
A CRITICAL AND COMPARATIVE ANALYSIS OF THE 'WATERFALL MECHANISM' PROVIDED UNDER THE INSOLVENCY AND BANKRUPTCY CODE OF 2016

Apoorva Katti & Neha Venkatesh, CHRIST (Deemed to be University)

ABSTRACT

The Indian insolvency regime underwent a complete overhaul as a result of the enactment of the Insolvency and Bankruptcy Code of 2016. The legislation is the result of meticulous efforts and conceptualisation of inputs from various existing insolvency legislations and global law regimes, it continues to have its innate shortcomings and ambiguities and is ever-evolving in nature. On this note, this paper seeks to examine the shortcomings in the legislation. Firstly, the paper seeks to analyse the 'waterfall mechanism' provided under Section 53 of the Code and its failure to recognise inter se prioritisation among secured creditors and subordinate agreements. Following this, the priority of claims between financial creditors over operational creditors shall be analysed. To conclude, a comprehensive and comparative analysis of various international laws and standards shall also be presented. The authors have adopted the qualitative method of research throughout. Primarily, the paper focuses on the ambiguities surrounding Section 53 of the Code.

INTRODUCTION

The Insolvency and Bankruptcy Code, 2016 has two primary objectives. Firstly, to rescue economically viable businesses and companies through the Corporate Insolvency Resolution Process and secondly, to maximise the value of assets. Section 53 of the Code¹, read with Regulations 33 and 35 of the Liquidation Regulations, provides for the distribution of assets if the Corporate Insolvency Resolution Process fails to rescue the corporate debtor from financial distress and has an overriding effect on Sections 326 and 327 of the Companies Act.² It provides for a ‘waterfall mechanism’ or prescribes the order of priority that determines the distribution of proceeds post-liquidation.

These proceeds are first diverted to cover the costs of the resolution and liquidation process. According to Section 5(13) and Regulation 31 of CIRP Regulations, only those expenses ratified by the Committee of Creditors shall be accounted for under the Corporate Insolvency Resolution Process cost. If not ratified accordingly, it must be borne by the Applicant itself. In the second tier, workmen’s dues and debts owed to a secured creditor are ranked equally. The salaries of the workmen as well as welfare funds like provident, gratuity etc., fall under the ambit of workmen’s dues. Wages and unpaid dues owed to employees other than workmen are provided for in the succeeding slab. The assets are then utilised to cover financial debts owed to unsecured creditors. The fifth class comprises the amount due to the Central Government and the State Government and debts owed to a secured creditor for any amount unpaid following the enforcement of security interest. Other dues, debts owed to preference shareholders, and lastly, amounts due to equity shareholders or partners are the last three classes in the order of priority, respectively. The distribution of assets amongst one class of parties may either be paid in full or, if the amount is insufficient, it may be paid in equal proportion. The provision also lays down that contractual agreements entered into by two or more recipients would be dismissed by the liquidator if it obstructs the order of the distribution of assets.

The emergence of this notion may be traced back to an awareness of the unique nature of challenges associated with multinational company group bankruptcy, which arise from group operational and financial interconnectivity. It highlights that, despite the increased acceptance of the group phenomenon, no cohesive and well-defined legal concept has emerged.

¹ The Insolvency and Bankruptcy Code, 2016, § 53, No. 31, Acts of Parliament, 2016 (India).

² The Companies Act, 2013, No. 18, Acts of Parliament, 2016 (India).

I. Prioritisation among Secured Creditors during the Distribution of Assets under Section 53 of the IBC

The liquidation waterfall contained under Section 53 of the Code has been subject to public scrutiny on multiple occasions concerning its equal treatment of the secured creditors holding the first charge against the subsequent charge holders. While Section 52 of the Code provides for the realisation of security interest outside the liquidation process, it also provides the creditors with an option to relinquish their security interest in favour of the liquidation assets and thereby receive their shares as per the aforesaid waterfall procedure contained under Section 53 of the Code. When the latter is opted for, multiple charges are created over an asset, and the same is often shared on a *pari passu* basis which essentially places all those creditors in an equal position when it comes to the distribution of assets. This being said, the existence of inter se priority of charges is indeed possible which allows for certain classes of creditors who are first charge holders to satisfy their claims prior to the subsequent shareholders during the process of distribution of assets. Section 48 of the Transfer of Property Act of 1882 talks explicitly about prioritising these first charge holders over those other shareholders.

Section 53 of the Code fails to make any reference whatsoever to the inter se prioritisation within the different classes of secured creditors. This essentially presents an unfair situation to those first charge holders who are treated equally to the subsequent charge holders. The core objective of the Code is to advance the principle of equitable treatment wherein the entities are treated based on the legal rights vested with them. Entities with similar legal rights are treated as equals, and the distribution pattern of assets is also based on the same principles, wherein a proportional distribution of assets is based on their rights, ranking and interest. Thus, this ambiguity regarding Section 53 essentially violates those objectives of the IBC in true spirit.

The Insolvency Law Committee undertook the first attempts to address this objective through its reports issued between 2018 to 2020. The March 2018 report took direct cognisance of this said ambiguity and stated that specific intercreditor and subordination provisions are to be taken into account with respect to the liquidation waterfall prescribed under Section 53 of the Code. This being said, no proposals for an amendment were made, and the legislature made no subsequent efforts to codify the same. This presented a rather difficult situation as the said words remained a clarification and the Adjudicating authority continued to sway stances. Meanwhile, this clarification made by the 2018 report was dismissed by the Insolvency and Bankruptcy Board of India in a 2019 Discussion paper wherein it stated that “there was still a

debate” with regard to the said prioritisation among secured creditors. The Insolvency Law Committee took it upon itself to address this issue again in its 2020 report,³ wherein it recommended the insertion of an explanation under Section 53(2) of the Code to recognise those valid intercreditor and subordination agreements that existed. It also went on to clarify that the said priority shall be only to the extent of the value of the security interest that is relinquished by a creditor. The report further reasserted that value maximisation via a collective liquidation process was the legislative intent behind providing those secured creditors with a greater priority in the liquidation waterfall.

As stated earlier, even after the said clarifications, the Adjudicating authority and courts of this land have continued to hold differentiated stands with regard to this particular issue. In *J.M. Financial Asset Reconstruction Company Ltd. v. Finquest Financial Solutions Private Limited and Ors.*⁴, the NCLAT went on to hold that the said right to realise security is restricted to those creditors who vest an exclusive charge. In other words, the sole first charge holder. Thus, it was held that post the exercise of rights by one secured creditor, other secured creditors will not be provided with an option to enforce rights for the realisation of the amount from the same asset. Thereafter, in *Technology Development Board v. Anil Goel*⁵ The NCLAT went on to hold that once secured creditors chose to relinquish their interest over the secured assets, distribution and repayment would be strictly in accordance with the waterfall mechanism under Section 53 of IBC, which does not expressly recognise any difference between the different classes of secured creditors. Thus, this said judgement head-on disagreed with the clarifications provided by the Insolvency Law Committee and failed to recognise the validity of intercreditor and subordination agreements. This essentially means that secured creditors are not given any benefit of their priorities within the Corporate Liquidation Process.

The NCLAT in this particular case also differed from an earlier view taken by the Supreme Court of India in the case of *ICICI Bank Ltd. v. SIDCO Leathers Ltd. & Ors.*⁶ with regard to a similar question of law under Section 529 A of the Companies Act of 1956. In this case, the Supreme Court had held that the non - obstante clause under this particular Section shall not

³ Ministry of Corporate Affairs, Government of India, 2020. Report of the Insolvency Law Committee, Available at: <<https://ibbi.gov.in/uploads/resources/c6cb71c9f69f66858830630da08e45b4.pdf>> [Last Accessed 23 December 2022]

⁴ *J.M. Financial Asset Reconstruction Company Limited. v. Finquest Financial Solutions Private Limited and Ors.*, Company Appeal (AT) Insolvency No. 593/2019.

⁵ *Technology Development Board v. Anil Goel Liquidator of Gujarat Oleo Chem Limited and Ors.*, Company Appeal (AT) Insolvency No. 731 of 2020.

⁶ *ICICI Bank Limited v. Sidco Leathers Limited & Ors.* (2006) 10 SCC 452.

prevail over Section 48 of the Transfer of Property Act which provides for inter se priority amongst secured creditors. The rationale provided for the same was that the Right to property being Constitutional in nature, cannot be overridden unless specifically provided under the law. While it is understood that both Section 529 A of the Companies Act of 1956 and Section 53 of the Insolvency and Bankruptcy Code of 2016 contain non - obstante clauses and are similar in legislative intent, the NCLAT respectfully chose to hold the order of the NCLT based on the aforementioned Supreme Court judgement erroneous citing the non - obstante clause under Section 53 of the IBC and failed to read into Section 48 of the Transfer of Property Act which talks about the inter se priority.

Thus, on the whole, this stand taken by the Adjudicating authority fails to read into the importance of value maximisation. Besides the same, creditors may choose to opt out of the collective liquidation process, which effectively derails the entire liquidation process, creates a multiplicity of proceedings and can possibly even prevent enforcement of rights when the liquidation proceedings precede the separate enforcement proceedings initiated.

At length, this ambiguity surrounding the validity of inter se prioritisation and subordination has to be clarified with respect to Section 53 of the IBC. The legislative intent must be read into, and the serious commercial impact of the said move must be taken into account while addressing the said issue. An amendment to the Code shall go a long way in impacting the creditor's behaviour and push them towards collective resolution. One must always remember that insolvency and bankruptcy laws are evolving, and addressing concerns such as the aforementioned shall only make it more effective while sticking to its objectives. An intervention by the Apex Court of India, too, shall aid in the restoration of the priority principle interpreted in the SIDCO case.⁷

II. The priority of claims of financial creditors over operational creditors

As per the order of priority prescribed in Section 53, debts owed to unsecured financial creditors precede dues owed to the government. Operational creditors themselves have not specifically been mentioned in the entries. The provision explicitly provides for the satisfaction of the claims of financial creditors, whereas operational creditors fall under the ambit of "remaining debts and dues" in the final class, which is two entries after the former. The Bankruptcy Legislative Reforms Commission Report⁸ does not provide any justification for

⁷ ICICI Bank Limited v. Sidco Leathers Limited & Ors., (2006) 10 SCC 452.

⁸ *Id* at 3

not treating unsecured financial creditors and operational creditors at par even though both hold the same position contractually. This order of distribution fails to acknowledge and appreciate the significance of the supply of goods and services in the economy and that the financial sector cannot be prioritised at the expense of the real sector. It creates a sense of insecurity and hesitation on behalf of the operational creditors to enter into transactions or support new businesses. This ultimately reduces the number of transactions on a larger scale, impeding the exchange of wealth. Further, the distinction is unintelligible, inequitable and violates economic rationale. Lastly, insolvency laws in the UK and Singapore and the Companies Act, 2013 do not differentiate between them.⁹

The Supreme Court in the case of *Rajputana Properties Pvt. Ltd. v. Ultratech Cement Ltd.*¹⁰ and Ors. held that operational creditors and financial creditors may be treated differently as long as it is not discriminatory in nature. It stated that dues owed to both classes of creditors must be treated similarly. In the case of *Committee of Creditors of Essar Steel India Limited v. Satish Kumar Gupta and Ors.*,¹¹ The Apex court held that all creditors cannot be treated “equally” and that the same is determined by factors including security interest and status as operational or financial creditor. It opined that operational and financial creditors are to be treated as separate classes owing to the nature of their business and relationship with the corporate debtor. The fact that a winding-up order was issued suggests that there will most likely be insufficient funds to fully repay the creditors. In a liquidation, creditors are paid in a certain sequence, which is referred to as their priority ranking.

As per the United Kingdom Insolvency Act of 1986¹², the assets are distributed firstly, to cover the costs that were incurred to realise the fixed charge assets of the company. Second, to the Fixed charge creditor i.e., secured creditors who are vested with the right to sell a property of the debtor company to ensure settlement of a debt that the debtor has failed to pay. After the sale, if there is an excess of the outstanding debt, then the same should be given to the official liquidator and if it is less than the outstanding debt then a claim must be lodged against the company. Third, in case there are any obligations under any new contract that has been entered into during the process. Fourth, the costs required to transform the company’s assets into money, as well as the professional fees charged by the liquidator to handle the liquidation and

⁹ Kokorin, I. The Rise of ‘Group Solution’ in Insolvency Law and Bank Resolution. *Eur Bus Org Law Rev* 22, 781–811 (2021)

¹⁰ *Rajputana Properties Pvt. Ltd. v. Ultratech Cement Ltd.*, 2018 SCC OnLine NCLAT 521

¹¹ *Essar Steel India Limited v. Satish Kumar Gupta and Ors.*, 2019 SCC OnLine NCLAT 1525

¹² Insolvency Act, 1986, Chapter 45, Acts of Parliament, 1986 (United Kingdom)

distribution process, are included in the liquidation costs. Fifth, the preferential creditor receives payment before any unsecured creditors, despite the fact that they have no security for the debt owed to them. Sixth, when the assets that offer security for the repayment of a loan are continually changing as part of the company's activity, a floating charge is utilised. Seventh, if the debtor fails to pay the debt in full and on time, the creditor is unsecured since they do not have the authority to sell an asset of the debtor. Furthermore, statutory interest is interest that accrues on provable debts once the liquidation begins and continues until the obligation is paid in full. Finally, if there is any money left over after paying all of the previous categories of creditors in full, the remaining funds will be distributed to the company's members.

As per Chapter 7 of the United States Bankruptcy Code of 1978¹³, the priority of distribution of assets in the first place includes the cost of administration of the liquidation process which also includes the fees of the trustees'. Second, any expenditures incurred prior to the filing of an order of relief or the appointment of a trustee in an involuntary bankruptcy case. Third, wage, salary or commission claims that are due in the company. Fourth, claims for contribution to employee benefit plans and for farmers and fishermen in certain circumstances. Fifth, particular claims for contribution for alimony, maintenance or support. Sixth, income, property, employment, and excise taxes, as well as customs charges, are among the government's claims, followed by the claims by a federal depository institution regulatory agencies. Seventh, unsecured claims are when proof of the claim is punctually submitted by a creditor who was unaware of the bankruptcy, and unsecured claims are where proof of claim is tardily filed by a creditor who was aware of the bankruptcy. Eighth, claims for any punishment, penalty, or forfeiture, as well as claims for exemplary, punitive, or multiple damages followed by interest at the legal rate on the claims paid above from the date of filing the petition and lastly, according to the articles of incorporation or state legislation, to the individual debtor or equity investors of the corporate or partnership debtor.

On the contrary, the Insolvency, Restructuring and Dissolution Act, 2018 of Singapore¹⁴ is much more recent and relevant legislation. The priorities listed under it are the Official Receiver's costs and expenses of the winding-up followed by any other costs and expenses of the winding-up, including the liquidator's remuneration and the Applicant's fees for the

¹³ US Bankruptcy Code, 1978, Title 11 of the United States Code, Acts of Parliament, 1978 (United States)

¹⁴ Insolvency, Restructuring and Dissolution Act, 2018, No. 40, Acts of Parliament, 2018 (Singapore)

winding-up order. Further, any earnings or salaries, including any sum payable as an allowance or reimbursement under any employment contract and any retrenchment benefit or ex gratia payment owed to an employee, followed by all amounts due in respect of contributions payable towards superannuation or provident funds for the 12 months prior to commencement under the Work Injury Compensation Act and the payment due to any employee for vacation leave or, in the event of the employee's death, all remuneration due to any employee for death and lastly, the whole amount of all taxes assessed and payable under any written legislation prior to the start of the winding-up process.

CONCLUSION

Section 53 undoubtedly plays a crucial role in encouraging equitability and ensuring the realisation of the objectives of the Code. It is a derivative of the UNCITRAL Legislative Guide¹⁵ and provides for the distribution of assets in accordance with their relative ranking. However, it is also evident that there is a certain degree of uncertainty with respect to the priority of secured creditors who have renounced their security interests since Section 53(2) of the Code only prohibits and disregards contractual agreements that could potentially disrupt the order of priority. This being said, the interpretation of the Adjudicating authority in recent times with regard to the recognition of priority between different classes of secured creditors potentially deviates from the principle objective of the Code, i.e., unification of claims and value maximisation. This has to be addressed immediately by the legislature via an amendment or additional explanation interpreting the Section as prescribed by the Insolvency Law Committee in its 2020 report. The priorities under the English legislation merely emphasises the creditors and the shareholders, whereas, in the United States of America, it is more inclined towards the expenses incurred in the process and claims of the employees and the members. The Singaporean act is the most recent and relevant as it prioritises costs incurred, wages and salary, compensations and clearance of payment dues to the employees followed by the members of the company. The Indian Code is very similar to the priorities that are mentioned in the relevant act of the United Kingdom.

¹⁵ UNCITRAL Legislative Guide on Insolvency Law, 2005