Article

Guide to Liquidation Valuation for Insolvency Resolution under the Insolvency Code

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The Insolvency and Bankruptcy Code, 2016 (i.e. the Code) is expected to make far-reaching changes in the business scenario of the country by overhauling the existing corporate insolvency and liquidation framework. The Code envisions a holistic remedy for insolvent corporate entities – instead of allowing individual creditors to take their bites from the assets of the corporate debtor, it involves them, collectively, in the "resolution" process of the corporate debtor – a committee of creditors consisting of financial creditors of the corporate debtor decides on whether the entity may be resolved or should be liquidated. If the attempts to resolve the insolvency of the corporate debtor fail, the entity is taken into the stage of liquidation.

The resolution process under the Code rests on a well-defined plan called "resolution plan". It is a well-established principle that while resolving an entity, the creditors of that entity shall not be put in a situation worse than what would have been in case the entity were to be liquidated (or else, there would be no point in resolving the entity). This principle is referred to as "vertical comparison", as we discuss later in this article. The objective of vertical comparison is to determine the minimum level of returns which a particular stakeholder will have in the event of liquidation of the entity. This minimum level has been referred to as "liquidation value" under the recently notified Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 (hereinafter referred to as "the regulations").
The article tries to provide an understanding of liquidation value and read the related regulations *vis-à-vis* priorities provided under the Code.

Resolution Plan

Resolution plan is equivalent to the repayment plan in case of individuals. "Resolution plan" as defined under section 5 (26) of the Code means,

> "a plan proposed by any person for insolvency resolution of the corporate debtor as a going concern in accordance with Part II".

The resolution plan is prepared by "resolution applicants" who may be creditors of the corporate debtor, prospective lenders, prospective investors, or any other person. The plan shall be prepared on the basis of information memorandum, which in turn is prepared by the resolution professional. Though the Code is not prescriptive, except some illustrative measures mentioned in the regulations, as to what measures the resolution plan may or may not provide (which is unlike section 18 of the Sick Industrial Companies (Special Provisions) Act, 1985 (i.e. SICA), it specifies certain conditions which a resolution plan must confirm to.

Such conditions have been laid down under section 30 (2) of the Code. The section appears as follows:

> "(2) The resolution professional shall examine each resolution plan received by him to confirm that each resolution plan—
>
> > (a) provides for the payment of insolvency resolution process costs in a manner specified by the Board in priority to the repayment of other debts of the corporate debtor;

(b) *provides for the repayment of the debts of operational creditors in such manner as may be specified by the Board which shall not be less than the amount to be paid to the operational creditors in the event of a liquidation of the corporate debtor under section 53*;
(c) provides for the management of the affairs of the Corporate debtor after approval of the resolution plan;
(d) the implementation and supervision of the resolution plan;
(e) does not contravene any of the provisions of the law for the time being in force;
(f) conforms to such other requirements as may be specified by the Board."

Note the italicised words – the resolution plan must provide for repayment of debts of operational creditors in such manner as may be specified by the Board which shall not be less that the amount to be paid to the operational creditors in the event of liquidation of the corporate debtor under section 53. This calls for vertical comparison of a creditor's entitlement in these two scenarios – resolution and liquidation, as discussed further.

Vertical comparison

Vertical comparison means a comparison between a creditor's entitlement in the resolution plan and in a hypothetical liquidation. The author, in *Law Relating to Insolvency and Bankruptcy Code, 2016*[1] states,

"One of the important parameters on which a voluntary arrangement is to be tested is "vertical comparison", that is, the situation that would have prevailed, had the debtor been allowed to go into liquidation. This brings us to an important tenet based on which all resolution plans must be constructed.
A resolution plan is, after all, a mutually convenient alternative to liquidation. To liquidate the entity will unfairly affect several stakeholders – that is why the stakeholders decide to resolve the situation. The essential premise, therefore, is that the priorities and proportionalities that will obtain in case of liquidation will by and large be maintained in a voluntary arrangement as well."

The provisions relating to vertical comparison also exist in the insolvency laws of US. Chapter 11 of Title 11 of the US Code makes provisions for "reorganisation". Section 1129 (a) of Chapter 11 lists down the minimum requirements which the reorganisation plan shall meet in order to be confirmed, one such requirement is –

"(7) With respect to each impaired class of claims or interests—
(A) each holder of a claim or interest of such class—
(i) has accepted the plan; or
(ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is *not less than the amount that such holder would so receive or retain if the debtor were liquidated* under chapter 7 of this title on such date; or
xxx"

[1] First Edition, 2016, *Vinod Kothari & Sikha Bansal*

In UK, though there is no explicit provision calling for vertical comparison, yet section 6 of the UK Insolvency Act, 1986 provides for challenge of decisions approving a voluntary arrangement on the ground that a voluntary arrangement which has effect under section 4A *unfairly prejudices* the interests of a creditor, member or contributory of the company. As such, the rule of vertical comparison was emphasised in *Re T & N Ltd.* [2004] EWHC 2361 (Ch), [2005] 2 BCLC 488[2] by David Richards J, who states,

> "While I am wary of laying down in advance of a hearing on the merits of any scheme or CVA any particular rule, there is one element which can be mentioned at this stage. I find it very difficult to envisage a case where the court would sanction a scheme of arrangement, or not interfere with a CVA, which was an alternative to a winding up but which was likely to result in creditors, or some of them, receiving less than they would in a winding up of a the company, assuming that the return in a winding up would in reality be achieved and within an acceptable time-scale: see *Re English, Scottish and Australian Chartered Bank* [1893] 3 Ch 385."

The above case was also cited in *Prudential Assurance Co Ltd v. PRG Powerhouse Ltd* [2007] EWHC 1002 (Ch); [2008] 1 BCLC 289[3], wherein while deliberating on the fairness of a CVA arrangement, the court said,

> "In broad terms, the cases show that unfairness may be assessed by a comparative analysis from a number of different angles. They include what I would describe as vertical and horizontal comparisons. Vertical comparison is with the position on winding up (or, in the case of individuals, bankruptcy). Horizontal comparison is with other creditors or classes of creditors."

The court in *Mourant & Co Trustees Ltd v. Sixty UK Ltd (In Administration)* [2010] EWHC 1890 (Ch)[4] while relying upon the views expressed in *Re T & N Ltd (supra) and Powerhouse case (supra),* stated,

> "(c) In assessing the question of unfairness, a number of techniques may be used, including what may be described as "vertical" and "horizontal" comparisons. A vertical comparison is a comparison between the position that a creditor would occupy and the benefits it would enjoy in a hypothetical liquidation, as compared with its position under the CVA. The importance of this comparison is that it generally identifies the irreducible minimum below which the return in the CVA cannot go."

Therefore, the main objective of vertical comparison is to identify the minimum level below which the entitlement of a creditor under a resolution plan cannot go. This minimum level has been referred to as "liquidation value" under the regulations, as discussed below.

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[2] http://www.bailii.org/ew/cases/EWHC/Ch/2004/2361.html
[3] http://www.bailii.org/ew/cases/EWHC/Ch/2007/1002.html
[4] http://www.bailii.org/ew/cases/EWHC/Ch/2010/1890.html

Liquidation Value

Pursuant to section 30 (2) of the Code (as discussed above), the Board has specified reg. 38 in the regulations. Sub-reg. (1) of the said regulation states,

> "(1) A resolution plan shall identify specific sources of funds that will be used to pay the –
>
> (a) insolvency resolution process costs and provide that the insolvency resolution process costs will be paid in priority to any other creditor;
>
> (b) liquidation value due to operational creditors and provide for such payment in priority to any financial creditor which shall in any event be made before the expiry of thirty days after the approval of a resolution plan by the Adjudicating Authority; and
>
> (c) liquidation value due to dissenting financial creditors and provide that such payment is made before any recoveries are made by the financial creditors who voted in favour of the resolution plan."

Reg. 2 (1) (k) of the regulations define "liquidation value" as "the amount determined in accordance with Regulation 35". Reg. 35 (1) states,

> "Liquidation value is the estimated realizable value of the assets of the corporate debtor if the corporate debtor were to be liquidated on the insolvency commencement date."

The definition above is liquidation value of the "assets" of the corporate debtor in entirety. In a liquidation scenario, as is obvious, the liquidation value of the liabilities cannot exceed the liquidation value of the assets of the entity, since the entity shifts its identity from a going concern to being in liquidation. The liquidation value of the liabilities has to be paid out of the liquidation value of the assets of the entity. Question, therefore, is – what is "liquidation value due to operational creditors (or a financial creditor)" as mentioned in reg. 38 (1)? Drawing inference from the discussion made till now, it may be stated that the minimum value payable to operational creditor or a financial creditor in a hypothetical liquidation as on the insolvency commencement date will be termed as "liquidation value due to operational creditor/financial creditor".

While determining the liquidation value due to creditors (operational or financial), one has to *first arrange them in staking order* (i.e. the order of their priority in liquidation), and *then start distributing* the estimated realisable value of assets (i.e. liquidation value) down the ladder. The liquidation value assigned at each stage of staking order will be the liquidation value due to persons at that stage of the staking order.

Therefore, liquidation value must be distinguished from the amount of debts due to creditors – as the amount of debts due to creditors will be static (as may be "proved" by such creditors) and remain unaffected from other claims; on the other hand, while determining the liquidation value due to creditors, due regard shall be given to the priority of other debts in a liquidation scenario – as such the liquidation value due to a particular creditor may be much lesser than the actual amount of debts proved by and payable to such creditor.

At the same time it must be noted that though the regulations require that the resolution plan must ensure the payment of liquidation value to operational creditors, the same shall be paid in priority to any financial creditor. Similarly, the liquidation value due to the dissenting financial creditors must be paid in priority to any consenting financial creditor. Such a provision in the regulation shall in no way be taken to alter the priorities of payment laid down under the Code – it merely specifies the point of time at which payments shall be made to operational creditors and dissenting financial creditors. These points have been elaborated in examples produced later in the article.

Before substantiating the view above with the help of illustrations, it is important to understand the priority of debts in a liquidation scenario, provided under section 53 of the Code – *see* below.

Waterfall and its impact on liquidation value

Section 53 of the Code provides for distribution of assets in the event of liquidation in the following order of priority –

"(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) wages and any unpaid dues owed to employees other than workmen for the period of twelve months preceding the liquidation commencement date;

(d) financial debts owed to unsecured creditors;

(e) the following dues shall rank equally between and among the following:—

(i) any amount due to the Central Government and the State Government including the amount to be received on account of the Consolidated Fund of India and the Consolidated Fund of a State, if any, in respect of the whole or any part of the period of two years preceding the liquidation commencement date;

(ii) debts owed to a secured creditor for any amount unpaid following the enforcement of security interest;

(f) any remaining debts and dues;

(g) preference shareholders, if any; and

(h) equity shareholders or partners, as the case may be."

In the staking order as listed above, the operational creditors will fall in the following categories –

- rank (b) (i) – workmen's dues for the period of 24 months preceding the liquidation commencement date
- rank (c) – wages and any unpaid dues owed to employees other than workmen for the period of 12 months preceding the liquidation commencement date;
- rank (e) (i) – dues to the Central or the State Governments for a period of 2 years preceding the liquidation commencement date; and
- rank (f) – operational creditors (unsecured) other than the above three categories.

On the other hand, the financial creditors may fall in the following categories –

- rank (b) (ii), ranking *pari passu* with rank (b) (i) – debts owed to a secured creditor in the event such secured creditor has relinquished security;
- rank (d) – financial debts owed to unsecured creditors; and
- rank (e) (ii), ranking pari passu with rank (e) (i) – the debts owed to a secured creditor for any amount unpaid following the enforcement of security interest.

Let us now take up several examples to illustrate the concept of liquidation value and impact of the waterfall on the same.

Numerical Illustrations on Liquidation Value and Priorities

In US, the company filing for reorganisation has to file a disclosure statement containing therein, "liquidation analysis". Below is a format in which liquidation analysis may be made[5]:

[5] Source: http://www.njb.uscourts.gov/sites/default/files/forms/LocalForm18.pdf; pg. last visited on 27th December, 2016

Assets[75]

Real Property			$_____
Minus: 1st Mortgage	$_____		
2nd Mortgage	$_____		
Any exemption	$_____		
Costs of sale $_____			
Net equity			$_____
Personal Property [segregate by type]		$_____	
Total assets			$_____

Liabilities

Priority Claims:

Chapter 7 admin. expenses	$_____		
Chapter 11 admin. expenses	$_____		
Other priority claims	$_____		
Total priority claims		$_____	
Amount available for unsecured claims (total assets minus priority claims)		$_____	
Total unsecured claims			$_____
Estimated dividend in Chapter 7 (amount available - unsecured claims)		_____%	

A number of disclosure statements containing liquidation analysis in a Chapter 11 case are available from the website of US Securities and Exchange Commission[6]. Liquidation analysis is generally produced as an exhibit to the disclosure statement.

Provided below are certain illustrations (simplified) for better understanding of how liquidation value has to be assigned to different liabilities and provided for in the resolution plan.

Note that the numbers and figures below are purely hypothetical and solely for the purpose of illustration only. Further, reference date is the insolvency commencement date.

Also given is a list of claims and the priorities in which the claims shall be paid in accordance with section 53 of the Code. The illustrations cover 3 cases:

- Case 1: The liquidation value due to operational creditors is less than the actual claims proved by them.
- Case 2: The liquidation value due to operational creditors and financial creditors as well is less than the actual claims proved by them.
- Case 3: The liquidation value due to operational creditors and financial creditors as well is less than the actual claims proved by them and that a class of financial creditors dissents from the resolution plan.

[6] https://www.sec.gov/

CLAIMS		AMOUNT (Rs.)
1	Insolvency resolution process costs	400
2	Workmen (for 24 months preceding the reference date)	1000
3	Workmen (for periods prior to 24 months preceding the reference date)	500
4	Employees (for 12 months preceding the reference date)	3000
5	Employees (for periods prior to 12 months preceding the reference date)	600
6	Govt. dues (for 2 years preceding the reference date)	1500
7	Govt. dues (for periods prior to 2 years preceding the reference date)	1000
8	Secured financial creditors who have relinquished security interest	800
9	Secured financial creditors whose part of the debt remains unpaid after enforcement of security interest*	300
10	Unsecured creditors in respect of financial debts	200
11	Other debts	100
12	Preference shareholders	900
13	Equity shareholders	1700
	Total value of claims	**12000**
*Assumed that the secured creditors had debts amounting to Rs.1000, out of which Rs. 700 has been realised from enforcement of security.		

STEP 1: SORTING THE CLAIMS ACCORDING TO THE PRIORITIES UNDER THE CODE (COMMON FOR ALL CASES)			
		Amount (Rs.)	Amount (Rs.)
1	Insolvency resolution process costs		400
2 & 8	Workmen (for 24 months preceding the reference+B48 date)	1000	
	Secured financial creditors who have relinquished security interest	800	1800
4	Employees (for 12 months preceding the reference date)		3000
10	Unsecured creditors in respect of financial debts		200
6 & 9	Govt. dues (for 2 years preceding the reference date)	1500	
	Secured financial creditors whose part of the debt remains unpaid after enforcement of security interest	300	1800
3,5,7 & 11	Workmen (for periods prior to 24 months preceding the reference date)	500	
	Employees (for periods prior to 12 months preceding the reference date)	600	
	Govt. dues (for periods prior to 2 years preceding the reference date)	1000	
	Other debts	100	2200
12	Preference shareholders		900
13	Equity shareholders		1700
			12000

CASE 1: THE LIQUIDATION VALUE DUE TO OPERATIONAL CREDITORS IS LESS THAN THE ACTUAL CLAIMS PROVED BY THEM

Assumptions:

1. There are no dissenting financial creditors
2. The liquidation value of the assets is Rs. 9200.

Workings:

Liquidation value of assets	9200
Less: assets realised by secured creditors	700
Liquidation value available for distribution	**8500**

STEP 2: ASSIGNING LIQUIDATION VALUE TO CLAIMS				
	Particulars	**LV to be paid**	**LV to be paid**	**Bal. of LV**
				8500
1	Insolvency resolution process costs		400	8100
2 & 8	Workmen (for 24 months preceding the reference date)	1000		
	Secured financial creditors who have relinquished security interest	800	1800	6300
4	Employees (for 12 months preceding the reference date)		3000	3300
10	Unsecured creditors in respect of financial debts		200	3100
6 & 9	Govt. dues (for 2 years preceding the reference date)	1500		
	Secured financial creditors whose part of the debt remains unpaid after enforcement of security interest	300	1800	**1300**
3,5,7 & 11	Workmen (for periods prior to 24 months preceding the reference date)	295		
	Employees (for periods prior to 12 months preceding the reference date)	355		

	Govt. dues (for periods prior to 2 years preceding the reference date)	591		
	Other debts	59	**1300**	0
12	Preference shareholders	0		
13	Equity shareholders	0		
	Liquidation Value of Corporate Debtor		**8500**	

STEP 3	**LIQUIDATION VALUE DUE TO OPERATIONAL CREDITORS**		**LV (Rs.)**	**Actual claims (Rs.)**
2	Workmen (for 24 months preceding the reference date)		1000	1000
4	Employees (for 12 months preceding the reference date)		3000	3000
6	Govt. dues (for 2 years preceding the reference date)		1500	1500
3,5,7 & 11	Workmen (for periods prior to 24 months preceding the reference date)	295		500
	Employees (for periods prior to 12 months preceding the reference date)	355		600
	Govt. dues (for periods prior to 2 years preceding the reference date)	591		1000
	Other debts	59	1300	100
	Liquidation value due to operational creditors		**6800**	**7700**
STEP 4	**LIQUIDATION VALUE DUE TO FINANCIAL CREDITORS**		**LV (Rs.)**	**Actual claims (Rs.)**
8	Secured financial creditors who have relinquished security interest		800	800
10	Unsecured creditors in respect of financial debts		200	200
9	Secured financial creditors whose part of the debt remains unpaid after enforcement of security interest		300	300
	Liquidation value due to financial creditors		**1300**	**1300**

Therefore, the resolution plan shall provide for:

Payment of insolvency resolution process costs over other debts	400
Payment of liquidation value due to operational creditors before financial creditors	6800
Payment of liquidation value due to financial creditors	1300
Liquidation value	**8500**

CASE 2: THE LIQUIDATION VALUE DUE TO OPERATIONAL CREDITORS AND FINANCIAL CREDITORS IS LESS THAN THE ACTUAL CLAIMS PROVED BY THEM

Assumptions:

1. There are no dissenting financial creditors
2. The liquidation value of the assets is Rs. 6500.

Workings:

Liquidation value of assets	6500
Less: Assets realised by secured creditors	700
Liquidation value available for distribution	**5800**

STEP 2: ASSIGNING LIQUIDATION VALUE TO CLAIMS				
	Particulars	**LV to be paid**	**LV to be paid**	**Bal. of LV**
				5800
1	Insolvency resolution process costs		400	5400
2 & 8	Workmen (for 24 months preceding the reference date)	1000		

	Secured financial creditors who have relinquished security interest	800	1800	3600
4	Employees (for 12 months preceding the reference date)		3000	600
10	Unsecured creditors in respect of financial debts		200	400
6 & 9	Govt. dues (for 2 years preceding the reference date)	333		
	Secured financial creditors whose part of the debt remains unpaid after enforcement of security interest	67	**400**	
3,5,7 & 11	Workmen (for periods prior to 24 months preceding the reference date)	0		
	Employees (for periods prior to 12 months preceding the reference date)	0		
	Govt. dues (for periods prior to 2 years preceding the reference date)	0		
	Other debts	0		
12	Preference shareholders	0		
13	Equity shareholders	0		
	Liquidation Value of Corporate Debtor		**5800**	

STEP 3	**LIQUIDATION VALUE DUE TO OPERATIONAL CREDITORS**			
			LV (Rs.)	**Actual claims (Rs.)**
2	Workmen (for 24 months preceding the reference date)		1000	1000
4	Employees (for 12 months preceding the reference date)		3000	3000
6	Govt. dues (for 2 years preceding the reference date)		333	1500
3,5,7 & 11	Workmen (for periods prior to 24 months preceding the reference date)	0		500
	Employees (for periods prior to 12 months preceding the reference date)	0		600

	Govt. dues (for periods prior to 2 years preceding the reference date)	0		1000
	Other debts	0	0	100
	Liquidation value due to operational creditors		**4333**	**7700**
STEP 4	**LIQUIDATION VALUE DUE TO FINANCIAL CREDITORS**		**LV (Rs.)**	**Actual claims (Rs.)**
8	Secured financial creditors who have relinquished security interest		800	800
10	Unsecured creditors in respect of financial debts		200	200
9	Secured financial creditors whose part of the debt remains unpaid after enforcement of security interest		67	300
	Liquidation value due to financial creditors		**1067**	**1300**

Therefore, the resolution plan shall provide for:

Payment of insolvency resolution process costs over other debts	400
Payment of liquidation value due to operational creditors before financial creditors	4333
Payment of liquidation value due to financial creditors	1067
Liquidation value	**5800**

CASE 3: THE LIQUIDATION VALUE DUE TO OPERATIONAL CREDITORS AND FINANCIAL CREDITORS AS WELL IS LESS THAN THE ACTUAL CLAIMS PROVED BY THEM AND THAT A CLASS OF FINANCIAL CREDITORS DISSENTS FROM THE RESOLUTION PLAN.

Assumptions:

1. There are consenting and dissenting financial creditors
2. The liquidation value of the assets is Rs. 6050.

Workings:

Liquidation value of assets 6050

Less: Assets realised by secured creditors	700
	5350

Liquidation value available for distribution

STEP 2: ASSIGNING LIQUIDATION VALUE TO CLAIMS				
	Particulars	**LV to be paid**	**LV to be paid**	**Bal. of LV**
				5350
1	Insolvency resolution process costs		400	4950
2 & 8	Workmen (for 24 months preceding the reference date)	1000		
	Secured financial creditors who have relinquished security interest	800	1800	3150
4	Employees (for 12 months preceding the reference date)		3000	150
10	Unsecured creditors in respect of financial debts		150	0
6 & 9	Govt. dues (for 2 years preceding the reference date)	0		
	Secured financial creditors whose part of the debt remains unpaid after enforcement of security interest	0		
3,5,7 & 11	Workmen (for periods prior to 24 months preceding the reference date)	0		
	Employees (for periods prior to 12 months preceding the reference date)	0		
	Govt. dues (for periods prior to 2 years preceding the reference date)	0		
	Other debts	0		
12	Preference shareholders	0		

13	Equity shareholders	0		
	Liquidation Value of Corporate Debtor		**5350**	

STEP 3	**LIQUIDATION VALUE DUE TO OPERATIONAL CREDITORS**			
			LV (Rs.)	**Actual claims (Rs.)**
2	Workmen (for 24 months preceding the reference date)		1000	1000
4	Employees (for 12 months preceding the reference date)		3000	3000
6	Govt. dues (for 2 years preceding the reference date)		0	1500
3,5,7 & 11	Workmen (for periods prior to 24 months preceding the reference date)	0		500
	Employees (for periods prior to 12 months preceding the reference date)	0		600
	Govt. dues (for periods prior to 2 years preceding the reference date)	0		1000
	Other debts	0	0	100
	Liquidation value due to operational creditors		**4000**	**7700**
STEP 4	**LIQUIDATION VALUE DUE TO FINANCIAL CREDITORS**		**LV (Rs.)**	**Actual claims (Rs.)**
8	Secured financial creditors who have relinquished security interest		800	800
10	Unsecured creditors in respect of financial debts		150	200
9	Secured financial creditors whose part of the debt remains unpaid after enforcement of security interest		0	300
	Liquidation value due to financial creditors		**950**	**1300**

Say, the unsecured creditors were dissenting to the resolution plan.
Therefore, the resolution plan shall provide for:

Payment of insolvency resolution process costs over other debts	400
Payment of liquidation value due to operational creditors before financial creditors	4000
Payment of liquidation value due to dissenting financial creditors before other financial creditors	150
Payment of liquidation value due to consenting financial creditors	800
Liquidation value	**5350**

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