



Re-classifying Debt in Insolvency: An Analysis

Sainik Industries Private Limited versus Ritesh Raghunath Mahajan RP, Indian Sugar Manufacturing Company Limited

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Introduction

The classification of debts as “*financial*” and “*operational*” under the Insolvency and Bankruptcy Code, 2016 (IBC) has been a pivotal issue in Corporate Insolvency proceedings. The case of *Sainik Industries Private Limited versus Ritesh Raghunath Mahajan*¹ decided by the Hon’ble National Company Law Appellate Tribunal, New Delhi (NCLAT) revisits this debate by addressing whether an advance payment made for the supply of goods, secured and bearing interest, can be construed as a Financial Debt. Through this case, the Hon’ble Appellate Tribunal reinforced the principle that a transactions essence must determine the debts nature.

This Article analyses the ruling of the NCLAT in the aforementioned case and the Tribunal’s reliance on the Supreme Court’s Judgment in *Consolidated Construction Consortium Ltd. v. Hitro Energy Solutions Pvt. Ltd.*² to delineate the fine distinction between financial and operational debts in commercial contracts.

Provisions of the law under question

1. Section 5(8), IBC³ defines “financial debt” as “a debt along with interest, if any, which is disbursed against the consideration for the time value of money”. This section further includes various forms of credit transactions. The core element of a financial debt is the disbursal of money that carries an obligation to repay with consideration for the time value of money. The intention is to capture transactions that resemble borrowing, including those not traditionally structured as loans but which perform an equivalent economic function.
2. Section 5(21), IBC defines “operational debt” as “a claim in respect of the provision of goods or services including employment or a debt in respect of the 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”. An operational debt arises from routine business operations, such as the supply of goods or rendering services. It does not require a disbursal against the time value of money, unlike a financial debt.

Procedural History and Relevant Facts

The insolvency process against Indian Sugar Manufacturing Company Ltd. was initiated by the Hon’ble NCLT, Mumbai, vide Order, dated 23.03.2023. Pursuant to the same, *Sainik Industries Pvt. Ltd* filed an Application bearing IA No. 2909 of 2023 under Section 60(5) of the IBC, challenging the rejection of its claim of ₹34.65 crores as a financial debt by the Resolution Professional of the Corporate Debtor. The claim, originally submitted in the Form C (designated for financial creditors), was denied by the IRP vide email dated 01.06.2023, asserting it to be an operational debt, wherein the Hon’ble NCLT, Mumbai vide its Order, dated 23.03.2023, rejected the submission of the Appellant with respect to admission of its claim as a Financial Creditor, thereby upholding the decision of Resolution Professional. This led to an Appeal before the NCLAT.

The Applicant had entered into a Supply-cum-Loan Agreement with the Corporate Debtor dated 28.07.2016, for the purpose of 5,200 MT of sugar at a predetermined price. A sum of

¹ (2024) SCC Online NCLAT 63

² (2022) 7 SCC 164

³ Insolvency and Bankruptcy Code 2016



Rs.10,00,00,000/- (Rupees Ten Crores only) was paid as an advance backed by a pledge of 10% of the Corporate Debtor's equity shares. The Agreement also contained the clause with respect to issuance of security cheques by the Corporate Debtor towards refund of the advance amount.

Due to non-fulfilment of supply obligations, the Appellant requested the Corporate Debtor to refund the advance amount paid, however the Corporate Debtor failed to refund the same and in lieu of the same, the Appellant deposited the security cheques received from the Corporate Debtor, which were ultimately dishonored. Pursuant to the same, the Appellant filed proceedings under Section 138 of the Negotiable Instruments Act and filed a Commercial Suit before the Delhi High Court.

Issues involved

1. Whether the transaction between the Appellant and the Corporate Debtor qualifies as a Financial Debt under Section 5(8) of the IBC?
2. Whether the inclusion of interest, penalties, and securities can transform a supply advance into a Financial Debt?

Analysis and application of Law to Facts

The NCLAT emphasized the substance over form approach, relying on both the contractual clauses and the NCLT, Mumbai findings. It noted that the primary intent was the procurement of goods, and that the advance was to be adjusted to the supply of the foods. Interest was stipulated only upon failure to supply and refund, and not as a standalone consideration for lending. The interest and security mechanisms were merely ancillary protections, common even in operational contracts, and could not transform the nature of the transaction.

To buttress this view, the NCLT relied upon the Supreme Court's ruling in *Consolidated Construction Consortium Ltd. v. Hitro Energy Solutions Pvt. Ltd.*, where it was categorically held that advances paid for the supply of goods or services fall squarely within the ambit of operational debt. The Apex Court clarified that the existence of an advance payment or even default does not ipso facto convert such a debt into a financial obligation.

The Appellant relied on *Pioneer Urban Land and Infrastructure Ltd. v. Union of India*⁴, wherein the Hon'ble Supreme Court interpreted Section 5(8)(f) to include homebuyers as Financial Creditors due to the commercial effect of borrowing in real estate transactions. However, the NCLAT distinguished this case by pointing out that real estate Projects entail long-term staged financing by homebuyers, akin to loans, whereas Sainik's transaction was a one-time advance for the purchase of goods.

The NCLAT meticulously analyzed the Clauses of the Agreement- Clause 2: Provision for penalty upon non-supply. Clause 4: Price differential clause in case of market fluctuation. Clause 5: Interest for non-refund of advance. Clause 7 and 11: Security cheques and equity pledge. The Hon'ble NCLAT after examining the clauses of the Agreement, held that such clauses are common in supply contracts and do not convert the commercial character into a financial arrangement. The intention of the parties, commercial practice, and the nature of the transaction all indicated an operational debt.

Further, the Appellant's prior filing under Section 9 was cited as reflective of their understanding of the debt's character, despite the argument that there is no estoppel against law.

Whereas, the NCLT, Mumbai, had concluded that, firstly, the advance was made for supply, not for time-value or financial investment. Secondly, interests and securities in the agreement did not alter the essential characteristics of the debt. Thirdly, the claim must be treated as an operational debt, not a financial one.

⁴ (2019) 8 SCC 416



Given the foregoing discussions, NCLAT held that no error has been committed by the Adjudicating Authority (NCLT, Mumbai) in rejecting IA No. 2909 of 2023 filed by the Appellant. Appellant's claim has rightly been held to be operational debt. The Appellate Tribunal did not find any error in the Impugned Order. The Appeal was subsequently dismissed.

Conclusion

The Judgment *Sainik Industries Private Limited versus Ritesh Raghunath Mahajan RP* is a reaffirmation of the principle that form must not prevail over substance in insolvency proceedings. The NCLAT's approach rightly focuses on the purpose and structure of the underlying transaction to determine the nature of the debt. Even if security and interest mechanisms are present, if the primary objective is the supply of goods, the debt remains operational. The reliance on *Consolidated Construction Consortium Ltd. v. Hitro Energy Solutions* adds to the growing body of jurisprudence seeking clarity and precision in creditor classification. This decision also underscores the responsibility of resolution professionals to conduct substantive assessments beyond procedural missteps.

Ultimately, this ruling provides crucial guidance for both Creditors and the Resolution Professionals in classifying claims under the IBC, reinforcing the presidential boundary between commercial transactions and financial lending.
