final decision among operational creditors. The Committee stated that operational creditors should be permitted to partake actively in the CIRP's decision-making process in order for it to be seen as a fair and just procedure. Even though operational creditors do not currently have voting rights in the CoC, the Committee stated that measures have been made to defend their interests during the CIRP. As part of the 2019 Insolvency and Bankruptcy Code (Amendment) Act<sup>8</sup>, operational creditors now have better protections than before.

According to the Bankruptcy Law Reforms Committee<sup>9</sup>, a resolution plan must include certain safeguards for operational creditors. According to the Committee, the Code mentions three components of IRP. The first is that the solution-finding process is transparent and time-bound, with all information available at the moment. The second requirement is that any proposed solution must expressly account for IRP expenses and operational creditors' liabilities within a reasonable time after it has been approved. The Committee claims that the lack of a vote on the creditors committee by operational creditors must be counterbalanced. As a result, they came to the conclusion that, as part of the suggested solution, the operational creditors' debts must be paid first. The RP must ensure this when analysing a proposal before presenting it to the

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<sup>6</sup> The Insolvency and Bankruptcy Code, 2016; S. 31.

<sup>7</sup> 'REPORT of the INSOLVENCY LAW COMMITTEE Ministry of Corporate Affairs Government of India' (2020), available at: < [https://www.mca.gov.in/Ministry/pdf/ICLReport\\_05032020.pdf](https://www.mca.gov.in/Ministry/pdf/ICLReport_05032020.pdf) >.

<sup>8</sup> The Insolvency and Bankruptcy Code (Amendment) Act, 2019.

<sup>9</sup> 'The Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design' (2015), available at: < [https://ibbi.gov.in/BLRCReportVol1\\_04112015.pdf](https://ibbi.gov.in/BLRCReportVol1_04112015.pdf) >.

creditors committee. If there is any ambiguity in the information memoranda that the RP offers to obtain answers, the RP must ensure that this is explicitly mentioned and accounted for in the suggested solution.

The Principle IV of the BLRC Report<sup>10</sup> states that it is imperative that the law ensures that all relevant parties are included in the assessment of viability as a whole. All creditors who have the ability and inclination to restructure their debts must be included in the negotiations. Any negotiated solution must also take into account the obligations of all creditors who aren't involved in the negotiations.

### III. JUDICIAL OBSERVATIONS

The Insolvency and Bankruptcy Code, 2016 (IBC) first appeared to strengthen the position of suppliers and service providers by providing them creditor status (operational creditor). When it comes to operational creditors, the International Bankruptcy Code (IBC) has made it more difficult for them to be paid through the Corporate Insolvency Resolution Process (CIRP). In this regard, the Hon'ble NCLAT, while interpreting Section 30(2)(b)<sup>11</sup> of the IBC in *Binani Industries v. State Bank of India*<sup>12</sup>, observed that providing only liquidation value to operational creditors based on a misreading of Section 30(2)(b) would discourage creditors from continuing to supply goods and services to the corporate debtor. This would force suppliers of products and services to demand advance payments, which would be in violation of the I&B Code's core principle. The court found the 'Resolution Plan' provided by 'Rajputana Properties Private Limited' to be discriminatory and contrary to the plan of the 'I&B Code.' As a result, the 'Resolution Plan' presented by 'Rajputana Properties Private Limited' has been rejected as discriminatory.

If the 'Operational Creditors' are ignored and given 'liquidation value' based on a misunderstanding and misreading of Section 30(2)(b) of the 'I&B Code,' no creditor will deliver goods or render services on credit to any 'Corporate Debtor.' All those who will supply goods and give services would demand payment in advance, which is against the main premise of the 'I&B Code' and will have an impact on the Indian economy. As a result, it's critical to strike a balance between 'Financial Creditors' and 'Operational Creditors,' with a focus on maximising the assets of the 'Corporate Debtor.'

In *Hammond Power Solutions Private Limited v. Sanjit Kumar and Ors.*<sup>13</sup> according to the

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<sup>10</sup> *Ibid.*

<sup>11</sup> The Insolvency and Bankruptcy Code, 2016; S. 30 (2) (b).

<sup>12</sup> *Binani Industries v. State Bank of India*, Company Appeal (AT) (Insolvency) No. 82 of 2018.

<sup>13</sup> *Hammond Power Solutions Private Limited v. Sanjit Kumar and Ors.*, Company Appeal (AT) (Ins) No.606 of

NCLAT, it was critical for the resolution applicant to explain how the interests of all parties are protected.

In the case of *Committee of Creditors of Essar Steel India Limited vs. Satish Kumar Gupta*<sup>14</sup>, the Court held that- “as it has been rightly noted on behalf of the operational creditors, the preamble of the Code does talk of maximising the value of corporate debtors' assets and balancing the interests of all stakeholders. No doubt, a primary goal of the Code is to ensure that the corporate debtor is able to continue as a going concern during the insolvency resolution process and, as a result, the company must make past and present payments to various operational creditors in order to maintain this status.”

This is in fact reflected in this court's judgment in *Swiss Ribbons Pvt. Ltd. & Anr. V. Union of India & Ors*<sup>15</sup>. The court ruled out that Regulation 38(1A)<sup>16</sup> requires a resolution plan to address the interests of all stakeholders, including operational creditors. Regulation 38(1)<sup>17</sup> specifies that operational creditors have payment precedence over financial debtors. Because there is no minimum liquidation value for operational creditors if the debtor is unable to continue as a going concern, the minimum liquidation value, which in most situations would be zero, would not balance the interests of all stakeholders or maximise the value of a corporate debtor's assets. That is why it is imperative that the Committee of Creditors take into account these fundamental aspects of the Code before making payments to financial and operational creditors in an attempt to resuscitate the corporate debtor. The Committee of Creditors has the last say on how much to pay each class or subclass of creditors, but its decision must reflect that it has maximised the value of the corporate debtor's assets and balanced the interests of all stakeholders, including operational creditors.

In *Standard Chartered Bank v. Satish Kumar Gupta*<sup>18</sup>, the NCLAT relied on the Supreme Court judgment in case of *Swiss Ribbons v. Union of India*<sup>19</sup>, and observed that CIRP Regulation 38 strengthens operational creditors' rights because it incorporates the principle of fair and equitable treatment of operational creditors' rights, as well as priority in payment over financial creditors, into the statutes of India. NCLAT had always enquired about whether

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2019.

<sup>14</sup> *Supra Note 5*.

<sup>15</sup> *Swiss Ribbons Pvt. Ltd. & Anr. v. Union of India & Ors.*; (2019) 4 SCC 17.

<sup>16</sup> Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations, 2016, Regulation 38(1) available at: <  
<https://ibbi.gov.in/uploads/legalframework/24d3a39791e7ed970ddd681a984e5f07.pdf> >

<sup>17</sup> Insolvency and Bankruptcy Board of India (Insolvency Resolution Process For Corporate Persons) Regulations, 2016; Regulation 38(1).

<sup>18</sup> *Standard Chartered Bank v. Satish Kumar Gupta*; Company Appeal (AT) (Ins.) No. 242 of 2019.

<sup>19</sup> *Supra Note 15*.

operational creditors received about equal treatment to financial creditors when reviewing whether a resolution plan authorised by a committee of creditors was viable and feasible. The rights of operational creditors shall be protected if this is not the case, and any such plans will be rejected or revised. Additionally, the NCLAT found that the COC distributed far less money to operational creditors and significantly more money to financial creditors than it should have. The operational creditors were only allowed 'NIL,' or 0%, of their claim amount, while the finance creditors were given almost 90%. The NCLAT observed that such distribution was not only discriminatory but also arbitrary. The NCLAT also observed that Section 30(2)(b)<sup>20</sup> of the Code mandates that the resolution plan must provide for the payment of the debts of operational creditors in such manner as may be prescribed by the IBBI which shall not be less than the amount to be paid to the operational creditors in the event of a liquidation of the corporate debtor under Section 53<sup>21</sup> of the Code. That means that operational creditors should not be paid less than the amount they would have received had the corporate debtor been liquidated out of its assets. In other words, it doesn't mean that they shouldn't be given more money than they would have received if the company went bankrupt, which would constitute discriminatory. The NCLAT referred to its earlier decision in case of *Binani Industries Limited v. Bank of Baroda and Another*<sup>22</sup> where it observed that “Any ‘Resolution Plan’ if shown to be discriminatory against one or other ‘Financial Creditor’ or the ‘Operational Creditor’, such plan can be held to be against the provisions of the I&B Code”.

The boundaries of judicial review, as laid out in *Tata Cellular Vs. Union of India*<sup>23</sup>, should be invoked to rein in the CoC's unchecked power. Dissenting financial creditors' views may be thrown out by the Tribunal if the latter is convinced that such a determination cannot be reached by any reasonable and prudent person(s). NCLT can also intervene if the facts indicate that the dissenting financial creditors' decision was made due to an abuse of power or an unreasonable and irrational judgement.

#### IV. CONCLUSION

1. Despite its infancy, the IBC has already succeeded in bringing about a significant change in the Indian banking sector's prevailing culture of borrower impunity and lack of redress for creditors. However, it appears that such achievement comes at the expense of other stakeholders, particularly operational creditors.

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<sup>20</sup> The Insolvency and Bankruptcy Code, S. 30(2)(b).

<sup>21</sup> The Insolvency and Bankruptcy Code, S. 53.

<sup>22</sup> *Supra Note 12*.

<sup>23</sup> *Tata Cellular v. Union of India*, (1996) AIR 11, 1994 SCC (6) 651.

2. IBC modifications in the case of Essar Steel were found to be legitimate by the Supreme Court, which gave the CoC extensive control over the allocation of funds among creditors under a resolution plan. According to the Supreme Court, it is 'equitable' for operational creditors to get less money than their financial counterparts. Supreme Court judges tried to protect operational creditors by requiring the CoC to 'consider' their interests when making business decisions. Compliance can be enforced by NCLT as well. Insofar as the CoC's "business acumen" continues to reign supreme, the degree to which such protection exists is up for debate.
3. If "balancing all stakeholders' interests" is a stated purpose of the International Building Code, then Essar Steel and Genius Security & Allied Services' decision to merge goes against that goal. The creditors would have to compromise on their debts as part of a resolution procedure. All rights and remedies in relation to claims by operational creditors would be wiped out as a result (including disputed claims). The IBC's stated purposes and the wider public interest would not be served by such an annihilation of rights without due process.
4. Finally, the IBC and the Supreme Court ignore the interests of creditors with "disputed" claims by failing to develop a way to quantify and admit such claims in an insolvency resolution process. Liquidators should be given the same powers as the RP, or at least given first-stage jurisdiction over claims that are challenged. It would also be more consistent with the IBC's structure and aims if disputed debt could be estimated and admitted using these methods.

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