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FOREWORD

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Happy Reading.

(Editorial Board)

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THE BIASED POSITION OF OPERATIONAL CREDITORS – WHY THE CODE REQUIRES REVAMPING?

BY AKHIL KUMAR GOYAL¹ & HARSH GOYAL²

- **INTRODUCTION:**

It is well established fact that civil recovery matters take a long time to decide. Because of low recoverability, there is a low credit discipline in trade. This affects businesses as it often leads to large working capital requirement and thus more stress on margins.

Earlier, there was an option to initiate winding up petitions of insolvent corporate debtor before High Courts under Companies Act, 1956. However, the prohibitive cost of litigation and long litigation period often acted as dampener for actions by Creditors.

There has been a major shift with Insolvency & Bankruptcy Code (hereinafter referred as ‘The Code’), and now an operational creditor can also initiate action under IBC for recovery of its dues under very cost effective manner.

IBC, 2016 was notified by the Government of India on 28th May 2016. The Act consolidates and amends the laws relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximisation of value of assets of these persons, to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders. The code has also changed the order of priority of various payment dues and has given foremost priority to the payments of workmen’s dues even above Government dues, which are now to be made only after payment of financial debts owed to unsecured creditors. The code provides the complementary ecosystem for the insolvency law, and aims to ensure smoother settlement of insolvency cases, enable faster turnaround of businesses and provide for creating a database of creditors.

An operational creditor can initiate Corporate Insolvency Resolution Process (hereinafter referred to as “CIRP”) under Section 9 of the Code, The basic departure from the old law and fundamental rule under this new codified law is that a company which has gone insolvent

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cannot start the Liquidation process at the primary stage until and unless it has gone through the process of CIRP and the Code looks into the options for revival of the company.

- **WHO IS AN OPERATIONAL CREDITOR?**

According to Section 5(20) of the Code “Operational Creditor” is a person to whom operational debt is owed and includes such person to whom such debt has been legally assigned or transferred. However, the Code does not define “operational debt” per se.

A creditor would fall into the category of operational creditor only if an operational debt is owed to him. What exactly will fall under operational debt becomes clear from the case of *Vinod Awasthy v A.M.R Infrastructures Limited*³. 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.*”⁴

If the debt owed to the operational creditor does not fall in any of these four categories, the creditor cannot be called ‘operational creditor’ and hence he cannot initiate corporate insolvency resolution process against the corporate debtor.

- **FILLING OF APPLICATION: STEPS TO BE FOLLOWED:**

An operational creditor may make an application to the Adjudicating Authority for initiation of CIRP in accordance to Section 9 of the Insolvency and Bankruptcy Code, 2016 and Regulation 7 of the IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016. No operational creditor can apply for initiating CIRP if the defaulting amount is less than 100,000 by the corporate debtor. The process of initiating CIRP by an operational creditor primarily includes four steps as discussed hereunder:

First: A demand notice is delivered to corporate debtor by operational creditor as per sec 8 of code demanding payment in respect of the operational debt of which the default has occurred. The demand notice shall be in prescribed Form 3 or a copy of an invoice with a notice in Form 4 (under Rule 5 of the Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016)

³ Vinod Awasthy v A.M.R Infrastructures Limited, C.P. No. (IB)10(PB)/2017.

⁴ *Id.*

Secondly: The Corporate Debtor has to communicate to operational creditor within 10 days of receipt of the demand notice the existence of any dispute or payment of the unpaid operational debt. It is important to note that the dispute raised by corporate debtor has to be pre-existing to the demand notice issuance date.

Thirdly: If the operational creditor does not receive any payment or notice of dispute at the expiry of 10 days of delivering the demand notice to the corporate debtor, the operational creditor may make an application to the Adjudicating authority for initiation of CIRP under Section 9 of the code in Form 5 along with the documents evidencing the amount of debt claimed along with a copy of certificate from the financial institution maintaining accounts of the operational creditor confirming that there is no payment of an unpaid operational debt by the corporate debtor.

It is not mandatory for the operational creditor to propose the name of a resolution professional to act as an Interim Resolution Professional.⁵

Fourthly: The applicant (operational creditor) serves, a copy of the application made to the adjudicating authority (NCLT) to the corporate debtor at his registered office by speed post or registered post.

A nominal fee of Rs. 2000/- is charged for filing petition in NCLT. CIRP thus gets initiated against a corporate debtor by an operational creditor.

Once the Corporate Insolvency Resolution Process is initiated, the Interim Resolution Professional collects and verifies the claims of various debtors and constitutes a Committee of Creditors.

- **COMMITTEE OF CREDITORS:**

The Committee of Creditors is the linchpin of the Corporate Insolvency Resolution Process and all major decisions are routed *via* the Committee. However, as per section 21 of the Insolvency and Bankruptcy Code, 2016 ('Code'), the Committee of Creditors is solely comprised of the financial creditors unless no financial creditors exist.⁶

⁵ The Insolvency and Bankruptcy Code, 2016, No. 31, Acts of Parliament, Section 9.

⁶ The Insolvency and Bankruptcy Code, 2016, No. 31, Acts of Parliament, Section 21.

- **OPERATIONAL CREDITORS UNDER CoC: EXAMINING THE LEGAL DIMENSIONS:**

Operational creditors are only allowed to send one representative if their aggregate dues are not less than 10% of the total debt,⁷ but such a representative does not possess voting rights in such meetings. Furthermore, if the debts owed to the operational creditors do not make up 10% of the total debt, then they are completely left out of the meetings of the CoC and are even not notified about the meetings of CoC.⁸ On the other hand, a financial creditor have the right to participate in the meetings of the Committee of Creditors and also vote even if the percentage of debt owed to the financial creditor is less than 1% of the total debt.⁹

It is pertinent to mention that financial creditors are not neutral parties who have no personal interest. The aim of every financial creditor being a commercial entity is to ensure that the maximum dues are recovered qua their debts and the dues of operational creditors are a secondary concern at best. This problem is compounded by the lack of safeguards under the IBC, 2016 to protect the rights of the operational creditors. The only safeguard that is available to operational creditors is under Section 30 (2) (b) of the Code, which provides that a resolution plan has to ensure that the operational creditor receives at least the amount which would have been paid to the operational creditors if the corporate debtor had been liquidated i.e. the operational creditors must at least receive the liquidation value.¹⁰

- **RECENT DEVELOPMENTS IN THE CODE: TRACING THE EVOLUTION OF BANKRUPTCY LAWS IN INDIA:**

The IBBI had passed the Insolvency Resolution Process for Corporate Person (Amendment) Regulation, 2018 whereby it had become mandatory for the fair value of the assets of the corporate debtor also to be determined in addition to the liquidation value. Liquidation value is defined under Regulation 38 of the Insolvency Resolution Process for Corporate Persons Regulations, 2016 as the estimated realisable value of the assets of the corporate debtor if the corporate debtor were to be liquidated on the insolvency commencement date. However, there may be a huge difference between the actual value of the assets of a corporate debtor and its liquidation value.

⁷ The Insolvency and Bankruptcy Code, 2016, No. 31, Acts of Parliament, Section 24(3)(c).

⁸ Insolvency Resolution Process for Corporate Persons Regulations, 2016, Regulation 24 (7).

⁹ The Insolvency and Bankruptcy Code, 2016, No. 31, Acts of Parliament, Section 5 (28).

¹⁰ The Insolvency and Bankruptcy Code, 2016, No. 31, Acts of Parliament, Section 30(2).

Prior to the amendments enacted to the IBC in October 2018, there was very little protection available to an operational creditor. The erstwhile regulation 38(1) of IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2018 made matters even more complex. The said regulation provides that the resolution plan should identify the specific sources of funds that will be used to pay the liquidation value which is due to the operational creditors and make such payments in priority to the financial creditor. Such payments are required to be made prior to the expiry of 30 days after the approval of a resolution plan by the NCLT.¹¹

- **THE POSITION OF OPERATIONAL CREDITOR POST 2018 AMENDMENT: IDENTIFYING THE REALITY OF THE LATEST CHANGES:**

This amendment provided some relief to the operational creditors. However the CoC still comprises of financial creditors only and have the sole right to decide the amounts payable to an operational creditor. The amendment has failed to bring any significant change in the position of operational creditor and only brought in parity with respect to the priority of the payments to be made.

The amendment also provides that the fair value and liquidation value which shall be provided to the Committee of Creditors after the receipt of the resolution plans and the same shall be kept confidential. No mention is made of providing the fair value and liquidation value to the operational creditors unless they have a representative on the Committee of Creditors as aforesaid which further handicaps the operational creditors. Even if the representative of the operational creditors is present, he/she cannot vote to accept a resolution plan which provides operational creditors with more than the liquidation value. The most that they can do is to attempt to convince the financial creditors to vote for such a resolution plan.

This can lead to absurd situations. For example, if an operational creditor approaches the adjudicating authority and initiates Corporate Insolvency Resolution Process against the corporate debtor by spending its own funds, even then the operational creditor will have no voting right to determine which resolution plan should be accepted. If the operational creditor had been owed a debt of Rs. 10 crores and financial creditors as a whole were only owed Rs. 5 crores, the decision-making power would still lie in the hands of the financial creditors and the operational creditor would be a spectator at best despite being owed the majority of the debt.

¹¹ Insolvency Resolution Process for Corporate Persons, 2018, Regulations 38(1).

The financial creditors will be free to accept a haircut of the debt owed to the operational creditor and force the operational creditor to accept the minimum repayment of the debt due i.e. liquidation value while the Financial Creditors enjoy full repayment of their loans. The Resolution Applicants would also be tempted to reduce the operational creditors compensation to the liquidation value as long as they can obtain votes from the financial creditors to whom they promise full payment.

• **THE WATERFALL PROVISION FOR REPAYMENT OF DUES UNDER THE CODE:**

All was well before the NCLAT, New Delhi in its decision in *Binani Industries* held that “the ‘I&B Code’ or the Regulations framed by the IBBI do not prescribe differential treatment between the similarly situated ‘Operational Creditors’ or the ‘Financial Creditors’ on one or other grounds”.¹²

Prior to this decision the common understanding was that the IBC gave an upper hand to Financial Creditors vis-à-vis Operational Creditors. This could be seen through various provisions of the code. Section 21 of the code provides that the Committee of Creditors shall comprise only of Financial Creditors, and Section 53 (also known as the “waterfall” provision) accords priority of treatment to Financial Creditors over all other classes of creditors in the matter of repayment of dues of which Operational Creditors are included in these “other classes of creditors”.¹³

Financial Creditors are covered under sub-clause b(ii), (d) and e(ii) of sub-section (1) of section 53 whereas Operational Creditors fall under sub-clause (f) of sub-section (1) of section 53. Hence, Financial Creditors rank higher than Operational Creditors and their dues are, therefore, required to be paid in priority over the latter.

Though Section 53 finds place in Chapter III – Liquidation Process, sub-clause (b) of sub-section (2) of Section 30 specifically makes it applicable to Chapter II – Corporate Insolvency Resolution Process with only caveat that the resolution plan must allocate to the Operational Creditors at least the amount which they would have received in the event of liquidation of the Corporate Debtor. In other words, sub-clause (b) prescribes only a lower limit on the amount that is to be paid to Operational Creditors in a resolution process carried out under Chapter II of the Code. This minimum amount can be easily ascertained by calculating the Corporate

¹² *Binani Industries Ltd. v. Bank of Baroda & Anr., Company Appeal (AT) (Insolvency) No. 82 of 2018.*

¹³ The Insolvency and Bankruptcy Code, 2016, No. 31, Acts of Parliament, Section 53.

Debtor's liquidation value and subtracting there from the total dues of Financial Creditors and other persons ranking above the Operational Creditors in the waterfall provision.

The actual implication of these provisions is seen in cases where the Financial Debt of a Corporate Debtor exceeds its Liquidation Value by a considerable margin and the Resolution Plan offers a sum that is insufficient to repay the entire Financial Debt. In such cases, by virtue of the waterfall provision, nothing remains to be paid to Operational Creditors as the resolution amount gets exhausted in repaying the debts/sums ranking higher than the dues of Operational Creditors under Section 53. Only when the resolution amount exceeds the dues of Financial Creditors does the question of repaying the Operational Creditors arise.

➤ **OPERATIONAL CREDITOR AT PAR WITH FINANCIAL CREDITOR : THE NCLAT VIEW:**

The decision in Binani Industries, however, virtually rewrites these provisions and declares that the dues of Financial and Operational Creditors must get "similar treatment" in a resolution process, and that Section 53 cannot be relied upon while approving the Resolution Plan. The following extracts from the aforesaid decision deserve to be quoted:

The court held that "*the liabilities of all creditors who are not part of 'Committee of Creditors' must also be met in the resolution*"¹⁴. "*A creditor cannot maximise his own interests in view of moratorium.*"¹⁵ "*Further the 'Financial Creditors can modify the terms of existing liabilities, while other creditors cannot take risk of postponing payment for better future prospectus*"¹⁶. "*That is, 'Financial Creditors' can take haircut and can take their dues in future, while 'Operational Creditors' need to be paid immediately.*"¹⁷

The court further went on to say that "*if one type of credit is given preferential treatment, the other type of credit will disappear from market.*"¹⁸ "*If the 'Operational Creditors' are ignored and provided with 'liquidation value' on the basis of misplaced notion and misreading of Section 30(2)(b) of the 'I&B Code', then in such case no creditor will supply the goods or render services on credit to any 'Corporate Debtor'.*"¹⁹ "*All those who will supply goods and provide services, will ask for advance payment for such supply of goods or to render services*

¹⁴ Binani Industries Ltd. v. Bank of Baroda & Anr., Company Appeal (AT) (Insolvency) No. 82 of 2018.

¹⁵ Binani Industries Ltd. v. Bank of Baroda & Anr., Company Appeal (AT) (Insolvency) No. 82 of 2018.

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

which will be against the basic principle of the 'I&B Code' and will also affect the Indian economy.” “Therefore, it is necessary to balance the 'Financial Creditors' and the 'Operational Creditors' while emphasizing on maximization of the assets of the 'Corporate Debtor'.” “Any 'Resolution Plan' if shown to be discriminatory against one or other 'Financial Creditor' or the 'Operational Creditor', such plan can be held to be against the provisions of the 'I&B Code'.”²⁰

“Therefore, the dues of creditors of 'Operational Creditors' must get at least similar treatment as compared to the due of 'Financial Creditors'.”

- **ANALYSING THE OPEN ENDED JUDGEMENT: PROBLEMS NEED TO BE ADDRESSED:**

The aforesaid decision presents the following problems. *First*, it virtually rewrites the provisions of the Code by excluding the applicability of Section 53 from resolution process carried out under Chapter II of the Code, contrary to the plain and unambiguous language of Section 30(2)(b). *Secondly*, it fails to recognize the legislative intent in creating a distinction between two classes of creditors, viz. Financial Creditors and Operational Creditors and instead, virtually erases the said distinction, once again over-stepping the limits of its jurisdiction and wrongly exercising law-making powers. *Thirdly*, it relies on conjectures and extraneous considerations for bolstering its position. There is no factual basis for observing that Operational Creditors will “*refuse to supply goods or render services on credit*” or “*ask for advance payment for such supply of goods or to render services*” if their dues are not given priority.

There are many other grounds on which the aforesaid decision can be questioned. The fact remains that the aforesaid decision, rightly or wrongly, places Financial and Operational Creditors on an equal footing, thus virtually erasing the distinction specifically carved between these two classes of creditors by the provisions of the Code. Shortly after it was pronounced, the above decision was upheld by the Supreme Court of India through an unreasoned order and has thus attained finality.

²⁰ *Id.*

- **INTELLIGIBLE DIFFERENTIA VALID - SUPREME COURT:**

Supreme Court shortly after the decision of NCLAT delivered a landmark judgement in *Swiss Ribbons*²¹ upholding the constitutional validity of various IBC provisions including, *inter alia*, the waterfall provision i.e. Section 53. The hon'ble court held that the classification between Financial and Operational Creditors is neither discriminatory, nor arbitrary, nor violative of Article 14 of the Constitution of India, and that there is obviously an intelligible differentia between the two classes of creditors which has a direct relation to the objects sought to be achieved by the Code. While upholding the validity of Section 53, the Court observed as under:

“It will be seen that the reason for differentiating between financial debts, which are secured, and operational debts, which are unsecured, is in the relative importance of the two types of debts when it comes to the object sought to be achieved by the Insolvency Code. We have already seen that repayment of financial debts infuses capital into the economy inasmuch as banks and financial institutions are able, with the money that has been paid back, to further lend such money to other entrepreneurs for their businesses. This rationale creates an intelligible differentia between financial debts and operational debts, which are unsecured, which is directly related to the object sought to be achieved by the Code. In any case, workmen's dues, which are also unsecured debts, have traditionally been placed above most other debts. Thus, it can be seen that unsecured debts are of various kinds, and so long as there is some legitimate interest sought to be protected, having relation to the object sought to be achieved by the statute in question, Article 14 does not get infringed. For these reasons, the challenge to Section 53 of the Code must also fail.”²¹

Though the court is quite clear about the position of operational creditor, it still does not countenance Binani's exclusion of Section 53 from Chapter II of the Code. What follows from a combined reading of both judgments is, that even though there exists intelligible differentia for differentiating between Financial and Operational Creditors, they would still be treated at par for the purposes of repayment of dues pursuant to a Corporate Resolution Insolvency Process under Chapter II of the Code. This presents an inherent contradiction leading to uncertainties in the outcome of resolution process.

²¹ Swiss Ribbons Pvt. Ltd. v. Union of India, Writ Petition (Civil) No. 99 of 2018.

The situation is further confounded by the following paragraphs of the Supreme Court's decision:

*"The NCLAT has, while looking into viability and feasibility of resolution plans that are approved by the committee of creditors, always gone into whether operational creditors are given roughly the same treatment as financial creditors, and if they are not, such plans are either rejected or modified so that the operational creditors' rights are safeguarded. It may be seen that a resolution plan cannot pass muster under Section 30(2)(b) read with Section 31 unless a minimum payment is made to operational creditors, being not less than liquidation value. Further, on 05.10.2018, Regulation 38 has been amended. The aforesaid Regulation strengthens the rights of operational creditors by statutorily incorporating the principle of fair and equitable dealing of operational creditors' rights, together with priority in payment over financial creditors."*²²

Here, the Supreme Court is seen to be supportive of the Binani ratio that the dues of Financial and Operational Creditors are to be treated on equal footing. In fact, the Supreme Court has gone one step further and observed that the amended Regulation 38 ensures priority of repayment to Operational Creditors over Financial Creditors.

In the face of these ambiguities and contradictions, it would be safe to say that the question of applicability of Section 53 to Chapter II of the Code was not in issue before the Supreme Court and hence, the above observations cannot be taken as a precedent. However, the decision in Binani Industries is still good law, as also the basis for challenge by Operational Creditors to Resolution Plans that do not provide for repayment of their dues at par with the dues of Financial Creditors.

- **CONCLUSION:**

Based on the existing judgements, it is evident that doors are not open in case of recovering the debts of operational creditors under IBC. Also, the interest of the Operational Creditors is not fully protected under IBC as they cannot raise their voice in the CoC formed with the Financial Creditors as per the existing provisions under IBC.

²² *Id.*

With the new interpretation given to the aforesaid provisions in Binani Industries, the Operational Creditor is now at liberty to challenge the above resolution plan on the ground of “discrimination”. However, there is no clarity on;

- What Must Be Done Once Such Challenge Is Made?
- How Should The Resolution Amount Be Distributed Between The Financial And Operational Creditors?
- Whether The Amount Should Be Divided Equally Or On *Pro Rata* Basis Depending On Their Dues?
- Whether Financial Creditors Get Priority In Repayment Over Operational Creditors Or Is It The Other Way Around?
- Who Should Take A Bigger Hair-Cut, The Financial Creditors Or The Operational Creditors?

There is also no clarity or guidance available for future Resolution Applicants and Committees of Creditors, who are affected by the seemingly confounding and/or contradictory views put forth in Binani Industries and Swiss Ribbons. These contradictions raise questions galore, and till such time these questions are conclusively answered by the Supreme Court of India, the battle between Financial and Operational Creditors is unlikely to end.

One quick glance at the amended Regulation 38 shows that it directly militates against the provisions of the Code. The term “priority” used in amended Regulation 38 can only mean that the dues of the Operational Creditors shall be accorded priority over the dues of Financial Creditors. The “priority” accorded to Operational Creditors by amended Regulation 38 overrides the concept of a minimum payment prescribed in Section 30(2)(b). Besides, it also violates Section 53 of the Code by practically reversing the order of priority set out in Section 53.

The problem arises in the code when most of the applications are filled by the operational creditors in the NCLT, this needs to be monitored as this not only hampers the pace of NCLT but the credibility of the Adjudicating authority gets negatively affected, though the criteria is set at Rs. 100,000 but the amount is too less and the time given to the corporate debtor is too less. This has led to huge number of applications being filled in the NCLT most of which even get rejected in the initial stage.

- **SUGGESTION:**

We should also note that the “Operational Creditors” includes not only the suppliers of goods and services but also includes employees, workmen, government and local authorities to whom the Corporate Debtor owes debt. When an observation is made to give operational creditor voting rights in CoC, the workmen group and government authorities would also get the voting rights.

As IBC is evolving into a stable piece of legislation, many more amendments are expected to come and the time will stand to test for the Operational Creditors if they can get voting Rights in COC. IBC had till date proved to be effective in terms of adopting many resolution plans for revival of sick Corporate Debtors and also recovering bad debts to a huge extent. It is definitely heading towards being a more balanced legislation

The difficulty in allowing the operational creditors access and voting rights in the insolvency process would be that achieving consensus of thousands of operational creditors would not be feasible. That can be resolved by having the operational creditors appoint representatives wherein every representative would represent operational creditors holding a certain percentage of the total operational debt and these representatives would have voting rights equivalent to the proportion of the total operational and financial debt that they represent.

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