

HR Law Hotline

July 31, 2013

INDIAN COURT PROTECTS EMPLOYEES' PAYMENTS DURING LIQUIDATION PROCEEDINGS

The Supreme Court of India ("**SC**") has held that in the event of liquidation of a company, claims of employees have to be considered by the Official Liquidator of the company and not by the Debt Recovery Tribunal ("**DRT**"). The SC made this decision in the case of *Bank of Maharashtra v. Pandurang Keshav Gorwardkar & Ors.*¹, and laid down certain rules for deciding employee claims.

FACTS

Paper and Pulp Conversions Limited ("**Company**") had taken a loan from Bank of Maharashtra ("**Appellant**") in the year 1980. Upon facing liquidity problems, the Company closed its operations in 1992 followed by an order for liquidation by the Board of Industrial Financial Reconstruction ("**BIFR**"). The Appellant filed proceedings against the Company and its directors for recovery of certain amounts with future interest. The DRT ordered for payment of sums to the Appellant and held that in the event of the Company failing to repay the due and outstanding amounts, the Appellant was entitled to sell all the properties to recover such amounts.

Simultaneously, recovery proceedings were initiated by employees of the Company ("**Respondents**") before the DRT praying for registration of their claims before auctioning of the properties by the Appellant. The Recovery Officer auctioned the movable properties of the Company and received certain amounts of which a part was kept aside towards the employees' likely claims.

Almost immediately, the employees filed a writ petition before the Bombay High Court ("**Bombay HC**") for appointment of a provisional liquidator and for staying further proceedings before the DRT. The writ was opposed by the Appellant. The Bombay HC passed an order for liquidation of the Company and appointment of an Official Liquidator. The Bombay HC also held that the jurisdiction to determine the payment and its priorities totally vested with the DRT and directed the DRT to retain INR 11,755,000 (amount claimed by the employees) until the claim of the employees was determined leading to an appeal before the SC.

ISSUE

The issue before the SC was whether in case of liquidation of a company, the claims of the employees which rank *pari passu* to the creditors' claims, should be considered by the Official Liquidator or the DRT.

ARGUMENTS

The Appellant had a two-fold argument. The first being that no rights could be claimed by the employees over the security held by a bank or financial institution and that the DRT lacked the requisite competence to decide on adjudication of their claims. The purpose of DRT is adjudication and recovery of dues of banks or financial institutions and not employee related dues, which should be dealt with by an appropriate forum such as the Industrial Tribunal.

Secondly, if the debtor company is in liquidation and the security has been sold in proceedings before the DRT, then the sale proceeds should be distributed by taking into account the *pari passu* charge to the limited extent of the "employees portion".² It was argued that the Company was in the process of starting their liquidation process and the employees had no claims on the assets of the Company or any standing to approach the DRT to participate in a proceeding filed by a bank or financial institution.

The employees on the other hand contended that the DRT had the right to anticipate not only a situation when the Company is in liquidation but also when the Company, though not in liquidation, will be rendered as an empty shell if the assets of the Company are sold and the proceeds are handed over to financial institutions and banks. With regard to the claims of the creditor, it was argued that the official liquidator represented the entire body of creditors and the rights of the employees rank *pari passu* with that of the secured creditors.

JUDGMENT AND ANALYSIS

The SC while analyzing the arguments, held that the employees' dues were *pari passu* with secured creditors under section 529A of the Companies Act, 1956 (duly amended from time to time) ("**Act**") and a combined reading of section 529A and proviso to section 529(1)(c) of the Act indicates that where a company is in liquidation, a statutory charge is created in favour of the employees in respect of their dues over the security of every secured creditor and this charge is *pari passu* with that of the secured creditor. Such statutory charge of the secured creditor is limited to the extent of the employees' portion in relation to the security held by the secured creditor in the company.

In view of the observations, the SC laid down certain rules for the determination of the claims of the employees:

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1. Statutory charge is created in favour of employees for their dues which is pari passu with that of the secured creditor when a company is in liquidation or when the assets of the company have been sold for the recovery of dues but before the proceeds realized from the sale have been disbursed. However, the same is limited to the extent of employee's portion in relation to the security held by the secured creditor of the debtor company and will be decided on the date of the liquidation order.
2. Prior to full and final disbursement of sale proceeds if the debtor company goes into liquidation and subsequently Official Liquidator is appointed, disbursement of undisbursed sale proceeds by DRT can only be done after giving notice to and hearing the liquidator. In the event of claims by employees, the DRT has two options:
 1. either pay off the bank or the financial institution as per the recovery certificate after securing an indemnity bond of restitution of the amount of the employees' dues as may be finally determined by the Official Liquidator, or
 2. set apart tentatively, a portion of the undisbursed amount towards employees' dues in the ratio as per the illustration in Section 529(3)(c) of the Act and disburse the balance amount to the bank on an undertaking to reconstitute the amount to the extent of the employees' dues as may be finally decided by the Official Liquidator.
3. The first option must be exercised only in the situation where no application for distribution of employees' dues against the company has been made by the Official Liquidator or the employees before the DRT.
4. Where the sale of security has been effected in lieu of DRT's recovery certificate, the distribution of proceeds has to be made by the DRT alone according to Section 529A of the Act and by no other authority.
5. The employees acquire the standing of the secured creditors on and from the date of order of liquidation and become entitled to the distribution of sale proceeds.

- Payel Chatterjee, Sahil Shah and Vikram Shroff

You can direct your queries or comments to the authors

¹ 2013 (6) SCALE 716

² Section 529(1)(c) proviso read with Section 529A of the Companies Act, 1956

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