

Comprehending Financial Debt under IBC: A Review Study

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Abstract

Finance debt is defined in section 5(8) of the Insolvency and Bankruptcy Code, 2016. However, there are several practical considerations which were referred to Adjudicating Authorities for further interpretation and judicial pronouncements. Therefore, there are several judgements on the theme which are reviewed in this paper to comprehend the term financial debt. It is the term financial debt which is ultimately very relevant to considering a creditor a financial creditor for filing admission under section 7 of the code. This paper could review the judicial pronouncements on the definition of financial debt.

Introduction:

In the Insolvency and Bankruptcy Code, 2016¹ (code/IBC) Financial Debt is one of the major terminology having implications in admitting the application under 7, 9 and 10 of the code. The concept of financial debt has several components. Further on these components, there are several judicial pronouncements giving interpretations and clarifications. The section 5(8) of the code defines the concept “financial debt”. According to section 5(8)² of the code, “financial debt” means a debt along with interest, if any, which is disbursed against the consideration of the time value of money and includes -

- (a) any money borrowed against the payment of interest;
- (b) any amount raised by acceptance under any acceptance credit facility or its de-materialised equivalent;
- (c) any amount raised pursuant to any note purchase facility or the issue of bonds, notes, debentures, loan stock or any similar instrument.
- (d) the amount of any liability in respect of any lease or hire purchase contract;
- (e) any receivables sold or discounted other than any receivables sold on non-recourse basis.
- (f) any amount raised under any other transaction, including any forward sale or purchase agreement, having the commercial effect of a borrowing.

[Explanation for the purposes of this sub-clause, -

- (i) any amount raised from an allottee under a real estate project shall be deemed to be an amount having the commercial effect of a borrowing; and
- (ii) the expressions, “allottee” and “real estate project” shall have the meanings respectively assigned to them in clauses (d) and (zn) of section 2 of the Real Estate (Regulation and Development) Act, 2016;]
- (g) any derivative transaction entered into and only the market value of such transaction shall be taken into account;

- (h) any counter-indemnity obligation in respect of a guarantee, indemnity, bond, documentary letter of credit or any other instrument issued by a bank or financial institution;
- (i) the amount of any liability in respect of any of the guarantee or indemnity for any of the items referred to in above sub clauses (a) to (h) of this clause.

Review of Judicial Pronouncements on Financial Debt:**(a) Reciprocal Rights & Obligations on Joint Agreement is no financial debt:**

There shall be financial debt in the meaning of section 5(8) of the code. There shall be a contract such as for borrowing etc., as stated in the section 5(8) of code to establish financial debt. In the case of Vipul Limited Vs. Solitaire Buildmart Pvt. Ltd. [CA (AT) (Ins.) No. 550 of 2020] NCLAT order dt. 18.08.2020³, it was observed that -

- there was no financial debt under section 5(8) of the code where;

- A contract of reciprocal rights and obligations based on a Joint Development Agreement entered into cannot be considered for financial debt.;
- both parties are admittedly Joint Development Partners, who entered into a consortium.
- The purpose of such an agreement is meant to develop an Integrated Township. And for any breach of the terms of the contract.

Accordingly, application by FC under section 7 the code is not maintainable as the amount cannot be construed as financial debt as defined under section 5(8) of the Code.

(b) Money advanced by the Promoter, Director even without the term interest is held financial debt:

In the case of Shailesh Sangani Vs. Joel Cardoso & Anr. [CA (AT) (Ins.) No. 616 of 2018] NCLAT order dt. 30.01.2019⁴ a Adjudicating Authority did not consider money advanced by a Promoter, Director or a Shareholders of the CD with interest component and accordingly held not a financial debt. However, in the appeal it was considered as financial debt.

The crux of the judgement is that -

- It is manifestly clear that money advanced by a promoter, director or a shareholder of the CD as a stakeholder to improve the financial health of the company and boost its economic prospects, would have the commercial effect of borrowing on the part of CD, notwithstanding the fact that no provision is made for interest thereon.

The extract of the judgement substantiated how and why it is considered as financial debt as under:

- “..A plain look at the definition of ‘financial debt’ brings it to fore that the debt along with interest, if any, should have been disbursed against the consideration for the time value of money. Use of the expression ‘if any’ as suffix to ‘interest’ leaves no room for doubt that the component of interest is not a sine qua non for bringing the debt within the fold of ‘financial debt’.
- The amount disbursed as debt against the consideration for time value of money may or may not be interest-bearing.
- What is material is that the disbursement of debt should be against consideration for the time value of money. Clauses (a) to (i) of Section 5(8) embody the nature of transactions which are included in the definition of ‘financial debt’.
- It includes money borrowed against the payment of interest. Clause (f) of Section 5(8) specifically deals with the amount raised under any other transaction having the commercial effect of a borrowing, which also includes a forward sale or purchase agreement.
- It is manifestly clear that money advanced by a Promoter, Director or a Shareholder of the Corporate Debtor as a stakeholder to improve the financial health of the company and boost its economic prospects, would have the commercial effect of borrowing on the part of the Corporate Debtor notwithstanding the fact that no provision is made for interest thereon.
- Due to fluctuations in the market and the risks to which it is exposed, a company may at times feel the heat of a resource crunch and the stakeholders, like promoters, directors or shareholders may, in order to protect their legitimate

interests, be called upon to respond to the crisis and in order to save the company they may infuse funds without claiming interest. In such a situation, such funds may be treated as long term borrowings.

- Once it is so, it cannot be said that the debt has not been disbursed against the consideration for the time value of the money.
- The interests of such stakeholders cannot be said to be in conflict with the interests of the company. Enhancement of assets, increase in production and the growth in profits, share value or equity ensures the benefit of such stakeholders and that is the time value of the money constituting the consideration for disbursement of such amount raised as debt with obligation on the part of the Company to discharge the same.
- Viewed thus, it can be said without any amount of contradiction that in such cases, the amount taken by the company is in the nature of a 'financial debt'."

A similar view was established in the case of **Orator Marketing Pvt. Ltd. Vs. Samtex Desinz Pvt. Ltd. [Civil Appeal No. 2231 of 2021]** SC order dt. 26.07.2021⁵ wherein it was observed that -

- The definition of 'financial debt' does not expressly exclude an interest free loan.
- 'Financial debt' would have to be construed to include interest free loans advanced to finance the business operations of the corporate body.

The detailed relevant extract of the Hon'ble Supreme Court order in respect of the appeal is as under:

- "From the perusal of the Application, it is clear that the Hon'ble NCLT, vide its order dated 23.10.2020 1n IB no. 908/ND/2020, is of the view that neither the present claim of the Financial Creditor can be termed to be a 'Financial Debt' nor does the Financial Creditor come within the meaning of 'Financial Creditor' thereby dismissing the petition.
- However, the Hon'ble Supreme Court of India vide its order dated 26.07.2021 in Civil Appeal No. 2231/2021 at para 31 and 32 held that: 31. At the cost of repetition, it is reiterated that the trigger for initiation of the Corporate Insolvency Resolution Process by a Financial Creditor under Section 7 of the IBC is the occurrence of a default by the Corporate Debtor.
- 'Default' means nonpayment of debt in whole or part when the debt has become due and payable and debt means a liability or obligation in respect of a claim which is due from any person and includes financial debt and operational debt.
- The definition of 'debt' is also expansive and the same includes inter alia financial debt. The definition of 'Financial Debt' in Section 5(8) of IBC does not expressly exclude an interest free loan.
- 'Financial Debt' would have to be construed to include interest free loans advanced to finance the business operations of a corporate body. 32. The appeal is, therefore, allowed. The judgment and order impugned is, accordingly, set aside".

(c) Intercompany deposit with interest element is considered as financial debt:

Inter-Company Deposit is made for a certain period. Later, the same was to be paid back with interest, Therefore, such a transaction would fall into the definition of 'financial debt' under section 5(8) of the code. This was observed in the case of Narender Kumar Agarwal & Anr. Vs. Monotrone Leasing Pvt. Ltd. & Anr. [CA (AT) (Ins.) No. 549 of 2020] NCLAT order dt. 19.01.2021⁶.

(d) Financial debt includes a debt together with interest which is disbursed:

In Swiss Ribbons Pvt. Ltd. & Anr. Vs. Union of India & Ors. [WP (Civil) Nos. 99, 100, 115, 459, 598, 775, 822, 849, and 1221 of 2018, SLP (Civil) No. 28623 of 2018 and WP (Civil) 37 of 2019] SC order dt. 25.01.2019⁷, a financial debt is a debt together with interest, if any, which is disbursed against the consideration of time value of money. It may further be money that is borrowed or raised in any of the manners prescribed in Section 5(8) or otherwise, as Section 5(8) is an inclusive definition.

(e) The Difference between Financial Debt & Operational Debt:

In case, money is lent in anticipation of returns in the form of interest, is called a financial debt. Whereas in operational debt it is a transaction where payment is made for goods or services. This view was held in the case of DF Deutsche Forfait AG & Anr. Vs. Uttam Galva Steel Ltd. [C.P. No. 45/I & P/NCLT/MAH/2017] NCLT, Mumbai order dt. 10.04.2017⁸.

(f) Equity capital subscription is not a financial debt:

Any amount raised pursuant to any note purchase facility or the issue of bonds, notes, debentures, loan stock or any similar instrument is considered as financial debt under section 5(8)(c). Accordingly, in the case of Radha Exports (India) Pvt. Ltd. Vs. K.P. Jayaram & Anr. [Civil Appeal No. 7474 of 2019] SC order dt. 28.08.2020⁹, the payment received for shares, duly issued to a third party at the request of the payee as evident from official records, was not considered as financial debt.

Similarly, in the case of Nikhil Mehta and Sons Vs. AMR Infrastructure Ltd. [CA (AT) (Ins.) No. 07 of 2017] NCLAT order dt. 21.07.2017¹⁰, it was observed that to consider a financial transaction as financial debt it should be in the nature of debt (under section 5(8) of the code. Accordingly, no equity has been implied by the opening words of section 5(8) of the code.

(g) Money advanced by allottee in Real Estate considered as financial debt:

In the case of Pioneer Urban Land and Infrastructure Ltd. & Anr. Vs. Union of India & Ors. [WP (C) No. 43 of 2019 with other appeals] SC order dt. 09.08.2019¹¹, In this real estate projects, money is raised from the allottee, against consideration for the time value of money. Accordingly, the Builder was directed to pay the principal amount along with interest. In an elaborate case, several issues were observed -

- the agreement between parties were one sided and allottee is an aggrieved party;
- In the event of refund only the principal amount was to paid back and no interest.
- The National Commission on consumers forum did not consider the agreement in certain aspects due to its one-sided nature and accordingly directed the builder to pay the principal along with prescribed interest applicable in the Haryana State.

Similar view was considered in the case of **Pioneer Urban Land and Infrastructure Ltd. & Anr. Vs. Union of India & Ors. [WP (C) No. 43 of 2019¹² with other appeals] SC order dt. 09.08.2019**. It was held in this case that in real estate projects, money is raised from the allottee, against consideration for the time value of money. Thus, allottees are to be regarded as FCs.

(h) The amount raised under a Forward Purchase Agreement (FPA) is not financial debt:

It was held in the case of State Bank of India Vs. Rajendra Bhuta, IRP of Prabhat Technologies (India) Ltd. & Ors. [IA No. 440 of 2020 in C.P. No. 1874/MB/2019] NCLT, Mumbai order dt. 06.01.2021¹³ that the amount raised under a Forward Purchase Agreement (FPA) would not come within the definition of a 'financial debt' unless it bears the dual attributes of (i) having been disbursed against the consideration for time value of money and (ii) has the commercial effect of a borrowing.

An extract from the judgement is provided hereunder for comprehending the concept established:

- As already indicated a Forward Purchase Agreement may or may not be regarded as a financial transaction for it to be a financial debt. It must have the commercial effect of a borrowing.

- The recitals of the Forward Purchase Agreement indicated above do not envisage the financial transactions in the nature of financial debt as defined under section 5(8) of the Code. The Agreements do not satisfy the parameters discussed in the cited precedent supra.
- A forward contract to sell a product at the end of a specified period cannot be regarded as a financial contract. Both the FPAs indicate that they were essentially forward contracts for supply of specified goods (products).
- The Corporate Debtor or for that matter the purchaser under the Agreement dated 29.09.2018 has not raised any amount thereunder. Under the Agreements they agreed to purchase certain products and pay therefor.
- The Corporate Debtor executed deeds of guarantee binding itself to pay any shortfall in case of default. Such transactions accordingly may at best amount to an operational debt in terms of section 5(21) of the Code for provision of goods and services and payment in respect thereto.
- Therefore, the FPAs dated 29.09.2018 and 28.12.2018 cannot be regarded as financial transactions in which a debt was raised or payment was made against the consideration for the time value of money which also had the commercial effect of borrowing.
- On examination of the nature of the transactions, we find that the transactions were essentially simple agreements of sale and purchase. The same would not come within the definition of 'financial debt' under section 5(8)(f) of the code.

(I) Pledge would not form part of guarantee and financial debt:

In the case of Vistara ITCL (India) Ltd. & Ors. Vs. Dinkar

Venkatasubramanian & Ors. [CA (AT) (Ins.) No. 703 of 2020] NCLAT order dt. 24.08.2020 it was observed that Pledge of shares would not fall within the concept of guarantee and indemnity so as to bring it within the meaning of financial debt.

Conclusion:

The paper comprehensively traced the substantiation of the concept of financial debt from several judicial pronouncements on the term theme. The judicial review could provide an understanding of the definition with practical perspective based on the several reviews. The review could draw a distinction between what is financial debt and what is not? Similarly, what is financial debt and what is operation debt? In addition several other dimensions of the concept were reviewed based on judicial pronouncements.

References:

1. Act 1 of 2016.
2. Ibid.
3. 'Vipul Limited Vs. Solitaire Buildmart Pvt. Ltd. [CA (AT) (Ins.) No. 550 of 2020] NCLAT order dt. 18.08.2020.
4. Shailesh Sangani Vs. Joel Cardoso & Anr. [CA (AT) (Ins.) No. 616 of 2018] NCLAT order dt. 30.01.2019.
5. Orator Marketing Pvt. Ltd. Vs. Samtex Desinz Pvt. Ltd. [Civil Appeal No. 2231 of 2021] SC order dt. 26.07.2021.
6. Narendra Kumar Agarwal & Anr. Vs. Monotrone Leasing Pvt. Ltd. & Anr. [CA (AT) (Ins.) No. 549 of 2020] NCLAT order dt. 19.01.2021.
7. Swiss Ribbons Pvt. Ltd. & Anr. Vs. Union of India & Ors. [WP (Civil) Nos. 99, 100, 115, 459, 598, 775, 822, 849, and 1221 of 2018, SLP (Civil) No. 28623 of 2018 and WP (Civil) 37 of 2019] SC order dt. 25.01.2019, quoted by Frequently Asked Questions on the IBC, 2016 (Revised January 2022 Edition) published by Committee on IBC, ICAI, New Delhi, 2022.
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9. Radha Exports (India) Pvt. Ltd. Vs. K.P. Jayaram &Anr. [Civil Appeal No. 7474 of 2019] SC order dt. 28.08.2020, quoted in Frequently Asked Questions on the IBC, 2016 (Revised January 2022 Edition) published by Committee on IBC, ICAI, New Delhi, 2022.
10. Nikhil Mehta and Sons Vs. AMR Infrastructure Ltd. [CA (AT) (Ins.) No. 07 of 2017] NCLAT order dt. 21.07.2017, quoted by Frequently Asked Questions on the IBC, 2016 (Revised January 2022 Edition) published by Committee on IBC, ICAI, New Delhi, 2022.
11. Pioneer Urban Land and Infrastructure Ltd. &Anr. Vs. Union of India & Ors. [WP (C) No. 43 of 2019 with other appeals] SC order dt. 09.08.2019.
12. Pioneer Urban Land and Infrastructure Ltd. &Anr. Vs. Union of India & Ors. [WP (C) No. 43 of 2019.
13. State Bank of India Vs. Rajendra Bhuta, IRP of Prabhat Technologies (India) Ltd. &Ors. [IA No. 440 of 2020 in C.P. No. 1874/MB/2019] NCLT, Mumbai order dt. 06.01.2021.