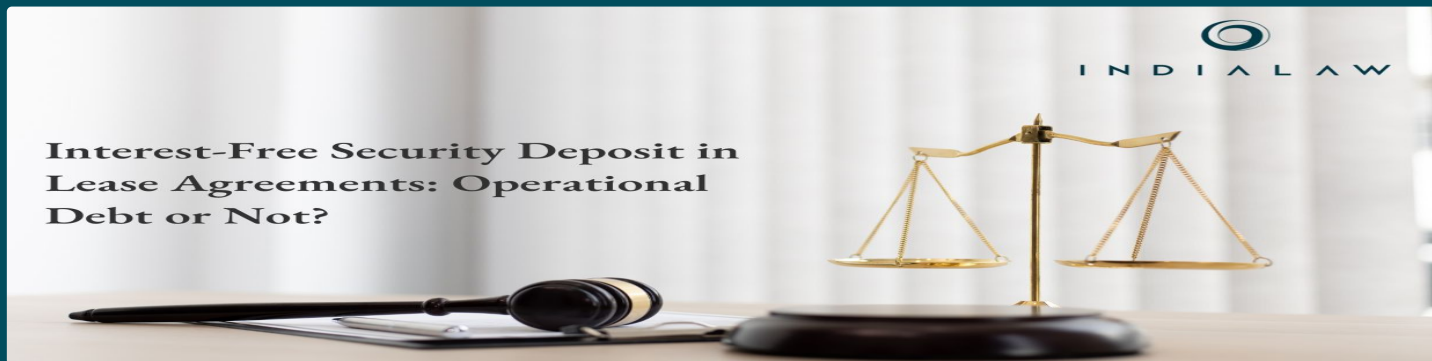




**Interest-Free Security Deposit in
Lease Agreements: Operational
Debt or Not?**

INSOLVENCY & BANKRUPTCY

Interest-Free Security Deposit in Lease Agreements: Operational Debt or Not?

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Introduction:

The Hon'ble NCLAT in a significant ruling, addressed the issue that has taken place recently which revolves around the matter of **Corob India Pvt. Ltd. v. Mr. Birendra Kumar Agrawal** (RP) and Anr filed under Section 61 of Insolvency and Bankruptcy Code 2016 ('IBC' in short) further delves to understand and consider whether the RP's treatment towards the claim made by the Appellant with respect of the Security Deposit made in discharge of the Lease deed under the category of 'Other Creditor' is considered justifiable with the given facts of the case being presented.

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Facts of the case:

Corob India Pvt. Ltd., the Appellant of the case, desired to acquire a premise from Renaissance Indus Infra Pvt. Ltd. (**Corporate Debtor**). A lease deed dated 12.12.2018 was decided between both parties, which was to commence from 12.12.2019 for 10 years.

The lease deed noted that the appellant provided a security deposit and bank guarantee to the corporate debtor (CD). However, with all the facts known, the CD failed to lease the premises to the appellant on the prescribed date. Further, admitting their poor financial condition, the corporate debtor also acknowledged that it was not in a position to grant the appellant the benefit of rent-free occupation.

Notice of Default was issued by the appellant on 30.06.2022. However, the CD continued to remain in breach of the lease deed. Although ultimately the CD was admitted into CIRP on 31.03.2023, which was followed by the appellant lodging its claim in respect of the BG (**Bank Guarantee**) and security deposit in Form C and Form F with the resolution professional. The RP informed the appellant that their claim has been admitted in the category of "Other Creditors."

The appellant filed an IA before the adjudicating authority seeking the return of the original BG issued by Respondent No. 2 on behalf of the Appellant to the CD, RP to return the security deposit with an interest of 18 percent, and alternatively, the RP to admit the amount of the security deposit as a financial debt owed by the CD. The issue was then brought to the Adjudicating Authority, but it did not fully satisfy the Appellant, resulting in additional interpretation of the case.

Contentions :

Contentions of Appellant –

The Appellant contended that the security deposit made with the corporate debtor was an asset that belonged to the appellant, not the corporate debtor. It was proposed that the RP should refund the Security Deposit to the Appellant, which was never part of the Corporate Debtor's assets. Furthermore, it was claimed that the Security Deposit was primarily used for the development of the leased premises and should be classified as financial debt under the IBC framework. It was recognized without prejudice that the appellant had filed a Form-C claim requesting that the Security Deposit be admitted as a financial responsibility. Furthermore, it was claimed that the Adjudicating Authority erred in determining whether the appellant was an operational creditor because the appellant made no such claims.

It was further contended, using the precedent case of *Embassy Property Development Pvt. Ltd. vs. State of Karnataka and Others* (2020) 13 SCC 308 that the moratorium established in Section 14 of the IBC just maintains the status quo and does not

bestow any new rights. As a result, the Adjudicating Authority and the RP (**Resolution Professional**) made a patent mistake in failing to recognize that the Security Deposit belonged to the Appellant rather than the Corporate Debtor.

Contentions of the Respondent-

While opposing the Appellants' accusations, RP maintained that the security deposit could not be considered a loan. The nature of the transaction at the time of money distribution is the most important factor in defining the party's standing, and no party may be allowed to take an advantageous position later on. Furthermore, the proposition said that if the security deposit was not repaid within the given time limit, it would be returned with an 18% interest rate, and the appellant would not be forced to pay lease rent until the deposit was recovered. It was further contended that the Adjudicating Authority was justified in ruling that the transaction did not even constitute an operational debt because the Appellant had not provided any services or delivered any goods for which payment could be claimed. According to the RP, once the CIRP is initiated, any creditor desiring to seek payment from the Corporate Debtor must submit a claim with the RP. As stated in Section 3(6) of the IBC, a claim includes the right to seek redress for violation of contract. Thus, it is a claim for payment resulting from the Corporate Debtor's breach of contract by failing to reimburse the Security Deposit following the lease deed's termination.

The arguments of both parties were extensively gone through and then studied to determine if the RP's categorization of "Other Creditor is valid"

Analysis:

Analysing the facts, we observe the sequence of events, such as the Appellant's submission that the Corporate Debtor failed to take over control of the leased premises to the Appellant on time, as well as the CD's explanations for the delay. The CD's alternative plan to pay the Appellant, however, was not accepted, and the appellant sent a Termination Notice to the CD. The facts also reveal that the CD never disputed the termination of the lease deed. The Corporate Debtor retained no rights when the lease deed was terminated. It was determined that the security deposit was not part of the CD's estate, and so the RP had no right to retain it. It was recognized that the security deposit was an asset of the Appellant and could not be maintained by the CD under section 18 of the IBC, which prohibits the RP from taking control of assets owned by third parties, even if held in the CD's custody under trust or contractual arrangements. It is also worth noting that the deposit was a payment paid by the appellant to the corporate debtor in exchange for the time value of money, a financial obligation. As a result, this case was similar to others in which homebuyers were identified as creditors. The disputed ruling was challenged on the basis that the appellant could not be classified as a "other creditor". While the lease's termination remains an undisputed fact. The termination of the lease by the Appellant plainly resulted in a breach of contract. The Security Deposit requested by the Appellant fell within the ambit of the IBC, which later also investigated the appellant's contention that they entitled to be considered as a financial creditor and receive their security deposit.

However, after further consideration, it was determined that the appellant did not qualify as a financial creditor since they did not meet the fundamental characteristics of financial debt as defined in section 5(8) of the IBC. This leads us to the next section, which examines whether the appellant could be contested as an Operational Creditor to whom an Operational debt, i.e. section 5(21), is owed in respect of the provision of goods and services, including employment, or debt in respect of the payment of dues arising under any law currently in force and payable to the central government, any state government, or any local authority.

Given that services are not actively defined by IBC in a broad and purposive manner, the reasonability was questioned in this case, despite the fact that debt was alluded to as an operational debt in the preceding supreme court case of *M/s Consolidated Construction Consortium Ltd. Vs M/s Hitro Energy Solutions Pvt. Ltd. In Civil Appeal No. 2839 of 2020*.

Conclusion:

After all of the occurrences had been observed and understood, it was determined that it is the responsibility of the RP under Section 18 of the IBC to take the required actions to gain ownership and custody of the Corporate Debtor's assets. Section 20 of the IBC seeks to protect and preserve the value of the Corporate Debtor's property.

We have already decided, for the reasons explained, that the Security Deposit was in the form of operational debt and did not match with the RP's idea of designating the Appellant as an "Other Creditor". Since the elements of operational debt are met, which covers all those who provide or receive operational services from the corporate debtor. As a result, we consider that the Appellant should be classified as an Operational Creditor under the current factual matrix. The Hon'ble NCLAT directs the RP to

admit claim of the Appellant as an Operational Creditor and Appellant be allowed to substitute Form -C as already filled up with Form B.

[1] **Corob India Pvt Ltd v. Mr. Birendra Kumar Agrawal & Anr.** [2024] Comp. App. (AT) (Ins) No. 749 of 2024, (NCLAT) (08 November 2024).