



Senior creditor priority disregarded in liquidation waterfall

Highlights

1. The Appellate Court for insolvency matters, the NCLAT, in its recent landmark ruling has destroyed the idea of inter-creditor seniority amongst secured creditors in the liquidation waterfall.
2. Unlike liquidation under the Companies Act, liquidation waterfall under the Insolvency Code is based on election made by the secured creditor, between enforcement outside the code or relinquishment to the liquidation estate.
3. Sub-classification amongst secured creditors is irrelevant where the secured creditor elects to relinquish its security interest.
4. Such liquidation waterfall is likely to better the position of dissenting secured financial creditors at resolution stage as well.

Background

The National Company Law Appellate Tribunal (**NCLAT**) in *Technology Development Board v Anil Goel*¹ (**NCLAT Decision**) has held that inter-se priority or hierarchy between the secured creditors should be disregarded while distributing the proceeds of liquidation under Section 53(1) of the Insolvency and Bankruptcy Code, 2016 (**Code**).

¹ Company Appeal (AT)(Insolvency)No. 731 of 2020

The NCLAT Decision overrules the decision of the NCLT² that sought to preserve the inter-se priority between the secured creditors in distribution of proceeds of liquidation. NCLT's decision was premised on the judgment of the Supreme Court in *ICICI Bank Limited v SIDCO Leathers Limited & Ors*³ (**SIDCO case**) which upheld the inter-se priority between secured creditors under the Companies Act, 1956.

The SIDCO case was also quoted by the Insolvency Law Committee (**ILC**) in its Report dated March 26, 2018⁴ in coming to the conclusion that *"valid inter-creditor and subordination provisions are required to be respected in the liquidation waterfall under section 53 of the Code."* The ILC report of February 2020 reiterates the conclusion of the 2018 report and recommends the insertion of a suitable explanation, which, interestingly, has not been acted upon by Parliament.

Disregarding the SIDCO case and the recommendations of the ILC, the NCLAT held that where the secured creditor relinquishes its security interest in favour of the liquidation estate, its claim shall rank pari-passu with other secured creditors (irrespective of their inter-se priority or hierarchy) who have similarly relinquished their security interest in favour of the liquidation estate. Hence, all inter-se hierarchies amongst secured creditors shall stand disregarded.

Distributions under the Code- Tracing the History

Section 52(1) of the Code provides an election mechanism to the secured creditors whereas Section 53 (1) of the Code provides for a waterfall mechanism detailing the order of priority to be followed for payment of dues pursuant to the option elected by the secured creditors under Section 52 of the Code.

²C.P.(I.B)No.4/NCLT/AHM/2017.

³(2006) 10 SCC 452

⁴Report of the Insolvency Law Committee dated March 26, 2018 available at https://ibbi.gov.in/uploads/resources/ILRReport2603_03042018.pdf

Section 52(1):

“A secured creditor in the liquidation proceedings may-

(a) relinquish its security interest to the liquidation estate and receive proceeds from the sale of assets by the liquidator in the manner specified in section 53; or

(b) realise its security interest in the manner specified in this section.”

Section 53(1):

(1) Notwithstanding anything to the contrary contained in any law enacted by the Parliament or any State Legislature for the time being in force, the proceeds from the sale of the liquidation assets shall be distributed in the following order of priority and within such period as may be specified, namely: -

(a) the insolvency resolution process costs and the liquidation costs paid in full;

(b) the following debts which shall rank equally between and among the following: -

(i) workmen’s dues for the period of twenty-four months preceding the liquidation commencement date; and

(ii) debts owed to a secured creditor in the event such secured creditor has relinquished security in the manner set out in section 52;

(c)....”

Section 53(2):“Any contractual arrangements between recipients under sub-section (1) with equal ranking, if disrupting the order of priority under that sub-section, shall be disregarded by the liquidator.”

The ILC 2018 Report interpreted these contractual arrangements to mean contracts between different classes of creditors (say workmen and unsecured creditors), but not between the same class of creditors (say secured creditors). Reliance was placed on SIDCO case where the Supreme Court, while taking note of Section 48 of the Transfer of Property Act (**TOPA**) which provides that the claim of the first charge holder shall prevail over the second charge, held that *“Only because the dues of workmen and debts due to the secured creditors are treated pari-passu with each other, the same by itself, in our considered view, would not lead to the conclusion that the concept of inter se priorities amongst the secured creditors had*

thereby been intended to be given a total go-by.”The court went on to add that in a case where the first charge holder was to be deprived of such a valuable right, the statute would have made an explicit mention of the same.

The ILC believed that even though the SIDCO case did not involve relinquishment of security by the creditors, the principles in the case would still hold good when creditors have relinquished their securities. The ILC 2018 report also took on record arguments that (a) subordination agreement inter-se creditors have been respected in practice during winding up proceedings; and (b) the position in other developed jurisdictions such as USA has been similar. ILC also noted that it may not be prudent to take away a valuable property right of senior secured creditors as it may adversely impact the credit markets.

Para 21.6 of the ILC 2018 Report sums up the conclusion on the matter as follows—*“To conclude, the Committee was of the opinion that it is sufficiently clear from a plain reading of section 53(1)(b) that it intended to rank workmen's dues equally with debts owed to secured creditors who have relinquished their security. Section 53(1)(b) does not talk about priority inter-se secured creditors. Thus, valid inter-creditor/subordination agreements would continue to govern their relationship. Further sub-section (2) of section 53 must also be interpreted accordingly. For instance, applying section 53(2) in the context of section 53(1)(b), any agreements between workmen and secured creditors which disrupts their pari-passu rights will be disregarded by the liquidator. However, agreements inter-se secured creditors do not disturb the equal ranking sought to be provided by section 53(1)(b) and therefore do not fall within the ambit of section 53(2). The Committee felt that there was no requirement for an amendment to the Code required since a plain reading of section 53 was sufficient to establish that valid inter-creditor and subordination provisions are required to be respected in the liquidation waterfall under section 53 of the Code.”*

However, the confusion on waterfall persisted. The issue was again discussed by the ILC in its 2020 report⁵, and the ILC recommended to insert an Explanation to Section 53(2) to clarify

⁵Report of the Insolvency Law Committee dated February 20, 2020 available at <https://ibbi.gov.in/uploads/resources/c6cb71c9f69f66858830630da08e45b4.pdf>.

that principles of subordination should apply between secured creditors. Interestingly, however, it appears that the legislature may not have been aligned as the recommendations did not find their way into the Code.

Analyzing the NCLAT Decision

Brief Facts

Technology Development Board (***Appellant***) was a financial creditor of Gujarat Oleo Chem Ltd. (“**GOCL**”) holding a second charge on certain assets. Gujarat Oleo Chem Ltd. was admitted in corporate insolvency and the Appellant was part of the Committee of Creditors having voting share of 14.54%. CIRP failed and GOCL was ordered to be liquidated.

Appellant lodged its claim with the liquidator, but was informed that the sale proceeds on liquidation had been distributed amongst the first charge holders, leaving nothing for the second charge holder, being the Appellant. The liquidator justified his decision basis the ILC recommendations as discussed above, which was upheld by the NCLT.

Findings

On appeal, the NCLAT set aside the decision of the NCLT on the following grounds:

- (1) **Interplay between Sections 52 and 53:** NCLAT has analyzed the interplay between Sections 52 and 53 of the Code in granular detail. Secured creditors may either: (a) enforce security interest against the asset outside the liquidation estate (under Section 52); or (b) relinquish the security interest and claim as a secured creditor under Section 53(1)(b)(ii) ranking equal to the other secured creditors. The election by the secured creditor determines the position that it would be accorded under the waterfall. If the secured creditor, despite electing to independently realise its security, still has unpaid dues, then the scheme of Section 53 still allows such creditors to participate in the liquidation waterfall under Section 53(1)(e)(ii) of the Code, but the creditor will now be junior to those secured creditors who took the plunge and relinquished their security interests.

- (2) **Relinquishment of security interest:** The major distinction between Sections 52 and 53 lies with respect to the realisation of interest. While Section 52 deals with the realization of security interest, Section 53 deals with the mere manner of distribution of the proceeds from the liquidation estate. The realisation of security interest bears a direct link with the asset subject to such security interest to be realized. The relinquishment of the security interest divests the secured creditor from enforcing its security interests qua the secured assets as the assets now form part of a common pool. No priority of security can exist at the stage of Section 53 since all security interests have been relinquished.
- (3) **Overriding effect of Section 53:** The foundational basis on which the NCLAT Decision disregarded the NCLT order (and the ILC recommendations) was premised on the fact that Section 53, armed with non-obstante provisions, superseded all legislations contrary to Section 53 of the Code. The SIDCO case, which was relied upon heavily by the ILC, was held not to be an accurate benchmark as the SIDCO case dealt with the Companies Act, which had to be read together with other legislations like the TOPA.

Relevance at the pre-liquidation stage

Distribution waterfall under Section 53(1) is not just relevant at the stage of liquidation, but also during the resolution stage. Section 30(2) lays down the requirements that the resolution plan received by the resolution professional must comply with.

Section 30(2):

“The resolution professional shall examine each resolution plan received by him to confirm that each resolution plan –

(b) provides for the payment of debts of operational creditors in such manner as may be specified by the Board which shall not be less than-

(i) the amount to be paid to such creditors in the event of a liquidation of the corporate debtor under section 53; or

(ii) the amount that would have been paid to such creditors, if the amount to be distributed under the resolution plan had been distributed in accordance with the order of priority in sub-section (1) of section 53,

whichever is higher, and provides for the payment of debts of financial creditors, who do not vote in favour of the resolution plan, in such manner as may be specified by the Board, which shall not be less than the amount to be paid to such creditors in accordance with sub-section (1) of section 53 in the event of a liquidation of the corporate debtor.”

Section 30(2) prescribes that operational creditors and dissenting financial creditors are entitled at least to an amount they would have received if distributions were to be made under Section 53(1). To that extent, dissenting junior secured creditors may see themselves as pari-passu with senior secured creditors, a spectre that senior lenders may not have envisaged thus far.

NCLAT Decision may be seen to be in contrast with the principles set out by the Supreme Court in *Committee of Creditors of Essar Steel India Ltd. v Satish Kumar Gupta & Ors.*⁶ which held that inter-se priority amongst secured creditors is a valid basis for classification amongst secured financial creditors and that junior lenders or lenders with a low security to claim ratio may be differentially treated under a resolution plan compared to senior lenders. It is to be remembered that the Essar Steel judgment applies only in the context of a resolution plan whereas the judgment of the NCLAT in *Technology Development Board* (supra) applies once the corporate debtor is in liquidation and there is no direct conflict between the two judgments.

Conclusion - The Road Ahead

The NCLAT Decision does appear to be contrary to the interpretation of Sections 52 and 53 of the Code advanced by the Insolvency Law Committee which relies on the position prevailing under the Companies Act, 1956 as interpreted by the Supreme Court in the SIDCO

⁶ 2019 SCC OnLine SC 1478.

case. However, the ILC is only an advisory body constituted by the executive and its opinion is not binding on a judicial forum or applicable as an aid to interpretation of the Code. These views may, at best, be persuasive.

However, the decision of the NCLAT may be upheld in challenge for the following reasons:

- (1) Despite recommendations by the ILC, Parliament has not amended Section 53(2) of the Code to recognize inter-se hierarchy amongst secured creditors in the distribution waterfall.
- (2) A secured creditor always has the option to elect to stand outside liquidation and independently realise the value of its security under Section 52 of the Code. There is no rationale for Section 52 of the Code to exist if inter-se priority and subordination arrangements are to be applied even in the liquidation waterfall. The upholding of inter-se hierarchy and seniority in the liquidation waterfall under Section 53 of the Code may render Section 52 of the Code entirely otiose and nugatory.
- (3) Section 53(2) reiterates the principle that no contractual arrangements can apply post-relinquishment, and unlike the ILC's interpretation, could well be argued to disregard any inter-creditor seniority within the same class of creditors as well.
- (4) Legislature may not be aligned with the ILC in its interpretation of Section 53(2). If it were, clarificatory amendments to Section 53(2) as recommended by the ILC in its 2020 report should have been brought into effect.

In any event, till the NCLAT Decision is overruled by the Supreme Court, the law is settled that inter-se priority among secured creditors will be disregarded amongst secured creditors who relinquish their security interest in favor of the liquidation estate. Senior secured lenders that allowed the creation of subordinate charges may need to re-evaluate their enforcement strategies. Going forward, senior secured lenders may not consent to subordinate charges being created, which may result in higher cost of capital for the borrower.

This material is for general information only and is not intended to provide legal advice. For further information, please contact:

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