SAMVĀD: PARTNERS

April 05, 2017

OPERATIONAL CREDITORS AND DISPUTED DEBT – AN UPDATE ON DECISIONS UNDER THE INSOLVENCY AND BANKRUPTCY CODE, 2016

Since the Insolvency and Bankruptcy Code, 2016 (the "**Code**") came into effect for corporate persons in December 2016, all three categories of applicants – financial creditors, operational creditors and corporate debtors – have begun to file applications under the Code. This Update analyses some decisions of the Mumbai Bench and the Principal Bench of the National Company Law Tribunal ("**Tribunal**") relating to applications filed by operational creditors. While some of these decisions have helped clear up ambiguities in interpretation, they also raise more questions and reveal contradictions in the decisions being rendered by these two benches. Clearly, however, there has been increased interest in the Code by all parties and the implementation of the Code is likely to evolve as debtors and creditors continue to access the Tribunal regularly in this context.

In the decisions discussed below, the Tribunal looked into questions regarding:

- How broadly the term "operational creditor" can be construed under the Code;
- What constitutes a disputed debt in relation to an operational creditor; and
- Whether the Limitation Act applies to proceedings under the Code.

1) Who is an Operational Creditor?

The Tribunal, Principal Bench considered the boundaries of the definitions of operational creditor and operational debt in the case of ***Col. Vinod Awasthy v. AMR Infrastructures Ltd.*** *(C.P. No. (IB)-10(PB)/2017. February 20, 2017).* In this case, the petitioner had paid a real estate developer, AMR Infrastructures Ltd. ("**AMR**"), a certain sum in 2011 as an advance for booking a flat, with possession of the flat to be delivered subsequently. Under the terms of the MOU between the parties, AMR was to pay the petitioner an agreed amount each month on the advance (termed as an "assured return") until possession of the flat was delivered. However, AMR failed to deliver possession within the stipulated time and stopped making the assured return payments to the petitioner after December 2013. After issuing a statutory demand notice under the Code, the petitioner filed an "operational creditor" application under Section 9 of the Code to commence insolvency resolution proceedings against AMR.

The issues the Tribunal considered were whether the petitioner qualified as an "operational creditor" and if the payments owed by AMR constituted "operational debt" under the Code. The Tribunal stated that "operational debt" as defined in Section 5(20) of the Code was debt that *"may arise out of the provision of goods or services including dues on account of employment or a debt in respect of repayment of dues arising under any law for time being in force and payable to centre or local authority."* The Tribunal further pointed out that the other category of debt used in the Code was "financial debt," which was defined as debt disbursed against the time value of money (such as bank loans, debentures etc..). However, the Code did not define "operational debt" as including any debt that was not financial debt. As a consequence, the term operational debt would have to be confined to the four categories included in the definition - goods, services, employment and government dues. The payments owed by AMR could, therefore, not be considered "operational debt" and the petitioner could not be considered an operational creditor. The Tribunal, Principal Bench also passed very similar orders in two other cases with nearly identical facts, including another case against the same developer, AMR *(Mukesh Kumar v. AMR Infrastructure (C.P. No. (IB)-30(PB)/2017) March 31, 2017; Pawan Dubey & Anr v. JBK Developers Pvt. Ltd. (C.P. No. (IB)-19(PB)/2017) March 31, 2017).*

An interesting point on this decision is that the Tribunal did not consider whether the payments owed by AMR constituted debt in the first place. This might be because the term "claim" is defined very broadly under the Code and "debt" is defined as *"a liability or obligation in respect of a claim…"* However, this decision could have wide ranging implications as it gives rise to the possibility that certain kinds of debts may not fit into either the operational debt or financial debt buckets. The attempts of the petitioners in these cases to use the Code to pursue remedies against real estate developers failed, but it would be worth watching if there are other kinds of creditors who attempt to push the boundaries of what constitutes operational debt.

2) What constitutes a Disputed Debt?

When an application for commencement of an insolvency resolution process is filed by an operational creditor, one of the grounds on which the Tribunal may reject the application is if the operational creditor has received notice of a dispute regarding the unpaid debt. But what constitutes a dispute and when must notice of a dispute be received? In two recent cases with very similar fact patterns, the Mumbai and Principal Benches of the Tribunal delivered contradictory decisions on these questions.

In **M/s. Essar Projects India Ltd. v. M/s. MCL Global Steel Pvt. Ltd.** *(C.P. No. 20/I&BP/NCLT/MAH/2017, March 6, 2017),* MCL Global Steel ("**MCL**") had not honoured the invoices raised by the petitioner for completion of construction work. After several reminders, the petitioner served MCL with a statutory demand notice under the Code. MCL responded to the demand notice stating that the petitioner had no grounds for commencing a proceeding under the Code as MCL disputed, among other

things, the amount of the debt in question as well the as the enforceability of the contract between the parties.

The Tribunal, Mumbai pointed out that MCL had not raised any of these disputes until it had been served the statutory demand notice. It further stated that it was evident from perusal of the definition of "dispute" in the Code, that *"dispute in existence means and includes raising dispute in court of law or arbitration tribunal before receipt of notice under Section 8 of the Code."* As in the present case no such proceeding was pending or had been initiated prior to serving of the demand notice, MCL was not entitled to raise the dispute as a bar to admission of the application.

By contrast, in two applications filed against the same debtor - **Coat Plaster v Ambience Private Limited** *(C.P. No. (I.B.) 07/PB/2017, March 1, 2017)* and **Shivam Construction Company v. Ambience Private Limited** *(C.P. No. (I.B.) 08/PB/2017, March 1, 2017)* - the Tribunal, Principal Bench's order suggests that the dispute could be raised even after the demand notice is issued by the petitioner. The term "dispute" is defined to *"**include** a suit or arbitration proceeding relating to (a) the existence of the amount of debt; (b) the quality of goods or services; or (c) the breach of a representation or warranty."* The Tribunal, Principal Bench stated that the use of the word "includes" showed that the definition of "dispute" was an illustrative definition and not exhaustive and, therefore, did not necessarily have to mean a suit or arbitration proceeding. The Tribunal then went on to reject the applications on the grounds that the debtor had filed replies to the demand notices disputing the debts.

The decision of the Principal Bench raises significant concerns. The Tribunal appears to have ignored the language in Section 8(2) of the Code which states that on receipt of a demand notice from an operational creditor, the corporate debtor shall either repay the unpaid portion of the debt or *"bring to the notice of the operational creditor existence of a dispute, if any, and record of the pendency of the suit or arbitration proceeding filed before the receipt of such notice or invoice in relation to the dispute."* This wording makes amply clear that the dispute must be one which was filed before receipt of the demand notice. It is also worth noting that the form of demand notice attached at Form 3 to the Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016) similarly provides that the dispute must have been filed prior to the demand notice. By contrast, the Principal Bench's decision in these cases leaves open the possibility that a debtor could simply avoid commencement of the insolvency resolution process by disputing a debt after a demand notice has been served.

The decisions of the Mumbai and Principal Benches discussed above were delivered in close proximity to each other, on March 6, 2017 and March 1, 2017, respectively. It will have to be seen which view ultimately prevails, but if subsequent decisions follow the reasoning of the Principal Bench, it could provide corporate debtors with an easy avenue to avoid admission of insolvency resolution applications filed by operational creditors.

3) Can Applications under the Code be Time Barred?

The Code is silent on the time period from the date of default within which an application for insolvency resolution must be filed. In the case of, **M/s. Deem Roll Tech Limited v. M/s. R.L. Steel & Energy Limited (**C.A. No. (I.B.) 24/PB/2017**,** March 31, 2017)**,** the Tribunal, Principal Bench considered whether the Limitation Act, 1963 (the "**Limitation Act**") was applicable to applications filed under the Code. In this case, the petitioner claimed a sum of money from R.L. Steel & Energy Limited ("**R.L. Steel**") arising out of a sale of goods transaction in March 2014. The petitioner initiated a summary suit in civil court for recovery of this money and had been awarded a decree in its favour in 2016. As R.L. Steel had not honoured the decree, the petitioner also filed a statutory demand notice against R.L. Steel, followed by an application to commence proceedings under the Code.

The Tribunal stated that while Section 255 of the Code amended various provisions of the Companies Act, 2013, it had not amended Section 433 of the Companies Act, which made the provisions of the Limitation Act specifically applicable to proceedings before the Tribunal and the Appellate Tribunal. The Tribunal further noted that the Code contained no prohibition on the application of the Limitation Act. Hence, in the absence of any such bar under the Code, coupled with Section 433 of the Companies Act, the Tribunal concluded that the petitioner's application was time barred under the Limitation Act as the invoices for which payment was claimed related to the period from 2011 to 2012.

This is an update for general information purposes only and does not constitute legal advice. Please contact us if you require further clarifications on this subject.
