

DEFINITION OF ‘FINANCIAL DEBT’ AND THE ‘COMMERCIAL EFFECT OF BORROWING’ TEST – WHAT IS THE FATE OF INTEREST FREE LOANS: A CASE COMMENT ON *ORATOR MARKETING V. SAMTEXDESINZ*

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I. Introduction

THE INSOLVENCY resolution process can be initiated under the Insolvency and Bankruptcy Code, 2016 (*hereinafter*, IBC), whenever a person defaults against any of its debts, which are due to any of its creditors. It is a very simplistic test in terms of the task before the judges in the Adjudicating Authority. If there has been a default then the application has to be admitted and the Corporate Insolvency Resolution Process (*hereinafter*, CIRP) commences. The IBC regime has however, created a legal difference between financial debt and operational debt. This difference is not found in any other jurisdiction.

The impact of this differentiation is profound on the rights and duties of the concerned stakeholders in the regime. Firstly, the financial creditors get a seat and voting rights in proportion to the debt which they are owed, in the Committee of Creditors (CoC), which is the primary commercial decision making body under the IBC process. Whereas, the operational creditors don’t get the membership of the CoC and the corresponding voting rights.

Secondly, the financial creditors have an easier mechanism under section 7 of the IBC to file an insolvency application and get it admitted, when compared to the operational creditors who have to file the application under section 9. For instance, section 7 doesn’t mandate a criteria for a demand notice, which an operational creditor has to supply under section 8, before they

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can even file an application. Thus, there is relatively lesser scope of litigation at the admission stage for a financial creditor when compared to an operational creditor.

This difference, for the abovementioned reasons, has led to substantial litigation on this front. To start with, the differentiation has been challenged before the Supreme Court as being violative of the equality clause of the Constitution under article 14.¹ The Court has however, consistently refused to interfere with the wisdom of the legislature on this issue.² Thus, financial and operational debt have been recognised to have different legal ramifications, where, financial debt leads to better rights for the creditors.

Therefore, the applicants under the IBC process have tried to classify the debt owed to them as financial debt, as it will lead to better rights being accorded to them. The initial judgements of the Supreme Court have held that the financial debt and the operational debt can be distinguished by relying on the concept of time value of money.³ This essentially means that the loan advanced to an entity should be on an interest. Interest free loans can't be termed financial debt. However, this understanding was reversed by the decision of the Supreme Court in *Orator Marketing Pvt. Ltd. v. Samtexdesinz Pvt. Ltd.*⁴ (hereinafter, *Orator*) wherein now it has been decided that even interest free loans can be termed financial debt. This write up will critically review the law laid down in the judgement while analysing the legal position which was prevailing before the judgement.

II. Statutory Scheme

In order to appreciate the judgement, we must refer to the statutory scheme of the IBC which is relevant in the context of the judgement. Since the judgment relates to the difference between financial and operational debt, it is important to refer to the relevant definition clauses which have been the basis of the various judgments of the Court.

The IBC defines 'debt' under section 3(11) as:

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

¹ See *Swiss Ribbons v. Union of India* (2019) SCC OnLine SC 73; and *Committee of Creditors of Essar Steel India Limited v. Satish Kumar Gupta*, (2019) SCC OnLine SC 1478.

² *Ibid.*

³ *Ibid.*

⁴ 2021 SCC OnLine SC 513.

The definition clearly identifies that debt can only be against a claim, which must also be due. Thus, a debt which doesn't give rise to a claim or is not due, will not be considered debt under the terms mandated by the section. The provision is also inclusive of the concepts of 'financial debt' and 'operational debt', which are separately defined under⁵. The IBC further defines 'claim' under section 3(6) as:

"claim" means –

- (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 provision is unambiguous when it connects claim to a 'right to payment'. Thus, debt is something which gives rise to a claim which is in the form of a right to payment. It is relevant now to refer to definitions of financial debt and operational debt. These are found under section 5, which is the definition clause applicable on Part II of the IBC, and governs the insolvency process for corporate persons. This is opposed to section 3, which is the definition clause applicable to the entire IBC. The relevant definitions are found under section 5(8) and section 5(21) respectively and are as follows:

Section 5(8):

- (8) "financial debt" means a debt alongwith interest, if any, which is disbursed against the consideration for the time value of money and includes–
- (a) money borrowed against the payment of interest;
 - (b) any amount raised by acceptance under any acceptance credit facility or its dematerialised 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 which is deemed as a finance or capital lease under the Indian Accounting Standards or such other accounting standards as may be prescribed;
 - (e) receivables sold or discounted other than any receivables sold on non-recourse basis;

⁵ IBC, s. 5.

- (f) any amount raised under any other transaction, including any forward sale or purchase agreement, having the commercial effect of a borrowing;⁶
- (g) any derivative transaction entered into in connection with protection against or benefit from fluctuation in any rate or price and for calculating the value of any derivative transaction, 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 sub-clause (a) to (h) of this clause;

Section 5 (21):

(21) “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;

The definition of operational debt is very clear and there is little scope of confusion. In normal parlance, operational debt is accrued on account of business operations of the company, whereas financial debt is accrued because money was borrowed by the company as finance for the company, like the working capital.

The definition of financial debt has scope of judicial interpretation in its first line itself because it mentions two seemingly contradictory things simultaneously. First, the clause mentions – *debt along with interest, if any*. The phrase ‘*if any*’ gives an impression that the debt may or may not be interest free, because it literally means that there may not be any interest associated with the debt, even then the debt can be financial debt.

Second, in the same line the provision adds - *which is disbursed against the consideration for the time value of money*. Here it mentions that the debt should mandatorily be disbursed against a consideration of time value of money. The time value of money is a concept of finance,

⁶ 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 s. 2 of the Real Estate (Regulation and Development) Act, 2016 (16 of 2016).

essentially meaning that the value of money invested is more and grows over time, when compared to value of money lying in a locker, where the owner loses the interest which can be earned even by depositing in a savings bank account. This means logically, that an interest free loan can never be disbursed against the consideration for the time value of money. Thus, there is a lot of confusion with respect to the fate of interest free loans and whether they are financial debts or operational debts.

III. Judicial Position Before the Case

Before this case, the issue of categorisation of an interest free loan as financial debt has not been directly dealt with by the Supreme Court. However, the concept of time value of money has been analysed by the Court in *Pioneer Urban Land and Infrastructure Ltd. v. Union of India*⁷ (*Pioneer*), in extensive detail. In this case the Court has held that:

The expression “disbursed” refers to money which has been paid against consideration for the “time value of money”. In short, the “disbursal” must be money and must be against consideration for the “time value of money”, meaning thereby, the fact that such money is now no longer with the lender, but is with the borrower, who then utilises the money.

The above paragraph certainly gives an impression that the court is emphasising that if any disbursement of debt is without time value of money can't be termed as a financial debt. However, it must be taken into context that the court was dealing with an entirely different question here, which was, if the advances taken by real estate developers from the homebuyers can be termed as financial debt. The court by using the above logic inferred that the advance amount taken by real estate developers is financial debt, because it accounts for time value of money. The entire judicial exercise in this judgment was to argue that the concerned real estate sector transactions have time value for money, which was necessary to prove the debts concerned were financial debts.

Moreover, the court has argued that section 5(8)(f) is a residuary provision which is a ‘catch all’ for any transaction which has a ‘commercial effect of borrowing’. The test employed in this provision is that the transaction should be in the form of borrowing and it should be commercial. The Court interpreted these two terms to argue that the loan should have a cost

⁷ (2019) 8 SCC 416.

associated with it in order for it to be termed ‘commercial’. This again if looked from another point of view will mean that an interest free loan can never have a commercial effect of borrowing and can’t incur financial debt. Though, it can technically be argued that the court here was considering an advance discounted transaction which a homebuyer undergoes at a discount in lieu of a higher price at the time of delivery of home.

Nevertheless, we can see that a clear judicial position emerging from the case on the necessity and criticality of time value of money as a test for the categorisation of a debt as financial debt.

IV. Decision in Orator – ‘Commercial Effect of Borrowing’ Test

The decision is important because it departed from the settled understanding of law on this point. As stated above, no Supreme Court decision had directly dealt with this issue before this as to what shall be the fate of debt which is disbursed without an interest being charged. This question was decided by the Court in this case in the following terms:

There was no occasion for this Court to consider the status of a term loan advanced to meet the working capital requirements of the Corporate Debtor, which did not carry interest. Having regard to the Aims, Objects and Scheme of the IBC, there is no discernible reason, why a term loan to meet the financial requirements of a Corporate Debtor for its operation, which obviously has the commercial effect of borrowing, should be excluded from the purview of a financial debt.

The Court here is right in the first line, there has not been a direct consideration by the Apex Court before this on the issue. However, the Court does not give any reasons elsewhere in the judgement also as to why such a loan - *obviously has the commercial effect of borrowing?* This was very necessary because of extensive exposition on this point by Justice Nariman in *Pioneer*, wherein it was held that something which is commercial has to be necessarily done with an intent of profit. The court had discussed the meaning of the word “commercial” as found in Collins English Dictionary & Thesaurus (Second Edition, 2000) as follows:

“commercial. -adj.

1. of or engaged in commerce.
2. sponsored or paid for by an advertiser: commercial television.
3. having profit as the main aim: commercial music.
- 4.(of chemicals, etc.) unrefined and produced in bulk for use in industry.

5. a commercially sponsored advertisement on radio or television.

After reproducing the meaning of the word commercial as above, the court deduced the law as mentioned below:

Also of importance is the expression “commercial effect”. “Commercial” would generally involve transactions having profit as their main aim.

The issue which the Supreme Court decided in *Orator*, is clearly covered by the abovementioned law, as laid down in *Pioneer*. Therefore, there are two fundamental issues with the judgement in *Orator*.

First, the Court entirely overlooked this portion of the judgment in *Pioneer*. To be fair, the Court could have arrived at the same conclusion at which it did, but it had to necessarily refer to the relevant portion of an earlier precedent. This is even more important because the Court did refer to *Pioneer* in its judgement but failed to refer to the test laid down in it. Thus, not referring to the relevant portion is itself an inaccuracy in the judgment.

Second, what the court decided is diametrically opposite to what it decided in *Pioneer*, even though in *Orator* the court believed that it is following *Pioneer*. In *Pioneer*, it was held that to have a commercial effect any particular action should be done with an aim of profit. No one can argue that an interest free loan can have profit as its aim, because of the virtue of the fact that no profit is being generated when no interest is being charged. In fact, a loan disbursed at no interest is actually a loss transaction for the lender because the value of the money is depreciating with time on account of inflation. The Court should have argued on this point that why will this financial arrangement will have the commercial effect of borrowing because it doesn't get established automatically, even more so because of the judgement in *Pioneer*.

This point can be appreciated better by referring to the facts of the case. It has been admitted in the loan agreement between the parties itself that lender is a related party to the borrower and no financial institution was otherwise willing to supply working capital to the corporate debtor and that's why the lender supplied the interest free loan. This makes it even more clear that there was no commercial dimension to the loan advanced. No other financial institution was willing to supply the loan, because it made no commercial sense to them as the corporate debtor was already under major debt. It was a gesture of benevolence on part of the lender simply because the borrower was a sister concern. Yet, if the Court felt that this arrangement

has commercial effect of borrowing then the same should have been argued because it is not obvious. What is actually obvious is something which is contrary to what court deduced.

V. The Ambit of Section 5(8)

The court further held that the definition of financial debt under section 5(8) is extensive and not restrictive and argued:

23. Furthermore, sub-clauses (a) to (i) of sub-section 8 of section 5 of the IBC are apparently illustrative and not exhaustive. Legislature has the power to define a word in a statute. Such definition may either be restrictive or be extensive. Where the word is defined to include something, the definition is *prima facie* extensive.

24. In *Dilworth v. Commissioner of Stamps the Privy Council*, dealing with a definition which incorporated the word “include”, said, “The word ‘include’ is very generally used in interpretation clauses in order to enlarge the meaning; and when it is so used these words or phrases must be construed as comprehending, not only such things as they signify according to their natural import, but also those as things which the interpretation clause declares that they shall include. But the word ‘include’ is susceptible of another construction, which may become imperative, if the context of the Act is sufficient to show that it was not merely employed for the purpose of adding to the natural significance of the words or expressions defined. It may be equivalent to ‘mean and include’, and in that case it may afford an exhaustive explanation of the meaning which, for the purposes of the Act, must invariably be attached to these words or expressions.

The entire argument of the Court is trying to draw the conclusion that the definition is wide enough and can include terms which are not explicitly mentioned in the sub-provisions. This rule of interpretation is well accepted and true. However, can terms which are directly opposite to the ones mentioned in an inclusive definition be interpreted by the court is the real issue at hand. This is so because section 5(8)(a) reads - *money borrowed against interest*. If *money not borrowed against interest* is to be interpreted within the general ambit of the provision, then the reasoning given by the court is lacklustre and doesn't explain any cogent rationale behind doing the same.

It is well established that the courts are free to liberally interpret provisions especially if they further the aims and objectives of the law. However, if there are illustrative situations

mentioned in the provision concerned, it is very difficult to argue that the court can also interpret situations which are directly opposite to the illustrations given in the law. On this count also, this decision suffers from a major infirmity.

VI. Conclusion

The IBC is a commercial law, which seeks to implement a vision of economic policy. As has been enunciated by the Court in *Swiss Ribbons v. Union of India*⁸, the Courts don't have a major role in deliberating upon the economic policy as contained in the law. This observation was in the context of differentiation created by the law between the financial creditors and the operational creditors. It is accordingly, cannot be contested that the legislature is not free to frame a law which furthers the economic vision of the government of the day. However, the problem which the courts have been dealing with situation is that the vision is not clearly reflected by the language of the law, so as to make the Courts understand what does the legislature exactly want.

Consequently, and most importantly, the error is in the drafting and in the language of the statute where two competing interpretations are legitimately possible, giving rise to litigations of this kind. The Court in *Pioneer* went with one interpretation and with another in *Orator*. This writeup focuses more on the methodology which the Court adopted in *Orator* while reaching the conclusion which it did. It should have reached the interpretation by arguing that it is changing its point of view from *Pioneer*. Ironically, the Court has cited *Pioneer* as one of the authorities in the support of the argument which it was making.

On the substantive ramification of the question which has been decided, it is very difficult to argue that if any entity advances a loan to another without charging any interest, it does so with a commercial motive. Yet, it can be argued that such an entity is a financial creditor because the money so lent is used to fulfil the working capital requirements of the company. Accordingly, it is necessary that detailed regulations are laid down by the executive to clarify the position, which has the potential of giving way to major litigations. Ideally, section 5(8) should be amended and worded in a simpler language identifying the clear policy intention of the government. Nevertheless, the Court should adopt a method of interpretation which takes into account its own earlier verdicts in the spirit they were pronounced and should provide arguments to negative the precedent if that is what it wants to do. In the absence of these, the

⁸ *Supra* note 1.

legal position becomes muddled which is especially not desirable for a commercial law like the IBC.