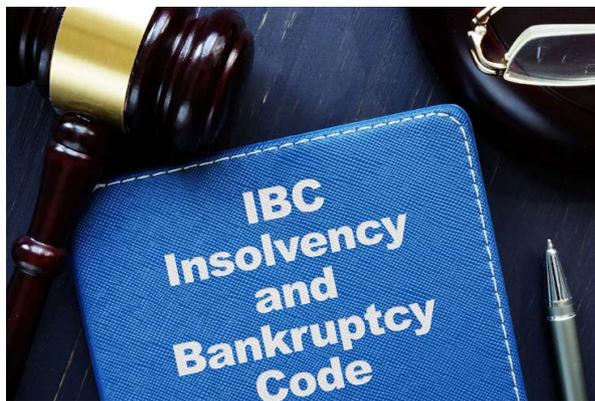


No equality amongst equals: Treatment of secured creditors under IBC

The government needs to amend the IBC regulation and recognize the difference between various classes of creditors basis priority and value of security interest in the context of corporate insolvency resolution process and corporate liquidation process, while ensuring that the ultimate objective of the Code is not obfuscated.

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The treatment of inter creditor and subordinate agreements under the Insolvency and Bankruptcy Code, 2016 (“**IBC**” and “**Code**”) has remained a subject of much debate since the inception of the Code. Over the years, it has raised critical issues in both the Corporate Insolvency Resolution Process (“**CIRP**”) as well as the Corporate Liquidation Process (“**CLP**”).

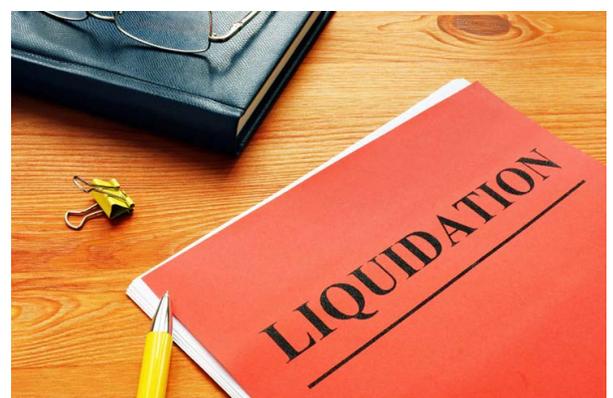
Clarification in context of CIRP only

In 2019, the government had introduced a clarification on differential treatment of [secured creditors](#) based on priority of charge. However, it was only in the context of CIRP. The clarification provided that “priority” of security interest of a secured creditor may be considered as a factor by the [committee of creditors](#) while approving distribution of resolution proceeds proposed under a resolution plan. As a result, a first charge holder could validly be accorded precedence in the apportionment of resolution proceeds by a resolution applicant.

Ambiguity remained in context of Liquidation

The question as to whether senior secured creditors would have any primacy over subordinate charge holders, remained unclear in the context distribution of liquidation proceeds in CLP. The liquidation waterfall provided under Section 53 of the Code provides that all secured creditors will be paid in proportion to their admitted claims but does not create any distinction between secured creditors based on inter-creditor or subordinate agreements.

The Insolvency Law Committee (“**ILC**”) in its 2018 Report (“**2018 Report**”) took cognizance of this issue and concluded that “valid inter-creditor and subordination provisions are required to be respected in the liquidation waterfall under section 53 of the Code”. However, the Insolvency and Bankruptcy Board of India (“**IBBI**”) in its 2019 Discussion Paper on Corporate Liquidation Process referred to the 2018 Report and observed that “there was still a debate as to whether a senior creditor has better rights than a junior credit in the waterfall under section 53 of the Code”. This confusion was addressed by the ILC again in 2020 (“**2020 Report**”), whereby it recommended that a clarification may be provided by inserting an Explanation under Section 53(2) to uphold the validity of inter-creditor and subordinate agreements.



However, the above recommendation of the ILC was not accepted by the government and no amendment in this regard was introduced in the Code in the 2020.

On the other hand, based on the ICL's views in 2018 Report and 2020 Report, various liquidators and NCLTs started taking the position that inter-creditor/ subordinate agreements between secured creditors must be recognized and given effect to. Thereby allowing a preferential treatment to senior secured creditors in the distribution of liquidation proceeds under the liquidation waterfall. Finally, the question of validity of inter-creditor and subordinate agreements in CLP was placed before the [NCLAT](#) in the matter of Technology Development Board v Mr. Anil Goel ("**TDB Judgment**"). The NCLAT in this judgment has disagreed with the interpretation of the ILC and provided clarity on the issue.



NCLAT Judgment

The NCLAT in the TDB Judgment held that:

(a) Secured creditors have the unfettered right to choose whether to enforce their individual security under applicable law and stay out of the liquidation process or relinquish their security interest and submit to the liquidation proceedings where all assets of the corporate debtor are pooled and sold.

(b) Once a security interest has been relinquished then it forms a part of the liquidation estate.

(c) Sale proceeds emanating out of the liquidation proceedings will be strictly distributed as per the waterfall provided in Section 53 of the Code.

(d) The waterfall under Section 53 of the Code does not recognize inter-creditor and subordinate agreements and treats all secured creditors on par.

As per the above TDB Judgment, rights created under an inter-creditor or subordinate agreement fall away as soon as the charge holders over an asset decide to participate in liquidation proceedings. Accordingly, senior secured [lenders](#) may take benefit of their priority only if they decide to realize their security interest outside of the CLP.

Future Challenges

While the above judgment clarifies the [legal](#) position, it might create a situation where charge holders are encouraged to stay outside the liquidation process and pursue their independent course of action. This may throw open many issues such as:

(a) The CLP provides for sale of the corporate debtor as a going concern which will be difficult if vital assets are being sold separately.

(b) There might be multiplicity of proceedings delaying an ultimate resolution for creditors.

(c) If the CLP concludes prior to the completion of separate enforcement proceedings, the legal entity having ownership over the assets will stand dissolved raising questions on the ability of the creditors to complete the enforcement.

(d) The entire CLP might become toothless with bifurcated mandates and perspectives of different secured creditors.

Who decides to relinquish?

Serious issues may crop up in situations where an asset is charged to multiple lenders and such lenders, owing to conflicting business interest, want to pursue different liquidation strategies. For example, one secured creditor may want to relinquish the security, while the others do not.

The NCLAT in the case of “J M Financial asset Reconstruction Co. Ltd. vs. Finquest Financial Solutions Pvt. Ltd. & Ors., has earlier held that only the first charge holder i.e. the secured creditor being highest in the inter creditor ranking is entitled to enforce its right for the realization of its debt outside the CLP. In another case of Surana v. BHEL, the NCLAT has held that when 73.76% in value have already relinquished their security interest into the liquidation estate, it would be prejudicial to stall the liquidation process at the instance of a single creditor having only 26.24% share (in value), in the secured assets.

The NCLAT applied the provisions of SARFAESI Act to end the deadlock between secured creditors and held that the decision of 73.76% of majority secured creditors, who have relinquished their security interest shall also be binding on the dissenting secured creditors.

These judgments, though well intentioned, are fraught with serious infirmities. It remains to be seen how the law is ultimately settled by the [Supreme Court](#) on such issues.

“ **As per regulation 32 of the Liquidation Regulations a liquidator cannot sell an asset subject to a security interest unless there is relinquishment of the security interest therein. Effectively an asset which is secured to multiple creditors might be taken out of the liquidation proceedings by any secured creditor irrespective of the priority of security and value of outstanding debt. This might result in unwilling creditors being drawn into protracted enforcement proceedings.**

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Conclusion

The Supreme Court in its judgment of Swiss Ribbons had mentioned that the larger objective of the Code is to avoid corporate death through liquidation. If inter creditor and subordinate agreements are recognized in CLP, then we might face a scenario where liquidations are preferred by senior secured lenders as that might remove the requirement of paying other creditors depending on the liquidation value of the corporate debtor.

The legislature in its wisdom has to amend the Code and recognize the difference between various classes of creditors basis priority and value of security interest in the context of CIRP and CLP, while ensuring that the ultimate objective of the Code is not obfuscated.

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