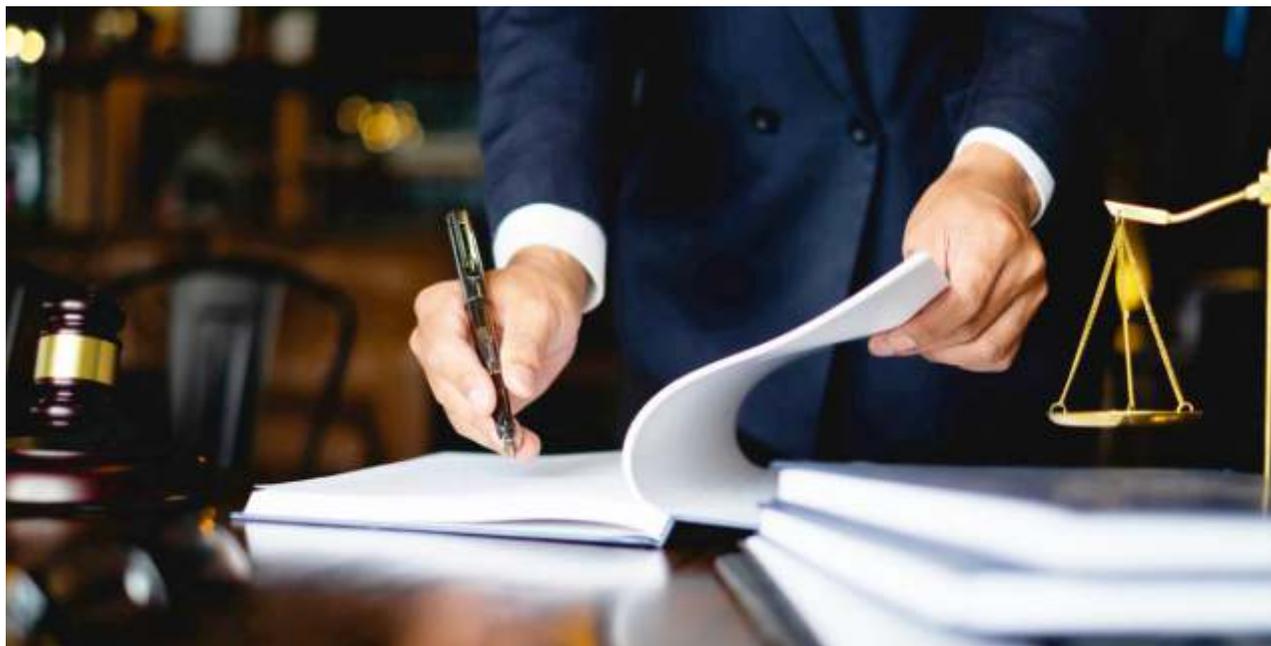


IBC Jurisprudence on Advance Payment By Creditor to Corporate Debtor



*Section 3 (6) of the IBC, 2016, clarifies, without ambiguity, the connection between a claim and the right to payment. Therefore, debt can be understood as something that generates a claim in the form of a right to be paid. The subsequent provisions of the Code also define Financial Debt and Operational Debt. However, the law is silent on the nature of advance payment made to the Corporate Debtor. Whether the advance payment given by the Creditor to the Corporate Debtor a Financial Debt within the meaning of Section 5(8) of the Code or an Operational Debt within the meaning of Section 5(21) of the Code? In the backdrop of various provisions of the IBC, 2016 and relevant judgements of NCLT, NCLAT and the Supreme Court, the author has presented a thorough analysis of the issue. **Read on to know more...***

1. Introduction

Since the Insolvency and Bankruptcy Code, 2016 (IBC/Code) came into effect, many legal questions have arisen regarding the interpretation of its various provisions. The Code has been amended several times to enhance the effectiveness and efficiency of the processes described. The judiciary has also played a significant role in interpreting its provisions in a way that promotes the objective to maximize the value of the assets of the Corporate Debtor.

One interpretational challenge that has arisen is whether a claim for the refund of an advance payment against a Corporate Debtor is an Operational Debt or a Financial Debt? The definitions of "claim," "debt," "default," "financial debt" and "operational debt," in the Code have led to a number of legal challenges. These challenges were also faced by the Courts during the winding-up regime under the Companies Act, 1956 before the commencement of the Code.

2. Relevant Statutory Provisions of the IBC

Before discussing whether a claim for refund of an advance payment is considered an Operational Debt or Financial Debt under the Code, it will be appropriate to



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highlight a few key clauses of the Code that may shed light on how this issue originally came to be:

'Claim' is defined as follows in Section 3(6) of the Code:

“(a) a right to payment, whether or not such right is reduced to judgment, fixed, disputed, undisputed, legal, equitable, secured, or unsecured;

(b) right to remedy for breach of contract under any law for the time being in force, if such breach gives rise to a right to payment, whether or not such right is reduced to judgment, fixed, matured, unmatured, disputed, undisputed, secured or unsecured.”

The connection between a claim and the right to payment in the provision is clear and leaves no room for ambiguity. Therefore, debt can be understood as something that generates a claim in the form of a right to be paid. It is important to consider the definitions of financial debt and operational debt, which can be found in Section 5 of IBC, 2016.

Section 3(11) of the Code provides the following definition of 'debt':

“a liability or obligation in respect of a claim which is due from any person and includes a financial debt and operational debt.”

The definition explicitly defines the debt as a liability or obligation in respect of a claim which is due from any person and includes a Financial Debt and Operational Debt. This provision encompasses both the notions of "financial debt" and "operational debt."

The definition under Section 3 (11) of the IBC, 2016, explicitly defines the debt as a liability or obligation in respect of a claim which is due from any person and includes a Financial Debt and Operational Debt.

The following definition of 'default' is provided in Section 3(12) of the Code:

“non-payment of debt when whole or any part or instalment of the amount of debt has become due and payable and is not paid by the debtor or the corporate debtor, as the case may be.”

Default means that a debtor has failed to make a payment on a debt when it is due.

The term "Financial Debt" is defined as follows in Section 5(8) of the Code:

“means a debt alongwith interest, if any, which is disbursed against the consideration for the time value of money”

Section 5(21) of the Code provides the following definition of "Operational Debt":

“means a claim in respect of the provision of goods or services including employment or a debt in respect of the payment of dues arising under any law for the time being in force and payable to the Central Government, any State Government or any local authority.”

According to the definition of 'operational debt' as described above, there are essentially two types of debts that might be considered operational debts:

- a) A claim 'in respect of the provision of goods and services including employment; and
- b) A debt the Corporate Debtor owes to the Central, State, or Local Authority.

3. Issue

Is the advance payment given by the Creditor to the Corporate Debtor a Financial Debt within the meaning of Section 5(8) of the Code or an Operational Debt within the meaning of Section 5(21) of the Code?

4. Analysis

The Adjudicating Authorities have taken different stances on the interpretation of 'Operational Debt' in different cases. The cases of *Eknath K. Aher v. Royal Twinkle Star Club Limited*¹ and *Sayali S. Rane v. Messrs. Citrus Check Inns Limited*², are two of the early instances where a claim for a return of an advance payment was accepted as an Operational Debt. On requests made pursuant to Section 9 of the Code, the NCLT, Mumbai admitted two CIRP applications against two corporate debtors. Individuals who had bought holiday plan certificates from the Corporate Debtor companies filed the applications, and the said companies failed to return the applicants' purchases of such certificates in full as agreed upon. It was determined that this default had resulted in an 'operational debt' in favour of the applicants, as defined by the Code. Although it may be accurate to say that in both instances the corporate debtors did not object to the CIRP applications'

¹ C.P. No. 895/IBC/NCLT/MB/MAH/2017, order dated May 2, 2017.

² C.P. No. 896/IBC/NCLT/MB/MAH/2017, order dated May 2, 2017.

admission on the grounds that the applicants were not "operational creditors" as defined by the Code, this issue did not properly come up for discussion before the NCLT in these cases.

The cases of *Eknath K. Aher v. Royal Twinkle Star Club Limited* and *Sayali S. Rane v. Messrs. Citrus Check Inns Limited* are two of the early instances where a claim for a return of an advance payment was accepted as an operational debt.

In the case of *Renish Petrochem FZE v. Ardour Global Private Limited*³, Hon'ble NCLT used a broad interpretation of the term "operational debt" under Section 5(21) of the Code for the first time. In this instance, the Applicant had given some commodities to a business under the agreement that, in the event the buyer failed to pay the consideration amount, the payment for those items would be insured by a buyer associate organisation. It was questioned whether an Operational Debt could even be asserted against a guarantor after the Applicant preferred the application under Section 9 of the Code against the buyer associate organisation. The application was approved by the NCLT, Ahmedabad. Further in the case of *Auspice Trading Private Limited v. Global Proserv Limited*⁴, for instance, the Applicant under Section 9 of the IBC, 2016 had placed orders for particular telecom equipment upon the Corporate Debtor and paid an advance based on commercial practice. The Applicant canceled the order and requested a refund of the advance payment. While the Corporate Debtor did refund a portion of the advance payment, the remaining total was still owed. Due to this, the applicant submitted an application for the Corporate Debtor to be admitted into Corporate Insolvency Resolution Process (CIRP). The Hon'ble NCLT, Mumbai, recognized the Applicant as an "operational creditor" according to the Code. In both of the cases mentioned above, NCLT has applied a purpose-driven interpretation and context-driven interpretation of 'operational debt' and concluded that claims made by the recipients of goods/services are included within its scope.

However, when it comes to the issue of a claim for a refund of the advance payment, the NCLT, Kolkata, has not taken such a broad interpretation of the phrase "operational debt". In *Ranual Technology Private Limited v. Calprin*

*Ads Private Limited*⁵, a creditor filed an application under Section 9 of the Code, alleging that the Corporate Debtor had received an advance of ₹10 lakhs as an "accommodation loan" but had failed to repay it despite repeated requests, and that this failure to repay the same amounted to an Operational Debt. The NCLT, Kolkata Bench rejected the creditor company's argument and ruled that the advance payment could not be taken into account. Further, in the case of *Daya Engineering Works Private Limited v. UIC Udhyog Limited*⁶, an application was filed under Section 9 of the IBC, 2016 but the matter was dismissed by the NCLT, Kolkata on the grounds that neither party had a written agreement that would have permitted the buyer to obtain a refund of the advance payment from the debtor in the event that the agreed-upon quantity of goods was not supplied or was not supplied in full and that there is no Operational Debt at all because the amount due to the applicant does not match any of the requirements specified for the definition of Operational Debt. The NCLT, Kolkata, in this case, adopted a narrower interpretation of 'operational debt'.

NCLAT in the matter of *Overseas Infrastructure Alliance (India) Private Limited v. Kay Bouvet Engineering Limited*, allowed the appeal and remitted the matter to the NCLT by adopting a much wider interpretation of the definition of operational debt' as contained in Section 5(21) of the Code.

The NCLAT, in various cases, has provided different interpretations on this matter. For instance, the creditor requested repayment of the advance from the corporate debtor in the case of *Overseas Infrastructure Alliance (India) Private Limited v. Kay Bouvet Engineering Limited*⁷, where the debtor was unable to pay and/or refused to do so. When the advance monies were not refunded, the creditor filed an application under Section 9 of the Code with NCLT, Mumbai, claiming that this created an "operational debt" and asking for the corporate debtor's admission into CIRP. The NCLT rejected the application on account of there being pre-existing disputes regarding the claim of the creditor. However, the NCLAT allowed the appeal and remitted the matter to the NCLT by adopting a much wider interpretation of the definition of operational debt' as contained in Section 5(21) of the Code

³ C.P. (I.B.) No. 33/9/NCLT/AHM/2017, order dated July 31, 2017.

⁴ CP No. 1584/IBC/NCLT/MB/MAH/2017, order dated February 23, 2018.

⁵ CP (IB) No. 212/KB/2018, order dated April 26, 2018.

⁶ CP (IB) No. 547/KB/2017, order dated May 16, 2018.

⁷ C.A. (AT) (Insolvency) No. 582 of 2018, judgment dated December 21, 2018.

and has construed the phrase 'a claim in respect of the provision of goods or services, as stated in such a definition, to not only cover claims from a supplier who has not received the agreed-upon payment from the buyer of its goods or services but also claims from a buyer/receiver who hasn't received the agreed-upon goods or services despite paying advance sums towards it.

Unfortunately, even after the ruling in *Kay Bouvet* (supra), conflicting orders were still being issued regarding whether or not an advance payment made by the buyer or receiver for the provision of goods and services counts as an Operational Debt.

Even though the facts of the present case were slightly different, the NCLAT's judgment in *Kavita Anil Taneja v. ISMT Limited*⁸ contains contradictory observations to those in *Kay Bouvet* (supra), further muddying the waters. The advance was held to be an amount not only for the supply of goods but also as a contribution to the establishment of a joint venture, and therefore could qualify as a "financial debt." Although the *Kay Bouvet* (supra) judgment was only handed down a month ago, the NCLAT appears to have changed its mind about how broadly it had interpreted Sections 5(20) and 5(21) of the Code in this judgment.

In a similar vein, the NCLAT ruled in the cases of *Roma Infrastructures India Pvt. Ltd. v. A.S. Iron & Steel (I) Private Limited*⁹, & *Andal Bonumalla v. Tomato Trading LLP*¹⁰, relied on its ruling in *Kavita Anil Taneja* (supra) and determined that a claim for a refund of the advance amount or balance of the advance amount, as applicable, would not fall under the definition of "operational debt" under Section 5(21) of the Code in cases where an advance payment had been made for the supply of goods and the supplier subsequently failed to supply all or part of the goods that had been agreed upon.

Following that, a new issue had come up before the Appellate Tribunal in the case of *Joseph Jayananda v. Navalmar (UK) Ltd*¹¹ while interpreting the situation, the Appellate Tribunal, among other things, took a different stance with regard to the same situation that had been decided and/or settled in the case of *Andal Bonumalla v.*

In the matter of *Joseph Jayananda v. Navalmar (UK) Ltd.*, the advance payment was given for projects and capital goods, but the Corporate Debtor altered the amount to account for cost and expense. The NCLAT considered the advance as Operational Debt.

*Tomato Trading LLP*¹². The advance payment in this instance was given for projects and capital goods, but the corporate debtor altered the amount to account for cost and expense. In this case, the NCLAT found that the advance granted by the creditor to the corporate debtor lacked any time value for money and, as a result, could not be regarded as a "financial debt." The payments owed under the transaction would be considered "operational debt" because the Corporate Debtor is an agent and service provider for the Operational Creditor.

In the recent landmark decision in the case of *Consolidated Construction Consortium Limited v. Hitro Energy Solutions Private Limited*¹³, the appellant (Consolidated Construction Consortium Limited) entered into a contract to supply light fittings to Chennai Metro Rail Limited (CMRL). The appellant had placed purchase orders pursuant to the contract with CMRL. CMRL sent a cheque for ₹50 lakhs to the proprietary firm on behalf of the appellant but afterward terminated the contract. While the appellant cleared the dues towards the CMRL, it itself was unable to recover the stated sum from the proprietary concern on account of some facts and circumstances. While the NCLT decided in favor of the appellant, the NCLAT decided against it. When the creditor went into appeal before the Supreme Court, the Apex Court observed that the term "operational debt" under Section 5(21) of the IBC, 2016 is defined as a "claim with regard to the provision of goods and services". As a result, it was stated that the definition does not limit the claim to simply those who provide goods and services, instead, it mandates that "the claim must have some relationship to the supply of goods or services, without identifying the supplier or recipient." "Operational debt" is defined by the Supreme Court as a debt that results from a payment made in advance to a corporation for the provision of goods or services.

⁸ C.A. (AT) (Insolvency) No. 545-546 of 2018, judgment dated January 24, 2019.

⁹ C.A. (AT) (Insolvency) No. 223 of 2019, judgment dated April 22, 2019.

¹⁰ C.A. (AT) (Insolvency) No. 752 of 2019, judgment dated August 20, 2020.

¹¹ C.A. (AT) (Insolvency) No. 718 of 2020, judgment dated April 7, 2021.

¹² C.A. (AT) (Insolvency) No. 752 of 2019, judgment dated 20 August 2020.

¹³ C.A. No. 2839 of 2020, Judgement dated February 04, 2022.

The distinction between the treatment of advance money provided by home buyers and advance payments made by recipients of goods and services has been addressed by the Supreme Court in the case of *Pioneer Urban Land and Infrastructure Ltd. v. Union of India*¹⁴, and further reiterated in the case of *Consolidated Construction Consortium Limited v. Hitro Energy Solutions Private Limited*¹⁵. The court highlighted the following differences to reconcile this differential treatment:

- i) Homebuyers give advance money to developers; however, operational creditors are providers of goods and services.
- ii) Contrary to home buyers, who have a crucial interest in the real estate project, operational creditors have no stake in the Corporate Debtor.
- iii) Because an Operational Debt is based on the goods or services the Operational Creditor provides, there is no consideration for the time value of money in an Operational Debt. However, in real estate developments, funds are raised from home buyers while taking the time value of money into account.

In summary, the court recognized these differences to explain why the advance money provided by home buyers is treated as Financial Debt, while advance payments made by recipients of goods and services fall under the category of Operational Debt under the Code.

5. Conclusion

In the beginning, the Hon'ble NCLAT and NCLTs expressed reluctance to broaden the meaning of "operational debt" as it is defined in Section 5(21) of the

Supreme Court in the case of *Consolidated Construction Consortium Ltd., v. Hitro Energy Solutions Private Ltd.*, has explained that why the advance money provided by home buyers is treated as Financial Debt but constitutes Operational Debt if made by recipients of goods and services.

IBC. But the Supreme Court's landmark judgment *Consolidated Construction Consortium Limited v. Hitro Energy Solutions Private Limited*, has brought essential clarity to the subject of Operational Debt. It is important to interpret terms like "claims" and "operational debt" broadly to protect the rights of operational creditors and avoid creating a separate category of creditors under the IBC.

It is illogical to assume that goods and services can only flow in one direction for a claim to arise. In the past, creditors seeking refunds of advance payments could file petitions for winding up a company's affairs under Section 433(e) of the Companies Act, 1956. Therefore, it is fair and just to allow providers of advance payments to claim as operational creditors under the IBC.

We have observed cases where advance payments made by a creditor to a Corporate Debtor are claimed as an operational debt under the Code. However, we are yet to witness cases where payments made by a creditor to a Corporate Debtor are categorized as Financial Debt under the definition outlined in Section 5(8)(f) of the Code, which reads, "any amount raised under any other transaction, including any forward sale or purchase agreement, having the commercial effect of a borrowing". If such matters were to be filed, it would introduce a new perspective that remains untouched as of today.



¹⁴ Writ Petition(s)(Civil) No. 43/2019, Judgment dated August 09, 2019.

¹⁵ C.A. No. 2839 of 2020, Judgement dated February 04, 2022.