

ERGO

Analysing developments impacting business

SC UPHOLDS NCLAT VIEW THAT A SECURITY DEPOSIT MAY CONSTITUTE A FINANCIAL DEBT IN CERTAIN CIRCUMSTANCES

6 May 2024

The Supreme Court (SC) in *Global Credit Capital Limited & Anr v. Sach Marketing Private Limited & Anr*, 2024 SCC OnLine SC 649 upheld the judgment and order of the National Company Law Appellate Tribunal, New Delhi Bench (NCLAT), dated 07 October 2021 (Impugned Order) by which Sach Marketing Private Limited (Sach) was held to be a 'financial creditor' of Mount Shivalik Industries Limited, the corporate debtor, (CD) in corporate insolvency resolution proceedings under the provisions of the Insolvency & Bankruptcy Code, 2016 (IBC). Sach's claim against the CD arose in respect of a security deposit provided by Sach to the CD under an agreement. The SC passed the common judgment and order in a group of appeals relating to claims against the CD which were raised by four persons claiming as financial creditors in the corporate insolvency resolution proceedings. The other claimants were lenders who provided financial assistance to the CD by way of unsecured loans. NCLAT held that Sach and the lenders were "financial creditors" for the purposes of IBC inasmuch as they had provided loans to the CD (MANU/NL/ 0454/2021 and MANU/NL/0480/2021). The successful resolution applicant challenged NCLAT's judgments and orders before the SC.

Facts giving rise to the present litigation:

1. Sach and the CD entered into two agreements in 2014 and 2015 (Agreements) by which CD appointed Sach as a "Sales Promoter" to promote the beer manufactured at its factory for a period of 12 months. Under the terms of the Agreements, Sach was liable to deposit certain amounts with the CD as security deposits which were repayable with interest by the CD.
2. In 2018, corporate insolvency resolution process was initiated against the CD. Sach filed a claim as a financial creditor claiming security deposit and interest as a "financial debt" which was rejected by the interim resolution professional (IRP) on the grounds that Sach could not be treated as a financial creditor. As against this, Sach preferred an application before the National Company Law Tribunal (NCLT) seeking a direction to admit its claim of Rs. 1.41 crore as a financial creditor. The NCLT dismissed Sach's application and Sach appealed to the NCLAT.
3. By virtue of the Impugned Order, the NCLAT allowed the appeal, holding that Sach was a financial creditor of the CD, and not an operational creditor. NCLAT relied upon the interpretation of "financial debt" in Orator Marketing Pvt Ltd v Samtex Desinz Pvt Ltd, (2023) 3 SCC 753 where the SC held that a transaction which has the commercial effect of borrowing falls within the definition of "financial debt" under Section 5(8)(f) of IBC. As against the Impugned Order, the present appeal came to be filed before the SC by the successful resolution applicant.

Submissions made before the SC:

4. It was contended by the Appellant before the SC that the Agreements were service agreements which indicated that the CD had appointed Sach to promote the beer manufactured by it, and this was a service rendered by Sach, and therefore the amounts paid towards security deposit were liable to be treated as an "operational debt" under Section 5(21) of the IBC, and not as a financial debt.
5. The Appellant further contended that the security deposit paid by Sach under the Agreements was merely a condition precedent to be satisfied for its appointment as a "Sales Promoter" of the CD, and that this could not be equated to money disbursed to the CD as a financial debt. Therefore, these amounts would not satisfy the definition of a "financial debt" under Section 5(8) of the IBC.
6. It was further contended that merely because the amounts paid towards security deposit were acknowledged by the CD in its books, and interest was payable towards the said amounts, would not be sufficient to treat the said amounts as a "financial debt" under the IBC.
7. Sach submitted that the Agreements did not contain any provision for deductions or forfeiture of the security deposits paid by Sach, and that the amounts paid towards the said deposits, were liable to be returned with interest. Therefore, from a holistic consideration of the facts, and considering the true nature of the Agreements, the NCLAT was right to hold the amounts paid towards the security deposit under the Agreements, as a 'financial debt', since all three criteria namely (i) disbursal, (ii) time value of money and (iii) commercial effect of a borrowing as specified under Section 5(8) of the IBC were satisfied.
8. The sole issue for consideration before the SC was whether the amounts paid by Sach to the CD as a security deposit under the Agreements, could be treated as 'financial debt' within the meaning of Section 5(8)(f) of the IBC.
9. The SC examined Section 3(6) and Section 3(11) of the IBC which define 'claim' and 'debt' respectively, holding that a 'claim' is a right to receive a payment whether under law, or equity, or arising as a remedy for breach of contract, and a 'debt', whether operational, or financial could only arise in respect of a claim under Section 3(6).
10. The SC also examined Section 5(8) of the IBC which defined the term 'financial debt', holding that the categories enlisted under sub-clauses (a) to (i) of Section 5(8), must satisfy the test of being a debt, along with interest if any, which is disbursed against the consideration for time value of money. The Court specifically emphasized Section 5(8)(f) which pertains to an amount raised under transaction which has the commercial effect of a borrowing.
11. In the above backdrop, the SC clarified that a debt arising out of a written agreement/arrangement providing for rendering of services, would be an operational debt, only if the claim made in respect of the debt, has some connection or nexus with the service rendered under the agreement. **The Court reiterated the real nature of the transaction would have to be determined, and the agreement could not be taken at face value. Therefore, merely because the written agreement is an agreement providing for rendering of services, would not always lead to a conclusion that the debt arising out of said agreement was an operational debt.**
12. In the facts, the Court found that the Agreements in question did not contemplate forfeiture of the security deposit paid by Sach. Nor was the security deposit linked to the performance of the other conditions of the Agreements or the service rendered by Sach under the Agreements. Therefore, the CD was liable to refund the security deposit amount with interest to Sach without any right of forfeiture, and Sach's right to seek a refund of the security deposit would amount to a "claim" within

the meaning of Section 3(6) of the IBC. The debt in question would be the amounts paid by Sach as security deposit which were repayable with interest by the CD.

13. In view of the specific finding that the security deposit was not linked to the performance of the services under the Agreement, the SC held that the said amounts could not be said to be an operational debt, since a plain reading of Section 5(21) which defines 'operational debt' indicates that it pertains to a claim arising in respect of the provision of goods or services.
14. The SC examined the definition of "financial debt" under Section 5(8)(f) which is "any amount raised under any other transaction having the commercial effect of a borrowing". The SC also noted the definition of "transaction" in Section 3(33) of the IBC which includes arrangements for transfer of assets, funds, goods from or to the CD. The SC also noted NCLAT's findings that the amounts paid towards the security deposit had been treated by the CD as long-term loans and advances in its financial statements, and that the CD had informed Sach that interest would be credited by the CD to Sach's account. In the facts, the SC came to a finding that the transaction between Sach and the CD fell within the definition of "transaction" under Section 3(33) as there was a written agreement for the transfer of funds to the CD. Further, the amounts raised under the two agreements by way of "security deposit" had the commercial effect of borrowing in as much as the CD treated the security deposits as borrowings.
15. On this basis, the SC upheld the Impugned Order, and held that the CD treated the said amounts as borrowings from Sach, and consequently, Sach was a financial creditor of the CD.

Comments

The SC held that a debt arising out of a written agreement must be examined to determine the real nature of the underlying transaction in order to determine whether a debt is a financial debt or an operational debt for the purposes of the IBC. Such an agreement would not be taken at face value, and it would be necessary for the claim to satisfy the respective requirements of operational debt or financial debt regardless of the nature of the written agreement. The SC further clarified that such a claim would fall within the meaning of "operational debt" if the subject matter of the debt had a connection with the service provided under the agreement.

- *Kumar Saurabh Singh (Partner); Thriyambak J. Kannan (Partner); Ashwiji Ramiah, (Principal Associate); Aditya Mukerjee (Senior Associate) and Hareepriya E. Narasimhan (Senior Associate)*

For any queries please contact: editors@khaitanco.com